

**Statutory Accounting Principles (E) Working Group
Maintenance Agenda Submission Form
Form A**

Issue: SSAP No. 56 – Book Value Separate Accounts

Check (applicable entity):

	P/C	Life	Health
Modification of Existing SSAP	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>
New Issue or SSAP	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Interpretation	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>

Description of Issue: This agenda item has been developed to expand the guidance in *SSAP No. 56—Separate Accounts* to further address situations and provide consistent accounting guidelines for when assets are reported at a measurement method other than fair value. The guidance in SSAP No. 56 predominantly focuses on separate account products in which the policyholder bears the investment risk. In those situations, the assets in the separate account are reported at fair value. SSAP No. 56, paragraph 17 provides limited guidance for assets supporting fund accumulation contracts (GICs), and this measurement method is generally referred to as “book value”:

Assets supporting fund accumulation contracts (GICs), which do not participate in underlying portfolio experience, with a fixed interest rate guarantee, purchased under a retirement plan or plan of deferred compensation, established or maintained by an employer, will be recorded as if the assets were held in the general account. Assets supporting all other contractual benefits shall be recorded at fair value on the date of valuation, or if there is no readily available market, then in accordance with the valuation procedures in the applicable contract.

NAIC staff are aware that there has been an increase in assets reported at “book value” within the separate account. These have been approved under state prescribed practices and/or interpretations that the reference for fund accumulation contracts captures pension risk transfer (PRT) or registered indexed-linked annuities (RILA) and other similar general-account type products that have been approved by the state of domicile for reporting in the separate account.

The guidance in *SSAP No. 56—Separate Accounts* focuses on the accounting and reporting for both the separate account and general account, with specific focus on what is captured within each account as well as transfers between the two accounts. As the focus is on fair value separate account assets, there is not guidance that details how transfers should occur between the separate and general accounts when the assets will be retained and reported at “book value.” Particularly, the guidance does not address whether assets should be disposed / recognized at fair value when transferring between accounts, with subsequent reporting at the general account measurement guidance or whether the assets should be transferred at the “book value” that is reported in the existing account. The process has the potential to impact recognition of gains / losses and IMR, so it should be clearly detailed to ensure consistent reporting.

Existing Authoritative Literature:

- *SSAP No. 56—Separate Accounts*

Although the entirety of SSAP No. 56 may be relevant, key paragraphs have been identified.

General Account Reporting

5. For those separate account contracts classified as life contracts under *SSAP No. 50—Classification of Insurance or Managed Care Contracts*, premiums and annuity considerations shall be recorded as income in the Summary of Operations of the general account, and as transfers to premiums and considerations in the

separate account statement. Deposit-type contracts shall be recorded in the general account in accordance with *SSAP No. 52—Deposit-Type Contracts*.^(INT 00-03) Charges (e.g., fees associated with investment management, administration, and contract guarantees) assessed on the separate accounts, as well as the net gain from operations of the separate account, shall be recorded as income in the Summary of Operations of the general account. Expenses relating to investment management, administration, and contract guarantees pertaining to separate account operations, as well as benefits and surrenders incurred on behalf of separate account contracts classified as life contracts, net transfers between separate accounts, commissions, and premium taxes (if any) shall be recorded as expenses in the Summary of Operations of the general account.

6. The general account shall include the total assets and liabilities, including transfers due or accrued, of any separate accounts business which it maintains and, therefore, the surplus, if any, of its separate accounts business. Transfers to the general account due or accrued shall be reported on a net basis so that the asset and the liability totals of the general account are not overstated. Changes in the surplus of the separate accounts business of an insurer, except for changes resulting from the net gain from operations of the separate account, shall be charged or credited directly to the unassigned funds (surplus) of the general account.

Separate Account Reporting

15. The separate accounts annual statement is concerned with the flow of funds related to investment activities and obligations of the separate accounts and with the transfer of funds between the separate account and the general account. As a result, the separate account statement shall report only the assets, liabilities, and operations of the separate account and shall not include general account expenses related to investment management, administration, or contract guarantees pertaining to separate account operations which are recorded in the general account.

16. The separate account records premiums, considerations (net of loading for sales charges such as commissions and premium taxes) and receipts (other than for net investment income and realized capital gains and losses) as income transfers from the general account. Net investment income and realized and unrealized capital gains and losses relating to the investment operations of the separate account are recorded as income in the Summary of Operations. When the contract provides for such, expenses and taxes associated with the separate account investment operations shall be deducted in the determination of net investment income. Deposits and withdrawals on deposit-type contracts shall be recorded in the Summary of Operations. Benefits and surrenders, reserve transfers, policy loans¹, policyholder charges (e.g., fees associated with investment management, administration, and contract guarantees), and federal income taxes relating to the separate account are recorded as expense transfers to the general account in the Summary of Operations. The net change in aggregate reserves relating to separate account contracts is reported as an expense in the Summary of Operations.

17. Assets supporting fund accumulation contracts (GICs), which do not participate in underlying portfolio experience, with a fixed interest rate guarantee, purchased under a retirement plan or plan of deferred compensation, established or maintained by an employer, will be recorded as if the assets were held in the general account. Assets supporting all other contractual benefits shall be recorded at fair value on the date of valuation, or if there is no readily available market, then in accordance with the valuation procedures in the applicable contract.

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):

1. Agenda Item 2022-19: Negative IMR introduced the discussion of interest maintenance reserve (IMR) within statutory accounting, specifically the guidance for nonadmittance of disallowed negative IMR. This agenda item resulted with *INT 23-01: Net Negative (Disallowed) Interest Maintenance Reserve*. This INT

¹ Policy loans related to separate account products shall follow the guidance in *SSAP No. 49—Policy Loans*. As detailed within *SSAP No. 49*, as part of the expense transfer, policy loans related to separate account products require a liquidation of the separate account assets to fund the loan issued by the general account. A transfer of assets from the separate account to the general account must have occurred to fund the policy loan issuance; otherwise the policy loan is nonadmitted in the general account.

permits admittance of disallowed negative IMR up to 10% of adjusted capital and surplus. The guidance permits admittance of the separate account negative IMR once the general account negative IMR has been admitted if the 10% limit has not been reached. The INT identifies that the concept of nonadmitted assets does not exist in the separate account, therefore the guidance includes application guidance for reversing prior actions that charged negative IMR to surplus before permitting the negative IMR to be recognized as an asset.

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:

NAIC staff recommend that the Working Group move this item to the active listing of the maintenance agenda categorized as a SAP clarification with direction to work with industry in determining current application / differences in interpretations to present to the Working Group along with suggested revisions to codify the approach within SSAP No. 56.

Staff Review Completed by: Julie Gann, NAIC Staff—February 2024

Updated Recommendation – 2024 Summer National Meeting:

The IMR Ad Hoc Subgroup has discussed a number of elements generating IMR, including the transfer of assets for cash between the general account (GA) and book value separate accounts (BVSA). This discussion is about transfers of assets where one account is purchasing existing assets held by the other account. This discussion received information from the ACLI noting that reporting entities have taken different approaches in the recording of these transfers, with three broad methods. All methods have a net zero surplus impact.

1. Market Value Offsetting Method:
 - Selling Account transfers the asset at fair value, with a realized gain or loss and allocation to IMR.
 - Purchasing Account records the asset at book value, with an adjustment to IMR for the difference between the fair value and book value.
 - This method has offsetting IMR impacts between the GA and BVSA, with a zero net impact to surplus.
2. Market Value SSAP No. 25 Method:
 - Selling Account transfers the asset at fair value. If resulting in a gain, the gain is offset by a *SSAP No. 25—Affiliates and Other Related Parties* adjustment (deferral until gain is permanent). Losses are recognized and allocated to IMR.
 - Purchasing Account records the asset at market value and records applicable amortized cost valuation adjustments over the term to maturity.
 - This method results in different IMR treatment between the GA and BVSA based on whether the transaction resulted in a gain or loss. This method requires the reporting entity to track the asset and recognize the deferred gain once the asset is subsequently sold or matured in the BVSA.
 - The reporting results in a net zero impact to surplus.
3. Book Value Method:
 - Both accounts (selling / purchasing) record the asset at book value.
 - There is no IMR impact and no surplus impact.
 - This method has raised concerns on whether a transfer from the GA at book value to an insulated BVSA, provides appropriate treatment to the GA policyholders.

The ACLI noted that although the above different approaches have been used, if the NAIC decides a standard accounting practice should be applied for transfers for cash between the GA and BVSA (and vice versa), the ACLI would support the market value offsetting IMR method. The rationale for supporting this method is as follows:

1. Market value transactions ensure the insurer is transacting to meet the fiduciary obligations of all policyholders (both GA and BVSA).
2. The method results in a net zero impact to surplus.
3. The method ensures a net zero impact to the combined GA and BVSA IMR in both gain and loss scenarios. (Although IMR is recognized in both accounts, the amounts recognized are offsetting.)
4. The method is more favorable operationally than the SSAP No. 25 method in which gains from the transfer must be deferred until a subsequent act that makes the transaction permanent (subsequent selling or maturity of asset).
5. The transfer at fair value combined with the offsetting IMR ensure that both the GA and BVSA retain the economic impact of the transaction without mingling the economics between the books.

The ACLI noted that this recommendation was only for transfers for cash between the GA and BVSA accounts and recommend additional research and discussion before creating a standard practice for less common transactions between the GA and BVSA, such as asset for asset swaps, contributions of assets to support deficiency in the SA and dividends of assets from the BVSA.

For the 2024 Summer National Meeting, NAIC staff recommend that the Working Group expose proposed revisions to SSAP No. 56 to clarify and expand guidance for book value separate accounts, and to incorporate accounting guidance for transfers of assets in exchange for cash between the general account and book value separate accounts. (Due to the design / order of SSAP No. 56, the entire SSAP has been reflected with the proposed edits shown as tracked changes.)

Status:

On March 16, 2024, the Statutory Accounting Principles (E) Working Group exposed this agenda item and directed NAIC staff to work with industry in determining current application and differences in the treatment of book value assets within the separate account and to prepare suggested revisions to codify an approach within *SSAP No. 56—Separate Accounts*.

On August 13, 2024, the Statutory Accounting Principles (E) Working Group exposed revisions to *SSAP No. 56—Separate Accounts*, as shown below as “2024 Summer National Meeting Exposed Revisions,” to allow for initial review and consideration of potential changes to update measurement method guidance and specify the process to transfer assets for cash between the general and book-value separate accounts. The Working Group also requested comments from regulators and industry on the noted questions, which are shown shaded in grey. This item was exposed with a longer comment period ending November 8, 2024. This item is not planned for detailed discussion at the 2024 Fall National Meeting but is planned for discussion in the interim after that meeting, or at the 2025 Spring National Meeting.

**2024 Summer National Meeting Exposed Revisions to SSAP No. 56:
(Paragraph references have been shaded for subsequent confirmation.)**

SCOPE OF STATEMENT

1. This statement establishes statutory accounting principles for accounting and reporting for separate accounts in both the general account and separate account statements.

SUMMARY CONCLUSION

Introduction

2. Separate accounts are used to fund variable life insurance, variable annuities, modified guaranteed annuities and modified guaranteed life insurance, or various group contracts under pension or other employee benefit plans where funds are held in a separate account to support a liability. When separate accounts are established and filed accordingly, they may be used to fund guaranteed benefits. Separate account contracts may also be used to accumulate funds which are intended to be applied at some later time to provide life insurance or to accumulate proceeds applied under settlement or dividend options.

3. Assets held in separate accounts are owned by the insurer. All investment income and realized and unrealized capital gains and losses from assets allocated to a separate account, net of related investment expenses, are generally reflected in the separate account and, except for modified guaranteed annuities, modified guaranteed life insurance, and separate accounts established and filed to provide guaranteed benefits, investment performance is generally not guaranteed by the insurer. Charges relating to contract guarantees, administration, and investment management are deducted from separate accounts.

General Account Reporting

4. Insurance activities such as sales, underwriting and contract administration, premium collection and payment of premium taxes, claims, and benefits are functions of the insurance company distinct from the separate account and shall be accounted for as transactions of the general account.

5. For those separate account contracts classified as life contracts under *SSAP No. 50—Classification of Insurance or Managed Care Contracts*, premiums and annuity considerations shall be recorded as income in the Summary of Operations of the general account, and as transfers to premiums and considerations in the separate account statement. Deposit-type contracts shall be recorded in the general account in accordance with *SSAP No. 52—Deposit-Type Contracts*.^(INT 00-03) Charges (e.g., fees associated with investment management, administration, and contract guarantees) assessed on the separate accounts, as well as the net gain from operations of the separate account, shall be recorded as income in the Summary of Operations of the general account. Expenses relating to investment management, administration, and contract guarantees pertaining to separate account operations, as well as benefits and surrenders incurred on behalf of separate account contracts classified as life contracts, net transfers between separate accounts, commissions, and premium taxes (if any) shall be recorded as expenses in the Summary of Operations of the general account.

6. The general account shall include the total assets and liabilities, including transfers due or accrued, of any separate accounts business which it maintains and, therefore, the surplus, if any, of its separate accounts business. Transfers to the general account due or accrued shall be reported on a net basis so that the asset and the liability totals of the general account are not overstated. Changes in the surplus of the separate accounts business of an insurer, except for changes resulting from the net gain from operations of the separate account, shall be charged or credited directly to the unassigned funds (surplus) of the general account.

7. Where a variable annuity contract or variable life insurance contract contains a guaranteed minimum death benefit, any reserve liability for such death benefit provision shall be recorded and held in the general account based on the reserving guidance in paragraphs 25 and 26. Any differences between the benefit paid and the separate

account asset value of the contract shall be charged against or credited to the general account in its net gain from operations.

8. Separate account surplus may not become negative. For example, for separate account contracts which have annuitized (i.e., contracts in the payout stage), lower than expected mortality on variable annuity contracts containing mortality guarantees may cause a deficiency in the investment funds underlying the contract reserves. Thus the general account incurs an expense and the separate account realizes revenue to cover the deficiency, if necessary. Conversely, excess funds from higher than expected mortality will result in mortality gains, which are included in the Summary of Operations of the separate account and are ultimately recorded as equity in net income from separate account operations as discussed in paragraph 5.

9. Separate account surplus created through the use of the commissioners' reserve valuation method (CRVM), commissioners' annuity reserve valuation method (CARVM), or other reserving methods, shall be reported by the general account as an unsettled transfer from the separate account. The net change on such transfers shall be included as a part of the net gain from operations in the general account.

10. Surplus funds transferred from the general account to the separate account, commonly referred to as seed money, and earnings accumulated thereon shall be reported as surplus in the separate accounts until transferred or repatriated to the general account. The transfer of such funds between the separate account and the general account shall be reported as surplus contributed or withdrawn during the year.

11. If an Asset Valuation Reserve (AVR) is required for investments held by separate accounts, it is combined with the general account AVR and accounted for in the general account financial statements (see *SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve*). The criteria for determining when an AVR is required for separate accounts are described in paragraph 18 of this statement.

12. Reporting entities collect fees for managing Separate Account Guaranteed Investment Contracts (GICs), Synthetic GICs, as well as participating separate account group annuities. These are in the form of administrative fees, risk fees and some investment management fees. For defined contribution business, these are in the form of fees related to mutual fund management. These fees are meant to offset expenses and generate some profit.

13. Amounts receivable from contractholders for separate account management fees meet the definition of assets as set forth in *SSAP No. 4—Assets and Nonadmitted Assets*.

14. An evaluation shall be made of the amounts receivable to determine any nonadmitted amounts. Next, an evaluation shall be made in accordance with *SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets*, to determine whether there is an impairment. This two-step process is set forth below:

- a. Uncollected separate account management fees receivable over ninety days due shall be accounted for as a nonadmitted asset. Reporting entities shall begin aging the receivable when it is contractually required to be billed, or in the absence of contract specifications, when the reporting entity actually sends the bill to the contractholder;
- b. Remaining amounts determined to be uncollectible shall be written off. If in accordance with *SSAP No. 5R*, it is "probable" the amount receivable is uncollectible, any uncollectible amount receivable shall be written off against operations in the period such determination is made. If it is "reasonably possible" the amount receivable is uncollectible, the disclosure requirements outlined in *SSAP No. 5R*, paragraph 32, shall be made.

Separate Account Reporting

15. The separate accounts annual statement is concerned with the flow of funds related to investment activities and obligations of the separate accounts and with the transfer of funds between the separate account and the general account. As a result, the separate account statement shall report only the assets, liabilities, and operations of the

separate account and shall not include general account expenses related to investment management, administration, or contract guarantees pertaining to separate account operations which are recorded in the general account.

16. The separate account records premiums, considerations (net of loading for sales charges such as commissions and premium taxes) and receipts (other than for net investment income and realized capital gains and losses) as income transfers from the general account. Net investment income and realized and unrealized capital gains and losses relating to the investment operations of the separate account are recorded as income in the Summary of Operations. When the contract provides for such, expenses and taxes associated with the separate account investment operations shall be deducted in the determination of net investment income. Deposits and withdrawals on deposit-type contracts shall be recorded in the Summary of Operations. Benefits and surrenders, reserve transfers, policy loans², policyholder charges (e.g., fees associated with investment management, administration, and contract guarantees), and federal income taxes relating to the separate account are recorded as expense transfers to the general account in the Summary of Operations. The net change in aggregate reserves relating to separate account contracts is reported as an expense in the Summary of Operations.

Measurement of Separate Account Assets

17. Assets supporting separate account contracts, except for contracts captured in paragraph 18, shall be reported at fair value, as determined under SSAP No. 100—Fair Value. Assets held in the separate account that reflect seed money from the general account shall follow all provisions of the SSAP to which the asset would be applicable if held in the general account. Assets that would not qualify for admittance in the general account are not permitted to be used as seed money in the separate account.

NAIC Staff Question: Information on the current measurement method for seed money is requested from industry. Although the guidance implies that seed money should be at book value, there is an assumption that companies may utilize fair value when included in a fair value separate account.

18. Assets supporting the following separate account contracts are permitted to be reported as if the assets were held in the general account. This measurement method is referred to as “book value.” For these assets, measurement shall follow all provisions of the SSAP to which the asset would be applicable if held in the general account. Assets that would not qualify for admittance in the general account are not permitted in a book-value separate account. Separate account contracts that do not qualify in the following categories are not permitted at book value without a permitted or prescribed practice from the state of domicile.

- a. Assets supporting fund accumulation contracts (GICs), which do not participate in underlying portfolio experience, with a fixed interest rate guarantee, purchased under a retirement plan or plan of deferred compensation, or established or maintained by an employer, will be recorded as if the assets were held in the general account.
- b. With approval of the state insurance regulator, assets supporting insulated or non-insulated separate account contracts that are similar to contracts generally found in the general account³. Unlike traditional separate account contracts, these contracts do not have investment directives determined by the contract holder and investment performance results are not attributed to a specific contract holder. Furthermore, unlike traditional separate account contracts, the insurance reporting entity

² Policy loans related to separate account products shall follow the guidance in SSAP No. 49—Policy Loans. As detailed within SSAP No. 49, as part of the expense transfer, policy loans related to separate account products require a liquidation of the separate account assets to fund the loan issued by the general account. A transfer of assets from the separate account to the general account must have occurred to fund the policy loan issuance; otherwise the policy loan is nonadmitted in the general account.

³ The inclusion of this guidance does not imply support for these contracts within the separate account instead of the general account. The domiciliary state insurance regulator is responsible for assessing and approving separate account contract classification in accordance with state statutes.

(general account) is often ultimately obligated to provide contract benefits that are not directly tied to the performance of the underlying assets, resulting with the general account serving as an overall backstop or providing an implied guarantee, although a distinct performance guarantee is not specified (such as a minimum crediting rate, death benefit, etc.). Examples of contracts expected to be captured within this provision include pension risk transfer (PRT) contracts and registered index-linked annuity (RILA) contracts.

NAIC Staff Question: Feedback is requested on the named contracts (PRT and RILA) and whether other example contracts should be named.

~~18. — Assets supporting fund accumulation contracts (GICs), which do not participate in underlying portfolio experience, with a fixed interest rate guarantee, purchased under a retirement plan or plan of deferred compensation, established or maintained by an employer, will be recorded as if the assets were held in the general account. Assets supporting all other contractual benefits shall be recorded at fair value on the date of valuation, or if there is no readily available market, then in accordance with the valuation procedures in the applicable contract.~~

Assets Transfers Between the General Account and Separate Account

19. Asset transfers that reflect sales for cash between the general account and separate account shall occur at fair value⁴. Specified guidance based on the measurement method of the assets in the separate account are detailed in paragraphs 20-21.

20. Asset sales for cash between the general account and “fair value” separate accounts:

- a. The account (either general or separate account) selling the asset shall receive cash equal to fair value and dispose of the asset from the investment schedules at fair value.
 - i. Assets sold from the general account shall result in a realized gain or loss based on the difference between fair value and book adjusted carrying value (BACV). The realized gain or loss, if resulting from interest rate changes, shall be allocated to the general account IMR and amortized as if the asset had been sold to an unrelated third-party. Realized gains from these transactions shall not be deferred pursuant to SSAP No. 25—Affiliates and Other Related Parties, paragraph 17. Realized losses from credit-related factors shall be allocated to the AVR.
 - ii. Assets sold from a “fair value” separate account shall not result in a realized gain or loss.
- b. The account (either general or separate account) purchasing the asset shall initially recognize the acquired asset at fair value. Subsequent measurements of the acquired asset should reflect the measurement method of the general or separate account.

21. Asset sales for cash between the general account and “book value” separate accounts:

- a. Seller - The account (either general or separate account) selling the asset shall receive cash equal to fair value and dispose of the asset from the investment schedules at fair value with recognition of a realized gain or loss. The realized gain or loss, if resulting from interest rate changes, shall be allocated to IMR and amortized in the selling account as if the asset had been sold to an unrelated third-party. The transfer of an asset under this guidance that results in a gain shall not be deferred by the selling account pursuant to SSAP No. 25, paragraph 17, as such a deferral would create a

⁴ This guidance is specific to asset sales for cash and is not intended to reflect administration functions for the payment of amounts owed to separate account policyholders/contractholders that may occur from the general account with reimbursement from the separate account.

mismatch in the IMR recognition between the general/separate accounts. Realized losses from credit-related factors shall be allocated to the AVR.

- b. Purchaser - The account (either general or separate account) purchasing the asset shall recognize the acquired asset at the BACV from the selling account. The difference between the asset's fair value and the BACV shall be reported to IMR in the purchasing account.
- c. The IMR activity between the selling account and the purchasing account shall be equal and offsetting resulting in a net zero impact in the IMR between the two accounts. IMR is tracked and reported separately in the general account and the separate account, but the net impact of the two accounts shall equal zero for each transfer transaction.
- d. Subsequent to initial acquisition, the purchasing account shall account for the acquired asset pursuant to the measurement method of the applicable SSAP.

22. Asset transfers that do not reflect sales for cash between the general account and separate account are subject to domiciliary state approval. Any transfer that does not represent an asset sale for cash shall be specifically disclosed in both the general account and separate account as detailed in paragraph 34e. This shall include, but not be limited to, the following transfers:

- a. Asset to asset swaps
- b. Contributions of general account assets to support separate account deficiencies
- c. Dividends of assets from the separate account to the general account.

NAIC Staff Question: Additional information is requested from industry on these transfers. NAIC staff recommend that these areas be expanded with consistent guidance for the treatment of transfers.

Separate Account AVR and IMR Reporting

~~19-23.~~ An AVR is generally required for separate accounts when the insurer reporting entity, rather than the policyholder/contractholder, suffers the loss in the event of asset default or fair value loss. An AVR is required unless:

- a. ~~The asset default or fair value risk is borne directly by the policyholders; or~~
- b. ~~The regulatory authority for such separate accounts already explicitly provides for a reserve for asset default risk, where such reserves are essentially equivalent to the AVR.~~

~~20-24.~~ Assets supporting traditional variable annuities and variable life insurance separate accounts that would qualify for separate account classification under U.S. GAAP generally do not require an AVR because the policyholders/contractholders bear the risk of change in the value of the assets. However, for those contracts an AVR is required for that portion of the assets representing seed money (including accumulated earnings on seed money) from the general account. the insurer's equity interest in the investments of the separate account (e.g., seed money).

~~21-25.~~ Assets supporting separate account contracts where the insurer bears the risk of investment performance, which shall include all book value separate accounts, typical modified guaranteed contracts, market value adjusted contracts, and contracts with book value guarantees similar to contracts generally found in the general account do require an AVR because the insurer is responsible for credit related asset or fair value loss.

~~22-26.~~ "Book Value" separate accounts, pursuant to paragraph 18, Certain separate accounts are also are required to maintain an Interest Maintenance Reserve (IMR). Separate accounts with assets reported at fair value are not required to maintain an IMR. The IMR requirements for investments held in separate accounts are applied on an

~~account by account basis.~~ **Once** If an IMR is required for a separate account, all of the investments in that separate account are subject to the requirement. If an IMR is not required for a separate account, none of the investments in that separate account are subject to the requirement.

NAIC Staff Question: Clarification is requested to this guidance for seed money similar to the prior question.

~~23. —As detailed in the Annual Statement Instructions, An IMR is required for separate accounts with assets recorded at book value, but is not required for separate accounts with assets recorded at fair value. For example, separate accounts for traditional variable annuities or variable life insurance do not require an IMR because assets and liabilities are valued at fair value.~~

~~24.27. If an Separate account~~ IMR is required for investments held by separate accounts, it is kept separate from the general account IMR and accounted for in the separate accounts statement.

~~25.28. The AVR and IMR shall be calculated and reported in accordance with SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve and the NAIC Annual Statement Instructions for Life, Accident and Health Insurance Companies.~~

Policy Reserves

~~26.29.~~ Statutory policy reserves shall be established for all contractual obligations of the insurer arising out of the provisions of the insurance contract. Where separate benefits are included in a contract, a reserve for each benefit shall be established as required in Appendix A-820. These statutory policy reserves are generally calculated as the excess of the present value of future benefits to be paid to or on behalf of policyholders less the present value of future net premiums. Statutory policy reserves meet the definition of liabilities as defined in SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets. The actuarial methodologies referred to in the following paragraph meet the criteria required for reasonable estimates in SSAP No. 5R.

~~27.30.~~ The reserving methodologies and assumptions used in computation of policy reserves shall also meet the provisions of Appendices A-200, A-250, A-255, A-270; A-585, A-588, A-620, A-695, A-820, A-822 and the actuarial guidelines found in Appendix C of this Manual. Where separate account contracts have guaranteed elements, the basis for determining the value of the liability shall be consistent with the basis used for asset values (i.e., valuation interest rates as defined in Appendix A-820 shall be used when assets are recorded as if held in the general account and current interest rates based on market rates shall be used when assets are recorded at fair value). Further, policy reserves shall be in compliance with those Actuarial Standards of Practice promulgated by the Actuarial Standards Board.

~~28.31.~~ Statutory policy reserves for those group annuity contracts or other contracts that, in whole or in part, establish the insurer's obligations by reference to a segregated portfolio of assets not owned by the insurer shall be established in accordance with the guidance in Appendix A-695. Statutory policy reserves for those contracts with nonlevel premiums or benefits, or contracts with secondary guarantees shall be established in accordance with the guidance in Appendix A-830. Statutory policy reserves for those group life contracts utilizing a separate account that meet the requirements outlined in paragraph 1 of Appendix A-200 shall be computed in accordance with the guidance in that appendix.

Other Liabilities

~~29.32.~~ The separate account shall accrue as a liability, subject to contractual provisions, amounts payable, including, but not limited to:

- a. Fees associated with investment management, administration, and contract guarantees;
- b. Investment expenses;

- c. Investment taxes, licenses, and fees (Investment taxes such as real estate taxes, licenses and fees (excluding federal income taxes) are usually paid directly by the separate account but may be transferred to the general account for payment);
- d. Federal income taxes;
- e. Unearned investment income;
- f. Net transfer due to (from) the general account;
- g. Remittances and items not allocated;
- h. Payable for investments purchased;
- i. Net adjustments in assets and liabilities due to foreign exchange rates.

Seed Money

~~30. —When a new separate account is initiated, the insurer may make a temporary transfer of surplus funds commonly referred to as seed money to the separate account. Such funds and earnings accumulated thereon shall be reported as surplus in the separate accounts statement until transferred or repatriated to the general account. The transfer of such funds to and from the separate account shall be reported as surplus contributed or withdrawn during the year.~~

Disclosures

~~31,33.~~ Paragraphs 31-35 detail the separate account disclosure requirements that shall be included within the Life, Accident and Health Annual Statement Blank. Paragraphs 36-38 detail the separate account disclosure requirements that shall be included within the Separate Account Annual Statement Blank.

~~32,34.~~ The general account financial statement shall include detailed information on the reporting entity's separate account activity. These disclosures shall include:

- a. A narrative of the general nature of the reporting entity's separate account business.
- b. Identification of the separate account assets that are legally insulated from the general account claims.
- c. Identification of the separate account products that have guarantees backed by the general account. This shall include:
 - i. Amount of risk charges paid by the separate account to the general account for the past five (5) years⁵ as compensation for the risk taken by the general account; and
 - ii. Amount paid by the general account due to separate account guarantees during the past five (5) years.
 - iii. Separate account contracts where the general account provides an inherent or ultimate guarantee, such as with pension risk transfer (PRT) or registered index-linked annuity (RILA) products. These products often do not have stated yield or death benefit guarantees, but rather the general account serves as a final backstop if the separate account assets are

⁵ Reporting entities are permitted to prospectively 'build' the five-year disclosure. Thus, upon the first year of application of the disclosure requirements, reporting entities should illustrate one year of the disclosure requirement. In the second year, the reporting entity would disclose two years, and so forth until the disclosure includes five years of disclosures.

insufficient to support the product obligations. This disclosure shall identify whether risk charges have been provided to the general account and affirm the inclusion of these separate account products within asset-liability testing.

- d. Discussion of securities lending transactions and repurchase/reverse repurchase agreements within the separate account. ~~This shall include separately including~~ the amount of any loaned securities within the separate account and the amount of any sold / acquired securities under repurchase agreements, and if policy and procedures for the separate account differ from the general account.
- e. Discussion of asset transfers that did not reflect sales in exchange for cash between the general account and the separate account. This shall include, but not be limited to, asset-for-asset swaps, contributions of general account assets to support separate account deficiencies, and dividends of assets from the separate account to the general account.

~~33.35.~~ For each grouping (as detailed in paragraph 33), the following shall be disclosed:

- a. Premiums, considerations or deposits received during the year;
- b. Reserves by the valuation basis of the investments supporting the reserves at the financial statement date. List reserves for separate accounts whose assets are carried at fair value separately from those whose assets are carried at amortized cost/book value;
- c. Reserves by withdrawal characteristics, including whether or not the separate account is subject to discretionary withdrawal. For reserves subject to discretionary withdrawal, the below categories are included if applicable:
 - i. With market value adjustment;
 - ii. at book value without market value adjustment and with surrender charge of 5% or more;
 - iii. at fair value;
 - iv. at book value without market value adjustment and with surrender charge of less than 5%;
- d. Reserves for asset default risk, as described in paragraph 18.b., that are recorded in lieu of AVR.

~~34.36.~~ For the disclosures required in paragraph 32, separate accounts shall be addressed in the following groupings (which are the same as those used for risk-based capital):

- a. Separate Accounts with Guarantees:
 - 1. Indexed separate accounts, which are invested to mirror an established index which is the basis of the guarantee;
 - 2. Nonindexed separate accounts, with reserve interest rate at no greater than 4% and/or fund long-term interest guarantee in excess of a year that does not exceed 4%;
 - 3. Nonindexed separate accounts, with reserve interest rate at greater than 4% and/or fund long-term interest guarantee in excess of a year that exceeds 4%.
- b. Nonguaranteed Separate Accounts—Variable separate accounts, where the benefit is determined by the performance and/or fair value of the investments held in the separate account. Include variable accounts with incidental risks, nominal expense, and minimum death benefit guarantees.

~~35.~~37. Provide a reconciliation of the amount reported as transfers to and from separate accounts in the Summary of Operations of the separate accounts statement and the amount reported as net transfers to or from separate accounts in the Summary of Operations of the general accounts statement.

~~36.~~38. The disclosures in *SSAP No. 51R—Life Contracts*, and *SSAP No. 61R—Life, Deposit-Type and Accident and Health Reinsurance* related to the withdrawal characteristics of products include separate account products and shall be completed in the general account disclosures.

~~37.~~39. The Separate Account Annual Statement Blank shall include detailed information on the characteristics of the separate account assets, specifically categorizing separate account assets in accordance with the following characteristics:

- a. Identification of separate account assets that are legally insulated from the general account and those which are not legally insulated.
- b. Aggregation of separate account assets from products registered with the SEC and separate account assets from products excluded from registration. In addition to the overall aggregation, this disclosure shall specifically identify separate account assets from private placement variable annuities (PPVA) and private placement life insurance (PPLI). The disclosures in this paragraph (36.b.) ~~are~~were effective December 31, 2018.
- c. Amount of separate account assets that represent seed money, other fees and expenses due to the general account, and additional required surplus amounts.⁶ This disclosure shall include the amount of seed money and other fees and expenses currently included in the separate account, as well as the amount of seed money received and repaid to the general account during the current year. This disclosure shall also include information on insulation (if applicable)⁷, the time duration for which seed money and other fees and expenses due the general account are retained in the separate account, and information on how whether seed money is invested pursuant to general account directives or in accordance with stated policies and procedures.
- d. Identification of the separate account assets in which the investment directive is not determined by a contractholder. (In most instances, having multiple investment choices at the option of a contractholder would be considered a situation in which the investment directive is determined by a contractholder. This is not true for situations in which the asset is invested in a manner that mirrors the investment directives of the general account.) Situations in which the investment directive is not determined by the contractholder (and situations in which the reporting entity is the contractholder) shall include disclosure regarding whether the investments of the respective separate account assets, if included within the general account investments, would have resulted with the reporting entity exceeding any investment limitations imposed on the general account.
- e. Identification of the separate account assets in which less than 100% of investment proceeds are attributed to a contractholder. This shall include identification of the separate account investment income attributed to the reporting entity during the reporting period and whether such income was transferred to the general account or reinvested within the separate account. Instances in which such income is reinvested within the separate account shall include disclosure on whether the

⁶ Additional Required Surplus Amounts is defined as additional or permanent surplus that is required to be retained in the separate account in accordance with state law or regulations. These amounts should not include reinvested separate account investment proceeds that have not been allocated to separate account contract holders.

⁷ As seed money is considered a temporary transfer of funds, it is generally not considered insulated.

subsequent investments, if categorized with investments in the general account, would have exceeded investment limitations imposed on the general account.

f. Identification of the assets supporting separate account contracts where the general account provides an inherent or ultimate guarantee, such as with pension risk transfer (PRT) or registered index-linked annuity (RILA) products. These products often do not have stated yield or death benefit guarantees, but the general account serves as a final backstop if the separate account assets are insufficient to support the product obligations or by the general account providing an inherent guarantee, although a distinct performance guarantee is not specified (such as a minimum crediting rate, death benefit, etc.).

~~38.40.~~ For all separate account assets not reported at fair value, indicate the measurement basis (amortized cost or other method) for each asset (or asset class) and whether the measurement method ~~was grandfathered in under the transition~~ is pursuant to the guidance in this SSAP, or whether the measurement method is allowed under a prescribed or permitted practice. This disclosure shall include a comparison of the assets' reported value to fair value with identification of the resulting unrealized gain/loss that would have been recorded if the assets had been reported at fair value.

41. For all separate accounts that include securities lending transactions, disclose the reporting entity's use and policy of securities lending within the separate account, including the amount of loaned securities from the separate account at the reporting date, the percentage of separate account assets lent as of that date, a description for which type of accounts (e.g., book value accounts, market value account accounts) are lent, if the separate account policyholder is notified or approves of such practices, the policy for requiring collateral, whether the collateral is restricted and the amount of collateral for transactions that extend beyond one year from the reporting date. This disclosure requires the entity to provide the following information as of the date of the statement of financial position: (1) the aggregate amount of contractually obligated open collateral positions (aggregate amount of securities at current fair value or cash received for which the borrower may request the return of on demand) and the aggregate amount of contractually obligated collateral positions under 30-day, 60-day, 90-day, and greater than 90-day terms, (2) the aggregate fair value of all securities acquired from the sale, trade and use of the accepted collateral (reinvested collateral), and (3) information about the sources and uses of that collateral.

42. For all separate accounts that include repurchase/reverse repurchase (repo) agreements, disclose the reporting entity's use and policies of repo agreements within the separate account, including the following: (1) fair value of securities sold or acquired, (2) cash collateral and the fair value of security collateral received or provided, (3) recognized liability or receivable for the return of collateral.

~~39.43.~~ Identify all products reported as a separate account product under statutory accounting principles and identify whether each product was classified differently under GAAP. For products that resulted with different classifications between GAAP and SAP, identify the characteristic(s) of the product that prevented it from receiving a separate account classification under GAAP. This disclosure is applicable for all reporting entities. Thus, if GAAP financial statements were not filed, the reporting entity should complete this disclosure as if GAAP financials had been completed.

~~40.44.~~ Refer to the Preamble for further discussion regarding disclosure requirements.

Relevant Literature

~~41.45.~~ This statement rejects ASU 2022-05, Transition for Sold Contracts, ASU 2018-12, Targeted Improvements to the Accounting for Long-Duration Contracts, and AICPA Statement of Position 03-1, Accounting and Reporting by Insurance Enterprises for Certain Nontraditional Long-Duration Contracts and for Separate Accounts (SOP 03-1). The disclosure elements included within this SSAP are derived from the criteria for separate account reporting under SOP 03-1; however, this SSAP does not restrict separate account reporting pursuant to the criteria established in SOP 03-1.

[42.46.](#) This statement incorporates the requirements of Appendices A-200, A-250, A-255, A-270, A-585, A-588, A-620, A-695, A-812, A-820, A-821, A-822 the Actuarial Standards Board Actuarial Standards of Practice, and the actuarial guidelines found in Appendix C of this Manual.

Effective Date and Transition

[43.47.](#) This statement is effective for years beginning January 1, 2001. Contracts with assets held in a Separate Account that were issued in accordance with applicable state laws and regulations and issued prior to that effective date, for which assets and liabilities have been recorded using a consistent basis since issue, i.e., both assets and liabilities are recorded either as if in the general account (“book value”) or as at fair value (current interest rates based on market rates shall be used for liabilities when assets are recorded at fair value), shall continue to be recorded using such basis until such time as the applicable contract terms or provisions are substantially changed, such as by a contract amendment modifying interest rate or withdrawal provisions. State laws and regulations shall be understood to include anything considered authoritative by the domiciliary state under the individual state’s statutory authority and due process procedures. Changes that do not require change in the basis of recording would include: address changes, continued deposits, and other non-substantive changes such as these. For example, additional funds received after January 1, 2001 under contracts issued prior to January 1, 2001 may continue to be recorded using the basis in effect prior to January 1, 2001 until such time as a triggering change is made. 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*.

[44.48.](#) Disclosure revisions adopted in September 2009 to paragraphs 30-39 shall initially be reported within the 2010 annual financial statements, with annual reporting thereafter.

REFERENCES

Other

- *NAIC Financial Condition Examiners Handbook*
- *Actuarial Standards Board Actuarial Standards of Practice*

Relevant Issue Papers

- *Issue Paper No. 89—Separate Accounts*
- *Issue Paper No. 110—Life Contracts, Deposit-Type Contracts and Separate Accounts, Amendments to SSAP No. 51—Life Contracts, SSAP No. 52—Deposit-Type Contracts, and SSAP No. 56—Separate Accounts*

GLOSSARY

Guarantee represents an insurance company's general account contractual obligation to reimburse life insurance and annuity policyholders for their separate account investment losses including the return of principal, minimum crediting rates, minimum death, withdrawal, accumulation of income benefits and no-lapse guarantees, and for separate account mortality losses.

NAIC Staff Question: From informal discussions with industry reps, NAIC staff do not have the impression that the above definition of a guarantee captures the inherent guarantee when the general account is a backstop to the separate account. Rather, the above definition only captures explicit guarantees, such as a guaranteed yield, death benefit, etc. NAIC staff requests feedback on this interpretation and comments on whether revisions are necessary to ensure consistent interpretation with regulators and reporting entities.

Insulation is the legal protection of separate account assets equal to the reserves and supporting contract liabilities from the general account liabilities of the insurance enterprise ensuring that the separate account contract holder is not subjected to insurer default risk to the extent of their assets held in the separate account.

Risk Charge is the contractual amount the general account charges the separate account policyholders' account for compensation relating to the general account's guarantee on separate account assets or contract performance.

Total Maximum Guarantee is the difference between the total amount of liability the general account is subject to reimbursing as at the balance sheet date and the policyholder's contract value referenced by the guarantee (e.g., account value). For guarantees in the event of death, it is the minimum guaranteed amount available to the contractholder upon death in excess of the contractholder's contract value referenced by the guarantee (e.g., account balance) at the balance sheet date. For guarantees of amounts at annuitization, it is the present value of the minimum guaranteed annuity payments available to the contractholder determined in accordance with the terms of the contract in excess of the contract value referenced by the guarantee (e.g., account balance).

<https://naiconline.sharepoint.com/teams/FRSStatutoryAccounting/NationalMeetings/A.NationalMeetingMaterials/2024/12-17-2024/24-10-SSAPNo56-BV.docx>

**Statutory Accounting Principles (E) Working Group
Maintenance Agenda Submission Form
Form A**

Issue: Asset Liability Management Derivatives

Check (applicable entity):

	P/C	Life	Health
Modification of Existing SSAP	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
New Issue or SSAP	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>
Interpretation	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>

Description of Issue: This agenda item has been developed to consider new statutory accounting guidance that prescribes guidance for interest-rate hedging derivatives that do not qualify as effective hedges under *SSAP No. 86—Derivatives*, but that are used for asset-liability management (ALM). Specifically, industry has proposed two assessment metrics for macro-hedges, the “ALM Risk Reduction Approach,” which is a hedging approach to reduce mismatches between identified assets and liabilities and the “ALM Target Management Approach,” which is a hedging approach to keep an asset portfolio aligned with a liability target. These programs do not qualify for effective hedge treatment under SSAP No. 86 (or any accounting regime) as they reflect macro-hedges.

This agenda item originated from discussions at the IMR Ad Hoc Group, noting that full Working Group discussion is needed on this topic. Industry has communicated that these hedging derivatives, although not accounting effective under SSAP No. 86, are economically effective (meaning effective in achieving the hedge intent). With this industry assessment, and their interpretation of the Annual Statement Instructions, the fair value fluctuations reported as unrealized gains and losses while the derivative is open have been allocated by some life entities to the interest maintenance reserve (IMR) upon derivative termination. This approach essentially reverses the surplus impact from the unrealized position and defers the realized impact from these derivative structures through the IMR formula with subsequent amortization into income over time.

INT 23-01: Net Negative (Disallowed) IMR, allows losses for interest-rate hedging derivatives that do not qualify for “hedge accounting” under SSAP No. 86 to continue to be allocated to IMR (and admitted if IMR is net negative) if the company has historically followed the same process for interest-rate hedging derivatives that were terminated in a gain position. The guidance does not permit entities to allocate current derivative losses to IMR without evidence illustrating the historical treatment for gains. This INT was established to provide limited-time exception guidance while IMR is further discussed and is effective through Dec. 31, 2025, with automatic nullification on Jan. 1, 2026. The treatment of the gains and losses from these non-accounting effective hedges is a key element in the long-term guidance for clarifying IMR.

SSAP No. 86 provides guidance on designations that hedge a variety of exposures, with assessments of effectiveness adopted from U.S. GAAP. Derivatives that qualify as “highly effective hedges” are permitted “hedge accounting treatment,” which means that the measurement method of the derivative mirrors the measurement method of the hedged item. (This measurement method is different than US GAAP, which requires all derivatives to be at fair value. This different measurement method is necessary under SAP to prevent a measurement mismatch between the hedged item and derivative, which would result in surplus volatility for accounting effective hedges.) Derivatives that do not qualify as “highly effective hedges” under SSAP No. 86 are reported at fair value, which does mirror the measurement method under U.S. GAAP. Pursuant to the IMR Ad Hoc Group discussion, this item is focused on hedges that address interest-rate risk exposure used in macro-hedges, that would not qualify under the effective hedge requirements under SSAP No. 86.

If the Working Group wants to pursue accounting guidance for macro-hedges focused on hedging interest-rate risk that results with different treatment than what is detailed in SSAP No. 86, the guidance is anticipated to detail:

- 1) The requirements for the interest-rate hedging derivatives, including effectiveness assessments.
- 2) The accounting for the derivatives and the resulting gains/losses (including amortization if those gains/losses are deferred from immediate recognition), and
- 3) Disclosure and reporting requirements for the derivatives.

If developing new guidance, it is anticipated that the concepts of *SSAP No. 108—Derivatives Hedging Variable Annuity Guarantees* will be followed to the extent possible, but there would need to be variations based on the specific intent and application of these derivatives. A key item to note is that SSAP No. 108 does not use IMR for the reporting of deferred derivative gains and losses and this approach will also be considered within the new guidance for consistency purposes.

Existing Authoritative Literature:

- **SSAP No. 86—Derivatives**

SSAP No. 86 provides the broad statutory accounting principles for derivative instruments. The guidance is used to determine whether a derivative qualifies as “effective” and therefore permitted to be accounted for under the “hedge accounting” provisions. (Derivatives that qualify for hedge accounting are reported at the measurement method that mirrors the hedged item. For example, a derivative that qualifies for hedge accounting that is hedging a bond would be reported at amortized cost, to mirror the amortized cost measurement of the bond.) Derivatives that do not qualify for “hedge accounting” are required to be reported at fair value.

The guidance in SSAP No. 86 is explicit that derivative gains or losses from derivatives that qualify for hedge accounting shall be recognized in a manner consistent with the hedged item. Hence, if the gain/loss on a hedged item was to go to IMR, then the gain/loss on the effective, hedging derivative should also go to IMR. This guidance makes sense, as the derivative gain/loss should predominantly offset the hedged item gain/loss, resulting in a zero (or negligible) impact to IMR.

SSAP No. 86 requires derivatives which do not qualify as effective to be carried at fair value and changes in fair value are reported in unrealized gains and losses until termination.

- **SSAP No. 108—Derivatives Hedging Variable Annuity Guarantees**

SSAP No. 108 provides special accounting treatment for limited derivatives hedging variable annuity guarantee benefits subject to fluctuations as a result of interest rate sensitivity. The items in scope of SSAP No. 108 would not qualify for hedge effectiveness under SSAP No. 86. The guidance is specific in that the provisions are only permitted if all of the components of the statement are met and that the guidance shall not be inferred as an acceptable statutory accounting approach for derivative transactions that do not meet the state qualifications or that are not specifically addressed within the guidance.

The guidance in SSAP No. 108 addresses derivative transactions that reflect a macro-hedge (portfolio of variable annuity contracts) as well as a dynamic hedging approach (rebalancing of derivative instruments). Due to the heightened risk of misrepresentation of successful risk management, specific provisions are detailed to ensure governance of the program as well as to provide sufficient tools for regulators to review.

Under SSAP No. 108, all derivatives are reported at fair value, and all fair value fluctuations attributed to the hedged risk (unrealized) are compared to the changes in the VM-21 reserve liability. The fair value fluctuations are then 1) recognized to realized gain/loss to offset a current period liability change, 2) recognized as deferred if attributed to the hedged risk but not offsetting a current period liability change or 3) recognized as unrealized if not attributed to the hedged risk. The changes recognized as deferred are amortized over a straight-line method into realized gains/losses via a timeframe that matches the Macaulay duration of the guarantee benefit cash flow, not to exceed 10 years. SSAP No. 108, although specific to interest rate risks, does not take derivative gains or losses to IMR.

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 2023, the Working Group adopted *INT 23-01: Net Negative (Disallowed) IMR* as short-term guidance and directed efforts towards a long-term resolution of IMR. The IMR Ad Hoc Group, comprised of accountants and actuaries representing regulators and industry, has met to discuss IMR, including the gains/losses from “economic effective” (ALM) derivatives that some reporting entities have been taking to IMR. With those discussions, and an ACLI presentation on ALM derivatives, regulators from the Ad Hoc Group supported moving discussion of potential statutory accounting guidance to the Working Group.

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:

NAIC staff recommends that the Working Group move this item to the active listing, classified as a new statutory accounting concept, with exposure of this agenda item to obtain comments from Working Group members, as well as interested regulators and interested parties on the potential to develop statutory guidance for macro-derivative programs that hedge interest rate risk for asset-liability matching purposes. Initially, NAIC staff is requesting feedback on the following key concepts:

- 1) Do Working Group members support the development of statutory accounting guidance that would defer derivative gains/losses for structures that hedge interest rate risk with amortization over time into income? (These derivative programs would not qualify as accounting effective under SSAP No. 86 and are not captured within the specific variable annuity guarantee guidance in SSAP No. 108.)
- 2) If further development / consideration of guidance is supported, the following items are noted for discussion:
 - a. Determination of effectiveness that permits the derivative program to qualify for the special accounting treatment.
 - b. Discussion of whether net deferred losses (reported as assets) would be admissible, and if so, any admittance limitations.
 - c. Macro-limits on admissible net deferred losses (reported as assets) and other “soft” assets. (For example, capturing IMR and derivative deferred net losses, and then perhaps considering other soft assets, such as DTAs, EDP equipment and software, goodwill, etc.)
 - d. Timeframes over which deferred items are amortized into income.
 - e. Extent of application across the industry. (NAIC staff notes that SSAP No. 108 is only applied by 9 entities, and from a review of the derivative disclosures for INT 23-01, only 14 entities captured derivative gains/losses in the IMR balance.)

NAIC staff requests direction to work with regulators and industry during the interim to continue discussions and in the consideration of guidance.

Staff Review Completed by: Julie Gann, NAIC Staff—May 2024

On August 13, 2024, the Statutory Accounting Principles (E) Working Group moved this item to the active listing, classified as a new SAP concept, and exposed this agenda item with a request for feedback on the items noted within

the above staff recommendation. This item was exposed with a longer comment period ending November 8, 2024. This item is not planned for detailed discussion at the 2024 Fall National Meeting but is planned for discussion in the interim after that meeting, or at the 2025 Spring National Meeting.

[https://naiconline.sharepoint.com/teams/FRSStatutoryAccounting/NationalMeetings/A. National Meeting Materials/2024/12-17-2024/24-15 - ALM Derivatives.docx](https://naiconline.sharepoint.com/teams/FRSStatutoryAccounting/NationalMeetings/A.NationalMeetingMaterials/2024/12-17-2024/24-15-ALM%20Derivatives.docx)

NAIC Accounting Practices and Procedures Manual
Editorial and Maintenance Update
November 17, 2024

Maintenance updates provide revisions to the *Accounting Practices and Procedures Manual* (Manual) such as editorial corrections, reference changes, and formatting.

SSAP/Appendix	Description/Revision
SSAP No. 26—Bonds	Editorial change to reinstate disclosure language and reporting category provision.

SSAP No. 26—Bonds:

Overview: The disclosure in paragraph 39.e. is an existing disclosure (pre-bond-definition revisions) in SSAP No. 26. However, the pre-bond-definition version of the disclosure included direction for disclosure by Schedule D broad reporting categories, with categories listed in the SSAP. These reporting categories were removed from the adopted revised SSAP No. 26 disclosure effective Jan. 1, 2025. Although this disclosure is satisfied by the completion of Schedule D-1-1 and D-1-2 for statutory accounting purposes, comments have been made that the adopted revised language could require a listing of all bonds in the audited financial statements. As such, editorial revisions have been proposed to reinstate the prior language for “receiving bond treatment” (as adopted, revised SSAP No. 43—*Asset-Backed Securities*, paragraph 44.m., points to this SSAP No. 26 disclosure for ABS items), and to include reference to reporting categories. A listing of the reporting categories is not deemed necessary within the SSAP.

Proposed Edits to SSAP No. 26 (effective Jan. 1, 2025):

39e. For each [annual](#) balance sheet presented, the book/adjusted carrying values, fair values, excess of book/carrying value over fair value or fair value over book/adjusted carrying values for each pertinent bond or assets ~~in scope of this statement~~ [receiving bond treatment, by category and subcategory as reported in annual statement Schedule D – Part 1, Section 1 \(Issuer Credit Obligations\) and Section 2 \(Asset-Backed Securities\)](#).

Staff Recommendation:

NAIC staff recommend that the Statutory Accounting Principles (E) Working Group move this agenda item to the active listing, categorized as a SAP clarification, and expose editorial revisions as illustrated within.

On November 17, 2024, the Statutory Accounting Principles (E) Working Group moved this item to the active listing and exposed the above editorial revisions to *SSAP No. 26—Bonds* for a shortened comment period ending December 9, 2024.

<https://naiconline.sharepoint.com/teams/FRSStatutoryAccounting/NationalMeetings/A.NationalMeetingMaterials/2024/12-17-2024/24-26EPFall2024.docx>

**Statutory Accounting Principles (E) Working Group
Dec. 17, 2024
Comment Letters Received – Agenda 1**

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**Mike Monahan**

Senior Director, Accounting Policy
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November 6, 2024

Mr. Dale Bruggeman

Chair, Statutory Accounting Principles (E) Working Group
National Association of Insurance Commissioners (NAIC)
110 Walnut Street, Suite 1500
Kansas City, MO 64106-2197

Re: 2024-10 – Book Value Separate Accounts

Dear Mr. Bruggeman:

The ACLI appreciates the opportunity to comment on the exposure referred to above that was released for comment by SAPWG on August 13, 2024.

We support clarification of statutory accounting guidance for Book Value Guaranteed Separate Accounts. ACLI is very appreciative of the on-going dialogue with SAPWG and the IMR Ad Hoc Working Group and stands ready to continue working with the NAIC on this initiative.

Within the exposure, NAIC staff has proposed changes to SSAP 56 and identified several items for further discussion. ACLI would like to provide specific comments regarding existing SSAP 56 guidance and proposed changes to SSAP 56, in addition to direct responses to NAIC Staff Questions.

The ACLI is in support of much of the exposed guidance updates. Particularly, we are in support of the proposed guidance for transfers between General Account and Separate Account (paragraphs 19 – 22). The ACLI previously provided a detailed presentation entitled “ACLI Derivative IMR Solution Proposal” (“ACLI Solution,” included as Appendix I) to the IMR Ad Hoc Working Group. Discussions of the ACLI solution at the NAIC Ad Hoc IMR WG were the impetus for this exposure. The exposed guidance updates to SSAP 56 largely reflect the findings from the ACLI Solution presentation and, should it be beneficial to regulators, the ACLI would appreciate the opportunity to present to the full SAPWG membership and any additional interested regulators.

While in support of much of the exposed guidance updates, the ACLI would like to further discuss some of the proposed guidance for Book Value Guaranteed Separate Accounts; specifically within SSAP 56 paragraph 18b. The General Account is often ultimately obligated to act as “an overall backstop or providing a guarantee”, the ACLI has found that the distinct performance guarantee can be specified for some contracts. The current wording can be interpreted that a distinct performance guarantee is never specified and we recommend the

following verbiage change: "...although a distinct performance guarantee may not be specified (such as minimum crediting rate, death benefit, etc...)...."

Additionally, while the first sentence of 18b is clear that Book Value Separate Accounts should be created with regulator approval, the subsequent inclusion of a list of current approved policy types could be misinterpreted as a restrictive list of those policy types available for regulator approval rather than a list of current examples. The ACLI recommends removing reference to specific Book Value Separate Account policy types to avoid the potential for misinterpretation and the subsequent diversity in practice that may lead to.

Also, stating that book value separate accounts provide benefits that are not directly tied to the performance of the assets is not always accurate as there are certain book value separate accounts where the asset performance is used to determine the general account obligation. Our proposed edits are highlighted below, which address these comments:

18.b. With approval of the state insurance regulator, assets supporting insulated or non-insulated separate account contracts that are similar to contracts generally found in the general account, **but do not directly pass all investment experience of the underlying assets to the policyholder, will be recorded as if the assets were held in the general account.** Unlike traditional separate account contracts, these contracts do not have investment directives determined by the contract holder and investment performance results are not attributed to a specific contract holder. **The general account may** serve as an overall backstop or **may provide** an implied guarantee, although a distinct performance guarantee **may not be** specified (such as a minimum crediting rate, death benefit, etc.).

Within the exposure NAIC Staff posed specific questions (below in **bold**) with ACLI responses immediately following:

NAIC Staff Question: Information on the current measurement method for seed money is requested from industry. Although the guidance implies that seed money should be at book value, there is an assumption that companies may utilize fair value when included in a fair value separate account.

Fair Value Separate Accounts are primarily invested in assets that would otherwise be recorded at Fair Value if held directly on the General Account. While ACLI has, to date, not identified any diversity in practice from SSAP 56 paragraph 17 guidance, we do recognize the possibility that commingling of seed money and policyholder funds within the investment strategy assets has the potential to lead to fair value reporting of seed money that would not otherwise be recorded at Fair Value if held directly on the General Account. The ACLI welcomes further discussion with regulators to determine if the accounting guidance updates currently being exposed can be utilized to solve for the, albeit remote, potential for diversity in practice.

NAIC Staff Question: Feedback is requested on the named contracts (PRT and RILA) and whether other example contracts should be named.

In addition to PRT and RILA, BOLI policies have also been identified as current separate account policy types being carried at Book Value by member companies. As previously addressed above, the listing of current book value separate account policy types does not account for the development and regulator approval of book value separate account policies in the future. As has been the case with the existing guidance, the listing of policy types could be misinterpreted by some as a definitive listing of approved Book Value Separate Accounts which will again lead to diversity in practice and the need to regularly update guidance to include new policy types within the list and/or could lead to implicit prescribed practices. For these reasons, the ACLI recommends that neither a full list nor example list of policy types be included within the guidance.

NAIC Staff Question: Additional information is requested from industry on these transfers (asset to asset swaps, contributions of general account assets to support separate account deficiencies, dividends of assets from the separate account to the general account). NAIC staff recommend that these areas be expanded with consistent guidance for the treatment of transfers.

The ACLI maintains that these types of transactions remain a) not common and b) often subject to accounting standard outlined within each separate account Memorandum or Plan of Operations ("Memorandum of Operations). Any codification of accounting guidance for these transactions could result in implicit prescribed practices where updated accounting guidance within SSAP 56 differs from the accounting guidance agreed upon with the domicile state within the Memorandum of Operations. The ACLI recommends further discussion as to the appropriateness of recommended expanded treatment, specifically as relates to the potential for and complications that arise from prescribed practice, effecting changes to Memorandum of Operations, and/or applying expanded guidance only to policies written after a certain date.

NAIC Staff Question: Clarification is requested to this guidance for seed money similar to the prior question.

The ACLI maintains that reporting guidance for seed money transfers, other than seed transfers of cash, can often be subject to accounting standard outlined within each separate account Memorandum of Operations. Please refer to concerns expressed in the prior question.

Once again, the ACLI appreciates the opportunity to provide comment and looks forward to continued dialogue and collaboration on Book Value Separate Account guidance. If you have any questions regarding this letter, please do not hesitate to contact us.

Sincerely,



Mike Monahan
ACLI

Cc: Julie Gann, Assistant Director - Solvency Policy, Robin Marcotte, Senior Manager II, Accounting Policy, Jake Stultz, Manager II – Accounting Policy, Jason Farr Senior SCA Valuation and Accounting Policy Advisor, and Wil Oden, Senior Technical Accounting Policy Advisor

Appendix I

Demonstration of Separate Account Transfers and IMR Treatments

As part of the holistic review of Interest Maintenance Reserve (“IMR”), industry members of the American Council of Life Insurers (“ACLI”) have conducted a cursory review of the accounting treatment of IMR eligible asset transfers for cash between Book Value Separate Accounts (“BVSA”) and General Account (“GA”). Upon review, it was found that there is some diversity in practice among industry with three primary methods identified: hereafter referred to as Market Value Offsetting IMR Method and Market Value SSAP 25 Method, and Book Value Method. It is important to note that despite the presence of these differing treatments, all methods do not produce gains to surplus as a result of these transfers.

It is also important to highlight that the primary difference between a company using the Book Value Method versus one of the Market Value methods is largely driven by whether the BVSA guidelines pre-approved by the state of domicile regulator, often referred to as the “Essentials of Operation” or “Memorandum of Operations” (“Memorandum”), requires such transfers for cash considerations to occur at fair value or book value. There does not appear to be diversity in accounting practice among those companies whose Memorandum require such transfers to occur at book value.

For purposes of the illustration of the three methods, some simplified assumptions have been made:

- Similar to past IMR related illustrations, tax impacts have been excluded
- Pre-transfer book value is equal to par value
- All examples include asset transfer from BVSA to GA, however the methods work similarly in both directions
- Reinvestment of cash can be assumed, however has been excluded from illustration to show the standalone impact of the transfer
- Impacts of the transfer have been retained on each balance sheet, ignoring potential offsets of reinvestment yield and/or surplus sweep from BVSA to GA, if applicable

Market Value Offsetting IMR Method

The Offsetting IMR Method can be summarized by these key features:

- Transfer from “Selling” book recorded at Market Value
- “Selling” book recognizes Realized Gain/Loss and subsequent transfer to IMR similar to third party sale
- “Purchasing” book records incoming asset at Book Value and makes an adjustment to IMR for the difference between purchase price and Book Value
- IMR activity on GA and BVSA are equal and offsetting, creating zero net impact to IMR balance
- Zero net impact to surplus

Transfer at Loss Example

GA buys a bond from SA at MV of \$90 (BV/PAR of \$100) and sets up IMR to bring GA Day 1 carrying value to SA BV												
Coupon	3%											
Current yield	4%											
Years to maturity	10											
	Day 1	YEAR 1	YEAR 2	YEAR 3	YEAR 4	YEAR 5	YEAR 6	YEAR 7	YEAR 8	YEAR 9	YEAR 10	Cumulative
Cash (decrease) for purchase price -GA	(90)											
Initial Carrying value (Equals BV on SA) - GA	100											
IMR asset (liability) established - GA	(10)											
Coupon payment - GA		3	3	3	3	3	3	3	3	3	3	
IMR Amortization - GA		1	1	1	1	1	1	1	1	1	1	
Surplus impact - Standalone GA	-	4	4	4	4	4	4	4	4	4	4	40
Cash increase for purchase price -SA	90											
Carrying value sold (Equals BV on SA)	(100)											
IMR asset (liability) established - SA	10											
IMR amortization - SA		(1)	(1)	(1)	(1)	(1)	(1)	(1)	(1)	(1)	(1)	
Surplus impact - Standalone SA	-	(1)	(1)	(1)	(1)	(1)	(1)	(1)	(1)	(1)	(1)	(10)
Total Surplus Impact	-	3	3	3	3	3	3	3	3	3	3	30
Combined IMR Balance	-	-	-	-	-	-	-	-	-	-	-	0

In this example, the full economics of a sale of bond are reflected within BVSA while the amortization of the IMR adjustment within General Account alleviates the need for separate Amortized Cost valuation adjustments. Net zero impact to surplus and annual impact of interest income of the bond remain (\$3 interest per year for 10 years). Net zero impact to cumulative IMR.

Transfer at Gain Example

GA buys a bond from SA at MV of \$110 (BV/PAR of \$100) and sets up IMR to bring GA Day 1 carrying value to SA BV												
Coupon	4%											
Current yield	3%											
Years to maturity	10											
	Day 1	YEAR 1	YEAR 2	YEAR 3	YEAR 4	YEAR 5	YEAR 6	YEAR 7	YEAR 8	YEAR 9	YEAR 10	Cumulative
Cash (decrease) for purchase price -GA	(110)											
Initial Carrying value (Equals BV on SA) - GA	100											
IMR asset (liability) established - GA	10											
Coupon payment - GA		4	4	4	4	4	4	4	4	4	4	
IMR Amortization - GA		(1)	(1)	(1)	(1)	(1)	(1)	(1)	(1)	(1)	(1)	
Surplus impact - Standalone GA	-	3	3	3	3	3	3	3	3	3	3	30
Cash increase for purchase price -SA	110											
Carrying value sold (Equals BV on SA)	(100)											
IMR asset (liability) established - SA	(10)											
IMR amortization - SA		1	1	1	1	1	1	1	1	1	1	
Surplus impact - Standalone SA	-	1	1	1	1	1	1	1	1	1	1	10
Total Surplus Impact	-	4	4	4	4	4	4	4	4	4	4	40
Combined IMR Balance	-	-	-	-	-	-	-	-	-	-	-	0

Similar impacts for gain example as were illustrated in the loss example.

Transfer at Gain and Subsequent Sale to Third Party Example

GA buys a bond from SA at MV of \$110 (BV/PAR of \$100) and subsequently sells to third part at MV of \$107 on Day 1 of Year 4												
Coupon	4%											
Current yield	3%											
Years to maturity	10											
	Day 1	YEAR 1	YEAR 2	YEAR 3	YEAR 4	YEAR 5	YEAR 6	YEAR 7	YEAR 8	YEAR 9	YEAR 10	Cumulative
Cash activity - GA	(110)				107							
Initial Carrying value (Equals BV on SA) - GA	100				(100)							
IMR asset (liability) established - GA	10				(7)							
Coupon payment - GA		4	4	4								
IMR Amortization Transaction 1- GA		(1)	(1)	(1)	(1)	(1)	(1)	(1)	(1)	(1)	(1)	
IMR Amortization Transaction 2- GA					1	1	1	1	1	1	1	
Surplus impact - Standalone GA	-	3	3	3	-	-	-	-	-	-	-	9
Cash increase for purchase price -SA	110											
Carrying value sold (Equals BV on SA)	(100)											
IMR asset (liability) established - SA	(10)											
IMR amortization - SA		1	1	1	1	1	1	1	1	1	1	
Surplus impact - Standalone SA	-	1	1	1	1	1	1	1	1	1	1	10
Total Surplus Impact	-	4	4	4	1	1	1	1	1	1	1	19
Combined IMR Balance	0	0	0	0	6	5	4	3	2	1	-	0

IMR and IMR amortization on GA and BVSA are equal and offsetting over the first three years after the transfer. The sale to the third party on Day one of year four triggers a realized gain on GA and subsequent transfer of that gain to IMR. Prior to sale to third party the company has zero net impact to surplus. Upon sale to third party, the impacts to IMR and surplus are consistent with third party transaction accounting.

Market Value SSAP 25 Method

The SSAP 25 Method can be summarized by these key features:

- Transfer from “Selling” book recorded at Market Value
- “Purchasing” book records asset at Market Value and records applicable amortized cost valuation adjustments over the term to maturity
- Differing Treatment for Gains vs Losses
 - Gains are immediately offset by a SSAP 25 adjustment in the GA book (the “parent” level)
 - Losses are not subject to SSAP 25 adjustment and applicable losses are immediately subject to IMR treatment
- Zero net impact to surplus

Transfer at Loss Example

GA buys a bond from SA at MV of \$90 (BV/PAR of \$100) and sets up IMR offset SA Loss												
Coupon	3%											
Current yield	4%											
Years to maturity	10											
	Day 1	YEAR 1	YEAR 2	YEAR 3	YEAR 4	YEAR 5	YEAR 6	YEAR 7	YEAR 8	YEAR 9	YEAR 10	Cumulative
Cash (decrease) for purchase price -GA	(90)											
Initial Carrying value (MV) - GA	90											
Coupon payment - GA		3	3	3	3	3	3	3	3	3	3	
Amortized Cost Carrying Value Adjustment		1	1	1	1	1	1	1	1	1	1	
Surplus impact - Standalone GA	-	4	4	4	4	4	4	4	4	4	4	40
Cash increase for purchase price -SA	90											
Carrying value sold (Equals BV on SA)	(100)											
IMR asset (liability) established - SA	10											
IMR amortization - SA		(1)	(1)	(1)	(1)	(1)	(1)	(1)	(1)	(1)	(1)	
Surplus impact - Standalone SA	-	(1)	(1)	(1)	(1)	(1)	(1)	(1)	(1)	(1)	(1)	(10)
Total Surplus Impact	-	3	3	3	3	3	3	3	3	3	3	30
Combined IMR Balance	(10)	(9)	(8)	(7)	(6)	(5)	(4)	(3)	(2)	(1)	-	

In this example, the transaction is recorded at Market Value on both BVSA and GA and the full economics of a sale of bond are reflected on each book, respectively. Net zero impact to surplus and annual impact of interest income of the bond remain (\$3 interest per year for 10 years). Day 1 Net impact to IMR, which amortizes over the remaining years to maturity.

Transfer at Gain Example

GA buys a bond from SA at MV of \$110 (BV/PAR of \$100) and sets up SSAP 25 Adjustment to defer SA Gain												
Coupon	4%											
Current yield	3%											
Years to maturity	10											
	Day 1	YEAR 1	YEAR 2	YEAR 3	YEAR 4	YEAR 5	YEAR 6	YEAR 7	YEAR 8	YEAR 9	YEAR 10	Cumulative
Cash (decrease) for purchase price -GA	(110)											
Initial Carrying value - GA	110											
SSAP 25 Adjustment - Deferred Liability Acct	(10)											
Coupon payment - GA		4	4	4	4	4	4	4	4	4	4	
Amortized Cost Carrying Value Adjustment		(1)	(1)	(1)	(1)	(1)	(1)	(1)	(1)	(1)	(1)	
SSAP 25 Carrying Value Offset											10	
Surplus impact - Standalone GA	(10)	3	3	3	3	3	3	3	3	3	3	30
Cash increase for purchase price -SA	110											
Carrying value sold (Equals BV on SA)	(100)											
IMR asset (liability) established - SA												
IMR amortization - SA												
Surplus impact - Standalone SA	10	-	-	-	-	-	-	-	-	-	-	10
Total Surplus Impact	-	3	3	3	3	3	3	3	3	3	3	40
Combined IMR Balance	-	-	-	-	-	-	-	-	-	-	-	

The day one transaction is recorded at Market Value on both BVSA and GA. A SSAP 25 adjustment is recorded in the GA to offset the transfer gain reported in the BVSA. The BV of the bond amortizes to par value over the term to maturity and the SSAP 25 deferral unwinds at time of maturity. In this example, there is no transfer to IMR.

Transfer at Gain and Subsequent Sale to Third Party Example

GA buys a bond from SA at MV of \$110 (BV/PAR of \$100) and subsequently sells to third party at MV of \$107 on Day 1 of Year 4												
Coupon	4%											
Current yield	3%											
Years to maturity	10											
	Day 1	YEAR 1	YEAR 2	YEAR 3	YEAR 4	YEAR 5	YEAR 6	YEAR 7	YEAR 8	YEAR 9	YEAR 10	Cumulative
Cash (decrease) for purchase price -GA	(110)				107							
Initial Carrying value - GA	110				(107)							
SSAP 25 Adjustment - Deferred Liability Acct	(10)				10							
Coupon payment - GA		4	4	4	-	-	-	-	-	-	-	-
Amortized Cost Carrying Value Adjustment		(1)	(1)	(1)	-	-	-	-	-	-	-	-
SSAP 25 Offset upon sale or maturity					-	-	-	-	-	-	-	-
Surplus impact - Standalone GA	(10)	3	3	3	10	-	-	-	-	-	-	9
Cash increase for purchase price -SA	110											
Carrying value sold (Equals BV on SA)	(100)											
IMR asset (liability) established - SA					(10)							
IMR amortization - SA					1.4	1.4	1.4	1.4	1.4	1.4	1.4	1.4
Surplus impact - Standalone SA	10	-	-	-	(8.6)	1.4	1.4	1.4	1.4	1.4	1.4	10
Total Surplus Impact	-	3	3	3	1.4	1.4	1.4	1.4	1.4	1.4	1.4	19
Combined IMR Balance	-	-	-	-	8.6	7.1	5.7	4.3	2.9	1.4	-	

The transaction follows the above Gain example until such time as the asset is then sold to a third party. Upon sale to third party, the SSAP 25 adjustment of \$10 on GA is reversed and a \$10 transfer to IMR is recorded on the BVSA. IMR is amortized over the remaining maturity of the sold bond.

Book Value Method

The Book Value Method can be summarized by these key features:

- Transfer recorded at Book Value for both “Selling” book and “Purchasing” book
- Zero net impact to surplus
- Zero net impact to IMR

Transfer Example

GA buys a bond from SA at BV of \$100 (BV/PAR of \$100) with MV of \$90												
Coupon	3%											
Current yield	4%											
Years to maturity	10											
	Day 1	YEAR 1	YEAR 2	YEAR 3	YEAR 4	YEAR 5	YEAR 6	YEAR 7	YEAR 8	YEAR 9	YEAR 10	Cumulative
Cash (decrease) for purchase price -GA	(100)											
Initial Carrying value (MV) - GA	100											
Coupon payment - GA		3	3	3	3	3	3	3	3	3	3	3
Surplus impact - Standalone GA	-	3	3	3	3	3	3	3	3	3	3	30
Cash increase for purchase price -SA	100											
Carrying value sold (Equals BV on SA)	(100)											
Surplus impact - Standalone SA	-	-	-	-	-	-	-	-	-	-	-	-
Total Surplus Impact	-	3	3	3	3	3	3	3	3	3	3	30
Combined IMR Balance	-	-	-	-	-	-	-	-	-	-	-	

In this example, the transaction is recorded at Book Value on both BVSA and GA. Net zero impact to surplus and annual impact of interest income of the bond remain (\$3 interest per year for 10 years). No transfers to IMR.

Transfer and Subsequent Sale to Third Party Example

GA buys a bond from SA at BV of \$100 (BV/PAR of \$100) and MV of \$110 and subsequently sells to third party at MV of \$107 on Day 1 of Year 4												
Coupon	4%											
Current yield	3%											
Years to maturity	10											
	Day 1	YEAR 1	YEAR 2	YEAR 3	YEAR 4	YEAR 5	YEAR 6	YEAR 7	YEAR 8	YEAR 9	YEAR 10	Cumulative
Cash (decrease) for purchase price -GA	(100)				107							
Initial Carrying value - GA	100				(100)							
IMR asset (liability) established - GA	-				(7)							
IMR amortization - GA		4	4	4								
IMR amortization - GA					1	1	1	1	1	1	1	
Surplus impact - Standalone GA	-	4	4	4	1	1	1	1	1	1	1	19
Cash increase for purchase price -SA	100											
Carrying value sold (Equals BV on SA)	(100)											
Surplus impact - Standalone SA	-	-	-	-	-	-	-	-	-	-	-	-
Total Surplus Impact	-	4	4	4	1	1	1	1	1	1	1	19
Combined IMR Balance	-	-	-	-	6	5	4	3	2	1	-	

The transfer between BVSA and GA produces no net gain nor IMR transfer, consistent with above example. Upon sale to third party the book holding the asset records a realized gain, that gain is subsequently deferred via IMR, and IMR is amortized over the remaining maturity of the sold bond.

Additional illustrations can be provided should there be scenarios as yet not covered by the above illustrations. We welcome any comments and/or questions. ACLI next steps are to socialize this more broadly with the intent to craft an industry recommendation for a transfer accounting standard.

**Mike Monahan**

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November 4, 2024

Mr. Dale Bruggeman

Chair, Statutory Accounting Principles (E) Working Group
National Association of Insurance Commissioners (NAIC)
110 Walnut Street, Suite 1500
Kansas City, MO 64106-2197

Re: 2024-15 – ALM Derivatives

Dear Mr. Bruggeman:

The ACLI appreciates the opportunity to comment on the exposure referred to above that was released for comment by SAPWG on August 13, 2024.

We support the development of new statutory accounting guidance for interest-rate hedging derivatives that do not qualify for hedge accounting under SSAP No. 86—Derivatives, but that are used for asset-liability management (ALM), also referred to as “ALM Hedges”. ACLI is very appreciative of the on-going dialogue with SAPWG and the IMR Ad Hoc Working Group and stands ready to continue working with the NAIC on this initiative.

Companies manage ALM programs to mitigate reinvestment, guarantee, and disintermediation risks, and to manage asset portfolios within limited ranges around a liability target duration. The new statutory accounting guidance is intended for derivative transactions that alter the interest rate characteristics of assets/liabilities under these types of risk mitigation programs. More specifically, “macro-hedging” ALM programs hedge risks that are often off-balance sheet risks given the “amortized cost” nature of statutory accounting, and therefore hedge accounting frameworks do not address this type of hedging construct. As discussed in our white paper “Derivatives and Hedging with Life Insurance” (included as Appendix I), this is because the duration and convexity of assets and liabilities may differ. When interest rates change, asset and liability durations may change by different amounts, making it nearly impossible to maintain the tight effectiveness assessment corridor requirements as the measurement criteria do not include metrics commonly used in these programs (e.g., duration). As a result, economically effective “macro-hedges” are generally considered hedges and carried at fair value, which misstates insurer solvency by causing surplus volatility or worse, can disincentivize prudent risk management. As further discussed in Appendix I, there is a critical need for developing appropriate accounting guidance.

Within the exposure, NAIC staff has identified several items for further discussion:

2) If further development / consideration of guidance is supported, the following items are noted for discussion:

- a. Determination of effectiveness that permits the derivative program to qualify for the special accounting treatment.
- b. Discussion of whether net deferred losses (reported as assets) would be admissible, and if so, any admittance limitations.
- c. Macro-limits on admissible net deferred losses (reported as assets) and other “soft” assets. (For example, capturing IMR and derivative deferred net losses, and then perhaps considering other soft assets, such as DTAs, EDP equipment and software, goodwill, etc.)
- d. Timeframes over which deferred items are amortized into income.
- e. Extent of application across the industry. (NAIC staff notes that SSAP No. 108 is only applied by 9 entities, and from a review of the derivative disclosures for INT 23-01, only 14 entities captured derivative gains/losses in the IMR balance.)

The ACLI previously provided a detailed presentation entitled “ACLI Derivative IMR Solution Proposal” (“ACLI Solution,” included as Appendix II) to the IMR Ad Hoc Working Group. Discussions of the ACLI solution at the NAIC Ad Hoc IMR WG were the impetus for this exposure. The solution addresses many of the exposure’s components and ACLI would appreciate the opportunity to present to the full SAPWG membership and any additional interested regulators.

Additionally, the ACLI would like to provide specific comments regarding the admittance limitations identified in discussion points 2b and 2c. Although one of the methods within the ACLI Solution includes accounting which does not utilize the IMR, discussion of accounting treatment revisions for ALM Hedging arose within the context of derivatives and IMR. Therefore, our comments start with the “Definition of IMR” developed by the IMR Ad Hoc Working Group:

IMR is a valuation adjustment to maintain consistency between insurance liabilities (the assumptions for which are often unchanged from origin) and the assets needed to support them (where the assumptions can essentially be revisited any time there are fixed income realizations).

IMR defers and amortizes the recognition of non-economic gains or losses where investment activity, whether through fixed income investment sales or fixed income derivative hedging transactions, essentially unlock unrealized gains/losses for either assets or liabilities. IMR is not intended to defer economic gains and losses related to asset sales compelled by liquidity pressures that fund significant cash outflows (e.g., such as excess withdrawals and collateral calls).

Specifically, the IMR valuation adjustment more appropriately reflects the impact to statutory surplus from fluctuations in interest rates and therefore provides a more accurate representation of solvency under the NAIC’s statutory framework which often includes amortized cost valuation of fixed income investments and liability valuations with fixed assumptions in accordance with the Accounting Practices and Procedures and Valuation Manual.

This definition is part of a broader document (see attached Appendix III) that provides foundational principles for the NAIC's statutory accounting framework.

As the document and definition of IMR states: fixed income investment assumptions can be more easily revised, that is "unlocked," when the investments are sold/purchased. Statutory reserve liability assumptions typically are not revised. Therefore, to avoid situations in which transitory interest rate related realized gains/losses caused inaccurate solvency reflections (which could disguise an insurer's true ability to pay claims), the IMR valuation adjustment was developed. Appendix III provides detailed examples in which this could occur. The IMR also remains a vital element of the statutory accounting framework and was incorporated in the methodology within other evolutions such as Principle-Based Reserving (PBR) and Asset Adequacy Testing (AAT).

The IMR is not an intangible asset, it is a valuation adjustment to reflect the company's true solvency position under statutory accounting. Therefore, equating negative IMR to an asset (tangible or intangible) with claims paying ability, is not logical or appropriate. Following this, imposing any limit on admittance would misconstrue an insurer's true solvency and would equate to a limit on unrealized losses on fixed income instruments more broadly, such as bonds where the unrealized losses are embedded within their amortized cost valuation; contrary to the purpose of the IMR and consistent valuation of assets and liabilities.

ACLI understands regulators may wish to separate ALM derivatives from IMR (both for recording unrealized during their lives and for recording any applicable realized gains/losses). However, ACLI emphasizes, in light of the previous, that:

1. Fixed income ALM hedges can be used to alter the interest rate characteristics of assets and/or liabilities, and therefore are another method of "unlocking" the fixed assumptions. Whether ALM hedge realized gains/losses are included in the IMR or a separate valuation adjustment, they will be theoretically aligned and maintain the intent of the IMR (see the definition of IMR discussed above); and
2. Any fixed income hedge unrealized gains/losses are not intangible assets. They represent the offset to the valuation of the derivative itself (the contract asset/liability) and equate to the value needed to close (settle) the derivative contract with the counterparty.

Any limits (or potential subsequent non-admittance) on these components would in fact equate to a limit on ALM hedging programs themselves, disincentivizing insurers from engaging in vital, prudent, fixed income hedging strategies. As discussed in Appendix I and II, ALM hedges are used to mitigate reinvestment, guarantee, and disintermediation risks, as well as managing asset portfolios within limited ranges around a liability target duration, all of which are shared goals between regulators and insurers.

Further limiting hedging programs through statutory accounting guidance creates significant regulatory redundancies given other existing, effective regulatory protections:

1. From a state perspective, insurer hedging programs are limited under individual state laws and insurer DUPs, such as the type(s) of derivative programs and/or derivative contract(s). Insurers are also prohibited from speculative derivatives.

2. From a federal perspective, most standard US agreements with derivative counterparties also require derivative trades to be collateralized through margin requirements.¹ Collateral agreements ensure each counterparty (both the insurer and the institution on the other side of the derivative) are able to financially fulfill the derivative contract (i.e., pay the amount owed for the derivative's fair value) and/or reduce default risks incorporated in the contract for either party. In this case, any limit on the "valuation offset" is overly punitive when the insurer is legally required to post collateral to the counterparty.

Therefore, an aggregate cap for IMR and/or ALM derivatives is not appropriate, and it is not logical to call them intangible assets that cannot be used to pay claims. Rather, "negative" or "asset" valuation adjustments are simply explicitly shown on the balance sheet, whereas other unrealized losses are embedded in their amortized cost carrying values (i.e., bonds), both of which are required for consistent valuation of assets and liabilities so surplus properly reflects an insurers claims paying ability.

Turning to the macro cap on "soft assets," it is difficult to group these items as one category given their unique characteristics and purpose within the statutory accounting framework. Prudent business and risk decisions should not be disincentivized by the presence of completely unrelated economically viable assets or valuation adjustments on a company's balance sheet. To view these "soft assets" or intangibles in isolation from their broader purpose is also not appropriate. The NAIC's framework is an "amortized cost framework" with appropriate embedded conservatism, not a liquidation basis of accounting, for both assets and liabilities.

Deferred Tax Assets (DTAs) have appropriate conservatism by limiting reversals to 3-years as well as limiting carryback and carryforward potential. Further, DTAs represent real economic value to an insurer, and in fact does help pay claims by way of realizing tax benefits (i.e., reduction in tax payments).

Goodwill generally represents the difference between the cost of acquiring an entity and the reporting entity's share of the book value of the acquired entity. Within the acquisition, components of Goodwill could represent things of value such as costs acquiring a fully amortized building or an asset manager. Asset managers generally have limited balance sheet assets where its value is attributable to asset manager fees and directly proportional to assets under management (i.e., a not balance sheet metric).

Unlike US GAAP or IFRS, where Goodwill is not amortized because it is considered to have an indefinite useful life, until it is determined to be impaired, under statutory accounting Goodwill is conservatively amortized over a period not to exceed 10-years, as well as being subject to impairment testing.

DTAs and Goodwill also have percentage of surplus limitations, which serves as another layer of conservatism.

The common theme among all of these valuation adjustments and/or assets is that they either adjust values for consistent valuation of assets and liabilities to provide an accurate picture of

¹ Mandated by the Dodd Frank Act and related SEC and CFTC regulatory requirements.

claims paying ability or represent real economic value that help insurers pay claims. They are also all unique, with distinct purpose in the statutory accounting framework, so an aggregate limiting cap across other completely unrelated economically viable assets or valuation adjustments on a company's balance sheet is inappropriate.

Lastly, ACLI proposes a few brief comments on exposure item 2e regarding the extent of application in industry. From conversations with our members, use of SSAP 108 is limited due to its narrow scope (variable annuity guarantees only) and the relative rigor of guardrails that must be satisfied to implement (resource intensive, so the benefit must be substantial to justify the effort). However, we understand that the population of insurers who engage in macro-hedging programs is significantly larger and using the Negative IMR disclosures to gauge the population is not truly representative for several reasons, such as:

1. The interim solution did not allow insurers to engage in new hedging programs or to include any hedging programs that did not previously include realized gains within the IMR. There could be insurers who have had to adjust or start programs as the interest rate environment evolved, which may have disqualified them from using this guidance and therefore including their programs in the disclosure.
2. There is diversity in practice in insurer's interpretation of SSAP 86; not all insurers included gains/losses from interest rate related macro-hedging programs in the IMR, which also would have precluded them from using the interim guidance and included balances in the disclosure. Ensuring clear ALM hedging guidance would reduce diversity in practice and would likely lead to more insurers clearly identifying these programs in any future required disclosures.

Once again, the ACLI appreciates the opportunity to provide comments and looks forward to continued dialogue and collaboration on new statutory guidance for ALM Hedges. If you have any questions regarding this letter, please do not hesitate to contact us.

Sincerely,



Mike Monahan
ACLI

Cc: Julie Gann, Assistant Director - Solvency Policy, Robin Marcotte, Senior Manager II, Accounting Policy, Jake Stultz, Manager II – Accounting Policy, Jason Farr Senior SCA Valuation and Accounting Policy Advisor, and Wil Oden, Senior Technical Accounting Policy Advisor

Appendix I

Derivatives and Hedging Under Life Insurance and the NAIC's Statutory Framework

The intent of this document is to offer insights into why life insurance companies have derivative overlays on their investment portfolios to achieve appropriate results under prudent risk or asset liability management (ALM) practices. Strictly adhering to covering the liability with cash bonds through either buy and hold strategies or more dynamic portfolio rebalancing strategies are often insufficient to achieve these same results. It also offers insights into why existing derivative accounting and hedge accounting rules under US GAAP and US statutory accounting (which has incorporated many US GAAP concepts) fall short in appropriately addressing insurer and regulator needs in the broader US statutory framework for the life insurance sector. It further highlights how this framework gap can inadvertently incentivize increased risk-taking in the life insurance sector. This document further discusses the special and prudent ALM & hedging needs of life insurance companies, the marking to market of derivatives under the US statutory framework, and the appropriate lens for assessing effectiveness of derivative hedging programs under the life insurance sector's prudent risk and ALM practices.

To fully understand the proper context of this document, it should be read in conjunction with the "Definition and Purpose of the Interest Maintenance Reserve (IMR)" document which provides grounding in core concepts of the US statutory framework, which includes the IMR. That context provides a basis for understanding Appendix 3 of that document (IMR in the context of Derivatives Hedging Transactions), while this document substantially expands upon those concepts. For convenience, that example is included here as Appendix I.

A Glossary of terms commonly used when discussing these strategies and/or used throughout this document is included in Appendix II. Glossary terms used throughout the document are in italics.

Background

As detailed in the aforementioned "Definition and Purpose of the Interest Maintenance Reserve (IMR)" document, the US statutory framework is generally an "amortized cost framework," where most fixed income investments and insurance liabilities are valued at amortized cost or with assumptions locked at their inception, respectively. The US GAAP framework, on the other hand, largely defaults to a market value or market consistent framework. The US statutory accounting framework is built on a modified US GAAP foundation. However, in the case of the derivative accounting guidance, the default market value carrying value was not modified, creating a mismatch in the accounting recognition of derivatives compared to the assets and liabilities they hedge.

Most life insurance and annuity products have complex ALM profiles that do not lend themselves to simple cash-flow-matching format of ALM using traditional fixed income instruments. Our liabilities are often very long dated (often for 40+ years), and frequently have embedded optionality for policyholders to withdraw their cash values at book or minimum crediting rate guarantees. These long-dated cash flows and embedded options create complex *duration* and *convexity* profiles. At the same time, the universe of fixed income assets is concentrated in maturities of 10 years or less, with very limited availability beyond the 30-year horizon or beyond.

A subset of the overall derivative accounting guidance, hedge accounting allows the derivatives to be accounted for in the same manner as the hedged item(s), however, there are additional concerns with the US GAAP based hedge accounting regime for certain unique life insurance sector derivative hedging programs as well. Current guidance makes it extremely difficult to achieve hedge accounting for *duration* portfolio hedging. This creates significant problems for those responsibly trying to limit *duration* and *convexity* risks:

1. While replication rules can be used to correct some of the *duration* issues, there is significant burden and cost associated with each replication derivative transaction. This makes the activity inefficient and, in some cases, cost prohibitive and/or limited under state law.
2. There is no capacity under these rules to include options or dynamic replication strategies necessary to manage the net *convexity* profile of the portfolios.
3. There are some allowances for “portfolio” or cash flow hedges or certain instances of anticipatory bond hedging. But there is often burden and difficulty in achieving this treatment in many cases, differing audit firm opinions on qualifying strategies, and these strategies are not always available for liability hedging.

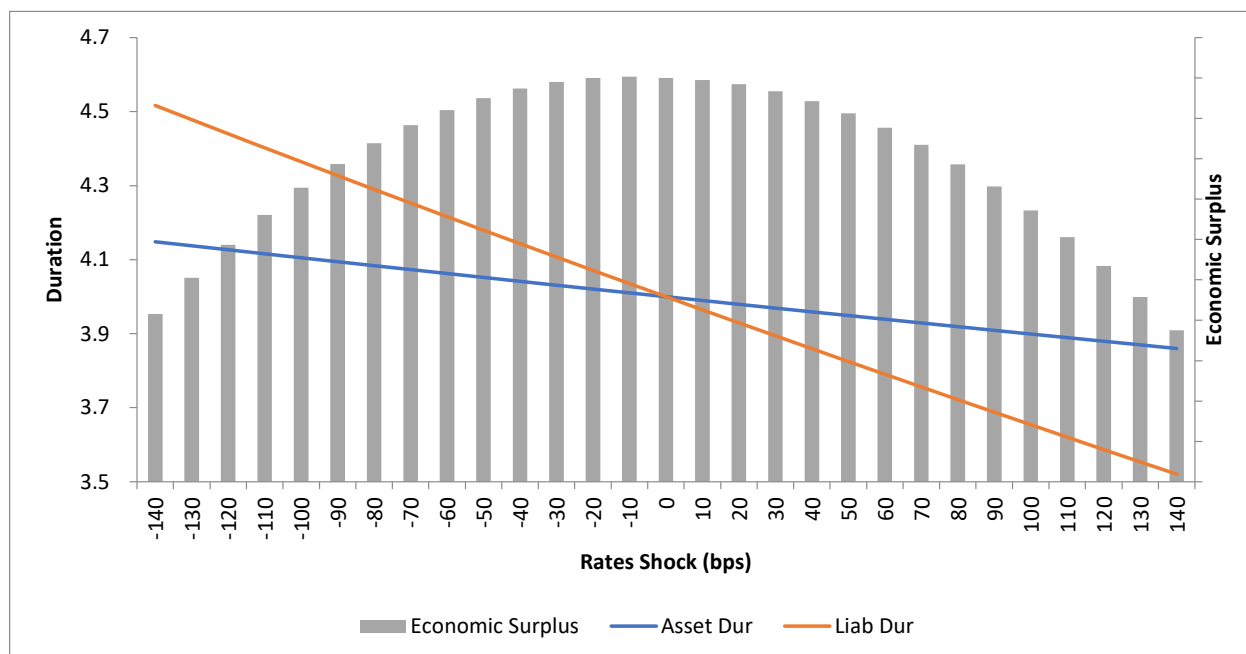
If alignment of the interest rate derivatives used for ALM with the investments and liabilities they support is not upheld, the framework creates disincentives for insurers to engage in prudent and comprehensive ALM and risk management. Consistent accounting through the balance sheet and income statements would create a much more appropriate view of insurers’ surplus and solvency.

The US GAAP hedge accounting framework (and as a result the US Statutory hedge accounting framework) is largely focused on hedges of identified current or future balance sheet and income statement items (i.e., bonds, cash flows, raw materials, etc.), however, the life insurance industry has additional considerations that must be addressed. The long *duration* nature of our products leads to additional risks, such as those from interest rates, which must be addressed and do not align with the existing hedge accounting frameworks. However, the ability to hedge these risks and amortize resultant realized gains and losses through the IMR will allow insurers to manage the risk in a manner consistent with the statutory framework.

Further, if hedge accounting rules are aligned to appropriately allow for the hedged item to be not limited to hedges of an asset or portfolio of assets, but rather the economic profile of the cash assets net of liabilities (*duration*), this would allow for effectiveness testing used in any economic framework where one can illustrate that the hedges move in a way that is offsetting the movement of the economic value of the rest of the hedged item.

Duration Risk Management of Life Insurance Companies

Let's first look at the following hypothetical example that life insurers face with regards to asset *duration* risk and how they manage that risk through asset liability management.



This chart shows where the asset *duration* (blue line) equals the liability *duration* (orange line) of approximately 4 at today's interest rate (0 on the horizontal axis). The sensitivity of *duration* to interest rates is referred to as *convexity* and the different slopes of the asset *duration* and liability *duration* lines show that the asset and liability convexities differ. Liability *convexity* is greater than asset *convexity*, which is often the case with life insurance and annuity products. In this example, if interest rates go up by 100 bps, liability *duration* is approximately 3.7 while asset *duration* is approximately 4.0. Likewise, if interest rates go down by 100 bps, liability *duration* is approximately 4.4, while asset *duration* is approximately 4.1. It is virtually impossible, and therefore impractical, for insurers to attempt to be perfectly cash flow matched in any particular interest rate scenario. Managing *convexity* is thus necessary to address this potential change in exposure as interest rates move.

As noted in the 2002 report to E-Committee, there are instances where the statutory framework (for which IMR was developed) gave rise to inappropriate results. The following is pertinent here:

Changes in values due to interest rate swings were recognized inconsistently on the asset and liability sides of the balance sheet. Liabilities are valued using interest rates fixed at issue while some assets may be valued using current interest rates through trading activity.

When the assets are poorly matched to the liabilities, a significant adverse swing in the interest rates will reduce financial strength and could lead to insolvency even though the balance sheet value of the assets exceeds the balance sheet value of the liabilities. Using long term assets to back demand liabilities is dangerous if there is a significant upswing in interest rates. In addition, individual insurance premiums are received and invested for many years after the

issue date on which the reserve interest rate is determined, creating a potential for inadequate yields that is not reflected in standard accounting procedures.

What the above example shows is an increase or decrease in interest rates can turn *duration* matched investments and liabilities into a scenario with other concerns that do not show up timely or appropriately under statutory accounting.

An insurance company, in these instances, could certainly address the 100 bp increases (decreases) by selling (buying) long *duration* securities and buying (selling) short *duration* securities, to match the *duration* of liabilities. In such a situation, the investment gains and losses would appropriately be IMR eligible, as liabilities are valued using interest rates fixed at issue while some assets are now valued using current interest rates through trading activity. However, it is not always practical to buy and sell securities to achieve this impact (e.g., availability, tax costs, bid/ask spread, etc.). More practically, the *duration* of the portfolio can be changed via more liquid derivatives instruments to protect against these same risks, in a more efficient way. This is why we believe the following was noted in the 2002 Report to E-Committee.

Realized gains and losses on derivatives investments, which alter the interest rate characteristics of assets/liabilities, also are allocated to the IMR and are to be amortized into income over the life of the associated assets/liabilities.

The E-Committee report only specifies hedging (derivatives which alter the interest rate characteristics of assets/liabilities) but does not distinguish that IMR eligibility is appropriate solely for derivatives that are hedge effective under accounting standards. This is also why we believe the 2002 Report to E-Committee called for symmetrical treatment for losses as well as gains.

Let's explore the implications of interest rate shocks upward and downward, respectively.

Due to the differences in *convexity* of assets and liabilities, the example shows how an interest rate spike can change a perfectly *duration* matched investment portfolio into one that is longer than the liabilities. As the E-Committee report's authors noted, it can be dangerous to back demand liabilities with long assets during an upswing in interest rates, as liabilities can become shorter in *duration* and more prone to disintermediation risk.

Similarly, the example shows how a downward interest rate move can also change a *duration* matched investment portfolio into one that is shorter than the liabilities. Individual insurance premiums can be received and invested for many years after the issue date on which the reserve interest rate is determined, creating a potential for investing in inadequate yields – a risk which is not reflected in standard accounting procedures. This same phenomenon also occurs when the insurance liabilities extend beyond 30 years, typically beyond US investable asset maturities.

Therefore, this example and subsequent discussion is intended to highlight several things:

- 1) The *duration* mismatch created by an interest rate shock creates increased risk, whether through reinvestment risk or disintermediation risk.
- 2) Why life insurance companies have developed sophisticated ALM practices to manage *duration* risk to ensure policyowner contractual obligations can be fulfilled.

- 3) Why it is important for the balance sheet to properly reflect these risk mitigation strategies and why not reflecting realizations from these risk management strategies in IMR, including for bond and derivative losses, can work to disincentivize prudent risk management practices, and increase life insurer risk, by requiring their immediate recognition.

Hedging *Duration* Risk and Hedge Accounting

The US statutory framework is fundamentally different than the US GAAP framework. US GAAP tends to focus more on earnings and market valuations, while US Statutory focuses on long-term solvency and utilizes amortized cost. US statutory accounting adopted much of US GAAP's derivative accounting framework, which is not aligned with and does not fully reflect the inherent nature of the life insurance industry and its policyholder liabilities. Therefore, the gap of what is needed from a regulatory accounting context is still significant considering the sophisticated ALM practices life insurance companies employ to manage *duration* risk so that they can fulfil policy contract liabilities.

To illustrate the difference between a company utilizing US GAAP to hedge risk, let's first walk through an example.

In some instances, the hedge accounting rules work well under US GAAP. Let's look at an example of ABC Company which makes widgets for the automotive industry. The widgets are each molded from 8 grams of 100% copper. ABC company's warehouse can only hold one month's supply of copper.

ABC Company recently signed a contract with XYZ Automotive to provide 100 widgets at \$10 each for each of the next 12 months. ABC Company will therefore need to purchase 80 grams of copper on the 1st of each month for the next 12 months at the prevailing spot rate (price). At today's price of \$1 per gram, ABC's expected profit margin is 20% or \$200 per month. However, if the price of copper goes up, the company's resulting profit would be different than expected (the target profit). If the price went up high enough the company might not even be able to fulfil their obligation to XYZ Automotive.

ABC Company's management is aware that the market for copper can be highly volatile, and their risk management committee decided to lock in the price of copper over the next 12 months to hedge against the risk that the price of copper increases and they will be making widgets at a loss. As such, ABC Company entered into forward/future derivative contracts for the 1st of each month for the next 12 months that lock in today's price of copper at \$1 per gram over the next 12 months for their anticipated copper needs.

With these derivative hedging transactions, ABC has guaranteed a 20% profit margin on the contract with XYZ Automotive over the next 12 months. If copper prices double or fall by half, ABC Company's profit margin is not impacted. Any gain (loss) on the derivative contracts is offset by an equal economic loss (gain) on the copper purchase price.

Additionally, because ABC Company does not want to have non-economic and volatile earnings over the course of the next 12 months (i.e., by marking the derivatives to market through income each month), it follows the documentation requirements of US GAAP to prove hedge

effectiveness (i.e., the terms match 100%). Any increase or decrease of the price of copper is offset by their derivative hedges.

While the derivatives are still required to be marked to market under US GAAP, any gain (loss) is recognized in other comprehensive income (OCI), not earnings, until the 1st of each month, which then offsets any economic loss (gain) on the copper purchases since the initial spot rate when the contract with XYZ Automotive was affected.

While the copper widget example is one example of hedge accounting under US GAAP, and by partial extrapolation to US Statutory Accounting, US GAAP only touches on the fringes of dynamic and portfolio hedging strategies. Let's explore some of the differences in the *duration* management insurance companies employ when compared to the copper widget example.

- 1) In life insurance, a change in interest rates can change the *duration* target being hedged. In the copper widget example, a change in copper prices does not change the target (i.e., the copper requirement is determined independently from the price) whereas in life insurance, any change in interest rates can change the risk that needs to be hedged due to the difference in *convexity* of the assets and liabilities. There can be less *duration* to hedge if interest rates rise and more reinvestment risk to hedge if interest rates decline.
- 2) In the copper widget example, it is easy to match the critical terms for each linear transaction, even if 100% of the transactions are not hedged, and prove 100% hedge effectiveness. Hedging programs which manage *duration* risk may relate to significantly large portfolio(s) of assets supporting large portfolio(s) of insurance contract liabilities, and often the same one-to-one relation of the hedging derivative and the hedged item does not exist. Often, the components of each portfolio are not static, occasionally beyond the control of the insurer, and many times they require ongoing balancing and adjustments. Therefore, these hedging programs must be dynamic.
- 3) In the copper widget example, under US GAAP, it may be appropriate to meet the required of 80-125% fair value change assessment requirement to keep the derivative fair value changes from impacting earnings. US GAAP is primarily an earnings-based accounting regime, and there is less focus on solvency. The statutory framework, on the other hand, focuses on solvency and the proper reflection of the balance sheet includes the utilization of IMR. As derivatives can be efficient substitutes for the selling and buying of bonds (which are themselves IMR eligible), dynamic interest rate hedging strategies that mitigate ALM risks in the service of meeting policyholder obligations needs to be a component of the framework.

That focus that assesses effectiveness in the context of life insurance makes more sense in the following examples, which illustrate simplified common life insurer hedging programs and further detail why these programs are vital.

Example: Duration gap risk reduction

Consider a product such as long-term care insurance or life insurance, where a company expects fixed premium payments each year of a given contract, and in return agrees to pay benefits in the future, contingent on realization of underwritten risk, upon which premium payments cease. Most investable assets in the US mature well within 30 years of issuance, while insurance liability benefits can extend significantly beyond that time horizon, which can create reinvestment risk for both coupons and principal payments. The premium dollars and bond coupons in future years will be reinvested at then prevailing yields. This can result in more interest rate (or *duration*) risk in the portfolio backing such a liability than what the insurer can cover with a portfolio of cash bonds alone. This is typically referred to as a *duration* gap between the assets and liabilities. The use of interest rate derivatives can help to hedge or reduce this risk.

For simplicity, in the below example, the book value of assets is set equal to the reserve for a block of liabilities. Assume the company invests in a long *duration* bond portfolio with a *duration* of 12.0 to back liabilities with a *duration* of 20.0. *DV01* is a measure of the mark-to-market sensitivity for a 1 basis point (0.01% or 1 bp) change in interest rates. Using this bond only investment example, there remains an unhedged *DV01* risk of -\$80,000 for every 1 bp move in rates. Ignoring *convexity* impacts, a 1% decline in interest rates could result in losing surplus equal to nearly 8% of the reserves.

However, the insurance company can hedge or reduce its *duration* gap using derivatives. For instance, it could use Treasury bond futures, interest rate swaps, or Treasury bond forwards to synthetically add *duration* to the bond portfolio. In this example, let's assume the company hedges some of the risk and adds \$60,000 of *DV01* sensitivity to the portfolio. If interest rates rise or fall, the total value of the assets will move much more closely to the liabilities, and surplus volatility is significantly reduced. The below chart illustrates the various outcomes of these scenarios.

Unhedged initial position (t=0):										
	(A) Assets SV (Stat BS)	(B) Asset MV	(C) Asset Duration	(D) Asset DV01	(E) Liability SV (Reserves, Stat BS)	(F) Liability MV (Reserves)	(G) Liability Duration	(H) Liability DV01	(I=D-H) Surplus DV01	
Bonds	\$100mm	\$100mm	12.0	\$120,000	\$100mm	\$100mm	20.0	\$200,000	-\$80,000	
Hedged initial position (t=0):										
	(A) Assets SV (Stat BS)	(B) Asset MV	(C) Asset Duration	(D) Asset DV01	(E) Liability SV (Reserves, Stat BS)	(F) Liability MV (Reserves)	(G) Liability Duration	(H) Liability DV01	(I=D-H) Surplus DV01	
Bonds	\$100mm	\$100mm	12.0	\$120,000	\$100mm	\$100mm	20.0	\$200,000		
Hedges	\$0mm	\$0mm	6.0*	\$60,000						
Total	\$100mm	\$100mm	18.0	\$180,000	\$100mm	\$100mm	20.0	\$200,000	-\$20,000	
Note: Example ignores convexity for simplicity. Bond duration is consistent with that of the Bloomberg Agg Long Corporate index as of 10/31/2023. Even if considering only 25 year and longer maturities in this index, the duration would only get to about 14.5 units. * Hedge duration included based on a \$100mm notional for ease of understanding.										

Potential scenarios (t=1) at MV (Economic view):				
		Rates -1%	Rates unch.	Rates +1%
	Bonds	\$112mm	\$100mm	\$88mm
	Hedges	\$6mm	\$0mm	-\$6mm
	Total Assets**	\$118mm	\$100mm	\$82mm
	Reserves	\$120mm	\$100mm	\$80mm
	Surplus Change (No Hedge)	-\$8mm	\$0mm	\$8mm
	Surplus Change (With Hedge)	-\$2mm	\$0mm	\$2mm
Potential scenarios (t=1) at SV (Statutory view):				
		Rates -1%	Rates unch.	Rates +1%
	Bonds	\$100mm	\$100mm	\$100mm
	Hedges	\$6mm	\$0mm	-\$6mm
	Total Assets**	\$106mm	\$100mm	\$94mm
	Reserves	\$100mm	\$100mm	\$100mm
	URCGL (Surplus)	\$6mm	\$0mm	-\$6mm
** For simplicity, hedges are considered part of Assets regardless of gain or loss position.				

In this approach, the company is reducing the mismatches between identified assets and liabilities. There is not a requirement to offset all mismatch risk, just that some of the risk is offset on a net basis. Derivatives for a given strategy would be considered on a net basis in terms of the *duration* metric that is offset.

Example: Pension Risk Transfer (PRT) Repositioning

Consider a PRT transaction where an up-front asset portfolio is received from the client on 1/1 consisting of \$1B of cash and short-term bonds (portfolio asset *duration* = 1, average interest rate = 5%). The liabilities have a *duration* of 10 (average effective interest rate = 4%), so the asset portfolio must be repositioned. The liability *duration* calculation has been simplified for the purposes of this example. It will take ~12 months to reposition the asset portfolio for various reasons (e.g., availability of desired bond issuers, maturities, credit qualities, etc.). For simplicity, the example assumes the initial asset portfolio is sold on day-365 (12/31).

On 1/1 (and throughout the following 12 months), significant bond reinvestment risk exists. For example, if (on 12/31) market interest rates for planned bond purchases drop to 1%, then eventually there will be insufficient assets to pay all policyholder liabilities. However, this risk can be hedged with 12-month forwards; so, when interest rates drop, the derivative increases in value thereby eliminating the yield and *duration* deficit of the assets vs. liabilities (which essentially locks in the positive yield difference of assets vs. liabilities on 1/1). Alternatively, if interest rates rise, the derivatives would generate a loss, but that loss would be offset by the ability to invest in higher yielding assets.

In combination, the bonds and derivatives are intended to earn the yield needed to support the liabilities. Without these transactions, the total yield on assets would not be aligned with the

presumed yield required to meet product obligations over the entire life of the product. See examples below:

Duration View (1% Change)

Unhedged initial position (t=0):										
	(A) Assets SV (Stat BS)	(B) Asset MV	(C) Asset Duration	(D) Asset DV01	(E) Liability SV (Reserves, Stat BS)	(F) Liability MV (Reserves)	(G) Liability Duration	(H) Liability DV01	(I=D-H) Surplus DV01	
Bonds	\$1B	\$1B	1.0	\$100K	\$1B	\$1B	10.0	\$1M	-\$900K	
Hedged initial position (t=0):										
	(A) Assets SV (Stat BS)	(B) Asset MV	(C) Asset Duration	(D) Asset DV01	(E) Liability SV (Reserves, Stat BS)	(F) Liability MV (Reserves)	(G) Liability Duration	(H) Liability DV01	(I=D-H) Surplus DV01	
Bonds	\$1B	\$1B	1.0	\$100K	\$1B	\$1B	10.0	\$1M		
Hedges	\$0	\$0	9.0*	\$900K						
Total	\$1B	\$1B	10.0	\$1M	\$1B	\$1B	10.0	\$1M	\$0	
* Hedge duration included based on a \$1B notional for ease of understanding.										

Potential scenarios (t=1) at MV (Economic view):				
	Rates -1%	Rates unch.	Rates +1%	
Bonds	\$1,010M	\$1B	\$990M	
Hedges	\$90M	\$0	-\$90M	
Total Assets**	\$1,100M	\$1B	\$900M	
Reserves	\$1,100M	\$1B	\$900M	
Surplus Change (No Hedge)	-\$90M	\$0	+\$90M	
Surplus Change (With Hedge)	\$0	\$0	\$0	
Potential scenarios (t=1) at SV (Statutory view):				
	Rates -1%	Rates unch.	Rates +1%	
Bonds	\$1B	\$1B	\$1B	
Hedges	\$90M	\$0M	-\$90M	
Total Assets**	\$1,190M	\$1,100M	\$1,010M	
Reserves	\$1B	\$1B	\$1B	
URCGL (Surplus)	\$90M	\$0M	-\$90M	
** For simplicity, hedges are considered part of Assets regardless of gain or loss position.				

Statutory & Yield View (1% Change)

Company will receive \$1B premium in short-term bonds											
After year 1, Company invests \$1B in longer term bonds to support the liabilities											
Short-term bond yields and to be purchased longer term bonds' current interest rates are 5% (i.e., flat yield curve)											
Liability effective rate (crediting) is 4%											
Company wants to hedge reinvestment risk on future bond purchases to economically lock in 5% yield											
Company enters into 1 year bond forwards											
Company will realize gain/loss at end of t=1 if rates change											
Calculation of derivative G/L has been simplified to make example intuitive											
Rates Unchanged											
	End of Year	<u>1</u>	<u>2</u>	<u>3</u>	<u>4</u>	<u>5</u>	<u>6</u>	<u>7</u>	<u>8</u>	<u>9</u>	<u>10</u>
Bond Yield at t=1 (EOP)	5%	Interest Income	50	50	50	50	50	50	50	50	50
Deriv G/L at t=1 (EOP)	0	IMR Amort (start BOY2)	-	-	-	-	-	-	-	-	-
		Total Income	50	50	50	50	50	50	50	50	50
		Asset Yield	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%
		Crediting	40	40	40	40	40	40	40	40	40
		Liability Yield	4.0%	4.0%	4.0%	4.0%	4.0%	4.0%	4.0%	4.0%	4.0%
		Net Income	10	10	10	10	10	10	10	10	10
		Net Yield	1.0%	1.0%	1.0%	1.0%	1.0%	1.0%	1.0%	1.0%	1.0%
Balance Sheet											
		IMR	-	-	-	-	-	-	-	-	-
		Surplus (Retained earnings)	10	20	30	40	50	60	70	80	90
Rates -1%											
	End of Year	<u>1</u>	<u>2</u>	<u>3</u>	<u>4</u>	<u>5</u>	<u>6</u>	<u>7</u>	<u>8</u>	<u>9</u>	<u>10</u>
Bond Yield at t=1 (EOP)	4%	Interest Income	40	40	40	40	40	40	40	40	40
Deriv G/L at t=1 (EOP)	90	IMR Amort (start BOY2)	10	10	10	10	10	10	10	10	10
		Total Income	50	50	50	50	50	50	50	50	50
		Asset Yield	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%
		Crediting	40	40	40	40	40	40	40	40	40
		Liability Yield	4.0%	4.0%	4.0%	4.0%	4.0%	4.0%	4.0%	4.0%	4.0%
		Net Income	10	10	10	10	10	10	10	10	10
		Net Yield	1.0%	1.0%	1.0%	1.0%	1.0%	1.0%	1.0%	1.0%	1.0%
Balance Sheet											
		IMR	80	70	60	50	40	30	20	10	-
		Surplus (Retained earnings)	10	20	30	40	50	60	70	80	90
Rates +1%											
	End of Year	<u>1</u>	<u>2</u>	<u>3</u>	<u>4</u>	<u>5</u>	<u>6</u>	<u>7</u>	<u>8</u>	<u>9</u>	<u>10</u>
Bond Yield at t=1 (EOP)	6%	Interest Income	60	60	60	60	60	60	60	60	60
Deriv G/L at t=1 (EOP)	(90)	IMR Amort (start BOY2)	(10)	(10)	(10)	(10)	(10)	(10)	(10)	(10)	(10)
		Total Income	50	50	50	50	50	50	50	50	50
		Asset Yield	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%
		Crediting	40	40	40	40	40	40	40	40	40
		Liability Yield	4.0%	4.0%	4.0%	4.0%	4.0%	4.0%	4.0%	4.0%	4.0%
		Net Income	10	10	10	10	10	10	10	10	10
		Net Yield	1.0%	1.0%	1.0%	1.0%	1.0%	1.0%	1.0%	1.0%	1.0%
Balance Sheet											
		IMR	(80)	(70)	(60)	(50)	(40)	(30)	(20)	(10)	-
		Surplus (Retained earnings)	10	20	30	40	50	60	70	80	90

Assume the same situation as above, and Company hedged their reinvestment risk, but was not able to defer any resulting hedge realized gains or losses to the IMR. The resulting statutory statements would appear as follows, giving a distorted view of the Company's financial position and solvency:

Rates Unchanged		End of Year	<u>1</u>	<u>2</u>	<u>3</u>	<u>4</u>	<u>5</u>	<u>6</u>	<u>7</u>	<u>8</u>	<u>9</u>	<u>10</u>
Bond Yield at t=1 (EOP)	5%	Interest Income		50	50	50	50	50	50	50	50	50
Deriv G/L at t=1 (EOP)	0	Realized G/L		-	-	-	-	-	-	-	-	-
		Total Income		50	50	50	50	50	50	50	50	50
		Asset Yield		5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%
		Crediting		40	40	40	40	40	40	40	40	40
		Liability Yield		4.0%	4.0%	4.0%	4.0%	4.0%	4.0%	4.0%	4.0%	4.0%
		Net Income		10	10	10	10	10	10	10	10	10
		Net Yield		1.0%	1.0%	1.0%	1.0%	1.0%	1.0%	1.0%	1.0%	1.0%
Balance Sheet												
		IMR		-	-	-	-	-	-	-	-	-
		Surplus (Retained earnings)		10	20	30	40	50	60	70	80	90
Rates -1%		End of Year	<u>1</u>	<u>2</u>	<u>3</u>	<u>4</u>	<u>5</u>	<u>6</u>	<u>7</u>	<u>8</u>	<u>9</u>	<u>10</u>
Bond Yield at t=1 (EOP)	4%	Interest Income		40	40	40	40	40	40	40	40	40
Deriv G/L at t=1 (EOP)	90	Realized G/L		90	-	-	-	-	-	-	-	-
		Total Income		130	40	40	40	40	40	40	40	40
		Asset Yield		13.0%	4.0%	4.0%	4.0%	4.0%	4.0%	4.0%	4.0%	4.0%
		Crediting		40	40	40	40	40	40	40	40	40
		Liability Yield		4.0%	4.0%	4.0%	4.0%	4.0%	4.0%	4.0%	4.0%	4.0%
		Net Income		90	-	-	-	-	-	-	-	-
		Net Yield		9.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Balance Sheet												
		IMR		-	-	-	-	-	-	-	-	-
		Surplus (Retained earnings)		90	90	90	90	90	90	90	90	90
Rates +1%		End of Year	<u>1</u>	<u>2</u>	<u>3</u>	<u>4</u>	<u>5</u>	<u>6</u>	<u>7</u>	<u>8</u>	<u>9</u>	<u>10</u>
Bond Yield at t=1 (EOP)	6%	Interest Income		60	60	60	60	60	60	60	60	60
Deriv G/L at t=1 (EOP)	(90)	Realized G/L		(90)	-	-	-	-	-	-	-	-
		Total Income		(30)	60	60	60	60	60	60	60	60
		Asset Yield		-3.0%	6.0%	6.0%	6.0%	6.0%	6.0%	6.0%	6.0%	6.0%
		Crediting		40	40	40	40	40	40	40	40	40
		Liability Yield		4.0%	4.0%	4.0%	4.0%	4.0%	4.0%	4.0%	4.0%	4.0%
		Net Income		(70)	20	20	20	20	20	20	20	20
		Net Yield		-7.0%	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%
Balance Sheet												
		IMR		-	-	-	-	-	-	-	-	-
		Surplus (Retained earnings)		(70)	(50)	(30)	(10)	10	30	50	70	90

Now let's assume the same situation, but the Company did not exercise prudent risk management and did not hedge their reinvestment risk. If rates decreased 2%, the resulting statutory statements would appear as follows, and the Company may not be able to meet their policyholder obligations:

Rates -2%		End of Year	1	2	3	4	5	6	7	8	9	10
Bond Yield at t=1 (EOP)	3%	Interest Income		30	30	30	30	30	30	30	30	30
Deriv G/L at t=1 (EOP)	0	Realized G/L		-	-	-	-	-	-	-	-	-
		Total Income		30	30	30	30	30	30	30	30	30
		Asset Yield		3.0%	3.0%	3.0%	3.0%	3.0%	3.0%	3.0%	3.0%	3.0%
		Crediting		40	40	40	40	40	40	40	40	40
		Liability Yield		4.0%	4.0%	4.0%	4.0%	4.0%	4.0%	4.0%	4.0%	4.0%
		Net Income		(10)	(10)	(10)	(10)	(10)	(10)	(10)	(10)	(10)
		Net Yield		-1.0%	-1.0%	-1.0%	-1.0%	-1.0%	-1.0%	-1.0%	-1.0%	-1.0%
Balance Sheet												
		IMR		-	-	-	-	-	-	-	-	-
		Surplus (Retained earnings)		(10)	(20)	(30)	(40)	(50)	(60)	(70)	(80)	(90)

Example: Single Premium Fixed Deferred Annuity (FDA)

Options and swaps are frequently used to hedge potential dis-intermediation and extension risk in insurance products. These examples are focused on the disintermediation risk in Fixed Deferred Annuities (FDA), which have an uncertain timing of potential realization of both derivative side and liability side gains or losses.

We start with a single 7-year single premium FDA product with \$1,000 of initial premium and a surrender charge of 7% in the first 4-years, then grading down to 3% from years 5-7. We issue policy when the 7-year treasury rate is 4.5%, and assume a credit spread of 1%. The fixed crediting rate for the guarantee period is 4.5%.

We invest our cash in a 7-year zero coupon bond to match to maturity of the contract. To manage the embedded option inside the product, we need an out-of-the-money, American exercise, 7-year put option on a 7-year bond (with declining maturity). Because these are not readily available instruments, we instead purchase two payer swaptions: one with a 2-year maturity on 5-year swap, and one with a 5-year options on a 2-year swap to cover majority of the exposure to potential losses due to early surrenders if rates were to spike up. Because of surrender charges, we need protection that is 100-200 basis points out of the money, so we purchase options with a 6% Strike. These options cost \$~14, the remaining \$986 is invested in bonds.

In all the cases below, where we illustrate amortization of the IMR, we conservatively amortize it from the time of realization to contract maturity (year 8 of the projection). Also, for simplicity purposes we did not amortize the upfront cost of the option and excluded taxes and expenses.

We start by looking at what happens in the scenario where interest rates don't move – Table 1. Here the options are expected to mature worthless, and we expect to realize the loss of premium in years 2 and 5.

The point of these simplified examples is to show that timing of realization of derivatives gains and losses (even when utilizing a buy-and-hold investment strategy) varies significantly from bonds and can introduce unintentional accounting volatility if the derivatives are not IMR eligible. This example is abstracted from real life practice, as it focuses on a single issuance cohort to

illustrate how the hedges, assets and liabilities could interact and therefore overstates the ease with which one may identify excess vs expected surrenders and what assets and derivatives are related to particular liabilities (i.e. the examples assume that the surrenders do not meet the excess withdrawal rules as they focus on just a single cohort that is part of a much broader mix of cohorts). We also use a static hedge portfolio for clarity of illustration. However, in reality, an evolving going concern book of business, with a mix of issuance cohorts is managed dynamically using a variety of instruments and strategies, where the realization of the derivatives gains and losses can be even more time-mismatched than this illustration. The purpose of these examples is to illustrate the appropriateness of IMR eligibility for derivatives consistently with bonds. Separately, excess withdrawals can be addressed in the future (e.g., consistently for derivatives and bonds).

The following examples will demonstrate that it is imperative (1) to use derivatives to hedge interest rate risk (which should be a shared goal of regulators and insurers); (2) to treat derivative gains/losses in a manner consistent with gains/losses on bonds; (3) to have accounting policies that do not disincentivize hedging or risk reduction practices by introducing non-economic income and surplus volatility.

Scenario 1. Interest rates stay the same as they were at issue, no excess surrenders.

Projection Year	T=0	1	2	3	4	5	6	7	8
Treasury Rate	4.50%	4.50%	4.50%	4.50%	4.50%	4.50%	4.50%	4.50%	4.50%
Asset Yield	5.50%	5.50%	5.50%	5.50%	5.50%	5.50%	5.50%	5.50%	5.50%
Surrender Value	930	972	1,016	1,061	1,121	1,184	1,250	1,320	1,422
Bond at Fair Value	986	1,041	1,098	1,158	1,222	1,289	1,360	1,435	92
Assets									
1 Bond Book Value	986	1,041	1,098	1,158	1,222	1,289	1,360	1,435	92
2 Market Value of derivative	14	8	4	3	1	-	-	-	-
3 Total Asset Book Value	1,000	1,049	1,102	1,161	1,223	1,289	1,360	1,435	92
Liabilities									
4 Account Value/Reserve	1,000	1,045	1,092	1,141	1,193	1,246	1,302	1,361	0
5 IMR Liability	-	-	(6)	(5)	(4)	(8)	(5)	(3)	-
Surplus	-	4	16	25	35	51	63	77	92
Net Income									
6 Interest Income	-	54	57	60	64	67	71	75	79
7 IMR Amortization (Derivatives)	-	-	(1)	(1)	(1)	(3)	(3)	(3)	(3)
8 IMR Amortization (Bond)	-	-	-	-	-	-	-	-	-
9 Premium (Claim)	1,000	-	-	-	-	-	-	-	(1,422)
10 Change in Liability Reserve	(1,000)	(45)	(47)	(49)	(51)	(54)	(56)	(59)	1,361
11 G/L on Liquidated Bonds	-	-	-	-	-	-	-	-	-
12 Derivative Loss	-	0	(7)	0	0	(6)	0	0	0
13 Net Income (held FV no IMR)	-	9	3	11	12	7	15	16	18
14 Net Income (held FV transfer to IMR)	-	9	9	10	11	11	12	14	15
15 Net Income (held amt cost transfer to IMR)	-	9	9	10	11	11	12	14	15
16 Chg in Surplus (held FV no IMR)	-	4	6	10	11	12	15	16	18
17 Chg in Surplus (held FV transfer to IMR)	-	4	12	9	10	16	12	14	15
18 Chg in Surplus (held amt cost transfer to IMR)	-	9	9	10	11	11	12	14	15
19 Surplus (held FV no IMR)	-	4	10	20	31	43	58	74	92
20 Surplus (held FV transfer to IMR)	-	4	16	25	35	51	63	77	92
21 Surplus (held amt cost transfer to IMR)	-	9	18	29	40	51	63	77	92

We can see in line 13, option losses introduce income volatility in years 2 and 5 and the change in surplus on lines 16-17 show non-economic surplus volatility due to expiry (early years lower surplus) If everything else happens as expected the cost of managing the “unrealized” risk should have been amortized over the life of the product, showing a smoother emergence of surplus in line 18 and consistent with Net Income in line 15. Sections highlighted in yellow illustrate inconsistency of accounting through the balance sheet and income statement from inconsistent treatment of derivatives from the rest of the block of business, which creates confusing views of either income or surplus/solvency. Meanwhile, when derivatives are treated on a consistent basis, as highlighted in green, surplus and income emerge in the same way that is more aligned to the block’s decay of risk, and emergence of profits. We see that divergence go away after year 5, in all the measures once the derivatives are off the books.

Scenario 2. Interest Rates stay as they were at issue, but we have an unexpected \$500 surrender in year 4.

Projection Year	T=0	1	2	3	4	5	6	7	8
Treasury Rate	4.50%	4.50%	4.50%	4.50%	4.50%	4.50%	4.50%	4.50%	4.50%
Asset Yield	5.50%	5.50%	5.50%	5.50%	5.50%	5.50%	5.50%	5.50%	5.50%
Surrender Value	930	972	1,016	1,061	1,121	656	693	731	788
Bond at Fair Value	986	1,041	1,098	1,158	722	762	804	848	107
Assets									
1 Bond Book Value	986	1,041	1,098	1,158	722	762	804	848	107
2 Market Value of derivative	14	8	4	3	1	-	-	-	-
3 Total Asset Book Value	1,000	1,049	1,102	1,161	723	762	804	848	107
Liabilities									
4 Account Value/Reserve	1,000	1,045	1,092	1,141	661	690	721	754	0
5 IMR Liability	-	-	(6)	(5)	(4)	(8)	(5)	(3)	-
Surplus	-	4	16	25	67	79	87	97	107
Net Income									
6 Interest Income	-	54	57	60	64	40	42	44	47
7 IMR Amortization (Derivatives)	-	-	(1)	(1)	(1)	(3)	(3)	(3)	(3)
8 IMR Amortization (Bond)	-	-	-	-	-	-	-	-	-
9 Premium (Claim)	1,000	-	-	-	(500)	-	-	-	(788)
10 Change in Liability Reserve	(1,000)	(45)	(47)	(49)	481	(30)	(31)	(32)	754
11 G/L on Liquidated Bonds		-	-	-	-	-	-	-	-
12 Derivative Loss		0	(7)	0	0	(6)	0	0	0
13 Net Income (held FV no IMR)		9	3	11	44	3	11	12	13
14 Net Income (held FV transfer to IMR)		9	9	10	43	7	8	9	10
15 Net Income (held amt cost transfer to IMR)		9	9	10	43	7	8	9	10
16 Chg in Surplus (held FV no IMR)		4	6	10	43	9	11	12	13
17 Chg in Surplus (held FV transfer to IMR)		4	12	9	42	12	8	9	10
18 Chg in Surplus (held amt cost transfer to IMR)		9	9	10	43	7	8	9	10
19 Surplus (held FV no IMR)		4	10	20	63	71	82	94	107
20 Surplus (held FV transfer to IMR)	-	4	16	25	67	79	87	97	107
21 Surplus (held amt cost transfer to IMR)		9	18	29	72	79	87	97	107

In this scenario there is no gain or loss on the bonds, and the surrender charges create a windfall in year 4. But derivatives, cause unexpected income volatility in years 2 & 5, if not amortized through IMR, as illustrated in net income lines 13 (without IMR). Years 1-5, highlighted in yellow, show uneconomic volatility and divergence between net income (lines 13 & 14) and change in surplus (on lines 16 & 17) due to the inconsistent treatment of the derivatives.

Scenario 3 interest rates jump 300 bps to 7.5% in year 2, but no excess surrenders are seen

Projection Year	T=0	1	2	3	4	5	6	7	8
Treasury Rate	4.50%	4.50%	7.50%	7.50%	7.50%	7.50%	7.50%	7.50%	7.50%
Asset Yield	5.50%	5.50%	8.50%	8.50%	8.50%	8.50%	8.50%	8.50%	8.50%
Surrender Value	930	972	1,016	1,061	1,121	1,184	1,250	1,320	1,463
Bond at Fair Value	986	1,041	1,006	1,092	1,185	1,310	1,421	1,542	210
Assets									
1 Bond Book Value	986	1,041	1,150	1,215	1,283	1,380	1,459	1,542	210
2 Market Value of derivative	14	8	24	24	24	-	-	-	-
3 Total Asset Book Value	1,000	1,049	1,174	1,239	1,308	1,380	1,459	1,542	210
Liabilities									
4 Account Value/Reserve	1,000	1,045	1,092	1,141	1,193	1,246	1,302	1,361	0
5 IMR Liability	-	-	38	32	26	33	22	11	-
Surplus	-	4	43	66	89	101	135	170	210
Net Income									
6 Interest Income	-	54	57	65	68	72	79	83	131
7 IMR Amortization (Derivatives)	-	-	6	6	6	11	11	11	11
8 IMR Amortization (Bond)	-	-	-	-	-	-	-	-	-
9 Premium (Claim)	1,000	-	-	-	-	-	-	-	(1,463)
10 Change in Liability Reserve	(1,000)	(45)	(47)	(49)	(51)	(54)	(56)	(59)	1,361
11 G/L on Liquidated Bonds	-	-	-	-	-	-	-	-	-
12 Derivative Gain	-	0	45	0	0	18	0	0	0
13 Net Income (held FV no IMR)	-	9	55	16	17	37	23	25	29
14 Net Income (held FV transfer to IMR)	-	9	17	22	24	30	33	36	40
15 Net Income (held amt cost transfer to IMR)	-	9	17	22	24	30	33	36	40
16 Chg in Surplus (held FV no IMR)	-	4	78	16	17	19	23	25	29
17 Chg in Surplus (held FV transfer to IMR)	-	4	40	22	24	12	33	36	40
18 Chg in Surplus (held amt cost transfer to IMR)	-	9	17	22	24	30	33	36	40
19 Surplus (held FV no IMR)	-	4	82	98	115	134	157	181	210
20 Surplus (held FV transfer to IMR)	-	4	43	66	89	101	135	170	210
21 Surplus (held amt cost transfer to IMR)	-	9	26	48	71	101	135	170	210

This scenario creates a windfall from derivatives in year 2 & 5 of \$45 and \$18. If there are no surrenders in year 2, this will create an unrealistic surplus bump in year 2, which may be consumed by a surrender in any of the following years, and hence should not be released into income or surplus at that time, similar holds for the value of the option that matures in year 5.

However, Lines 15 and 18 (highlighted in green) above show significantly smoother NII and Surplus when derivative gains are treated consistently with other fixed income and transferred to the IMR. Also, when derivatives are treated consistently with the rest of the assets and liabilities, there is no disconnect between income and surplus.

Scenario 4 – interest rates go up 300 bps and we see a 500 M surrender in year 4.

Projection Year	T=0	1	2	3	4	5	6	7	8
Treasury Rate	4.50%	4.50%	7.50%	7.50%	7.50%	7.50%	7.50%	7.50%	7.50%
Asset Yield	5.50%	5.50%	8.50%	8.50%	8.50%	8.50%	8.50%	8.50%	8.50%
Surrender Value	930	972	1,016	1,061	1,121	656	693	731	810
Bond at Fair Value	986	1,041	1,006	1,092	685	767	833	903	170
Assets									
1 Bond Book Value	986	1,041	1,150	1,215	739	806	853	903	170
2 Market Value of derivative	14	8	24	24	24		-	-	-
3 Total Asset Book Value	1,000	1,049	1,174	1,239	764	806	853	903	170
Liabilities									
4 Account Value/Reserve	1,000	1,045	1,092	1,141	661	690	721	754	0
5 IMR Liability	-		38	32	(10)	6	4	2	-
Surplus									
	-	4	43	66	113	110	128	147	170
Net Income									
6 Interest Income	-	54	57	65	68	42	47	50	77
7 IMR Amortization (Derivative)	-	-	6	6	6	11	11	11	11
8 IMR Amortization (Bond)	-	-	-	-	(9)	(9)	(9)	(9)	(9)
9 Premium (Claim)	1,000	-	-	-	(500)	-	-	-	(810)
10 Change in Liability Reserve	(1,000)	(45)	(47)	(49)	481	(30)	(31)	(32)	754
11 G/L on Liquidated Bonds	-	-	-	-	(43.88)	-	-	-	-
12 Derivative Gain	-	0	45	0	0	18	0	0	0
13 Net Income (held FV no IMR)	-	9	55	16	40	22	7	9	11
14 Net Income (held FV transfer to IMR)	-	9	17	22	47	15	18	20	22
15 Net Income (held amt cost transfer to IMR)	-	9	17	22	47	15	18	20	22
16 Chg in Surplus (held FV no IMR)	-	4	78	16	40	4	7	9	11
17 Chg in Surplus (held FV transfer to IMR)	-	4	40	22	47	(3)	18	20	22
18 Chg in Surplus (held amt cost transfer to IMR)	-	9	17	22	47	15	18	20	22
19 Surplus (held FV no IMR)	-	4	82	98	138	142	150	158	170
20 Surplus (held FV transfer to IMR)	-	4	43	66	113	110	128	147	170
21 Surplus (held amt cost transfer to IMR)	-	9	26	48	95	110	128	147	170

In this case, in year 1, we see the same surplus drag from the decay of market value as in the prior scenarios. We see the payout of the first option in year 2, before the surrender in year 4, creating outsized income and surplus in year 2 in lines 13, 16 & 17. If options are not included in IMR (line 16) there is a windfall in surplus in year 2 and there is a big drop in surplus in year 5. Treating derivatives consistently with assets and liabilities creates a much more reasonable profile of surplus and income, consistent with timing of the realization of the risk.

Scenario 5 - In Scenario 5 rate environment same as Scenario 4 but surrenders happen gradually starting in years 2 through 6.

Projection Year	T=0	1	2	3	4	5	6	7	8
Treasury Rate	4.50%	4.50%	7.50%	7.50%	7.50%	7.50%	7.50%	7.50%	7.50%
Asset Yield	5.50%	5.50%	8.50%	8.50%	8.50%	8.50%	8.50%	8.50%	8.50%
Surrender Value	930	972	1,016	852	689	516	334	247	274
Bond at Fair Value	986	1,041	806	675	532	402	336	365	122
Assets									
1 Bond Book Value	986	1,041	920	748	573	420	343	365	122
2 Market Value of derivative	14	8	24	24	24		-	-	-
3 Total Asset Book Value	1,000	1,049	944	772	598	420	343	365	122
Liabilities									
4 Account Value/Reserve	1,000	1,045	877	701	520	333	244	255	0
5 IMR Liability		-	13	(9)	(21)	(11)	(9)	(5)	-
Surplus									
	-	4	54	80	99	98	108	114	122
Net Income									
6 Interest Income		54	57	52	43	33	26	22	31
7 IMR Amortization (Derivative)		-	6	6	6	11	11	11	11
8 IMR Amortization (Bond)		-	(4)	(8)	(12)	(15)	(16)	(16)	(16)
9 Premium (Claim)	1,000	-	(200)	(200)	(200)	(200)	(100)	-	(274)
10 Change in Liability Reserve	(1,000)	(45)	168	176	181	187	89	(11)	255
11 G/L on Liquidated Bonds		-	(30.10)	(23.74)	(17.55)	(11.54)	(2.84)	-	-
12 Derivative Gain		0	45	0	0	18	0	0	0
13 Net Income (held FV no IMR)		9	66	19	12	24	(1)	(5)	(4)
14 Net Income (held FV transfer to IMR)		9	27	26	19	17	10	6	7
15 Net Income (held amt cost transfer to IMR)		9	27	26	19	17	10	6	7
16 Chg in Surplus (held FV no IMR)		4	89	20	12	6	(1)	(5)	(4)
17 Chg in Surplus (held FV transfer to IMR)		4	51	26	19	(1)	10	6	7
18 Chg in Surplus (held amt cost transfer to IMR)		9	27	26	19	17	10	6	7
19 Surplus (held FV no IMR)		4	93	112	125	131	130	125	122
20 Surplus (held FV transfer to IMR)	-	4	54	80	99	98	108	114	122
21 Surplus (held amt cost transfer to IMR)		9	37	62	81	98	108	114	122

Here, with different emergence of losses on bonds and gains on the derivatives the surplus and income are much more volatile without the symmetrical reflection of derivatives gains and losses in IMR. Even though surrenders start to happen in year 2, when we see the first gain on the derivatives, there is still an overwhelming windfall from the derivatives because of how it is sized compared to the surrender. Lines 15 & 18, show a much more reasonable profile of net income and surplus emergence than holding at fair value without IMR treatment as shown on lines 13 & 16.

Conclusion

In summary, the needs of US life insurers within the context of the US statutory accounting framework are broader than contemplated in the existing derivative and hedge accounting framework. The risks faced are often not fully visible within the financial statements, and therefore require additional risk management practices. The US GAAP hedge accounting framework does not adequately address these specific needs (i.e., *duration*, as it is not a true “balance sheet item”).

Insurers use derivatives to achieve the same results as buying and selling fixed income investments. Very often however, buying and selling fixed income investments would be inefficient, or the necessary investments do not exist. As fixed income investments are IMR eligible, and interest rate derivatives can be a substitute for them, removing IMR eligibility for their realized gains and losses would misalign the necessary economic picture insurers need to prudently enact their risk or ALM practices.

In order to avoid unintended disincentives against prudent behavior, all economically effective interest rate hedging derivatives should remain IMR eligible. Further, the hedge accounting effectiveness assessment requirements, at a minimum, should be revisited in relation to these hedging strategies so that impacts to surplus are appropriately recognized both during the derivatives' life and at termination.

Appendix I – IMR in the context of Derivative Hedging Transactions

The applicability of the IMR construct to gains or losses from derivative hedging transactions flows from the concepts outlined in the earlier text. To illustrate its importance within plausible ALM strategies, the example outlined here assumes a more complex and realistic set of insurance liabilities.

Example 3

Assume Company XYZ issues life insurance contracts where the premiums come in each year until death and there is a payment upon death estimated to occur at the end of 5 years. Assume Company XYZ is again starting out with \$10 of surplus invested in equity securities (again, assume no change in value over the period of valuation). The current interest rate environment is such that the fixed income bond yield and the insurance liability valuation rate are again both 4%, and Company XYZ:

- Sells 100 insurance contracts that pay \$1 upon death for yearly premiums of 18.47 cents at the end of each year 1 through 5.
- Purchases bonds with a coupon rate of 4%, with all premiums and coupons received, maturing at the anticipated time of death in 5 years.
- Assume the market yield of 4% is constant throughout the 5-year period.

Company XYZ's balance sheet for each year, using a simplified net premium calculation for reserves, would look like Figure H.

Figure H						
	Assets			Liabilities and Surplus		
Year	Bonds	Equities	Total	Insurance Liability	Surplus	Total
1	18.47	10.00	28.47	18.47	10.00	28.47
2	37.67	10.00	47.67	37.67	10.00	47.67
3	57.64	10.00	67.64	57.64	10.00	67.64
4	78.40	10.00	88.40	78.40	10.00	88.40
5	100.00	10.00	110.00	100.00	10.00	110.00

Company XYZ can pay all claims on the policy and the balance sheet surplus appropriately reflects surplus at the end of each reporting period. In the real world with this more dynamic pool of liabilities, other changes could occur, such as one or multiple of:

- Interest rates could decline, and coupon and premium payments would not be able to be invested at 4%.
- Death benefits could be paid at a point in time greater than the invested bond maturity and if interest rates decline, the bond would not be able to be re-invested at 4%.
- Policy surrenders could occur, including due to changes in market interest rates, causing the claims patterns to change from expectations.

Amidst this real-world uncertainty, Company XYZ could consider any of the following risk mitigating activities, which inherently depend upon its mix of insurance liabilities:

- Accept the risk of future asset and liability cash flow fluctuations, which could result in an inability pay claims in certain situations. For instance, if interest rates declined, the coupon payments, premium payments, and/or maturities would not be able to be re-invested in fixed income investments that have sufficient yield to pay claims as expected.
- Charge higher premiums at inception to account for the reinvestment risk and *duration* risk associated with the insurance liabilities.

- Manage the investment portfolio to a prudent liability *duration* or any number of appropriate and prudent asset liability management (ALM) strategies.
- Prudently hedge with derivatives within the ALM strategy. Such derivative usage strategies are used where purchases are not viable or where it is more efficient to utilize derivatives.

If the derivative strategy is applied, the reinvestment risk could be hedged to lock in a 4% yield. When interest rates fluctuate, any gain or loss on the derivative offsets the lower or higher actual yield that is received on the reinvestments.

In Example 3, if interest rates plunged to 0% on day 2, Company XYZ would not be able to support the liabilities because future premiums and coupons would not be able to be reinvested at 4%. If Company XYZ had hedged reinvestment risk, they would have a gain on derivatives equal to the economic loss of not being able to invest at 4%. Similarly, if interest rates doubled to 8%, Company XYZ would have a loss on derivatives equal to the economic gain of now being able to invest at the much higher interest rate of 8%. In both cases, Company XYZ has hedged reinvestment risk and has not changed the solvency picture in Example 3.

In summary, IMR is appropriate for all types of fixed income investments, including derivatives which alter the interest rate characteristics of assets/liabilities, for all realized capital gains and losses which result from changes in the overall level of interest rates as they occur.

Appendix II – Glossary

These terms are commonly used in these strategies and/or included in the document, therefore are defined here for common understanding.

- “Duration” is a measure of interest rate sensitivity related to the sensitivity of the market value of an instrument for a given change in interest rates, when the entire curve is shifted. This may be based on MacAuley, modified, or effective duration metrics. Shocks may be based on par curve, spot curve, or other similar methods.

$$Duration = \frac{PV_{CF}(Starting\ Yield\ Curve - 1bp) - PV_{CF}(Starting\ Yield\ Curve)}{PV_{CF}(Starting\ Yield\ Curve) * 0.0001} = \frac{DV01}{PV_{CF}(Starting\ Yield\ Curve) * 0.0001}$$

- “Convexity” is measure of the curvature of how price changes with respect to interest rates. Alternatively, it is the change in duration for changes in interest rates.

$$Convexity = DV01(Starting\ Yield\ Curve - 1bp) - DV01(Starting\ Yield\ Curve)$$

- “Duration dollars” is a measure of interest rate sensitivity when the entire curve is shifted, and is the duration times the market value of an instrument.
- “DV01” is a measure of interest rate sensitivity of how much the market value of an instrument changes, in dollars or other currency, for a 1 bps move in rates when the entire curve is shifted. It may be calculated off of a larger shock and scaled to a 1 bp size.

Dollar

$$DV01 = PV_{CF}(Starting\ Yield\ Curve - 1bp) - PV_{CF}(Starting\ Yield\ Curve)$$

Value 1 Basis Point

- “Key rate duration (KRD)” is similar to duration but represents the impact when a shock is applied to a specific bucket or set of maturities along the curve. The buckets to be used are not prescribed and can be determined by a given firm. The sum of all key rate exposures is very close to the overall duration
- “Key rate duration dollars” is similar to duration dollar but represents the impact when a shock is applied to a specific bucket or set of maturities along the curve. The buckets to be used are not prescribed and can be determined by a given firm.
- “Key rate DV01” is similar to DV01 but represents the impact when a shock is applied to a specific bucket or set of maturities along the curve. The buckets to be used are not prescribed and can be determined by a given firm.

Appendix II

Special Accounting Provision Proposal for Asset Liability Management (ALM) Derivatives

The “Derivatives and Hedging Under Life Insurance and the NAIC’s Statutory Framework” memo concluded:

- In summary, the needs of US life insurers within the context of the US statutory accounting (US Stat) framework are broader than contemplated in the existing derivative and hedge accounting framework. The risks faced are often not fully visible within the financial statements, and therefore require additional risk management practices. The US GAAP hedge accounting framework does not adequately address these specific needs (i.e., ALM exposures, like duration, as they are not true “balance sheet items,” but instead contribute to the volatility of other balance sheet items as financial markets move).
- Insurers use derivatives to achieve the same results as buying and selling fixed income investments. Very often however, buying and selling fixed income investments is inefficient or the necessary investments do not exist or are illiquid. As fixed income investments are IMR eligible, and interest rate derivatives can be a substitute for them, removing IMR eligibility for their realized gains and losses would misalign the appropriate economic portrayal of insurer solvency and be contrary to the goal of prudently enacting their risk management and ALM practices.
- To avoid unintended disincentives against prudent behavior, all derivative instruments that are economically effective in hedging interest rate risks should remain IMR eligible. Further, the accounting should be revisited in relation to these hedging strategies so that impacts to surplus are appropriately recognized both during the derivatives’ life and at termination.

This document expands on the above conclusion that derivatives used in interest rate hedging should remain IMR eligible and proposes updates to accounting for derivative IMR that reflect the economics of hedging activities while still presenting financial statements that appropriately reflect financial condition.

Current State

In 2023, the NAIC adopted interim guidance that allows for the admission of negative IMR up to 10% of surplus (excluding DTA, goodwill, etc.), which may include negative IMR generated by interest related realized gains and losses on fair value derivatives (as long as positive IMR generated by derivatives was previously admitted by the insurance company).

Current guidance highlights (including the interim IMR guidance):

- Per IMR instructions (2023 NAIC Annual Statement Instructions for LAH companies, pages 343-357), it is appropriate to include hedges in IMR:
 - For derivative instruments used in hedging transactions, the determination of whether the capital gains/(losses) are allocable to the IMR or the AVR is based on how the underlying asset is treated

- Realized gains/(losses), on derivative transactions entered into solely for the purpose of altering the interest rate characteristics of the company's assets and/or liabilities (hedging transactions) should be allocated to the IMR and amortized over the life of the hedged assets
- Note: "hedging transactions" are defined as derivative transactions which reduce the risk of a change in fair value or cash flow of assets and liabilities (SSAP 86, paragraph 8) and not whether the derivative is deemed "qualified" under US STAT for hedge accounting treatment
- While industry practice varies, many companies amortize gains and losses generated by certain derivatives hedging interest rates through IMR over the average maturity of the invested assets in the hedged portfolio
- Derivatives that qualify for hedge accounting treatment are reported using the same valuation method as the hedged asset (i.e., a derivative hedging bonds will be held at amortized cost)
- Statutory accounting guidance does not allow for a hedge accounting model specific to or sufficient for ALM hedges
 - Therefore, to achieve hedge accounting, interest rate derivatives must be linked to specific assets or liabilities and prove to be highly effective at offsetting their changes in cash flows or fair value from interest rate movements.
 - As noted in previously referenced memos, many of these hedging programs are calibrated on a portfolio basis and the existing hedge accounting frameworks do not address this type of hedging construct (i.e., focused on more of a fixed "1x1" relationship construct, as opposed to a dynamic portfolio of assets and liabilities).
 - As a result, many insurance companies with ALM and portfolio duration hedging programs mark their derivatives to market through surplus (unrealized gains/losses) and reclass realized gains/losses to IMR at termination/maturity.
 - This causes surplus volatility that does not reflect the economics of the hedging transactions (which ironically are intended to mitigate surplus volatility; see examples in the previously referenced memo)

More specifically, three items have been proposed for review given perceived shortfalls in current statutory accounting related to derivative accounting and IMR:

- 1) Effectiveness assessment methods for ALM hedging,
- 2) Accounting for hedges entered into and maintained in a manner consistent with the definition of IMR without causing inappropriate surplus volatility, and
- 3) Guidelines for the amortization of derivatives gains or losses that have been deferred to IMR.

Background

Current derivative accounting under SSAP No. 86 includes four categories of derivatives, none of which include speculative derivatives (which are disallowed under state insurance laws):

1) *Income Generation Transactions*

Income generation transactions are defined as derivatives written or sold to generate additional income or return to the reporting entity. They include covered options, caps, and floors (e.g., a reporting entity writes an equity call option on stock that it already owns).

Noting derivatives cannot be speculative, per SSAP 86, paragraphs 47 and 48, as well as state derivatives laws, income generation transactions are limited to “covered” transactions.

Derivative gains and losses are based on how the underlying interest (for a put) or covering asset (for a call, cap or floor) is treated. Therefore, if the underlying/covering asset is IMR eligible (e.g., a bond), the derivative gains and losses go to IMR. If it is not IMR eligible (e.g., equity), the derivative gains or losses do not go to IMR.

2) *Replication (Synthetic Asset) Transactions (RSATs)*

RSATs are entered into in conjunction with other investments to reproduce the investment characteristics of otherwise permissible investments. Hedging or income generation transactions shall not be considered an RSAT. Derivative gains and losses follow those of the replicated investment. If it is IMR eligible, the derivative gains and losses go to IMR. If it is not IMR eligible, the derivative gains or losses do not go to IMR.

3) *Other Derivatives (Derivatives that are not used in hedging, income generation, or replication transactions)*

Other derivatives are non-admitted under statutory accounting, examples include structured notes or private warrants. Given that state insurance law does not allow companies to engage in speculation using derivative instruments, any derivatives included in this category must still comply with state insurance law, which defines them as derivatives not used for hedging, income generation, or replication. Therefore, by default, they must be one of the aforementioned examples or a similar such instrument.

4) *Hedging Transactions*

Hedging transactions are defined as derivatives which reduce the risk of a change in fair value or cash flow of assets and liabilities. As mentioned previously, all hedges must be legally effective to comply with state insurance laws, and companies are not allowed to speculate using derivatives. There is no additional or prescriptive effectiveness assessment requirement within SSAP No. 86, unless companies elect hedge accounting under SSAP No. 86 or 108 (see additional detail below).

The US Stat framework for hedging transactions is largely aligned with US GAAP accounting, with a few variations due to the broader valuation standards within the accounting frameworks (ie., amortized cost

versus fair value). Hedging transactions that do not attain hedge accounting are carried at market value with unrealized gains and losses in surplus (under US Stat). This is aligned with US GAAP, except that US GAAP allows reporting of unrealized gains/losses within the P&L. US Stat does not use these concepts. Hereafter the “default” hedging transactions that are not designated as Hedge Accounting under SSAP No. 86 or 108 will be referred to as “Other Economic Hedges”.

The concept of “Hedge Accounting” (hereafter referred to as “HA Hedges”), a specific subset of hedging derivatives meeting prescriptive requirements, exists in both US Stat (SSAP No. 86 and 108) and US GAAP frameworks (and is also consistent with other accounting frameworks). Under US Stat, hedges for which the entity both elects the treatment and which “meet the criteria of a highly effective hedge shall be considered an effective hedge and are permitted to be valued and reported in a manner that is consistent with the hedged asset or liability.” Under US GAAP accounting, the derivative is carried at fair value regardless of its characterization as a HA Hedge. However, US GAAP HA Hedges receive a geography match, by which the derivative accounting appears in the same financial statement line as the hedged item. Additionally, under US GAAP, the balance sheet is largely carried at fair value for certain investments, so prudent hedging strategies can more easily achieve their purpose of both financial statement and economic risk and volatility mitigation even without hedge accounting treatment.

Under US Stat, any derivative in a HA Hedge relationship is permitted to be valued and reported in a manner that is consistent with the hedged asset or liability (there is nuance between SSAP No 86 and 108, but these are both effectively amortized cost when considering the direct accounting impact of the derivative(s) within surplus). As discussed in previous papers, this typically leads to amortized cost accounting (or a form of amortized cost accounting) for interest rate related hedges of assets and liabilities. However, if the derivative cannot achieve, or if the entity does not elect, hedge accounting there is an accounting mismatch between the hedging instrument (derivative at fair value) and the hedged item (asset or liability, often at amortized cost). This means the same prudent transaction would generally reduce volatility under US GAAP (as both are generally mark-to-market, albeit not within the same financial statement line), may actually introduce volatility under US Stat (as the hedged item is typically amortized cost and the derivative is mark-to-market).

While there is some nuance between SSAP 86 and SSAP 108, specifically within the hedge documentation requirements and actual accounting methodology, both could be considered a form of an amortized cost methodology. As a very high-level summary, one method could be thought of as “off Balance Sheet” amortized cost (SSAP No 86) and one method could be thought of as “grossed up Balance Sheet” amortized cost (SSAP No 108). However, both methods ensure that the matched derivative mark-to-market volatility (which is unrealized) is not reflected in surplus.

Many companies treat interest related gains and losses from both Other Economic Hedges and HA Hedges as IMR eligible due to the historical documentation of IMR which noted that:

Realized gains and losses on derivatives investments, which alter the interest rate characteristics of assets/liabilities, also are allocated to the IMR and are to be amortized into income over the life of the associated assets/liabilities.

Additionally, for HA Hedges of bonds under SSAP No 86, if the derivative is terminated when the bond is sold, gains and losses on the derivative follow and are aligned with the treatment of the bond’s gains and

losses. If only the derivative is terminated, the derivative gain/loss can either adjust the basis of the bond or be deferred to the IMR. This is consistent with the interpretation from the IMR instructions, which state:

For derivative instruments used in hedging transactions, the determination of whether the capital gains (losses) are allocable to the IMR or the AVR is based on how the underlying asset is treated. Realized gains (losses) on portfolio or general hedging instruments should be included with the hedged asset. Gains (losses) on hedges used, as specific hedges should be included only if the specific hedged asset is sold or disposed of.

As stated, insurance companies are often subject to Derivatives Use Plans (many with annual Agreed Upon Procedures by audit firms) filed with regulators. Any Income Generation, RSAT, and Hedging derivatives should not be considered Other Derivatives (and therefore non-admitted) as this would misstate solvency and disincentivize prudent risk management of insurers.

Given the wide variety of prudent hedging strategies required and employed by life insurers, the framework for assessing their effectiveness must be sufficiently flexible, while providing meaningful information to regulators as to their effectiveness. Therefore, it may be best to use the economic hedging framework within SSAP No. 108 for variable annuities where the embedded derivatives on VAs are not marked-to-market, while derivatives hedging the VA risk are. A proposal for requirements to qualify for a special accounting provision for ALM derivatives which effectively hedge interest rate risk is included below.

This proposal should be a company election on an individual program basis. Any Hedging derivatives utilized by the company which either do not meet the provision's criteria or those for which the company does not elect the provision (akin to the election and qualification process for Hedge Accounting under SSAP No. 86 and the special accounting provision under SSAP No. 108), would be considered as Other Economic Hedges under SSAP No. 86 (carried at fair value and gains/losses would not be IMR eligible).

ALM Hedging Derivatives Proposal

Due to uneconomic volatility caused by economical and precise hedges, as well as to prevent concerns related to the transformation of negative surplus to assets, we propose the following solution. This special accounting provision is intended for derivative transactions that alter the interest rate characteristics of assets/liabilities under risk mitigation programs. More specifically, "macro-hedging" ALM programs (which hedge risks that are often not true balance sheet items) and therefore hedge accounting frameworks do not address this type of hedging construct. This is because the duration and convexity of asset and liability may differ and when interest rates change, asset and liability duration may change by different amounts. Companies manage ALM programs to mitigate reinvestment, guarantee, and disintermediation risks, and to manage asset portfolios within limited ranges around a liability target duration. For these derivative transactions to be IMR eligible, they need to hedge assets/liabilities within the context of the definition and purpose of IMR; that is, to provide consistency between asset and liability measurement so solvency is accurately reflected.

If this proposal becomes effective, any existing programs with active derivatives could be redesignated (at the proposal implementation/effective date) to the solution proposed herein so as not to cause unintended consequences or disqualify existing programs. ACLI would work with NAIC Staff to determine appropriate accounting for the transition date.

Definition and Purpose of IMR

IMR is a valuation adjustment to maintain consistency between insurance liabilities (the assumptions for which are often unchanged from origin) and the assets needed to support them (where the assumptions can essentially be revisited any time there are fixed income realizations).

IMR defers and amortizes the recognition of non-economic gains or losses where investment activity, whether through fixed income investment sales or fixed income derivative hedging transactions, essentially unlock unrealized gains/losses for either assets or liabilities. IMR is not intended to defer economic gains and losses related to asset sales compelled by liquidity pressures that fund significant cash outflows (e.g., such as excess withdrawals and collateral calls).

Specifically, the IMR valuation adjustment more appropriately reflects the impact to statutory surplus from fluctuations in interest rates and therefore provides a more accurate representation of solvency under the NAIC's statutory framework which often includes amortized cost valuation of fixed income investments and liability valuations with fixed assumptions in accordance with the Accounting Practices and Procedures and Valuation Manual.

Program Parameters and Documentation

The entity must document and follow a Clearly Defined Hedging Strategy (CDHS) for each ALM hedging program, which, at a minimum, must identify:

- A. Specific risks being hedged,
- B. Hedge objectives,
- C. Risks not being hedged,
- D. Financial instruments that will be used to hedge the risks (incorporating all potential instruments),
- E. Hedge trading rules, including permitted tolerance from hedging objectives,
- F. Metric(s) used for measuring hedge 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.

The ALM hedging program may be based at a legal entity, product, segment, portfolio, investment strategy, or similar level. Any assessment should be completed at the overall ALM hedging program level and must include all hedged items (assets and/or liabilities) and hedging instruments (derivatives) within each program (aligned with the specifications within the program's CDHS). Specifically, the company should specify in advance the criteria that are being used to test for effectiveness. For example, companies could focus on duration, duration dollars, DV01, key rate durations, key rate duration dollars, and key rate DV01s, among other measures, for this approach (the latter referred to as "Allowed Metric"). At a minimum, one metric needs to be identified. Alternatively, a company may focus on a modeled downside risk measure over a range of interest rate scenarios to show a reduction in risk, such as n-th percentile or conditional tail expectation on the present value of ending surplus (PVES) or similar metric (referred to as "Allowed Modeled Metric.")

The portfolio of derivative positions meeting the quantitative assessment requirements would be eligible for the proposed special accounting provision.

Documentation required at inception

The Company must document the calculation and measured values for their records in support of initial qualification of the hedging activity/program. There should be a clear determination, in advance of the inception of the program or the trade (if one-off), that the intent of that program/position is to manage the risks noted below. This could include, but is not limited to, identifying a portfolio or other tagging approach to which all derivatives assigned to it would be included. Trades must be designated as included within the ALM hedging program at their inception (except any noted at the time of the transition, which will be identified at transition). Such documentation should be available for review by the firm's external auditor or domiciliary regulator.

Documentation required at each reporting period

Quantitative effectiveness assessment must occur and be documented at the beginning and end of each reporting period (at a minimum, at least every three months). All derivatives within the designated ALM program must be effective at both measurements to qualify for this special accounting provision. The selected effectiveness assessment and allowed metrics must be specified in the inception documentation (CDHS), see additional details in the "Effectiveness Assessment" section.

Effectiveness Assessment

The designated portfolio of assets, liabilities, and derivatives comprising a CDHS within this special accounting provision require a quantitative assessment at the beginning and end of each reporting period (at a minimum, at least every three months). Metric and assessment level (legal entity, etc.) should be consistent with prior periods and how the hedges are calibrated. Changes should be supported by changes in business conditions and hedging strategies and should be infrequent (e.g., not every quarter), with any changes documented in the CDHS (including the effective date of the change and the rationale details for the change). Given that exposure amounts can change day-over-day due to new sales, surrenders, interest rate moves, etc., it is acceptable for a quantitative assessment to reference metrics that are within three months of the assessment.

ALM Hedging Programs under this proposal will follow the guidance in SSAP No. 86, paragraph 23 and 40, as well as Exhibit A, regarding the effectiveness of the derivatives and any excluded components. The inception documentation (CDHS) and any assessment will clearly indicate which component(s) are excluded (e.g., foreign currency rates).

Definitions:

- L – the portfolio of liabilities hedged
- A – the portfolio of assets backing liabilities L (excluding derivatives)
- D – the portfolio of derivatives that is hedging the residual ALM exposure of assets and liabilities.
- M(x) – the Allowed Metric for L, A, D, or any linear combination of the three

Example Assessment Metrics:

1. “ALM Risk Reduction Approach”

- In this approach, the company is reducing the mismatches between identified assets and liabilities. The requirement is that the trades that are part of the designated program reduce the risk that would exist without the program. There is not a requirement to offset the entire mismatch. Derivatives for a given strategy or program would be considered on an aggregate basis in terms of the duration metric that is being hedged. The interest rate risk exposure for the chosen metrics for derivatives are measured consistently with the same metrics for the Hedged Item.
- The requirement would be that trades in D are such that Portfolio D under the designated program would reduce the risk in the portfolio of A & L that would exist without the program such that under above definitions: $|M(A)-M(L)| \geq |M(A+D)-M(L)|$, where $|X|$ = Absolute Value of X.
- Alternatively, a company may rely on actuarial modeling over a range of interest rate scenarios to show a reduction in an Allowed Modeled Metric. The requirement would be that the Allowed Modeled Metric is improved when performing the modeling on A+D (assets including the hedging derivatives), compared to only modeling with A (assets excluding the hedging derivatives).

2. “ALM Limit Management Approach”

- In this approach, the company is using derivatives to help keep an asset portfolio aligned with a duration or key rate duration target or threshold, backing a liability need. Using interest rate derivatives can be akin to buying/selling bonds, can be a more efficient way to keep the portfolio aligned with target durations, while also providing for investment flexibility.
- The liability target or threshold should be determined to align with the interest rate-related objectives for that given liability and/or the Specified Portfolio backing some or all of the assets of that liability. This target or threshold should be communicated based on an Allowed Metric. It is acceptable for the target or threshold to be represented in a number of ways, such as: a specific point metric, a calculation, a formula, a market-based investment index (like the Bloomberg US Aggregate bond index), or a customized version of a market-based investment index.
- Portfolio D under the designated program must comply with the following definition of staying within a limit P: $|M(A+D)-M(L)| < P$.
- The limit P can be specified as a certain percentage of either M(A) or M(L), or just as an absolute number defined and governed by the company’s Risk or Asset Liability Management Committee (or similar oversight Committee function).

Accounting

ACLI proposes three different possible accounting methods for derivatives which qualify under effective ALM hedging programs. Two approaches are modeled from existing derivative accounting guidance, and one approach is new. The following table illustrates the methodologies, with example journal entries to further illustrate and compare the potential accounting methods.

Note Method 3 is intended to incorporate the “total” derivative (both changes in FV and interest accruals) to treat all derivative instruments equally. Methods 1 and 2 do not incorporate changes in interest accruals within the unrealized gains/losses discussed below.

	Amortized Cost (Method 1)	Defer Unrealized (Method 2)	Mark and Spread (Method 3)
Precedent Guidance	Yes – same as SSAP No. 86 (qualified accounting hedges)	Yes – similar to SSAP No. 108	No – New method
Description	Derivatives carried at amortized cost (following the accounting treatment of the hedged items).	Derivatives carried at fair value, but any unrealized gains/losses are deferred to a different Balance Sheet account as opposed to recognized in surplus.	Derivatives carried at fair value, but any unrealized gains/losses are deferred to a different Balance Sheet account, as opposed to recognized in surplus, with amortization beginning immediately.
Derivative Basis (Carry Value)	Amortized Cost	Fair Value	Fair Value
Unrealized Gain/Loss Treatment	Not recognized until termination	Deferral Account until termination	Deferral Account with amortization through income beginning immediately
Realized Gain/Loss Treatment	Deferred to and amortized through the IMR	Deferred to and amortized through the IMR	Deferred to and amortized through the Deferral Account (same treatment as IMR)

The following table highlights differences between the methodologies:

	Amortized Cost (Method 1)	Defer Unrealized (Method 2)	Mark and Spread (Method 3)
Better Economic and Accounting Alignment?	Yes	Yes	Yes
Discretionary surplus changes (realized losses reclass from surplus to asset)	Virtually all eliminated (potential discretion on timing of realization, but no surplus impact)	Virtually all eliminated (potential discretion on timing of realization, but no surplus impact)	All eliminated (all derivatives treated as terminated each reporting period end)
Derivative Fair Value on Balance Sheet?	No	Yes	Yes
Derivative Unrealized (MTM) in Surplus?	No	No	No (current period amortization only)
Do Derivative and Hedged Portfolio accounting align?	Yes	Somewhat (Unrealized not reflected in surplus, net carry value approximates amortized cost)	Somewhat (Amortization is aligned)

The following simplified journal entries highlight each of the above methods:

Method 1 <i>Amortized Cost (URGL/RGL recognized only at termination, then amortized)</i>	Method 2 <i>Fair Value Deferred (amortized upon termination)</i>	Method 3 <i>Mark & Spread (MTM and defer each quarter, begin amortization the following quarter regardless of termination)</i>
Change in Value Example Entries:	Change in Value Example Entries:	Change in Value Example Entries:
Change in Value N/A	Change in Value DR-CR: Derivative Asset/Liab } surplus neutral DR-CR: Deferred Asset/Liab }	Change in Value DR-CR: Derivative Asset/Liab } surplus neutral DR-CR: Deferred Asset/Liab } <i>Change in value includes entire fair value of derivative instrument (clean value plus accrued income)</i>
Amortization (subsequent quarter) N/A	Amortization (subsequent quarter) N/A	Amortization (subsequent quarter) DR-CR: Deferred Asset/Liab } surplus impact DR-CR: Net Investment Income } over amort period <i>derivative is remeasured each reporting period, with any chg in value amortized starting in the subsequent qtr (regardless of termination)</i>
Termination Example Entries:	Termination Example Entries:	Termination Example Entries:
Termination DR-CR: Cash } surplus neutral DR-CR: IMR } (simplified RCGL to IMR)	Termination DR-CR: Cash } surplus neutral DR-CR: Derivative Asset/Liab }	Termination DR-CR: Cash } surplus neutral DR-CR: Derivative Asset/Liab }
	DR-CR: Deferred Asset/Liab } surplus neutral DR-CR: IMR } (simplified RCGL to IMR)	
Amortization (subsequent quarter) DR-CR: IMR } surplus impact DR-CR: Net Investment Income } over amort period	Amortization (subsequent quarter) DR-CR: IMR } surplus impact DR-CR: Net Investment Income } over amort period	Amortization (subsequent quarter) N/A (already occurring)
<i>Note-surplus impacts in year of termination limited (e.g., assuming 10-year life and mid-year termination, only 5% of g/l impacts surplus; so discretionary surplus changes materially eliminated)</i>	<i>Note-surplus impacts in year of termination limited (e.g., assuming 10-year life and mid-year termination, only 5% of g/l impacts surplus; so discretionary surplus changes materially eliminated)</i>	<i>Notes-amortization is independent of termination, so discretionary surplus changes eliminated</i>
		<i>At termination, any change in value (realized gain/loss) would continue to be recognized in the Deferred Asset/Liab account and amortized, which is the same treatment as deferring to IMR and amortizing.</i> <i>Propose a separate deferral account (similar to SSAP No. 108, however could utilize IMR)</i>

Method 1 <i>Amortized Cost (URGL/RGL recognized only at termination, then amortized)</i>	Method 2 <i>Fair Value Deferred (amortized upon termination)</i>	Method 3 <i>Mark & Spread (MTM and defer each quarter, begin amortization the following quarter regardless of termination)</i>
Using SSAP No. 86 as a guide:		
De-Designation Example Entries:	De-Designation Example Entries:	De-Designation Example Entries:
De-designation DR-CR: Derivative Asset/Liab } current value DR-CR: IMR } (surplus neutral) Start amortizing	De-designation DR-CR: Deferred Asset/Liab } reclass deferral to IMR DR-CR: IMR } (surplus neutral) Start amortizing	De-designation No entry or surplus impact (Deferral already booked) Amortization already occurring
Subsequent Accounting (MTM) DR-CR: Derivative Asset/Liab } (prospective MTM in URGL DR-CR: URGL (Surplus) } no addl IMR when RGL)	Subsequent Accounting (MTM) DR-CR: Derivative Asset/Liab } (prospective MTM in URGL DR-CR: URGL (Surplus) } no addl IMR when RGL)	Subsequent Accounting (MTM) DR-CR: Derivative Asset/Liab } (prospective MTM in URGL DR-CR: URGL (Surplus) } no addl IMR when RGL)

Regardless of the selected individual accounting method for ALM hedging program, any realized gain or loss at termination or de-designation is not permitted to adjust the basis of the hedged item (per SSAP No. 86 paragraph 24). Basis adjustments are limited to derivatives in Hedge Accounting relationships as specified in existing SSAP No. 86 guidance.

Along with each proposal above, ACLI would work with NAIC staff to create additional footnote disclosures and/or updates to Schedule DB. For example, for methods 2 and 3, additional disclosures could be added to separately report the balance carried in the IMR. New Schedule DB categories could be considered for any of the methods (e.g., new reporting categories similar to those added for SSAP No. 108).

IMR Amortization

ACLI acknowledges the diversity in practice for the amortization period used for any hedging derivatives' realized gain/loss after deferral to the IMR. However, this is due to how insurers view the risks hedged and their specific ALM hedging programs. To create industry uniformity, ACLI has highlighted two common amortization periods for discussion, with the intent to include both or one method in the final special accounting provision guidance.

The applicable amortization method would apply to realized gains/losses from the selected accounting methodology (applicable to Methods 1, 2, and 3), as well as for any deferred unrealized gains/losses under Method 3 (within the "Deferred Asset/Liability" account as illustrated within the sample journal entries above).

Possible amortization periods for this special accounting provision are summarized below:

- Proposed Amortization Period 1: Life of the underlying/referenced item: Utilize the underlying or referenced item, which may differ from the life of the derivative contract itself (ie., gains/losses from a 3-month futures contract on a 5-Year T-Note would be amortized over a 5-year period)

This method would tie to the underlying risk being managed by the derivative and creates a similar outcome as if a company had used cash bond transactions to achieve the same interest rate exposure. This method is preferable to using a single maturity assumption or the average duration of the hedged portfolio, as it more closely ties to the specific intent of a given derivative. Given that bonds (and derivatives) in the portfolio can each cover specific cash flow and key rate duration objectives for the liability(ies), tying the amortization period for derivatives to the underlying/referenced item most accurately aligns with the interest rate exposures being managed.

For instance, if an insurer trades ultra-bond futures to manage interest rate exposure at the 30-year point of the curve, this method would align with the deliverable basket of the bond future (25+ years). It would be similar to an insurer instead buying 30-year bonds. If the insurer uses bond forwards or forward starting interest rate swaps to manage reinvestment risk into long duration assets, the underlying bond or swap tenor aligns with the liability need being hedged and with the assets that would eventually be purchased on the other side of the hedge creating a smooth income pattern. When using a swaption to manage interest rate risks, the underlying swap that the trade is exercisable into is the exposure period being managed and aligns with managing price risk on a similar-tenor bond in the portfolio.

- Proposed Amortization Period 2: Average duration of the hedged portfolio (assets or liabilities): Utilize the duration of the assets or liabilities identified in the Program (must specify which population will be referenced and how often it will be calculated)

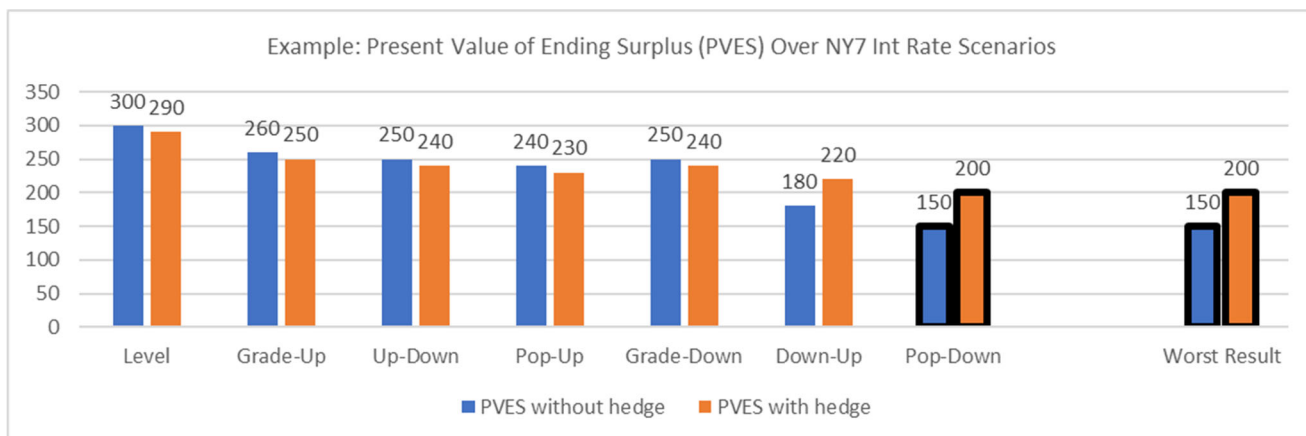
These types of ALM hedging programs are most often focused on a combination of static and dynamic activities to reduce the key rate DV01/duration mismatches between assets and liabilities. Therefore, the optimal amortization method would allow us to reflect these mismatches properly. However, to amortize over the mismatch (or DV01/duration gap between assets and liabilities), would likely be too complicated, as the mismatches can change more frequently, and can migrate over time. Therefore, the next best thing is the weighted average life (WAL) or duration of the liabilities, as that represents the set of cashflows that the portfolio of cash bonds and derivatives is intended to defease. A company could also choose to utilize the duration of the assets supporting the liabilities. This method also eliminates having different amortization periods based on the use of different derivative instruments.

Appendix: Example of an Allowed Modeled Metric to Show Effectiveness

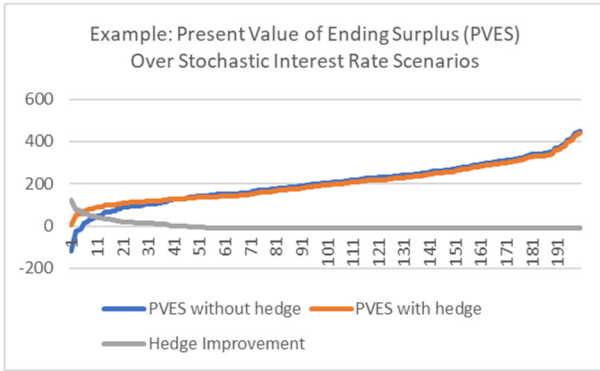
The use of an Allowed Modeled Metric can be a useful way to show hedge effectiveness. The example below shows hypothetical results under deterministic and stochastic interest rate scenarios, with and without a hedge. Metrics like the worst Present Value of Ending Surplus (PVES) outcome over a set of NY7 interest rate scenarios, or the 90th percentile outcome over a range of stochastic interest rate scenarios can be a good way to illustrate the benefit of these types of hedging instruments. While these aren't the only metrics that a company could focus on, these are used in the illustrations below.

Consider a company that has issued an annuity product with an embedded minimum interest rate guarantee. They will be subject to downside risk in the event interest rates decline. They could purchase interest rate floors or receiver swaptions as a hedge against this risk. They would pay an upfront premium (reducing the PVES in most "good" scenarios) and would see a benefit of a hedge payout (increasing the PVES in the worst scenarios). This type of hedge can help to support guarantees, protect against the risk of reserve deficiencies, and reduce income volatility - which are desirable outcomes for all stakeholders.

The first chart shows hypothetical modeled results over a set of deterministic interest rate scenarios like the NY7, and an improvement in "Worst Result" from the unhedged product (blue) compared to with the hedge (orange).



The second chart shows hypothetical modeled results over a set of stochastic scenarios, including the reduced downside risk (PVES improvement in the left side of the distribution). Additionally, the table below shows improvement in some potential Allowed Modeled Metrics that a company may consider using based on the distribution of modeled results.



	PVES Without Hedge	PVES With Hedge	Hedge Improvement
90th %ile	81	106	24
95th %ile	37	84	46
99th %ile	-61	34	96
80 CTE	65	98	32
90 CTE	27	78	52
95 CTE	-10	60	70
99 CTE	-89	21	109

Appendix III

Definition and Purpose of the Interest Maintenance Reserve (IMR)

The intent of this document is to offer a theoretical definition and purpose of IMR within the context of the U.S. Statutory Framework so that specific IMR-related issues can be addressed in future sessions of the Ad Hoc Technical Working Group from a mutually agreed upon foundation. In summary, the conceptual development of IMR recognized the need for a valuation adjustment to ensure consistent treatment of assets and liabilities and an accurate presentation of solvency amid fluctuations in interest rates. Illustrative examples further illuminate the necessity of an IMR for both positive and negative balances within the context of such a framework. After such a conceptual grounding, IMR is then considered in tandem with the more recent development of Principles-based Reserves (PBR) in Appendix 1 with Asset Adequacy Testing (AAT) in Appendix 2 and with Derivatives in Appendix 3 ensuring no inconsistencies need to be separately addressed.

The Objective of the Statutory Framework and the Necessity of IMR

The most important and fundamental purpose of the Statutory Statements is to provide basic financial information focusing on solvency. It must provide regulators (and management) the tools to monitor and ensure policy and contract holder obligations can be met when they come due. To that end, “the valuation of assets and liabilities proceeds on the assumption that the insurer is a going concern” and “valuation is not done on a liquidation basis.”²

Liability Valuation

In keeping with the focus on solvency and conservatism, the prudent valuation of long duration insurance liabilities needs to be determined. Because insurance liabilities generally do not have a deep and wide market, their valuation is dependent on assumptions, calculations, and/or models. A market-consistent approach to liability valuation can be challenging to develop, is highly sensitive to the assumptions used, and can over rely upon or misapply current market conditions. These challenges can distort financial solvency and inhibit companies from issuing long duration insurance products. A market-consistent approach has not been adopted in the U.S. Statutory framework.

The Statutory framework’s amortized cost valuation approach utilizes conservative methodologies and assumptions. In many cases, these conservative methodologies and assumptions are determined at origin and may not be changed over the entire course of the liability. As the U.S. Statutory framework has evolved, additional/new valuation approaches have been introduced (e.g., PBR). Regardless of the specific approach, the U.S. Statutory framework has remained focused on ensuring the company’s long-term solvency in a stable, durable, and conservative manner.

Asset Valuation

To support their insurance liabilities and ensure solvency, companies need to invest their assets such that they have a very high probability of paying contractual liabilities when they become due. For long-duration liabilities, these investments are predominantly in conservative fixed income assets. To accurately assess whether a company can fulfill its obligations, its liabilities and assets must be presented on a financially integrated and consistent basis.

In the Statutory framework, asset valuations for fixed income securities are primarily based on amortized cost accounting principles. Here the valuations reflect the market available yields (interest rates) and outlook at the time of purchase. They

² “Asset Valuation Reserves and Interest Maintenance Reserves, Blue Book, December 2002”. Report to the NAIC Financial Condition Committee.

are generally not revisited for changes in interest rates (only for impairment). The amortized cost asset valuation approach maintains consistency with the valuation of liabilities. It also limits the use of market values, which are not always observable or reliable across the spectrum of assets insurance companies hold in support of their liabilities.

However, if an asset is sold and a new asset is purchased, the company effectively “unlocks” the yield and reflects the current market available yield in the asset valuation. The liability assumptions, as explained earlier, cannot be readily adjusted in the same manner. Because of this potential for inconsistent asset and liability valuations, the company’s financial statements could provide false indicators of financial strength or of financial weakness. Concerns related to this dynamic led to the development of a prudent and innovative valuation adjustment concept within the Statutory framework: the Interest Maintenance Reserve.

Interest Maintenance Reserve

The original E Committee report lays out many considerations reviewed during its development of IMR, and it summarizes the IMR as:

*The Interest Maintenance Reserve (IMR) - captures for all types of fixed income investments, all of the realized capital gains and losses which result from changes in the overall level of interest rates as they occur. Once captured, these capital gains or losses are amortized into income over the remaining life (period to maturity) of the investments sold. Realized gains and losses on derivative investments, which alter the interest rate characteristics of assets/liabilities, also are allocated to the IMR and are to be amortized into income over the life of the associated assets/liabilities.*³

Ultimately, the IMR facilitates better alignment of the timing of interest rate related gain/loss realizations on certain fixed income investments with the interest rate assumptions embedded in the policyholder liabilities they support. The IMR was developed to complement existing valuation practices, rather than replace them, and subsequent updates to valuation methodologies considered IMR in their development.

There are times when IMR treatment of an interest-related gain or loss would not be appropriate; for instance, if assets are sold to fund excess withdrawals or surrenders or to meet other significant expenses, collateral calls, etc. In general, the IMR is only appropriate for fixed income gains and losses from a portfolio of assets that support existing insurance liabilities.

Applicable Illustrative Examples

Illustrative examples are useful for understanding the concepts underpinning IMR. The following examples are simplified (e.g., the role asset adequacy testing plays in the valuation of liabilities is ignored), but they illustrate the implications of the valuation concepts involved in the IMR’s development. They can then be appropriately extrapolated to the more complex insurance contracts and reserve methodologies.

³ “Asset Valuation Reserves and Interest Maintenance Reserves, Blue Book, December 2002”. Report to the NAIC Financial Condition Committee.

Example 1

Assume Company XYZ starts out with \$10 of surplus invested in equity securities with no change in value over the period of valuation. The prevailing interest rate environment is such that the fixed income bond yield and the insurance liability valuation rate are both 4%, and Company XYZ:

- Sells an insurance contract that pays \$100 at the end of ten years as well as pays \$4 at the end of years 1 – 10 for \$100 dollars of premium received today.
- Purchases a 10-year bond with a coupon rate of 4% to support the liability.

Under statutory accounting, Company XYZ's balance sheet would look like Figure A.

Figure A			
Assets		Liabilities and Surplus	
Bonds	100	Insurance liability	100
Equities	<u>10</u>	Surplus	<u>10</u>
Total Assets	<u>110</u>	Liabilities & Surplus	<u>110</u>

Next, assume that bond yields drop to 2% immediately after Company XYZ purchases the bond. Company XYZ's balance sheet would not change, although the bond is now valued at \$118. From a statutory solvency perspective, there is no concern with the balance sheet because the bond can fund the liability and the financial statements are reported on a financially integrated basis and accurately reflect solvency.

Later that day, assume Company XYZ sells the bond and immediately invests the proceeds in a new 10-year bond of the same credit quality with a coupon rate of 2%. Par value would now be \$118. Company XYZ's balance sheet, without the Interest Maintenance Reserve concept (or performing asset adequacy analysis), would now look like Figure B.

Figure B			
Assets		Liabilities and Surplus	
Bonds	118	Insurance liability	100
Equities	<u>10</u>	Surplus	<u>28</u>
Total Assets	<u>128</u>	Liabilities & Surplus	<u>128</u>

Without IMR, Company XYZ's balance sheet shows an illusory increase in surplus as the bond has essentially been marked to market at \$118 but the insurance liability is unchanged. The bond's coupon payments are now insufficient to meet policyholder obligations, and the company may have to sell a portion of the bond every year to meet its yearly obligation.

To further illustrate the solvency distortion absent the IMR, assume Company XYZ sells \$18 of the bond and dividends the \$18 to its owners. Its balance sheet in Figure C would show the company still appearing solvent.

Figure C			
Assets		Liabilities and Surplus	
Bonds	100	Insurance liability	100
Equities	<u>10</u>	Surplus	<u>10</u>
Total Assets	<u>110</u>	Liabilities & Surplus	<u>110</u>

However, the total shortfall (without adjusting for minor interest effects) as the liability runs off would be:

Total of yearly (40) and final (100) payments owed policyholder	(140)
Total bond interest payments (20) and maturity (100)	120
Total equity sale	<u>10</u>
Total shortfall including sale of surplus assets	<u>(10)</u>

As discussed earlier, the IMR was developed to address the marking to market of assets upon sale, where the liabilities are unchanged, with a valuation adjustment (IMR) so that the Statutory framework can value both assets and liabilities on a consistent basis. With IMR, the inappropriate portrayal of solvency in Figures B and C would not occur. More importantly, the inappropriate dividend would not have been able to occur, and the balance sheet would instead look like Figure D.

Figure D			
Assets		Liabilities and Surplus	
Bonds	118	Insurance liability	100
Equities	<u>10</u>	IMR	18
Total Assets	<u>128</u>	Surplus	<u>10</u>
		Liabilities & Surplus	<u>128</u>

Example 2

After demonstrating the importance of IMR in a declining interest rate environment in Example 1, Example 2 demonstrates its importance in a rising interest rate environment. For Company XYZ, assume the same starting position as Example 1. Immediately after purchasing the bond, the bond yield increases to 6%. Company XYZ's balance sheet would not change although the bond now has a market value of \$85. From a statutory solvency perspective, there is no concern with the balance sheet valuation because the bond can fund the liability and the financial statements are reported on a financially integrated basis and accurately reflect solvency.

Later that day, assume Company XYZ sells the bond and immediately invests the proceeds in a 10-year bond of the same credit quality with a coupon rate of 6%. Par value would now be \$85. Company XYZ's balance sheet, without IMR, would look like Figure E.

Figure E			
Assets		Liabilities and Surplus	
Bonds	85	Insurance liability	100
Equities	<u>10</u>	Surplus	<u>(5)</u>
Total Assets	<u>95</u>	Liabilities & Surplus	<u>95</u>

Company XYZ's balance sheet now shows illusory decreased financial strength as the bond has essentially been marked to market at \$85 but the insurance liabilities are unchanged. The company could still fund the liability by retaining and investing the increased bond coupons received. The total surplus as the liability runs off would be:

Total of yearly (40) and final (100) payments owed policyholder	(140)
Total bond interest payments (55*) and maturity (85)	140
Total equity sale	<u>10</u>
Total surplus including after sale of surplus assets	<u>10</u>

*10 payments of \$5.10 (\$85 x 6%) plus approximately \$4 of interest earnings from investing the annual excess of the coupon payments the new bond generates (\$5.10) from that paid to the policyholder (\$4).

Just like in Example 1, the inappropriate portrayal of solvency in this example would not occur after including IMR, and the balance sheet would look like Figure F.

Figure F			
Assets		Liabilities and Surplus	
Bonds	85	Insurance liability	100
IMR*	15	Surplus	<u>10</u>
Equities	<u>10</u>	Liabilities & Surplus	<u>110</u>
Total Assets	<u>110</u>		

* For these examples, it is inconsequential whether negative IMR is reported an asset or contra liability. It is placed here as an asset for illustrative purposes only.

Prior to selling the original bond and re-investing the proceeds, the bond on Company XYZ's balance sheet was in an unrealized loss position. Hypothetically, it could have been shown in the financial statements as in Figure G.

Assets		Liabilities and Surplus	
Bonds at Market	85	Insurance liability	100
Unrealized Loss	15	Surplus	<u>10</u>
Equities	<u>10</u>	Liabilities & Surplus	<u>110</u>
Total Assets	<u>110</u>		

As the original bond and the new bond are transacted at market value, there would be no difference in solvency position pre- and post-trade for Company XYZ. Disallowing negative IMR in Figure F (the IMR value under "Assets") is no more appropriate than disallowing the unrealized loss embedded within the balance sheet in Figure G.

An illustrative example regarding IMR in the context of derivative hedging transactions is provided in Appendix 3.

Definition of IMR

With this background, we now have the proper context to define and state the purpose of IMR:

IMR is a valuation adjustment to maintain consistency between insurance liabilities (the assumptions for which are often unchanged from origin) and the assets needed to support them (where the assumptions can essentially be revisited any time there are fixed income realizations).

IMR defers and amortizes the recognition of non-economic gains or losses where investment activity, whether through fixed income investment sales or fixed income derivative hedging transactions, essentially unlock unrealized gains/losses for either assets or liabilities. IMR is not intended to defer economic gains and losses related to asset sales compelled by liquidity pressures that fund significant cash outflows (e.g., such as excess withdrawals and collateral calls).

Specifically, the IMR valuation adjustment more appropriately reflects the impact to statutory surplus from fluctuations in interest rates and therefore provides a more accurate representation of solvency under the NAIC's statutory framework which often includes amortized cost valuation of fixed income investments and liability valuations with fixed assumptions in accordance with the Accounting Practices and Procedures and Valuation Manual.

To accurately assess whether a company can fulfill its obligations, it must present its liabilities and assets on a financially integrated and consistent basis. If they are inconsistent, then the annual statement will not reveal the degree to which assets exceed liabilities and neither regulators nor management can appropriately determine the risk of insolvency for the company. Taken further, limiting IMR balances creates an inconsistency within the Statutory framework and would generate false solvency signals for regulators. Limiting IMR balances can also disincentivize prudent interest rate risk management. By appropriately recognizing fixed income gains and losses within the Statutory framework, the IMR prevents the misrepresentation of surplus from changes in interest rates.

Appendix 1 – IMR in the context of Principle-Based Reserving (PBR)

PBR is a relatively recently developed method for calculating U.S. statutory reserves that intends to better quantify product risks. Distinctive to PBR in the Statutory framework, the approach considers a range of future economic scenarios and uses justified company-specific assumptions that can change over time as company experience emerges, subject to regulatory guardrails. PBR is generally applicable for individual life insurance contracts issued 2020 and later (VM-20) and for all variable annuity contracts (VM-21). PBR is expected to apply to fixed annuity contracts issued 2025 and later (VM-22). Minimum reserves under PBR are the maximum of a formula-based reserve and modeled reserves.

For PBR's formula-based reserves, the accounting basis is "frozen" and "locked in" at issue and does not reflect underlying assets or a company's investment strategy (e.g., the net premium reserve). As a result, the existing IMR construct works in tandem with PBR's formula-based reserves to maintain consistency between the liability and asset valuations when the asset valuation is unlocked due to asset sales.

For PBR's modeled reserves, the accounting basis is not "frozen" but is unlocked over time with assumptions that reflect company experience in its cash flow models (e.g., the deterministic reserve and the stochastic reserve). Under PBR's modeled reserves, the reserves reflect the company's underlying assets and investment strategy, and the impact of asset gains or losses is reflected in the modeled reserve calculation. Distinctive to the modeled reserve component(s) of PBR, the modeled reserves then reflect an explicit adjustment for IMR so that there is no surplus impact at time of asset sale.

In summary, the IMR construct is necessary for consistent liability valuation under PBR's formula-based reserves and is already explicitly reflected and accounted for under PBR's modeled reserves.

Appendix 2 – IMR in the context of Asset Adequacy Testing (AAT)

Asset adequacy analysis is an analysis of the adequacy of reserves and other liabilities, considering the assets supporting such reserves and other liabilities under moderately adverse conditions. If additional assets are needed, then the actuary should establish an additional reserve equal to the value of those additional assets.

A common form of asset adequacy analysis is cash flow testing, which is the projection and comparison of the timing and amount of cash flows under one or more scenarios. Conceptually, cash flow testing is similar to the deterministic reserve, or a set of deterministic reserves, under PBR as discussed in Appendix 1.

In 2022 and 2023, the NAIC's Life Actuarial (A) Task Force provided guidance on allocating negative IMR for PBR and AAT. This guidance recommended that any portion of negative IMR that is an admitted asset should be allocated for PBR and AAT in a principle-based, reasonable, and appropriate manner that would be consistent with the handling of negative IMR. Effectively, AAT explicitly accounts for admitted negative IMR by reducing the amount of interest-earning assets. Likewise, AAT can reflect positive IMR by allowing for a larger starting balance of interest-earning assets. In summary, AAT has been designed in tandem with the IMR construct to ensure the consistent valuation of assets and liabilities within the Statutory framework.

Appendix 3 – IMR in the context of Derivative Hedging Transactions

The applicability of the IMR construct to gains or losses from derivative hedging transactions flows from the concepts outlined in the earlier text. To illustrate its importance within plausible ALM strategies, the example outlined here in Appendix 3 assumes a more complex and realistic set of insurance liabilities.

Example 3

Assume Company XYZ issues life insurance contracts where the premiums come in each year until death and there is a payment upon death estimated to occur at the end of 5 years. Assume Company XYZ is again starting out with \$10 of surplus invested in equity securities (again, assume no change in value over the period of valuation). The current interest rate environment is such that the fixed income bond yield and the insurance liability valuation rate are again both 4%, and Company XYZ:

- Sells 100 insurance contracts that pay \$1 upon death for yearly premiums of 18.47 cents at the end of each year 1 through 5.
- Purchases bonds with a coupon rate of 4%, with all premiums and coupons received, maturing at the anticipated time of death in 5 years.
- Assume the market yield of 4% is constant throughout the 5-year period.

Company XYZ's balance sheet for each year, using a simplified net premium calculation for reserves, would look like Figure H.

Year	Assets			Liabilities and Surplus		
	Bonds	Equities	Total	Insurance Liability	Surplus	Total
1	18.47	10.00	28.47	18.47	10.00	28.47
2	37.67	10.00	47.67	37.67	10.00	47.67
3	57.64	10.00	67.64	57.64	10.00	67.64
4	78.40	10.00	88.40	78.40	10.00	88.40
5	100.00	10.00	110.00	100.00	10.00	110.00

Company XYZ can pay all claims on the policy and the balance sheet surplus appropriately reflects surplus at the end of each reporting period. In the real world with this more dynamic pool of liabilities, other changes could occur, such as one or multiple of:

- Interest rates could decline, and coupon and premium payments would not be able to be invested at 4%.
- Death benefits could be paid at a point in time greater than the invested bond maturity and if interest rates decline, the bond would not be able to be re-invested at 4%.
- Policy surrenders could occur, including due to changes in market interest rates, causing the claims patterns to change from expectations.

Amidst this real-world uncertainty, Company XYZ could consider any of the following risk mitigating activities, which inherently depend upon its mix of insurance liabilities:

- Accept the risk of future asset and liability cash flow fluctuations, which could result in an inability pay claims in certain situations. For instance, if interest rates declined, the coupon payments, premium payments, and/or maturities would not be able to be re-invested in fixed income investments that have sufficient yield to pay claims as expected.

- Charge higher premiums at inception to account for the reinvestment risk and duration risk associated with the insurance liabilities.
- Manage the investment portfolio to a prudent liability duration or any number of appropriate and prudent asset liability management (ALM) strategies.
- Prudently hedge with derivatives within the ALM strategy. Such derivative usage strategies are used where purchases are not viable or where it is more efficient to utilize derivatives.

If the derivative strategy is applied, the reinvestment risk could be hedged to lock in a 4% yield. When interest rates fluctuate, any gain or loss on the derivative offsets the lower or higher actual yield that is received on the reinvestments.

In Example 3, if interest rates plunged to 0% on day 2, Company XYZ would not be able to support the liabilities because future premiums and coupons would not be able to be reinvested at 4%. If Company XYZ had hedged reinvestment risk, they would have a gain on derivatives equal to the economic loss of not being able to invest at 4%. Similarly, if interest rates doubled to 8%, Company XYZ would have a loss on derivatives equal to the economic gain of now being able to invest at the much higher interest rate of 8%. In both cases, Company XYZ has hedged reinvestment risk and has not changed the solvency picture in Example 3.

In summary, IMR is appropriate for all types of fixed income investments, including derivatives which alter the interest rate characteristics of assets/liabilities, for all realized capital gains and losses which result from changes in the overall level of interest rates as they occur.

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December 9, 2024

Mr. Dale Bruggeman, Chairman
Statutory Accounting Principles Working Group
National Association of Insurance Commissioners
hut Street, Suite 1500
Kansas City, MO 64106-2197

RE: Interested Parties Comments on Ref #2024-26 EP

Dear Mr. Bruggeman:

Interested parties appreciate the opportunity to comment on the following item that was exposed for comment by the Statutory Accounting Working Group (the Working Group) with comments due December 9th.

Ref #2024-26 EP: Editorial Revisions

Interested parties request a deferral of Ref #2024-26 EP for further discussion in 2025 to address several concerns that we have with the proposal. We believe that the terms ‘category and subcategory’ need clarification as we’ve interpreted that category equates to *ICO* and *ABS* and subcategory equates to examples such as ‘*Non-U.S. Sovereign Jurisdiction Securities*’ and ‘*Other Non-Financial Asset-Backed Securities – Practical Expedient*’. We suggest clarifying language in the Investment Schedules General Instructions of the Annual Statement Instructions to differentiate between Categories and Subcategories. The proposed revisions to SSAP No. 26 would require disclosure of all the new Schedule D – Part 1 categories and the underlying subcategories in the audited financial statements. The Principles-Based Bond Project has: a) significantly increased the number of Schedule D – Part 1 categories/subcategories and b) introduced more judgment and subjectivity with respect to the classification of bonds into these subcategories. As a result, we are concerned that subjecting these processes to audit will result in additional reporting and audit burden disproportionate to the value of these disclosures in the audited financial statements. We understand regulators' desire for comfort with respect to the appropriate classification of bonds. However, we would like to discuss whether a less prescriptive, principles-based approach might

Statutory Accounting Principles Working Group
December 9, 2024
Page 2

provide the desired information and audit comfort, while limiting the undue burdens for reporting entities and their auditors.

* * * *

Please feel free to contact either one of us if you have any questions or would like to discuss further.

Sincerely,

D. Keith Bell

Rose Albrizio

cc: Interested parties
NAIC staff

**Statutory Accounting Principles (E) Working Group
Maintenance Agenda Submission Form
Form A**

Issue: Issue Papers in Statutory Hierarchy

Check (applicable entity):

	P/C	Life	Health
Modification of Existing SSAP	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>
New Issue or SSAP	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Interpretation	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>

Description of Issue: This agenda item has been drafted to capture issue papers in Level 5 of the statutory hierarchy pursuant to the direction from the 2024 Fall National Meeting. Additionally, revisions have been proposed to update the process to develop issue papers to reflect current Working Group practice.

This issue originated in response to a Sept. 27, 2024, interested parties’ comment letter for the Principles-Based Bond Definition Questions and Answer Implementation Guide where interested parties suggested that issue papers should be recognized as authoritative guidance. These comments suggested inclusion of issue papers in Level 2 or Level 4 of the statutory hierarchy. However, NAIC staff identified that a Level 5 classification would better prevent unintended conflicts between issue papers and other sources of statutory guidance. Issue papers are not always updated after adoption of an SSAP, especially a clarification adoption, and should not be considered more applicable than any other statutory-specific guidance, whether that guidance is in SSAP, interpretation, reporting instructions or information from the *Purposes and Procedures Manual of the Investment Analysis Office*. By classifying issue papers as Level 5, issue papers will be on the same level as non-authoritative U.S. GAAP guidance/literature and will be behind all other sources of statutory guidance. Although this inclusion clarifies that issue papers are a source of statutory guidance that can be applied and utilized, the Level 5 classification would only allow application if they do not conflict with other statutory guidance. This classification confirms that an issue paper cannot be used or cited above any other source of established statutory guidance captured in the statutory hierarchy. The excerpt from the Hearing agenda discussed during the 2024 Fall National Meeting (captured within the authoritative literature) noted that some users have attempted to cite issue paper guidance as authoritative, particularly once they were publicly posted on the website, although the guidance had been replaced by a more current SSAP. It was also noted that some citations in issue papers discuss proposed guidance that is evaluated and rejected. These reasons further support the identification of issue papers in Level 5 of the statutory hierarchy, as they are a source of statutory accounting, but shall be applied only to the extent that they do not conflict with a higher level of guidance.

The proposed revisions to incorporate these changes are predominantly captured in the Statutory Hierarchy reflected in the Statutory Accounting Preamble and Appendix E. Revisions have not been proposed to modify the effective date language of historical Issue Papers. Rather, a note has been included to identify the revisions to the classification of issue papers as Level 5 of the statutory hierarchy.

Excerpt from Interested Parties’ Sept. 27, 2024 Comment Letter:

First, interested parties would like to suggest that Issue Papers be recognized as authoritative guidance and included in Level 2, or alternatively Level 4, in the statutory hierarchy of authoritative guidance. Level 2 would place issue papers higher in the hierarchy than the annual statement instructions (Level 3) which arguably is appropriate. Level 4 specifically includes the preamble as authoritative guidance and paragraph 45 of the preamble states, “While it is not intended that there be any significant differences between an underlying issue paper and the resultant SSAP, if differences exist, the SSAP prevails and shall be considered definitive.” This part of the preamble implies if a difference exists, and is not addressed by the SSAP, it is authoritative. If this interpretation by interested parties is not consistent with the NAIC’s interpretation, it is important that the issue papers be explicitly included in the statutory hierarchy as many are drafted to include interpretative guidance not included in the SSAPs (e.g., feeder funds related to the

new principles-based bond definition (PBBB) and superseded US GAAP OTTI impairment guidance that is still applicable for statutory accounting but is not codified within the SSAPs). Further, other areas of the Accounting Practices & Procedures Manual that suggest issues papers are not authoritative (e.g., Appendix E) would need to be updated for consistency.

Existing Authoritative Literature:

Statutory Accounting Principles Preamble

V. Statutory Hierarchy

42. The following Hierarchy is not intended to preempt state legislative and regulatory authority.

Level 1

SSAPs, including U.S. GAAP reference material to the extent adopted by the NAIC from the FASB Accounting Standards Codification¹ (FASB Codification or GAAP guidance)

Level 2

Consensus positions of the Emerging Accounting Issues (E) Working Group as adopted by the NAIC (INTs adopted before 2016)

Interpretations of existing SSAPs as adopted by the Statutory Accounting Principles (E) Working Group (INTs adopted in 2016 or beyond)

Level 3

NAIC Annual Statement Instructions

Purposes and Procedures Manual of the NAIC Investment Analysis Office

Level 4

Statutory Accounting Principles Preamble and Statement of Concepts²

Level 5

Sources of nonauthoritative GAAP accounting guidance and literature, including: (a) practices that are widely recognized and prevalent either generally or in the industry, (b) FASB Concept Statements, (c) AICPA guidance not included in FASB Codification, (d) International Financial Reporting Standards, (e) Pronouncements of professional associations or regulatory agencies, (f)

¹ Effective September 15, 2009, the FASB Codification is the source of authoritative U.S. generally accepted accounting principles. As of that date, the FASB Codification superseded all then-existing non-SEC accounting and reporting standards. All other nongrandfathered, non-SEC accounting literature not included in the FASB Codification is nonauthoritative. As of September 15, 2009, AICPA Statements of Position are no longer reviewed as part of the statutory maintenance process as they are no longer considered authoritative GAAP literature. If the AICPA were to address an issue that affects the FASB Codification, an accounting standard update (ASU) would be issued and reviewed for applicability to statutory accounting.

² The Statutory Accounting Principles Statement of Concepts incorporates by reference FASB Concepts Statements Five and Eight to the extent they do not conflict with the concepts outlined in the statement. However, for purposes of applying this hierarchy the FASB Concepts Statements shall be included in Level 5 and only those concepts unique to statutory accounting as stated in the statement are included in Level 4.

Technical Information Service Inquiries and Replies included in the AICPA Technical Practice Aids, and (g) Accounting textbooks, handbooks and articles

43. If the accounting treatment of a transaction or event is not specified by the SSAPs, preparers, regulators and auditors of statutory financial statements should consider whether the accounting treatment is specified by another source of established statutory accounting principles. If an established statutory accounting principle from one or more sources in Level 2 or 3 is relevant to the circumstances, the preparer, regulator or auditor should apply such principle. If there is a conflict between statutory accounting principles from one or more sources in Level 2 or 3, the preparer, regulator or auditor should follow the treatment specified by the source in the higher level—that is, follow Level 2 treatment over Level 3. Revisions to guidance in accordance with additions or revisions to the NAIC statutory hierarchy should be accounted for as a change in accounting principle in accordance with SSAP No. 3—*Accounting Changes and Corrections of Errors*.

44. Because of developments such as new legislation or the evolution of a new type of business transaction, there sometimes are no established statutory accounting principles for reporting a specific transaction or event. In those instances, it might be possible to report the event or transaction on the basis of its substance by selecting a statutory accounting principle that appears appropriate when applied in a manner similar to the application of an established statutory principle to an analogous transaction or event. In the absence of a SSAP or another source of established statutory accounting principles, the preparer, regulator or auditor of statutory financial statements may consider other accounting literature, depending on its relevance in the circumstances. Other accounting literature includes the Statutory Accounting Principles Statement of Concepts and GAAP reference material and accounting literature identified in Level 5. The appropriateness of other accounting literature depends on its relevance to the particular circumstances, the specificity of the guidance, and the general recognition of the issuer or author as an authority. For example, the Statutory Accounting Principles Statement of Concepts would be more authoritative than any other sources of accounting literature. Similarly, FASB Concepts Statements would normally be more influential than other sources of nonauthoritative GAAP pronouncements.

VI. Statements of Statutory Accounting Principles (Bolding and underlining added for emphasis)

45. This Manual consists primarily of Statements of Statutory Accounting Principles (SSAPs). SSAPs are the primary Accounting Practices and Procedures promulgated by the NAIC. These statements are the result of issue papers that have been exposed for public comment and finalized. Finalized issue papers are in Appendix E. **While it is not intended that there be any significant differences between an underlying issue paper and the resultant SSAP, if differences exist, the SSAP prevails and shall be considered definitive.**

Appendix E – Issue Papers (Bolding and underlining added for emphasis)

Introduction

Issue papers are used as the first step in developing new or revised SSAPs, and each contains a recommended conclusion, discussion and relevant literature section. **While issue papers do not constitute an authoritative level of statutory accounting guidance as defined by the statutory hierarchy, they are an important part of the Accounting Practices and Procedures Manual (Manual) because they reference the history and discussion of the related SSAP.**

Issue papers are published in the Manual within Appendix E the first year after adoption of the related SSAP, but are then removed from the subsequent year's Manual and posted for public reference on the Statutory Accounting Principles (E) Working Group (SAPWG) web page at https://content.naic.org/cmte_e_app_sapwg.htm.

2024 Fall National Meeting Discussion

NAIC staff presented a recommendation along with a review of historical guidance and references in issue papers during the 2024 Fall National Meeting. This information has been retained within this agenda item for reference purposes:

2024 Fall National Meeting Recommendation: NAIC staff recommend that the Working Group direct a new agenda item to consider capturing issue papers in Level 5 of the statutory hierarchy. Although interested parties have proposed a classification of Level 2, and an alternative classification in Level 4, NAIC staff suggest that consideration of a Level 5 classification is most appropriate to prevent any unintended conflicts with other sources of statutory guidance. The rationale for this position is that issue papers are not always updated after adoption of an SSAP, especially a clarification adoption, and should not be considered more applicable than any other statutory-specific guidance, whether that guidance is deemed to reflect accounting guidance, reporting instructions or information from the SVO manual. The Level 5 classification will put issue papers on the same level as non-authoritative GAAP guidance and literature. NAIC staff believe this is appropriate, as if guidance for a topic is not specifically detailed in any other form of statutory-specific sources, adopted issue papers should be a viable source for guidance along with non-authoritative GAAP.

As detailed within, from a review of references in the issue papers, various references imply that issue papers can be applied and utilized as long as the guidance within the Issue Paper does not conflict with other guidance. There are a few explicit instances that note they are not authoritative/in the statutory hierarchy. NAIC staff notes that Issue Papers often include discussion of guidance or components that are not incorporated into SSAP, therefore it is imperative for the guidance to only be applicable if consistent with an adopted SSAP. By adding the issue papers to Level 5, this reference would clarify the intent to use issue papers, and the use of information detailed within, eliminating questions on the use of the guidance that is consistent with currently adopted SSAPs.

- By classifying issue papers as Level 5, instead of Level 2, if there is a subsequent reporting revision that is not captured in statutory accounting but only reflected in the annual statement instructions, the updated instructions, which are Level 3, shall be followed. If issue papers were classified as Level 2, there could be inherent reporting conflict if the issue paper detailed reporting requirements at the time of adoption as that issue paper guidance would not be subsequently updated.
- By classifying issue papers as Level 5, instead of Level 4, issue papers will continue to be below the SAP Preamble and Statement of Concepts. As such, if there are revisions to the Preamble, those revisions will continue to override any potential conflicts with a previously adopted issue paper.

NAIC staff recognizes that existing guidance presents inconsistent references to issue papers causing confusion on how/when they should apply. As noted, there are a few explicit statements that issue papers are not authoritative, but other references imply application and use of Issue Papers when there are no differences between the issue paper and the SSAP. NAIC staff believe it is imperative to stress application only when the guidance is in line with a current adopted SSAP. As SSAPs have not historically been posted publicly, NAIC staff receive questions that cite guidance in issue papers as they are posted publicly. Often in these situations, the citations have been superseded by more current SSAP, so attempting to use the issue paper guidance in those instances would not be in line with current SSAP. The following Preamble excerpt has been within the NAIC *Accounting Practices and Procedures Manual* since original codification (2000 Manual) and implies that finalized issue papers are applicable but defer to the SSAP if differences exist. (This was paragraph 41 in the 2000 Manual and is reflected as paragraph 45 in the 2024 Manual.)

- 41/45. This Manual consists primarily of Statements of Statutory Accounting Principles (SSAPs). SSAPs are the primary Accounting Practices and Procedures promulgated by the NAIC. These statements are the result of issue papers that have been exposed for public comment and finalized. **Finalized issue papers are in Appendix E. While it is not intended that there be any significant differences between an underlying issue paper and the resultant SSAP, if differences exist, the SSAP prevails and shall be considered definitive.**

The following Preamble excerpt has also been within the NAIC *Accounting Practices and Procedures Manual* since original codification (2000 Manual) and indicates in the absence of a SSAP or “established source of statutory accounting principles,” other accounting literature may be considered. As issue papers would represent an established source of statutory guidance, this Preamble guidance could be argued to have always supported issue papers as a source that could be considered along with non-authoritative GAAP if other statutory guidance did not exist. (This is paragraph 40 in the 2000 Manual and is reflected as paragraph 44 in the 2024 Manual.)

- 40/44. Because of developments such as new legislation or the evolution of a new type of business transaction, there sometimes are no established statutory accounting principles for reporting a specific transaction or event. In those instances, it might be possible to report the event or transaction on the basis of its substance by selecting a statutory accounting principle that appears appropriate when applied in a manner similar to the application of an established statutory principle to an analogous transaction or event. **In the absence of a SSAP or another source of established statutory accounting principles, the preparer, regulator or auditor of statutory financial statements may consider other accounting literature, depending on its relevance in the circumstances. Other accounting literature includes the Statutory Accounting Principles Statement of Concepts and GAAP reference material and accounting literature below category c in the GAAP hierarchy as defined in SAS 69.** The appropriateness of other accounting literature depends on its relevance to the particular circumstances, the specificity of the guidance, and the general recognition of the issuer or author as an authority. For example, the Statutory Accounting Principles Statement of Concepts would be more authoritative than any other sources of accounting literature. Similarly, FASB Concepts Statements would normally be more influential than other sources below category d in the GAAP hierarchy⁴.

From a review of all issue papers, NAIC staff has identified that the original issue papers that correspond to the original codification of statutory accounting principles through issue papers adopted in 2000 did not include an “Effective Date” section. Beginning with *Issue Paper No. 107—Certain Health Care Receivables and Receivables Under Government Insured Plans*, which was finalized Aug. 8, 2001, an Effective Date section was included. After that issue paper, some form of “Effective Date” guidance was generally included (but not always). From Issue Paper No. 107 through Issue Paper No. 164, when effective date language was included, it was worded like the excerpts below. Although these excerpts identify that the issue papers are not in the statutory hierarchy, they also indicate an expectation that the issue paper's conclusions can be “applied” once the SSAP has been adopted.

Issue Paper No. 107: Finalized Aug. 1, 2001

28. Upon adoption of this issue paper, the NAIC will release a Statement of Statutory Accounting Principle (SSAP) for comment. The SSAP will contain the adopted Summary Conclusion of this issue paper. **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.** It is expected that the SSAP will contain an effective date of years ending on or after December 31, 2001.

Issue Paper No. 164: Finalized July 30, 2020

23. 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 July 30, 2020. The substantive revisions to SSAP No. 32R are detailed in Exhibit A of this issue paper and reflected in the substantively-revised SSAP No. 32R—Preferred Stock. The effective date of the guidance 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**

⁴ As specified by AU Section 411, paragraph 11.

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.

Although the original process for issue papers was to have them adopted prior to the development and adoption of the SSAP (which could result in differences between the SSAP and issue paper), current practice more often adopts the SSAP revisions, and then uses the issue paper for historical documentation purposes, or they are completed concurrently. Note, however, that not all SSAP revisions, especially those of clarification type and not contested, have a related issue paper updated. The following effective date language is captured in more recent issue papers adopted between 2019-2023. (Noted also in Issue Papers No. 163, 165 and 167.)

Issue Paper No. 162: Finalized Aug. 3, 2019

24. As issue papers are not represented in the Statutory Hierarchy (see Section IV of the Preamble), the subsequent consideration and adoption of this issue paper will not have any impact of the effective date of the substantive revisions adopted to SSAP No. 62R during the 2018 Fall National Meeting.

NAIC staff only identified the following two issue papers that appear to have been expanded to include language as “not authoritative” in the issue paper’s effective date language. These are relatively recent issue papers adopted in 2022 and 2023.

Issue Paper No. 166—Updates to the Definition of a Asset (Finalized Aug. 10, 2022)

21. **As issue papers are not authoritative** and are not represented in the Statutory Hierarchy (see Section V of the Preamble), the consideration and adoption of this issue paper will not have any impact on the SAP clarifications adopted to SSAP No. 4 by the Working Group on August 10, 2022.

Issue Paper No. 168—Updates to the Definition of a Liability (Finalized Aug. 13, 2023)

24. **As issue papers are not authoritative** and are not represented in the Statutory Hierarchy (see Section V of the Preamble), the consideration and adoption of this issue paper will not have any impact on the SAP clarifications adopted to SSAP No. 5R by the Working Group on August 13, 2023.

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): N/A

Staff Recommendation:

NAIC staff recommend that the Working Group move this item to the active listing and expose this agenda item with proposed revisions to include issue papers within Level 5 of the statutory hierarchy. Other corresponding revisions to update references are also proposed as applicable. Upon adoption of this agenda item issue papers will not be updated but will include the following note: “On (month/year), Issue Papers were included in Level 5 of the Statutory Hierarchy.”

Statutory Accounting Principles Preamble

V. Statutory Hierarchy

42. The following Hierarchy is not intended to preempt state legislative and regulatory authority.

Level 1

SSAPs, including U.S. GAAP reference material to the extent adopted by the NAIC from the FASB Accounting Standards Codification³ (FASB Codification or GAAP guidance)

Level 2

Consensus positions of the Emerging Accounting Issues (E) Working Group as adopted by the NAIC (INTs adopted before 2016)

Interpretations of existing SSAPs as adopted by the Statutory Accounting Principles (E) Working Group (INTs adopted in 2016 or beyond)

Level 3

NAIC Annual Statement Instructions

Purposes and Procedures Manual of the NAIC Investment Analysis Office

Level 4

Statutory Accounting Principles Preamble and Statement of Concepts⁴

Level 5

[Statutory Accounting Issue Papers^{FN}](#)

Sources of nonauthoritative GAAP accounting guidance and literature, including: (a) practices that are widely recognized and prevalent either generally or in the industry, (b) FASB Concept Statements, (c) AICPA guidance not included in FASB Codification, (d) International Financial Reporting Standards, (e) Pronouncements of professional associations or regulatory agencies, (f) Technical Information Service Inquiries and Replies included in the AICPA Technical Practice Aids, and (g) Accounting textbooks, handbooks and articles

[New FN: With inclusion of Level 5, issue papers shall only be used and applied as authoritative guidance if they do not conflict with other sources of statutory guidance.](#)

43. If the accounting treatment of a transaction or event is not specified by the SSAPs, preparers, regulators and auditors of statutory financial statements should consider whether the accounting treatment is specified by another source of established statutory accounting principles. If an established statutory accounting principle from one or more sources in Level 2 or 3 is relevant to the circumstances, the preparer, regulator or auditor

³ Effective September 15, 2009, the FASB Codification is the source of authoritative U.S. generally accepted accounting principles. As of that date, the FASB Codification superseded all then-existing non-SEC accounting and reporting standards. All other nongrandfathered, non-SEC accounting literature not included in the FASB Codification is nonauthoritative. As of September 15, 2009, AICPA Statements of Position are no longer reviewed as part of the statutory maintenance process as they are no longer considered authoritative GAAP literature. If the AICPA were to address an issue that affects the FASB Codification, an accounting standard update (ASU) would be issued and reviewed for applicability to statutory accounting.

⁴ The Statutory Accounting Principles Statement of Concepts incorporates by reference FASB Concepts Statements Five and Eight to the extent they do not conflict with the concepts outlined in the statement. However, for purposes of applying this hierarchy the FASB Concepts Statements shall be included in Level 5 and only those concepts unique to statutory accounting as stated in the statement are included in Level 4.

should apply such principle. If there is a conflict between statutory accounting principles from one or more sources in Level 2 or 3, the preparer, regulator or auditor should follow the treatment specified by the source in the higher level—that is, follow Level 2 treatment over Level 3. Revisions to guidance in accordance with additions or revisions to the NAIC statutory hierarchy should be accounted for as a change in accounting principle in accordance with *SSAP No. 3—Accounting Changes and Corrections of Errors*.

44. Because of developments such as new legislation or the evolution of a new type of business transaction, there sometimes are no established statutory accounting principles for reporting a specific transaction or event. In those instances, it might be possible to report the event or transaction on the basis of its substance by selecting a statutory accounting principle that appears appropriate when applied in a manner similar to the application of an established statutory principle to an analogous transaction or event. In the absence of a SSAP or another source of established statutory accounting principles, the preparer, regulator or auditor of statutory financial statements may consider other accounting literature, depending on its relevance in the circumstances. Other accounting literature includes the Statutory Accounting Principles Statement of Concepts and GAAP reference material and accounting literature identified in Level 5. The appropriateness of other accounting literature depends on its relevance to the particular circumstances, the specificity of the guidance, and the general recognition of the issuer or author as an authority. For example, the Statutory Accounting Principles Statement of Concepts would be more authoritative than any other sources of accounting literature. Similarly, FASB Concepts Statements would normally be more influential than other sources of nonauthoritative GAAP pronouncements.

Appendix E – Issue Papers

Introduction

Issue papers are often used ~~as the first step~~ in developing new or revised SSAPs and in documenting the discussions and issues leading to the adoption of new statutory accounting concepts. ~~, and each contains a recommended conclusion, discussion and relevant literature section. While issue papers do not constitute an authoritative level of statutory accounting guidance~~ Issue papers are captured in Level 5 as defined by of the statutory hierarchy and, as they are not typically updated after adoption, shall only be used and applied if they do not conflict with other sources of statutory guidance. SSAP clarifications, especially those non-contested, many times will not have a corresponding update to a related issue paper. Issue papers, ~~they~~ are an important part of the *Accounting Practices and Procedures Manual* (Manual) because they reference the history and discussion of ~~the related~~ SSAP.

Issue papers are published in the Manual within Appendix E the first year after adoption of the related SSAP, but are then removed from the subsequent year’s Manual and posted for public reference on the Statutory Accounting Principles (E) Working Group (SAPWG) web page at https://content.naic.org/cmt_e_app_sapwg.htm.

How to Use This Manual:

Appendix E – Issue Papers:

Appendix E includes issue papers associated with SSAPs adopted through year end prior to publication of the Manual. Issue papers are often used ~~as the first step~~ in developing new or revised SSAPs and in documenting the discussions and issues leading to the adoption of new statutory accounting concepts. ~~contain a recommended conclusion, discussion and relevant literature section.~~ Issue papers are captured in Level 5 of the statutory hierarchy, ~~and, as they are not typically updated after adoption, shall only be used and applied if they do not conflict with other sources of statutory guidance. SSAP clarifications, especially those non-contested, many times will not have a corresponding update to a related issue paper.~~ **DO NOT** ~~constitute an authoritative level of statutory accounting, as supported by the statutory hierarchy, and should only be used as reference material. Nevertheless, i~~ Issue papers are important because they reference the history and discussion of a related SSAP. The “Relevant Statutory Accounting and GAAP Guidance” section of the issue paper may ~~contains~~ excerpts of

accounting guidance considered, but not necessarily adopted, by the Statutory Accounting Principles (E) Working Group (SAPWG) when forming the conclusions reached in the resultant SSAP. Historical issue papers associated with SSAPs adopted prior to the current year are posted for public reference on the SAPWG web page at https://content.naic.org/cmt_e_app_sapwg.htm.

NAIC Policy Statement on Maintenance of Statutory Accounting Principles

Development of New SSAPs or New SAP Concepts⁵ in an Existing SSAP

4. New SSAPs will be developed to address, but will not be limited to: 1) concepts not previously addressed by a SSAP and that do not fit within the scope of an existing SSAP; 2) concepts that fit within the scope of an existing SSAP, but the Working Group elects to supersede existing SSAPs and 3) existing concepts that warrant significant revisions. New SAP concepts to existing SSAPs will be developed to address, but will not be limited to: 1) concepts that fit within the accounting topic of an existing SSAP, but have not been addressed by the Working Group; 2) changes to the valuation and/or measurement of an existing SSAP; and 3) modifications to the overall application of existing SSAPs. The decision to undertake development of a new SSAP or a new SAP concept in an existing SSAP will rest with the Working Group. New SSAPs or a new SAP concept in an existing SSAP will have a specified effective date.
5. Research and drafting of a new SSAP or a new SAP concept in an existing SSAP will be performed by NAIC staff under the direction and supervision of the Working Group which may enlist the assistance of interested parties and/or consultants with requisite technical expertise as needed or desired. Issue papers are often used ~~The first step in the process to develop~~ ~~developing~~ new SSAPs and new SAP concepts in existing SSAPs ~~will commonly be the drafting of an issue paper, which will contain a summary of the issue, a summary conclusion, discussion, and a relevant literature section~~ and to document the discussions and issues leading to the adoption of new statutory accounting concepts. Public comments will be solicited on an issue paper (at least one exposure period), and at least one public hearing will be held before the issue paper ~~is converted to a SSAP~~ is adopted. Upon approval by the Working Group, all proposed SSAPs will be exposed for public comment for a period commensurate with the length of the draft and the complexities of the issue(s). After a hearing of comments, adoption of new SSAPs or new SAP concepts in existing SSAPs (including any amendments from exposure) may be made by simple majority. If no comments are received during the public comment period, the Working Group may adopt the proposal collectively (one motion/vote) with other non-contested positions after the opportunity is given during the hearing to separately discuss the proposal. All new SSAPs and new SAP concepts in existing SSAPs must be on the agenda for at least one public hearing before presentation to the Task Force for consideration. Adoption by the Task Force, its parent and the NAIC membership shall be governed by the NAIC bylaws.

Staff Review Completed by: Julie Gann, NAIC Staff—November 2024

<https://naiconline.sharepoint.com/teams/FRSStatutoryAccounting/NationalMeetings/A.NationalMeetingMaterials/2024/12-17-2024/A-24-27-IssuePaperStatHierarchy.docx>

⁵ Prior to December 11, 2021, the term used to describe a new SAP concept was “substantive” and the term used to describe a SAP clarification was “nonsubstantive.” The new terms will be reflected in materials to describe revisions to statutory accounting principles on a prospective basis and historical documents will not be updated to reflect the revised terms.

**Statutory Accounting Principles (E) Working Group
Maintenance Agenda Submission Form
Form A**

Issue: Holders of Capital Notes

Check (applicable entity):

	P/C	Life	Health
Modification of Existing SSAP	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>
New Issue or SSAP	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Interpretation	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>

Description of Issue: This agenda item has been prepared in response to the direction of the Working Group during the 2024 Fall National Meeting with the adoption of *INT 24-01: Principles-Based Bond Definition Implementation Questions and Answers*. With the adoption of the INT, and the guidance for reporting certain debt securities as capital notes in scope of *SSAP No. 41—Surplus Notes*, industry identified that slight revisions may be necessary to reflect the capital note distinctions. The Working Group directed NAIC staff to work with industry in this review and identifying necessary changes.

From the initial review and working with industry, revisions have been proposed to address the following specifically for capital notes:

1. Incorporate a definition/reference to the INT for capital notes.
2. Clarify the admittance restrictions.
3. Clarify the guidance for NAIC designations.
4. Update the impairment guidance to refer to capital notes.

In addition to these items, it was identified that an existing disclosure for surplus notes, which requires disclosure of any holder of 10% or more of an SEC-registered surplus note, is likely an extensive administrative burden, may be difficult to complete, and as a narrative disclosure only (not data-captured), is likely not often utilized. From a review of the disclosure, it predates the issuance of *SSAP No. 41—Surplus Notes*, and there are questions as to how a disclosure of certain holders of SEC-registered notes would be purposeful or used. NAIC staff has proposed to eliminate this aspect of the disclosure but retain the disclosure focusing on surplus notes with affiliates. NAIC staff requests feedback on whether this disclosure should be retained.

Existing Authoritative Literature:

- ***SSAP No. 41—Surplus Notes***

1. This statement establishes statutory accounting principles for issuers and holders of surplus notes, and for holders of capital notes. Statutory accounting principles for issuers of capital notes are provided in *SSAP No. 15—Debt and Holding Company Obligations*.

(Paragraphs 2-8 Is limited to “Issuers of Surplus Notes” so is not included.)

Holders of Capital or Surplus Notes

9. Investments in capital or surplus notes 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. Additionally, the amount admitted is specifically limited to the following two provisions:
 - a. The admitted asset value of a capital or surplus note shall not exceed the amount that would be admitted if the instrument was considered an equity instrument and added to any other

equity instruments in the issuer held directly or indirectly by the holder of the capital or surplus note.

- b. The surplus note shall be nonadmitted if issued by an entity that is subject to any order of liquidation, conservation, rehabilitation or any company action level event based on its risk-based capital. Subsequent to this nonadmittance, if any of the conditions described ceased to exist, the holder may admit the surplus note at the value determined under paragraph 11. If a surplus note was nonadmitted pursuant to this paragraph, and the surplus note was ultimately determined to be other-than-temporarily impaired, the reporting entity shall recognize a realized loss for the portion of the surplus note determined to be other-than-temporarily impaired, with elimination of a corresponding amount of the previously nonadmitted assets.

10. Capital or surplus notes shall be valued in accordance with paragraph 11. Pursuant to that paragraph, the value is determined by NAIC credit rating provider (CRP) ratings. Part One – Capital and Surplus Debentures of the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* provides guidance in determining the NAIC designation for these investments.

11. If the capital or surplus note has been rated by an NAIC CRP and has a designation equivalent of NAIC 1 or NAIC 2, then it shall be reported at amortized cost. If the capital or surplus note is not CRP rated or has an NAIC designation equivalent of NAIC 3 through 6, then the balance sheet amount shall be reported at the lesser of amortized cost or fair value, with fluctuations in value reflected as unrealized valuation changes.

12. For reporting entities required to maintain an AVR, the accounting for unrealized gains and losses shall be in accordance with *SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve*. For reporting entities not required to maintain an AVR, unrealized gains and losses shall be recorded as a direct credit or charge to unassigned funds (surplus).

13. For surplus notes issued and held (directly or indirectly) between insurance reporting entities and subsidiary, controlled and affiliated entities, the guidance in *SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities* requires adjustment to prevent double-counting of surplus notes. For example, an insurance reporting entity is not permitted to report the issuance of a surplus note as an increase in surplus and have an asset representing an investment in the SCA that includes the issued surplus note (held by an SCA). Pursuant to *SSAP No. 97*, the “investment in the SCA” shall be adjusted to eliminate the surplus note issued by the direct or indirect parent insurance reporting entity. This treatment shall also apply for instances in which the SCA acquires any portion of outstanding surplus notes issued by the direct or indirect parent through any means (e.g., directly acquired from the parent, acquired through a third-party broker, or via the market).

Income

14. Only interest that has been approved by the issuer’s domiciliary commissioner shall be accrued as income by a holder of surplus notes. Interest income for any period consists of interest collected during the period and the change in the due and accrued interest between the beginning and end of the period approved by the issuer’s domiciliary commissioner.

15. Except for the specific limitations on recognizing interest income in paragraph 14, investment income, and the recognition of uncollectible accrued interest, shall follow the guidance in *SSAP No. 34—Investment Income Due and Accrued*.

Impairment

16. An other-than-temporary impairment^(INT 06-07) shall be considered to have occurred if it is probable that the reporting entity will be unable to collect all amounts due according to the contractual terms of the surplus note. Pursuant to the terms of a surplus note, payments of principal and interest may be delayed if the issuer’s domiciliary commissioner does not approve payment. Extended delays of either principal or interest shall trigger an evaluation for an other-than-temporary impairment. An other-than-temporary impairment shall be recognized in situations when the reporting entity has made a decision to sell a surplus note prior to its maturity at an amount below its carrying value. If it is determined that a decline in fair value is other-than-temporary, an impairment loss shall be recognized as a realized loss equal to the difference between the surplus note’s

carrying value and the fair value at the balance sheet date of the reporting period for which the assessment is made. The measurement of impairment shall not include partial recoveries of fair value subsequent to the balance sheet date. For reporting entities required to maintain an AVR, realized losses shall be accounted for in accordance with SSAP No. 7.

17. In periods subsequent to the recognition of an other-than-temporary impairment loss for a surplus note, the holder of the surplus note shall account for the other-than-temporarily impaired surplus note as if the surplus note had been purchased on the measurement date of the other-than-temporary impairment. The fair value of the surplus note on the measurement date shall become the new cost basis of the surplus note and the new cost basis shall not be adjusted for subsequent recoveries in fair value. The discount or reduced premium recorded for the surplus note, based on the new cost basis, shall be amortized over the remaining life of the surplus note in the prospective manner based on the amount and timing of future estimated cash flows. The surplus note shall continue to be subject to impairment analysis for each subsequent reporting period. Future declines in fair value which are determined to be other-than-temporary shall be recorded as realized losses.

Disclosures

18. The notes to the financial statements of a reporting entity that issues surplus notes shall disclose the following as long as the surplus notes are outstanding:

- a. Date issued;
- b. Description and fair value of the assets received;
- c. Holder of the note or, if public, the names of the underwriter and trustee, with identification on whether the holder of the surplus note is a related party per *SSAP No. 25—Affiliates and Other Related Parties*;
- d. Original issue amount of note;
- e. Carrying value of note;
- f. The rate at which interest accrues;
- g. Maturity dates or repayment schedules, if stated;
- h. Unapproved interest and/or principal;
- i. Life-to-date and current year approved interest and principal recognized;
 - i. Percentage interest payments offset through ‘administrative offsetting’ (not inclusive of amounts paid to a third-party liquidity provider). For example, if \$100 in interest was recognized through the year, \$10 of which was remitted to a third-party liquidity provider and the remainder \$90 was offset, the reporting entity shall report 100% as offset.
- j. Disclosure of whether the surplus note was issued as part of a transaction with any of the following attributes:
 - i. Do surplus note/associated asset terms negate or reduce cash flow exchanges, and/or are amounts payable under surplus note and amounts receivable under other agreements contractually linked? (For example, the asset provides interest payments only when the surplus note provides interest payments.)
 - ii. Are any amounts due under surplus notes and associated assets netted or offset (partially or in full) thus eliminating or reducing the exchange of cash or assets that would normally occur throughout the duration, or at maturity, of the agreement? (This may be referred to as administrative offsetting.)

- iii. Were the proceeds from the issuance of a surplus note used to purchase an asset directly or indirectly from the holder of the surplus note?
- k. Principle amount and fair value of assets received upon surplus note issuance, if applicable;
- l. Subordination terms;
- m. Liquidation preference to the reporting entity's common and preferred shareholders;
- n. The repayment conditions and restrictions;
- o. Information about any guarantees, support agreements or related party transactions associated with the surplus note issuance, and whether payments have been made under such agreements.

19. If a reporting entity has ceded business to a surplus note issuer that is a related party as part of a reinsurance transaction in which the surplus note meets any of the criteria in paragraph 18.j., the ceding entity shall provide a description of the transaction, including whether the criteria in paragraph 18.j. were met with respect to the surplus note issuance, as long as the reinsurance agreement remains in force. The ceding entity should provide a description of the risks reinsured, the related party reinsurer, any guarantees or support agreements, and the amount of notes outstanding.

20. If the proceeds from the issuance of a surplus note used to purchase an asset directly or indirectly from the holder of the surplus note, the following information shall be disclosed regarding the assets received:

- a. Identification of asset, including the investment schedule where the asset is reported and reported NAIC designation.
- b. Book/adjusted carrying value of asset as of the current reporting date.
- c. A description of terms under which liquidity would be provided should a triggering event occur.

21. In addition to the above, a reporting entity shall identify all affiliates that hold any portion of a surplus debenture or similar obligation (including an offering registered under the Securities Act of 1933 or distributed pursuant to rule 144A under the Securities Act of 1933), and any holder of 10% or more of the outstanding amount of any surplus note registered under the Securities Act of 1933 or distributed pursuant to Rule 144A under the Securities Act of 1933.

INT 24-01: Principles-Based Bond Definition Implementation Questions and Answers

10. Q – How should hybrid securities be accounted and reported? [SSAP No. 26, paragraph 13]

10.1 A – SSAP No. 26 prior to the principles-based bond definition explicitly scoped in a class of assets referred to as “hybrid securities” which are defined as “securities whose proceeds are accorded some degree of equity treatment by one or more of the nationally recognized statistical rating organizations (NRSRO) and/or which are recognized as regulatory capital by the issuer’s primary regulatory authority. Hybrid securities are designed with characteristics of debt and equity and are intended to provide protection to the issuer’s senior note holders. Hybrid securities are sometimes referred to as capital securities.” During the development of the principles-based bond definition, it was decided to remove the explicit scope-in and instead rely on the new principles to determine whether bond classification is appropriate. As these securities come in several forms, additional clarity on where to report such securities is warranted.

10.2 Equity Securities: Investments that represent shares, units, or an ownership interest in a company or other entity but do not reflect common stock that were previously considered hybrids under SSAP No. 26 are equity investments and shall be captured as preferred stock in scope of SSAP No. 32—*Preferred Stock*. Investments in debt securities are not permitted to be reported in scope of SSAP No. 30—*Unaffiliated Common Stock* or SSAP No. 32.

10.3 Debt Securities: Investments in debt securities previously considered hybrids under SSAP No. 26

(including those debt securities with cumulative interest features) **that qualify** under the principles-based bond definition shall be reported as bonds on Schedule D. An example may include certain debt securities which NRSROs allow to be treated as equity but for which all the principles-based bond definition requirements are present. To be clear, a set maturity date for a debt security is not a requirement for bond classification if the bond otherwise qualifies under the definition. (Perpetual bonds that qualify under the bond definition are permitted as bonds.)

10.4 Investments in debt securities treated as regulatory capital by the issuer's primary regulatory authority, and **that do not qualify** under the principles-based bond definition solely because interest can be cancelled in the event of financial stress in a non-resolution scenario without triggering an act of default are capital notes and shall be captured in *SSAP No. 41—Surplus Notes*. These capital notes are often issued by domestic or foreign banks, and the domestic or foreign bank regulator or the Issuer has the ability to cancel interest or dividends, without future interest accumulation or payment.

10.5 Debt securities other than capital notes (as defined in 10.4 above) that permit the issuing entity to cancel interest without future interest accumulation or payment and without triggering an act of default, or that incorporate other equity components that do not permit bond classification under the principles-based bond definition are non-bond debt securities and shall be captured in scope of *SSAP No. 21—Other Admitted Assets*.

10.6 Debt securities issued by regulated institutions where only the issuer's primary regulator may have regulatory power to cancel or convert to equity all or a portion of the debt and/or its related interest payments, solely in a resolution scenario were not previously considered hybrid securities and should continue to be reported as Schedule D bonds, as Issuer Credit Obligations under *SSAP No. 26*, so long as all principles-based bond definition requirements are met.

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):

On Nov. 17, 2024, the Statutory Accounting Principles (E) Working Group adopted *INT 24-01: Principles-Based Bond Definition Implementation Questions and Answers*. This INT addresses hybrid securities, including debt securities that are treated as regulatory capital. With the adoption of this guidance, and the reference for capital notes to be in scope of *SSAP No. 41*, industry identified minor revisions are needed to *SSAP No.41*.

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:

NAIC staff recommend that the Working Group move this item to the active listing as a SAP clarification and expose revisions to *SSAP No. 41—Surplus Notes*, to incorporate needed changes to clarify certain aspects for capital notes. As part of the review, minor other clarification revisions were also incorporated.

As there are two separate reporting lines on Schedule BA for “Surplus Notes” and “Capital Notes” with very few items currently being reported in the “Capital Note” category, this agenda item recommends annual statement instruction revisions to clarify that qualifying insurer-issued notes held by another insurance reporting entity be reported as “Surplus Notes” on Schedule BA. There is also proposed clarification on what should be included as “Capital Notes.”

Proposed revisions to SSAP No. 41:

1. This statement establishes statutory accounting principles for issuers and holders of surplus notes, and for holders of capital notes^{FN}. Statutory accounting principles for issuers of capital notes are provided in *SSAP No. 15—Debt and Holding Company Obligations*.

New Footnote: INT 24-01: Principles-Based Bond Definition Implementation Questions and Answers identifies that debt securities treated as regulatory capital by the issuer's primary regulatory authority and that do not qualify under the principles-based bond definition solely because interest can be cancelled in the event of financial stress in a non-resolution scenario without triggering an event of default are capital notes in scope of this statement. For consistency in investment reporting for held securities, only insurer-issued notes that qualify under paragraph 3 shall be reported as surplus notes. As detailed within, surplus notes are subject to additional restrictions not applicable capital notes.

Holders of Capital or Surplus Notes

9. Investments in capital or surplus notes 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. Additionally, the amount admitted is specifically limited to the following two provisions:

- a. In the absence of specific instruction pursuant to state law or direction of the domiciliary regulator, ~~T~~the admitted asset value of a capital or surplus note shall not exceed the amount that would be admitted under state investment limits if the instrument was considered an equity instrument and added to any other equity instruments in the issuer held directly or indirectly by the holder of the capital or surplus note.

NAIC Staff Note: The SSAPs do not have equity limits for admitted assets. The above paragraph would pertain to state investment limits. This guidance requires capital and surplus notes to be combined with other equity items to determine whether the state investment limit for equity instruments has been surpassed. It is not characteristic of the SSAPs to detail provisions used in state investment limitations, but this paragraph has been part of SSAP No. 41 since codification. If preferred by Working Group members, this paragraph could be deleted.

- b. The surplus note shall be nonadmitted if issued by an entity that is subject to any order of liquidation, conservation, rehabilitation or any company action level event based on its risk-based capital. Capital notes shall be nonadmitted in any event in which the regulatory authority halts principal or interest payments. Subsequent to this nonadmittance, if any of the conditions described ceased to exist, the holder may admit the capital or surplus note at the value determined under paragraph 11. If a capital or surplus note was nonadmitted pursuant to this paragraph, and the capital or surplus note was ultimately determined to be other-than-temporarily impaired, the reporting entity shall recognize a realized loss for the portion of the surplus note determined to be other-than-temporarily impaired, with elimination of a corresponding amount of the previously nonadmitted assets.

10. Capital or surplus notes shall be valued in accordance with paragraph 11. Pursuant to that paragraph, the value is determined by NAIC ~~credit rating provider (CRP) ratings designations. Part One—Capital and Surplus Debentures of ~~t~~~~The Purposes and Procedures Manual of the NAIC Investment Analysis Office provides guidance in determining the NAIC designation for these investments.

11. If the capital or surplus note has been rated by an NAIC CRP and has a designation equivalent of NAIC 1 or NAIC 2, then it shall be reported at amortized cost. If the capital or surplus note ~~is not CRP rated~~does not have an NAIC designation or has an NAIC designation ~~equivalent~~ of NAIC 3 through 6, then the balance sheet amount shall be reported at the lesser of amortized cost or fair value, with fluctuations in value reflected as unrealized valuation changes.

12. For reporting entities required to maintain an AVR, the accounting for unrealized gains and losses shall be in accordance with SSAP No. 7—*Asset Valuation Reserve and Interest Maintenance Reserve*. For reporting entities not required to maintain an AVR, unrealized gains and losses shall be recorded as a direct credit or charge to unassigned funds (surplus).

13. For surplus notes issued and held (directly or indirectly) between insurance reporting entities and subsidiary, controlled and affiliated entities, the guidance in SSAP No. 97—*Investments in Subsidiary, Controlled and Affiliated Entities* requires adjustment to prevent double-counting of surplus notes. For example, an insurance reporting entity is not permitted to report the issuance of a surplus note as an increase in surplus

and have an asset representing an investment in the SCA that includes the issued surplus note (held by an SCA). Pursuant to SSAP No. 97, the “investment in the SCA” shall be adjusted to eliminate the surplus note issued by the direct or indirect parent insurance reporting entity. This treatment shall also apply for instances in which the SCA acquires any portion of outstanding surplus notes issued by the direct or indirect parent through any means (e.g., directly acquired from the parent, acquired through a third-party broker, or via the market).

Income

14. Only interest that has been approved by the issuer’s domiciliary commissioner shall be accrued as income by a holder of surplus notes. Interest income for any period consists of interest collected during the period and the change in the due and accrued interest between the beginning and end of the period approved by the issuer’s domiciliary commissioner.

15. Except for the specific limitations on recognizing interest income in paragraph 14, investment income, and the recognition of uncollectible accrued interest, shall follow the guidance in *SSAP No. 34—Investment Income Due and Accrued*.

Impairment

16. An other-than-temporary impairment^(INT 06-07) shall be considered to have occurred if it is probable that the reporting entity will be unable to collect all amounts due according to the contractual terms of the surplus or capital note. Pursuant to the terms ~~of a surplus note~~, payments of principal and interest may be delayed if the issuer’s domiciliary commissioner or other regulatory authority does not approve payment. Extended delays of either principal or interest shall trigger an evaluation for an other-than-temporary impairment. An other-than-temporary impairment shall be recognized in situations when the reporting entity has made a decision to sell a surplus note prior to its maturity at an amount below its carrying value. If it is determined that a decline in fair value is other-than-temporary, an impairment loss shall be recognized as a realized loss equal to the difference between the surplus note’s carrying value and the fair value at the balance sheet date of the reporting period for which the assessment is made. The measurement of impairment shall not include partial recoveries of fair value subsequent to the balance sheet date. For reporting entities required to maintain an AVR, realized losses shall be accounted for in accordance with SSAP No. 7.

17. In periods subsequent to the recognition of an other-than-temporary impairment loss for a surplus or capital note, the holder of the surplus note shall account for the other-than-temporarily impaired surplus or capital note as if the ~~surplus~~ note had been purchased on the measurement date of the other-than-temporary impairment. The fair value of the ~~surplus~~ note on the measurement date shall become the new cost basis ~~of the surplus note~~ and the new cost basis shall not be adjusted for subsequent recoveries in fair value. The discount or reduced premium recorded for the surplus or capital note, based on the new cost basis, shall be amortized over the remaining life of the ~~surplus~~ note in the prospective manner based on the amount and timing of future estimated cash flows. The ~~surplus~~ note shall continue to be subject to impairment analysis for each subsequent reporting period. Future declines in fair value which are determined to be other-than-temporary shall be recorded as realized losses.

Disclosures

18. The notes to the financial statements of a reporting entity that issues surplus notes shall disclose the following as long as the surplus notes are outstanding:

- a. Date issued;
- b. Description and fair value of the assets received;
- c. Holder of the note or, if public, the names of the underwriter and trustee, with identification on whether the holder of the surplus note is a related party per *SSAP No. 25—Affiliates and Other Related Parties*;
- d. Original issue amount of note;
- e. Carrying value of note;

- f. The rate at which interest accrues;
- g. Maturity dates or repayment schedules, if stated;
- h. Unapproved interest and/or principal;
- i. Life-to-date and current year approved interest and principal recognized;
 - i. Percentage interest payments offset through 'administrative offsetting' (not inclusive of amounts paid to a third-party liquidity provider). For example, if \$100 in interest was recognized through the year, \$10 of which was remitted to a third-party liquidity provider and the remainder \$90 was offset, the reporting entity shall report 100% as offset.
- j. Disclosure of whether the surplus note was issued as part of a transaction with any of the following attributes:
 - i. Do surplus note/associated asset terms negate or reduce cash flow exchanges, and/or are amounts payable under surplus note and amounts receivable under other agreements contractually linked? (For example, the asset provides interest payments only when the surplus note provides interest payments.)
 - ii. Are any amounts due under surplus notes and associated assets netted or offset (partially or in full) thus eliminating or reducing the exchange of cash or assets that would normally occur throughout the duration, or at maturity, of the agreement? (This may be referred to as administrative offsetting.)
 - iii. Were the proceeds from the issuance of a surplus note used to purchase an asset directly or indirectly from the holder of the surplus note?
- k. Principle amount and fair value of assets received upon surplus note issuance, if applicable;
- l. Subordination terms;
- m. Liquidation preference to the reporting entity's common and preferred shareholders;
- n. The repayment conditions and restrictions;
- o. Information about any guarantees, support agreements or related party transactions associated with the surplus note issuance, and whether payments have been made under such agreements.

19. If a reporting entity has ceded business to a surplus note issuer that is a related party as part of a reinsurance transaction in which the surplus note meets any of the criteria in paragraph 18.j., the ceding entity shall provide a description of the transaction, including whether the criteria in paragraph 18.j. were met with respect to the surplus note issuance, as long as the reinsurance agreement remains in force. The ceding entity should provide a description of the risks reinsured, the related party reinsurer, any guarantees or support agreements, and the amount of notes outstanding.

20. If the proceeds from the issuance of a surplus note used to purchase an asset directly or indirectly from the holder of the surplus note, the following information shall be disclosed regarding the assets received:

- a. Identification of asset, including the investment schedule where the asset is reported and reported NAIC designation.
- b. Book/adjusted carrying value of asset as of the current reporting date.
- c. A description of terms under which liquidity would be provided should a triggering event occur.

21. ~~In addition to the above, a~~ reporting entity shall identify all affiliates that hold any portion of a surplus debenture or similar obligation (including an offering registered under the Securities Act of 1933 or distributed pursuant to rule 144A under the Securities Act of 1933), ~~and any holder of 10% or more of the outstanding amount of any surplus note registered under the Securities Act of 1933 or distributed pursuant to Rule 144A under the Securities Act of 1933.~~

Proposed Revisions to Annual Statement Instructions – Schedule BA

Surplus Debentures:

Include: That portion of any subordinated indebtedness, surplus debenture, surplus note, debenture note, premium income note, or other contingent evidence of indebtedness, that qualifies as a surplus note pursuant to SSAP No. 41—Surplus Notes, that is reported in the surplus of the issuer.

Capital Notes:

Include: This reporting line shall be utilized for held debt securities, that do not qualify as issued surplus notes pursuant to SSAP No. 41—Surplus Notes, that are treated as regulatory capital by the issuer’s primary regulatory authority and that do not qualify under the principles-based bond definition solely because interest can be cancelled in the event of financial stress in a non-resolution scenario without triggering an event of default. ~~The portion of any capital note that is reported on the line for capital notes of the issuance insurance reporting entity.~~

Staff Review Completed by: Julie Gann, NAIC Staff—December 2024

[https://naiconline.sharepoint.com/teams/FRSStatutoryAccounting/NationalMeetings/A.NationalMeetingMaterials/2024/12-17-2024/B-24-28-SSAP No. 41 - Capital Notes.docx](https://naiconline.sharepoint.com/teams/FRSStatutoryAccounting/NationalMeetings/A.NationalMeetingMaterials/2024/12-17-2024/B-24-28-SSAPNo.41-CapitalNotes.docx)

**Statutory Accounting Principles (E) Working Group
Maintenance Agenda Submission Form
Form A**

Issue: Repack and Derivative Investments

Check (applicable entity):

	P/C	Life	Health
Modification of Existing SSAP	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
New Issue or SSAP	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>
Interpretation	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>

Description of Issue: This agenda item has been developed to address debt security investments with derivative components that do not qualify as structured notes. Although the original focus was on specific “credit repack” investments, the agenda item has been expanded to ensure that all debt security investments with derivative wrappers / components are captured.

As an overview of a special purpose vehicle (SPV) “repacking,” the structure consists of an SPV acquiring a debt security and reprofiling the cash flows by entering a derivative transaction with a derivative counterparty (known as “credit repacks”). The redesigned debt instrument (reflecting the combined debt security and derivative) is then sold to an investor. NAIC staff has recently received calls on the classification of repacks under the bond definition, but the discussions of these transactions have identified that additional guidance may be warranted to ensure consistent reporting of these transactions within the statutory financial statements. From the discussions, there are initiatives for these combined investments to become more prevalent with U.S. insurance entities, but investment makers have noted that these investments are already common in other countries.

As a key element, repacking (and potentially other derivative wrapped debt structures) takes two separate items (debt security and derivative) and combines them into one instrument that resembles a debt security. This is done at an SPV, with the SPV issuing a new debt security to the reporting entity. From discussions, there are several variations of the derivative components that can be combined with the debt security. Some of them are very simple (such as a cross-currency swap), but others are complex, altering both the amount and timing of cash flows. The structures can be customized allowing for ongoing innovation, benefiting insurers with the ability of entering derivative transactions to appropriately reduce risk, but creating difficulty in the ability to group repacks structures into limited exception guidance.

For all of these structures, the derivative arrangements could be entered into separately and do not need to be entered into as a combined transaction, however, the noted benefits for entering into a combined structure include:

- 1) **Derivative Margin / Collateral Requirement:** There is no daily settling of a margin requirement at the derivative counterparty based on fair value changes in the derivative. **This is because the debt security in the structure serves as constant collateral, and any amount owed to the derivative counterparty would be taken first from debt instrument cash flows before payment is made to the investor. (The derivative counterparty is senior in priority.)** The repack structure limits the collateral obligation to the debt security in the structure, so there is no potential for the reporting entity to be obligated for more collateral beyond the linked debt security. This is a benefit of a repack in comparison to normal derivatives that do not have a collateral limit.
 - Although perceived as a benefit from the entity / investment maker as it reduces liquidity risk associated with margin calls, from a statutory accounting perspective, if the transactions were reported separately and the debt investment was pledged as collateral, the debt instrument would be identified as a restricted asset. If the repack is collectively reported as a debt instrument, there would be no identification that the debt instrument is restricted or encumbered as collateral to the derivative counterparty. This is

because the restriction is at the SPV and not the reporting entity. Also, if separately engaging in derivative transactions, the derivative counterparty is known and reported. If a repack is collectively reported as a debt instrument, it is uncertain if the affiliation between the derivative counterparty and reporting entity would be known.

- 2) **Bond Reporting:** If these structures are accounted for as bonds, **reporting entities would determine measurement method and RBC impact based on the NAIC designation. Ultimately, this structure provides the reporting entity with a derivative arrangement, with no separate reporting or acknowledgement of the derivative instrument within the financial statements.**
 - From a statutory accounting perspective, if reporting is combined in a repack, derivatives would not be captured on Schedule DB and reporting entities would not be required to assess whether the derivative is effective under *SSAP No. 86—Derivatives*. (There is also a question on whether these arrangements would be captured in a reporting entity’s derivative use plan filed with the domiciliary state.) Any obligation based on the performance of the derivative would not be reported in the investor’s financials.
- 3) **RBC Impact:** By reporting as a bond investment, the reporting entity would incur a single RBC factor charge based on the NAIC designation on the debt security issued by the SPV.
 - From a statutory perspective, if the investment had been reported separately as a bond and a derivative, there would be RBC impacts for both components. The collateral pledged to the derivative counterparty (bond) would also be coded as a restricted asset. Whether the combined reporting results in a benefit to RBC depends on how the derivative would have been reported separately (at amortized cost or fair value) and whether the derivative is in a loss position. However, if reported separately, these components are captured in the RBC formula to reflect those dynamics.

The following identifies specific elements for discussion:

- 1) **Sale / Reacquisition:** A “credit repack” can be originated with a reporting entity’s currently held debt security. In those situations, the insurer would sell the debt security to an SPV, that security would be combined with a derivative at the SPV, and the SPV would sell the restructured combined instrument back to the insurer.

From the discussions held, inconsistent interpretations may exist on whether the initial debt security should be reflected as disposed, with the reporting entity acquiring a new investment for the “repack.” The discussions have referred to “substantially similar” U.S. GAAP guidance and have noted that the base investment (original debt security) has not changed, therefore the action did not warrant disposal / new acquisition reporting. If this interpretation was applied, the original debt security would still be shown on the financial statements, but with the repack the issuer, yield and NAIC designation have been impacted. If it is concluded that the revised instrument is substantially similar to what was originally held and did not require a disposal / reacquisition, it is likely that there would be no indication in the financial statements that the entity has entered into a new arrangement that combines a debt security and derivative instrument. NAIC staff does not agree with interpretations that the repack is substantially similar based on existing guidance in SSAP No. 103, paragraph 52, but this has been noted as part of the discussions. Under SSAP No. 103, to be considered substantially the same, an investment needs to have the same primary obligor, identical contractual interest rates and identical form and type to provide the same risks and rights. Under a repack, the issuer, yield and designation are impacted as follows, disallowing consideration that the instrument is substantially the same:

- The revised issuer is the SPV and the new instrument is a combined instrument of the debt instrument and the derivative.
- The fees for engaging in this instrument are built into the investment yield, resulting in a lower yield than what would have been received if the original debt instrument was still held.

- The NAIC designation (CRP rating) could also be impacted, as the revised instrument reflects the credit quality of both the original issuer and the derivative counterparty. From discussions, this is often a 1-level decrease in rating.

Not all repacks involve a previously held debt instrument. An entity may acquire a repack directly from the SPV rather than sell a currently owned debt security to the SPV. From the discussions, if this was to occur, it is believed that entities would report the acquired investment as a bond (under existing SSAP guidance), unless the structure is considered to be a structured note under paragraph 5.g. of *SSAP No. 86—Derivatives*:

5.g. “Structured Notes” in scope of this statement are instruments defined in *SSAP No. 26R—Bonds* (often in the form of debt instruments), in which the amount of principal repayment or return of original investment is contingent on an underlying variable/interest¹. Structured notes that are “mortgage-referenced securities” are captured in *SSAP No. 43R—Loan-Backed and Structured Securities*.

There is also a question on whether all repacks should be considered structured notes. In a repack structure, if the debt security is liquidated early and there is an amount owed from the derivative performance, the SPV must first satisfy that amount to the derivative counterparty. This could result in a payment less than the principal amount being remitted to the insurer holder. Although the repack designs differ based on the derivative instrument and intent, in some situations this is only driven by the early liquidation of the structure and not a component that comes into play if the structure is held to maturity. In those structures, the design would not be considered a structured note. However, in other designs, the repack may reflect a structured note regardless, and the structured note guidance should be followed.

- 2) **Derivative Obligation:** A credit repack investment ultimately could allow an insurer to enter into derivative arrangements that are not separately reported or assessed within the scope of SSAP No. 86, which is currently explicit that embedded derivatives shall not be separated from the host contract. If the derivative was to be separately reported, it would only qualify for amortized cost treatment if determined to be highly effective pursuant to SSAP No. 86, otherwise it would be reported at fair value.

From discussions of these investment / derivative designs, NAIC staff has the impression that these derivative arrangements would be reported at fair value if held separately from the debt instrument. (Discussions have indicated that they would be separately reported at fair value under U.S. GAAP.) By combining with the debt security, and if permitted to follow bond accounting, reporting entities would utilize an amortized cost measurement for the combined credit repack based on the NAIC designation pursuant to current guidance within SSAP No. 26 / SSAP No. 43.

Although it has been communicated that the derivative is designed to match the maturity duration of the debt instrument, if the investment was to be liquidated in advance of the maturity date, the obligation with the derivative counterparty must still be satisfied. If the derivative was in a liability position, upon liquidation of the debt instrument, the SPV would collect the proceeds from the debt instrument and first remit any amount owed to the derivative counterparty before providing the remaining balance to the reporting entity. Although it depends on the derivative arrangement, in some designs, the reporting entity could receive less than the stated

¹ 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 positive interest rates in response to a linked underlying variable or the passage of time, 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 as structured notes in scope of this statement.

principal amount of the bond. For these designs, unless the derivative was reported separately (or the repack was reported at fair value), the amount to be received at any point in time for the repack investment may be overstated due to the derivative impact. *(The inverse is also true, whereas if the derivative was in an asset position, the SPV would collect funds from the derivative counterparty and the reporting entity would receive an amount that exceeds the principal amount of the bond.)*

- 3) **Principles-Based Bond Definition Application**: The discussion with NAIC staff on credit repacks initially occurred due to questions on whether the repack is an issuer credit obligation (ICO) or an asset-backed security (ABS) under the principles-based bond definition. Initially, it was noted that a repack with a derivative that simply converted cash flows (fixed to floating or foreign currency), but which did not impact the timing or extent of cash flows could still potentially reflect an ICO obligation under the single-entity payer provision, assuming that the investment did not reflect a structured note. However, any design that was to alter the timing or amount of cash flows would result in an ABS classification. For example, if the repack altered the timing of cash flows so instead of periodic interest in line with the debt security terms, all interest payments were accumulated at the SPV and provided at maturity, this would require an ABS classification. If classified as an ABS, it was noted that there would be no substantive credit enhancement (as the structure simply passes through cash flows) and the structure would fail to qualify as a bond. However, after further assessment of these structures, NAIC staff recommends explicit guidance for the accounting of these combined debt / derivative structures. From discussions on these investments, a key driver is getting the combined structure classified as a Schedule D investment. From information shared, a vast array of different derivative structures could be combined with the debt security to form a combined item, with many different cashflow desired outcomes.

Ultimately, NAIC staff believes the issue goes further than bond classification as ICO or ABS. As such, this agenda item proposes SSAP guidance / interpretation to address all situations in which a debt security may be wrapped or combined with a derivative structure to ensure consistent and transparent reporting as well as information to the regulators on these investment transactions. NAIC staff believes the potential for these structures originates from the existing SSAP No. 86 guidance that indicates that embedded derivatives shall not be separated from the host contract and accounted for separately as a derivative instrument. NAIC staff notes that this SSAP No. 86 guidance allows these investment structures to be reported in ways that were perhaps not intended when that embedded derivative guidance was originally established.

Existing Authoritative Literature:

- ***SSAP No. 26R—Bonds (Effective Jan. 1, 2025)***

SSAP No. 26R includes the adopted principles-based bond definition and the provisions for detailing an ICO or ABS. Key provisions from this SSAP are provided below. These excerpts focus on the definition of a bond, the creditor relationship review involving pre-determined interest and principal payments, and relevant provisions of the ICO and ABS terms.

Specific Excerpts:

5. A bond shall be defined as any security representing a creditor relationship, whereby there is a fixed schedule for one or more future payments, and which qualifies as either an issuer credit obligation or an asset-backed security as described in this statement.

6. Determining whether a security represents a creditor relationship should consider its substance, rather than solely the legal form of the instrument. The analysis of whether a security represents a creditor relationship should consider all other investments the reporting entity owns in the investee as well as any other contractual arrangements. A security that in substance possesses equity-like characteristics or represents an ownership interest in the issuer does not represent a creditor relationship.

6.d. In order for a debt instrument to represent a creditor relationship in accordance with **Paragraph 6**, it must have pre-determined principal and interest payments (whether fixed interest

or variable interest) with contractual amounts that do not vary based on the appreciation or depreciation (i.e., performance) of any underlying collateral value or other non-debt variable. For example, an issued security that has varying principal and interest payments based on the appreciation of referenced equity, real estate or other non-debt variable is precluded from bond treatment. This exclusion is not intended to restrict variables that are commonly related to debt instruments such as, but not limited to, plain-vanilla inflation or benchmark interest rate adjustments (such as with U.S. TIPs or SOFR-linked coupons, respectively), scheduled interest rate step-ups, or credit-quality related interest rate adjustments. This exclusion is also not intended to encompass nominal interest rate adjustments². For clarification purposes, all returns from a debt instrument in excess of principal are required to be considered as interest. Therefore, investments with “stated” interest and then “additional returns” to which the holder of the debt instrument is entitled are collectively considered as interest and shall be assessed together in determining whether the investment has variable principal or interest due to underlying referenced non-debt variables. Examples of securities excluded from the bond definition under this guidance:

- i. Structured Notes, which are securities that otherwise meet the definition of a bond, but for which the contractual amount of the instrument to be paid at maturity (or the original investment) is at risk for other than the failure of the borrower to pay the principal amount due, are excluded from the bond definition. These investments, although in the form of a debt instrument, incorporate the 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. These investments are addressed in *SSAP No. 86—Derivatives*. Mortgage-referenced securities issued by a government sponsored enterprise are explicit inclusions in scope of *SSAP No. 43*. Foreign-denominated bonds subject to variation as a result of foreign currency fluctuations are not structured notes.
- ii. Principal-protected securities, as defined in the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* are excluded from the bond definition as they have a performance component whose payments originate from, or are determined by, non-fixed income securities. These investments shall follow the guidance for non-bond securities in *SSAP No. 21—Other Admitted Assets*.

7. An issuer credit obligation is a bond, for which the general creditworthiness of an operating entity or entities through direct or indirect recourse, is the primary source of repayment. Operating entity or entities includes holding companies with operating entity subsidiaries where the holding company has the ability to access the operating subsidiaries’ cash flows through its ownership rights. An operating entity may be any sort of business entity, not-for-profit organization, governmental unit, or other provider of goods or services, but not a natural person or “ABS Issuer” (as defined in paragraph 8). Examples of issuer credit obligations include, but are not limited to:

7.g. Investments in the form of securities for which repayment is fully supported by an underlying contractual obligation of a single operating entity (e.g., Credit Tenant Loans (CTLs), Equipment trust certificates (ETCs), other lease backed securities, Funding Agreement Backed Notes (FABNs), etc.). For purposes of applying this principal concept, repayment is fully-supported by the underlying operating entity obligation if it provides cash flows for the repayment of all interest and at least 95% of the principal of the security.

8. An asset-backed security is a bond issued by an entity (an “ABS Issuer”) created for the primary

² Nominal interest rate adjustments are those that are too small to be taken into consideration when assessing the investment’s substance as a bond. Nominal adjustments are not typically influential factors in an investors’ evaluation of investment return and are often included to incentivize certain behavior of the issuer. An example would include sustainability-linked bonds where failure to achieve performance metrics could cause interest rate adjustments. In general, interest rate adjustments that adjust the total return from interest by more than 10% (e.g., >0.4% for a 4% yielding bond), would not be considered nominal. Further, any such adjustments that cause an investment to meet the definition of a structured note would not be considered nominal.

purpose of raising debt capital backed by financial assets or cash generating non-financial assets owned by the ABS Issuer, for which the primary source of repayment is derived from the cash flows associated with the underlying defined collateral rather than the cash flows of an operating entity. In most instances, the ABS Issuer is not expected to continue functioning beyond the final maturity of the debt initially raised by the ABS Issuer. Also, many ABS Issuers are in the form of a trust or special purpose vehicle (“SPV”), although the presence or lack of a trust or SPV is not a definitive criterion for determining that a security meets the definition of an asset-backed security. The provisions in paragraphs 9-10 detail the two defining characteristics that must be present for a security to meet the definition of an asset-backed security.

10. The holder of a debt instrument issued by an ABS Issuer is in a different economic position than if the holder owned the ABS Issuer’s assets directly. The holder of the debt instrument is in a different economic position if such debt instrument benefits from substantive credit enhancement through guarantees (or other similar forms of recourse), subordination and/or overcollateralization.

10a. *Substantive Credit Enhancement:* The intent of the criteria requiring the holder to be in a different economic position is to distinguish qualifying bonds from instruments with equity-like characteristics or where the substance of the transaction is more closely aligned with that of the underlying collateral. To qualify as an ABS under this standard, there is a requirement that there are substantive credit enhancements within the structure that absorb losses before the debt instrument being evaluated would be expected to absorb losses. This is inherent in the context of an issuer credit obligation in scope of SSAP No. 26R as the owners of the equity in the operating entity are the first to absorb any variability in performance of the operating entity. The same concept applies to asset-backed securities. If substantive credit enhancement did not exist, the substance of the debt instrument being evaluated would be more closely aligned with that of the underlying collateral than that of a bond. Credit enhancement that is merely nominal or lacks economic substance does not put a holder in a different economic position. The substantive credit enhancement

- **SSAP No. 86—Derivatives**

SSAP No. 86 provides guidance for derivatives. Paragraph 5.g. addresses structured notes, paragraph 16 addresses variation margin, paragraph 17 addresses embedded derivative investments, with paragraphs 20-21 providing recognition guidance.

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.

5g. “Structured Notes” in scope of this statement are instruments defined in *SSAP No. 26R—Bonds* (often in the form of debt instruments), in which the amount of principal repayment or return of original investment is contingent on an underlying variable/interest³. Structured notes that are “mortgage-referenced securities” are captured in *SSAP No. 43R—Loan-Backed and Structured Securities*.

³ 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 positive interest rates in response to a linked underlying variable or the passage of time, 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 as structured notes in scope of this statement.

16. “Variation Margin” reflects the daily change in market value of derivative contracts (e.g., daily gain/loss on a derivative contract due to market movements). Amounts received/paid to adjust variation margin on derivative contracts that are both cleared and settled on an exchange shall be recognized as an adjustment to the carrying value of the derivative contract (e.g., futures). Amounts received/paid to adjust variation margin on all other derivative contracts shall be recognized on the balance sheet as an asset or liability separate from the carrying value of the derivative instrument. This treatment shall occur under statutory accounting regardless if the counterparty/exchange considers amounts exchanged for variation margin to be legal settlement or collateral. Changes in variation margin shall not be treated as realized gains or adjustments to the basis of the hedged item until the derivative contract has been sold, matured or expired.

Embedded Derivative Instruments

17. Contracts that do not in their entirety meet the definition of a derivative instrument, such as bonds, insurance policies, and leases, may contain “embedded” derivative instruments—implicit or explicit terms that affect some or all of the cash flows or the value of other exchanges required by the contract in a manner similar to a derivative instrument. The effect of embedding a derivative instrument in another type of contract (“the host contract”) is that some or all of the cash flows or other exchanges that otherwise would be required by the contract, whether unconditional or contingent upon the occurrence of a specified event, will be modified based on one or more underlyings. An embedded derivative instrument shall not be separated from the host contract and accounted for separately as a derivative instrument.

Recognition of Derivatives

20. Derivative instruments represent rights or obligations that meet the definitions of assets (SSAP No. 4—Assets and Nonadmitted Assets) or liabilities (SSAP No. 5R) and shall be reported in financial statements. In addition, derivative instruments also meet the definition of financial instruments as defined in *SSAP No. 27—Off-Balance-Sheet and Credit Risk Disclosures*. Should the cost basis of the derivative instrument be undefined (i.e., no premium is paid), the instrument shall be disclosed in accordance with paragraphs 46-50 of *SSAP No. 100R—Fair Value*. Derivative instruments used in hedging, income generation or replication (synthetic asset) transactions shall be recognized and measured in accordance with the specific provisions within this statement and are admitted assets to the extent they conform to the requirements of this statement.

21. Derivative instruments that are not used in hedging, income generation or replication (synthetic asset) transactions shall be considered “Other” derivatives. These derivatives shall be accounted for at fair value and the changes in fair value shall be recorded as unrealized gains or losses. These derivatives do not qualify as admitted assets.

- ***SSAP No. 103—Transfers and Servicing of Financial Assets and Extinguishments of Liabilities***

SSAP No. 103 provides guidance for the transfers of assets and liabilities, including guidance for when a sale shall be considered to have occurred. Guidance is captured for when securities are sold/reacquired are considered to be substantially the same and how those transactions should be reflected. As detailed in paragraph 52, credit repack notes would not qualify as substantially the same as the credit repack generally has a different issuer, different yield and modified NAIC designation/CRP rating from the original underlying investment.

12. Repurchase agreements, reverse repurchase agreements, repurchase financing, collateral requirements and dollar repurchase agreements are described in paragraphs 102-118. When an asset is sold and the proceeds are reinvested within 30 days in the same or substantially the same security, such transfers shall be considered to be wash sales and shall be accounted for as sales as discussed in paragraphs 96-101 and disclosed as required by paragraph 28⁴. Unless there is a concurrent contract

⁴ Paragraph 28.I. also details the items that are excluded from the wash sale disclosure.

to repurchase or redeem the transferred financial assets from the transferee, the transferor does not maintain effective control over the transferred financial assets.

Agreement to Repurchase or Redeem Transferred Financial Assets

51. An agreement that both entitles and obligates the transferor to repurchase or redeem transferred financial assets from the transferee maintains the transferor's effective control over those assets as described in paragraph 8.c.(1) when all of the following conditions are met:

- a. The financial assets to be repurchased or redeemed are the same or substantially the same as those transferred (paragraph 52).
- b. The agreement is to repurchase or redeem them before maturity, at a fixed or determinable price.
- c. The agreement is entered into contemporaneously with, or in contemplation of, the transfer.

52. To be substantially the same, the financial asset that was transferred and the financial asset that is to be repurchased or redeemed need to have all of the following characteristics:

- a. The same primary obligor (except for debt guaranteed by a sovereign government, central bank, government-sponsored enterprise or agency thereof, in which case the guarantor and the terms of the guarantee must be the same);
- b. Identical form and type so as to provide the same risks and rights;
- c. The same maturity (or in the case of mortgage-backed pass-through and pay-through securities similar remaining weighted-average maturities that result in approximately the same market yield);
- d. Identical contractual interest rates;
- e. Similar assets as collateral; and
- f. The same aggregate unpaid principal amount or principal amounts within accepted "good delivery" standards for the type of security involved.

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 2023, the Working Group adopted the principles-based bond definition, which resulted in key revisions to *SSAP No. 26R—Bonds* and *SSAP No. 43R—Asset-Backed Securities*, and *SSAP No. 21R—Other Admitted Assets* for the review and classification of debt securities pursuant to the bond definition. This guidance is effective Jan. 1, 2025.

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:

NAIC staff recommends that the Working Group move this item to the active listing as a new SAP concept and expose proposed edits to *SSAP No. 86—Derivatives*, to establish guidance that requires separate accounting and reporting of derivatives that are captured in debt security structures. This is a change from existing guidance that explicitly precludes the separation of embedded derivatives. In addition to these changes, minor revisions are also proposed to *SSAP No. 26—Bonds* and to the annual statement instructions to clarify application guidance. NAIC staff will also draft an issue paper to document these revisions.

From initial discussions with banks / investment makers, guidance to separate the derivative from the debt security is believed to be preferred over a conclusion that would preclude bond treatment for the combined structure. With the proposal, debt security repack structures will be treated similarly to investments where the bond and derivative are not combined. (Ultimately, there would be no capital benefit or detriment due to the structure.) Additionally, this proposal will allow transparency as to the derivatives being used and ensure compliance with the reporting entity's derivative use plan. (If this proposed guidance is not supported, the combined repack, which represents a debt structure, would need to be assessed under the bond definition. This may require more detailed guidance to assess different types of derivative structures to determine whether the repack should qualify as a bond or as a non-bond debt security.)

NAIC staff has not proposed revisions to SSAP No. 103 as the existing guidance is clear that a sale of a debt security which is subsequently or simultaneously reacquired as a credit repack would not meet the criteria of substantially the same. This is because a credit repack generally has a revised issuer, yield and NAIC designation to reflect the additional derivative risk. As noted, minor revisions have been proposed to the annual statement instructions to clarify that the sale of a security that is reacquired with different terms shall be reported as a sale on Schedule D-Part 4 and a new acquisition on Schedule D-Part 3.

Proposed Revisions to SSAP No. 86—Derivatives:

Embedded Derivative Instruments

17. Contracts that do not in their entirety meet the definition of a derivative instrument, such as ~~bonds~~, insurance policies, and leases, may contain “embedded” derivative instruments—implicit or explicit terms that affect some or all of the cash flows or the value of other exchanges required by the contract in a manner similar to a derivative instrument. The effect of embedding a derivative instrument in another type of contract (“the host contract”) is that some or all of the cash flows or other exchanges that otherwise would be required by the contract, whether unconditional or contingent upon the occurrence of a specified event, will be modified based on one or more underlyings. For these contracts, excluding debt securities with derivative components/wrappers pursuant to paragraph 18, an embedded derivative instrument shall not be separated from the host contract and accounted for separately as a derivative instrument.

18. Debt securities that have derivative components or wrappers shall initially be assessed to determine if they are a structured note pursuant to paragraph 5.g. Structured notes shall not be bifurcated and shall be collectively reported as a derivative investment and shall be measured and reported pursuant to the guidance within this statement. Debt securities that are not structured notes, but have been combined with a derivative instrument^{FN1} shall be bifurcated with separate reporting as a debt security and a derivative instrument. Once the investment is bifurcated, the debt security shall be reviewed in accordance with the bond definition within SSAP No. 26—Bonds and captured as an issuer credit obligation, asset-backed security, or non-bond debt security, based on the characteristics of the debt security^{FN2}. If the debt security serves as collateral to the derivative counterparty, the reported debt security shall be coded as a restricted asset under SSAP No. 1—Accounting Policies, Risks & Uncertainties and Other Disclosures. The derivative shall be captured in scope of this statement, measured and classified pursuant to the guidance within and reported on Schedule DB.

New Footnote 1: This guidance applies to all debt securities with derivative components or wrappers but was incorporated in response to credit repack notes. With a credit repack, a debt security is combined with a derivative instrument at an SPV, with the reporting entity acquiring a new debt security (“repack”) from the SPV reflecting the combined components. This structure can be viewed as advantageous over the separate acquisition of a derivative instrument as the debt security held in the structure serves as the sole source of collateral to the derivative counterparty, reducing potential liquidity concerns based on future market fluctuations. However, if this repack structure was collectively reported as a debt security, information on the use of derivatives would not be identifiable within the statutory financial statements. A repack note often has a reduced interest yield from the stated yield of

the underlying debt security held in the structure to cover the fees of issuing the repack, as well as a revised NAIC designation/CRP rating that reflects the added risk of the SPV and derivative counterparty.

New Footnote 2: Assessment under the bond definition shall be based on the characteristics of the underlying debt security, but the issuer, investment yield, NAIC designation/CRP rating, as well as any other reported investment components, shall reflect the terms of the held (combined) investment and not the terms of the underlying security.

Proposed Revisions to SSAP No. 26—Bonds

4. This statement excludes:
 - e. Replication (synthetic asset) transactions and debt security structures that have been combined with derivative components or wrappers addressed in *SSAP No. 86—Derivatives*. The admissibility, classification and measurement of a replication (synthetic asset) transactions are not preemptively determined by the principles-based bond definition and should be evaluated in accordance with the guidance on replication (synthetic asset) transactions within SSAP No. 86. Debt security structures combined with a derivative, such as a credit repack note that does not reflect a structured note, shall follow the guidance in SSAP No. 86 for bifurcation. After bifurcation, the underlying debt security is subject to the guidance in this statement in determining whether it qualifies for bond reporting.

Proposed Revisions to Annual Statement Instructions:

Schedule D – Part 4 – Long Term Bonds and Stocks Sold, Redeemed or Otherwise Disposed Of During Current Year

This schedule should include a detailed listing of all securities that were sold/disposed of during the current reporting year that were owned as of the beginning of the current reporting year (amounts purchased and sold during the current reporting year are reported in detail on Schedule D, Part 5 and only in subtotal in Schedule D, Part 4). This should include all transactions that adjust the cost basis of the securities (except other-than-temporary impairments that are not part of a disposal transaction). ~~Thus, it~~ This schedule should not be used for allocations of TBAs to specific pools subsequent to initial recording in Schedule D, Part 3 or ~~other~~ situations ~~such as~~ that only involve CUSIP number changes. The following list of items provides examples (not all inclusive) of the items that should be included:

Pay downs of securities still owned (including CMO prepayments);

Subsequent partial sales of investment issues still owned;

Sales of securities to an SPV or other entity for which a new instrument is reacquired from the SPV/entity reflecting a combined instrument containing the original security and derivative instruments or other components (such as a credit repack note). The sale shall be captured on this schedule (or Schedule D, Part 5 if the debt security was acquired in the current year), and the new security shall be reported on Schedule D, Part 3.

Reallocation of the cost basis of an already owned stock to the cost basis of a new stock received as a dividend (e.g., spin off); and

Any decreases in the investments in SCA companies that adjust the cost basis, not including other-than-temporary impairments alone (e.g., subsequent return of capital from investments in SCA companies valued using the equity method).

Schedule D – Part 5 – Long-Term Bonds and Stocks Acquired During the Year and Fully Disposed Of During Current Year

As with Schedule D, Parts 3 and 4, this schedule should ~~not~~ be used for ~~a~~-transactions ~~unless it that~~ affects the cost basis of the securities. ~~Thus, it~~ This schedule should not be used for allocations of TBAs to specific pools subsequent to initial recording in Schedule D, Part 3 or ~~other~~ situations ~~such as that only involve~~ CUSIP number changes. Refer to the examples on Schedule D, Part 4 of transactions that should be captured.

Existing Guidance in SSAP No. 103, paragraph 52 – No Revisions Proposed:

With this existing guidance, debt securities sold and reacquired as a credit repack should not be considered to be substantially the same. This is because the credit repack is acquired from a new issuer, with a revised yield and with revised risks and rights (including revised NAIC designation/CRP rating) to reflect the derivative components / counterparty. Comments are requested on different interpretations and if edits are needed to ensure proper application of this guidance.

52. To be substantially the same, the financial asset that was transferred and the financial asset that is to be repurchased or redeemed need to have all of the following characteristics:
- a. The same primary obligor (except for debt guaranteed by a sovereign government, central bank, government-sponsored enterprise or agency thereof, in which case the guarantor and the terms of the guarantee must be the same);
 - b. Identical form and type so as to provide the same risks and rights;
 - c. The same maturity (or in the case of mortgage-backed pass-through and pay-through securities similar remaining weighted-average maturities that result in approximately the same market yield);
 - d. Identical contractual interest rates;
 - e. Similar assets as collateral; and
 - f. The same aggregate unpaid principal amount or principal amounts within accepted “good delivery” standards for the type of security involved.

Staff Review Completed by: Julie Gann, NAIC Staff—June 2024

On August 13, 2024, the Statutory Accounting Principles (E) Working Group moved this item to the active listing, classified as a new SAP concept, and exposed revisions to *SSAP No. 86--Derivatives*, as shown above, to require bifurcation of debt securities with derivative wrappers or components if the item does not reflect a structured note. The guidance details the accounting and reporting guidance for the bifurcated debt and derivative components. This item was exposed until September 27, 2024 to allow for discussion at the 2024 Fall National Meeting.

On November 17, 2024, the Statutory Accounting Principles (E) Working Group elected to not proceed with the proposed edits to SSAP No. 86 to require bifurcation of debt securities with derivative wrappers or components. With this action, debt securities with derivative components that reflect structured notes will be retained in *SSAP No. 86—Derivatives*, and all other debt securities with derivative components and wrappers shall be assessed in accordance with the principles-based bond definition. Debt securities that do not qualify as bonds under the principles-based bond definition and shall be reported as non-bond debt securities in scope of *SSAP No. 21—Other Admitted Assets* and on Schedule BA. The Working Group did agree with proceeding with the clarifications in the investment disposal schedules, and the sponsoring of a blanks proposal, to ensure that a debt security sold to an

SPV and reacquired with derivative components is shown as a disposal and an acquisition in the investment schedules. With the action that occurred on November 17, 2024, this agenda item is limited to the investment schedule revisions as shown below:

Proposed Revisions to Annual Statement Instructions:

Schedule D – Part 4 – Long Term Bonds and Stocks Sold, Redeemed or Otherwise Disposed Of During Current Year

This schedule should include a detailed listing of all securities that were sold/disposed of during the current reporting year that were owned as of the beginning of the current reporting year (amounts purchased and sold during the current reporting year are reported in detail on Schedule D, Part 5 and only in subtotal in Schedule D, Part 4). This should include all transactions that adjust the cost basis of the securities (except other-than-temporary impairments that are not part of a disposal transaction). ~~Thus, if~~ This schedule should not be used for allocations of TBAs to specific pools subsequent to initial recording in Schedule D, Part 3 or ~~other~~ situations ~~such as~~ that only involve CUSIP number changes. The following list of items provides examples (not all inclusive) of the items that should be included:

Pay downs of securities still owned (including CMO prepayments);

Subsequent partial sales of investment issues still owned;

Sales of securities to an SPV or other entity for which a new instrument is reacquired from the SPV/entity reflecting a combined instrument containing the original security and derivative instruments or other components (such as a credit repack note). The sale shall be captured on this schedule (or Schedule D, Part 5 if the debt security was acquired in the current year), and the new security shall be reported on Schedule D, Part 3.

Reallocation of the cost basis of an already owned stock to the cost basis of a new stock received as a dividend (e.g., spin off); and

Any decreases in the investments in SCA companies that adjust the cost basis, not including other-than-temporary impairments alone (e.g., subsequent return of capital from investments in SCA companies valued using the equity method).

Schedule D – Part 5 – Long-Term Bonds and Stocks Acquired During the Year and Fully Disposed Of During Current Year

As with Schedule D, Parts 3 and 4, this schedule should ~~not~~ be used for ~~a~~ transactions ~~unless it~~ that affects the cost basis of the securities. ~~Thus, if~~ This schedule should not be used for allocations of TBAs to specific pools subsequent to initial recording in Schedule D, Part 3 or ~~other~~ situations ~~such as~~ that only involve CUSIP number changes. Refer to the examples on Schedule D, Part 4 of transactions that should be captured.

[https://naiconline.sharepoint.com/teams/FRSStatutoryAccounting/NationalMeetings/A.NationalMeetingMaterials/2024/12-17-2024/C-24-16-Repacks and Derivative Wrapper Investments.docx](https://naiconline.sharepoint.com/teams/FRSStatutoryAccounting/NationalMeetings/A.NationalMeetingMaterials/2024/12-17-2024/C-24-16-RepacksandDerivativeWrapperInvestments.docx)