Public Hearing Agenda

Statutory Accounting Principles (E) Working Group
Public Hearing Agenda
March 21, 2020

ROLL CALL

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

REVIEW AND ADOPTION OF MINUTES
1. Fall National Meeting Minutes - (Attachment 1)
2. January 8, 2020 Conference Call - (Attachment 2)

REVIEW AND ADOPTION of NON-CONTESTED POSITIONS – SSAP REVISIONS
The Working Group may individually discuss the following items, or may consider adoption in a single motion:

1. Ref #2018-26: SCA Loss Tracking – Accounting Guidance
2. Ref #2018-38: Prepayment to Service and Claims Adjusting Providers
3. Ref #2019-32: Look-Through with Multiple Holding Companies
4. Ref #2019-35: Update Withdrawal Disclosures
5. Ref #2019-43: ASU 2017-11, EPS, Distinguishing Liabilities from Equity, Derivatives & Hedging
8. Ref #2019-46: ASU 2016-14, Presentation of Financial Statements of Not-for-Profit Entities

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<td>2018-26</td>
<td>SCA Loss Tracking – Accounting Guidance</td>
<td>3- Agenda Item</td>
<td>No Comment</td>
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<tr>
<td>SSAP No. 5R</td>
<td>(Julie/Fatima)</td>
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<td>SSAP No. 97</td>
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Summary:
During the 2019 Fall National Meeting, the Working Group exposed revisions to SSAP No. 97—*Investments in Subsidiary, Controlled and Affiliated Entities* to update the existing reporting requirements for when a reporting entity has a negative equity value in a SCA investment and has provided a financial guarantee or commitment.

With the exposed revisions, the financial guarantee or commitment will be recognized under SSAP No. 5R—*Liabilities, Contingencies and Impairments of Assets* and the equity losses of the SCA will stop at zero (thus not to be reported as a negative value) under SSAP No. 97. Revisions in the current exposure reflect modifications previously proposed by interested parties.
**Interested Parties’ Comments:**
Interested parties have no comment on this item.

**Recommended Action:**
NAIC staff recommends that the Working Group adopt the exposed revisions to SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets and SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities as final. With these revisions, the reported equity losses of the SCA would not go negative (thus stopping at zero), however the guaranteed liabilities would be reported to the extent there is a financial guarantee or commitment. The revisions are nonsubstantive, so they will be effective immediately upon adoption. (Adoption at the 2019 Fall National Meeting was contemplated, however the additional exposure allowed more time to review the industry edits as well as prevent adoption immediately before year-end.)

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<td>2018-38</td>
<td>Prepayment to Service and Claims Adjusting Providers</td>
<td>4 - Agenda Item</td>
<td>No Comment</td>
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**Summary:**
During the 2019 Fall National Meeting, the Working Group exposed revisions to SSAP No. 55—Unpaid Claims, Losses and Loss Adjustment Expenses, emphasizing existing guidance that loss and loss adjusting expense liabilities shall be established regardless of payments to third parties (except for capitated health claim payments). The liabilities are not recognized as paid until the losses are paid to claimants or claims are adjusted. Prepayments to third party administrators, which are not for claims or loss adjusting expense, are “miscellaneous underwriting expenses.” The revisions also added a reference to SSAP No. 84—Health Care and Government Insured Plan Receivables regarding prepayments to providers. The liability for claims on non-capitated payments under managed care contracts are established as an amount necessary to pay the losses/claims irrespective of payments made to third-party administrators.

**Interested Parties’ Comments:**
Interested parties have no comment on this item.

**Recommended Action:**
NAIC staff recommends that the Working Group adopt the exposed revisions to SSAP No. 55—Unpaid Claims, Losses and Loss Adjustment Expenses, which emphasize existing guidance, as final. These revisions clarify that loss and loss adjusting expense liabilities are established regardless of payments to third parties (except for capitated health claim payments).
Public Hearing Agenda

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<td>2019-32 SSAP No. 97 (Jim/Fatima)</td>
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<td>5 - Agenda Item</td>
<td>No Comment</td>
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**Summary:**
During the 2019 Fall National Meeting, the Working Group exposed revisions to SSAP No. 97—*Investment in Subsidiary, Controlled and Affiliated Entities* emphasizing existing guidance stating that a look-through is permitted through more than one downstream holding company as long as each look-through entity complies with the requirements as directed in SSAP No. 97.

**Interested Parties’ Comments:**
Interested parties have no comment on this item.

**Recommended Action:**
NAIC staff recommends that the Working Group adopt the exposed revisions to SSAP No. 97—*Investments in Subsidiary, Controlled and Affiliated Entities* as final. These revisions clarify that a more-than-one holding company structure is permitted as a look-through if each of the holding companies within the structure complies with the requirements in SSAP No. 97.

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<td>Update Withdrawal Disclosures</td>
<td>6 - Agenda Item</td>
<td>No Comment</td>
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**Summary:**
In November 2018, the Working Group updated the life, health and separate account liquidity disclosures to provide additional granularity of the withdrawal characteristics by product type. These updates were developed by the Financial Stability (Ex) Task Force and were adopted in agenda item 2018-28: Updates to Liquidity Disclosures. These updated liquidity disclosures were reflected in SSAP No. 51R—*Life Contracts*, SSAP No. 52—*Deposit-Type Contracts*, and SSAP No. 61R—*Life, Deposit-Type and Accident and Health Reinsurance* with an effective date of year-end 2019. The updates in this agenda item propose the following minor clarifying edits to the previously adopted disclosures:

1. Add a consistency revision to SSAP No. 51R, ensuring separate account guaranteed products are referenced in all applicable paragraphs of the withdrawal characteristics disclosures,
2. Correct an identified inconsistency in one of the new disclosures that was added regarding products that will move from the reporting line of having surrender charges at 5% or more to the reporting line of surrender charges at less than 5%, and
3. Add a cross reference from SSAP No. 56—*Separate Accounts* to the existing disclosures by withdrawal characteristics in SSAP No. 51R and SSAP No. 61R as the disclosures include separate account products.

**Interested Parties’ Comments:**
Interested parties have no comment on this item.
**Recommended Action:**
NAIC staff recommends that the Working Group adopt the exposed revisions to SSAP No. 51R, SSAP No. 56, and SSAP No. 61R as final.

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<td>2019-43</td>
<td>ASU 2017-11, Earnings Per Share, Distinguishing Liabilities from Equity, Derivatives &amp; Hedging</td>
<td>7 - Agenda Item</td>
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**Summary:**
During the 2019 Fall National Meeting, the Working Group exposed revisions to SSAP No. 86—Derivatives to reject ASU 2017-11, Accounting for Certain Financial Instruments with Down Round Features; Replacement of the Indefinite Deferral for Mandatorily Redeemable Financial Instruments of Certain Noncontrolling Interests with a Scope Exception and to incorporate guidance into SSAP No. 5R—Liabilities, Contingencies and Impairment of Assets and SSAP No. 72—Surplus and Quasi-Reorganizations for when freestanding instruments shall be recognized as liabilities and not equity.

This ASU primarily addresses the complexity of accounting for certain freestanding financial instruments (or embedded features such as a conversion option) with down round features. A down round feature is a provision in certain financial instruments (most often warrants or convertible instruments) that allows for the reduction in the strike price of the financial instrument if the issuer sells additional shares of common stock for an amount less than the financial instrument’s stated strike price, or if the issuer issues another equity-linked instrument with a strike price below the current strike price of the original financial instrument. Down (financing) rounds typically occur when additional capital is required, but the company’s valuation is now lower than it was in an earlier stock offering. Financial instruments with down round features help protect the holder from declines in the issuer’s share price because if a company issues additional equity shares at a lower price than had been previously sold, the holder is allowed to exercise its purchase option at a lower strike price than was originally stated on the financial instrument.

This agenda item proposed changes to SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets and SSAP No. 72—Surplus and Quasi-Reorganizations incorporating key concepts from ASC 480 in that issued, freestanding financial instruments with characteristics of both liability and equity shall be reported as a liability to the extent the instruments embodies an unconditional obligation of the issuer. Several criteria items are proposed however summarized that in the issuer shall report a liability on financial instruments in which they are obligated to transfer assets and the transfer is unavoidable.

**Interested Parties’ Comments:**
Interested parties have no comment on this item.

**Recommended Action:**
NAIC staff recommends that the Working Group adopt the exposed revisions to SSAP No. 51R, SSAP No. 72, and SSAP No. 86 as final. These revisions reject ASU 2017-11 in SSAP No. 86 and require that issued, freestanding financial instruments with characteristics of both liability and equity shall be reported as a liability to the extent the instruments embodies an unconditional obligation to the issuer.
Summary:
During the 2019 Fall National Meeting, the Working Group exposed revisions to reject ASU 2013-11 in SSAP No. 101—Income Taxes. As detailed in the agenda item, Topic 740, Income Taxes did not include explicit guidance for the financial statement presentation of an “unrecognized tax benefit” when a net operating loss carryforward, a similar tax loss, or a tax credit carryforward exists. An unrecognized tax benefit generally reflects a tax position that does not meet the ASC 740 more-likely-than-not recognition threshold, but to a certain extent owes their existence to an uncertain tax position. A more-likely-than-not threshold requires a recognized benefit of having a greater than 50 percent likelihood of being realized upon settlement.

Interested Parties’ Comments:
Interested parties support adoption of this item but note that the following statement should be removed from the document as it is incorrect (see IFRC 23, Uncertainty over Income Tax Treatments):

Convergence with International Financial Reporting Standards (IFRS): N/A
IFRS does not include specific guidance on the presentation of unrecognized tax benefits.

Recommended Action:
NAIC staff recommends that the Working Group adopt the exposed revisions to SSAP No. 101—Income Taxes as final. The revisions reject ASU 2013-11 for statutory accounting. Further, while not affecting statutory guidance, NAIC staff support the removal of the IFRS convergence statement as proposed by interested parties. (This is shown as a tracked change in the agenda item and does not impact the proposed statutory accounting resolution.)

Summary:
During the 2019 Fall National Meeting, the Working Group exposed revisions to SSAP No. 62R—Property and Casualty Reinsurance to reference “reciprocal jurisdictions.” These revisions pertain to the Covered Agreement.

On June 25, 2019, NAIC Executive Committee and Plenary adopted revisions to the Credit for Reinsurance Model Law (#785) and the Credit for Reinsurance Model Regulation (#786) to incorporate relevant provisions from the “Bilateral Agreement Between the United States of America and the European Union on Prudential Measures Regarding Insurance and Reinsurance” and the “Bilateral Agreement Between the United States of America and the United Kingdom Regarding Insurance and Reinsurance” (collectively referred to as the Covered Agreement).

Interested Parties’ Comments:
Interested parties have no comment on this item.
**Recommended Action:**
NAIC staff recommends that the Working Group adopt the exposed revisions to **SSAP No. 62R—Property and Casualty Reinsurance** as final. The revisions incorporate disclosure updates for reinsurers from Reciprocal Jurisdictions.

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<td>ASU 2016-14, Presentation of Financial Statements of Not-for-Profit Entities</td>
<td>10- Agenda Item</td>
<td>No Comments</td>
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**Summary:**
During the Fall National Meeting, the Working Group exposed revision to reject ASU 2016-14 as not applicable to statutory accounting. The FASB issued ASU 2016-14 to provide more useful information to donors, grantors, creditors, and other financial statements users of not-for-profit (NFP) entities. This update is to improve the current net asset classification requirements and the information presented in financial statements regarding liquidity, financial performance, and cash flows. While several changes were implemented within this ASU, the main provisions include the presentation of two classes of net assets – with donor restrictions and without donor restrictions. Due to complexities regarding the appropriate use of the previous three classes of net assets (unrestricted, temporarily restricted, and permanently restricted) that focused on the absence or presence of donor-imposed restrictions and whether those restrictions were temporary or permanent, this ASU designates presentation of two classes of net assets. Changes in these two classes of net assets are to be reported on the statement of activities.

**Interested Parties’ Comments:**
Interested parties have no comment on this item.

**Recommended Action:**
NAIC staff recommends adopting the exposed revisions to **Appendix D—Nonapplicable GAAP Pronouncements** to reject ASU 2016-14, *Presentation of Financial Statements of Not-for-Profit Entities* as not applicable to statutory accounting.
REVIEW of COMMENTS on EXPOSED ITEMS – EXPECTING MINIMAL DISCUSSION

The following items received comments during the exposure period that are open for discussion. NAIC staff has separated these items as limited discussion is expected prior to considering action.

1. Ref #2019-04: SSAP No. 32 – Investment Classification Project
2. Ref #2019-08: Reporting Deposit Type Contracts
3. Ref #2019-38: Financing Derivatives
4. Ref #2019-40: Reporting of Installment Fees and Expenses
5. Ref #2019-41: Eliminating Financial Modeling Process

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<td>2019-04</td>
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<td>11- SSAP 12- Issue Paper</td>
<td>Minor Comments Received</td>
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Summary:

During the 2019 Fall National Meeting, the Working Group exposed an issue paper and substantively revised SSAP No. 32R—Preferred Stock to revise the definitions, measurement and impairment guidance for preferred stock pursuant to the investment classification project.

Interested Parties’ Comments:

Interested parties substantially agree with the objectives of the proposal and appreciate Staff’s inclusion of revisions for previously communicated comments. We have the following additional comments related to the issue paper:

Scope

Interested parties note that the scope retains, albeit edited, the guidance that preferred stock of subsidiary, controlled and affiliated entities is included and therefore accounted for under the guidance for preferred stock regardless of their SCA character. We acknowledge the current exposure added the requirement to file investments in response to our request. The existing wording in SSAP No. 32 and the exposed language for SSAP No. 32 is below with interested parties suggested clarifying sentence and additional wording (underlined).

Existing language in SSAP No. 32:

SCOPE OF STATEMENT

1. This statement establishes statutory accounting principles for preferred stock.

2. Investments in preferred stock of subsidiaries, controlled or affiliated entities, including preferred stock interests of certified capital companies (CAPCO) per INT 06-02: Accounting and Reporting for Investments in a Certified Capital Company (CAPCO) are included within the scope of this statement.

Exposed language in SSAP No. 32 and interested parties suggested additional sentence (underlined):

SCOPE OF STATEMENT

1. This statement establishes statutory accounting principles for preferred stock.

2. Investments in preferred stock of entities captured in SSAP No. 97—Investments in Subsidiaries, Controlled or Affiliated Entities or SSAP No. 48—Joint Ventures, Partnerships and Limited Liability Companies, as well as preferred stock interests of certified capital companies per INT 06-02: Accounting and Reporting for Investments in a Certified Capital Company (CAPCO) are included within the scope of this statement. The requirement to
file investments in preferred stock of certain subsidiaries, controlled or affiliated entities with the NAIC pursuant to SSAP No. 97 does not affect the application of the accounting, valuation or admissibility under this statement.

Definitions
We are opposed to the proposed edits to the definitions of redeemable and perpetual preferred stock for the following reasons:

a. The change would create a divergence from GAAP that does not exist under the current definitions. Both the definition and accounting for redeemable securities under the current definition aligns with the GAAP definition and accounting for debt securities. Preferred stock accounted for as debt securities under GAAP are those where ability for the holder to collect repayment is assured by the contract terms. We have not identified any benefit to diverging from this view for statutory reporting. The NAIC guidance is different from the GAAP ASC 480 guidance for issuers in multiple ways:

- Preferred stock redeemable at the option of the holder for GAAP is classified as equity (mezzanine equity for SEC filers) but under statutory reporting currently (and proposed) is classified as debt-like in valuation. This conflicts with GAAP ASC 480 guidance for issuers and so it is more straightforward to use the GAAP ASC guidance for holders.
- Alignment of statutory accounting with the ASC 320 guidance for holders results in more equity-like classification in the valuation of preferred stock which is generally more conservative than debt-like classification in valuation.
- Preferred stock redeemable for other reasons outside of issuer’s control is equity (mezzanine equity for SEC filers) for GAAP but equity-like in valuation under current statutory reporting and debt-like in valuation under the proposed statutory reporting.

b. The definition that the NAIC staff has proposed to align to is used in GAAP only for compliance with SEC Regulation S-X, Rule 5-02, which is relevant only to the issuer of preferred stock and does not apply to nonpublic companies. Further, the definitions under Rule 5-02 were designed to include preferred stock with redemption features outside of the control of the issuer in order to provide investors information regarding potential future cash obligations. This is not a relevant consideration for the holder of preferred stock, which is why GAAP does not consider this from the holder’s perspective. From the holder’s perspective, the only relevant consideration is whether the holder is able to redeem its investment, either through a fixed and determinable date, or through a redemption option that the holder can control.

c. Evaluation of whether there are any features that are outside the control of the issuer is a very complex and cumbersome analysis, even on an infrequent basis as is the case under GAAP (as it only applies to issuers). This is because there are a vast number of potential features that could be outside the control of the issuer (i.e., change in control, lapse in SEC registration, failure to pay dividend, etc.). Insurance companies frequently invest in preferred stock and often purchase many such securities each reporting period. Evaluating every preferred stock investment at this level of detail would be operationally burdensome and would provide no additional benefit as the investor is often economically indifferent to many of these low-probability redemption features that are outside of the control of both the issuer and investor.

As a result, we propose the following edits to the proposed definitions:

a. Redeemable preferred stock, which is preferred stock subject to mandatory redemption requirements or whose redemption is outside the control at the option of the issuer holders. Redeemable preferred stock is any stock which 1) the issuer undertakes to redeem at a fixed or determinable price on the fixed or determinable date or dates, whether by operation of a sinking fund or otherwise; or 2) is redeemable at the option of the holders; or 3) has conditions
for redemption which are not solely within the control of the issuer, such as stock which must be redeemed out of future earnings. Preferred stock which meet one or more of these three criteria would be classified as redeemable preferred stock regardless of other attributes such as voting rights or dividend rights;

b. Perpetual preferred stock, which is preferred stocks which are not redeemable or for which redemption is not at the option of the holder are redeemable solely at the option of the issuer (non-redeemable preferred stock). Perpetual preferred stock is any preferred stock which does not meet the criteria to be classified as redeemable preferred stock pursuant to paragraph 3.a.

**Balance Sheet Amount**

The issue paper discusses carrying perpetual preferred at fair value capped by any stated call price. However, it did not provide guidance on timing for application of the cap. Because the call may not be effective for a period of time, and to ensure that purchases of perpetual preferred stock could still be carried at values greater than par (assuming market values remain above par), we recommend the following revisions to paragraph 10.a.ii, 10.b.ii and the correspondingly to paragraph 11 (underlined):

Paragraphs 10.a.ii and 10.b.ii:

i. Perpetual preferred stocks shall be valued at fair value, not to exceed *any currently effective call price*.

Paragraph 11:

11. An other-than-temporary (INT 06-07) impairment 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 preferred stock in effect at the date of acquisition. An assessment of other-than-temporary impairment shall occur whenever mandatory redemption rights or sinking fund requirements do not occur. A decline in fair value which is other-than-temporary includes situations where the reporting entity has made a decision to sell the preferred stock prior to its maturity at an amount below its carrying value (i.e., amortized cost). If it is determined that a decline in the fair value of a redeemable preferred stock is other-than-temporary, an impairment loss shall be recognized as a realized loss equal to the entire difference between the redeemable preferred stock’s carrying value and its fair value, *not to exceed any currently effective call price*, at the balance sheet date of the reporting period for which the assessment is made. The measurement of the impairment loss 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.

**Income**

The issue paper clarifies the guidance on dividends on preferred stock. Specifically, paragraph 14 states:

14. Dividends on preferred stock shall be recorded as investment income for qualifying preferred stock on the ex-dividend date with a corresponding receivable to be extinguished upon dividend settlement.”

Interested parties request clarification on the use of the term “qualifying” preferred stock as the term is not defined within the issue paper or within the new glossary of terms. If the inclusion of the word “qualifying” was unintentional, interested parties recommend deleting the word from paragraph 14 to avoid confusion.

**Recommended Action:**

NAIC Staff recommends that the Working Group adopt the issue paper and SSAP with modifications suggested by interested parties and as further detailed below. It is proposed that the substantive revisions be effective as of January 1, 2021. (If preferred, the Working Group could re-expose the issue paper and SSAP with the proposed edits and the proposed effective date.) (Although NAIC staff does not expect significant changes from this adoption, a January 1, 2021 effective date has been proposed to allow the guidance to take effect at the start of a reporting year. An earlier effective date could be considered.)
Overview of Proposed Modifications to Exposed Issue Paper and SSAP:

- **Definitions:** After further consideration, NAIC staff are supportive of the changes suggested by interested parties as they align with the original objective of preferred stock classification and reflect the expected economics of the investment. This change, and the differences from the GAAP definitions has been detailed in the issue paper for future reference.

- **Reference to call price:** NAIC staff agree with the interested parties’ proposed language regarding the fair value reporting being capped by any currently effective call price. Original language states *any stated call price*, however as call terms are generally not infinite, and adding language to note *any currently effective call price* is recommended.

- **Dividends:** Interested parties commented on the use of the word “qualifying” in paragraph 14, which states that “dividends on preferred stock shall be recorded as investment income for qualifying preferred stock on the ex-dividend date with a corresponding receivable to be extinguished upon dividend settlement.” The use of “qualifying” was to relay the fact that only preferred stock eligible for dividends shall accrue investment income; meaning only preferred stock owned before the ex-dividend date qualify for dividends. For clarification purposes, NAIC staff has edited the description to include “dividend eligible” as a descriptor, rather than “qualifying.”

- **Scope:** In addition to the comments from interested parties to clarify the impact of SSAP No. 97 filing requirements to preferred stock held, informal comments were received sharing that certain legal entities, specifically those captured in SSAP No. 48—Joint Ventures, Partnerships and Limited Liability Companies, do not issue preferred stock in legal form, but instead issued identical instruments labeled preferred units, interests, or shares. For clarification purposes and to explicitly provide guidance that preferred shares of joint ventures and limited liability entities are to be reported the same as preferred stock, NAIC staff has proposed a footnote highlighting this distinction to ensure only these instruments in which operate in a manner identical to preferred stock are captured in this statement.

**Proposed Edits** *(The edits highlighted in grey below, show the changes from the prior exposure. The revisions are also shown in the issue paper and SSAP attachments.)*

1. Investments in preferred stock of entities captured in SSAP No. 97—Investments in Subsidiaries, Controlled or Affiliated Entities or SSAP No. 48—Joint Ventures, Partnerships and Limited Liability Companies, as well as prefered stock interests of certified capital companies per INT 06-02: Accounting and Reporting for Investments in a Certified Capital Company (CAPCO) are included within the scope of this statement. The requirement to file investments in preferred stock of certain subsidiaries, controlled or affiliated entities with the NAIC pursuant to SSAP No. 97 does not affect the application of the accounting, valuation or admissibility under this statement.

**Proposed footnote:**

*New FootnoteFN:* Certain legal entities captured in SSAP No. 48, do not issue preferred stock in legal form, but instead issue identical instruments labeled preferred units, interests, or shares. These instruments shall be captured in this statement provided they meet the structural characteristics as defined in paragraph 3. Additionally, these instruments shall not be in-substance common stock is which the holder has risk and reward characteristics that are substantially similar to common stock.

2. Preferred stock, which may or may not be publicly traded, is a security that represents ownership of a corporation and gives the holder a claim, prior to the claim of common stockholders on earnings and also generally on assets in the event of liquidation. Most preferred stock pays a fixed dividend that is paid prior to the common stock dividend, stated in a dollar amount or as a percentage of par value. Preferred
Preferred stock does not usually carry voting rights. Preferred stock has characteristics of both common stock and debt. Preferred stock shall include:

a. Redeemable preferred stock, which is preferred stock subject to mandatory redemption requirements or whose redemption is outside the control at the option of the holders or issuer. Redeemable preferred stock is any stock which 1) the issuer undertakes to redeem at a fixed or determinable price on the fixed or determinable date or dates, whether by operation of a sinking fund or otherwise; or 2) is redeemable at the option of the holders; or 3) has conditions for redemption which are not solely within the control of the issuer, such as stock which must be redeemed out of future earnings. Preferred stock which meet one or more of these three criteria would be classified as redeemable preferred stock regardless of other attributes such as voting rights or dividend rights.

b. Perpetual preferred stock, which is preferred stocks which are not redeemable or for which redemption is not at the option of the holder are redeemable solely at the option of the issuer (non-redeemable preferred stock). Perpetual preferred stock is any preferred stock which does not meet the criteria to be classified as redeemable preferred stock pursuant to paragraph 3.a.

(Note – This definition will also be updated in the glossary.)

10. Preferred stock shall be valued based on (a) the underlying characteristics (redeemable, perpetual or mandatory convertible), (b) the quality rating expressed as an NAIC designation, and (c) whether an asset valuation reserve (AVR) is maintained by the reporting entity:

a. For reporting entities that do not maintain an AVR:

i. Highest-quality or high-quality redeemable preferred stocks (NAIC designations 1 and 2) shall be valued at amortized cost. All other redeemable preferred stocks (NAIC designations 3 to 6) shall be reported at the lower of amortized cost or fair value.

ii. Perpetual preferred stocks shall be reported at fair value, not to exceed any currently effective stated call price.

iii. Mandatory convertible preferred stocks (regardless if the preferred stock is redeemable or perpetual) shall be reported at fair value, not to exceed any stated call price, in the periods prior to conversion. Upon conversion to common stock, these securities shall be in scope of SSAP No. 30R.

iv. For preferred stocks reported at fair value, unrealized gains and losses shall be recorded as a direct credit or charge to unassigned funds (surplus).

b. For reporting entities that maintain an AVR:

ii. Highest-quality, high-quality or medium quality redeemable preferred stocks (NAIC designations 1 to 3) shall be valued at amortized cost. All other redeemable preferred stocks (NAIC designations 4 to 6) shall be reported at the lower of amortized cost or fair value.

iii. Perpetual preferred stocks shall be valued at fair value, not to exceed any currently effective stated call price.

iv. Mandatory convertible preferred stocks (regardless if the preferred stock is redeemable or perpetual) shall be reported at fair value, not to exceed any stated call price, in the periods prior to conversion. Upon conversion to common stock, these securities shall be in scope of SSAP No. 30R.
v. For preferred stocks reported at fair value, the accounting for unrealized gains and losses shall be in accordance with SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve (SSAP No. 7).

11. An other-than-temporary (INT 06-07) impairment 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 preferred stock in effect at the date of acquisition. An assessment of other-than-temporary impairment shall occur whenever mandatory redemption rights or sinking fund requirements do not occur. A decline in fair value which is other-than-temporary includes situations where the reporting entity has made a decision to sell the preferred stock prior to its maturity at an amount below its carrying value (i.e., amortized cost). If it is determined that a decline in the fair value of a redeemable preferred stock is other-than-temporary, an impairment loss shall be recognized as a realized loss equal to the entire difference between the redeemable preferred stock’s carrying value and its fair value, not to exceed any currently effective call price, at the balance sheet date of the reporting period for which the assessment is made. The measurement of the impairment loss 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.

14. Dividends on preferred stock shall be recorded as investment income for qualifying-dividend eligible preferred stock on the ex-dividend date with a corresponding receivable to be extinguished upon dividend settlement. Dividends received shall be recognized in the form received (e.g., cash, preferred stock, common stock) at fair value with differences between fair value and the dividend receivable recognized as gains or losses. Subsequent treatment shall follow the statement that addresses the type of asset received. For example, dividends received in the form of common stock shall be accounted for and reported in accordance with SSAP No. 30R—Unaffiliated Common Stock.

Discussion on Definition Change:
NAIC staff’s original intent was to align investment definitions with common industry definitions or those specified by U.S. GAAP. The definition proposed by NAIC staff was made with the understanding that preferred stock is either redeemable or perpetual. While the issue paper does mention some stock is labeled as “redeemable perpetual preferred stock,” distinctions are made in the prospectus as to its true underlying characteristics (thus being redeemable or perpetual). In general, NAIC staff continue to believe that for a majority of preferred stock issuances, a share which is redeemable at the option of the holder is by definition redeemable outside (or not solely within) the control of the issuer – thus the actions are mutually exclusive. However, interested parties cited guidance for additional circumstances in which, through legal technicalities, could create a third class of preferred shares – those redeemable outside the control of the issuer and holder. Since the definition refers to “outside the control of the issuer” as a determination for classifying a preferred share as redeemable (reported at amortized cost), certain circumstances which are technically “not solely within the issuer’s control” could cause shares to be reclassified to redeemable which were originally categorized as perpetual (reported at fair value). ASC 480-10 provides a few of these examples as: change in state law, the issuer fails to achieve certain project milestones, the issuer fails to pay specified dividends, the issuer experiences a change in credit rating, etc. As such, although the definitions differ slightly from U.S. GAAP definitions, NAIC staff are supportive of the changes suggested by interested parties as they align with the original objective of preferred stock classification and reflect the expected economics of the investment. (The issue paper includes discussion of this change.)
Summary:
During the 2019 Fall National Meeting, the Working Group exposed this agenda item to gain further clarification regarding circumstances when guaranteed investment contracts (GICs), or other deposit-type contracts, are reported in Exhibit 5 - Life Contracts or Exhibit 6 - Accident and Health Contracts, instead of Exhibit 7 – Deposit-Type Contracts.

This agenda item: 1) exposed revisions for an excerpt on Exhibit 5 (to disclose cases when a mortality risk is no longer present or a significant factor – i.e. due to a policyholder electing a payout benefit), 2) requested feedback on circumstances where a morbidity risk is no longer present or a significant factor for Exhibit 6 items and whether a similar footnote disclosure would be appropriate, and 3) requested industry input for instruction clarifications regarding the classifications of deposit-type contracts captured in Exhibit 7.

Interested Parties’ Comments:
Interested parties support the proposed Exhibit 5 footnote which, among other things, would provide clarification on contracts where a mortality risk is no longer present or a significant factor.

With respect to the implementation of additional disclosures for Exhibit 6, interested parties believe that the current product disaggregation in Exhibit 6 is sufficient to analyze the risks present in the subject contracts, and would suggest no changes.

Interested parties have no additional clarifications for Exhibit 7 instructions – we believe the current instructions are sufficiently clear for deposit type contracts.

Recommended Action:
NAIC staff agree with the assessments made by interested parties regarding Exhibit 5, Life Contracts and Exhibit 6, Accident and Health Contracts. While an update is not required for statutory accounting, **NAIC staff recommends adopting the proposed edits in the agenda item with a Blanks proposal to add the footnote to disclose when a mortality risk is no longer present.** (NAIC staff is suggesting a minor change to what was exposed as shaded below.)

Proposed Exhibit 5 Footnote:

> Included in the above table are amounts that originally contained a mortality risk. Amounts in Column 2, that no longer contain a mortality risk are $__________ in Column 2 (Life Insurance), $__________ in Column 2 (Annuities), $__________ (Supplementary Contracts with Life Contingencies), $__________ (Accidental Death Benefits), $__________ (Disability – Active Lives), $__________ (Disability – Disabled Lives), $__________ (Miscellaneous Reserves).

The recommendation to improve the instructions for Exhibit 7 classification was received from the NAIC staff for the Financial Stability (Ex) Task Force. If there is a continued desire to improve the existing definitions, consideration will occur in a separate agenda item, or perhaps in a sole Blanks proposal.
Summary:
During the Fall National Meeting, the Working Group exposed revisions to SSAP No. 86—Derivative to require gross reporting of derivative activity for financing derivative transactions. A financing derivative transaction is one in which the premium to acquire the derivative is paid throughout the derivative term or at maturity of the derivative. With the accounting and reporting that has been utilized by some companies, the associated “cash flows” (related to the derivative obtained versus the premium liability owed) are netted, generally resulting with zero-value reporting at inception. Over the course of the derivative term, an unrealized loss is recognized for changes in the present value of the premium liability (increase), which may be offset by any value change in the underlying derivative (increase or decrease). (With derivative financing, a gain would only ever be recognized if the fair value change of the derivative exceeded the cost of the derivative.) When the derivative matures, the calculation of realized gains and losses reflects the deferred cost (amount owned), adjusted for any actual fair value change.

In addition to revisions to SSAP No. 86, the exposure suggested potential Blanks revisions and potential RBC changes to consider the unpaid premium similar to collateral in determining RBC.

Interested Parties’ Comments:
Interested parties request the exposure be given an effective date of at least January 1, 2021. The exposure represents a significant change to how certain companies account for derivatives and must be implemented in our investment systems prior to adoption. Interested parties do not believe the assets and liabilities under this exposure meet the right to offset criteria in SSAP No. 64—Offsetting and Netting of Assets and Liabilities, because they originate within the same contract. Additionally, we believe the netting guidance outlined in paragraph 19c would be difficult to implement and recommend it be removed.

Recommended Action:
NAIC staff recommends adopting the exposed nonsubstantive revisions to SSAP No. 86—Derivatives with the proposed edits from interested parties to delete paragraph 19c and with the suggested effective date of January 1, 2021. The revisions ensure consistency 1) in the gross reporting of derivatives - without inclusion of financing components, and 2) in reporting amounts owed to / from the reporting entity from the acquisition or writing of derivatives. NAIC staff highlights that the concepts are consistent with existing statutory accounting guidelines, but these revisions will clarify the guidance and improve uniform application across the industry. With adoption, NAIC staff recommends Blanks proposals and referrals to Capital Adequacy (E) Task Force to consider the Blanks and RBC revisions.

Although limited comments were received, if preferred, the agenda item could be re-exposed, with the distribution of the referral / Blanks proposal. With a proposed January 1, 2021 effective date, there is time to incorporate the SSAP No. 86 revisions as well as Blanks / RBC changes.

Pursuant to the Interested Parties’ comments, paragraph 19c would be deleted:
(This is a new section that was proposed in SSAP No. 86.)

Derivative Premium (New Section – All Other Sections Renumbered Accordingly)

19. Derivative premium is the amount paid (acquired derivative) or received (written derivative) to enter into a derivative contract. At inception, the premium generally represents the fair value of the derivative. Derivative premium that is not paid or received at inception represents a liability or
receivable for the reporting entity. Derivatives with premiums not remitted at acquisition are considered “financed derivatives.” Financed derivatives shall be reported in accordance with the following provisions:

a. At acquisition and subsequently, the gross reported fair value of the derivative shall exclude the impact of financing premiums. Only market changes in the actual fair value of the derivative shall be reflected as unrealized gains or losses.

b. At acquisition and subsequently, premiums payable (acquired derivative) and premiums receivable (written derivatives) shall be separately reported as “payable for securities” and “receivables for securities.”

c. If premium payable or receivable meet the requirement for a valid right of setoff with the derivative in accordance with SSAP No. 64, the derivative asset can be reduced by a premium payable, and a derivative liability can be reduced by a premium receivable for overall reporting on the balance sheet. This offset provision does not permit a derivative asset to be reported as a derivative liability (or vice versa) due to premium payable or receivable. Rather, once a derivative asset (or liability) is fully reduced by a premium liability (or receivable), any remaining premium liability (or receivable) shall be reported as a “payable for security” or “receivable for security” pursuant to paragraph 19.b. This net balance sheet reporting does not impact the gross presentation of open derivatives on Schedule DB-A or Schedule DB-B. If reported net on the balance sheet due to a valid right to offset, the offsetting adjustment shall be shown on schedule DB-D and the SSAP No. 64 disclosures are required.

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<td>2019-40</td>
<td>Reporting of Installment Fees and Expenses</td>
<td>15 - Agenda Item</td>
<td>Comments Received</td>
<td>IP – 23 Farmers - 48</td>
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<tr>
<td>SSAP No. 53 (Robin)</td>
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Summary:
During the 2019 Fall National Meeting, the Working Group exposed revisions to SSAP No. 53—Property and Casualty Contracts—Premiums, to clarify the application of the installment fee guidance. SSAP No. 53, paragraph 6, provides specific guidance that allows for installment fees that meet specified criteria to be excluded from premium and reported as “other income.” The specified criterion provides that the installment must be avoidable by the policyholder and that the policy would not be cancelled for nonpayment.

The exposed revisions added language to SSAP No. 53, footnote 1, to ensure that the installment fee guidance is narrowly applied, because some reporting entities were seeking to analogize the application of that guidance to exclude other fees from premium income. The revisions clarify that the installment fee guidance should not be used to exclude other fees from being reported as premium.

The exposure also requested comments regarding potential diversity in the application of reporting of the installment fee expenses related to the installment fee (other revenue). A regulator noted that while reporting entities were reporting the installment fees in other income, there was diversity in practice for the related installment fee expenses:

- Most entities were reporting the installment fee expenses in underwriting expenses where there are clear reporting lines for such expenses in the underwriting exhibits.
- Some entities were reporting the installment fee expenses either as a contra amount to finance and service charges not included in premium or as a contra amount to “aggregate write-ins for miscellaneous
income.” The amounts are being reported as “contra” to other income because there is not an explicit reporting line in the property and casualty statement of income for expenses not related to underwriting.

**Interested Parties’ Comments:**
With regard to the proposed change to emphasize that current guidance in SSAP No. 53 should be interpreted narrowly, interested parties recommend the following revision to the last sentence of the proposed wording in the footnote to SSAP No. 53 paragraph 6:

**Clarification:** Reporting of installment fees in finance and service charges as other income should not be construed as having any bearing on whether such charges are subject to premium taxation, which remains an issue of state law and regulation.

Although interested parties did not survey companies, we believe the assertion by NAIC staff that expenses associated with installment fees are often immaterial is reasonable. We also believe that current reporting of the related installment fee expenses in other underwriting expenses is appropriate. For practical purposes, we do not see the benefit of isolating the expense related to processing the relatively small fee component of a premium billing for separate expense reporting purposes. We believe the reporting of expenses should be consistent and would not support the reporting of the related expenses as an “aggregate write-ins for miscellaneous income” or as a contra revenue to “finance and service charges not included in premiums.”

**Farmers Insurance Comments:**
At the December 2019 meeting, the NAIC exposed and requested comments on the “Reporting of Installment Fees and Expenses” in the financial statements. This guidance allows for installment fees that meet specified criteria to be excluded from premium income, if it is an avoidance amount by the policyholder and the policy would not be cancelled for nonpayment of the installment fees. The guidance is consistent with the footnote in SSAP No.53 (“Property Casualty Contracts – Premiums”) and in line with our current industrywide reporting of this item in the financial statements.

With respect to the reporting of the corresponding “Installment fees related Expenses,” we believe that these associated Expenses should be reported as part of the Other Underwriting Expenses Incurred (“OUE”) on Line 4 of the Statement of Income and as an ancillary to the normal underwriting activities primarily due to immateriality. Such a presentation will allow insurers to report and reconcile the gross Installment fees amount to the corresponding balance reflected in Schedule T, Column 8 as well as in the Write-ins amount on the Statutory Page 14, along with premium tax payments. Currently, there is inconsistency in reporting in the industry, with some companies reflecting these associated Expenses as part of the Other Underwriting Expenses Incurred on Line 4 of the Statement of Income while others reflect such Expenses as part of the Aggregate write-ins for miscellaneous income on Line 14 of the Statement of Income.

However, as we believe others have also pointed out, this guidance specifically addresses fees charged on Installment premiums, but there are other equally nonrefundable “Other fees” charged by many companies, as part of the billing and collection process, but that are not specifically mentioned in this guidance. That is to say, there are “Other Fees” charged by insurers as part of the collection process, all of which, like Installment fees, are not only non-refundable, but are also avoidance amount by the policyholder and would not be cancelled for non-payment of the installment fees, similar to Installment fees.

These nonrefundable “Other fees,” include, but are not limited to:

1. Late fees - fees and expenses charged on flexible/installment plans that are received after a specified cut-off period e.g. 30 days
2. Non-sufficient funds (“NSF”) fees - fees and expenses collected on returned payments due to non-sufficient funds

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3. Reinstatement fees - fees and expenses received on policies that expired and are subsequently reinstated, among others etc.

Currently, there is divergence in reporting in this area of this relatively immaterial amounts for nonstandard and standard writers and therefore need for clarification for consistency in reporting going in.

The reporting issue here then is, where and how to report all of these “Other fees,” excluding Installment fees. Should all these “Other fees” be reported as part of:

a) Other underwriting expense incurred on Line 4 of the Statement of Income
b) Finance and service charges on Line 13 of the Statement of income, akin to installment fees
c) Aggregate write-ins for miscellaneous income on Line 14 of the Statement of income

Typically, most companies report these nonrefundable “Other fees” as “Other income” on Line 14 of the Statement of Income

Consistent with current practice, we also believe all these “Other fees,” net of applicable expenses, if any, should be reported as part of the Aggregate-write-ins for miscellaneous income on Line 14 of the Statement of Income. However, if for some reason this first preference is determined to be untenable, then we believe the next viable alternative could be the “Other underwriting expenses incurred” on Line 4 of the Statement of Income, under the assumption that all these other fees are ancillary to the normal underwriting activities, but defer ultimately decision to the NAIC staff for review and consideration.

Recommended Action:
Because the items under discussion can impact loss ratios and information reported in Schedule P, during the 2019 Fall National Meeting exposure, the Working Group directed notice of the exposure and the request for comments to the Casualty Actuarial and Statistical (C) Task Force and the Property and Casualty Risk-Based Capital (E) Working Group. Both groups have indicated that they do not expect to have a response on the installment fee expense comments until after the Spring National Meeting. NAIC staff has forwarded the 2020 comments received to both groups.

NAIC staff recommends that the Working Group take the following actions:

1. Adopt the exposed revision with the minor shaded edit from interested parties as illustrated below. This revision clarifies that existing installment fee revenue guidance should be narrowly applied.

2. When comments on the installment fee expense are received from the Casualty Actuarial and Statistical (C) Task Force and the Property and Casualty Risk-Based Capital (E) Working Group it is recommended that those comments be discussed as a separate agenda item (if needed).

Proposed Revisions for Adoption:

6. Written premiums for all other contracts shall be recorded as of the effective date of the contract. Upon recording written premium, a liability, the unearned premium reserve, shall be established to reflect the amount of premium for the portion of the insurance coverage that has not yet expired. Flat fee service charges on installment premiums (fees charged to policyholders who pay premiums on an installment basis rather than in full at inception of contract) are reported in the Other Income section of the Underwriting and Investment Exhibit as Finance and Service Charges. Flat fee service charges on installment premiums, which do not meet the requirements outlined in footnote 1 (e.g., policy may be cancelled for non-payment of fee or fee is refundable), shall be recorded as written premium on the effective date of the contract and subject to the unearned premium guidelines included in paragraph 8.
1 If the policyholder elects to pay an installment rather than the full amount or the full remaining balance, the policyholder is traditionally charged a flat fee service charge on the subsequent billing cycle(s). The amount charged is primarily intended to compensate the insurer for the additional administrative costs associated with processing more frequent billings and has no relationship to the amount of insurance coverage provided, the period of coverage, or the lost investment income associated with receiving the premium over a period of time rather than in a lump sum. As described, there is no underwriting risk associated with this service charge. If a policyholder does not pay the service charge, the policy is not cancelled (unlike non-payment of premium), but instead the policy is converted back to an annual pay plan. If a policyholder cancels coverage, the premium is returned but the service charge is not, as the service charge is not a part of premium. Note that this footnote on flat fee service charges on installment premium is intentionally narrow and specific and this guidance should not be applied to other fees or service charges. Clarification: Reporting of installment fees and service charges as other income should not be construed as having any bearing on whether such charges are subject to premium taxation, which remains an issue of state law and regulation.

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Summary:
During the 2019 Fall National Meeting, the Working Group exposed revisions to eliminate the “financial modeling” process from SSAP No. 43R—Loan-backed and Structured Securities. This agenda item is in coordination with a Valuation of Securities (E) Task Force proposal and final action by the Working Group will not be considered until Task Force first takes action on this item.

The current RMBS/CMBS multi-step modeling practice (“financial modeling”) is the only remaining approach that utilizes breakpoints to determine final NAIC designations. In March 2019, agenda item 2018-19 removed the multi-step modeling approach for modified filing exempt (MFE) securities. This change removed the carrying value from the designation determination analysis and investments previously captured in the “MFE” guidance, now utilize the original NAIC designation, without adjustment, to determine the measurement method under SSAP No. 43R and corresponding RBC charges. With elimination of the “MFE” approach, identical securities captured under that guidance now have identical NAIC designations.

Interested Parties’ Comments:
Interested parties have no comment on this item at this time.

Recommended Action:
NAIC staff recommends that the Working Group defer discussion on this agenda item as the Valuation of Securities (E) Task Force continues review of this topic.

NAIC staff is aware that the Task Force is considering a different proposal with regards to this issue. With the Task Force’s revised approach, the financial modeling approach would be retained, but the NAIC designation (NAIC 1-6) would be mapped to a specific NAIC designation modifier. (For example, an NAIC 1 would be an NAIC 1.D and an NAIC 2 would be an NAIC 2.B.)

If the Task Force moves forward with the altered approach, NAIC staff would recommend disposing this agenda item (Ref #2019-41) with the development of a new agenda item if considered necessary to reflect the new approach. (At this time, revisions to SSAP No. 43R may not be necessary with the altered approach.)
REVIEW of COMMENTS on EXPOSED ITEMS

The following items received comments during the exposure period that are open for discussion.

1. Ref #2019-12: ASU 2014-17, Business Combinations, Pushdown Accounting
2. Ref #2019-14: Attribution of Goodwill
3. Ref #2019-20: Rolling Short-Term Investments
4. Ref #2019-42: Cash Equivalent – Cash & Liquidity Pools
5. Ref #2019-24: Levelized and Persistency Commission
7. Ref #2019-33: SSAP No. 25 – Disclosures
8. Ref #2019-34: Related Parties, Disclaimer of Affiliation and Variable Interest Entities
9. Ref #2019-36: Expand MGA and TPA Disclosures
12. Ref #2019-47: VM 21 Grading
13. Ref #2019-49: Retroactive Reinsurance Exception

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<tr>
<td>2019-12</td>
<td>ASU 2014-17, Business Combinations, Pushdown Accounting</td>
<td>17 - Agenda Item</td>
<td>Comments Received</td>
<td>IP – 6 &amp; 35</td>
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Summary:
During the 2019 Fall National Meeting, the Working Group adopted an update clarifying that “goodwill resulting from the acquisition of an SCA by an insurance reporting entity that is reported on the SCA’s financial statements (resulting from the application of pushdown accounting), is limited in the aggregate to 10% of the acquiring entity’s capital.” In continuation of this agenda item, the Working Group exposed revisions to assess ASU 2014-17, Business Combinations – Pushdown Accounting for statutory accounting with a request for comments on whether pushdown shall be rejected, permitted for noninsurance entities, or permitted only for U.S. Securities and Exchange Commission (SEC) registrants.

Interested Parties’ Comments:
Interested parties recommend that paragraph 5 of SSAP No. 68 be revised further as marked below to clarify the appropriate valuation that should be used for an acquired entity:

5. A business combination accounted for under the statutory purchase method and in which the acquired entity is valued in accordance with paragraphs 8.b.ii., 8.b.iii. or, 8.b.iv. of SSAP No. 97 shall determine the amount of positive goodwill or negative goodwill created by the combination using the reporting entity’s share of the GAAP net book value of the acquired entity, adjusted to a statutory basis of accounting in accordance with paragraph 9 of SSAP No. 97 in the case of acquired entities valued in accordance paragraphs 8.b.ii. or 8.b.iv. of SSAP No. 97. The GAAP net book value of the acquired entity used in this determination shall reflect the acquisition-date fair values of identifiable assets acquired and liabilities assumed, and goodwill, as recognized in the post pushdown GAAP financial statements of the acquired entity, if applicable. Business combinations accounted for under the statutory purchase method and in which the acquired entity is valued in accordance with, paragraph 8.b.i. of SSAP No. 97 shall determine the amount of positive or negative goodwill created by the business combination using the insurer’s share of the statutory book value of the acquired entity.
Pushdown Accounting

Interested parties note that the GAAP guidance in ASU 2014-17, which was adopted by the SEC in Staff Accounting Bulletin (SAB) 115, provides clear guidance that an acquired entity has the option to apply pushdown accounting in its separate financial statements upon the occurrence of an event in which an acquirer obtains control of the acquired entity. Under applicable GAAP guidance, control generally results when one entity obtains, either directly or indirectly, more than 50 percent of the outstanding voting shares of another entity. This differs from the definition of control under statutory guidance which uses a threshold of 10 percent or more of voting control. As such, under GAAP, there would not be a scenario where an entity would be controlled by multiple owners with 10% or more ownership of outstanding shares.

Whether a company chooses to apply pushdown accounting depends on the facts and circumstances of a particular transaction. In certain situations, pushdown is preferable to eliminate the basis difference between an acquirer and the acquired entity. In other situations, a company may prefer pushdown accounting to better reflect the actual values of the acquired assets and assumed liabilities based on the purchase price of the entity.

When the SEC required pushdown for SEC registrants, there was limited guidance for non-registrants under GAAP which resulted in some non-registrants also applying the SEC pushdown guidance. We believe retaining the optionality for statutory reporting allows for consistency and comparability across both SEC registrants and non-registrants and provides operational efficiency.

The option of not allowing subsequent elections for pushdown accounting is not practicable for SEC registrants that previously elected to use pushdown accounting. In order for such companies to discontinue use of pushdown accounting, a preferability letter would be required for a change in accounting policy to discontinue the use of pushdown accounting. Given that an election to discontinue use of pushdown accounting is not likely preferable, the insurer would be in the position of having to continue using pushdown accounting in order to receive a clean audit opinion on the GAAP financial statements of the SCA. Additionally, while ASC 805, Business Combinations, allows the election to be made for each change in control event, acquirers that report consolidated results may as a practical matter choose pushdown accounting at the subsidiary level to avoid separately tracking assets, and liabilities at two different values in two different ledgers.

As noted in the examples below, and in accordance with the guidance adopted during the December 7, 2019 Working Group meeting, interested parties understand the guidance clarified that all goodwill from an insurance entity’s acquisition of SCAs, regardless of whether pushdown accounting is applied, is subject to the existing 10% admittance limitation. Interested parties have summarized the interpretation of this clarification for an insurance entity’s acquisition of an 8.b.i (example 1), 8.b.ii (example 2a and 2b), 8.b.iii (example 3a and 3b) or 8.b.vi (example 2a and 2b) entity as follows:

<table>
<thead>
<tr>
<th>Example</th>
<th>Type of acquired SCA</th>
<th>Is Pushdown elected?</th>
<th>Where does Goodwill resides?</th>
<th>Admissibility of goodwill limited to 10% of</th>
<th>Is Goodwill required to be amortized?</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>8.b.i</td>
<td>Not permitted per SSAP No. 68 para 6</td>
<td>Insurance entity (Statutory goodwill)</td>
<td>Insurance Entity’s Surplus per SSAP No. 68 para 7</td>
<td>Yes per SSAP No. 68 para 8</td>
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<tr>
<th>2a</th>
<th>8.b.ii or 8.b.iv</th>
<th>No</th>
<th>Insurance entity (Statutory goodwill)</th>
<th>Insurance Entity's Surplus per SSAP No. 68 para 7</th>
<th>Yes per SSAP No. 68 para 8</th>
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<tr>
<td>2b</td>
<td>8.b.ii or 8.b.iv</td>
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<td>SCA (GAAP goodwill)</td>
<td>SCA's GAAP equity per SSAP No. 97 para 9.d</td>
<td>Yes per SSAP No. 97 para 9.c.iii</td>
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<td>8.b.iii</td>
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<td>Yes per SSAP No. 68 para 8</td>
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<tr>
<td>3b</td>
<td>8.b.iii</td>
<td>Yes</td>
<td>SCA (GAAP goodwill)</td>
<td>Insurance Entity's Surplus per SSAP No. 68 para 7</td>
<td>No *</td>
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* See further discussion below related to amortization

After evaluating the accounting for goodwill from the various entities described in paragraph 8.b, we concluded that the NAIC should continue to allow insurers to elect pushdown accounting for acquisitions of non-insurance entities (Option 2) for the following reasons:

1. Statutory goodwill, created when the insurer is the acquirer, is subject to an existing 10% admittance limitation as clarified in the changes adopted by the Working Group during the Fall National Meeting and demonstrated above; therefore, the resulting goodwill from pushdown accounting is subject to the statutory thresholds.

2. Pushdown accounting is consistent with GAAP, prior to ASU 2014-17, for SEC registrants and non-registrants that used pushdown accounting. As noted above, it is not practical to discontinue use of pushdown accounting as an insurer would need to continue the use of pushdown accounting in order to obtain a clean audit opinion on the GAAP financial statements of the SCA.

3. It is important to maintain consistency with current GAAP. Under ASU 2014-17, pushdown accounting may be elected in a later reporting period, after the initial acquisition date. We understand that there may be concerns with electing pushdown at a later reporting period after goodwill was originally determined and reported at initial acquisition date. However, rather than disallowing a later election to apply pushdown accounting, which creates a variance to GAAP, we suggest this could be addressed through changes to SSAP No. 97 to ensure that goodwill is not subsequently increased for statutory reporting, in the event pushdown accounting is elected after the initial acquisition date.

4. The recommendations above would allow the continued use of audited GAAP equity as the statutory carrying value for all non-insurance entities for insurers that previously elected pushdown accounting (both SEC registrants and non-registrants). Additionally, the ability to elect pushdown accounting for future acquisitions retains GAAP equity as the statutory valuation basis for SCAs and avoids restrictions that can impact insurers’ ability to obtain an unqualified opinion on the stand-alone financial statements of SCAs.

If a restriction were placed on the use of pushdown accounting at a future date, those entities that have previously elected pushdown will be forced to separately track assets, and liabilities at two different values in...
two different ledgers as well as address the issue of making a change in accounting policy that may not have preferability.

As a separate point, we suggest changing the heading for Option 2 from “Permission to use pushdown for all non-insurance entities” to “Use of pushdown for all non-insurance entities”, as the term “permission” implies that use of pushdown accounting is a permitted practice under the statutory accounting framework.

**Amortization**

Interested parties reiterate the concern that the revisions from the adopted language (new SSAP No. 68 paragraph 10) would inadvertently require amortization of pushdown goodwill. While staff has noted that amortization may be the proper approach, interested parties believes as it relates to paragraph 8.b.iii entities acquired by an insurance entity where pushdown is applied, there has been diversity in practice.

Interested parties concur with the NAIC’s staff’s position described in the December 2019 Public Hearing Agenda materials:

“(As detailed in the earlier discussion, the minor edit being discussed only focuses on nonadmittance for insurer entity acquired SCAs that have been pushdown. The edit would not mandate amortization for those pushdown situations. The discussion on whether amortization should be required for those situations is proposed to occur after the next exposure.)”

**Recommended Action:**

NAIC staff recommends that the Working Group hear comments from interested parties. However, it is recommended that the Working Group not take action during the Spring National Meeting. Rather, it is anticipated that future discussion will occur during a separate call or a subsequent National Meeting.

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<td>2019-14 SSAP No. 97 (Julie/Fatima)</td>
<td>Attribution of Goodwill</td>
<td>18- Agenda Item</td>
<td>Comments Received</td>
<td>IP – 7 &amp; 39</td>
</tr>
</tbody>
</table>

**Summary:**

During the 2019 Fall, the Working Group exposed revisions to SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities, to clarify that the “assignment” of goodwill is a disclosure element, with revisions to the disclosure requirements for downstream holding companies. The revisions did not dictate the method of assignment, but rather directed that allocation of goodwill to acquired subsidiaries shall be disclosed upon acquisition and cannot change once assigned. The revisions also reflect a change in terminology from “allocation” to “assignment.”

**Interested Parties’ Comments:**

Interested parties note that the December 2019 Public Hearing Agenda materials state:

“It is important to highlight that the clarification edit proposed for adoption consideration is specific to insurance entity acquisitions of SCAs. As such, if an acquisition occurred downstream from the insurance company (by a non-insurance holding company), and the holding company applied pushdown accounting, so that the goodwill was reported at the holding company’s acquired SCA, the proposed edit would not require that push down goodwill to be brought up to the insurance entity’s level and included in the 10% limit.”

Requiring attribution would be onerous and misleading to the users of the financial statements, particularly if the disclosure included detailing GAAP goodwill that is not subject to the 10% limit. Interested parties do not believe
it is necessary to “attribute” goodwill to downstream SCAs of downstream holding companies. We believe that any concerns about the carrying value of the downstream holding company being overstated because it did not push down GAAP goodwill to a downstream SCA that was subsequently sold is mitigated by the fact that GAAP already requires the attribution and derecognition of goodwill associated with the business or SCA that is sold. To layer in a statutory attribution of goodwill is not necessary, overly complex, and may distort the accounting impact of a sale of a downstream SCA.

Therefore, we recommend that the disclosure of GAAP goodwill attributed to downstream SCAs of downstream holding companies focus on actual GAAP goodwill that was pushed down to the downstream SCAs and any statutory goodwill that occurred when the insurer is the acquirer, subject to the existing 10% admittance limitation as illustrated and discussed in the examples above.

**Recommended Action:**
NAIC staff believes that Interested Parties’ may have the incorrect impression regarding this attribution of goodwill agenda item. **This agenda item does not necessarily pertain to pushdown accounting.** Rather, this agenda item pertains to the look-through of downstream holding companies. **If a reporting entity acquires a downstream holding company that qualifies for the “look-through” approach, and the acquired holding company owns three underlying SCAs, the goodwill from the acquisition of the downstream holding company must be attributed to the underlying SCAs.** This is necessary to ensure that goodwill is properly addressed when an underlying SCA is nonadmitted or sold. The reason for the proposed clarification is that instances have been presented in SCA filings in which only one underlying SCA within a “look-through” downstream holding company group qualifies for admittance, however, there is no detail on how goodwill was attributed. In these instances, the full amount of goodwill from the acquisition of the downstream holding company would be nonadmitted. (If the goodwill was pushed down, it would already be a component of the downstream holding company.) **NAIC staff has proposed a provision to exclude “pushdown” goodwill until the decision from the Working Group on that issue has been addressed. If preferred this guidance could be re-exposed, or the Working Group could consider adoption of this disclosure element. (This disclosure element is not proposed to be data-captured.)**

- Scenario 1: In year 1, the downstream holding company is audited, therefore the “look-through” provisions are not used. However, in year 2, the downstream holding company is not audited and qualifies for look-through. If only one of the underlying SCAs is audited, then only the audited SCA can be admitted, and only the goodwill attributed to that SCA can be admitted. (Without attribution of goodwill, then all of the goodwill related to the downstream holding company would be nonadmitted.)

- Scenario 2: In year three, one of the underlying SCAs held by the downstream holding company is sold. The reporting entity needs to know how much of the original goodwill was attributed to this underlying entity in order for it to be removed from the financial statements.

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1 ASC 350-20-40, *Intangibles – Goodwill and Other - Goodwill – Derecognition*, paragraphs 1 and 2:

40-1: When a reporting unit is to be disposed of in its entirety, goodwill of that reporting unit shall be included in the carrying amount of the reporting unit in determining the gain or loss on disposal.

40-2: When a portion of a reporting unit that constitutes a business (see Section 805-10-55) or nonprofit activity is to be disposed of, goodwill associated with that business or nonprofit activity shall be included in the carrying amount of the business or nonprofit activity in determining the gain or loss on disposal.
Below is the proposed disclosure included in the last exposure (with slight modifications) that detail the downstream holding company application and the attribution of goodwill:

<table>
<thead>
<tr>
<th>Downstream Holding Company</th>
<th>Carrying Value</th>
<th>Goodwill</th>
<th>Total (Carrying Value + Goodwill)</th>
<th>Total Admitted Value</th>
<th>Total Nonadmitted</th>
</tr>
</thead>
<tbody>
<tr>
<td>ABC Downstream**</td>
<td>$3,000,000</td>
<td>$250,000</td>
<td>$3,250,000</td>
<td>$2,712,500</td>
<td>$537,500</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Name of Look-Through Entity</th>
<th>Audited F/S (Yes / No)</th>
<th>Carrying Value</th>
<th>Assigned Goodwill %</th>
<th>Assigned Goodwill</th>
<th>Admitted Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>XYZ Entity</td>
<td>Yes</td>
<td>2,500,000</td>
<td>85%</td>
<td>$212,500</td>
<td>$2,712,500</td>
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<tr>
<td>QRS Entity</td>
<td>No</td>
<td>400,000</td>
<td>10%</td>
<td>$25,000</td>
<td>$0</td>
</tr>
<tr>
<td>MNO Entity</td>
<td>No</td>
<td>100,000</td>
<td>5%</td>
<td>$12,500</td>
<td>$0</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td>$3,000,000</td>
<td>100%</td>
<td>$250,000</td>
<td>2,712,500</td>
</tr>
</tbody>
</table>

Note: The Total Nonadmitted value for ABC Downstream has been updated as it did not reflect the full value.

Proposed edits to exclude pushdown scenarios from the disclosure:

5. A business combination accounted for under the statutory purchase method and in which the acquired entity is valued in accordance with paragraphs 8.b.ii., 8.b.iii. or, 8.b.iv. of SSAP No. 97 shall determine the amount of positive goodwill or negative goodwill created by the combination using the reporting entity’s share of the GAAP net book value of the acquired entity, adjusted to a statutory basis of accounting in accordance with paragraph 9 of SSAP No. 97 in the case of acquired entities valued in accordance with paragraphs 8.b.ii. or 8.b.iv. of SSAP No. 97. If the acquired entity is a holding company and pushdown has not been applied, the purchase price and goodwill shall be calculated to determine the amount of goodwill that should be assigned to the downstream entities that were acquired as part of the holding company acquisition. This is required because a reporting entity that subsequently qualifies and elects to look-through the holding company pursuant to SSAP No. 97, paragraphs 25-26 is only permitted to admit the goodwill attributed to the downstream entities that are admitted through the SSAP No. 97 look-through approach. Information on the assigned goodwill shall be captured in the initial Sub 1 filing to the NAIC for all holding company acquisitions and disclosed in accordance with paragraph 42 if the reporting entity utilizes the look-through approach. Business combinations accounted for under the statutory purchase method and in which the acquired entity is valued in accordance with, paragraph 8.b.i. of SSAP No. 97 shall determine the amount of positive or negative goodwill created by the business combination using the insurer’s share of the statutory book value of the acquired entity.
Summary:
During the 2019 Fall National Meeting, the Working Group exposed revisions to SSAP No. 2R—Cash, Cash Equivalents, Drafts and Short-Term Investments to incorporate additional principle concepts in the classification of investments as cash equivalents or short-term investments. As detailed in the exposure, the original proposed revisions would have restricted the classification as a cash equivalent or short-term investment for all affiliated SSAP No. 26R—Bond investments, all affiliated and nonaffiliated investments in scope of SSAP No. 43R—Loan-backed and Structured Securities, and all affiliated and non-affiliated investments that would be reported on Schedule BA in the event that 1) the reporting entity does not reasonably expect that the investment will actually terminate or mature within the timeframe permitted for cash equivalent or short-term investment classification, 2) the investment was previously reported as a cash equivalent / short-term investment and the initial maturity timeframes have passed, 3) the investment was sold or matured and the same or substantially similar investment was reacquired within a 1-year timeframe.

As a reminder, this agenda item has been drafted to consider statutory accounting guidance for short-term investment structures that are being purposely designed to mature at or around 364 days (often with affiliates), with the full expectation that the investment structure would be renewed (rolled) continuously for subsequent years. These structures occur because reporting as short-term investments (or cash equivalents) results with the following benefits: 1) More-desirable risk-based capital (RBC) charge, 2) to avoid filing with either the SVO or to avoid obtaining a rating from a credit rating provider, or 3) limited affiliate reporting.

Additionally, this agenda item was exposed to exclude certain cash/liquidity pool’s (as defined in agenda item 2019-42: Cash Equivalent - Cash & Liquidity Pools) from the short-term rolling guidance.

Interested Parties’ Comments:
Interested parties appreciate the staff’s exclusion of qualifying cash pools from the provisions of the short-term rolling re-exposure. There remain two types of short-term lending arrangements within the scope of the re-exposure that should be addressed separately. We respectfully request that the Working Group give consideration to the broader implications discussed below prior to moving forward with this proposal. Specifically, it might be advantageous to split the exposure into two work streams – one for affiliated investments and another for unaffiliated investments.

Non-affiliate Short-Term Lending
In the case of non-affiliated loans (i.e., Schedule BA Other Invested Assets), in order to provide appropriate flexibility to both the lender and the borrower, a loan facility may be structured as a short-term obligation. Such short-term obligations permit an insurer to more efficiently deploy its capital and streamline its underwriting process. Specifically, short term, non-affiliated loans: (a) provide the insurer with the ability to review and consider credit and collateral on a regular basis, (b) allow the insurer to reevaluate each investment at maturity and make new investments based on current market conditions if desired, and (c) allow the insurer to consider a renewal with an existing base of knowledge about the borrower and collateral, making the underwriting process more streamlined and allowing for better informed credit decisions. As with any investment, diligent underwriting of the borrower and the collateral, and structuring of the investment with appropriate safeguards is critical and should not deviate from standards used for longer-term investments. These facilities fill a market need for borrowers that require short-term or warehouse-type financings on assets prior to reaching the window for securitization and provide the insurer with attractive risk-adjusted returns relative to other short-term investments.
In this context, interested parties propose that all non-affiliated short-term obligations, obligations in scope of either SSAP No. 26 or SSAP No. 43R, where the counterparty is not an affiliate or related party of the reporting entity, including collateral loans, which meet certain objective criteria should be defined, reported, and monitored in the existing Schedule DA as a non-affiliated short-term investment. In order for a non-affiliated transaction to qualify as short term for reporting purposes, such investment must include the following features:

1) The loan includes a maturity date less than one year from closing at which the borrower has an unconditional repayment obligation and on which the lender has a reasonable expectation that the investment can be terminated and repaid if so desired by the insurer; and

2) Any subsequent renewal is only completed in the sole discretion of BOTH the borrower and the lender.

Given that the transaction is between unaffiliated counterparties, interested parties believe the terms of these transactions, including the interest rate and advance rate, are on arms’ length terms.

Finally, with no obligation at any time to renew a transaction, the reporting entity is required to re-evaluate and re-underwrite the transaction at maturity. If any of the relevant underwriting criteria have changed, the insurer can require repayment or can request adjustments to the terms and conditions to conform to market conditions. If, but only if, both the borrower and lender agree to renew the transaction on the same or adjusted terms, the transaction may be renewed. This process, however, requires an independent credit decision and results in a new transaction.

Interested parties acknowledges the NAIC staff’s concern about the ability of auditors and regulators to discern between renewals that have been re-underwritten and those that have not; however, without an appreciation for the nuanced economic differences of these transactions, interested parties have concerns about unintended consequences of the re-exposure. Consider a transaction in which an entity purchases a GNMA with less than a one-year maturity, which was classified as a short-term investment or cash equivalent and matures/is settled as expected. Shortly after, that entity decides to purchase another GNMA with less than a one-year maturity. As proposed, the guidance precludes short-term investment or cash equivalent reporting for reacquired investments (or substantially similar investments) when purchased within one year from the initial investment. Without further clarification regarding substantially similar investments, or alternative objective criteria like those proposed above, we anticipate that diversity in practice could result. Additionally, regarding the example described, operationally burdensome tracking requirements would be required for entities to ensure appropriate reporting.

Therefore, we believe that unaffiliated SSAP No. 26 investments should be excluded from the scope of this exposure for the reasons discussed above. The scope of this exposure should also continue to exclude other unaffiliated SSAP No. 26 investments such as treasury bills, commercial paper, certificates of deposits and other similar short-term investments since such investments are used for short-term liquidity and do not have long-term investment risk.

Affiliate Short-Term Lending

Interested parties believe that the same principles discussed above and in our previous letter apply to affiliated short-term investments to merit continued classification as short term in nature, even when a subsequent short-term investment is re-underwritten to the same borrower within a year. We believe there is already sufficient regulatory oversight on the fundamental objectives, usage and risks of material affiliated transactions to validate the alignment of these vehicles with the fundamental characteristics implied by the statutory short-term investment classification. In this case, prudently managed, governed and executed liquidity optimization across an insurance holding company system can be observed with the current regulatory oversight mechanisms. While re-underwriting may be warranted based on liquidity needs, the risk profile continues to be commensurate with that of short-term investments.

NAIC Guidance should not supersede regulatory oversight. The domiciliary commissioners already have authority to disapprove of material affiliated transactions as deemed necessary. The NAIC Model Holding Company Act (the “Act”), which has been broadly incorporated into state laws, requires filing and domiciliary commissioner approval of affiliated transactions over certain materiality thresholds. As the Act was promulgated by the NAIC, interested
Prudent and appropriately governed liquidity management within a holding company structure enhances insurance company solvency. Appropriately managed, governed and regulator-approved affiliate lending programs create opportunities for liquidity optimization across a holding company system, essentially sharing objectives similar to that of affiliated liquidity pools. This management is necessary due to diversification of product offerings as timing of cash receipts and disbursements will vary across such products and different entities within a holding company system. The ability to prudently draw upon excess liquidity surplus within one entity at a time when another entity has a short-term need for liquidity serves as an immediate buffer against uneconomic alternatives such as forced asset sales or relatively costly external short-term financing. If adopted as written, the exposed guidance could result in entities foregoing this powerful in-house liquidity tool, which enables companies within a holding company system to more effectively manage inherent cash flow timing mismatches, and instead resort to alternatives that would result in an unnecessary drain on capital available to support policyholder obligations.

SSAP 43R—Loan-backed and Structured Securities
Investments in the scope of SSAP 43R, Loan-backed and Structured Securities, have payments that are driven by underlying collateral with modifications that are driven by the performance of the underlying assets and typically overseen by a collateral manager or otherwise laid out in deal documents. In many cases, these instruments also have clean-up call provisions that would remove the investment from the market while the remaining underlying collateral may be repackaged into a re-securitization. The concept of rolling a short-term investment that would be in the scope of SSAP 43R is often-times outside the control of investors in these instruments and possibly part of the normal life cycle of a small portion of the underlying collateral. Because of these characteristics, the interested parties propose that any non-affiliated investment that would qualify within SSAP 43R—Loan-backed and Structured Securities be exempt from the proposed new concepts like what is proposed for non-affiliated investment that would qualify within SSAP 26R—Bonds. Further consideration of affiliated investments that fall within SSAP 43R is recommended, given the underlying assets drive these investments and the other considerations for affiliate short-term lending outlined previously in this response.

Interested parties respectfully requests that the Working Group give consideration to these broader implications prior to moving forward with this proposal. If the Working Group has lingering concerns or appetite for additional elaboration as to the character and traditional efficacy of existing regulatory oversight mechanisms, interested parties would request that staff work with industry to draft materials for future dialogue and examination of this topic.

American Property Casualty Insurance Association (APCIA) Comments:
APCIA writes to highlight our support for the recommendations on this proposal provided in the comment letter of the “Interested Parties” coalition. APCIA and our members regularly participate in the Interested Parties’ discussions and drafting process.

SSAP No. 2R generally requires debt obligations with a maturity date of less than one year to be reported on Schedule DA. However, the proposed revisions to SSAP No. 2R would specify that any investment reported as a short-term obligation which was renewed or extended past its original maturity date would need to be reported as a long-term obligation, and a reporting entity would not be permitted to acquire the same or a substantially similar security within a 1-year time frame unless such security is reported as a long-term obligation. APCIA believes
appropriate safeguards already exist, or could be put in place, to address the concerns underlying this proposal. We support the recommendations of the Interested Parties in the context of both unaffiliated and affiliated short-term loans.

Unaffiliated short-term loans provide important flexibility and efficiencies for insurers. So long as the lender has a reasonable expectation that the investment can terminate and be repaid on the maturity date, and both the borrower and lender have the ability to reevaluate and renew the loan at maturity, we believe unaffiliated short-term loans are properly reported on Schedule DA as a short-term risk asset. As such, APCIA supports the objective criteria proposed by the Interested Parties for determining when an unaffiliated loan qualifies as short term:

1) The loan includes a maturity date less than one year from closing at which the borrower has an unconditional repayment obligation and on which the lender has a reasonable expectation that the investment can be terminated and repaid if so desired by the insurer; and
2) Any subsequent renewal is only completed in the sole discretion of both the borrower and the lender.

In the context of short-term loans between affiliates, the Model Holding Company Act already requires regulatory filing and approval of loans exceeding a materiality threshold. Further, as the Interested Parties’ letter also points out, loans between affiliates are an important mechanism for meeting short-term liquidity needs for an entity within a broader group. Given the importance of insurers being able to utilize loans from affiliates to meet short-term needs and the regulatory oversight of these transactions that already exists, APCIA agrees with Interested Parties that short-term loans between affiliates should continue to be classified as short term.

**Recommended Action:**
NAIC staff concurs that it may be advantageous to separate the discussion of related party/affiliated vs unrelated/nonaffiliated investments. Upon review, NAIC staff agrees with the comments received from interested parties that unrelated/nonaffiliated transactions operate in an arm’s length transaction in that the reporting entity is under no obligation to renew or roll a transaction. Upon contract maturity, a reporting entity is required to re-evaluate and re-underwrite the transaction and is able to adjust terms and conditions to conform to current market conditions. Additionally, both parties (the reporting entity and investee) independently review the terms and can terminate the transaction prior to renewal.

In terms of related/affiliated transactions, NAIC staff believe that although the operating units within a holding company are related, they can function independently and, in a manner, sufficient for short-term reporting under certain circumstances. In many cases in liquidity needs and optimization across an insurance holding company system warrant the need for short-term affiliated investments. However, at a minimum, in order for a related/affiliated transaction to remain on short-term scheduled for more than one year, the reporting entity shall maintain adequate documentation of that the short-term investment was appropriately re-underwritten to contain evidence the transaction operates in a manner similar to an unrelated/nonaffiliated investment. Additionally, NAIC staff support an identification in the Blanks for short-term investments that remain on the short-term investment schedule for more than one year.

NAIC staff recommends that the Working Group expose, with revisions from the previous exposure, as shown in gray, to SSAP No. 2R—Cash, Cash Equivalents, Drafts and Short-Term Investments. Changes incorporate additional principle concepts in classifying investments as cash equivalents or short-term investments. This item is proposed to have a shortened exposure period to allow for adoption prior to the corresponding blanks proposal.

The proposed revisions will restrict the classification of certain investments as a cash equivalent or short-term investment for related party or affiliated investments that would be in scope of SSAP No. 26R—Bonds, SSAP No. 43R—Loan-backed and Structured Securities, or that would be reported as “Other Invested Assets.” These shall be reported as long-term investments under the noted criteria unless the reporting entity re-underwrites the investment, maintains appropriate re-underwriting documentation, and each participating party has the ability
to independently review the terms and can terminate the transaction prior to renewal. **Further, an additional disclosure has been proposed to identify short-term investments (or substantially similar investments) which remain on the short-term schedule for more than one year (i.e. a re-underwritten investment that is renewed).** A concurrent Blanks exposure is proposed to include a reporting code for renewed short-term investments as well as a new general interrogatory to certify that re-underwriting has occurred. **(This code will also apply to nonaffiliated non-related party transactions for identification purposes.)**

**Proposed Revisions for Spring 2020 Discussion: to SSAP No. 2R—Cash, Cash Equivalents, Drafts and Short-Term Investments:**

**Cash Equivalents**

6. **Cash equivalents are short-term, highly liquid investments that are both (a) readily convertible to known amounts of cash, and (b) so near their maturity that they present insignificant risk of changes in value because of changes in interest rates. Only investments with original maturities of three months or less can qualify under this definition, with the exception of money market mutual funds, as detailed in paragraph 787, and cash pooling, as detailed in paragraph 8.** Regardless of maturity date, derivative instruments shall not be reported as cash equivalents and shall be reported as derivatives on Schedule DB. Securities with terms that are reset at predefined dates (e.g., an auction-rate security that has a long-term maturity and an interest rate that is regularly reset through a Dutch auction) or have other features an investor may believe results in a different term than the related contractual maturity shall be accounted for based on the contractual maturity at the date of acquisition, except where other specific rules within the statutory accounting framework currently exist.

7. **Regardless of maturity date, related party or affiliated investments that would be in scope of SSAP No. 26R—Bonds, and all investments that would be in the scope of SSAP No. 43R—Loan-backed and Structured Securities, or that would be reported as “Other Invested Assets” shall be reported as long-term investments if any of the following conditions apply. FN, unless the reporting entity has re-underwritten the investment, maintained appropriate re-underwriting documentation, and each participating party had the ability to independently review the terms and can terminate the transaction prior to renewal:**

   a. The reporting entity does not reasonably expect the investment to terminate on the maturity date. This provision includes investments that are expected to be renewed (or rolled) with a maturity date that ends subsequent to the initial 90-day timeframe.

   b. The investment was previously reported as a cash equivalent investment and the initial maturity timeframe has passed. If an investment is reported as a cash equivalent and it is unexpectedly renewed / rolled, the reporting entity is not permitted to continue to report the held security as a cash equivalent regardless of the updated maturity date and shall report the security as a long-term investment. An investment is only permitted to be reported as a cash equivalent for one quarter reporting period. Meaning, if an investment was reported as a cash equivalent in the first quarter, it is not permitted to be reported as a cash equivalent in the second quarter.

   c. The reporting entity reacquired the investment (or a substantially similar investment) within 1 year after the original security matured or was terminated. These reacquired securities shall be reported as long-term investments. **(These securities are also not permitted to be reported as short-term investments regardless of the maturity date of the reacquired investment.)**

**New Footnote 1:** Repurchase and reverse repurchase transactions are excluded from these provisions if admitted in accordance with collateral requirements pursuant to **SSAP No. 103R—Transfers and Servicing of Financial Assets and Extinguishments of Liabilities**, permitted under Cash equivalents.

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2 Original maturity means original maturity to the entity holding the investment. For example, both a three-month U.S. Treasury bill and a three-year Treasury note purchased three months from maturity qualify as cash equivalents. However, a Treasury note purchased three years ago does not become a cash equivalent when its remaining maturity is three months.
subject to the provisions of paragraph 7 are not permitted to be subsequently reported as short-term investments, even if the updated / reacquired maturity date is within 1 year. These investments shall be reported as long-term investments. To avoid changes in reporting schedules, reporting entities are permitted to report securities as long-term investments at initial acquisition regardless of the initial maturity date.

Short-Term Investments

12. Short-term investments are investments that do not qualify as cash equivalents, with remaining maturities (or repurchase dates under repurchase agreements) of one year or less at the time of acquisition. (excluding derivatives and those investments classified as cash equivalents as defined in this statement) shall be considered short-term investments. Short-term investments can include, but are not limited to, bonds, commercial paper, repurchase agreements, and collateral and mortgage loans, which meet the noted criteria. Short-term investments shall not include certificates of deposit. Regardless of maturity date, derivative instruments shall not be reported as short-term investments and shall be reported as derivatives on Schedule DB.

13. Regardless of maturity date, related party or affiliated investments in scope of SSAP No. 26R—Bonds, and all investments that would be in scope of SSAP No. 43R—Loan-backed and Structured Securities, or that would be reported as “Other Invested Assets” shall be reported as long-term investments if any of the following conditions apply FN, unless the reporting entity has re-underwritten the investment, maintained appropriate re-underwriting documentation, and each participating party had the ability to independently review the terms and can terminate the transaction prior to renewal.

a. The reporting entity does not reasonably expect the investment to terminate on the maturity date. This provision includes investments that are expected to be renewed (or rolled) with a maturity date that ends subsequent to the initial “less than one year” timeframe.

b. The investment was previously reported as a short-term investment and the initial maturity timeframe has passed. If an investment is reported as a short-term investment and it is unexpectedly renewed / rolled, the reporting entity is not permitted to continue to report the held security as a short-term investment (or as a cash equivalent) regardless of the updated maturity date and shall report the security as a long-term investment. An investment is only permitted to be reported as a short-term investment for one annual reporting period. Meaning, if an investment was reported as a short-term investment as of December 31, 2018, it is not permitted to be reported as short-term investment as of December 31, 2019.

c. The reporting entity reacquired the investment (or a substantially similar investment) within 1 year after the original security matured or was terminated. These reacquired securities shall be reported as long-term investments. (These securities are also not permitted to be reported as cash equivalent investments regardless of the maturity date of the reacquired investment.)

New Footnote 1: Repurchase and reverse repurchase transactions are excluded from these provisions if admitted in accordance with collateral requirements pursuant to SSAP No. 103R—Transfers and Servicing of Financial Assets and Extinguishments of Liabilities. Short-term investments subject to the provisions of paragraph 13 are not permitted to be subsequently reported as cash equivalents, even if the updated / reacquired maturity date is within 90-days. These investments shall be reported as long-term investments. To avoid changes in reporting schedules, reporting entities are permitted to report securities as long-term investments at initial acquisition regardless of the initial maturity date.

12.14. All short-term investments shall be accounted for in the same manner as similar long-term investments.

13.15. Short-term investments meet the definition of assets as defined in SSAP No. 4 and are admitted assets to the extent they conform to the requirements of this statement.
Disclosures

The following disclosures shall be made for short-term investments in the financial statements:

a. Fair values in accordance with SSAP No. 100R—Fair Value;

b. Concentrations of credit risk in accordance with SSAP No. 27—Off-Balance-Sheet and Credit Risk Disclosures;

c. Basis at which the short-term investments are stated.

d. The items in the scope of this statement are also subject to the annual audited disclosures in SSAP No. 26R—Bonds, paragraph 30.f.

e. Identification of short-term investments or substantially similar investments in which remain on the short-term schedule for more than one year.

Proposed Revisions to SSAP No. 103R—Transfers and Servicing of Financial Assets and Extinguishments of Liabilities: (No changes to prior exposure.)

28.I. A reporting entity shall disclose the following information for wash sales, as defined in paragraph 12, for all affiliated investment transactions (including items originally classified as cash equivalents and short-term investments) and for non-affiliated involving investment transactions for securities with an NAIC designation of 3 or below, or that do not have an NAIC designation. (For non-affiliated investments, excluding all cash equivalents, derivative instruments as well as and short-term investments with credit assessments equivalent to an NAIC 1-2 designation, are excluded from this disclosure.) This disclosure shall be included in the financial statements for when the investment was initially sold. For example, if the investment was sold December 20, 2017, and reacquired on January 10, 2018, the transaction shall be captured in the wash sale disclosure included in the year-end 2017 financial statements:

i. A description of the reporting entity’s objectives regarding these transactions;

ii. An aggregation of transactions by NAIC designation 3 or below, or that do not have an NAIC designation;

iii. The number of transactions involved during the reporting period;

iv. The book value of securities sold;

v. The cost of securities repurchased; and

vi. The realized gains/losses associated with the securities involved.

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Summary:
This agenda item was drafted in response to feedback received from interested parties in conjunction with agenda item 2019-41: Rolling Short-Term Investments. Feedback received indicated that cash pooling, also known as liquidity bundling or liquidity pools, could inadvertently be scoped into the short-term rolling guidance; however it was noted by NAIC staff that cash pools are not specifically addressed in SSAP No. 2R—Cash, Cash Equivalents, Drafts and Short-Term Investments and thus are not technically in scope of SSAP No. 2R. This agenda item
recommends revisions to allow specific structures that strictly hold cash, cash equivalents and short-term investments and meet certain other criteria, to be captured under SSAP No. 2R.

**Interested Parties’ Comments:**

Interested parties appreciate that a separate Form A (Ref #2019-42) was written related to Cash/Liquidity Pools (“pools”) to clarify the accounting associated with them. We agree with the addition of a paragraph, similar to paragraph 8, to SSAP No. 2R to provide guidance related to pools; however, given that the characteristics of pools differ by company, we propose some modifications to paragraph 8 in order to address those varied characteristics.

Interested parties’ comments related to the proposed paragraph 8 are as follows:

1) Regarding the proposal to look through the ownership structure to report the assets held as cash equivalents, we agree that look through is appropriate. Some pools, as approved by regulators, consist of assets that meet the Statutory definition of cash equivalents and thus the interest held in the pools are reported as cash equivalents on Schedule E2. However, other pools, also approved by regulators, include assets that meet the definition of short-term investments in SSAP No. 2 and thus the interest held in the pools are reported as short-term investments on Schedule DA. Some pools may include both short-term investments and cash equivalents.

Given the varied characteristic discussed above, we recommend paragraph 8 be modified to state that, if the requirements of paragraph 8 are met, the reporting entity may look through the ownership structure and report the assets as either cash equivalents or short-term assets based on the predominant characteristic of the underlying assets. This would allow companies the flexibility to report their investments in the pools in the Statutory statement schedule that is more reflective of the type of underlying investments in their pool and prevent the need for companies to reclassify/change their existing reporting to Schedule E2 from DA if they currently report the pools in DA due to the underlying assets.

2) Regarding paragraph 8d (i.e., the requirement to produce annual U.S. GAAP audited report of the pools including schedules showing each affiliate’s prorata share of the investments), insurance companies already receive an independent audit under Statutory Accounting Principles (“SAP”), which would include the insurance company’s investment in a pool. Requiring cash pools to be separately audited under U.S. GAAP would come at a cost, in time and resources, to insurers with pools. In addition, some insurers have pools which are not in the form of legal entities.

An alternative to the U.S. GAAP audit requirement of paragraph 8d is to require a footnote disclosure at the reporting date for each insurer that participates in a pool, which identifies that the insurer is invested in a cash pool, provides the reporting entity’s share of the pool, and the insurers dollar share of cash equivalents and short-term investments in the pool. This disclosure would be subject to audit on an SAP basis of accounting. IPs believe the audit of the disclosure along with the audit of the insurance company would be adequate to meet the objectives of ensuring that the pool allocation process is accurate. Other alternatives include targeted financial examination procedures for pools, which could include procedures to confirm the balance of the pool and verify the individual legal entities’ balances for participating in the pool.

3) We note that the addition of the proposed pool language in SSAP No. 2 does not specifically address the reporting and accounting for the interests held in the pool. We recommend, if the pool is managed on a fair value basis (i.e., interest in the pool are bought and sold at fair value), that the book/adjusted carrying value for the interest held in the pool would be reported at fair value with changes in fair value reported in unrealized gains and losses. If the pool is not managed on a fair value basis, the interest held in the pool would be reported at amortized cost. It is important to note that pools managed on a fair value basis may use amortized cost as the best estimate of fair value, depending on the characteristics of the underlying assets.
Finally, in the issue paper, NAIC staff questioned whether changes to SSAP No. 48, Joint Ventures, Partnerships and Limited Liability Companies are needed, since many pools are held in a Limited Liability Company (“LLC”). Interested parties do not believe such changes are needed to SSAP No. 48; however, it would be helpful to users of the SSAPs to add a footnote to paragraph 8 of proposed SSAP No. 2R stating that pools may be held in LLCs, for example, and if so, SSAP No. 2 is to be applied and not SSAP No. 48.

**Recommended Action:**

NAIC staff recommends that the Working Group adopt the exposure, with revisions as shown below to SSAP No. 2R—Cash, Cash Equivalents, Drafts and Short-Term Investments as final. Changes reflect that certain cash/liquidity pools, meeting defined criteria, may be reported as cash, cash equivalents, or short-term investments. (May inquire with industry / regulators on whether exposure should be considered.)

NAIC staff appreciated the feedback from interested parties, agrees with and has integrated a majority of the suggestions. Each one will be addressed individually below:

1) Interested parties recommended that due to the varied characteristics of regulator approved liquidity pools, single line reporting be allowed to reflect the majority of the assets held. I.E. If a majority of the assets held represented cash equivalents, then the reporting entity’s share in the liquidity pool shall be reported as a cash equivalent.

NAIC staff originally proposed reporting as a cash equivalent for simplicity, however, is supportive of the suggested proposal. It is noted cash, cash equivalents, and short-term investments are aggregated together for solvency and analysis reviews. Due to this aggregation, reporting on the schedule which reflects the investments predominantly held should not cause an adverse effect for financial statement users. It’s also important to note that a disclosure remains requiring a reporting entity to disclose their share of the cash pool by asset type (cash, cash equivalents, or short-term investments). Further, Risk Based Capital (RBC) charges are identical among these three asset classes and thus differentiated reporting cannot create RBC arbitrage.

2) Interested parties requested reconsideration in terms of the originally proposed U.S. GAAP audit requirements of the cash pool. NAIC staff is supportive of removing the cash pool independent audit requirement, noting that the reported balance in the pool as well as the footnote disclosure would be subject to independent audit under Statutory Accounting Principles. An independent audit of the cash pool, while likely appreciative of the reporting entities independent auditors, would be duplicative for the reporting entities themselves.

3) Interested Parties inquired on valuation and reporting of cash pool balances and suggested variations in valuation methodologies. NAIC recommends that the Working Group require consistent valuation reporting of the assets held in accordance with existing requirements in SSAP No. 2R. For example, paragraph 13 states, “All short-term investments shall be accounted for in the same manner as similar long-term investments.” Allowing for varied reporting dependent on the manner in which the cash pool is managed would allow for identical investments to be reported in differing manners. NAIC staff believes the accounting for these investments should reflect the accounting which would have taken place had the assets been held directly, and not held in a liquidity pool. As such, NAIC staff has added guidance stating that assets held in the pool shall be valued consistently with the valuations required by asset type as currently stipulated in SSAP No. 2R.
NAIC staff propose the following updates to the exposed guidance. (Updates are highlighted below in grey).

**Proposed Revisions to SSAP No. 2R—Cash, Cash Equivalents, Drafts and Short-Term Investments**

**Cash Equivalents**

6. Cash equivalents are short-term, highly liquid investments that are both (a) readily convertible to known amounts of cash, and (b) so near their maturity that they present insignificant risk of changes in value because of changes in interest rates. Only investments with original maturities of three months or less qualify under this definition, with the exception of cash pools that meet the requirements of paragraph 8 and money market mutual funds described in paragraph 7. Regardless of maturity date, derivative instruments shall not be reported as cash equivalents and shall be reported as derivatives on Schedule DB. Securities with terms that are reset at predefined dates (e.g., an auction-rate security that has a long-term maturity and an interest rate that is regularly reset through a Dutch auction) or have other features an investor may believe results in a different term than the related contractual maturity shall be accounted for based on the contractual maturity at the date of acquisition, except where other specific rules within the statutory accounting framework currently exist.

7. Money market mutual funds registered under the Investment Company Act of 1940 and regulated under rule 2a-7 of the Act shall be accounted for and reported as cash equivalents for statutory accounting. Investments in money market mutual funds shall be valued at fair value or net asset value (NAV) as a practical expedient. For reporting entities required to maintain an asset valuation reserve (AVR), the accounting for unrealized capital gains and losses shall be in accordance with SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve. For reporting entities not required to maintain an AVR, unrealized capital gains and losses shall be recorded as a direct credit or charge to surplus. Sales/reinvestments in money market mutual funds are excluded from the wash sale disclosure in SSAP No. 103R.

8. Cash pooling is a technique utilized by some companies under common control by which several entities’ cash accounts are aggregated for numerous purposes, including liquidity management, optimizing interest or investment returns and reducing investment or banking transaction fees. Cash pools can have numerous functions and structures, however only those that have obtained domiciliary regulator approval and meet the requirements may look through the ownership structure to report the assets held as cash, cash equivalents, or short-term investments.
   a. Members or participants in the pool are limited to affiliated entities as defined in SSAP No. 25.
   b. Investments held by the pool are limited to non-affiliated investments.
   c. The pool must permit each participant to withdraw, at any time, cash up to the amount it has contributed to the pool. Each participant must own an undivided interest in the underlying assets of the pool in proportion to the aggregate amount of cash contributed. All affiliates’ interests in the pool shall be of the same class, with equal rights, preferences and privileges. All membership interests shall be fully paid and non-assessable and shall have no preemptive, conversion or exchange rights. The liability of a participant’s debts and obligations of the pool shall be limited to the amount of its contributions and no participant shall be obligated to contribute money to the pool for any reason other than to participate in the pool’s investments. Additionally, participants shall not cover the debits or credits of another participant (commonly referred to as notional cash pooling).
   d. A reporting entity shall receive an annual report from the pool manager, which identifies the participant’s investment (share) in the cash pool and the dollar value of its share of cash, cash equivalents and short-term investments. The reporting entity shall report their total balances in the cash pool on the schedule which represents a majority of the held assets. (For example, a qualifying cash pool that contains 20% cash, 70% cash equivalents, and 10% short-term investments, the reporting entity would report their entire balance invested...
as a cash equivalent. An audited U.S. GAAP annual report of the cash pool and schedules showing each affiliate’s prorated share of investments shall be provided annually to each participant as of December 31. The reporting entity shall independently determine if the investments would have qualified as cash, cash equivalents or short-term investments had the entity independently acquired the investments. To the extent the pool holds investments that do not meet the definition of cash, cash equivalents, short-term investments, or if the cash pool is not supported by an audited statement, the pool does not qualify within scope of this statement.

a-e. Valuation of the assets in the pool shall remain consistent with the valuations required by reported asset type as stipulated in SSAP No. 2R.

Disclosures
15. The following disclosures shall be made for short-term investments in the financial statements:

   a. Fair values in accordance with SSAP No. 100R—Fair Value;
   b. Concentrations of credit risk in accordance with SSAP No. 27—Off-Balance-Sheet and Credit Risk Disclosures;
   c. Basis at which the short-term investments are stated.
   d. The items in the scope of this statement are also subject to the annual audited disclosures in SSAP No. 26R—Bonds, paragraph 30.f.

16. The financial statements shall disclose the reporting entity’s share of the cash pool by asset type (cash, cash equivalents, or short-term investments).

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Summary:
During the 2019 Fall National Meeting, the Working Group exposed revisions to SSAP No. 71—Policy Acquisition Costs and Commissions to provide clarifications to the long standing levelized commissions guidance and provide additional guidance regarding commission that is based on policy persistency. The revisions clarify that a levelized commission arrangement (whether linked to traditional or nontraditional elements) requires the establishment of a liability for unpaid principal and accrued interest payable, regardless of the timing of payments made to a third party. Additionally, persistency commission shall be accrued proportionately over the policy period in which the commission relates to and is not deferred until fully earned.

The exposed recommendations are intended to be consistent with the original intent of SSAP No. 71 as well as the Statutory Statement of Concepts focusing on Recognition (noted in the Preamble, paragraphs 37 and 38) stating that liabilities require recognition as they are incurred and accounting treatments which tend to defer expense recognition do not generally represent acceptable SAP treatment.

Notice of the exposure were also sent to the Life Actuarial (A) Task Force. The Working Group forwarded comments received at the Fall National Meeting inquiring whether there is specific Valuation Manual language in VM-20, Requirements for Principle-Based Reserves for Life Products, and VM 21, Requirements for Principle-Based Reserves for Variable Annuities, that needs to be addressed in the coordination process as part of this agenda.
Interested Parties’ Comments:
Interested parties appreciate staff’s availability to discuss the proposed revisions. Based on that discussion and the discussion at the Fall Meeting, interested parties propose suggested edits that we believe achieve the goal of a nonsubstantive change and clarify the original intent of SSAP 71. (Note: the NAIC Accounting Practices and Procedures Manual-Life which was in force prior to the effective date of current SAP includes the same wording as current SSAP No. 71). The suggested edits add a clear definition of a funding agreement. This will clarify the distinction between funding agreements and persistency-based commissions, without unintentionally changing the existing accounting. We welcome the opportunity to discuss the suggested edits further with the Working Group.

Interested parties’ revisions shown as shaded and tracked text to the exposed language.

3. Contingent commission liabilities shall be determined in accordance with the terms of each individual commission agreement. Commission liabilities determined on the basis of a formula that relates to loss experience shall be established for the earned portion. Assumptions used to calculate the contingent commission liability shall be consistent with the terms of the policy contract and with the assumptions made in recording other assets and liabilities necessary to reflect underwriting results of the reporting entity such as retrospective premium adjustments and loss reserves, including incurred but not reported. Commission contracts that include persistency (or other such components) shall not use these clauses to defer recognition of commission expense. If a commission is based on annual policy persistency (or other similar components), the commission shall be accrued based on experience to date for the policy period that the commission relates. In regard to persistency commission, it is inappropriate to wait until the amount is fully earned and/or unavoidable to accrue experience to date commission expenses. Actual policy cancellation would reverse the accrual of the related persistency commission.

4. Levelized commissions occur in situations where agents receive normal (non-level) commissions with payments made by a third party. It is intended, but not necessarily guaranteed, that the amounts paid to the agents by the third party would ultimately be repaid (with interest explicit or implied) to the third party by levelized payments (which are less than the normal first year commissions but exceed the normal renewal commissions) from the reporting entity. (Note: levelized repayments made by the reporting entity extend the repayment period but might not be a straight-line repayment.) These transactions are, in fact, funding agreements between a reporting entity and a third party, regardless of how the payment to the third party is characterized. A funding agreement is an agreement whereby a third party provides a lump sum of money in return for a guaranteed stream of payments over a predetermined time period enabling the third party to earn investment spread. The payment stream is fixed without regard to the traditional elements of continued premium payments or policy persistency. The continuance of the stream of payments specified in the levelized commission contract is a mechanism to bypass recognition of those expenses which are ordinarily charged to expense in the first year of the contract. Consequently, the normal link between the persistency of the policy, the continuance of the premium payment or the maintenance of the agent’s license with the reporting entity is not maintained with respect to the payment stream.

5. The use of an arrangement such as a levelized commission arrangement where commission payments are not linked to traditional elements such as premium payments and policy persistency, but rather are linked to the repayment of an advance amount paid by a third party to the agents requires the establishment of a liability by the reporting entity for the full amount of the unpaid principal and accrued interest which is payable to a third party related to levelized commissions.

New Footnote — The guidance in this paragraph notes that levelized commissions which use a third party to pay agents that are linked to traditional elements require establishment of a liability for the amounts that have been paid to the agents and any interest accumulated to date.
Acadia/Capital Solutions’ Comments:

We have reviewed the proposed changes to SSAP No. 71 – Policy Acquisition Costs and Commissions as outlined in Ref. #2019-24 as revised on December 7, 2019.

The most effective way to appreciate the unintended consequences of the proposal is to start with a basic understanding of a typical distribution structure. Reporting entities execute distribution agreements, including compensation structure, with distribution partners (IMO, BGA, TPM, MGA, BD, for example). These distribution partners recruit, contract, train, supervise, and compensate smaller organizations (agencies, selling groups, brokerages, etc.) and individual producers (agents, brokers, etc.).

SSAP No. 71 proscribes statutory accounting treatment for reporting entity compensation agreements entered for the sale, distribution, and servicing of policies. The revisions proposed in Exposure Draft 2019-24 (as revised December 7, 2019) focus on two areas: (1) levelized commissions or “trail” payments paid directly to distribution partners or individual producers by a reporting entity and (2) levelized commissions or other installment payments paid to “third parties” by the reporting entity solely in exchange for the third party making non-levelized payments to the distribution partners or individual producers in place of the reporting entity (sometimes called “funding agreements”).

The proposed Exposure Draft relating to the first are in Paragraph 2 and call for “…commission shall be accrued based on experience to date for the policy period that the commission relates.” This specifically relates to the required timing or obligating event of a reporting entity’s liability for the cost of a commission payment specifically linked to persistency or policy renewal upon the anniversary of a policy issue date or some other future date or event.

The proposed Exposure Draft revisions relating to the second are (a) in paragraph 4, “…regardless of how the payment to the third party is characterized.”, (b) in paragraph 5, “…paid by a third party to the agents…by the reporting entity.”, and (c) in a footnote to paragraph 5, “The guidance in this paragraph notes that levelized commissions which use a third party to pay agents that are linked to traditional elements require establishment of a liability for the amounts that have been paid to the agents and any interest accumulated to date.”

The proposed revisions have different implications for different constituencies. We have endeavored to capture the essence of the concern from each party below. The proposed revisions have substantive implications for each of the noted constituencies, contrary to the non-substantive assertion in the revised exposure draft 2019-24. As a direct result of the inequity of the proposed changes upon various constituencies and the potential for substantial financial and economic harm incurred by the adoption of these changes to a variety of constituencies, we strongly recommend and request that the proposal not go forward.

Reporting Entity/Carrier perspective:

1. Levelized commission programs are economic equivalents to “normal (non-level) commissions.” Levelized commission programs are preferable as they create a virtuous cycle linking the interests of consumers, agents, distribution partners and carriers to maintain ongoing servicing relationships, improving consumer support and policy persistency. Distribution relationships are multi-faceted, including agent recruitment and oversight, sales, sales support, underwriting support, premium collection, policy delivery and agent payment. Characterizing distribution partners as a ‘third party’ under the proposed footnote to paragraph 5 of SSAP No. 71 discounts the complexity of these relationships and the value of these vital roles dramatically altering carrier dynamics with distribution partners.

2. Reporting entities or carriers will be unduly penalized for economic transactions negotiated under existing accounting principles as a direct result of this proposal. The value of those transactions is retroactively altered by the introduction of a modified accounting principle which neither party initially anticipated, negotiated or priced.
3. Higher required capital and lower returns resulting from an arbitrary modification to an existing accounting practice will drive product design reviews and likely product redesigns modifying or eliminating levelized commission options or reducing value to the consumer through higher premiums and/or lower benefits.

4. The proposal to require reserves for future persistency based levelized commissions creates a disconnect with GAAP accounting where there is no reserve requirement. Moreover, the proposal creates new uncertainty around which other, long standing accounting treatment will be changed next.

Distributor/Agent perspective

1. The trail compensation approach incentivizes all parties to maintain a long-term relationship based upon ongoing agent support of consumer needs. Reducing or removing recurring compensation in the form of persistency based levelized commissions, shifts distributor economic motivation to new product sales, further degrading product level returns for the carrier. Reducing benefit levels or increasing premiums for the same benefit levels will lower the value proposition for effected products very likely reducing sales and consumer protection delivered by the products.

Consumer perspective:

1. The fallout from the changes will diminish value of insurance products through higher premiums and/or lower benefits enacted by carriers seeking to make up lost economic value and from lower service levels provided by brokers or agents as their incentives shift from ongoing consumer service relating to in-force policies to selling new policies (whether to the individual policyholder or other prospective clients).

Greenberg Traurig’s Comments: on behalf of DRB Insurance Solutions

Thank you for the opportunity to provide comments on Proposal 2019-24 from the Statutory Accounting Principles Working Group regarding Policy Acquisition Costs and Commissions. The Working Group voted to re-expose revisions to SSAP 71 – Policy Acquisition Costs and Commissions - for comment at the NAIC Fall Meeting on December 7, 2019, continued to categorize the revisions as non-substantive, and further clarified levelized commission guidance and direction regarding certain commission obligations. I offer comments on behalf of our client, DRB Insurance Solutions, LLC, a licensed insurance producer (“DRB”).

SSAP No. 71 provides that levelized commissions occur in situations in which a third party, such as a funding agent, pays agents non-levelized commissions and the reporting entity pays the third party by levelized payments. The Working Group notes that it is intended, but not necessarily guaranteed, that the amounts paid to the agents by the third-party would ultimately be repaid to the third-party from the reporting entity. SSAP No. 71 identifies such arrangements as “funding agreements” between the reporting entity and the third-party. SSAP No. 71 further provides that the use of a commission arrangement where commission payments are not linked to traditional elements (such as premium payments and policy persistency) requires the establishment of a liability for the full amount of the unpaid principal and accrued interest which is payable to a third-party related to levelized commissions.

While revisions were made to several paragraphs and footnote 1 in the initial proposal at the Working Group’s meeting in December, the current exposure language remains overly broad to address the issue identified and intended to be clarified by the Working Group. Regulators have identified levelized commissions as funding arrangements to bypass recognition of acquisition costs by insurers and believe recognizing the full acquisition expense at the time of policy issuance is appropriate accounting treatment pursuant to SSAP No. 5R and the Statement of Concepts focusing on Recognition. Notably, the Working Group intended to restrict intercompany and affiliated transfers of trailing commission structures as pure accounting transactions solely for the purpose of deferring expense recognition of commission obligations, which is a laudable goal.

However, the language exposed to classify trailing commission transactions as funding arrangements is so broad, it encompasses practically every broker contract with an insurer that allows for any alternative payment arrangement between the broker and the issuing agent. DRB Insurance Solutions is an independent third-party master producer.
which uses various contracts between DRBIS and its sub-agents for commission payment, including trailing, heaped, partially heaped and trailing commissions, etc. The agreements between DRBIS and reporting entities are arms-length transactions, include the transfer of lapse risk, mortality risk and the commission expense obligation. The proposal requiring all insurers to accrue the full commission expense under these circumstances is illogical when the insurer no longer has the legal obligation to pay the expense and therefore, no longer has legally incurred the expense.

While regulators have opined that affiliated transactions shrouded as commission arrangements appear to circumvent accrual of commission expense at policy issuance, the goal to affect those transactions may continue to be addressed while narrowing the language to clarify that non-affiliated third-party contracts are not included. Accordingly, DRBIS offers the following amendment to the exposure draft to narrow the applicability to those affiliated transactions. Suggested language for Paragraph 4 and the footnote to Paragraph 5 is shown as shaded text as follows:

4. Levelized commissions occur in situations where agents receive normal (non-level) commissions with payments made by a third party under the control of the reporting entity, its parent, and/or any subsidiary or affiliate of the reporting entity or its parent. It is intended, but not necessarily guaranteed, that the amounts paid to the agents by the third party would ultimately be repaid (with interest explicit or implied) to the third party by levelized payments (which are less than the normal first year commissions but exceed the normal renewal commissions) from the reporting entity. (Note: levelized repayments made by the reporting entity extend the repayment period but might not be a straight-line repayment.) These transactions are, in fact, funding agreements between a reporting entity and a third party, regardless of how the payment to the third party is characterized. The continuance of the stream of payments specified in the levelized commission contract is a mechanism to bypass recognition of those expenses which are ordinarily charged to expense in the first year of the contract. Consequently, the normal link between the persistency of the policy, the continuance of the premium payment or the maintenance of the agent’s license with the reporting entity is not maintained with respect to the payment stream.

5. The use of an arrangement such as a levelized commission arrangement where commission payments are not linked to traditional elements such as premium payments and policy persistency, but are linked to the repayment of an advance amount paid by a third party under the control of the reporting entity, its parent, and/or any subsidiary or affiliate of the reporting entity or its parent requires the establishment of a liability by the reporting entity for the full amount of the unpaid principal and accrued interest which is payable to a third party under the control of the reporting entity, its parent, and/or any subsidiary or affiliate of the reporting entity or its parent related to levelized commissions.\(^\text{FN}\). New Footnote – The guidance in this paragraph notes that that levelized commissions which use a third party to pay agents do not imply that levelized commissions that are linked to traditional elements do not require establishment of a liability for the amounts that have been paid to the agents and any interest accumulated to date. Rather, such levelized commission obligations should be accrued for as set forth in paragraph 3.

The proposed language requires recognition of commission expense in situations where affiliated companies trade lapse and mortality risk amongst and between affiliated reporting entities using a commonly owned master producer while excepting unaffiliated third-party transactions from similar treatment. In these unaffiliated contractual arrangements, where risk and liability is transferred, the reporting entity may not even be aware of the payment schedule between the master producer and its sub-agents and certainly should not be required to accrue the full amount of the commission expense at policy issuance when the insurer is no longer legally required to pay that expense.

Non-Substantive Change
Finally, DRBIS would like to restate its opposition to consideration of the exposure draft as a non-substantive change. As previously stated, levelized commission programs began over thirty years ago, before the 1998
publication of Statutory Issue Paper No. 71 and the January 1, 2001 codification of Statutory Accounting Principles. The primary objectives of a levelized commission structure include aligning the interests of the customer, the agent, and the company and improved persistency from providing ongoing customer service. There is a duty to act in the best interests of the policyholder, as well as a compensation incentive, to make sure policies are well serviced so they stay in-force.

The proposed revisions to SSAP No. 71 are designated as non-substantive and deemed to be a clarification of intent of the codified statutory guidance. However, levelized commission programs were implemented more than a decade before the codification in 2001. Therefore, this is a material change to historical accounting practices and not a clarification of original intent. Even after codification, levelized commission programs continued for years and were not identified as applying statutory accounting incorrectly.

In conclusion, the current exposure draft of SSAP 71 is clearly not “non-substantive” and would have substantial unintended consequences without the amendments proposed above. Additionally, the expansive effect of this policy decision should be subject to open deliberation and public comment as the Working Group considers adoption. Thank you for the opportunity to comment.

**Recommended Action:**
NAIC Staff recommends that the Working Group adopt the revisions as exposed from the 2019 Fall National Meeting or provide additional direction to NAIC Staff. As summarized below, the proposed language from Interested Parties and DRB Insurance Solutions are not viable as both proposals are inconsistent with existing principles. **The exposed language would not allow the use of a third-party agent agreement to delay recognition of liability and expense from an in-force insurance contract.** If the Working Group wants to consider changes to allow third-party agents agreements to delay the recognition of liability and expense by the insurance reporting entity, then this would be considered a substantive change from existing statutory accounting principles. **While parties agree that the related amounts are ultimately liabilities/expenses, the issue is when to record the liability/expense. NAIC Staff believe a liability and expense is incurred when the contract is written, not when the payment is due. In addition, NAIC Staff has concern with the comments regarding assumption of insurance risk by brokers and other third parties.**

**Overview of Interested Parties’ proposed revisions**
Interested Parties proposed language recommends deleting most of the exposed revisions and adding guidance that would redefine a funding arrangement to only include those items where repayment is guaranteed. This proposal would conflict with the long-standing guidance in SSAP No. 71, paragraph 4 which notes that “It is intended, but not necessarily guaranteed, that the amounts paid to the agents by the third party would ultimately be repaid…” The existing language seeks to look at the big picture substance of the transactional arrangement noting, that in essence, a third party would not prepay an entity’s commission expenses without an expectation of repayment. As the proposed language would conflict with the existing principle, NAIC staff does not view this as a viable proposal.

**Overview of Acadia/Capital Solutions’**
The comments from Acadia Capital Solutions focus on what they describe as unintended consequences and potential impacts to various entities. It asserts that clarifying existing language is a substantive change. However, NAIC staff notes that the proposed revisions are trying to emphasize existing language that has been in effect since prior to codification is being ignored by some reporting entities in an attempt to defer expense recognition. Expensing acquisition costs when incurred is a long-standing principle in statutory accounting.

**Overview of GreenbergTraurig on behalf of DRB Insurance Solutions**
DRB’s proposed language recommends only requiring levelized commission liability recognition if the third party, which prepaas the commission, is a under the control or has common control with the insurance reporting entity. Presumably that means if an unrelated party fronts the commission expense, no liability recognition is required by
the insurance reporting entity. As the substance of the transaction is the same for related and unrelated parties, NAIC staff does not view this as a viable proposal.

NAIC also notes that the comment letter asserts that the third-party broker, by virtue of their agreement, has assumed “lapse risk, mortality risk and the commission expense obligation.” It also asserts that “requiring all insurers to accrue the full commission expense under these circumstances is illogical when the insurer no longer has the legal obligation to pay the expense and therefore, no longer has legally incurred the expense.” **NAIC staff notes that some of the identified items that are noted as being transferred to the broker are insurance risks that should only be transferable to an insurance entity through a reinsurance agreement.** NAIC staff also notes that the substance of the arrangement is still profit based. The company that fronts the commission expense of behalf of the insurance reporting entity has the expectation of repayment until the policy is cancelled.

**SSAP No. 71 With Revisions Exposed at the Fall National Meeting for Potential Adoption Consideration:**

**SUMMARY CONCLUSION**

2. Acquisition costs are those costs that are incurred in the acquisition of new and renewal insurance contracts and include those costs that vary with and are primarily related to the acquisition of insurance contracts (e.g., agent and broker commissions, certain underwriting and policy issue costs, and medical and inspection fees). Acquisition costs and commissions shall be expensed as incurred. Determination of when acquisition costs and commissions have been incurred shall be made in accordance with SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets.

3. Contingent commission liabilities shall be determined in accordance with the terms of each individual commission agreement. Commission liabilities determined on the basis of a formula that relates to loss experience shall be established for the earned portion. Assumptions used to calculate the contingent commission liability shall be consistent with the terms of the policy contract and with the assumptions made in recording other assets and liabilities necessary to reflect underwriting results of the reporting entity such as retrospective premium adjustments and loss reserves, including incurred but not reported. **Commission contracts that include persistency (or other such components) shall not use these clauses to defer recognition of commission expense.** If a commission is based on annual policy persistency (or other similar components), the commission shall be accrued based on experience to date for the policy period that the commission relates. In regard to persistency commission, it is inappropriate to wait until the amount is fully earned and/or unavoidable to accrue experience to date commission expenses. Actual policy cancellation would reverse the accrual of the related persistency commission.

4. Levelized commissions occur in situations where agents receive normal (non-level) commissions with payments made by a third party. It is intended, but not necessarily guaranteed, that the amounts paid to the agents by the third party would ultimately be repaid (with interest explicit or implied) to the third party by levelized payments (which are less than the normal first year commissions but exceed the normal renewal commissions) from the reporting entity. **(Note: levelized repayments made by the reporting entity extend the repayment period but might not be a straight-line repayment.)** These transactions are, in fact, funding agreements between a reporting entity and a third party, regardless of how the payment to the third party is characterized. The continuance of the stream of payments specified in the levelized commission contract is a mechanism to bypass recognition of those expenses which are ordinarily charged to expense in the first year of the contract. Consequently, the normal link between the persistency of the policy, the continuance of the premium payment or the maintenance of the agent's license with the reporting entity is not maintained with respect to the payment stream.

5. The use of an arrangement such as a levelized commission arrangement where commission payments are not linked to traditional elements such as premium payments and policy persistency, but rather are linked to the repayment of an advance amount paid by a third party to the agents requires the establishment of a liability by the reporting entity for the full amount of the unpaid principal and accrued interest which is payable to a third party related to levelized commissions. **
New Footnote – The guidance in this paragraph notes that levelized commissions which use a third party to pay agents that are linked to traditional elements require establishment of a liability for the amounts that have been paid to the agents and any interest accumulated to date.

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**Summary:**
During the 2019 Fall National Meeting, the Working Group exposed substantive revisions to No. 105—*Working Capital Finance Investments*, using 6 of the 10 industry-proposed concepts.

**Summary of revisions detailed in the SSAP:**

1. **Functionally Equivalent Foreign Regulators** - Removed the requirement that the SVO determine if the International Finance Agent is the functional equivalent of the U.S. Regulator. (paragraph 10.a)

2. **Commingling Prohibitions** - Removed the finance agent prohibitions on commingling. (paragraph 10.b)

3. **Investor Rights Edit** - Removed duplicative text regarding exercise of investor rights. (paragraph 11.b)

4. **Requirements for filer to Certify Perfected Interest** – Removed requirements, with revisions allowing the SVO to determine if a first priority perfected interest has been obtained. (paragraphs 14 & 15)

5. **Finance Agent Validation Requirements** – The independent review requirements were broadened to allow independent review of the finance agent by either audit or through an internal control report. (paragraph 16)

6. **Default Date** - Changed the default provisions from 15 to 30 days so the default date and the cure period are consistent. This has the effect of changing the date of nonadmission for an investment in default for a period up to 30 days instead of up to 15 days. (paragraph 28)

**Interested Parties’ Comments:**
In 2016, the American Council of Life Insurers (ACLI) advised the NAIC that the implementation of SSAP No. 105 was not successful and that adoption had been low. ACLI began a dialogue with staff and regulators about both the shortcomings of the 2013 adopted rules and outlined required changes to make the rules suitable. As part of that process, ACLI marked up both the SSAP and NAIC SVO Purposes and Procedures Manual (P&P Manual) with the suggested changes which have subsequently been characterized as "10 required items", which staff have in turn opined on, and noted that four of the items are not supported by staff. Absent all 10 required items, WCFI adoption will remain low. Staff have noted an immaterial number of programs have been filed with only a subset of those approved, resulting in limited investments made. The existing Exposure provided to staff and regulators by ACLI and was utilized by staff to produce the current proposal, without addressing the proposed language by ACLI on the four required items not supported by staff.

Objections to the four required changes are:

1) evaluating non-rated subsidiaries of obligors (even though the existing SSAP already provides guidance to do).

2) expanding covered investment credit quality to include NAIC 3 and 4 investments,
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3) requiring domiciliary regulator authorization for investment, and
4) requiring reporting on Schedule BA even though the asset class qualifies for look through RBC treatment.

In the ACLI draft provided to the NAIC, ACLI proposed an evaluation mechanism that is suitable for NAIC implementation on un-rated subsidiaries. With regard to NAIC objection on lower rated investments, such position is inexplicable as statutory RBC requirements reflect investment quality decisions in capital calculations limiting Industry investments to compliant assets. Domiciliary regulator prior approval for investment is a transfer of transaction review from staff to state insurance departments when, if regulators are concerned about the asset class, they can uniformly limit investment as a whole. Finally, Schedule BA reporting is both cumbersome and expensive for industry further exacerbating adoption without useful purpose. Regulators can track any specific asset class or investment by requiring the use of a specific investment code on the appropriate accounting schedule, which in the case of WCFI is Schedule DA).

Interested parties note that private placements, as opposed to public investments, are typically available only to large industry participants and that the economic impact of a $10,000 industry filing fee per issue per filing entity has an operating impact on a $1,000,000 investment in WCFI, which for the avoidance of doubt would be sizable for most industry investors, of 1% of the investment income in year 1 of that investment. Current investment yields for NAIC 1 and 2 investments in WCFI offer gross returns of 2 – 2.5%. Such a high cost to a small industry investor, coupled with the fact that dealers would unlikely choose to document such investments bilaterally with small industry investors, limits access to the assets to large industry investors. In summary, interested parties request that regulators reconsider ACLI markup with the additional four requirements as originally submitted by ACLI and ultimately, after appropriate exposure and review, to direct staff to implement these changes.

Recommended Action:
NAIC staff recommends that the Working Group:

1. Adopt the exposed revisions to SSAP No. 105 with an effective date to be specified by the Working Group. It is perceived that industry would like this to be effective as soon as possible. It could have an immediate effective date (e.g., March 31, 2020). If desired, a later date can be considered.


Interested parties continue to advocate for inclusion of the four items that the Working Group opted to exclude from the additional revisions to the revised Statement.

1. Possible Domestic Regulator Approval – The statement that the reporting entity may need to seek approval from the domestic regulator was maintained.

2. Only High-Quality Obligors – The current requirement which restricts designations of programs and obligors to being of high quality (NAIC 1 or NAIC 2) was maintained.

3. Unrated subsidiaries / Credit substitution – The industry proposed credit substitution methodology for unrated subsidiaries was not incorporated in the exposed revisions. The industry proposal is very different than the existing SVO credit substitution methodology. The industry proposal had two aspects:
   i. Credit substitution for unrated subsidiary obligors of a rated obligor – Industry proposed to attribute the credit strength of the rated parent to the unrated subsidiary obligor without the rated parent being a guarantor of the unrated subsidiary’s WCFI obligations. This aspect envisions the rated entity having some of its own obligations in the program.
ii. Credit Substitution of rated obligor for its unrated subsidiaries which are key transaction participants, but not obligors. The industry proposal was to create criteria to allow the “program” to obtain an acceptable NAIC designation by evaluating if the unrated “key transaction participant” is able to perform its functions. Industry proposed several different ways to attribute the rated entity’s credit rating to the unrated entity including:

(a) Documented operational control of unrated obligor, or

(b) An important inter-relationship with unrated obligor, or

(c) If the unrated key transaction participants are reasonably expected to perform their functions.

4. Change Reporting Schedule – The Working Group did not change the reporting requirements to move the WCFI investments from Schedule BA – Other Assets, to Schedule DA – Short term Investments as Schedule DA does not provide for designations, which are needed for RBC.

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**Summary:**

This agenda item has been drafted to data-capture disclosures from SSAP No. 25—Affiliates and Other Related Parties. Currently, all disclosures from SSAP No. 25 are completed in a narrative (pdf) format. With the proposal to data-capture disclosures, the regulators can aggregate and query related party relationships.

This item is separate from an agenda item (Ref #2019-34) that is considering revisions to SSAP No. 25 to clarify the identification of related parties and consider enhanced disclosures for when there is a disclaimer of control approved by a domiciliary state and when a company outside of the holding company group owns more than 10% of the insurance reporting entity. This agenda item will follow a separate work stream to allow for year-end 2020 data capturing. If the revisions being considered under the separate agenda item are adopted by June 2020 (Blanks deadline), then those disclosures may modify or expand the data templates proposed in this agenda item.

**Interested Parties’ Comments:**

Interested parties believe that clarifications to paragraph 20 of SSAP No. 25 are necessary. We believe that the aggregation of similar transactions may result in immaterial transactions becoming material, meeting the threshold of 1/2 of 1% of the total admitted assets of the reporting entity. Therefore, we propose the edits highlighted below to ensure that aggregation occurs subsequent to the application of the criteria in paragraph 20.b. for materially identified transactions.

**Proposed Edits to the exposure**

**Disclosures**

20. The financial statements shall include disclosures of all material related-party transactions. In some cases, aggregation of similar transactions, that on a stand-alone basis are not material, may be appropriate. Sometimes, the effect of the relationship between the parties may be so pervasive that disclosure of the relationship alone will be sufficient. If necessary to the understanding of the relationship, the name of the related party should be disclosed. Transactions shall not be purported to be arm’s-length transactions unless there is demonstrable evidence to support such statement. The disclosures shall include:
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a. The nature of the relationships involved;

b. A description of the transactions for each of the periods for which financial statements are presented, and such other information considered necessary to obtain an understanding of the effects of the transactions on the financial statements. Exclude reinsurance transactions, any non-insurance transactions which involve less than ½ of 1% of the total admitted assets of the reporting entity, and cost allocation transactions. The following information shall be provided if applicable:

**Recommended Action:**
NAIC staff recommends that the Working Group adopt the exposed data capture templates for SSAP No. 25—Affiliated and Other Related Parties, with the minor interested party edit as final. A Blanks proposal will be considered for 2020 annual reporting.

With inclusion of these data templates, narrative (pdf) reporting shall still occur to provide additional information regarding related party transactions. These newly created templates data capture information currently provided in narrative form and aside from the edit proposed by interested parties, did not result in a change to SSAP No. 25.

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**Summary:**
The intent of this agenda item is to clarify identification of related parties and affiliates in SSAP No. 25—Affiliates and Other Related Parties and to incorporate new disclosures to ensure regulators have the full picture of complicated business structures.

The proposed SSAP revisions intend to address the following key aspects:

- Clarify the identification of related parties and ensure that any related party identified under U.S. GAAP or SEC reporting requirements would be considered a related party under statutory accounting principles.

- Clarify that non-controlling ownership over 10% results in a related party classification regardless of any disclaimer of control or disclaimer of affiliation.

- Clarify the impact of a disclaimer of control or disclaimer of affiliate under SAP. As detailed, such disclaimers impact holding company group allocation and reporting as an SCA under SSAP No. 97, but do not eliminate the classification as a “related party” and the disclosure of material transactions as required under SSAP No. 25.

- Proposes rejection of several U.S. GAAP standards addressing variable interest entities.

**Interested Parties’ Comments:**
Interested parties understand and agree with the need for transparency in disclosures of related party transactions. However, we have significant concerns with the proposal as it is not very clear based on the proposed changes to SSAP No. 25 what it is that will be required going forward based on the expansion of the definition of a related party. We include some of our observations below.
Interested parties would like clarity around the new proposed wording that states that non-controlling ownership over 10% results in a related party classification regardless of any disclaimer of control or disclaimer of affiliation. One of our concerns in this area relates to limited partnership/joint ventures/limited liability company (LPs/JVs/LLCs) investments where the insurer owns more than 10% of the equity of the investee but has no affiliation to the investee’s general partner/asset manager. SSAP No. 97 currently includes a possible scope exception in paragraph 6 for these types of investments so that they are not considered affiliated or controlled investees of the insurer. It is not clear from the proposal what the expected impact is from now having to consider all investments in unaffiliated LPs/JVs/LLCs where the insurer owns more than 10% of the equity but has no other affiliation, as related parties. If the intent is just to have insurers disclose material transactions with these entities other than the equity investment held in each entity, we believe that this needs to be more clearly stated in the proposal so that there is no misrepresentation of what needs to be disclosed or whether these investments need to be reported in a different section of Schedule BA (i.e., affiliated vs. non-affiliated).

Another, but similar concern relates to certain entities consolidated under U.S. GAAP based on the Variable Interest Entity (VIEs) guidance. For some of these consolidated VIEs, the insurer has no control or affiliation with the VIE other than its debt investment in the entity. The insurer is simply a passive investor in the structure. However, under the VIE rules, the insurer must consolidate the entity as the insurer may be able to make decisions for the VIE if there is ever an event of default of the assets at some point in the future. These rights are given to certain classes of bonds issued by the securitization as a protection to the investors, but do not give the investors any type of power or control over the VIE at inception or on a day-to-day basis. It is important to note that consolidation rules under FASB Codification Topic 810 are very complex with some insurers concluding consolidation is required under a set of fact and circumstances and others concluding consolidation is not required under the same set of facts and circumstances. In the example just shared, some insurers have concluded consolidation is required because when no day-to-day decisions are being made for the VIE, decisions upon the occurrence of a certain event which may be unlikely to occur, rise to the point where they are the decisions that have the most significant impact on the economic results of the VIE. We believe that even though insurers have to consolidate these entities, there is no true related party affiliation. The proposal requires that any entity identified as a related party under U.S. GAAP will also be considered a related party for statutory reporting. Since these entities are consolidated for GAAP, the presumption would be that they are a related party of the insurer. If these entities will be considered related parties on a statutory basis going forward, the exposure needs to clarify that the inclusion of these types of entities only impacts related party disclosures for any material transactions held with these entities other than the debt investment held by the insurer in the VIE and that the debt instrument is still reported on Schedule D as unaffiliated.

Interested parties also have concerns with SSAP No. 25 including references to U.S. GAAP and SEC reporting for mutual insurers that do not prepare U.S. GAAP financial statements and do not file with the SEC. Therefore, interested parties recommend that the specific guidance from the GAAP and SEC be stated in SSAP No. 25 (rather than incorporated by reference) so that any future changes in GAAP and SEC guidance are subject to NAIC review prior to being applicable. Also, it is important to note that even when an entity is considered a related party under U.S. GAAP, disclosure of that relationship is only required when there are material transactions with that party. U.S. GAAP allows reporting entities to evaluate the significance of a relationship and determine when disclosure of that relationship is material/significant enough for disclosure to a user of the financial statements. As a result, we suggest this be clarified in the exposure as well so that it is clear that the reference to related parties under GAAP and SEC rules is only relevant if the insurer has material transactions with such parties outside of the insurer’s investment in the entity.

Response from the Group Solvency Issues (E) Working Group to the Working Group’s referral at the 2019 Fall National Meeting:

The Group Solvency Issues (E) Working Group has recently noted several challenges in identifying and tracking the various affiliated/related parties within insurance groups, as well as the relationships an insurance group may have with other insurance groups. At the same time, regulators have noted an increased number of situations where the solvency and liquidity of insurers were negatively impacted by affiliated investments and relationships. Given
the above-mentioned issues and concerns, the Working Group would like to express its support for the changes to SSAP No. 25—Affiliates and Other Related Parties that are proposed in agenda item 2019-34.

The Working Group agrees that each of the clarifications provided within the proposed revisions are valuable and will assist insurers and regulators in understanding the proper accounting treatment and disclosure requirements in this area. However, the Working Group notes that there may be additional disclosures necessary to clearly understand the nature of relationships across insurance groups. For example, Working Group members have found it difficult to understand and track relationships between insurers that are not affiliated (i.e., not under common control) but that share some level of common ownership. The Working Group recommends consideration of a new statutory disclosure that would provide information on minority ownership interests, as well as significant relationships between minority owners and other U.S. domestic insurers/groups.

**Recommended Action:**

**NAIC staff recommend that the Working Group direct NAIC staff to work with interested parties to update the proposed revisions to SSAP No. 25.** Interested parties’ comments include several main points which are listed out below, along with NAIC staff comments.

1. Interested parties would like clarity around the new proposed wording that states that non-controlling ownership over 10% results in a related party classification regardless of any disclaimer of control or disclaimer of affiliation.

   *NAIC staff believe that we will need to work with interested parties to clarify this section. The Group Solvency Issues (E) Working Group requests information on the non-controlling interests greater than 10%.*

2. Another, but similar concern relates to certain entities consolidated under U.S. GAAP based on the Variable Interest Entity (VIEs) guidance.

   *NAIC staff believe that if an entity must be consolidated under U.S. GAAP, that it is a related party.*

3. Interested parties have concerns with SSAP No. 25 including references to U.S. GAAP and SEC reporting for mutual insurers that do not prepare U.S. GAAP financial statements and do not file with the SEC.

   *NAIC staff understand these concerns and will plan to work with interested parties on finding the best language to accomplish the goals.*

After the 2019 Fall National Meeting, the Working Group sent a referral to the Group Solvency Issues (E) Working Group that outlines agenda item 2019-34 and asked for any further guidance or clarification. The Group Solvency Issues (E) Working Group recommended consideration of a new statutory disclosure that would provide information on minority ownership interests, as well as significant relationships between minority owners and other U.S. domestic insurers/groups. NAIC staff will draft proposed revisions to capture this information.
Summary:
At the 2019 Fall National Meeting, the Working Group exposed revisions which expand the MGA/TPA note in the following statements:

- SSAP No. 51R—Life Contracts, paragraph 50,
- SSAP No. 53—Property Casualty Contracts—Premiums, paragraph 19,
- SSAP No. 54R—Individual and Group Accident and Health Contracts, paragraph 33 and
- SSAP No. 59—Credit Life and Accident and Health Insurance Contracts, paragraph 19

Two states have requested that the existing annual statement disclosure regarding managing general agent (MGA) and third-party administrator (TPA) be expanded to include additional information. The exposed revisions provide:

- Aggregate direct written premium and total premium written by MGA/TPA;
- Aggregate dollar amount of claims process / total claims processed by MGA/TPA; and
- Information on related party / affiliate status and if the MGA/TPA is independently audited and / or bonded.

The state sponsors have advocated that more transparency would also help in the assessment of the Enterprise Risk Management (ERM) framework, Own Risk Solvency Assessment (ORSA) report, market analysis reviews, operational risks, group analysis, and recovery and resolution considerations.

Interested Parties’ Comments:
Interested parties note that the proposal does not define a TPA. It just states that TPAs “that write direct policies or provide claims adjusting or other services.” That is overly broad and could include a variety of entities that provide services. The NAIC model (NAIC Third Party Administrator Act, or NAIC model) guidelines define TPAs as it relates to life/health and workers compensation. Also, the NAIC model definition has a long list of activities that are excluded from the definition, such as self-insured employers administering its own workers’ compensation, insurers administering coverage, producers engaged in selling insurance, attorneys handling claims, MGAs, etc. We recommend that the proposed disclosure reference the NAIC model so that there is consistency in the definition used in applying the guidance.

Additionally, it is unclear how the reporting threshold should be applied. The reporting applies to TPAs if “the claims adjusting services are greater than 5% of annual average claims volume”. Is that threshold based on the amount of claim dollars paid or the number of claims handled? Is that measured across all lines of business for the company? Would claims paid within insureds’ deductibles/SIRs be included? Depending on how this is defined, it could be quite burdensome for insurers to monitor. We recommend that the threshold be based on written premium, consistent with how other thresholds have been applied.

Recommended Action:
NAIC staff recommends that the Working Group adopt the exposed revisions with the modifications illustrated in the agenda item. In addition, the Working Group should direct that the modification to the annual statement illustration be forwarded to the Blanks (E) Working Group to coordinate on its concurrent exposure. The additional revisions are drafted to address interested parties’ comments as follows:
1. Consistent with interested parties’ recommendation, TPA has been defined to be consistent with the NAIC Model Guideline, VI-1090 Registration and Regulation of Third-Party Administrators (TPAs).

2. The sponsors of the agenda item indicated that they preferred to maintain a claims measure for determining which TPAs to be disclosed, instead of a written premium measure suggested by interested parties. However, to address the interested parties’ operational concerns the language has been revised from “claims adjusting services are greater than 5% of annual average claims volume” to “if the total count of claims processed by the TPA /MGA are greater than 5% of the total count of claims processed.”

If preferred by the Working Group, this item could be exposed with the minor modifications and included in the earlier comment deadline for May discussion. If this is chosen, the Working Group should also direct notification to the Blanks (E) Working Group of the proposed modifications for its concurrent exposure.

Excerpt of proposed edits with industry modifications shaded:

The disclosures in this paragraph should be completed regarding Disclose the aggregate amount of direct premiums written through following regarding managing general agents (MGAs) or third-party administrators (TPAs) that write direct policies or provide claims adjusting or other services. For purposes of this disclosure, a managing general agent means the same as in Appendix A-225. For purposes of this disclosure a third-party administrator is consistent with NAIC Model Guideline, VI-1090 Registration and Regulation of Third-Party Administrators (TPAs). If -the premium written amount is equal to or greater than 5% of surplus, or if the total count of claims processed by the TPA or MGA are greater than 5% of the total count of claims processed, provide the following information for each managing general agent and third-party administrator:

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Summary:
Surplus notes are unique statutory accounting items which have the characteristics of both debt and equity and are addressed in SSAP No. 41R—Surplus Notes. Surplus notes are debt instruments that are required to be subordinated to policyholders, claimants and all other creditors; with interest and principal repayments requiring approval by the domiciliary commissioner. As such, surplus notes are reported as equity for statutory accounting purposes. (This treatment is specific to statutory accounting. Surplus notes are reported as debt under U.S. GAAP.) Pursuant to the requirements of SSAP No. 41R, proceeds received by the issuer of a surplus note must be in the form of cash or other admitted assets meeting both value and liquidity requirements of the state of domicile’s commissioner.

In conjunction with agenda item 2018-07, originally a referral from the Reinsurance (E) Task Force, the Working Group has been discussing surplus notes where an “associated” asset is received by the surplus note issuer. These discussions have questioned whether a surplus note that does not result with an exchange of cash flows (as the cash flows offset with an associated asset), shall be considered surplus notes under SSAP No. 41R. Although the discussion on how to treat these surplus notes will occur in agenda item 2018-07, the Working Group directed that additional disclosures be captured in SSAP No. 41R. The intent of this agenda item is to consider new disclosures involving surplus notes to better identify these situations in the statutory financial statements.

Interested Parties’ Comments:
Interested parties understand regulators’ concerns that the details of certain transactions involving surplus notes may not be transparent to regulators who were not involved in the initial approval or ongoing review of such transactions. However, these transactions and the related pricing represent confidential information that we believe is inappropriate for public disclosure and may be misleading if presented in the proposed format.

Our concerns with the proposed disclosures are outlined in detail below, followed by our suggested revisions.

The proposed disclosures may not provide the desired transparency or consistency

Throughout the discussion on any potential revisions to SSAP No. 41R over the past twenty-two months, interested parties have agreed that robust disclosures should be added to SSAP No. 41R to fully reflect situations where a reporting entity receiving proceeds from the issuance of surplus notes used those proceeds to purchase an asset directly or indirectly from the holder of the surplus note. However, we also believe that these disclosures should be included in the financial statements of a ceding company, which would provide a much greater level of transparency and consistency in disclosure. We believe that in most situations where a surplus note issuer uses proceeds from the issuance to purchase an asset directly or indirectly from the holder of the surplus note, the surplus note issuer is an affiliated captive reinsurer. As some captive financial statements are not provided to the NAIC, we believe disclosure in the financial statements of the ceding company would provide a much greater level of transparency and consistency in disclosure for these transactions. Our proposed revisions include suggested language for this disclosure requirement.

The proposed disclosure goes beyond the stated regulatory concern and requires additional information that may be incorrectly interpreted.

We believe that the proposed disclosure departs from the original regulatory concern expressed in the public meetings of the Working Group, namely that a reporting entity should not be permitted to circumvent regulatory authority as it relates to the preservation of capital at a regulated entity by contractually linking the cash outflows associated with a surplus note to cash inflows from another financial instrument held by the surplus note issuer. However, rather than identify such transactions, the proposed disclosure would require detailed information about surplus note interest regardless of whether cash flows are contractually linked. We are concerned that the operational burden of compiling this information for all surplus notes with netting provisions exceeds the benefit to regulators of providing information on the few transactions of concern.

Interested parties note that the scope of the proposed disclosure is substantially identical to that of the recent surplus note data call issued by the NAIC. The stated intent of this data call was to obtain information on surplus note transactions without regard to whether offsetting of cash flows was due to: a) contractual linkage or b) administrative offset provisions. While we agree that this scope was appropriate to assess the universe of affected transactions, we do not believe it is the appropriate scope for an Annual Statement disclosure and could be misleading in certain cases as outlined below.

The proposed disclosure includes confidential information that is not appropriate for public filings.

The proposal would require the disclosure of surplus note interest paid, net of any payments made by the surplus note holder. As a practical matter, for many captive structures, this amount often corresponds to the fees paid to the financing provider(s) to provide liquidity in the event of adverse experience or other conditions with respect to the subject policies, as defined in the applicable agreement.

The pricing and terms of the subject transactions were heavily vetted, negotiated, and submitted to state regulators for approval with the reasonable understanding that this information was subject to robust confidentiality protections. We do not object to this information being made available to regulators in the context of a confidential data call or regulator communication. However, we are concerned with its inclusion in public filings. The primary focus should be on whether the surplus note issuer is statutorily solvent rather than its surplus note pricing terms.

The net presentation of interest paid could be misleading for some transactions

We also believe that the change to the current disclosure to replace surplus note interest paid with interest paid net of amounts offset is problematic. We believe this disclosure could be misleading for many of the transactions in the
scope of the disclosure, given that the full amount of surplus note interest paid was/would be due regardless of whether a portion is offset pursuant to an administrative netting arrangement.

**Proposed Revisions**

Interested parties recommend revisions to the proposed disclosures which would provide regulators who are not involved in the approval and ongoing review of a surplus note transaction with information to assess the nature of the transaction and to determine whether more detailed review is needed. Specifically, our revisions would require disclosure of whether cash flows are offset but would differentiate between administrative offsetting and the contractual “linkage” that is of concern to regulators. These revisions would also remove information that we believe is confidential in nature and would not be appropriate for public disclosure. Finally, we have proposed several additions to the required disclosures, which we believe would provide useful information about transactions involving surplus notes.

Our suggested revisions to the disclosures are included in Exhibit A and summarized below. For ease of review, revisions proposed by NAIC staff have been accepted, and interested parties’ comments are presented as tracked changes.

**Summary of Proposed Revisions**

- Expand the disclosure requirement to the financial statements of the ceding company as well as the surplus note issuer.
- Retain the current disclosure of total interest paid (gross of any administrative or other netting)
- Replace quantitative disclosure of “interest remitted” and “cost of liquidity” with three Y/N disclosure columns which correspond to the criteria used in the data call scoping:
  1. Do surplus note / associated asset terms negate or reduce cash flow exchanges, and/or are amounts payable under surplus notes and amounts receivable under other agreements contractually linked? (For example, the asset provides interest payments only when the surplus note provides interest payments.)
  2. 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.)?
  3. 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?
- Replace confidential information about 3rd party liquidity (e.g. maximum liquidity amount and cost of liquidity source) with a description of terms under which liquidity would be provided should a triggering event occur.
- Add requirement for narrative disclosure of any related guarantees or support agreements.

[Proposed changes from interested parties have been highlighted below].

**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;
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/or principal recognized;
j. Disclosure of whether the surplus note was issued as paid part of a transaction with identification of 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 amount of approved interest and/or principal remitted 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, (actual transfer of cash / assets) and the amount of approved interest and/or principal not remitted to the holder of the surplus note (no transfer of cash / assets);
k. Information regarding a 3rd party liquidity source including name, identification if a related party, cost of the liquidity guarantee, and maximum amount available should a triggering event occur;
l. Principal amount and fair value of assets received upon Surplus Note issuance, if applicable;
m. Subordination terms;
n. Liquidation preference to the reporting entity’s common and preferred shareholders;
o. The repayment conditions and restrictions.
p. 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 not remitting actual cash or assets to a related party as part of a reinsurance transaction in which the surplus note meets any of the criteria in 18. j above, the ceding entity shall provide a description of the transaction, including whether the criteria in 18. j above 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.

19-20. 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 for approved interest or principal (as reported under paragraph 18.h), because the reporting entity is offsetting the amount owed under the surplus note with an amount receivable from a reported asset, the following information shall be disclosed regarding the offsetting asset:
   a. Identification of asset, including the investment schedule where the asset is reported and reported NAIC designation;
   b. Book/adjusted carrying value of asset and interest income recognized in as of the current year reporting date.
c. **Amount of principle return and interest income from the asset not received by the reporting entity as the amounts were offset with approved amounts owed by the reporting entity’s issued surplus note. A description of terms under which liquidity would be provided should a triggering event occur.**

20.21. 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.

**Recommended Action:**
NAIC staff agree that the proposed edits by interested parties (as seen above), in essence, require disclosure of the desired items as detailed in the agenda item. Additionally, in some cases, the proposed edits expanded surplus note structure disclosures. **NAIC staff recommends that the Working Group expose this agenda item with the shortened comment deadline, with the revisions as proposed by interested parties. The proposed Blanks disclosures includes both edits suggested by interested parties with a few further modifications proposed by NAIC staff.** For readability and due to the amount of proposed changes, the proposed Blanks revisions are documented in the agenda item. (This item is proposed to have a shortened comment deadline for concurrent blanks consideration.)

These revisions will require additional disclosures regarding the issuance of Surplus Notes – specifically those structured in a manner in which typical cashflows have been reduced or eliminated.

**(Agenda item 2018-07 and the discussion of whether linked surplus notes should be in scope of SSAP No. 41R will be revisited during the Summer National Meeting.)**

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**Summary:**
During the 2019 Fall National Meeting, the Working Group exposed proposed revisions to address potential misinterpretation for Blank instructions on Schedule DB-D, section 1, column 4 (Fair Value of Acceptable Collateral). This issue exists as collateral is reported as 1) the fair value of collateral pledged by a counterparty, or 2) for central clearinghouses as the **net positive variation margin** received by the reporting entity.

NAIC staff believes the intent of **net positive variation margin** was originally meant to **reflect net realizable margin**. For example, if a reporting entity originally paid $5k as collateral to initiate a position, then subsequently received $15k in variation margin true-up, the reporting entity should report $10k in the fair value of acceptable collateral (assuming the counterparty has the legal right to offset the original $5k received). With the legal right to offset, in this example the holder can only realize a net $10k in collateral if liquidation were to occur. As the instructions indicate “net positive variation margin,” the variation collateral of $15k could be reported, disregarding the $5k initial margin.

Conversely, had the reporting entity received $5k in initial margin, and a subsequent $20k in variation margin, a total of $25k should be reported as collateral, thus giving credit for the initial margin received. NAIC staff believe this intent is articulated in SSAP No. 86, as collateral is defined in the disclosures as “net assets held.”
This agenda item included proposed clarification language that collateral shall be determined by the summation of any assets held less any collateral paid/pledged from collateral received, if the counterparty has a legal right to offset as defined in SSAP No. 64.

Interested Parties’ Comments:
Interested parties fully support the appropriate depiction within the statutory financial statements and schedules of the availability of insurance company assets to fulfill policyholder obligations, including consideration of a reporting entity’s access to and control over the assets and any contingencies pertaining to the attendant rights & benefits of ownership. We appreciate the opportunity to dialogue further on this matter and ensure the regulatory objective is achieved regarding both financial statement presentation and the risk-based assessment of capital.

The ability to make efficient use of derivative instruments as part of hedging transactions, income generation transactions and replication (synthetic asset) transactions, in accordance with SSAP No. 86 – Derivatives (“SSAP No. 86”), is a crucial component of insurers’ ability to effectively manage risk and prudently maintain yields in support of our ability to deliver on promises to our policy and contract holders. With broader federal regulation now driving a migration for many of the interest rate and credit derivatives insurers use to these ends towards the central clearinghouse or “cleared” space, the significance of appropriately depicting the specific economic substance and attendant risks associated with each of the various forms of collateral posted to central clearinghouses has never been greater.

Given this backdrop, our concerns with exposure 2019-39 are as follows:

1) The language in the proposal does not provide clear, consistent definition of scope or objective(s);

2) The exchange of initial margin on cleared trades represents a contingency distinct from that associated with the exchange of variation margin; and

3) The existing statutory accounting, reporting and risk-based capital models already appropriately depict the economic substance and inherent risk associated with the exchange of initial margin, and the proposed changes would result in inappropriate duplication of risk-based capital charges.

In terms of intended scope, the narrative commentary and proposed updates to existing guidance make it unclear as to whether the proposal aims to refine accounting & reporting guidance for:

- initial margin, variation margin, or both;
- bilateral (over-the-counter, “OTC”) trades, trades executed with central clearinghouses, or both;
- exchanges of cash collateral, non-cash collateral (e.g. securities) or both.

The summary introduction to the proposal appears to target a perceived issue with the Schedule DB-D, Section 1 reporting of initial margin exchanged with central clearinghouses. The narrative commentary provided does not identify specific concerns pertaining to the reporting of collateral associated with bilateral OTC trades or variation margin. However, the attendant proposed edits to SSAP No. 86 and the Blank Instructions for Schedule DB-D, Section 1 encompass collateral exchanges with both bilateral OTC counterparties and central clearinghouses…inherently scoping in both OTC and cleared trades as well as all forms of collateral (variation margin, initial margin and traditional margin on legacy bilateral OTC trades). In addition, the proposal makes no clear distinction between proposed updates regarding exchanges of cash collateral vs exchanges of non-cash collateral, often using the terms collectively and interchangeably, whereas the guidance within the AP&P Manual makes clear distinctions regarding their respective accounting and reporting - as they have distinct implications for users of statutory financial statements. The guidance for cash collateral exchanges under SSAP No. 103R – Transfers and Servicing of Financial Assets and Extinguishments of Liabilities (“SSAP 103R”) paragraphs 19 & 20 is distinct from that of non-cash collateral exchanges, which is also further detailed in INT 01-31 – Assets Pledged as Collateral (“INT 01-31”). Anecdotally, though the SSAP No. 86 Appendix C guidance for the initial carrying value on futures paraphrased in the 2019-39 exposure commentary applies to exchange traded derivatives (which
The exchange of initial margin with central clearinghouses is clearly distinct in function from the exchange of variation margin. As referenced in the proposal, initial margin is a minimum amount of equity that must be provided to a clearinghouse to initiate a position. It effectively represents the deposit of chips required to play at the table ("table stakes"), and is required from both respective parties entering into the derivative transaction as protection for the clearinghouse against the potential that either respective party will not make good on its respective commitments (i.e., initial and continuing participation in the transaction and the associated exchanges of variation margin driven by the derivative price movements until expiry or novation) – leaving the clearinghouse exposed, as intermediary, to the remaining party. Once such a trade expires or is novated, assuming the respective party has made good on all its variation margin payments during the course of the trade being open, the asset(s) posted to the clearinghouse as initial margin is returned to that exiting party. In the instance that a party exiting the derivative transaction has not stayed current with its respective variation margin obligations, the clearinghouse will return the remaining value of the initial margin after settling up the unpaid variation margin obligations. As such, the contingencies associated with maintenance of exclusive control over the rights and benefits of asset ownership for an entity posting initial margin are primarily a function of the entity’s continuing involvement in the trade with the clearinghouse, which is distinct from the derivative price movement contingencies directly associated with variation margin.

Reporting entities often utilize non-cash collateral (e.g., US Treasuries) for posting as initial margin to clearinghouses, as the required initial margin value can be comparatively high (driven by risk adjusted trailing price volatility of the underlying derivative and overcollateralization conventions) but the reporting entity maintains the full rights & benefits of ownership over an already held yield generating asset – in many instances preferable to locking up a chunk of otherwise investible cash. The ability to maintain full control over the rights and benefits of ownership on this yield generating non-cash collateral posted (e.g., avoiding forced sales of the non-cash collateral to satisfy unfulfilled variation margin obligations) also incentivizes a reporting entity to remain current on variation margin obligations while the trade remains open.

Existing statutory accounting guidance (e.g., the previously referenced SSAP No. 103R and INT 01-31) already provides for appropriate classification, measurement and presentation of collateral posted as initial margin. In the much more likely instance that non-cash collateral has been posted to a clearinghouse as initial margin, the pledging insurer continues to record the pledged collateral as an admitted asset until they have committed a contract default that has not been cured. In the unlikely instance that the non-cash collateral has to be liquidated in order to satisfy unmet variation margin payment obligations associated with a trade being exited, any associated realized loss would be recognized and the reclassification of the remaining initial margin value due back from the clearing house will be recorded – likely as either cash or a receivable - in accordance with applicable statutory guidance. The Blanks instructions require that any such non-cash or cash collateral posted as initial margin be marked as such on the attendant investment schedule, identified at the specific asset level on Schedule DB-D Section 2 (complete with an identifier indicating that the posting represents initial margin) and summarized within Note 5 (Restricted Assets). As such, the availability of the assets to fulfill policyholder obligations, as well as identification at the specific asset level of the unique and specific contingencies associated with initial margin posting are already presented appropriately for the consideration of financial statement users. Altering the presentation of initial margin postings on the summary Schedule DB-D Section 1 would not augment a financial statement user’s understanding of the reporting entity’s solvency or financial condition, as the “net realizable margin” associated with the open derivative contracts is already appropriately presented – initial margin posted is not directly or typically subject to the derivative price movement contingencies inherent in arriving at an appropriate “Exposure Net of Collateral” total on Schedule DB-D Section 1.
Equally as important, incorporation of initial margin posted into the “Exposure Net of Collateral” total on Schedule DB-D Section 1 would lead to inappropriate and misleading downstream consequences for a reporting entity’s Risk Based Capital calculation. Any collateral (whether non-cash or cash) posted as initial margin is already captured in the Life RBC formula on LR017 (Off Balance Sheet and Other Items), where all collateral postings are pulled directly from Schedule DB-D Section 2 and assessed RBC charges associated with the specific contingency of pledging of the assets to an external counterparty. Thus, netting initial margin postings into the “Exposure Net of Collateral” total on Schedule DB-D Section 1 would make the total derivative exposure (net of collateral) that flows through to LR012 in the Life RBC formula too high – inappropriately double counting the RBC charges associated with the posting of initial margin to a clearinghouse. In addition, the understatement of net realizable collateral (Fair Value of Acceptable Collateral) on Schedule DB-D Section 1 would also, in many instances, mechanically carry through to overstate the “Off Balance Sheet Exposure” reported on the same schedule – which would result in even further overstatement of RBC charges as this “Off Balance Sheet Exposure” flows through the Life RBC formula to be assessed charges on LR017. Doubling, and possibly tripling the RBC charges associated with the posting of initial margin to a central clearinghouse is not an appropriate depiction of true risk for such margin.

Given the ambiguities in the exposure language, the appropriate depiction of economic substance and inherent risk associated with exchanging initial margin within the existing statutory accounting, reporting and RBC frameworks, and the importance of maintaining insurers’ ability to utilize cleared derivatives to effectively manage risk and prudently support yields, we respectfully request that the Working Group withdraw the current proposal and direct NAIC Staff to collaborate with industry to specify and appropriately address any remaining concerns. We stand ready to work through any lingering misgivings the Working Group may have with regard to financial statement presentation but request that such endeavors be empirically grounded in specific observed instances of incomplete or inappropriate reporting.

**Recommended Action:**
The original intent of the agenda item was to facilitate a discussion regarding if a reporting entity should report or potentially receive ‘credit’ for initial margin pledged from a counterparty in central clearinghouse transactions. However, from in-depth discussions with interested parties, NAIC staff agree that the utilization of third-party initial margin is not only an incredibly rare event, that such utilization would only occur in a series unlikely adverse actions, all of which have various compensating controls to ensure variation margin transfer/compliance. Further, while also remote, retroactive reductions in central clearing houses margin return to the counterparty and do not convert into variation margin.

It is also important to note that reporting entities often utilize non-cash collateral (e.g., US Treasuries) for posting initial margin to clearinghouses. Maintaining such collateral on the books of the collateral provider is appropriate as they maintain the full rights & benefits of ownership of the asset.

**In summary, NAIC staff believe third-party derivative exposure through centrally cleared exchanges is appropriately captured in the existing disclosure requirements and in the Blanks. Accordingly, NAIC staff recommend the Working Group dispose of this agenda item without statutory revision.**
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**Summary:**
At the Fall National Meeting, the Working Group exposed nonsubstantive revisions to *SSAP No. 51R—Life Contracts* and *SSAP No. 3—Accounting Changes and Corrections of Errors* for reporting years beginning Jan. 1, 2020. The revisions add reference, disclosures and accounting for Section 21 of the *Valuation Manual*, requirements for Principle-Based Reserves for Variable Annuities, and grade-in requirements for reporting changes in the valuation basis for years beginning January 1, 2020.

1. Revises the existing guidance, which prohibits grading-in changes in valuation basis unless provided for in the statement, to allow a grade-in for changes in valuation basis if permitted by the statement or the *Valuation Manual* in section VM-21 Requirements for Principle-Based Reserves for Variable Annuities (VM-21). Historically choosing effective dates for major reserving changes for the *Accounting Practices and Procedures Manual* has been determined by Working Group, for example the 2001 CSO table (adopted in 2002) was effective for policies January 1, 2004 in Appendix A-820. This has been to promote consistent implementation and reporting. By deferring to the VM-21 on grade-in options with many varied features, there will be less comparability in reporting, because there is more optionality in reserve reporting. Therefore, additional disclosure regarding grade-in has been proposed.

2. A change in valuation basis under SSAP No. 51R is recognized through surplus. As the unrecognized graded-in reserve represents an unrecognized adjustment to surplus, the revisions require the unrecognized grade-in amount from a change in valuation basis, if resulting with an increase in reserves (decrease from surplus), to be reported as an allocation from unassigned funds to special surplus until the amount has been fully graded into unassigned funds. The reclassification from unassigned funds to special surplus does not reduce total surplus. This is to provide transparency regarding the increased reserve amount that has not been reflected into surplus. As amounts are graded-in to reduce surplus, the amount in special surplus is reclassified to unassigned funds.

3. The proposed revisions to SSAP No. 51R expand the disclosure for changes in valuation basis as a change in accounting principle under SSAP No. 3 to also include details regarding grade-ins of changes in valuation basis, including the grade-in period applied, the remaining amount to be graded-in, remaining time for the grade-in period and the initial grade-in amount and any adjustments to the original amount.

4. Adds a reference in SSAP No. 3 regarding additional disclosures of grade-in features.

Notice of the exposure was also sent to the Life Actuarial (A) Task Force as part of the *Valuation Manual* and *Accounting Practices and Procedures Manual* coordination process.

**Interested Parties’ Comments:**
This exposure consists of several parts, some of which we agree with and others we find both confusing and unnecessary. We agree that documentation of the choices made among the options for phase-in in VM-21 and the impact of those choices is important. The exposed edits focus on the adoption of the new reserve requirements for variable annuities (revised VM-21 and AG-43). Information on those choices and impacts will be provided to regulators through the PBR Actuarial Memorandum required by VM-31. This includes highlighting the elements of any Phase-in in the executive summary of the PBR Actuarial Memorandum. Given the current requirements of SSAP3 and SSAP51, documentation in the notes to the Annual Statement is also appropriate.
In Recommendation #2, the proposal would require the amounts from the Phase-in to be designated as “special surplus”. We disagree with this recommendation for the following reasons:

- This is a new requirement whose need has not been established. Disclosure of the amounts will provide information necessary for users of the financial statements to understand the basis of the reported financials.
- SSAP72 defines Special Surplus as amounts designated for specific contingencies. Recommendation #2 would be a change to the definition and purpose of special surplus that is inappropriate and would create an undesirable precedent.

Finally, the proposed language is unnecessary, and possibly confusing. VM-21 defines the minimum reserve requirement. Within that requirement, the company has the option to compute the reserves using the Phase-in provision of Section 2.B. Whichever option is elected, VM-21 defines the reserve. SSAP51 defines the amount of the “Change in Basis” as the difference between the amount under the prior VM-21 and the amount required by the current VM-21 as of 1/1/2020. If the Phase-in has been elected, that difference will generally be zero. The change in basis amount as defined in SSAP51 paragraph 39 is not being graded in – it is what it is following the VM-21 reserve requirements as stated. As such, SSAP51 does not need to make provision for a grade in. We propose the attached language as being clearer in defining the amounts to be disclosed, to use language consistent with VM-21, and to recognize the role of VM-21 to define the reserve requirement.

Interested Parties illustration is on pages 32-34 of the comments.

Recommended Action:

NAIC Staff recommends that the Working Group adopt the exposed revisions, incorporating interested parties proposed edits of removing the reclassification to special surplus as summarized and illustrated in the agenda item and below. The proposed text for adoption does not incorporate all of the interested parties’ revisions. If preferred, the Working Group could have a short re-exposure, but such a deferral may raise first quarter reporting concerns. If re-exposed, the Life Actuarial (A) Task Force should be notified of the exposure.

NAIC Staff does not propose to incorporate the following revisions requested by Interested Parties:

- SSAP No. 51, paragraph 39, 40 and SSAP No. 3 - Keep the exposed grade in guidance as which defers only to the VM 21 CARVM grade in guidance and requires coordination on future VM grade in proposals.
- SSAP No. 51, paragraph 40 – did not add industry proposed language on retroactivity.

NAIC Staff illustration incorporates the following revisions requested by Interested Parties:

- SSAP No. 51, paragraph 39 and subparagraphs c and d – Delete the exposed reclassification to special surplus until the grade in for reserving amount is fully recognized. Most entities will have a short-term impact (three years) and disclosure should be adequate.
- SSAP No. 51, paragraph 39/40 – Maintain the existing language on changes in accounting in paragraph 39 instead of moving it paragraph 40 as proposed in the exposure.
- SSAP No. 51, paragraph subparagraphs and SSAP No. 3 – editorial - Change “grade-in” to “phase in” as suggested by interested parties to maintain consistency with SSAP No. 51 and the Valuation Manual.
“Clean version” of revisions tracked only to SSAP 51R and SSAP No. 3 with shading new wording

SSAP No. 51R

39. The impact of a change in valuation basis on surplus is based on the difference between the reported reserve under the old and new methods as of the beginning of the year. This difference shall not be graded in over time unless this statement or the Valuation Manual in section VM-21 Requirements for Principle-Based Reserves for Variable Annuities (VM-21) prescribes a new method and a specific transition that allows for grading. Some changes will meet the definition of a change in accounting as defined in SSAP No. 3 and a change in valuation basis as described in paragraphs 36-38 of this statement, but the adjustment to surplus will be zero. This can happen when the change in valuation basis is prospective and only applies to new policies and reserves meaning that policies inforce for the prior year-end are not affected, or situations in which the change in reserving methodology did not change the reserves reported in the financial statements. The changes remain subject to the disclosures prescribed in SSAP No. 3. Effective January 1, 2020, if the Valuation Manual section VM-21 (on variable annuities) or this statement prescribes or permits a grading in period or provides the option of multiple grading periods, reporting entities shall also include in the change in accounting disclosures required by SSAP No. 3, disclosure of the following:

   a. the phase in period being applied, and the remaining time period of the phase in
   b. any adjustments to the phase in period.
   c. amount of change in valuation basis phase in, -and
   d. the remaining amount to be phased-in.

40. The Valuation Manual is effective prospectively for policies written on or after the operative date, however, as the CARVM methodology was already principles based, some changes to the CARVM methodology in section VM-21 (on variable annuities) and to the related AG 43 may result in retroactive application to the reserving for existing contracts. Therefore, upon the initial prospective adoption of principle-based reserving, the change in valuation basis reflected as an adjustment to surplus for most entities will be zero. After initial adoption of the Valuation Manual, changes in valuation basis will need to be evaluated to determine the amount of any surplus adjustments.

SSAP No. 3—Accounting Changes and Corrections of Errors

Disclosures

13. Disclosure of material changes in accounting and correction of errors shall include:

   a. A brief description of the change, encompassing a general disclosure of the reason and justification for change or correction;

   b. The impact of the change or correction on net income, surplus, total assets, and total liabilities for the two years presented in the financial statements (i.e., the balance sheet and statement of income and operations); and

   c. The effect on net income of the current period for a change in estimate that affects several future periods, such as a change in the service lives of depreciable assets or actuarial assumptions affecting pension costs. Disclosure of the effect on those income statement amounts is not necessary for estimates made each period in the ordinary course of accounting for items such as uncollectible accounts; however, disclosure is recommended if the effect of a change in the estimate is material;

   d. Changes in accounting that are changes in reserve valuation basis as described in SSAP No. 51R—Life Contracts which have elected phase in provided for in the Valuation Manual
Section VM 21, shall also include in the change in accounting disclosures information regarding the application of any phase in as provided for in SSAP No. 51R, and

e. When subsequent financial statements are issued containing comparative restated results as a result of the filing of an amended financial statement, the reporting entity shall disclose that the prior period has been restated and the nature and amount of such restatement.

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**Summary:**
At the 2019 Summer National Meeting, the Statutory Accounting Principles (E) Working Group, the Casualty Actuarial and Statistical (C) Task Force and the Surplus Lines (C) Task Force received a request from the Committee on Property and Liability Financial Reporting (COPLFR) of the American Academy of Actuaries Working Group. The request was to clarify the accounting and reporting for retroactive reinsurance which meets the SSAP No. 62R—Property and Casualty Reinsurance exceptions to be accounted for as prospective reinsurance. The request specifically asked for the NAIC groups to:

- Provide consistent guidance on the reporting treatment to both the ceding entity and assuming entity, where both are members of the same group and are consolidated in the same Combined Annual Statement.

- Clarify the reporting method to be used if the ceding entity and assuming entity are not in the same group.

During the 2019 Fall National Meeting, this Working Group exposed agenda item 2019-49 to address the inconsistencies in application of the reinsurance accounting and reporting guidance, particularly the impact on Schedule P – Analysis of Losses and Loss Expenses (Schedule P) that were highlighted in the request. The goal of this agenda item was to clarify both the accounting and reporting for retroactive contracts which are accounted for prospectively, including:

- Both the ceding entity and assuming entity, where both are members of the same group and are consolidated in the same Combined Annual Statement.

- The reporting method to be used if the ceding entity and assuming entity are not in the same group.

The Working Group also directed notice of the exposure and the request for volunteers to be sent to the Casualty Actuarial and Statistical (C) Task Force and the Property and Casualty Risk-Based Capital (E) Working Group.

**Interested Parties’ Comments:**
With regard to retroactive portfolio transfer deals within the same group that qualify for prospective treatment, interested parties identified the following issues related to reporting transactions in Schedule P.

**Main Issues**
- Should there be a requirement to have offsetting entries for the ceding and assuming entity within the group, such that the group Schedule P is not impacted (and industry Schedule P is not impacted)? (If so, then the ceding entity can’t record ceded amounts for prior AYs while the assuming company records assumed amounts all in the current CY/AY.)
• Should retroactive changes in previous premium amounts be allowed? (If no, and there is a desire to have both entities record the ceded/assumed in the affected older AYs, then the reinsurance premium would need to be treated as a paid loss – positive paid for the ceding entity and negative paid for the assuming entity.)

• Should the reporting prevent “cliffs” in the historic development reported in Schedule P. (If the cede transaction is reported as a premium and spreading to prior CYs, effectively changing prior values retroactively, then the prior incurred loss amounts in Schedule P, Part 2 would need to be adjusted to avoid a “cliff”.) Note that cliffs in Schedule P, Part 2 can have a material RBC impact with regard to the company experience adjustment.

Two Alternative Approaches
Interested parties identified two alternative approaches to recording intercompany, retroactive reinsurance:

• Record the reinsurance premium as a paid loss (positive paid for the cedant, negative for the assuming company), spreading the “premium” to the same AYs as the ceded losses. This avoids cliffs and avoids restating past CY Earned Premium, although it produces unusual results for the assuming company’s Schedule P.

• Record the reinsurance premium as premium, restating prior CY Earned Premium. Spread losses to the impacted AYs. This would create cliffs in Schedule P unless prior AYs are restated for the impact by AY of the reinsurance contract at inception.

Committee on Property and Liability Financial Reporting (COPLFR) of the American Academy of Actuaries Working Group

Comments received from COPFLR immediately prior to the Spring National Meeting have been included in the comment letter packet. The letter is in response to comments and inquiries regarding the prior COPLFR letter made by a member of the Casualty Actuarial and Statistical (C) Task Force.

Note: The company specific annual statement filings included as attachments to the most recent COPLFR letter were not included in the comment letter packet, but will be included for interim discussions.

Recommended Action:
No action is needed by the Working Group during the 2020 Spring National Meeting. NAIC staff received some volunteers and plans to hold calls in the interim and will keep the Working Group updated on activities.

The Committee on Property and Liability Financial Reporting (COPLFR) of the American Academy of Actuaries Working Group provided follow up comments to address interim comments by members of the Casualty Actuarial and Statistical (E) Task Force. Note Company Specific Exhibits and the prior COPLFR comments were not included in the comment letters but will be included in interim discussions).

The comment letters are included in Attachment 32 (54 pages).
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The Statutory Accounting Principles (E) Working Group of the Accounting Practices and Procedures (E) Task Force met in Austin, TX, Dec. 7, 2019. The following Working Group members participated: Dale Bruggeman, Chair (OH); Jim Armstrong, Vice Chair (IA); Sheila Travis (AL); Kathy Belfi and William Arfanis (CT); Rylynn Brown (DE); Carrie Mears (IA); Eric Moser, and Cindy Anderson (IL); Stewart Guerin (LA); Judy Weaver (MI); Doug Bartlett (NH); Tom Dudek (NY); Joe DiMemmo and Kimberly Rankin (PA); Jamie Walker (TX); Doug Stolte and David Smith (VA); and Amy Malm (WI).

1. **Adopted its Sept. 9 and 2019 Summer National Meeting Minutes**

Ms. Walker made a motion, seconded by Ms. Malm, to adopt the Working Group’s Sept. 9 (Attachment One-A) and Aug. 3, 2019 minutes (*see NAIC Proceedings – Summer 2019, Accounting Practices and Procedures (E) Task Force, Attachment One*). The motion passed unanimously.

2. **Adopted Non-Contested Statutory Accounting Revisions During its Public Hearing**

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

Ms. Malm made a motion, seconded by Mr. Bartlett, to adopt the statutory accounting revisions detailed below as non-contested statutory accounting revisions. The motion passed unanimously.

   a. **Agenda Item 2019-19**

Mr. Bruggeman directed the Working Group to agenda item 2019-19: SIRI – Equity Interests. Julie Gann (NAIC) stated that during the Summer National Meeting, the Working Group exposed revisions to clarify what should be captured in the Supplemental Investment Risk Interrogatory (SIRI) Line 13: Largest Equity Interests. With the exposed revisions, a look-through to the underlying investments shall occur for non-diversified funds. However, underlying investments in diversified funds would not need to be individually assessed and aggregated in determining the top ten largest equity interests. Ms. Gann stated that if an individual equity fund (diversified or non-diversified) was one of the top ten largest equity interests, the fund shall be reported in the top ten listing. Ms. Gann stated no comments were received and no statutory accounting revisions would be required, but the Working Group will sponsor a blanks proposal to update Annual Statement instructions for year-end 2020. (Attachment One-C)

   b. **Agenda Item 2019-22**

Mr. Bruggeman directed the Working Group to agenda item 2019-22: Wash Sales Disclosures. Jake Stultz (NAIC) stated that this nonsubstantive agenda item clarified wash sale disclosures would only be required when applicable transactions took place over quarterly or year-end reporting periods. Wash sales occurring within a reporting period do not need to be reported. Mr. Stultz stated that interested parties were supportive of the proposal. (Attachment One-D)

   c. **Agenda Item 2019-23**

Mr. Bruggeman directed the Working Group to agenda item 2019-23: Going Concern. Mr. Stultz stated this nonsubstantive agenda item expands language to clarify that if an unalleviated going concern is noted in any location within an audit opinion or in the financial statements, the SCA shall be nonadmitted. No comments were received. (Attachment One-E)

   d. **Agenda Item 2019-26**

Mr. Bruggeman directed the Working Group to agenda item 2019-26: A-785 Covered Agreements. Mr. Stultz stated that this nonsubstantive agenda item adopts language to incorporate covered agreements into Appendix A-785. Interested parties noted
one paragraph reference edit was required. Mr. Stultz recommended adoption with the editorial change as requested by interested parties.  

Draft Pending Adoption

Attachment One

Accounting Practices and Procedures (E) Task Force

12/9/19

Mr. Bruggeman directed the Working Group to agenda item 2019-27EP: Editorial Updates. Mr. Stultz stated this nonsubstantive agenda item covered three editorial revisions exposed from the Summer National Meeting and that no comments were received.  

f. Agenda Item 2019-28

Mr. Bruggeman directed the Working Group to agenda item 2019-28: ASU 2019-05, Targeted Transition Relief. Jim Pinegar (NAIC) stated this nonsubstantive agenda item provides an alternative accounting treatment for certain financial assets previously held at amortized cost. He advised the ASU was proposed for rejection as it allows alternative measurements methods, which are not permitted in applicable investment SSAP’s. Interested parties’ comments supported the proposed action.  

g. Agenda Item 2019-29

Mr. Bruggeman directed the Working Group to agenda item 2019-29: ASU 2019-06, Extending the Private Company Accounting Alternatives on Goodwill and Certain Identifiable Intangible Assets to Not-for-Profit Entities. Mr. Pinegar stated that this ASU extends goodwill alternatives currently allowed for private companies to Not-For-Profit entities, in that either an impairment only or amortization method is permitted. This nonsubstantive agenda item proposes to reject the ASU as it allows optionality in goodwill accounting. Interested parties’ comments supported the proposed revisions.  

3. Adopted Revisions to Reject U.S. GAAP as Not Applicable to Statutory Accounting

Ms. Walker made a motion, seconded by Mr. Dudek, to revise Appendix D—Nonapplicable GAAP Pronouncements to reject the following U.S. Generally Accepted Accounting Principles (GAAP) Accounting Standard Updates (ASUs) as not applicable. The motion passed unanimously.  

- ASU 2019-03, Updating the Definitions of Collections (Agenda Item 2019-30 - Attachment One-J)
- ASU 2018-08, Clarifying the Scope and the Accounting Guidance for Contributions Received and Contributions Made. (Agenda Item 2019-31 - Attachment One-K)

4. Reviewed Comments and Considered Action on Exposed Items with Minimal Discussion

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

a. Agenda Item 2018-26

Mr. Bruggeman directed the Working Group to agenda item 2018-26: SCA Loss Tracking – Accounting Guidance. Ms. Gann stated that during the Summer National Meeting, the Working Group exposed nonsubstantive revisions to update the existing financial reporting requirements when a reporting entity has a negative equity value in a subsidiary, controlled or affiliated (SCA) investment and the reporting entity has provided a financial guarantee or commitment. She stated that with the last exposure, the SCA investment would be reported at zero on the investment schedule, and the financial guarantee or commitment would be recognized as a liability pursuant to SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets. Ms. Gann stated that NAIC staff supports the comments received and believes the Working Group could consider adoption of the guidance, as revised by the interested parties’ comments. However, she stated that since the change would result in a distinct change from current reporting guidance and it is close to year-end, NAIC staff was recommending exposure of the proposed guidance to ensure adequate time to review the revisions and incorporate system changes. Additionally, she noted that the intent was to incorporate a new exhibit into SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities to pull in guidance from an existing statutory accounting interpretation. Although the proposed exhibit was exposed in a prior exposure period, she stated that reference to this change was not included in the exposure from the Summer National Meeting. She stated that with exposure, reference to the new SSAP No. 97 exhibit would be included.
Ms. Walker made a motion, seconded by Ms. Mears, to expose the nonsubstantive revisions to SSAP No. 5R and SSAP No. 97 to revise the reporting guidance for SCAs that have a negative equity value when there if a reporting entity financial guarantee or commitment, as modified from the interested parties’ comments, along with the proposed SSAP No. 97, Exhibit F. The motion passed unanimously.

b. **Agenda Item 2019-04**

Mr. Bruggeman directed the Working Group to agenda item 2019-04: SSAP No. 32 – Investment Classification Project. Ms. Gann stated that during the Summer National Meeting, the Working Group exposed an issue paper to revise the definitions, measurement and impairment guidance for SSAP No. 32—Preferred Stock, pursuant to the investment classification project. She stated that most of the comments received had been reflected in a revised issue paper, with the key exception proposed modifications from the U.S. GAAP definitions for redeemable and perpetual preferred stock. Although NAIC staff agrees that some aspects of the definitions primarily reflect the perspective of the issuer (e.g., whether redemption is within control of the issuer); these characteristics should be considered by the holder in properly classifying preferred stock as redeemable or perpetual. She stated that NAIC staff supports retaining consistency between U.S. GAAP and SAP definitions.

Resh Reese (Teachers Insurance and Annuity Association of America—TIAA) representing interested parties, stated support for the consideration of submitted comments and will review the revised issue paper and draft SSAP during the exposure period.

Ms. Brown made a motion, seconded by Mr. Bartlett, to expose the revised issue paper and substantively revised SSAP No. 32. The motion passed unanimously.

c. **Agenda Item 2019-08**

Mr. Bruggeman directed the Working Group to agenda item 2019-08: Reporting Deposit Type Contracts. Ms. Gann stated that this nonsubstantive agenda item originated to gather information on deposit-type contracts that were being reported in the annual statement exhibits as life (Exhibit 5) or accident and health (Exhibit 6) contracts. She stated that the long-standing practice is to classify and report contracts at policy inception. As a significant redesign of classifying insurance contracts is not supported, a footnote excerpt is proposed to detail amounts reported as life contracts that no longer have an associated mortality or morbidity risk. The exposure proposes the footnote for exhibit 5 and requests feedback if a similar footnote is needed for Exhibit 6. Finally, regulator and industry feedback is requested regarding the annual statement instructions for classifying deposit-type contracts in Exhibit 7.

Mr. Bruggeman stated NAIC staff conferred with the Financial Stability (EX) Task Force staff to ensure the proposal would address the current concerns on aggregating contracts without mortality or morbidity risks for liquidity analysis. He also stated that in response to interested party comments, the intent of collecting this information was to identify the amount based on risk type. This is different from the degree of risk as referenced in the interested parties’ comments. John Bauer (Prudential), representing interested parties, stated agreement with the suggested recommendation and noted that interested parties will provide additional information as requested with the proposed exposure.

Ms. Walker made a motion, seconded by Ms. Weaver, to expose the nonsubstantive agenda item with the proposed footnote to Exhibit 5 and the inquiries for additional information regarding Exhibits 6 and 7. The motion passed unanimously. The Working Group directed NAIC staff to notify the Financial Stability (EX) Task Force of the exposure.

d. **Agenda Item 2019-18**

Mr. Bruggeman directed the Working Group to agenda item 2019-18: Other Derivatives. Ms. Gann stated that this nonsubstantive agenda item was re-exposed at the Summer National meeting in response to interested parties’ comments requesting more time to evaluate investments to determine if there would unintended consequences with the proposed accounting guidance. She stated that the proposed revisions clarify the accounting guidance in SSAP No. 86—Derivatives when a derivative is not part of a hedging, income generation or an asset replication transaction. Ms. Gann stated that the exposed revisions clarify that other derivatives shall be reported at fair value and nonadmitted. Ms. Gann stated that the nonadmitted classification is consistent with the current guidance applicable pursuant to SSAP No. 4—Assets and Nonadmitted Assets, as
other derivatives are not currently identified as admitted assets. As the exposed language is a clarification of existing guidance, adoption for year-end 2019 was recommended.

Mr. Bruggeman stated statutory accounting guidance does not override state investment code and does not preclude a permitted or prescribed practice. Joshua Bean (Transamerica), representing the American Council of Life Insurers—ACLI, stated that in conjunction with the North American Securities Valuation Association—NASVA, they have submitted a comment letter to the Capital Adequacy (E) Task Force in response to the referral sent from the Working Group to the Task Force pertaining to this item. He advised that their comment letter requested that Risk Based Capital (RBC) charges not be imposed on structured notes reported as other derivatives and nonadmitted.

Ms. Brown made a motion, seconded by Ms. Mears, to adopt the exposed nonsubstantive revisions to SSAP No. 86 (Attachment One-L). The motion passed unanimously.

5. Reviewed Comments and Considered Action on Exposed Items

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

a. Agenda Item 2017-28

Mr. Bruggeman directed the Working Group to agenda item 2017-28: Reinsurance Credit – Informal Life and Health Reinsurance Drafting Group Recommendations. Ms. Marcotte stated that during the Summer National Meeting, the Working Group exposed for comment four items which were recommended by the informal life and health reinsurance drafting group including SSAP No. 61R—Life and Health Reinsurance disclosures and three A-791 Life and Health Insurance Question and Answers. Ms. Marcotte recommended that the Working Group adopt the nonsubstantive SSAP No. 61R disclosures with paragraph number updates with an initial effective date of Dec. 31, 2020. She noted that the disclosures were originally requested by the Financial Analysis (E) Working Group. Ms. Marcotte also recommended that the Working Group adopt the new A-791 question and answer item regarding contracts with medical loss ratios.

Ms. Marcotte then recommended that the Working Group adopt the A-791 question and answer revisions regarding paragraph 2c with the addition of applying to contracts in effect Jan. 1, 2021. She stated that after discussion with industry representatives, their comments are supportive of the adoption of the exposed QA for A-791, question 2c. She noted that these revisions would prevent risk transfer for group term YRT contracts which have risk limiting features when the reinsurance contract premium exceeds the underlying direct premium. She stated that the interested parties’ recommendation was that this QA have a Jan. 1, 2021 effective date. She stated that while some of the informal regulator comments received by NAIC staff note that they are not in full agreement with the industry provided comments on other non-group YRT contracts, there is agreement on the item exposed and that the exposed language is specific to the described contracts. She noted that NAIC staff also recommends that the Working Group send a notification to the Life Actuarial (A) Task Force as part of their YRT project.

Ms. Marcotte recommended that the Working Group refer to the informal life and health reinsurance drafting group the exposed revisions to the A-791 question and answer update to clarify the phrase “certain non-proportional contracts” to address informal questions received by NAIC staff regarding: 1) the application of the exposed language regarding measurement period and settlement period and, 2) the application of substantially less likely than not. She stated that based on informal input from with various drafting group members, more discussion is needed regarding this question and answer item and she believes that this is an issue that the drafting group can lend some useful expertise. She noted that a few of the technical members did not fully agree on the application of certain wording.

Mr. Bruggeman noted that the Life Actuarial (A) Task Force is continuing their work on the reinsurance credit that a YRT contract can generate under principles-based reserving and a notification would be beneficial

Steve Clayburn (American Council of Life Insurers—ACLI) stated support for a Jan. 1, 2021 effective date of the paragraph 2c A-791 QA.

Mr. Stolte made a motion, seconded by Ms. Travis, to 1) adopt the SSAP No. 61R disclosures with a year end 2020 effective date; 2) adopt the A-791 QA on products subject to medical loss ratios; and 3) adopt the A-791 QA on paragraph 2c regarding group term life yearly renewable term contracts with an effective date of Jan. 1, 2021; and 4) to refer the initial A-791 QA on
the phrases “certain non-proportional contracts” back to the informal drafting group (Attachment One-M). The motion passed unanimously.

b. **Agenda Item 2018-38**

Mr. Bruggeman directed the Working Group to agenda item 2018-38: Prepaid Providers. Ms. Marcotte stated that this nonsubstantive agenda item was exposed during the Summer National Meeting with revisions to emphasize existing guidance that unpaid loss and loss adjusting expense liabilities are established regardless of payments to third parties. She stated industry comments suggested separating guidance by product type.

Tom Finnell (American Health Insurance Plans—AHIP) stated support for the Working Group’s continued work on this topic and looks forward to providing additional feedback as a result of this exposure.

Ms. Malm made a motion, seconded by Ms. Walker, to expose agenda item 2018-38 with revisions to SSAP No. 55—Unpaid Claims, Losses and Loss Adjustment Expenses incorporating a majority of interested parties’ comments. The motion passed unanimously.

c. **Agenda Item 2019-12**

Mr. Bruggeman directed the Working Group to agenda item 2019-12: ASU 2014-17, Business Combinations, Pushdown Accounting. Ms. Gann stated this nonsubstantive agenda item was exposed at the Summer National Meeting with three options presented for Working Group consideration: 1) full rejection of pushdown accounting, 2) allowing pushdown for non-insurance SCAs, or 3) allowing pushdown for non-insurance SEC registrants. She stated that interested parties have requested additional time in order to provide specific examples for consideration. Ms. Gann stated that while re-exposure is recommended, a nonsubstantive revision for year-end 2019 was proposed to clarify in SSAP No. 68—Business Combinations and Goodwill that admitted goodwill is limited to 10% of the acquiring entity’s adjusted capital and surplus, regardless if pushdown was utilized. She stated that the proposed edit is specific to SCAs acquired by an insurance reporting entity. Ms. Gann stated that in order to prevent questions on whether the proposed edit will require amortization of goodwill pushed down to U.S. GAAP SCAs (instead of the U.S. GAAP impairment test), a proposal to separate the existing paragraph 9 into two separate paragraphs was suggested.

Ms. Brown stated support for the proposed edit to clarify the statutory admitted goodwill limitation. She inquired whether additional disclosures will be presented to capture supplemental information on the use of pushdown in the statutory financial statements. Ms. Gann stated that a new agenda item is planned to capture additional goodwill disclosures and the use of pushdown as insurance reporting entities do not appear to currently be including this information in the statutory financial statements. Mr. Bruggeman inquired whether the proposed edit to clarify the 10% admittance limitation should be effective immediately or for year-end 2020. Mr. Stolte and Mr. Smith responded for an immediate effective date.

Ms. Reese stated appreciation for the clarification of the history of goodwill and the assessment of nonsubstantive changes provided in the agenda and indicated that TIAA would be involved in the continued pushdown discussion.

Keith Bell (Travelers) requested clarification of the Working Group direction regarding pushdown disclosures. He stated that there are concerns with pushdown disclosures as entities have pushed down goodwill on a U.S. GAAP basis, not a statutory accounting basis. Ms. Gann stated that the existing guidance in SSAP No. 68, paragraph 4 provides the calculation of goodwill and explicitly encompasses acquired SCAs reported on the basis of the audited U.S. GAAP equity of the investee (entities captured under paragraph 8.b.iii of SSAP No. 97.) Ms. Gann stated that the calculation of goodwill is different between U.S. GAAP and SAP, and if goodwill was pushed down on the basis of the U.S. GAAP calculation, it would seem that the existing guidance in SSAP No. 68 was not followed. Mr. Bell stated that in order to obtain a clean audit opinion for an SCA, pushdown may have been required on the basis of U.S. GAAP and inquired if the requested disclosures would only apply to U.S. GAAP SCA’s. Mr. Bruggeman stated anticipated disclosures would detail the amount of goodwill pushed down if a reporting entity directly purchased a SCA. He stated that the disclosures would likely include only SCAs reported on the basis of U.S. GAAP equity and requested feedback when the agenda item is exposed.

Ms. Brown made a motion, seconded by Mr. Stolte, to adopt the clarification edit indicating that goodwill from an insurance reporting entity’s acquisition of an SCA that is pushed down and reported on the SCA’s financial statements is subject to the

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10% admittance limitation as a nonsubstantive change effective for year-end 2019, and to separate SSAP No. 68, paragraph 9 into two paragraphs. This motion also included re-exposure of agenda item 2019-12 with a request for comments on the three options for future consideration of pushdown and the request of explicit examples on the historical use of pushdown. The motion passed unanimously (Attachment One-N). The Working Group also directed NAIC staff to develop a new agenda item to capture statutory accounting disclosures on the use of pushdown and other goodwill/intangible asset items.

d. Agenda Item 2019-14

Mr. Bruggeman directed the Working Group to agenda item 2019-14: Attribution of Goodwill. Ms. Gann stated this nonsubstantive agenda item is a disclosure item as when a reporting entity purchases a holding company, and the holding company owns multiple entities, goodwill shall be allocation to each entity at the time of purchase. She stated that comments received from interested parties on this item were combined with the comments received for agenda item 2019-12 and requested additional time for assessment. Ms. Gann stated that although this agenda item is strictly a disclosure item, and is not planned for data-capture, it may be difficult to compile the disclosure information for year-end 2019 reporting. As such, re-exposure could occur to provide additional time for comments and still allow for disclosures to be adopted for year-end 2020. Ms. Gann suggested that the Working Group direct NAIC staff to revise the Sub-1 SCA filing template to capture this information beginning with Sub-1 submissions in 2020.

Ms. Walker made a motion, seconded by Mr. Dudek, to re-expose agenda item 2019-14 and directed NAIC staff to revise the Sub-1 filing template to capture this information for new SCA acquisitions. The motion passed unanimously.

e. Agenda Item 2019-20

Mr. Bruggeman directed the Working Group to agenda item 2019-20: Rolling Short-Term Investments. Ms. Gann stated that this nonsubstantive agenda item was originally exposed during the Summer National Meeting to address certain investments that were structured to mature at or around 364 days in order to be classified as short-term investments, with those investments being rolled or renewed. She stated that the definition of a cash equivalent is an investment, that when acquired, has a remaining maturity of three months or less; while a short-term investment, when acquired, has a remaining maturity of one year or less. Ms. Gann stated that while investments default to a long-term reporting schedule, if they meet the maturity date parameters at acquisition, they are reported as cash equivalents or short-term investments. She stated that examples have risen where entities purchase affiliated investments that are scheduled to mature within one year, however, the investments continuously roll or have the expectation of being renewed or rolled with recurring short-term maturity dates. Under existing statutory accounting guidance, these investments are continuously reported as short-term investments and this reporting results with favorable RBC charges and avoids other requirements imposed on long-term investments, including the requirement to obtain an NAIC designation.

Ms. Gann stated this agenda item proposes that if a short-term investment is expected to renew, it shall be reported as a long-term investment. Further, if a short-term investment is renewed or rolled, upon subsequent renewal, it shall be reported as a long-term investment, in effect acting as a tainting rule to prevent continuous reporting as a short-term investment. Ms. Gann stated that comments from interesting parties expressed concerns that cash pooling arrangements were not excluded from the exposed short-term rolling guidance. She stated cash pools were not originally excluded as they are not currently addressed in SSAP No. 2R—Cash, Cash Equivalents, Drafts and Short-Term Investments, however from information received entities have been reporting pooling arrangements as cash equivalents. She stated NAIC staff recommends exposure of this agenda item with revisions to exclude qualifying cash pooling arrangements as defined in agenda item 2019-42 from the rolling short-term guidance and to request industry and regulator feedback on other investments that should be considered in scope of the short-term rolling guidance, or excluded from the guidance and permitted to be continuously reported as short-term. In response to comments received on other investments, Ms. Gann stated NAIC staff does not recommend expanding exemptions for affiliate loans or collateral loans and noted that collateral loans already receive favorable RBC charges under their designation reporting line on Schedule BA – Other Long-Term Invested Assets. She also indicated that using re-underwriting provisions as a threshold for continuous short-term reporting may be difficult for regulators and auditors to assess.

Lyle Rudin (State Farm), representing interested parties, stated support for the cash pool exemption from the proposed short-term rolling guidance and stated that they will review the qualifying conditions for cash pools in that exposure.
Ms. Belfi made a motion, seconded by Ms. Weaver, to expose agenda item 2019-20 with the revisions to exclude qualifying cash pools from the short-term rolling restrictions and to request comments on other investments that should be considered within or excluded from the short-term rolling restrictions. The motion passed unanimously.

f. Agenda Item 2019-24

Mr. Bruggeman directed the Working Group to agenda item 2019-24: Levelized and Persistency Commission. Ms. Marcotte stated that during the Summer National Meeting, the Working Group exposed nonsubstantive revisions to SSAP No. 71—Policy Acquisition Costs and Commissions to clarify the existing levelized commissions guidance and provide additional guidance regarding commissions based on policy persistency. She stated that the exposed recommendations were intended to be consistent with the original intent of SSAP No. 71 as well as the Statutory Statement of Concept on Recognition, which states that liabilities require recognition as they are incurred and accounting treatments which tend to defer expense recognition do not generally represent acceptable SAP treatment. Ms. Marcotte noted that three comment letters were received from the original exposure. For the current National Meeting, Ms. Marcotte recommended that the Working Group expose the agenda item with additional NAIC staff modifications regarding persistency and levelized commission guidance to allow for further discussion. She stated that the intent of the additional revisions was to focus on levelized commission arrangements, particularly those that are currently being miscategorized.

In response to comments received about the intent the guidance, Ms. Marcotte stated that Issue Paper No. 71—Policy Acquisition Costs and Commissions, paragraph 10, identifies the pre-codification statutory accounting guidance which is the basis for the existing SSAP No. 71 guidance. She stated that the pre-codification guidance quoted in the 1996 issue paper also notes the same concerns regarding reporting entities use of levelized commission arrangements which operate as funding agreements. She stated that the referenced paragraph provides that, “The accounting treatment for certain transactions, characterized as levelized commissions, which results in enhancement of surplus, has been determined to be inappropriate for statutory reporting.” She stated that the intent of SSAP No. 71 for levelized commissions is that repayment of a funding advance, even if it has been labeled as a commission, requires the establishment of a liability for the full amount of unpaid principal and accrued interest.

Ms. Marcotte noted that additional edits proposed for exposure attempts to address some of the industry concerns on traditional persistency commissions. She stated that one of the challenges is trying to make a distinction between a true persistency commission and the use of a levelized commission arrangement that functions as a funding agreement as described in SSAP No. 71. She noted that is more difficult because some of the identified funding agreements are calling the repayment a persistency commission. She stated that the intent of the exposed guidance was not to change the annual accrual of normal persistency commission, but rather to require accrual of levelized commission arrangements which are being termed persistency. Some of the proposed edits remove previously exposed revisions and add clarifying phrases regarding persistency commission accrual, with the addition of clarifying phrases to assist with identifying levelized commission funding agreements and redrafting of the footnote to remove double negative wording.

Ms. Marcotte noted that the levelized commission arrangements described to NAIC staff had a third-party (“super-agent”) paying agents upfront, which represents a large commission similar to normal initial sales commission policy acquisition costs for business directly written on behalf of the reporting entity in the year of policy issuance. She stated that repayment to the third party by the reporting entity was expected, but not necessarily guaranteed and was over a period of years. She stated that consistent with the guidance in SSAP No. 71, paragraph 4, the levelized commission arrangement was repaying the super-agent amounts “which are less than the normal first year commissions but exceed the normal renewal commissions.”

Marty Carus (Marty Carus Consulting) noted that they looked forward to reviewing the updated revisions during the exposure. He stated that a significant segment of the industry view the change as substantive and that the revisions impact a wide range of products, and the Working Group should take this into account when reviewing this item. He stated that the NAIC staff comments noted preliminary discussion with the Life Actuarial (A) Task Force staff regarding the industry comments about Principles-Based Reserving (“PBR”) methodology and he recommended additional dialogue with Task Force on this aspect. Ms. Marcotte stated that the PBR methodology takes commission into account when projecting future cash flows. However, per discussion with the Task Force staff, the projected future cash flows would not be double-counted if there is an existing liability. She requested if there is specific Valuation Manual language in VM-20 and VM 21 that needs to be addressed in the coordination process, to provide specific concerns. Mr. Bruggeman noted that his understanding is that PBR takes into account future commissions when determining the present value of future cash flows, but would not set up an additional liability if
there is an existing liability. Mr. Bruggeman noted that it would be beneficial to notify the Life Actuarial (A) Task Force of the exposure.

Lynn Kelley (Delaware Life) representing interested parties, stated support for the consideration of their comments and the additional exposure to allow time for discussion to distinguish between levelized commission arrangements and other commission arrangements.

Ms. Walker made a motion, seconded by Ms. Travis, to expose nonsubstantive revisions to SSAP No. 71, modified from the prior exposure as discussed during the meeting, regarding levelized commissions and to notify the Life Actuarial (A) Task Force of the exposure. The motion passed unanimously.

6. Considered Maintenance Agenda—Pending Listing—Exposures

Mr. Dudek made a motion, seconded by Ms. Mears to move agenda items 2019-32 through 2019-49 to the active listing, and expose all items for comment, with distinction of each item as either substantive or nonsubstantive, and with corresponding referrals as recommended by NAIC staff. The motion passed unanimously.

a. Agenda Item 2019-32

Mr. Bruggeman directed the Working Group to agenda item 2019-32: Look-Through with Multiple Holding Companies. Ms. Gann stated that this nonsubstantive agenda item was drafted from Working Group direction at the Summer National Meeting. Ms. Gann stated that it was agreed that multiple holding companies in a structure could be looked-through if each holding company qualifies with the look-through requirements in SSAP No. 97. With this conclusion from the Summer National Meeting, interested parties had requested that this be clarified within the SAP guidance.

In response to an inquiry from Mr. Bruggeman, there was no objection to exposure.

b. Agenda Item 2019-33

Mr. Bruggeman directed the Working Group to agenda item 2019-33: SSAP No. 25 – Disclosures. Ms. Gann stated that this nonsubstantive agenda item has been drafted to data-capture disclosures from SSAP No. 25—Affiliates and Other Related Parties. She noted that disclosures from SSAP No. 25 are currently completed in a narrative (pdf) format. With the proposal to data-capture disclosures, the regulators can aggregate and query party relationships. She noted that there are items that are proposed to be data-captured that are not explicitly included in the narrative description but are presumed to be currently captured in the existing general references for “information considered necessary to obtaining an understanding of the effects of the transactions on the financial statements.” She stated that all of these instances are specifically noted in the agenda item. Ms. Gann stated that this item is separate from agenda item Ref #2019-34, which is considering revisions to clarify what is captured in SSAP No. 25, in order to follow a separate work stream to allow for year-end 2020 data capturing. If the revisions being considered under the separate agenda item are adopted by June 2020, then those disclosures may modify or expand the data templates proposed in this agenda item.

In response to an inquiry from Mr. Bruggeman, there was no objection to exposure.

c. Agenda Item 2019-34

Mr. Bruggeman directed the Working Group to agenda item 2019-34: Related Parties, Disclaimer of Affiliation and Variable Interest Entities. Mr. Stultz stated that the intent of this nonsubstantive agenda item is to clarify identification of related parties and affiliates in SSAP No. 25 and to incorporate new disclosures to ensure regulators have a full picture of complicated business structures. He noted that this agenda item intends to have the related party and affiliate reporting more closely match that of SEC filings, and this will be done by adding language from SEC guidance and by clarifying the disclaimer of affiliation or control from a statutory reporting standpoint. He noted that the proposed revisions intend to address the following key aspects: 1) clarify the identification of related parties and ensure that any related party identified under U.S. GAAP or SEC reporting requirements would be considered a related party under statutory accounting principles; 2) clarify that non-controlling ownership over 10% results in a related party classification regardless of any disclaimer of control or disclaimer of affiliation; 3) clarify the impact of a disclaimer of control or disclaimer of affiliate under SAP. He stated that disclaimers of control or
affiliation may impact holding company group allocation or reporting as an SCA under SSAP No. 97, but do not eliminate the classification as a “related party” and the disclosure of material transactions as required under SSAP No. 25; and 4) propose rejection of several FASB Accounting Standards Updates related to Variable Interest Entities (VIE) and Consolidation (FASB Codification Topic 810). Mr. Stultz stated the concept of consolidation has been rejected for statutory accounting, as such, the main concepts included in the FASB ASUs discussed in this agenda item are proposed to be rejected for statutory accounting. While this agenda item is not intended to change the concept of consolidation for statutory accounting, Mr. Stultz notes that there is a need and justification for enhanced disclosures to supplement the reporting process of related parties and affiliates within a company structure. Mr. Stultz noted that the requirements for the SEC filings do not allow for a disclaimer of affiliation, as is allowed in the Insurance Holding Company System Regulatory Act (#440) and the Insurance Holding Company System Model Regulation (#450) and included in Appendix A-440.

In response to an inquiry from Mr. Bruggeman, there was no objection to exposure.

d. **Agenda Item 2019-35**

Mr. Bruggeman directed the Working Group to agenda item 2019-35: Update Withdrawal Disclosures. Ms. Marcotte stated that the Working Group updated the life, health and separate account liquidity disclosures to provide more granularity of the withdrawal characteristics by product type. These updates were developed by the Financial Stability (EX) Task Force and were adopted in agenda item 2018-28: Updates to Liquidity Disclosures, with an effective date of year-end 2019. Ms. Marcotte stated that this nonsubstantive agenda item proposes minor clarifying edits to the disclosures identified subsequent to the adoption of the related 2019 annual statement blanks proposal. She stated that revisions are proposed as follows: 1) add a consistency revision to SSAP No. 51R—Life Contracts to ensure separate account guaranteed products are referenced in all applicable paragraphs of the withdrawal characteristics disclosures; 2) correct an identified inconsistency in one of the new disclosures that was added regarding products that will move from the reporting line of having surrender charges at 5% or more to the reporting line of surrender charges at less than 5%. A clarification is being recommended to ensure consistency in annual statement reporting; and 3) add a cross reference from SSAP No. 56—Separate Accounts to the existing disclosures by withdrawal characteristics in SSAP No. 51R and SSAP No. 61R as the disclosures include separate account products.

In response to an inquiry from Mr. Bruggeman, there was no objection to exposure.

e. **Agenda Item 2019-36**

Mr. Bruggeman directed the Working Group to agenda item 2019-36: Expanded MGA and TPA Disclosures. Ms. Marcotte stated that this nonsubstantive agenda item was drafted pursuant to a request from two states that the existing annual statement disclosure regarding managing general agents or third-party administrators be expanded to include additional information. She stated that state insurance regulators and policyholders should be able to fully understand the level and extent core services and binding authority are provided by managing general agents (MGA) and third-party administrators (TPA). The state sponsors have advocated that this understanding would also help in the assessment of the Enterprise Risk Management (ERM) framework, Own Risk Solvency Assessment (ORSA) report, market analysis reviews, operational risks, group analysis, and recovery and resolution considerations. Ms. Marcotte noted that the enhanced disclosure would list any MGA and TPA and the respective core service(s) provided to the insurer or authority granted by the insurer. Additionally, the affiliated, related party or unaffiliated relationship would be disclosed, along with whether the entity is independently audited and/or bonded.

In response to an inquiry from Mr. Bruggeman, there was no objection to exposure.

f. **Agenda Item 2019-37**

Mr. Bruggeman directed the Working Group to agenda item 2019-37: Surplus Notes – Enhanced Disclosures. Mr. Pinegar stated this nonsubstantive agenda item was drafted from the Working Group’s request that additional disclosures be captured in SSAP No. 41R—Surplus Notes. He stated the disclosure reflects items detailed in the current surplus note data call. While numerous disclosures are proposed, key concepts relate to the cashflows (or lack thereof) between the surplus note issuer and holder, related party identification, descriptions of the types and fair value of the assets received, and information regarding the third-party financial guarantor, which is commonly referred to a source of liquidity for the surplus note issuer.
In response to an inquiry from Mr. Bruggeman, there was no objection to exposure.

g. Agenda Item 2019-38

Mr. Bruggeman directed the Working Group to agenda item 2019-38: Financing Derivatives. Ms. Gann stated this topic was discussed a few years ago, however, after reviewing the year-end 2018 financial statements, the issue is being reintroduced as a nonsubstantive revision to clarify the reporting of derivatives with financing components on derivative schedules DB-A and DB-B. NAIC Staff stated that financing derivatives represent situations where the premium due as a result of acquiring or writing a derivative is paid throughout the derivative term or at maturity. She stated that the agenda item proposes the elimination of the allowance of net reporting, with a requirement for gross reporting for derivatives purchased or sold. Ms. Gann said that the current process to net the derivative asset and premium due generally results in a net zero-value at inception, which does not present a clear picture on derivative activity in the statutory financial statements. Ms. Gann stated that the original discussion on this item focused on acquired financed derivatives, however, from the review of the 2018 financial statements, it was identified that reporting entities use also use financing components in the writing of derivatives. She stated that the proposed revisions to SSAP No. 86—Derivatives would require gross reporting of derivatives, without the effect of financing premiums due or payable and would present the true financial asset and liability position associated with the use of derivatives. She noted that proposed concepts included in the agenda item suggest revisions to the RBC calculations so that the premium due can be considered similar to derivative collateral. If the statutory accounting revisions are supported, a future referral would be considered to the Capital Adequacy (E) Task Force for consideration of these RBC changes.

In response to an inquiry from Mr. Bruggeman, there was no objection to exposure.

h. Agenda Item 2019-39

Mr. Bruggeman directed the Working Group to agenda item 2019-39: Acceptable Collateral for Derivatives. Mr. Pinegar stated that a potential misinterpretation exists in the annual statement instructions regarding the reporting of collateral for derivatives. Currently the instructions indicates reporting “net positive variation margin,” which by definition only reflects collateral flows due to daily changes in market values. He stated that an additional type of margin should be considered – i.e. initial margin, which reflects the original collateral given to initiate a position. SSAP No. 86 refers to disclosures of “net assets held,” which infers a totality of assets. Mr. Pinegar stated this nonsubstantive agenda item is to clarify that collateral held reflects both initial and variation margin.

In response to an inquiry from Mr. Bruggeman, there was no objection to exposure.

i. Agenda Item 2019-40

Mr. Bruggeman directed the Working Group to agenda item 2019-40: Reporting of Installment Fees and Expenses. Ms. Marcotte noted that SSAP No. 53—Property Casualty Contracts—Premiums, paragraph 6, provides specific guidance that allows for installment fees that meet specified criteria to be excluded from premium and reported as other income. She stated that an installment fee is the amount the policyholder pays if they make the choice to pay their premium on an installment basis and that the fee is allowed to be excluded from premium income if it is an avoidable amount by the policyholder and the policy would not be cancelled for nonpayment of the installment fee.

Ms. Marcotte stated that NAIC staff has received regulator requested clarifications regarding potential diversity in the application of the SSAP No. 53 installment fee guidance. She stated that the recommendation in the nonsubstantive agenda item is to expose revisions to SSAP No. 53 and request comments. She stated that the revisions note that the installment fee and services charges guidance should be applied narrowly to the specific situation described and not analogized to exclude other fees from written premium. Ms. Marcotte stated that in addition, notification of the exposure to the Casualty Actuarial and Statistical (C) Task Force and the Property and Casualty Risk Based Capital (E) Working Group was recommended. She stated that the questions for exposure are as follows:

- Should the Working Group develop guidance to allow installment fee expenses associated with fees that are reported in other income according to the criteria in SSAP No. 53 be permitted reported in or as an expense in “Other Income?”
• If included in Other Income, there is no line to report “other expenses” in the annual statement blank, therefore should the expense be classified as a contra revenue in or an “Aggregate Write-Ins for Miscellaneous Income”?

• Installment fees and expenses are often immaterial for property and casualty except for nonstandard writers. Should diversity be allowed in reporting installment fee expenses (that is optional to report as other expense category of contra other revenue “Aggregate Write-Ins for Miscellaneous Income”), particularly for immaterial amounts?

In response to an inquiry from Mr. Bruggeman, there was no objection to exposure with the request for comments on the noted questions and with notifying the Casualty Actuarial and Statistical (C) Task Force and the Property and Casualty Risk Based Capital (E) Working Group of the exposure.

j. Agenda Item 2019-41

Mr. Bruggeman directed the Working Group to agenda item 2019-41: SSAP No. 43R – Financial Modeling. Mr. Pinegar stated the current RMBS/CMBS multi-step modeling practice is the only remaining approach that utilizes breakpoints to determine final NAIC designations. During the Spring National Meeting, the Working Group adopted modifications to eliminate reference to multi-step modeling for modified filing exempt (MFE) securities. He stated this nonsubstantive agenda item was in conjunction with an expected proposal from the Valuation of Securities (E) Task Force, in which they are also proposing to eliminate multi-step modeling. Mr. Bruggeman stated that this agenda item was proposed to remain current with the Task Force and that the exposure of this agenda item will be removed from the exposure listing if the Task Force does not expose their corresponding agenda item.

In response to an inquiry from Mr. Bruggeman, there was no objection to exposure.

k. Agenda Item 2019-42

Mr. Bruggeman directed the Working Group to agenda item 2019-42: Cash Equivalent – Cash & Liquidity Pools. Mr. Pinegar stated this nonsubstantive agenda item arose as a result of the short-term rolling agenda item (Ref #2019-20), in which interested parties commented that cash pools were not appropriately scoped out of the proposed short-term restriction guidance. He stated cash pools are techniques in which affiliates combine excess cash in order to earn additional interest, access additional short-term investment markets, and improve liquidity management. Mr. Pinegar stated that this agenda item proposes to allow cash pools that meet certain requirements to be reported as cash equivalents. He stated several safeguards were proposed including restrictions related to investments, liquidity requirements and the disallowance of notional pooling in where one participant can cover the expenses of another.

In response to an inquiry from Mr. Bruggeman, there was no objection to exposure.

l. Agenda Item 2019-43

Mr. Bruggeman directed the Working Group to agenda item 2019-43: ASU 2017-11, Earning Per Share, Distinguishing Liabilities from Equity, Derivatives & Hedging. Mr. Pinegar stated this ASU primarily details accounting guidance for financial instruments with “down round” features. A down round feature is a provision in certain financial instruments that allows for a reduction in an option’s strike price in certain situations. He stated resultant of this ASU, down round features are allowed to be considered indexed to stock in which the value of the instrument is reclassified from a liability to equity. Mr. Pinegar stated that this specific guidance is proposed for rejection, however the nonsubstantive agenda item proposes language for SSAP No. 5R and SSAP No. 72—Surplus and Quasi-Reorganizations to reflect that freestanding financial instruments with characteristics of both liability and equity shall be reported as a liability to the extent the instrument embodies an unconditional obligation of the issuer. Mr. Pinegar stated that while this language is new for these particular SSAP’s, the liability versus equity concept is not new to statutory accounting. He stated that the concepts are materially consistent with guidance that currently exists in Exhibit A in SSAP No. 104R—Share-Based Payments.

In response to an inquiry from Mr. Bruggeman, there was no objection to exposure.
m. **Agenda Item 2019-44EP**

Mr. Bruggeman directed the Working Group to agenda item 2019-44EP: Editorial Updates. Ms. Marcotte stated that this nonsubstantive agenda item proposes editorial revisions to update paragraph references for SSAP No. 62R—Property and Casualty Reinsurance and update references to the annual statement instructions to reflect proper titles. In order to ensure revisions are in the 2020 AP&P manual, a shortened exposure period was suggested ending Dec. 20, 2019.

In response to an inquiry from Mr. Bruggeman, there was no objection to exposure.

n. **Agenda Item 2019-45**

Mr. Bruggeman directed the Working Group to agenda item 2019-45: ASU 2013-11, Income Taxes – Presentation of Unrecognized Tax Benefits. Mr. Pinegar stated this ASU addressed the financial statement presentation of unrecognized tax benefits. An unrecognized tax benefit represents a tax position that does not meet the more-likely-than-not recognition threshold and in essence is a tax deduction that has a less than 50 percent likelihood of being utilized or upheld. He stated that this nonsubstantive agenda item proposes to reject the ASU as items having less than a 50 percent likelihood of being upheld require current year expense recognition per SSAP No. 101—Income Taxes.

In response to an inquiry from Mr. Bruggeman, there was no objection to exposure.

o. **Agenda Item 2019-46**

Mr. Bruggeman directed the Working Group to agenda item 2019-46: ASU 2016-14, Presentation of Financial Statements for Not-for-Profit Entities. Mr. Pinegar stated this ASU requires financial statement presentation of two classes of net assets for Not-For-Profit entities – with donor restrictions and without donor restrictions. He stated this nonsubstantive agenda item proposes to reject the ASU as not being applicable for statutory accounting.

In response to an inquiry from Mr. Bruggeman, there was no objection to exposure.

p. **Agenda Item 2019-47**

Mr. Bruggeman directed the Working Group to agenda item 2019-47: VM-21 Grading. Ms. Marcotte stated that at the Summer National Meeting, the NAIC Executive and Plenary adopted comprehensive revisions drafted by the Life Actuarial (A) Task Force to Section 21 of the Valuation Manual Requirements for Principle-Based Reserves for Variable Annuities (VM-21) and also to Actuarial Guideline 43, Commissioners Annuity Reserve Valuation Method (AG 43) which provide guidance on reserving for variable annuities. The revisions adopted to VM-21 and AG 43 represent a change in accounting principle that must be recognized as a change in valuation basis under SSAP No. 51R—Life Contracts.

Ms. Marcotte stated that this nonsubstantive agenda item proposes revisions to SSAP No. 51R—Life Contracts and reference to the additional grade-in disclosure requirements in SSAP No. 3—Accounting Changes and Corrections of Errors for reporting years beginning Jan. 1, 2020. She stated that the revisions are to remove the existing guidance, which prohibits grading-in changes in valuation basis unless provided for in the statement, to allow a grade-in for changes in valuation basis if permitted by the statement or the Valuation Manual in section 21 Requirements for Principle-Based Reserves for Variable Annuities (VM-21). She stated that in deferring to VM-21 on grade-in options there will be less comparability in reporting because there is more optionality in reserve reporting.

Ms. Marcotte stated that to address the issue of lack of comparability, additional disclosure regarding grade-in has been proposed. She stated that the proposed revisions to SSAP No. 51R expand the disclosure for changes in valuation basis as a change in accounting principle under SSAP No. 3 to also include details regarding grade-ins of changes in valuation basis, including the grade-in period applied, the remaining amount to be graded-in, remaining time for the grade-in period and the initial grade-in amount and any adjustments to the original amount. She noted that a reference in SSAP No. 3 regarding additional disclosures of grade-in features is also proposed.

Ms. Marcotte stated that a change in valuation basis under SSAP No. 51R is recognized through surplus. As the unrecognized graded-in reserve represents an unrecognized adjustment to surplus, the proposed revisions require the unrecognized grade-in
amount from a change in valuation basis, if resulting with an increase in reserves (decrease from surplus), to be reported as an allocation from unassigned funds to special surplus until the amount has been fully graded into unassigned funds. She stated that the proposed reclassification from unassigned funds to special surplus does not reduce total surplus. She said this proposal is to provide transparency regarding the increased reserve amount that has not been reflected into surplus. As amounts are graded-in to reduce surplus, the amount in special surplus is reclassified to unassigned funds.

Mr. Bruggeman noted that statutory accounting does not typically allow optionality and providing disclosure for comparability and having some accounting transparency seems to be useful. Ms. Marcotte noted that NAIC staff plans a future agenda item regarding exercise of Commissioner Discretion in the Valuation Manual.

In response to an inquiry from Mr. Bruggeman, there was no objection to exposure.

q. Agenda Item 2019-48

Mr. Bruggeman directed the Working Group to agenda item 2019-48: Disclosure Update for Reciprocal Jurisdiction Reinsurers. Mr. Stultz stated that on June 25, 2019, NAIC Executive Committee and Plenary adopted revisions to the Credit for Reinsurance Model Law (#785) and the Credit for Reinsurance Model Regulation (#786) to incorporate relevant provisions from the “Bilateral Agreement Between the United States of America and the European Union on Prudential Measures Regarding Insurance and Reinsurance” and the “Bilateral Agreement Between the United States of America and the United Kingdom Regarding Insurance and Reinsurance” (collectively referred to as the Covered Agreement). He stated that while developing the blanks proposal to include reciprocal jurisdictions reinsurers a needed change to the disclosure was identified. He stated that the purpose of this nonsubstantive agenda item is to revise one disclosure in SSAP No. 62R—Property and Casualty Reinsurance to reference “reciprocal jurisdictions.”

In response to an inquiry from Mr. Bruggeman, there was no objection to exposure.

r. Agenda Item 2019-49

Mr. Bruggeman directed the Working Group to agenda item 2019-49: Retroactive Reinsurance Exception. Ms. Marcotte noted that at the Summer National Meeting, the Working Group, the Casualty Actuarial and Statistical (C) Task Force and the Surplus Lines (C) Task Force received a request from the Committee on Property and Liability Financial Reporting (COPLFR) of the American Academy of Actuaries Working Group. She stated that the request was to clarify the accounting and reporting for retroactive reinsurance which meets the SSAP No. 62R—Property and Casualty Reinsurance exceptions to be accounted for as prospective reinsurance.

Ms. Marcotte stated that the request was for the various NAIC groups to develop guidance to address the inconsistencies in application of the reinsurance accounting and reporting guidance, particularly the impact on Schedule P – Analysis of Losses and Loss Expenses (Schedule P) and data which is utilized for RBC. She stated that the recommendation is to request comments and to ask for industry and regulator volunteers to assist with developing guidance. She stated that the request asks for guidance on both the accounting and reporting for retroactive contracts which are accounted for prospectively, including situations in which both the ceding entity and assuming entity are members of the same group and are consolidated in the same Combined Annual Statement as well as the reporting method to be used if the ceding entity and assuming entity are not in the same group.

Ms. Marcotte stated that comments are specially requested regarding the preferred approaches to reporting and the advantages and disadvantages to each approach being used, including both the Schedule P (and related loss analysis) and risk-based capital impacts. She stated that a Working Group notification to the Casualty Actuarial (C) Task Force of the request for comments and to highlight the need for coordination will occur with exposure.

In response to an inquiry from Mr. Bruggeman, there was no objection to exposure.

7. Considered Maintenance Agenda—Active Listing
   a. Agenda Item 2019-25
Mr. Bruggeman directed the Working Group to agenda item 2019-25: Working Capital Finance Notes. Ms. Marcotte noted that the materials contain the proposed substantive revisions incorporating the industry proposed language for the six specific items directed by the Working Group at the Summer National Meeting to SSAP No. 105—Working Capital Finance Investments. She stated that the revisions: 1) remove the requirement that the SVO determine if the International Finance Agent is the functional equivalent of the U.S. regulator; 2) remove the finance agent prohibitions on commingling; 3) remove duplicative text regarding exercise of investor rights; 4) remove requirements, with revisions allowing the SVO to determine if a first priority perfected interest has been obtained; 5) lower the independent review requirements to allow independent review of the finance agent by either audit or through an internal control report; and 6) change the default provisions from 15 to 30 days so the default date and the cure period are consistent.

Ms. Weaver made a motion, seconded by Mr. Bartlett, to expose the substantively revised SSAP No. 105—Working Capital Finance Investments and direct NAIC staff to draft an issue paper. The motion passed unanimously.

8. Discussed Other Matters

a. Agenda Item 2019-21: SSAP No. 43R – Equity Interests

Ms. Gann stated a conference call to discuss agenda item 2019-21 is scheduled for Jan. 8, 2020. She stated a call was preferable so sufficient time can be dedicated to the topic and to allow multiple commenters the opportunity to participate in the discussion. Mr. Bruggeman stated that final resolution of this topic is not expected on the conference call.

b. Agenda Item 2018-07: Surplus Notes

Mr. Pinegar stated that in response to the Working Group direction from the Summer National Meeting, a data call regarding “linked” surplus notes was developed and issued. He reminded that a data call response is not required if reporting entities do not have issued surplus notes that meet the criteria detailed in the instructions and that submissions are due Dec. 31, 2019. Mr. Bruggeman stated this data call was issued as there was not sufficient time to data capture the information in year-end 2019 statutory financial statements. He stated any questions should be directed to NAIC staff or regulators.

c. Agenda Item 2016-20: Credit Losses

Mr. Pinegar stated that since the ASU regarding credit losses was originally released in 2016, numerous technical updates have been issued from the FASB and further updates continue as evidenced by a subsequent update issued in late November 2019. He stated that on Oct. 18, 2019, the FASB board voted unanimously to delay the credit loss standard for most entities until 2023. While large SEC filers are required to follow the standard in 2020, all remaining entities were granted a reprieve until 2023. Mr. Pinegar stated NAIC staff recommends continual monitoring of FASB for updates and will keep the Working Group informed regarding developments. Mr. Bruggeman stated only large SEC filers will be required to follow the credit loss standard in the near future and the Working Group will continue to defer and monitor for updates.

d. AP&P Update – Manual & Electronic Version

Mr. Pinegar stated that the reserving process to obtain a printed Accounting Practices and Procedures Manual will continue, and reservations must be made by Dec. 13, 2019 in order to secure a printed version. He stated those who do not reserve printed copies by this date may only have an electronic version available. Ms. Gann stated that members of the Working Group will receive complementary printed versions, however if additional copies are requested, the reservation process should be utilized.

e. U.S. GAAP Exposures

Mr. Pinegar stated that NAIC staff has reviewed U.S. GAAP exposures and noted that comments during the exposure periods are not recommended, but a review will occur once issued as final ASUs under the statutory maintenance process. Mr. Pinegar briefly discussed two such items. First discussed was an exposed ASU regarding proposed guidance for cash flow hedges and FASB’s proposal to allow prospective or retrospective review of hedged risk. The second topic discussed was FASB’s Reference Rate Reform project. This initiative is in conjunction with the move away from LIBOR as a primary reference rate. Mr. Pinegar stated that once the rate reform ASU is issued, NAIC staff will immediately review and will likely request an interim exposure of an applicable agenda item.
Mr. Monahan (ACLI) stated that the ACLI is pleased with the Working Group’s attention to the Reference Rate Reform project as the FASB has indicated an expected release in early 2020. He stated this project provides temporary relief for certain hedging and contract modifications due to the discontinuance of LIBOR as a primary reference rate. He stated that the ACLI was supportive of the FASB proposal. Mr. Monahan also stated that the ACLI continues to work with FASB staff in an attempt to obtain additional temporary relief for ASU 2018-12, Targeted Improvements to the Accounting for Long-Duration Contracts. He stated the ACLI’s concerns are large SEC filers will be required to follow the standard earlier than smaller reporting companies and entities, and this misalignment of accounting guidance could negatively impact the reinsurance marketplace. Due to the significant volume of reinsurance placed, the ACLI will continue to seek a favorable resolution with FASB.

Mr. Bruggeman stated that Jan. 31, 2020, is the public comment deadline for all exposures other than the editorial agenda item (Ref #2019-44EP), which has a comment deadline of December 20, 2019.

Having no further business, the Statutory Accounting Principles (E) Working Group adjourned.
The Statutory Accounting Principles (E) Working Group of the Accounting Practices and Procedures (E) Task Force conducted a conference call Jan. 8, 2020. The following Working Group members participated: Dale Bruggeman, Chair (OH); Carrie Mears, Vice Chair (IA); Richard Ford (AL); Kim Hudson (CA); William Arfanis (CT); Danielle Hopp (DE); Eric Moser and Kevin Fry (IL); Stewart Guerin (LA); Judy Weaver (MI); Doug Bartlett (NH); Joe DiMemmo (PA); Doug Stolte (VA); Jamie Walker (TX); and Elena Vetrina and Randy Milquet (WI).

1. **Adopted Editorial Revisions from Agenda Item 2019-44EP**

   Mr. Bruggeman directed the Working Group to agenda item 2019-44EP: Editorial Updates. Robin Marcotte (NAIC) stated that during the 2019 Fall National Meeting, the Working Group exposed editorial revisions to *Statement of Statutory Accounting Principles (SSAP)* No. 62—Property and Casualty Reinsurance throughout the NAIC Accounting Practices and Procedures Manual (AP&P Manual) to update references to the Annual Statement Instructions. Ms. Marcotte stated that the editorial revisions were exposed with a shortened comment period to allow for the edits to be reflected in the “As of March 2020” AP&P Manual. She stated that no comments were received.

   Mr. Hudson made a motion, seconded by Ms. Walker, to adopt the exposed editorial revisions (Attachment One A1). The motion passed unanimously.

2. **Reviewed Comments on Agenda Item 2019-21: SSAP No. 43R – Equity Instruments**

   The Working Group held a public hearing to review comments (Attachment One A2) on agenda item 2019-21.

   Mr. Bruggeman directed the Working Group to agenda item 2019-21: SSAP No. 43R – Equity Instruments. Julie Gann (NAIC) stated that during the 2019 Summer National Meeting, the Working Group exposed revisions to SSAP No. 43R—Loan-Backed and Structured Securities to exclude collateralized fund obligations (CFOs), and similar structures that reflect underlying equity interests, from the scope of the statement, as well as prevent existing equity assets from being repackaged as securitizations and reported as long-term bonds. Ms. Gann stated that comments were received from interested parties, as well as Global Atlantic. After review of the comments, NAIC staff are recommending that the Working Group direct NAIC staff to undertake a substantive project to review and consider revisions to SSAP No. 43R. In making this recommendation, Ms. Gann stated that there have been state insurance regulator concerns with the current application of SSAP No. 43R. These concerns have included structures that mask affiliated transactions, structures that have used the “trust” component in SSAP No. 43R to classify investments that primarily determine repayment based on market returns that have been reflected as “debt instruments,” and situations in which insurer-owned assets may be repackaged (self-securitized) to obtain different accounting and reporting treatment.

   Ms. Gann stated that NAIC staff propose to proceed with an issue paper to address SSAP No. 43R holistically and clarify the securities intended to be in scope of the statement. Ms. Gann stated that the recommendation included potential initial concepts to be considered in the issue paper, but highlighted that all aspects would be discussed throughout the issue paper process. Additionally, Ms. Gann stated that a key aspect of the recommendation is for NAIC staff to work directly with key members of industry throughout the drafting of the issue paper and preparing an initial draft for exposure at the Spring National Meeting.

   Ms. Gann summarized the initial concepts to be considered in the issue paper as follows:

   - Division of guidance between items considered “asset-backed securities” (ABS) as defined under the Code of Federal Regulations (CFR) and items that do not meet this definition. Ms. Gann stated that initial guidance is anticipated to retain historical SSAP No. 43R accounting and reporting guidance for items that meet the CFR definition. An assessment of whether different accounting and reporting treatment, including potential use of lower of amortized cost or fair value or the elimination of filing exempt (FE), will occur for investments that do not meet the ABS definition.
• Removal from SSAP No. 43R investments in the form of a debt instrument where the investment provides that the amount of principal or interest to be earned or returned to the holder is calculated solely with reference to an external market indicator.

• Inclusion of guidance, investment reporting provisions and disclosures to clearly identify and assess insurer-sponsored securitizations. Disclosures are anticipated to capture the conditions from SSAP No. 103R—Transfers and Servicing of Financial Assets and Extinguishments of Liabilities and how an insurer concluded that the conditions were met to attain “sale” accounting treatment.

• Separate review and reference for equipment trust certificates, credit tenant loans and lease-backed securities. This review will coordinate work with the Securities Valuation Office (SVO) staff on provisions reflected in the Purposes and Procedures Manual of the NAIC Investment Analysis Office (P&P Manual) and discussions occurring with the Valuation of Securities (E) Task Force.

Mr. Bruggeman stated that the proposed issue paper approach is a logical step to properly review SSAP No. 43R using principle concepts. Ms. Mears stated support for the approach, agreeing with the use of principle concepts within SSAP No. 43R.

Mike Reis (Northwestern Mutual) stated that a small group of industry representatives worked together to develop the interested parties’ comment letter. He stated that this group is interested in the actual concerns that state insurance regulators are trying to address. He stated that they want to be supportive and assist NAIC staff, as well as state insurance regulators, in addressing concerns, but they would like more detail and direct state insurance regulator comments on what those concerns are so they can be as helpful as possible. Mr. Reis stated that the proposed issue paper is intended to address concerns, but the review of these investments is also in response to the Working Group’s ongoing Investment Classification Project. He stated that if the Working Group proceeds with the direction to holistically review and possibly revise SSAP No. 43R, industry would like to make the following comments or requests:

• Industry does not believe the concerns about CFOs were fully or clearly articulated in the recent exposure and that the potential solution went beyond addressing the potential abuses noted. As a result, some CFO securities were indicted without specific state insurance regulator concerns being attributed to them, causing the applicable market to freeze and become inactive. He stated that companies hold these securities, and industry believes there are perfectly accepted CFO debt-type securities. Industry believes that if state insurance regulators understood these securities, they would agree that they are in the best interest of policyholders. As such, industry requests that CFOs be addressed concurrently with the project in order to unfreeze the CFO market.

• Industry identified that the proposal seems to indict any security that does not meet the CFR ABS definition, as the agenda proposes to possibly consider use of lower of amortized cost or fair value and removal of eligibility for an FE status for NAIC designations. Although he stated that the recommendation includes qualifiers that these could be the possible treatment, it is requested that the direction just be to consider the appropriate accounting and reporting for securities that do not meet the CFR ABS definition.

• The American Council of Life Insurers (ACLI), the North American Securities Valuation Association (NASVA) and the Private Placement Investors Association (PPIA) are all willing to work with NAIC staff, but the emphasis should be on getting the guidance right and not getting the guidance done quickly. Although industry would prefer for the project to be done timely, it needs to be done correctly. He stated that an exposure for the Spring National Meeting may be aggressive if it is to properly identify the population of securities that do not meet the CFR ABS definition. He stated that interested parties request NAIC staff work with the SVO as part of this project. He stated that the SVO has also been working on CFOs, principal-protected notes (PPNs) and combo notes, and the NAIC staff for the Working Group could leverage off those discussions.

Mr. Hudson noted that the reference to possible exposure at the Spring National Meeting is simply a marker to work towards, but the focus would be getting the project done correctly. Mr. Bruggeman agreed with these comments, noting that NAIC staff are aiming for a spring exposure and will be working with industry in the interim to develop the document.

Mr. Bruggeman responded to the comments from Mr. Reis, initially stating that the exposure reference to “CFO” investments was not necessarily intended to solely identify CFOs but was intended to capture investments that include components of both debt and equity. He stated that these structures seemingly take an investment that would be on the bond schedule and an
investment that would be on the Other Invested Asset Schedule (Schedule BA) and with combining, the entire investment is reported as a bond on the bond schedule. He stated that the reference for “equity interest” was intended to be a generic reference that went beyond CFOs to encompass these combined structures. Mr. Bruggeman stated that state insurance regulators understand that industry is predominantly trying to do the right thing and that there is a drive for yield in this low-interest rate environment, but industry needs to be sensitive that state insurance regulators have noted concerning investments and cannot disclose company specifics. Mr. Reis stated that his company has investments in debt from closed-end funds and CFOs, and it is difficult to address questions on whether additional securities can be acquired since the future accounting and reporting is uncertain.

Mr. Bruggeman stated that the proposal from NAIC staff is attempting to use overarching principles, and use of the CFR ABS definition is a good starting point as it provides an overall principle basis to begin discussions. He stated that the assessment for non-ABS securities will be whether the securities are truly debt, or debt tranches, with nationally recognized statistical rating organization (NRSRO) rated principal and interest, maturity dates, scheduled payments, additional structural protections, diversification, ratings triggers and/or other protections that safeguard the debt instrument. Mr. Bruggeman stated that even if insurers acquire investments that are allowed in accordance with the state investment code, the insurer should be cognizant of the impact the investment will have on the balance sheet and overall statutory financial statements.

Mr. Hudson stated that it would be productive for industry and the NAIC SVO to work with NAIC staff for the Working Group on this project. Charles A. Therriault (NAIC) stated agreement with the overall proposal from Ms. Gann and noted that they have seen concerning investments in both SSAP No. 43R and SSAP No. 26R—Bonds. He stated that they agree with the use of the SVO to review these transactions, noting that they have seen some structures that are debt instruments that have the noted protections and others that do not appear to be an actual debt instrument. He stated that the SVO is willing to assist the NAIC staff throughout the process. Steve Broadie (American Property Casualty Insurance Association—APCI) stated that the property/casualty (P/C) industry has the same investments as the life companies and would like to be included in the industry group working with NAIC staff.

Brian Keating (Guardian Life), representing the interested parties’ comment letter drafting group, stated that about half of their securities reported on Schedule D-I as “Other Loan-Backed and Structured Securities” would meet the ABS definition. He stated there definitely are large categories of securities that do not meet the ABS definition that are perfectly fine debt investments that should be retained within SSAP No. 43R, and they believe the state insurance regulators will agree with these assessments. Mr. Bruggeman stated that NAIC staff have done a good job in taking into account the comment letter in determining the initial focus of the issue paper discussion.

Mr. Reis asked whether the proposed direction would be clarified to not specify that the possible options for non-ABS securities could include lower of amortized cost or fair value or elimination of FE reporting provisions. Ms. Gann stated that the direction proposed is to review the non-ABS for accounting and reporting treatment. Mr. Bruggeman stated that the agenda item reference to lower of amortized cost or fair value and/or elimination of FE are possible options, and potentially the worst-case options, and do not reflect the only possibilities that could result from the review of the securities. Mr. Bruggeman stated that if the guidance were to be restated, it would be to indicate that the review could result with any treatment permitted in accordance with the AP&P Manual, pursuant to the statutory accounting principles and consistency concepts. Mr. Hudson agreed that the review could result with a range of varying accounting and reporting treatments.

Mr. Bruggeman stated that since the Working Group is simply providing direction, a formal vote is not needed, but in response to his inquiry, no Working Group members objected to providing direction to NAIC staff as recommended for development of an issue paper to review and revise SSAP No. 43R. He stated agreement with following the general approach of the Working Group and focusing on a detailed issue paper in determining the proper statutory treatment rather than aiming to resolve the issue quickly. Ms. Gann clarified that the intent of NAIC staff is to have consistent forward progress on the issue, so although it will be the goal to have a document prepared for the Spring National Meeting, it is not anticipated that the issue will be presented for resolution. Rather, it is anticipated that NAIC staff will present aspects for discussion, along with comments and questions that will assist them in developing the appropriate statutory accounting guidance.

3. Discussed Other Matters

Mr. Bruggeman reminded the Working Group that the comment deadline for items currently exposed is Jan. 31. He also stated that the Valuation of Securities (E) Task Force had provided four referrals to the Working Group on Jan. 7. Mr. Bruggeman advised that NAIC staff is currently reviewing the referrals. He directed NAIC staff to post the referrals on the Working Group’s website so they could be reviewed during the interim.
Having no further business, the Statutory Accounting Principles (E) Working Group adjourned.
Statutory Accounting Principles (E) Working Group
Maintenance Agenda Submission Form
Form A

Issue: SCA Loss Tracking – Accounting Guidance

Check (applicable entity):

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

Description of Issue:
This agenda item has been drafted to clarify the accounting guidance for SCA losses that result in zero or negative equity in an SCA. Agenda item 2018-09 - SCA Loss Tracking clarified the reporting guidance for SCA losses that result in zero, or negative, equity in an SCA. When reviewing that agenda item, it was identified that there could be uncertainty on the existing provisions that require a negative SCA reporting amount (rather than a zero reporting value). The intent of this agenda item is to clarify the instances that require a negative SCA value and ensure the accounting guidance in SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities for these instances is clear.

Existing Authoritative Literature:

SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets

Guarantees

16. A guarantee contract is a contract that contingently requires the guarantor to make payments (either in cash, financial instruments, other assets, shares of its stock, or provision of services) to the guaranteed party based on changes in the underlying that is related to an asset, a liability, or an equity security of the guaranteed party. Commercial letters of credit and loan commitments, by definition, are not considered guarantee contracts. Also excluded from the definition are indemnifications or guarantees of an entity’s own performance, subordination arrangements or a noncontingent forward contract. This definition could include contingent forward contracts if the characteristics of this paragraph are met.

19. With the exception of the provision for guarantees made to/or on behalf of a wholly-owned subsidiaries in paragraph 18.f, and “unlimited” guarantees in 18.g., this guidance does not exclude guarantees issued as intercompany transactions or between related parties from the initial liability recognition requirement. Thus, unless the guarantee is provided on behalf of a wholly-owned subsidiary or considered “unlimited,” guarantees issued between the following parties are subject to the initial recognition and disclosure requirements:

a. Guarantee issued either between parents and their subsidiaries or between corporations under common control;

b. A parent’s guarantee of its subsidiary’s debt to a third party; and

c. A subsidiary’s guarantee of the debt owed to a third party by either its parent or another subsidiary of that parent.

20. At the inception of a guarantee, the guarantor shall recognize in its statement of financial position a liability for that guarantee. Except as indicated in paragraph 22, the objective of the initial measurement of the liability is the fair value of the guarantee at its inception.

---

1 As practical expedients, when a guarantee is issued in a standalone arm’s-length transaction, the liability recognized at the inception of the guarantee should be the premium received or receivable by the guarantor. When a guarantee is issued as part of a transaction with multiple elements, the liability recognized at the inception of the guarantee should be an estimate of the guarantee’s fair value. In that

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21. The issuance of a guarantee obligates the guarantor (the issuer) in two respects: (a) the guarantor undertakes an obligation to stand ready to perform over the term of the guarantee in the event that the specified triggering events or conditions occur (the noncontingent aspect) and (b) the guarantor undertakes a contingent obligation to make future payments if those triggering events or conditions occur (the contingent aspect). Because the issuance of a guarantee imposes a noncontingent obligation to stand ready to perform in the event that the specified triggering event occurs, the provisions of paragraph 8 should not be interpreted as prohibiting the guarantor from initially recognizing a liability for that guarantee even though it is not probable that payments will be required under that guarantee.

22. In the event that, at the inception of the guarantee, the guarantor is required to recognize a liability under paragraph 8 for the related contingent loss, the liability to be initially recognized for that guarantee shall be the greater of (a) the amount the satisfies the fair value objective as discussed in paragraph 20 or (b) the contingent liability amount required to be recognized at inception of the guarantee by paragraph 8. For many guarantors, it would be unusual for the contingent liability under (b) to exceed the amount that satisfies the fair value objective at the inception of the guarantee.

SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities

13. On at least a quarterly basis, the procedures set forth below shall be followed by a reporting entity in applying an equity method of accounting (as described in paragraphs 8.b.i. through 8.b.iv.), as applicable, to investments in SCA entities:

   e. For entities subject to 8.b.i., 8.b.iii. and 8.b.iv. a reporting entity’s share of losses of an investee may equal or exceed the carrying amount of an investment accounted for by an equity method plus advances made by the investor. The reporting entity shall discontinue applying an equity method when the investment (including advances) is reduced to zero\(^2\) and shall not provide for additional losses unless the reporting entity has guaranteed obligations of the investee or is otherwise committed to provide further financial support for the investee (guaranteed obligations meeting the definition of liabilities in SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets shall be recorded as liabilities). If the investee subsequently reports net income, the reporting entity shall resume applying an equity method only after its share of that net income equals the share of net losses not recognized during the period that an equity method was suspended;

Disclosures

34. All SCA investments within the scope of this statement (except paragraph 8.b.i. entities) shall include disclosure of the SCA balance sheet value (admitted and nonadmitted) as well as information received from the NAIC in response to the SCA filing (e.g., date and type of filing, NAIC valuation amount, whether resubmission of filing is required). This disclosure shall include an aggregate total of all SCAs (except paragraph 8.b.i. entities) with detail of the aggregate gross value under this statement with the admitted and nonadmitted amounts reflected on the balance sheet. (As noted in paragraph 4, joint ventures, partnerships and limited liability companies are accounted for under the guidance in SSAP No. 48. As such, those entities are not subject to this disclosure.)

   a. For all periods presented, a reporting entity whose shares of losses in an SCA exceeds its investment in the SCA shall disclose its share of losses. (This is required regardless of a guarantee or commitment of future financial support to the SCA.) This disclosure shall include the following:

\(2\) Refer to the additional guidance related to discontinuance of an equity method in paragraphs 15-17 and INT 00-24: EITF 98-13: Accounting by an Equity Method Investor for Investee Losses When the Investor Has Loans to and Investments in Other Securities of the Investee and EITF 99-10: Percentage Used to Determine the Amount of Equity Method Losses.

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i. The reporting entity’s accumulated share of the SCA losses not recognized during the period that the equity method was suspended;

ii. The reporting entity’s share of the SCA’s equity, including negative equity;

iii. Whether a guaranteed obligation or commitment for financial support exists; and

iv. The SCA’s reported value.

This disclosure shall apply beginning in the period the SCA’s equity initially falls below zero and shall continue to be disclosed as long as the SCA investment is in a deficit position. Additionally, the reporting entity shall detail in a narrative disclosure whether losses in the SCA have impacted other investments as required by INT 00-24: EITF 98-13: Accounting by an Equity Method Investor for Investee Losses When the Investor Has Loans to and Investments in Other Securities of the Investee and EITF 99-10: Percentage Used to Determine the Amount of Equity Method Losses.

SCA Loss Tracking \(^{FN1}\)

<table>
<thead>
<tr>
<th>SCA Entity</th>
<th>Reporting Entity’s Share of SCA Net Income (Loss)</th>
<th>Accumulated Share of SCA Net Income (Losses)</th>
<th>Reporting Entity’s Share of SCA’s Equity, Including Negative Equity</th>
<th>Guaranteed Obligation / Commitment for Financial Support (Yes / No)</th>
<th>SCA Reported Value (^{FN2})</th>
</tr>
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NOTE: FN1 - This disclosure is only required for SCAs in which the reporting entity’s share of losses exceed the investment in an SCA, (the SCA investment is in a negative equity position). This disclosure shall apply beginning in the period the investment in the SCA equity initially falls below zero and shall continue to be disclosed as long as the SCA investment is in a negative equity position. The disclosure is required whenever an investment in an SCA entity is in a negative equity position, and in the first year subsequent to the negative equity position in which a positive equity position has been attained.

FN2 - For Column 6, as detailed in SSAP No. 97, (unless the entity is subject to statutory adjustments under paragraph 9), once the reporting entity’s share of losses equals or exceeds the investment in the SCA, the SCA shall be reported at zero, with discontinuation of the equity method, unless there is a guaranteed obligation or a commitment for future financial support. If there is a guaranteed obligation or a commitment for future financial support, the guarantee requirement shall be recognized pursuant to SSAP No. 5R, and the reporting entity shall report the investment in the SCA reflecting their share of losses as a contra-asset. (Disclosure of the guarantee or commitment would be captured in Note 14 and is not duplicated in this disclosure.)
SSAP No. 97, Exhibit C – Implementation Questions and Answers

7. Q - Is it possible for an SCA investment valued using an equity method to be reported as a negative value?

7.1 A - Yes, the equity method noninsurance SCA could have a negative equity. SSAP No. 97 paragraph 8.b.ii. relating to noninsurance SCA entities requires some assets to be reported as a negative value (nonadmitted) in paragraph 9. For example an 8.b.ii. SCA subsidiary that is only holding furniture, which is nonadmitted, would be reflected with negative equity to the extent the value of the nonadmitted asset(s) exceed(s) reported equity. It should be noted that although SSAP No. 97, paragraph 13.e. discusses some situations in which the equity method should be discontinued, this does not apply to SCA entities, which meet the requirements of paragraph 8.b.ii. In addition, SSAP No. 97, paragraph 13.e. lists some situations where the equity method would result in a valuation that is less than zero; examples are if reporting entity has guaranteed obligations of the investee or is otherwise committed to provide further financial support for the investee, in these cases, the valuation of the investment in subsidiary could be a negative value.

8. Q - Paragraph 13.e. of SSAP No. 97, lists some situations where the equity method should be discontinued. If the equity method is discontinued, does the reporting entity cease tracking equity losses?

8.1 A - No, the reporting entity does not cease tracking losses related to the investment in the SCA if an equity method is discontinued. If the equity method is discontinued, follow the guidance in paragraphs 15-17 and INT 00-24: EITF 98-13: Accounting by an Equity Method Investor for Investee Losses When the Investor Has Loans to and Investments in Other Securities of the Investee and EITF 99-10: Percentage Used to Determine the Amount of Equity Method Losses (INT 00-24).

8.2 INT 00-24 lists situations that might require the reporting entity to write down other investments in the SCA subsidiary, such as loans, because of continuing losses in the SCA investment. Paragraphs 15-17 provides guidance to assist in determining whether prior losses are being funded if the reporting entity purchases additional stock, etc. after suspending the equity method. Paragraphs 15-17 in INT 00-24 note that even if the equity method is not being applied, the investment should be tracked to determine if additional losses have to be applied to other items and to determine if the investment in the SCA has a future recovery.

Activity to Date (issues previously addressed by the Working Group, Emerging Accounting Issues (E) Working Group, SEC, FASB, other State Departments of Insurance or other NAIC groups): The Statutory Accounting Principles (E) Working Group previously adopted agenda item 2018-09 – SCA Loss Tracking, which incorporated an additional disclosure to track an SCA’s losses.

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

Convergence with International Financial Reporting Standards (IFRS): N/A

Staff Recommendation:
Staff recommends that the Working Group move this item to the active listing, categorized as nonsubstantive and expose revisions to SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities, as detailed below, to clarify the existing reporting requirements for an SCA in a loss position. Staff would also request comments from regulators and interested parties regarding additional situations that require negative reporting.

Proposed Revisions:

SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities
13. On at least a quarterly basis, the procedures set forth below shall be followed by a reporting entity in applying an equity method of accounting (as described in paragraphs 8.b.i. through 8.b.iv.), as applicable, to investments in SCA entities:

   e. For entities subject to 8.b.i., 8.b.ii., 8.b.iii. and 8.b.iv. a reporting entity’s share of losses of an investee may equal or exceed the carrying amount of an investment accounted for by an equity method plus advances made by the investor. The reporting entity shall discontinue applying an equity method when the investment (including advances) is reduced to zero\(^3\) and shall not provide for additional losses unless the situations in paragraph 13.e.i. or paragraph 13.e.ii. exist. Reporting entity has guaranteed obligations of the investee or is otherwise committed to provide further financial support for the investee (guaranteed obligations meeting the definition of liabilities in SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets (SSAP No. 5R) shall be recorded as liabilities). If the investee subsequently reports net income, the reporting entity shall resume applying an equity method only after its share of that net income equals the share of net losses not recognized during the period that an equity method was suspended. \(\text{In situations in which negative equity is reported (paragraph 13.e.i. and paragraph 13.e.ii.), the book adjusted carrying value for the investment in the SCA shall reflect the reporting entity’s negative equity value (reflecting the reporting entity’s share of the SCA losses). (This would be reported as a contra-asset.)}\)

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

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

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Staff Review Completed by:
Fatima Sediqzad - NAIC Staff
July 2018

Status:
On August 4, 2018, the Statutory Accounting Principles (E) Working Group moved this item to the active listing, categorized as nonsubstantive, and exposed revisions to SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities, as shown above, to clarify the existing reporting requirements for when the reporting entity has a negative equity valuation in an SCA investment.

On November 15, 2018, the Statutory Accounting Principles (E) Working Group re-exposed this agenda item and directed NAIC staff to work with interested parties and research applicable U.S. GAAP guidance to consider revisions to existing guidance that requires negative subsidiary, controlled and affiliated (SCA) entity reporting when there is a guarantee or commitment to provide financial support.

On April 6, 2019, the Statutory Accounting Principles (E) Working Group exposed revisions to SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities, as detailed below, to revise the existing reporting requirements for when a reporting entity has a negative value in an SCA investment when the reporting entity has provided a financial commitment or guarantee. The illustration from the existing INT 00-24: EITF 98-13: Accounting by an Equity Method Investor for Investee Losses When the Investor Has Loans to and Investments in Other Securities of the Investee and EITF 99-10: Percentage Used to Determine the Amount of Equity Method Losses.

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\(^3\) Refer to the additional guidance related to discontinuance of an equity method in paragraphs 15-17 and INT 00-24: EITF 98-13: Accounting by an Equity Method Investor for Investee Losses When the Investor Has Loans to and Investments in Other Securities of the Investee and EITF 99-10: Percentage Used to Determine the Amount of Equity Method Losses.
Losses has also been moved to SSAP No. 97, in its entirety, as a new exhibit. This INT provides examples of how losses in an SCA shall be applied to other investments once the SCA equity investment has been halted at zero.

Spring 2019 National Meeting Exposure:

SSAP No. 97—Subsidiary, Controlled and Affiliated Entities:

13. On at least a quarterly basis, the procedures set forth below shall be followed by a reporting entity in applying an equity method of accounting (as described in paragraphs 8.b.i. through 8.b.iv.), as applicable, to investments in SCA entities:

   e. For entities subject to 8.b.i., 8.b.ii., 8.b.iii. and 8.b.iv. a reporting entity’s share of losses of an investee may equal or exceed the carrying amount of an investment accounted for by an equity method plus advances made by the investor. The reporting entity shall discontinue applying an equity method when the investment (including advances) is reduced to zero and shall not provide for additional losses, while still continuing to track the amount of unreported equity method losses, until any future equity method income can be reported. If the reporting entity has guaranteed obligations of the investee or is otherwise committed to provide further financial support for the investee, such as (guaranteed obligations meeting the definition of liabilities in SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets (SSAP No. 5R), they shall be recorded as liabilities). If the entire loss is recognized under SSAP No. 5R, it does not also need to be recognized under SSAP No. 97. However, if there is a guarantee or commitment, and the entire loss is not recognized under SSAP No. 5R, the reporting entity shall not stop at zero, and shall recognize a negative value of the SCA. If the investee subsequently reports net income, the reporting entity shall resume applying an equity method only after its share of that net income equals the share of net losses not recognized during the period that an equity method was suspended;

Footnote 2: Refer to the additional guidance related to discontinuance of an equity method in paragraphs 15-17 and INT 00-24: EITF 98-13: Accounting by an Equity Method Investor for Investee Losses When the Investor Has Loans to and Investments in Other Securities of the Investee and EITF 99-10: Percentage Used to Determine the Amount of Equity Method Losses. As detailed in INT 00-24, a reporting entity’s share of losses in an SCA shall be applied to other investments held in the SCA once the SCA (common stock) investment has been reduced to zero.

EXHIBIT F – ILLUSTRATION OF THE APPLICATION OF INT 00-24

XYZ Investment in ABC Company

1. ABC Company is a life insurance company, formed January 2, 20X1 to sell health insurance in the state of New York. On January 2, 20X1, XYZ Insurance Company invested $500,000 in ABC, and purchased 100,000 shares of common stock at par, and 40,000 shares of preferred stock at par. ABC Preferred stock is non-voting, 5% cumulative.

2. XYZ determined it has obtained a controlling interest in ABC as XYZ owns 50% of the voting interests of ABC. XYZ accounted for its investment in ABC Insurance Company under the statutory equity method of accounting. The following table is selected information from the financial statements of ABC Insurance Company.

<table>
<thead>
<tr>
<th>20X1 – 20X4</th>
<th>1/2/20X1</th>
<th>12/31/20X1</th>
<th>12/31/20X2</th>
<th>12/31/20X3</th>
<th>12/31/20X4</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital and Surplus:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Common stock, $1 par</td>
<td>$200,000</td>
<td>$200,000</td>
<td>$200,000</td>
<td>$200,000</td>
<td>$200,000</td>
</tr>
</tbody>
</table>
At 1/2/20X1, XYZ recorded the following entry to record its investment in ABC:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment in ABC Common stock</td>
<td>$100,000</td>
</tr>
<tr>
<td>Investment in ABC Preferred stock</td>
<td>$400,000</td>
</tr>
<tr>
<td><strong>Cash</strong></td>
<td><strong>$500,000</strong></td>
</tr>
</tbody>
</table>

To record initial investment in ABC Insurance Company.

During the year ended 12/31/20X1, ABC had statutory net income before dividends of $200,000. At 12/31/20X1, ABC declared and paid a 5% preferred dividend, and a common stock dividend of $0.10 per share. XYZ recorded the following entries:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Cash</strong></td>
<td><strong>$20,000</strong></td>
</tr>
<tr>
<td>Dividend Income</td>
<td><strong>$20,000</strong></td>
</tr>
</tbody>
</table>

To record preferred dividend income from ABC Insurance Company for 20X1.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment in ABC Common stock</td>
<td>$75,000</td>
</tr>
<tr>
<td><strong>Unrealized Gain/Loss</strong></td>
<td><strong>$75,000</strong></td>
</tr>
</tbody>
</table>

To record 20X1 unrealized gain on investment in ABC Common. (($200,000 - $50,000) * 50%)

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Cash</strong></td>
<td><strong>$10,000</strong></td>
</tr>
<tr>
<td>Unrealized Gain/Loss</td>
<td><strong>$10,000</strong></td>
</tr>
<tr>
<td>Dividend Income</td>
<td><strong>$10,000</strong></td>
</tr>
<tr>
<td>Investment in ABC Common stock</td>
<td><strong>$10,000</strong></td>
</tr>
</tbody>
</table>

To record 20X1 dividend on ABC Common. (100,000 shares * $0.10)

During the year ended 12/31/20X2, ABC issued an 8% surplus note of $500,000. XYZ purchased 100% of the surplus note. During that same year, ABC incurred a statutory net loss before dividends of $250,000. At 12/31/20X2, ABC declared and paid a 5% preferred dividend, and a common stock dividend of $0.05 per share. No interest or principal repayments of the surplus note were approved. XYZ recorded the following entries:
6. During the year ended 12/31/20X3, ABC Insurance Company incurred a statutory net loss before dividends of $400,000. ABC Insurance Company did not declare any dividends, and no interest or principal repayments of the surplus note were approved. XYZ recorded the following entries:

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dividends Receivable</td>
<td>$ 20,000</td>
</tr>
<tr>
<td>Dividend Income</td>
<td>$ 20,000</td>
</tr>
</tbody>
</table>

To record preferred dividend income from ABC Insurance Company for 20X3.

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unrealized Gain/Loss</td>
<td>$ 182,000</td>
</tr>
<tr>
<td>Investment in ABC Preferred stock</td>
<td>$ 172,000</td>
</tr>
<tr>
<td>Investment in ABC Common stock</td>
<td>$ 10,000</td>
</tr>
</tbody>
</table>

To record 20X3 unrealized loss on investment in ABC Common and Preferred.

7. During the year ended 12/31/20X4, ABC Insurance Company incurred a statutory net loss before dividends of $750,000. ABC Insurance Company did not declare any dividends, and no interest or principal repayments of the surplus note were approved. XYZ recorded the following entries:

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dividends Receivable</td>
<td>$ 20,000</td>
</tr>
<tr>
<td>Dividend Income</td>
<td>$ 20,000</td>
</tr>
</tbody>
</table>

To record preferred dividend income from ABC Insurance Company for 20X4.

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
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<tbody>
<tr>
<td>Unrealized Gain/Loss</td>
<td>$ 458,000</td>
</tr>
</tbody>
</table>

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Investment in ABC Preferred stock $ 228,000
Investment in ABC Surplus note $ 230,000

To record 20X4 unrealized loss on investment in ABC Preferred and Surplus Notes.

Total net loss and preferred stock dividend ($800,000),
Common stock component reduces the Investment in ABC Preferred stock component to $0. (570,000 * 40%)
Preferred stock component calculated as:

- Total net loss and preferred dividend (-$750,000 - $50,000) $800,000
- Less amount used to reduce preferred stock investment to $0 570,000
- Amount remaining to be allocated to investment in surplus note 230,000
- XYZ ownership % of surplus note 100%

iii. XYZ reduction in investment in ABC Surplus Notes $230,000

8. During the year ended 12/31/20X5, ABC Insurance Company incurred a statutory net loss before dividends of $500,000. ABC Insurance Company did not declare any dividends, and no interest or principal repayments of the surplus note were approved. XYZ recorded the following entries:

Dividends Receivable $ 20,000
Dividend Income $ 20,000

To record preferred dividend income from ABC Insurance Company for 20X5.

Unrealized Gain/Loss $ 270,000
Investment in ABC Surplus note $ 270,000

To record 20X5 unrealized loss on investment in ABC Surplus Notes.

Total ABC net loss and preferred stock dividend (-$500,000 - $50,000),
Surplus Note component calculated as:

- Total net loss and preferred dividend (-$500,000 - $50,000) $550,000
- XYZ ownership % of ABC Surplus Note 100%
- Amount of unrealized loss recognized in 20X5 $270,000
- iv. Amount of unrealized loss suspended $280,000

9. Since XYZ has not guaranteed any liabilities of ABC, the reduction they would recognize is limited to their remaining investment in ABC Surplus Notes. Therefore, they would only recognize a 20X5 unrealized loss on their investment in ABC of $270,000.

10. During the year ended 12/31/20X6, ABC Insurance Company realigned their marketing efforts and modified the products they were selling. ABC also issued an additional 8% surplus note of $500,000. This surplus note was purchased by an unaffiliated third party. During the year ended 12/31/X6, ABC Insurance Company had statutory net income before dividends of $200,000. ABC Insurance Company did not declare any dividends on common stock, but declared and paid current and dividends in arrears on preferred. XYZ recorded the following entries:

Cash $ 80,000
Dividends Receivable $ 60,000
Dividend Income $ 20,000

To record preferred dividend income from ABC Insurance Company for 20X6, and receipt of preferred dividends receivable for 20X3, 20X4 and 20X5.
11. XYZ did not record any change in their investment in ABC Surplus Notes, ABC Preferred or ABC Common, since ABCs’ net income after preferred dividends did not exceed the losses accumulated during the period that XYZ suspended recording unrealized losses.

12. The following amounts were tracked:

   Total ABC net income and preferred stock dividend ($200,000 - $50,000).
   Surplus Note component calculated as:
     Total net income and preferred dividend ($200,000 - $50,000) $150,000
     XYZ ownership % of ABC Surplus Note 50%
     Amount of unrealized loss suspended in 20X5 $75,000
     Remaining amount of unrealized loss suspended $205,000

13. During the year ended 12/31/20X7, ABC Insurance Company had statutory net income before dividends of $600,000. At 12/31/20X7, ABC declared and paid a 5% preferred dividend. No interest or principal repayments of the surplus note were approved. XYZ recorded the following entries:

   Cash $20,000
   Dividend Income $20,000
   To record preferred dividend income from ABC Insurance Company for 20X7.

   Investment in ABC Surplus Notes $70,000
   Unrealized Gain/Loss $70,000
   To record 20X7 unrealized gain on investment in ABC Surplus Notes.

   Total ABC net income and preferred stock dividend ($600,000 - $50,000).
   Surplus Note component calculated as:
     Total net income and preferred dividend ($600,000 - $50,000) $550,000
     XYZ ownership % of ABC Surplus Note 50%
     Remaining amount of unrealized loss suspended in 20X5 $205,000
     vi. 20X7 amount of unrealized gain on investment in ABC Surplus Note $70,000

14. During the year ended 12/31/20X8, ABC Insurance Company had statutory net income before dividends of $900,000. At 12/31/20X8, ABC declared and paid a 5% preferred dividend. No interest or principal repayments of the surplus note were approved. XYZ recorded the following entries:

   Cash $20,000
   Dividend Income $20,000
   To record preferred dividend income from ABC Insurance Company for 20X8.

   Total ABC net income and preferred stock dividend ($900,000 - $50,000).
   Surplus Note component calculated as:
     Total net income and preferred dividend ($900,000 - $50,000) $850,000
     XYZ ownership % of ABC Surplus Note 50%
     vi. 20X8 amount of unrealized gain on investment in ABC Surplus Note $425,000

   Investment in ABC Surplus Notes $425,000
   Unrealized Gain/Loss $425,000
   To record 20X8 unrealized gain on investment in ABC Surplus Notes.
15. During the year ended 12/31/20X9, ABC Insurance Company had statutory net income, before interest on surplus notes and dividends, of $1,400,000. The Commissioner approved one year’s interest payment on the surplus notes. At 12/31/20X9, ABC declared and paid a 5% preferred dividend, and a $.10 dividend per share on Common stock. XYZ recorded the following entries:

Cash $20,000  Dividend Income $20,000  
To record preferred dividend income from ABC Insurance Company for 20X9.

Cash $40,000  Interest Income $40,000  
To record surplus notes interest income from ABC Insurance Company for 20X9. ($500,000 * 8%)

Investment in ABC Surplus Notes $5,000
Investment in ABC Preferred Stock $400,000
Investment in ABC Common Stock $130,000
Unrealized Gain/Loss $535,000  
To record 20X9 unrealized gain on investment in ABC Common, Preferred and Surplus Notes.

Components computed as follows:

Total Net Income net of preferred stock dividend and interest on surplus notes $1,270,000
($1,400,000 - $50,000 - $80,000)
Less amount needed to restore investment in surplus notes ($10,000)
Amount available for preferred stock and common stock investment $1,260,000
Amount needed to restore preferred stock component ($1,000,000)
Amount available to restore common stock component $260,000

Surplus Notes component ($10,000 * 50%) $5,000
Preferred Stock component ($1,000,000 * 40%) $400,000
Common stock component ($260,000 * 50%) $130,000

Cash $10,000  Unrealized Gain/Loss $10,000  
Dividend Income $10,000  Investment in ABC Common stock $10,000

To record 20X9 dividend on ABC Common. (100,000 shares * $.10)

On August 3, 2019, the Statutory Accounting Principles (E) Working Group exposed revisions to SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets and SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities, as illustrated below, to require a financial commitment or guarantee for a subsidiary, controlled, or affiliated entity to be recognized as a non-contingent guarantee liability. These proposed revisions differ from the prior exposure as they would capture the entire financial guaranty or commitment for an SCA within scope of SSAP No. 5R and report a zero value for SCAs with a negative equity value.

SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets

8. An estimated loss from a loss contingency or the impairment of an asset shall be recorded by a charge to operations if both of the following conditions are met:
a. Information available prior to issuance of the statutory financial statements indicates that it is probable that an asset has been impaired or a liability has been incurred at the date of the statutory financial statements. It is implicit in this condition that it is probable that one or more future events will occur confirming the fact of the loss or incurrence of a liability; and

b. The amount of loss can be reasonably estimated.

18. The following types of guarantees are exempted from the initial liability recognition in paragraphs 20-25, but are subject to the disclosure requirements in paragraphs 29-32. For the guarantees addressed in paragraphs 18f and 18g, recognition of a contingent guarantee may be required subsequent to initial recognition in accordance with paragraph 24a:

a. Guarantee that is accounted for as a derivative instrument, other than credit derivatives within SSAP No. 86;

b. Guarantee for which the underlying is related to the performance of nonfinancial assets that are owned by the guaranteed party, including product warranties;

c. Guarantee issued in a business combination that represents contingent consideration;

d. Guarantee in which the guarantor’s obligation would be reported as an equity item;

e. Guarantee by an original lessee that has become secondarily liable under a new lease that relieved the original lessee from being the primary obligator;

f. Guarantees (as defined in paragraph 16) made to/or on behalf of directly or indirectly wholly-owned insurance or non-insurance subsidiaries; and

g. Intercompany and related party guarantees that are considered “unlimited” (e.g., typically in response to a rating agency’s requirement to provide a commitment to support).

19. With the exception of the provision for guarantees made to/or on behalf of a wholly-owned subsidiaries in paragraph 18.f. and “unlimited” guarantees in 18.g., this guidance does not exclude guarantees issued as intercompany transactions or between related parties from the initial liability recognition requirement. Thus, unless the guarantee is provided on behalf of a wholly-owned subsidiary or considered “unlimited,” guarantees issued between the following parties are subject to the initial recognition and disclosure requirements:

d. Guarantee issued either between parents and their subsidiaries or between corporations under common control;

e. A parent’s guarantee of its subsidiary’s debt to a third party; and

f. A subsidiary’s guarantee of the debt owed to a third party by either its parent or another subsidiary of that parent.

20. At the inception of a guarantee, the guarantor shall recognize in its statement of financial position a liability for that guarantee. Except as indicated in paragraph 22, the objective of the initial measurement of the liability is the fair value\(^5\) of the guarantee at its inception.

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\(^5\) The exclusion for wholly-owned subsidiaries includes guarantees from a parent to, or on behalf of, a direct wholly-owned insurance or non-insurance subsidiary as well as guarantees made from a parent to, or on behalf of, an indirect wholly-owned insurance or non-insurance subsidiary. The “wholly-owned” exclusion in paragraph 18.f. does not include guarantees issued from one subsidiary to another subsidiary, regardless if both subsidiaries are wholly-owned (directly or indirectly) by a parent company.
Footnote: As practical expedients, when a guarantee is issued in a standalone arm’s-length transaction, the liability recognized at the inception of the guarantee should be the premium received or receivable by the guarantor. When a guarantee is issued as part of a transaction with multiple elements, the liability recognized at the inception of the guarantee should be an estimate of the guarantee’s fair value. In that circumstance, guarantors should consider what premium would be required by the guarantor to issue the same guarantee in a standalone arm’s-length transaction.

21. The issuance of a guarantee obligates the guarantor (the issuer) in two respects: (a) the guarantor undertakes an obligation to stand ready to perform over the term of the guarantee in the event that the specified triggering events or conditions occur (the noncontingent aspect) and (b) the guarantor undertakes a contingent obligation to make future payments if those triggering events or conditions occur (the contingent aspect). Because the issuance of a guarantee imposes a noncontingent obligation to stand ready to perform in the event that the specified triggering event occurs, the provisions of paragraph 8 should not be interpreted as prohibiting the guarantor from initially recognizing a liability for that guarantee even though it is not probable that payments will be required under that guarantee.

22. In the event that, at the inception of the guarantee, the guarantor is required to recognize a liability under paragraph 8 for the related contingent loss, the liability to be initially recognized for that guarantee shall be the greater of (a) the amount the satisfies the fair value objective as discussed in paragraph 20 or (b) the contingent liability amount required to be recognized at inception of the guarantee by paragraph 8. For many guarantors, it would be unusual for the contingent liability under (b) to exceed the amount that satisfies the fair value objective at the inception of the guarantee.

23. The offsetting entry pursuant to the liability recognition at the inception of the guarantee depends on the circumstances in which the guarantee was issued. Examples include:

   a. If the guarantee was issued in a standalone transaction for a premium, the offsetting entry would the consideration received.

   b. If the guarantee was issued in conjunction with the sale of assets, a product, or a business, the overall proceeds would be allocated between the consideration being remitted to the guarantor for issuing the guarantee and the proceeds from that sale. That allocation would affect the calculation of the gain or loss on the sale transaction.

   c. If a residual value guarantee were provided by a lessee-guarantor when entering into an operating lease, the offsetting entry would be reflected as prepaid rent, which would be nonadmitted under SSAP No. 29.

   d. If a guarantee were issued to an unrelated or related party for no consideration on a standalone basis, the offsetting entry would be to expense.

24. Except for the measurement and recognition of continued guarantee obligations after the settlement of a contingent guarantee liability described in paragraph 25, and the provisions for SCAs detailed in paragraph 24a, this standard does not describe in detail how the guarantor’s liability for its obligations under the guarantee would be measured subsequent to initial recognition. The liability that the guarantor initially recognized in accordance with paragraph 20 would typically be reduced (as a credit to income) as the guarantor is released from risk under the guarantee. Depending on the nature of the guarantee, the guarantor’s release from risk has typically been recognized over the term of the guarantee (a) only upon either expiration or settlement of the guarantee, (b) by a systematic and rational amortization method, or (c) as the fair value of the guarantee changes (for example, guarantees accounted for as derivatives). The reduction of liability does not encompass the recognition and subsequent adjustment of the contingent liability recognized under paragraph 8 related to the contingent loss for the guarantee. If the guarantor is required to subsequently recognize a contingent liability for the guarantee, the guarantor shall eliminate any remaining noncontingent liability for that guarantee and recognize a contingent liability in accordance with paragraph 8.
a. In situations in which a reporting entity has provided a financial guarantee or commitment to support a subsidiary, controlled or affiliated entity (SCA), and the reporting entity’s share of losses in the SCA exceed the equity method carrying amount of the SCA (resulting in a negative equity value in the SCA), the reporting entity shall adjust the initially recognized guarantee obligation to reflect the greater of the then-current fair value of the guarantee or the negative equity position. (For guarantees captured in paragraphs 18f and 18g, this guidance requires recognition of a contingent guaranty when negative equity exists in an SCA.) The recognized guarantee liability shall not exceed the maximum amount of the financial guarantee or commitment provided by the reporting entity. The guidance in paragraphs 24 and 25 shall be followed for recognizing a contingent liability and subsequent re-recognition of a noncontingent liability as applicable.

25. After recognition and settlement of a contingent guarantee liability in accordance with paragraph 8, a guarantor shall assess whether remaining potential obligations exist under the guarantee agreement. If the guarantor still has potential obligations under the guarantee contract, the guarantor shall recognize the remaining noncontingent guarantee that represents the current fair value of the potential obligation remaining under the guarantee agreement. This noncontingent guarantee liability shall be released in accordance with paragraph 24.

SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities

13. On at least a quarterly basis, the procedures set forth below shall be followed by a reporting entity in applying an equity method of accounting (as described in paragraphs 8.b.i. through 8.b.iv.), as applicable, to investments in SCA entities:

e. For entities subject to 8.b.i., 8.b.ii., 8.b.iii. and 8.b.iv. a reporting entity’s share of losses of an investee may equal or exceed the carrying amount of an investment accounted for by an equity method plus advances made by the investor. The reporting entity shall discontinue applying an equity method when the investment (including advances) is reduced to zero7 and shall not provide for additional losses, while still continuing to track the amount of unreported equity method losses, until any future equity method income can be reported. If the reporting entity has guaranteed obligations of the investee or is otherwise committed to provide further financial support for the investee, the provisions of such as (guaranteed obligations meeting the definition of liabilities in SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets shall be followed (SSAP No. 5R), they shall be recorded as liabilities). If the entire equity method loss (subject to the financial guarantee / commitment) shall be recognized under SSAP No. 5R, it does not also need to be recognized under SSAP No. 97. If the investee subsequently reports net income, the reporting entity shall resume applying an equity method only after its share of that net income equals the share of net losses not recognized during the period that an equity method was suspended;

Footnote 2: Although the SCA is reported at zero in the investment schedule, a guarantee liability (either contingent or noncontingent) may be required to be reported under SSAP No. 5R. Additionally, refer to the additional guidance related to discontinuance of an equity method in paragraphs 15-17 and INT 00-24: EITF 98-13: Accounting by an Equity Method Investor for Investee Losses When the Investor Has Loans to and Investments in Other Securities of the Investee and EITF 99-10: Percentage Used to Determine the Amount of Equity Method Losses. As detailed in INT 00-24, a reporting entity’s share of losses in an SCA shall be applied to other investments held in the SCA once the SCA (common stock) investment has been reduced to zero.
35. All SCA investments within the scope of this statement (except paragraph 8.b.i. entities) shall include disclosure of the SCA balance sheet value (admitted and nonadmitted) as well as information received from the NAIC in response to the SCA filing (e.g., date and type of filing, NAIC valuation amount, whether resubmission of filing is required). This disclosure shall include an aggregate total of all SCAs (except paragraph 8.b.i. entities) with detail of the aggregate gross value under this statement with the admitted and nonadmitted amounts reflected on the balance sheet. (As noted in paragraph 4, joint ventures, partnerships and limited liability companies are accounted for under the guidance in SSAP No. 48. As such, those entities are not subject to the disclosures in this statement, unless specifically directed by SSAP No. 48.)

a. For all periods presented, a reporting entity whose shares of losses in an SCA exceeds its investment in the SCA shall disclose its share of losses. (This is required regardless of a guarantee or commitment of future financial support to the SCA.) This disclosure shall include the following:

i. The reporting entity’s accumulated share of the SCA losses not recognized during the period that the equity method was suspended;

ii. The reporting entity’s share of the SCA’s equity, including negative equity;

iii. Whether a guaranteed obligation or commitment for financial support exists; and

iv. The SCA’s reported value and the amount of the recognized guarantee under SSAP No. 5R.

2019 Fall National Meeting Exposure

SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets - (Industry edits are shaded.)

8. An estimated loss from a loss contingency or the impairment of an asset shall be recorded by a charge to operations if both of the following conditions are met:

a. Information available prior to issuance of the statutory financial statements indicates that it is probable that an asset has been impaired or a liability has been incurred at the date of the statutory financial statements. It is implicit in this condition that it is probable that one or more future events will occur confirming the fact of the loss or incurrence of a liability; and

b. The amount of loss can be reasonably estimated.

18. The following types of guarantees are exempted from the initial liability recognition in paragraphs 20-25, but are subject to the disclosure requirements in paragraphs 29-32. For the guarantees addressed in paragraphs 18f and 18g, recognition of a contingent guarantee may be required subsequent to initial recognition in accordance with paragraph 24a:

a. Guarantee that is accounted for as a derivative instrument, other than credit derivatives within SSAP No. 86;

b. Guarantee for which the underlying is related to the performance of nonfinancial assets that are owned by the guaranteed party, including product warranties;

c. Guarantee issued in a business combination that represents contingent consideration;

d. Guarantee in which the guarantor’s obligation would be reported as an equity item;
e. Guarantee by an original lessee that has become secondarily liable under a new lease that relieved the original lessee from being the primary obligator;

f. Guarantees (as defined in paragraph 16) made to/or on behalf of directly or indirectly wholly-owned insurance or non-insurance subsidiaries;

g. Intercompany and related party guarantees that are considered “unlimited” (e.g., typically in response to a rating agency’s requirement to provide a commitment to support).

The exemptions for items f and g above do not apply in situations in which a reporting entity has provided a financial guarantee or commitment to support a subsidiary, controlled or affiliated entity (SCA), and the SCA’s equity is negative (see paragraph 24).

19. With the exception of the provision for guarantees made to/or on behalf of a wholly-owned subsidiaries in paragraph 18.f. and “unlimited” guarantees in 18.g., this guidance does not exclude guarantees issued as intercompany transactions or between related parties from the initial liability recognition requirement. Thus, unless the guarantee is provided on behalf of a wholly-owned subsidiary or considered “unlimited,” guarantees issued between the following parties are subject to the initial recognition and disclosure requirements:

a. Guarantee issued either between parents and their subsidiaries or between corporations under common control;

b. A parent’s guarantee of its subsidiary’s debt to a third party; and

c. A subsidiary’s guarantee of the debt owed to a third party by either its parent or another subsidiary of that parent.

20. At the inception of a guarantee, the guarantor shall recognize in its statement of financial position a liability for that guarantee. Except as indicated in paragraph 22, the objective of the initial measurement of the liability is the fair value of the guarantee at its inception.

Footnote: As practical expedients, when a guarantee is issued in a standalone arm’s-length transaction, the liability recognized at the inception of the guarantee should be the premium received or receivable by the guarantor. When a guarantee is issued as part of a transaction with multiple elements, the liability recognized at the inception of the guarantee should be an estimate of the guarantee’s fair value. In that circumstance, guarantors should consider what premium would be required by the guarantor to issue the same guarantee in a standalone arm’s-length transaction.

21. The issuance of a guarantee obligates the guarantor (the issuer) in two respects: (a) the guarantor undertakes an obligation to stand ready to perform over the term of the guarantee in the event that the specified triggering events or conditions occur (the noncontingent aspect) and (b) the guarantor undertakes a contingent obligation to make future payments if those triggering events or conditions occur (the contingent aspect). Because the issuance of a guarantee imposes a noncontingent obligation to stand ready to perform in the event that the specified triggering event occurs, the provisions of paragraph 8 should not be interpreted as prohibiting the guarantor from initially recognizing a liability for that guarantee even though it is not probable that payments will be required under that guarantee.

8 The exclusion for wholly-owned subsidiaries includes guarantees from a parent to, or on behalf of, a direct wholly-owned insurance or non-insurance subsidiary as well as guarantees made from a parent to, or on behalf of, an indirect wholly-owned insurance or non-insurance subsidiary. The “wholly-owned” exclusion in paragraph 18.f. does not include guarantees issued from one subsidiary to another subsidiary, regardless if both subsidiaries are wholly-owned (directly or indirectly) by a parent company.
22. In the event that, at the inception of the guarantee, the guarantor is required to recognize a liability under paragraph 8 for the related contingent loss, the liability to be initially recognized for that guarantee shall be the greater of (a) the amount the satisfies the fair value objective as discussed in paragraph 20 or (b) the contingent liability amount required to be recognized at inception of the guarantee by paragraph 8. For many guarantors, it would be unusual for the contingent liability under (b) to exceed the amount that satisfies the fair value objective at the inception of the guarantee.

23. The offsetting entry pursuant to the liability recognition at the inception of the guarantee depends on the circumstances in which the guarantee was issued. Examples include:

a. If the guarantee was issued in a standalone transaction for a premium, the offsetting entry would the consideration received.

b. If the guarantee was issued in conjunction with the sale of assets, a product, or a business, the overall proceeds would be allocated between the consideration being remitted to the guarantor for issuing the guarantee and the proceeds from that sale. That allocation would affect the calculation of the gain or loss on the sale transaction.

c. If a residual value guarantee were provided by a lessee-guarantor when entering into an operating lease, the offsetting entry would be reflected as prepaid rent, which would be nonadmitted under SSAP No. 29.

d. If a guarantee were issued to an unrelated or related party for no consideration on a standalone basis, the offsetting entry would be to expense.

24. Except for the measurement and recognition of continued guarantee obligations after the settlement of a contingent guarantee liability described in paragraph 25, and the provisions for SCAs detailed in paragraph 24a this standard does not describe in detail how the guarantor’s liability for its obligations under the guarantee would be measured subsequent to initial recognition. The liability that the guarantor initially recognized in accordance with paragraph 20 would typically be reduced (as a credit to income) as the guarantor is released from risk under the guarantee. Depending on the nature of the guarantee, the guarantor’s release from risk has typically been recognized over the term of the guarantee (a) only upon either expiration or settlement of the guarantee, (b) by a systematic and rational amortization method, or (c) as the fair value of the guarantee changes (for example, guarantees accounted for as derivatives). The reduction of liability does not encompass the recognition and subsequent adjustment of the contingent liability recognized under paragraph 8 related to the contingent loss for the guarantee.

25. In situations in which a reporting entity has provided a financial guarantee or commitment to support a subsidiary, controlled or affiliated entity (SCA), and the reporting entity’s share of losses in the SCA exceed the equity method carrying amount of the SCA (resulting in a negative equity value in the SCA), the reporting entity shall adjust the initially recognized guarantee obligation to reflect the greater impact of (i) the then-current fair value liability for of the guarantee or (ii) the negative equity position, limited to the maximum amount of the financial guarantee or commitment provided by the reporting entity. (ForThis guidance requires the recognition of a guarantee liability for guarantees captured in paragraphs 18f and 18g, when negative equity exists in an SCA, this guidance requires recognition of a contingent guaranty.) The recognized guarantee liability shall not exceed the maximum amount of the financial guarantee or commitment provided by the reporting entity. The guidance in paragraphs 24 and 25 shall be followed for the recognition of recognizing a contingent liability and subsequent recognition of a noncontingent liability, as applicable.
25.26. After recognition and settlement of a contingent guarantee liability in accordance with paragraph 8, a guarantor shall assess whether remaining potential obligations exist under the guarantee agreement. If the guarantor still has potential obligations under the guarantee contract, the guarantor shall recognize the remaining noncontingent guarantee that represents the current fair value of the potential obligation remaining under the guarantee agreement. This noncontingent guarantee liability shall be released in accordance with paragraph 24.

**SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities – No industry edits to this section**

12. On at least a quarterly basis, the procedures set forth below shall be followed by a reporting entity in applying an equity method of accounting (as described in paragraphs 8.b.i. through 8.b.iv.), as applicable, to investments in SCA entities:

- **e.** For entities subject to 8.b.i., 8.b.ii., 8.b.iii. and 8.b.iv. a reporting entity’s share of losses of an investee may equal or exceed the carrying amount of an investment accounted for by an equity method plus advances made by the investor. The reporting entity shall discontinue applying an equity method when the investment (including advances) is reduced to zero\(^\text{10}\) and shall not provide for additional losses, while still continuing to track the amount of unreported equity method losses, until any future equity method income can be reported. If the reporting entity has guaranteed obligations of the investee or is otherwise committed to provide further financial support for the investee, the provisions of such as (guaranteed obligations meeting the definition of liabilities in SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets shall be followed) (SSAP No. 5R), they shall be recorded as liabilities. If the entire equity method loss (subject to the financial guarantee / commitment) shall be recognized under SSAP No. 5R, it does not also need to be recognized under SSAP No. 97. If the investee subsequently reports net income, the reporting entity shall resume applying an equity method only after its share of that net income equals the share of net losses not recognized during the period that an equity method was suspended;

Footnote 2: Although the SCA is reported at zero in the investment schedule, a guarantee liability (either contingent or noncontingent) may be required to be reported under SSAP No. 5R. Additionally, refer to the additional guidance related to discontinuance of an equity method in paragraphs 15-17 and INT 00-24: EITF 98-13: Accounting by an Equity Method Investor for Investee Losses When the Investor Has Loans to and Investments in Other Securities of the Investee and EITF 99-10: Percentage Used to Determine the Amount of Equity Method Losses. As detailed in INT 00-24, a reporting entity’s share of losses in an SCA shall be applied to other investments held in the SCA once the SCA (common stock) investment has been reduced to zero.

35. All SCA investments within the scope of this statement (except paragraph 8.b.i. entities) shall include disclosure of the SCA balance sheet value (admitted and nonadmitted) as well as information received from the NAIC in response to the SCA filing (e.g., date and type of filing, NAIC valuation amount, whether resubmission of filing is required). This disclosure shall include an aggregate total of all SCAs (except paragraph 8.b.i. entities) with detail of the aggregate gross value under this statement with the admitted and nonadmitted amounts reflected on the balance sheet. (As noted in paragraph 4, joint ventures, partnerships and limited liability companies are accounted for under the guidance in SSAP No. 48. As such, those entities are not subject to the disclosures in this statement, unless specifically directed by SSAP No. 48.)

- **a.** For all periods presented, a reporting entity whose shares of losses in an SCA exceeds its investment in the SCA shall disclose its share of losses. (This is required regardless of a guarantee or commitment of future financial support to the SCA.) This disclosure shall include the following:
i. The reporting entity’s accumulated share of the SCA losses not recognized during the period that the equity method was suspended;

ii. The reporting entity’s share of the SCA’s equity, including negative equity;

iii. Whether a guaranteed obligation or commitment for financial support exists; and

iv. The SCA’s reported value. The amount of the recognized guarantee under SSAP No. 5R.

Proposed New Exhibit F – This is not new guidance, it pulls in prior guidance from INT 00-24

EXHIBIT F – ILLUSTRATION OF THE APPLICATION OF INT 00-24

XYZ Investment in ABC Company

1. ABC Company is a life insurance company, formed January 2, 20X1 to sell health insurance in the state of New York. On January 2, 20X1, XYZ Insurance Company invested $500,000 in ABC, and purchased 100,000 shares of common stock at par, and 40,000 shares of preferred stock at par. ABC Preferred stock is non-voting, 5% cumulative.

2. XYZ determined it has obtained a controlling interest in ABC as XYZ owns 50% of the voting interests of ABC. XYZ accounted for its investment in ABC Insurance Company under the statutory equity method of accounting. The following table is selected information from the financial statements of ABC Insurance Company.

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</tr>
<tr>
<td>Common stock, $1 par, 200,000 shares issued and outstanding</td>
<td>$200,000</td>
<td>$200,000</td>
<td>$200,000</td>
<td>$200,000</td>
<td>$200,000</td>
</tr>
<tr>
<td>Preferred stock, $10 par, 100,000 shares issued and outstanding</td>
<td>$1,000,000</td>
<td>$1,000,000</td>
<td>$1,000,000</td>
<td>$1,000,000</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Surplus Notes</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>($500,000)</td>
<td>$1,000,000</td>
<td>$1,000,000</td>
<td>$1,000,000</td>
<td>$1,000,000</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Unassigned Funds (Surplus)</td>
<td>($1,980,000)</td>
<td>($1,830,000)</td>
<td>($1,280,000)</td>
<td>($430,000)</td>
<td>$820,000</td>
</tr>
<tr>
<td>Total Capital and Surplus</td>
<td>$(280,000)</td>
<td>$370,000</td>
<td>$920,000</td>
<td>$1,770,000</td>
<td>$3,020,000</td>
</tr>
</tbody>
</table>

3. At 1/2/20X1, XYZ recorded the following entry to record its investment in ABC:

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment in ABC Common stock</td>
<td>$100,000</td>
</tr>
<tr>
<td>Investment in ABC Preferred stock</td>
<td>$400,000</td>
</tr>
</tbody>
</table>
Cash $ 500,000

To record initial investment in ABC Insurance Company.

4. During the year ended 12/31/20X1, ABC had statutory net income before dividends of $200,000. At 12/31/20X1, ABC declared and paid a 5% preferred dividend, and a common stock dividend of $.10 per share. XYZ recorded the following entries:

Cash $ 20,000
Dividend Income $ 20,000

To record preferred dividend income from ABC Insurance Company for 20X1.

Investment in ABC Common stock $ 75,000
Unrealized Gain/Loss $ 75,000

To record 20X1 unrealized gain on investment in ABC Common. (($200,000 - $50,000) * 50%)

Cash $ 10,000
Unrealized Gain/Loss $ 10,000
Dividend Income $ 10,000
Investment in ABC Common stock $ 10,000

To record 20X1 dividend on ABC Common. (100,000 shares * $.10)

5. During the year ended 12/31/20X2, ABC issued an 8% surplus note of $500,000. XYZ purchased 100% of the surplus note. During that same year, ABC incurred a statutory net loss before dividends of $250,000. At 12/31/20X2, ABC declared and paid a 5% preferred dividend, and a common stock dividend of $.05 per share. No interest or principal repayments of the surplus note were approved. XYZ recorded the following entries:

Investment in ABC Surplus Notes $ 500,000
Cash $ 500,000

To record investment in ABC Insurance Company surplus notes.

Cash $ 20,000
Dividend Income $ 20,000

To record preferred dividend income from ABC Insurance Company for 20X2.

Unrealized Gain/Loss $ 150,000
Investment in ABC Common stock $ 150,000

To record 20X2 unrealized loss on investment in ABC Common. (($-250,000 - $50,000) * 50%)

Cash $ 5,000
Unrealized Gain/Loss $ 5,000
Dividend Income $ 5,000
Investment in ABC Common stock $ 5,000

To record 20X2 dividend on ABC Common. (100,000 shares * $.05)

6. During the year ended 12/31/20X3, ABC Insurance Company incurred a statutory net loss before dividends of $400,000. ABC Insurance Company did not declare any dividends, and no interest or principal repayments of the surplus note were approved. XYZ recorded the following entries:
7. During the year ended 12/31/20X4, ABC Insurance Company incurred a statutory net loss before dividends of $750,000. ABC Insurance Company did not declare any dividends, and no interest or principal repayments of the surplus note were approved. XYZ recorded the following entries:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dividends Receivable</td>
<td>$20,000</td>
</tr>
<tr>
<td>Dividend Income</td>
<td>$20,000</td>
</tr>
</tbody>
</table>

To record preferred dividend income from ABC Insurance Company for 20X4.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unrealized Gain/Loss</td>
<td>$458,000</td>
</tr>
<tr>
<td>Investment in ABC Preferred stock</td>
<td>$228,000</td>
</tr>
<tr>
<td>Investment in ABC Surplus note</td>
<td>$230,000</td>
</tr>
</tbody>
</table>

To record 20X4 unrealized loss on investment in ABC Preferred and Surplus Notes.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total net loss and preferred stock dividend ($800,000). Common stock component reduces the Investment in ABC Preferred stock component to $0. (570,000 * 40%) Preferred stock component calculated as:</td>
<td></td>
</tr>
<tr>
<td>Total net loss and preferred dividend (-$750,000 - $50,000)</td>
<td>$800,000</td>
</tr>
<tr>
<td>Less amount used to reduce preferred stock investment to $0</td>
<td>570,000</td>
</tr>
<tr>
<td>Amount remaining to be allocated to investment in preferred</td>
<td>230,000</td>
</tr>
<tr>
<td>XYZ ownership % of preferred</td>
<td>100%</td>
</tr>
<tr>
<td>XYZ reduction in investment in preferred Surplus note</td>
<td>$230,000</td>
</tr>
</tbody>
</table>

8. During the year ended 12/31/20X5, ABC Insurance Company incurred a statutory net loss before dividends of $500,000. ABC Insurance Company did not declare any dividends, and no interest or principal repayments of the surplus note were approved. XYZ recorded the following entries:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dividends Receivable</td>
<td>$20,000</td>
</tr>
<tr>
<td>Dividend Income</td>
<td>$20,000</td>
</tr>
</tbody>
</table>

To record preferred dividend income from ABC Insurance Company for 20X5.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unrealized Gain/Loss</td>
<td>$270,000</td>
</tr>
<tr>
<td>Investment in ABC Surplus note</td>
<td>$270,000</td>
</tr>
</tbody>
</table>
To record 20X5 unrealized loss on investment in ABC Surplus Notes.

Total ABC net loss and preferred stock dividend (-$500,000 - $50,000).
Surplus Note component calculated as:
  Total net loss and preferred dividend (-$500,000 - $50,000) $550,000
  XYZ ownership % of ABC Surplus Note 100%
  Amount of unrealized loss recognized in 20X5 $270,000
  Amount of unrealized loss suspended $280,000

9. Since XYZ has not guaranteed any liabilities of ABC, the reduction they would recognize is limited to their remaining investment in ABC Surplus Notes. Therefore, they would only recognize a 20X5 unrealized loss on their investment in ABC of $270,000.

10. During the year ended 12/31/20X6, ABC Insurance Company realigned their marketing efforts and modified the products they were selling. ABC also issued an additional 8% surplus note of $500,000. This surplus note was purchased by an unaffiliated third party. During the year ended 12/31/X6, ABC Insurance Company had statutory net income before dividends of $200,000. ABC Insurance Company did not declare any dividends on common stock but declared and paid current and dividends in arrears on preferred. XYZ recorded the following entries:

   Cash $80,000
   ______ Dividends Receivable $60,000
   ______ Dividend Income $20,000

To record preferred dividend income from ABC Insurance Company for 20X6, and receipt of preferred dividends receivable for 20X3, 20X4 and 20X5.

11. XYZ did not record any change in their investment in ABC Surplus Notes, ABC Preferred or ABC Common, since ABCs’ net income after preferred dividends did not exceed the losses accumulated during the period that XYZ suspended recording unrealized losses.

12. The following amounts were tracked:

   Total ABC net income and preferred stock dividend ($200,000 - $50,000).
   Surplus Note component calculated as:
   150,000
   XYZ ownership % of ABC Surplus Note 50%
   Amount of unrealized loss suspended in 20X5 $75,000
   Remaining amount of unrealized loss suspended $280,000
   $205,000

13. During the year ended 12/31/20X7, ABC Insurance Company had statutory net income before dividends of $600,000. At 12/31/20X7, ABC declared and paid a 5% preferred dividend. No interest or principal repayments of the surplus note were approved. XYZ recorded the following entries:

   Cash $20,000
   ______ Dividend Income $20,000

To record preferred dividend income from ABC Insurance Company for 20X7.

   Investment in ABC Surplus Notes $70,000
   ______ Unrealized Gain/Loss $70,000

To record 20X7 unrealized gain on investment in ABC Surplus Notes.

   Total ABC net income and preferred stock dividend ($600,000 - $50,000).
14. During the year ended 12/31/20X8, ABC Insurance Company had statutory net income before dividends of $900,000. At 12/31/20X8, ABC declared and paid a 5% preferred dividend. No interest or principal repayments of the surplus note were approved. XYZ recorded the following entries:

- **Cash** $ 20,000
- **Dividend Income** $ 20,000

To record preferred dividend income from ABC Insurance Company for 20X8.

- **Total ABC net income and preferred stock dividend ($900,000 - $50,000).**
- **Surplus Note component calculated as:**
  - **Total net income and preferred dividend ($900,000 - $50,000)** $850,000
  - **XYZ ownership % of ABC Surplus Note** 50%
  - **20X8 amount of unrealized gain on investment in ABC Surplus Note** $425,000

- **Investment in ABC Surplus Notes** $ 425,000
- **Unrealized Gain/Loss** $ 425,000

To record 20X8 unrealized gain on investment in ABC Surplus Notes.

15. During the year ended 12/31/20X9, ABC Insurance Company had statutory net income, before interest on surplus notes and dividends, of $1,400,000. The Commissioner approved one year’s interest payment on the surplus notes. At 12/31/20X9, ABC declared and paid a 5% preferred dividend, and a $.10 dividend per share on Common stock. XYZ recorded the following entries:

- **Cash** $ 20,000
- **Dividend Income** $ 20,000

To record preferred dividend income from ABC Insurance Company for 20X9.

- **Cash** $ 40,000
- **Interest Income** $ 40,000

To record surplus notes interest income from ABC Insurance Company for 20X9. ($500,000 * 8%)

- **Investment in ABC Surplus Notes** $ 5,000
- **Investment in ABC Preferred Stock** $ 400,000
- **Investment in ABC Common Stock** $ 130,000
- **Unrealized Gain/Loss** $ 535,000

To record 20X9 unrealized gain on investment in ABC Common, Preferred and Surplus Notes.

Components computed as follows:

- **Total Net Income net of preferred stock dividend and interest on surplus notes** $ 1,270,000
  - **(1,400,000 - $50,000 - $80,000)**
- **Less amount needed to restore investment in surplus notes** ($ 10,000)
- **Amount available for preferred stock and common stock investment restoration** $ 1,260,000
- **Amount needed to restore preferred stock component** ($ 1,000,000)
- **Amount available to restore common stock component** $ 260,000
**Surplus Notes component ($10,000 * 50%)** | $5,000
---|---
**Preferred Stock component ($1,000,000 * 40%)** | $400,000
**Common stock component ($260,000 * 50%)** | $130,000

<table>
<thead>
<tr>
<th>Category</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$10,000</td>
</tr>
<tr>
<td>Unrealized Gain/Loss</td>
<td>$10,000</td>
</tr>
<tr>
<td>Dividend Income</td>
<td>$10,000</td>
</tr>
<tr>
<td>Investment in ABC Common stock</td>
<td>$10,000</td>
</tr>
</tbody>
</table>

**To record 20X9 dividend on ABC Common. (100,000 shares * $.10)**

On December 7, 2019, the Statutory Accounting Principles (E) Working Group exposed revisions, with modifications suggested by interested parties, as illustrated above, to *SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets* to expand guidance regarding financial guarantees and the use of the equity method for when losses exceed the equity value of an SCA investment. With the revisions, the equity value of an SCA would not go negative, and guaranteed liabilities would be reported to the extent that there is a financial guarantee or commitment. The “Illustration of the Application of INT 00-24” will also be inserted into *SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities*.

G:\FRS\DATA\Stat Acctg\3. National Meetings\A. National Meeting Materials\2020\Spring\Hearing3 - 18-26 - SCA Loss Tracking - Accounting Guidance.docx
Statutory Accounting Principles (E) Working Group  
Maintenance Agenda Submission Form  
Form A

Issue: Prepayments to Service and Claims Adjusting Providers

Check (applicable entity):

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

Description of Issue:
This agenda item seeks to address a regulator inquiry regarding prepayments to providers of claims and adjusting services in which the service provider is prepaid by the insurer. While the initial inquiry for this agenda item was a prepaid roadside assistance provider, the accounting issues are relevant to other providers of claims and adjusting services as well.

The prepayments can take a variety of forms and the provider can take on a variety of duties, but in the example provided, the roadside assistance provider was being prepaid a flat fee for a minimum number of vehicles/policies regardless of claims incurred or sales. The provider additionally received a flat fee per vehicle if actual sales exceed the negotiated minimum number of vehicles. The provider, who is not an insurer, was contracted to provide roadside assistance and administer and settle claims using only the prepaid amounts. So, to use a health care analogy, the provider accepts a “capitated” payment to administer and settle claims.

Roadside assistance is a common feature or rider to many automobile insurance policies that has been available for several years. Roadside assistance provides towing and other services such as jumpstarting car batteries, unlocking doors and gas refills for the insured. Discussions with industry representatives indicate that in most cases, roadside assistance providers may have rates that are negotiated, but providers are not typically prepaid. Rather, when the insured calls for assistance negotiated rate providers are dispatched and subsequently paid at negotiated rates as the claims for assistance are incurred. This agenda item is focused on prepayments to providers.

To provide a fictional numeric example, the minimum annual payment to the provider was for 50,000 vehicles at $10 per vehicle, with additional payments per vehicle required if sales exceed the initial fees. The provider in this example, was also responsible for administering claims and dispatching service in exchange for the “capitated” fee. Therefore, the roadside assistance provider would not bill the insurer further when claims are incurred.

The guidance in SSAP No. 55—Unpaid Claims, Losses and Loss Adjustment Expenses, paragraphs 4 and 5 (excerpted in the Authoritative Literature section) are relevant to the timing of claims recognition and payment of loss adjustment expenses. The guidance provides that claims are recognized when incurred. The existing guidance indicates that paying a third party in advance to adjust claims in the future does not decrease the claims adjustment liability. The claim adjustment liability is only reduced when the claim has been adjusted, not when it is prepaid. In accordance with SSAP No. 64—Offsetting and Netting of Assets and Liabilities, prepayments to a third party do not meet the right of offset requirements.

The statutory accounting and reporting questions at issue are how the direct writer accounts for and reports the prepaid claims and adjusting expenses initially and subsequently. The existing guidance notes that claim adjusting expenses are not reduced for payments to third parties. The guidance in SSAP No. 55 indicates liabilities shall be established in an amount necessary to adjust all unpaid claims irrespective of payments to third parties with the exception that the liability is established net of capitated payments to managed care providers. The prepaid...
expenses under consideration may include a prepayment for claims administration and or a prepayment for the claims.

In reviewing the annual statement instructions for the Underwriting and Expense Exhibit, Part 3, and the related instructions for property and casualty expenses, the initial prepayment to the provider seems be consistent with miscellaneous underwriting expense.

For policies that purchase the coverage and incurred a claim, it seems appropriate to reclassify a proportionate percentage of the initial prepayment to claims incurred and loss adjustment expenses as losses are incurred and adjusted. However, it would be inappropriate to allocate claims expense and claims adjusting expenses to policies that did not purchase the coverage and inappropriate to allocate the costs of the provider to claims or claims adjusting expenses prior to incurring the claims. Therefore, in the event of prepayment to a third-party provider, some of the costs may remain in miscellaneous adjusting expense.

Existing Authoritative Literature:

- SSAP No. 55—Unpaid Claims, Losses and Loss Adjustment Expenses, paragraphs 4 and 5 includes the following:

**SUMMARY CONCLUSION**

4. Claims, losses, and loss/claim adjustment expenses shall be recognized as expenses when a covered or insured event occurs. In most instances, the covered or insured event is the occurrence of an incident which gives rise to a claim or the incurring of costs. For claims-made type policies, the covered or insured event is the reporting to the entity of the incident that gives rise to a claim. Claim payments and related expense payments are made subsequent to the occurrence of a covered or insured event, and in order to recognize the expense of a covered or insured event that has occurred, it is necessary to establish a liability. Liabilities shall be established for any unpaid claims and unpaid losses (loss reserves), unpaid loss/claim adjustment expenses (loss/claim adjustment expense reserves) and incurred costs, with a corresponding charge to income. Claims related extra contractual obligations losses and bad-faith losses shall be included in losses. See individual business types for the accounting treatment for adjustment expenses related to extra contractual obligations and bad-faith lawsuits.

5. The liability for unpaid LAE shall be established regardless of any payments made to third-party administrators, management companies or other entities except for capitated payments under managed care contracts. The liability for claims adjustment expenses on non-capitated payments under managed care contracts shall be established in an amount necessary to adjust all unpaid claims irrespective of payments made to third-party administrators, etc. The liability for claims adjustment expenses on capitated payments under managed care contracts shall be established in an amount necessary to adjust all unpaid claims irrespective of payments to third parties with the exception that the liability is established net of capitated payments to providers.

**General**

10. The liability for claim reserves and claim liabilities, unpaid losses, and loss/claim adjustment expenses shall be based upon the estimated ultimate cost of settling the claims (including the effects of inflation and other societal and economic factors), using past experience adjusted for current trends, and any other factors that would modify past experience. These liabilities shall not be discounted unless authorized for specific types of claims by specific SSAPs, including SSAP No. 54R and SSAP No. 65—Property and Casualty Contracts.

The guidance in SSAP No. 55, paragraph 5 was incorporated from INT 02-21: Accounting for Prepaid Loss Adjustment Expenses and Claim Adjustment Expenses, which was nullified when the guidance was moved to SSAP No. 55.
• **SSAP No. 64—Offsetting and Netting of Assets and Liabilities** provides the following:

2. Assets and liabilities shall be offset and reported net only when a valid right of setoff exists except as provided for in paragraphs 3 and 4. A right of setoff is a reporting entity’s legal right, by contract or otherwise, to discharge all or a portion of the debt owed to another party by applying an amount that the other party owes to the reporting entity against the debt\(^{\text{INT 09-08}}\). A valid right of setoff exists only when all the following conditions are met:

a. Each of the two parties owes the other determinable amounts. An amount shall be considered determinable for purposes of this provision when it is reliably estimable by both parties to the agreement;

b. The reporting party has the right to set off the amount owed with the amount owed by the other party;

c. The reporting party intends to setoff; and

d. The right of setoff is enforceable at law.

• **Property and Casualty Annual Statement Instructions Underwriting and Investment Exhibit Part 3—Expenses** provides the following:

A company that pays any affiliated entity (including a managing general agent) for the management, administration, or service of all or part of its business or operations shall allocate these costs to the appropriate expense classification items (salaries, rent, postage, etc.) as if these costs had been borne directly by the company. Management, administration, or similar fees should not be reported as a one-line expense. The company may estimate these expense allocations based on a formula or other reasonable basis.

A company that pays any non-affiliated entity (including a managing general agent) for the management, administration, or service of all or part of its business or operations shall allocate these costs to the appropriate expense classification item as follows:

a. Payments for claims handling or adjustment services are allocated to Loss Adjustment Expenses (Column 1) in the Underwriting and Investment Exhibit, Part 3. If the total of such expenses incurred equals or exceeds 10% of the total incurred Loss Adjustment Expenses (Line 25, Column 1), the company shall allocate these costs to the appropriate expense classification items as if these costs had been borne directly by the company. If such expenses are less than 10% of the total, they may be reported on Line 1 of Column 1.

b. Payments for services other than claims handling or adjustment services are allocated to the appropriate expense classification items as if these costs had been borne directly by the company, if the total of such fees paid equals or exceeds 10% of the total incurred Other Underwriting Expenses (Line 25, Column 2). If the total is less than 10%, the payments may be reported on Line 2 if the fees are calculated as a percentage of premiums, or on Line 3 if the fees are not calculated as a percentage of premiums.

The total management and service fees incurred attributable to affiliates and non-affiliates is reported in the footnote to the Underwriting and Investment Exhibit, Part 3 of the annual statement, and the method(s) used for allocation shall be disclosed in the Notes to the Financial Statements. The company shall use the same allocation method(s) on a consistent basis. Refer to **SSAP No. 70—Allocation of Expenses** for accounting guidance.

Exclude from investment expenses brokerage and other related fees, to the extent they are included in the actual cost of a bond upon acquisition. Refer to **SSAP No. 26R—Bonds** for accounting guidance.
Include all other internal costs or costs paid to an affiliated company related to origination, purchase or commitment to purchase bonds.

For the purpose of establishing uniformity in classifications of expenses in reporting entities’ statements and reports filed with the Insurance Departments, the company shall observe the instructions contained in the Appendix of these instructions for the Uniform Classification of Expenses.

Activity to Details of Write-ins Aggregated at Line 24 for Miscellaneous Expenses

List separately each category of miscellaneous expenses for which there is no pre-printed line on Underwriting and Investment Exhibit, Part 3.

- Property and Casualty Annual Statement Instructions Underwriting Appendix Instructions for Uniform Classifications of Expenses of Property and Casualty Insurers provides the following:

1.1 Direct

Include: The Following Expenses When in Connection with the Investigation and Adjustment of Policy Claims:

Independent Adjusters: Fees and expenses of independent adjusters or settling agents

Legal: Fees and expenses of lawyers for legal services in the defense, trial, or appeal of suits, or for other legal services

Bonds: Premium costs of bonds

Appeal Costs and Expenses: Appeal bond premiums, charges for printing records, charges for printing briefs, court fees and incidental to appeals

General Court Costs and Fees: Entry fees and other court costs, and other fees not includible in Losses (Note: Interest and costs assessed as part of or subsequent to judgment are includible in Losses.)

Medical Testimony: Fees and expenses of medical witnesses of attendance or testimony at trials or hearings ("Medical" includes physicians, surgeons, chiropractors, chiropodists, dentists, osteopaths, veterinarians, and hospital representatives.)

Expert Witnesses: Fees and expenses of expert witnesses for attendance or testimony at trials or hearings

Lay Witnesses: Fees and expenses of lay witnesses for attendance or testimony at trials or hearings

Services of Process: Constables, sheriffs, and other fees and expenses for service of process, including subpoenas

Transcripts of Testimony: Stenographers’ fees and fees for transcripts of testimony

Medical Examinations: Fees for medical examinations, fees for performing autopsies, fees for impartial examination, x-rays, etc., for the purpose of trial and determining questions of liability (This does not include fees for medical examinations, x-rays, etc., made to determine necessary treatment, or made solely to determine the extent or continuation of disability, or first aid charges, as such fees and charges are includible in Losses.)

Miscellaneous: Costs of appraisals, expert examinations, surveys, plans, estimates, photographs, maps, weather reports, detective reports, audits, credit or character reports, watchmen (Charges for hospital records and records of other kinds, notary fees, certified copies of certificates and legal documents, charges for Claim Adjustment Services by underwriting syndicates, pools, and associations)
Exclude: Compensation to employees (see Salaries)

Expenses of salaried employees (see Travel and Travel Items)

Items includible in Allowances to Managers and Agents

Payments to State Industrial Commissions (see Taxes, Licenses, and Fees)

Payments to claim adjusting organizations except where the expense is billed specifically to individual companies (see Boards, Bureaus, and Associations)

Cost of services of medical examiners for underwriting purposes (see Surveys and Underwriting Reports)

Salvage and subrogation recovery expense, rewards, lost and found advertising, expenses for disposal of salvage (Such expenses shall be deducted from salvage.)

Any expenses which by these instructions are includible elsewhere

Separation of Claim Adjustment Services:

The Statistical Plans filed by certain rating bureaus contain definitions of “Allocated Loss Adjustment Expenses” which exclude for rating purposes certain types of claim adjustment services as defined herein. For the lines of business thus affected, companies that are members of such rating bureaus shall maintain records necessary to the reporting of Claim Adjustment Services—Direct, as follows:

a. As defined in Statistical Plans

b. Other than as defined in Statistical Plans

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: June 2017 updates to the AICPA Revenue Recognition Guide noted in Issue #9- 1: Considerations for applying the scope exception in FASB ASC 606-10-15-2 and 606-10-15-4 to Contracts within the Scope of ASC 944 contains some discussion on roadside assistance that is tangential but does not address the prepayments under discussion. The updates were issued in response to questions regarding Accounting Standards Update (ASU) 2016-20: Technical Corrections and Improvements to Topic 606, Revenue from Contracts from Customers.

At issue was whether to bifurcate insurance contracts within the scope of Topic 944, Financial Services—Insurance that contain noninsurance elements and account for them within the scope of Topic 606, Revenue from Contracts from Customers. Roadside assistance provided with an automobile insurance policy was listed as an example of activities performed by an insurance entity, included in contracts within the scope of FASB Topic 944, that Financial Reporting Executive Committee (FinREC) believes generally should be considered fulfillment activities (that either mitigate risks to the insurer or contain costs related to services to fulfill the insurer’s obligation) that are not within the scope of FASB Topic 606, but should be considered part of the insurance contract within the scope of FASB Topic 944. Roadside assistance was noted as mitigating the risk of a further accident or damage to the insured automobile.

Convergence with International Financial Reporting Standards (IFRS): During the development of IFRS 17, Insurance Contracts, the International Accounting Standards Board (IASB) had discussions regarding classification for the revenue which are not on point to roadside assistance prepayments. Similar to the AICPA issue noted above, the issue was whether roadside assistance sold as part of an insurance policy should be included within the scope of insurance contracts or whether it should be accounted for separately as fee for
service. The IFRS 17 issued in May 2017 notes that some fixed-fee service contracts meet the definition of an insurance contract (for example, automobile roadside assistance) and IFRS 17 provides an option to use IFRS 15, Revenue from Contracts with Customers to account for as fee for service.

Staff Review Completed by:
Robin Marcotte, NAIC Staff - September 2018

Staff Recommendation:

NAIC Staff recommends that the Working Group move this item to the active listing, categorized as nonsubstantive and expose revisions to SSAP No. 55 to provide guidance as follows:

1. The initial prepayment for providers of claims adjusting expense and claim payment is recognized as a miscellaneous underwriting expense.

2. Subsequently, for direct policies that purchased the related insurance coverage which used the claims or adjusting services incur losses which are paid, a proportionate percentage of the initial provider prepayment amounts are reclassified from miscellaneous underwriting expense to claims adjustment expense and or claims expense, as applicable

3. To the extent that additional amounts are prepaid for direct policies that did not purchase services, the prepaid expenses shall remain in miscellaneous underwriting expenses.

Note that NAIC staff envisions that additional annual statement instruction clarifications may be indicated after the Working Group finalizes guidance.

Proposed revisions to SSAP No. 55 recommended for November 2018 exposure:

4. Claims, losses, and loss/claim adjustment expenses shall be recognized as expenses when a covered or insured event occurs. In most instances, the covered or insured event is the occurrence of an incident which gives rise to a claim or the incurring of costs. For claims-made type policies, the covered or insured event is the reporting to the entity of the incident that gives rise to a claim. Claim payments and related expense payments are made subsequent to the occurrence of a covered or insured event, and in order to recognize the expense of a covered or insured event that has occurred, it is necessary to establish a liability. Liabilities shall be established for any unpaid claims and unpaid losses (loss reserves), unpaid loss/claim adjustment expenses (loss/claim adjustment expense reserves) and incurred costs, with a corresponding charge to income.

   a. Prepayments to third party administrators, management companies or other entities for unpaid losses/claims, except for capitated payments for manage care contracts, shall not reduce losses/claims and shall be initially reported as miscellaneous underwriting expenses. When incurred losses/claims are paid, claims prepayments to third party administrators, management companies or other entities (except for capitated payments for manage care contracts) are reclassified proportionately based on the losses/claims cost from miscellaneous underwriting expenses to loss/claim expenses paid. Flat fee minimum prepayments to third party administrators or management companies or other entities that do not relate to services or adjusting for the underlying direct policy benefits are reported as miscellaneous underwriting expenses and not reclassified to loss/claim adjusting expenses.

   b. Claims related extra contractual obligations losses and bad-faith losses shall be included in losses. See individual business types for the accounting treatment for adjustment expenses related to extra contractual obligations and bad-faith lawsuits.
5. The liability for unpaid LAE shall be established regardless of any payments made to third-party administrators, management companies or other entities except for capitated payments made under managed care contracts. The liability for claims adjustment expenses on non-capitated payments under managed care contracts shall be established in an amount necessary to adjust all unpaid claims irrespective of payments made to third-party administrators, etc. The liability for claims adjustment expenses on capitated payments under managed care contracts shall be established in an amount necessary to adjust all unpaid claims irrespective of payments to third parties with the exception that the liability is established net of capitated payments to providers.

a. Prepayments to third party administrators, management companies or other entities, except for capitated payments for manage care contracts, for unpaid losses/claims adjusting expenses shall be initially reported as miscellaneous underwriting expenses.

b. When incurred losses/claims adjusting expenses are paid, prepayments to third party administrators, management companies or other entities (except for capitated payments for manage care contracts) are reclassified proportionately based on the adjusting expenses from miscellaneous underwriting expenses to paid loss/claim adjusting expenses. Flat fee minimum prepayments to third party administrators or management companies or other entities that do not relate to services or adjusting for the underlying direct policy benefits are reported as miscellaneous underwriting expenses and not reclassified to loss/claim adjusting expenses.

Status:
On November 15, 2018, the Statutory Accounting Principles (E) Working Group moved this item to the active listing, categorized as nonsubstantive, and exposed revisions to SSAP No. 55—Unpaid Claims, Losses and Loss Adjustment Expenses, as shown above, to provide guidance clarifying that prepayments to providers of claims and adjusting services shall be recognized as miscellaneous underwriting expenses, with guidance for reclassification as claims adjustment expense or claims expense, as applicable, as claims are paid. During the November 2018 Working Group discussion, it was highlighted that the proposed treatment is different than recognizing a nonadmitted prepaid asset, as the amounts are not expected to be material. Comments were requested on this difference and if the amounts are expected to be material.

Spring 2019 National Meeting discussion:

NAIC staff recommends re-exposure of modified proposed language which was developed with interested parties input as illustrated below and in the agenda item. The interested parties responded to the request for comments and noted a preference to “nonadmit a prepaid asset” for prepaid loss and LAE, which is consistent with existing guidance, instead of the to the previously exposed “expense and reclassify as amounts are paid” approach. NAIC staff has proposed a modification to the interested parties’ proposed language to exclude the reference to SSAP No. 84—Health Care and Government Insured Plan Receivables which is not currently referenced in SSAP No. 55. In addition, NAIC staff has recommended guidance regarding flat fee bundled payments which indicates nonadmission of prepaid amounts and allocation to expense categories as benefits or services are rendered.

On April 6, 2019, the Statutory Accounting Principles (E) Working Group exposed modified language, developed with interested parties’ input as described above, which requires nonadmittance for prepaid loss and LAE. This guidance is consistent with existing statutory accounting principles and was revised from the previously exposed “expense and reclassify as amounts are paid” approach. In addition, guidance was exposed regarding flat fee bundled payments which indicates nonadmission of prepaid amounts and allocation to expense categories as benefits or services are rendered. The exposed language is illustrated below.

2019 Spring National Meeting exposure:
SSAP No. 55—Unpaid Claims, Losses and Loss Adjustment Expenses:

4. Claims, losses, and loss/claim adjustment expenses shall be recognized as expenses when a covered or insured event occurs. In most instances, the covered or insured event is the occurrence of an incident which gives rise to a claim or the incurring of costs. For claims-made type policies, the covered or insured event is the reporting to the entity of the incident that gives rise to a claim. Claim payments and related expense payments are made subsequent to the occurrence of a covered or insured event, and in order to recognize the expense of a covered or insured event that has occurred, it is necessary to establish a liability. Liabilities shall be established for any unpaid claims and unpaid losses (loss reserves), unpaid loss/claim adjustment expenses (loss/claim adjustment expense reserves) and incurred costs, with a corresponding charge to income.

   a. All prepayments (i.e., variable, fixed or bundled amounts) to third party administrators, management companies or other entities for unpaid claims, losses and losses/claims adjustment expenses, except for capitated payments for managed care contracts, shall not reduce losses/claims and shall be initially reported as a prepaid asset and nonadmitted in accordance with SSAP No. 29—Prepaid Expenses. When the benefit has been provided to the policyholder or claimant, the claims prepayments to third party administrators, management companies or other entities (except for capitated payments for managed care contracts), are reclassified proportionately from the prepaid nonadmitted asset to claims, losses or loss/claim expenses paid based on the amount of losses/claims cost incurred to provide the benefit.

   b. Prepayments to third party administrators or management companies or other entities that do not relate to services or adjusting for the underlying direct policy benefits are reported as miscellaneous underwriting expenses.

   c. Claims related extra contractual obligations losses and bad-faith losses shall be included in losses. See individual business types for the accounting treatment for adjustment expenses related

5. The liability for unpaid LAE shall be established regardless of any payments made to third-party administrators, management companies or other entities except for capitated payments under managed care contracts. The liability for claims adjustment expenses on non-capitated payments under managed care contracts shall be established in an amount necessary to adjust all unpaid claims irrespective of payments made to third-party administrators, etc. The liability for claims adjustment expenses on capitated payments under managed care contracts shall be established in an amount necessary to adjust all unpaid claims irrespective of payments to third parties with the exception that the liability is established net of capitated payments to providers.

   a. When the prepaid benefit as described in paragraph 4 has been provided to the policyholder or the claimant, the associated prepayments to third party administrators, management companies or other entities (except for capitated payments for managed care contracts) are reclassified proportionately from the prepaid nonadmitted asset to paid loss/claim adjusting expenses based on the amount of losses/claims cost incurred to provide the benefit. Prepayments to third party administrators or management companies or other entities that do not relate to services or adjusting for the underlying direct policy benefits are reported as miscellaneous underwriting expenses.

On August 3, 2019, the Statutory Accounting Principles (E) Working Group exposed revisions to SSAP No. 55, as illustrated below, that emphasize existing guidance that loss and loss adjusting expense liabilities are established regardless of payments to third parties (except for capitated health claim payments). The liabilities are not recognized as paid until the losses are paid to claimants or claims are adjusted. Prepayments to third party administrators, which are not for claims or loss adjusting expense, are “miscellaneous underwriting expenses.” The revisions also add a reference to SSAP No. 84—Health Care and Government Insured Plan Receivables regarding prepayments to providers.
2019 Summer National Meeting exposure:

SSAP No. 55—Unpaid Claims, Losses and Loss Adjustment Expenses:

4. Claims, losses, and loss/claim adjustment expenses shall be recognized as expenses when a covered or insured event occurs. In most instances, the covered or insured event is the occurrence of an incident which gives rise to a claim or the incurring of costs. For claims-made type policies, the covered or insured event is the reporting to the entity of the incident that gives rise to a claim. Claim payments and related expense payments are made subsequent to the occurrence of a covered or insured event, and in order to recognize the expense of a covered or insured event that has occurred, it is necessary to establish a liability. Liabilities shall be established for any unpaid claims and unpaid losses (loss reserves), unpaid loss/claim adjustment expenses (loss/claim adjustment expense reserves) and incurred costs, with a corresponding charge to income.

a. The liability for unpaid losses and claims shall be established regardless of any payments made to third-party administrators, management companies or other entities except for capitated payments under managed care contracts. The liability for claims on non-capitated payments under managed care contracts shall be established in an amount necessary to pay the losses/claims irrespective of payments made to third-party administrators, etc. The liability for claims on capitated payments under managed care contracts shall be established in an amount necessary to adjust all unpaid claims irrespective of payments to third parties with the exception that the liability is established net of capitated payments to providers. As loss or claims payments occur, from the third-party administrators, management companies or other entities, to the policyholder or claimant, (except for capitated payments for managed care contracts) paid claims, losses or paid loss/paid claim adjusting liabilities are reduced. Note that guidance regarding the admissibility of loans and advances to providers which apply to health insurance and managed care contracts are addressed in SSAP No. 84—Health Care and Government Insured Plan Receivables.

b. Prepayments to third party administrators or management companies or other entities that do not relate to services or adjusting for the underlying direct policy benefits are reported as 1) Aggregate write ins for miscellaneous expenses - Property and Casualty (Underwriting and Investment Exhibit Part 3); 2) Aggregate write ins for expenses - Life/Health (Exhibit 2 – General expenses) or 3) aggregate write ins for expenses (General Administrative Expenses)- health (Underwriting and Investment Exhibit Part 3).

c. Claims related extra contractual obligations losses and bad-faith losses shall be included in losses. See individual business types for the accounting treatment for adjustment expenses related

5. The liability for unpaid LAE shall be established regardless of any payments made to third-party administrators, management companies or other entities except for capitated payments under managed care contracts. The liability for claims adjustment expenses on non-capitated payments under managed care contracts shall be established in an amount necessary to adjust all unpaid claims irrespective of payments made to third-party administrators, etc. The liability for claims adjustment expenses on capitated payments under managed care contracts shall be established in an amount necessary to adjust all unpaid claims irrespective of payments to third parties with the exception that the liability is established net of capitated payments to providers.

a. Prepayments to third party administrators or management companies or other entities that do not relate to services or adjusting for the underlying direct policy benefits are reported as 1) Aggregate write ins for miscellaneous expenses - Property and Casualty (Underwriting and Investment Exhibit Part 3); 2) Aggregate write ins for expenses - Life/Health (Exhibit 2 – General expenses) or 3) aggregate write ins for expenses (General Administrative Expenses)- health (Underwriting and Investment Exhibit Part 3).
For Fall 2019 National Meeting Discussion:

NAIC Staff recommends that the Working Group expose revisions incorporating the majority of interested parties’ comments as reflected below as tracked changes to SSAP No. 55 (rather than as reflected as changes to the Summer 2019 exposure). Interested parties’ comments primarily delete the exposed guidance and move the same or similar concepts into the broad product guidance for property and casualty, life and health or health in SSAP No. 55. These revisions are to reinstate annual statement references by entity type and to adjust scoping language and make the SSAP No. 29 prepaid guidance consistent. Note that shading reflects staff proposed variations in wording from the interested parties proposed wording that accomplishes a similar intent.

On December 7, 2019, the Statutory Accounting Principles (E) Working Group exposed revisions to SSAP No. 55—Unpaid Claims, Losses and Loss Adjustment Expenses, as illustrated below, that incorporate interested parties’ recommendations to separate the guidance by product type and emphasize guidance that loss and loss adjusting expense liabilities are established regardless of payments to third parties (except for capitated health claim payments). The revisions emphasize existing guidance that claims that related liabilities are not recognized as paid until the losses are paid to claimants or claims are adjusted. Note that shading reflects staff proposed variations in wording from the interested parties’ proposed wording that accomplishes a similar intent.

Fall
Unpaid Claims, Losses and Loss Adjustment Expenses SSAP No. 55

SUMMARY CONCLUSION

4. Claims, losses, and loss/claim adjustment expenses shall be recognized as expenses when a covered or insured event occurs. In most instances, the covered or insured event is the occurrence of an incident which gives rise to a claim or the incurring of costs. For claims-made type policies, the covered or insured event is the reporting to the entity of the incident that gives rise to a claim. Until claim payments and related expense payments are made subsequent to the occurrence of a covered or insured event, and in order to recognize the expense of a covered or insured event that has occurred, it is necessary to establish a liability. Liabilities shall be established for any unpaid claims and unpaid losses (loss reserves), unpaid loss/claim adjustment expenses (loss/claim adjustment expense reserves) and incurred costs, with a corresponding charge to income. Claims related extra contractual obligations losses and bad-faith losses shall be included in losses. See individual business types for the accounting treatment for adjustment expenses related to extra contractual obligations and bad-faith lawsuits.

5. The liability for unpaid LAE shall be established regardless of any payments made to third-party administrators, management companies or other entities except for capitated payments under managed care contracts for which the liability for claims adjustment expenses on non-capitated payments under managed care contracts shall be established in an amount necessary to adjust all unpaid claims irrespective of payments made to third-party administrators, etc. The liability for claims adjustment expenses on capitated payments under managed care contracts shall be established in an amount necessary to adjust all unpaid claims irrespective of payments to third parties with the exception that the liability is established net of capitated payments to providers.

Property/Casualty

6. The following are types of future costs relating to property and casualty contracts, as defined in SSAP No. 50, which shall be considered in determining the liabilities for unpaid losses and loss adjustment expenses:

   a. Reported Losses: Expected payments for losses relating to insured events that have occurred and have been reported to, but not paid by, the reporting entity as of the statementdate;
b. Incurred But Not Reported Losses (IBNR): Expected payments for losses relating to insured events that have occurred but have not been reported to the reporting entity as of the statement date. As a practical matter, IBNR may include losses that have been reported to the reporting entity but have not yet been entered to the claims system or bulk provisions. Bulk provisions are reserves included with other IBNR reserves to reflect deficiencies in known case reserves;

c. Loss Adjustment Expenses: Expected payments for costs to be incurred in connection with the adjustment and recording of losses defined in paragraphs 6.a. and 6.b. Examples of expenses incurred in these activities are estimating the amounts of losses, disbursing loss payments, maintaining records, general clerical, secretarial, office maintenance, occupancy costs, utilities, computer maintenance, supervisory and executive duties, supplies, and postage. Loss adjustment expenses can be classified into two broad categories: Defense and Cost Containment (DCC) and Adjusting and Other (AO):

i. DCC include defense, litigation, and medical cost containment expenses, whether internal or external. DCC include, but are not limited to, the following items:

(a) Surveillance expenses;
(b) Fixed amounts for medical cost containment expenses;
(c) Litigation management expenses;
(d) Loss adjustment expenses for participation in voluntary and involuntary market pools if reported by accident year;
(e) Fees or salaries for appraisers, private investigators, hearing representatives, reinspectors and fraud investigators, if working in defense of a claim, and fees or salaries for rehabilitation nurses, if such cost is not included in losses;
(f) Attorney fees incurred owing to a duty to defend, even when other coverage does not exist; and
(g) The cost of engaging experts;

ii. AO are those expenses other than DCC as defined in (i) above assigned to the expense group “Loss Adjustment Expense.” AO include, but are not limited to, the following items:

(a) Fees and expenses of adjusters and settling agents;
(b) Loss adjustment expenses for participation in voluntary and involuntary market pools if reported by calendar year;
(c) Attorney fees incurred in the determination of coverage, including litigation between the reporting entity and the policyholder;

Legal defense costs incurred under the definition of covered damages or losses as the only insured peril would be accounted for as losses, while legal defense costs incurred under a duty to defend would be accounted for as Defense and Cost Containment (DCC). For policies where legal costs are the only insured peril, the insurer would record the legal costs that reimburse the policyholder as loss and, to the extent the insurer participated in the defense, would record its legal costs as DCC. This is not intended to change the
classifications of legal expenses for existing long tailed lines of liability coverage, such as medical malpractice and workers' compensation insurance.

(d) Fees and salaries for appraisers, private investigators, hearing representatives, reinspectors and fraud investigators, if working in the capacity of an adjuster; and

(e) Adjustment expenses arising from claims related lawsuits such as extra contractual obligations and bad faith lawsuits.

d. The contractual terms for arrangements (i.e., variable, fixed or bundled amounts) to third party administrators, management companies, or other entities for unpaid claims, losses and losses/claims adjustment expenses, shall be evaluated to determine if the arrangement meets the criteria to be reported as a prepaid asset and nonadmitted in accordance with SSAP No. 29—Prepaid Expenses. These payments shall not be offset against any amounts required to be reported in accordance with paragraphs 4 or 5 within this guidance. Only when loss/claim and related adjusting expense payments which are made by the third-party administrators, management companies or other entities, to the policyholder or claimant, shall the insurer's liability (loss/claim or loss/claim adjustment expense reserves) be reduced.

c. Prepayments to third party administrators or management companies or other entities that do not relate to services or adjusting for the underlying direct policy benefits are reported as aggregate write-in for miscellaneous underwriting benefits in the Underwriting and Investment exhibit Part 3.

Life, Accident and Health

7. The following future costs relating to life and accident and health indemnity contracts, as defined in SSAP No. 50, shall be considered in determining the liability for unpaid claims and claim adjustment expenses:

a. Accident and Health Claim Reserves: Reserves for claims that involve a continuing loss. This reserve is a measure of the future benefits or amounts not yet due as of the statement date which are expected to arise under claims which have been incurred as of the statement date. This shall include the amount of claim payments that are not yet due such as those amounts commonly referred to as disabled life reserves for accident and health claims. The methodology used to establish claim reserves is discussed in SSAP No. 54R.

b. Claim Liabilities for Life/Accident and Health Contracts:

i. Due and Unpaid Claims: Claims for which payments are due as of the statement date;

ii. Resisted Claims in Course of Settlement: Liability for claims that are in dispute and are unresolved on the statement date. The liability either may be the full amount of the submitted claim or a percentage of the claim based on the reporting entity’s past experience with similar resisted claims;

iii. Other Claims in the Course of Settlement: Liability for claims that have been reported but the reporting entity has not received all of the required information or processing has not otherwise been completed as of the statement date;
iv. Incurred But Not Reported Claims: Liability for which a covered event has occurred (such as death, accident, or illness) but has not been reported to the reporting entity as of the statement date.

c. Claim Adjustment Expenses for Accident and Health Reporting Entities are those costs expected to be incurred in connection with the adjustment and recording of accident and health claims defined in paragraphs 7.a. and 7.b. Certain claim adjustment expenses reduce the number or cost of health services thereby resulting in lower premiums or lower premium increases. These claim adjustment expenses shall be classified as cost containment expenses.

d. Claim Adjustment Expenses for Life Reporting Entities: Costs expected to be incurred (including legal and investigation) in connection with the adjustment and recording of life claims defined in paragraph 7.b. This would include adjustment expenses arising from claims-related lawsuits such as extra contractual obligations and bad-faith lawsuits.

c. In cases where insurers advance funds to third-party administrators, management companies or other entities prior to the occurrence of the claim who then, on behalf of the insurer, adjudicate the claim and make payments to insureds or other claimants, the guidance in paragraph 9 applies.

Managed Care

8. The following costs relating to managed care contracts as defined in SSAP No. 50 shall be considered in determining the claims unpaid and claims adjustment expenses:

a. Claims unpaid for Managed Care Reporting Entities:

i. Unpaid amounts for costs incurred in providing care to a subscriber, member or policyholder including inpatient claims, physician claims, referral claims, other medical claims, resisted claims in the course of settlement and other claims in the course of settlement;

ii. Incurred But Not Reported Claims: Liability for which a covered event has occurred (such as an accident, illness or other service) but has not been reported to the reporting entity as of the statement date;

iii. Additional unpaid medical costs resulting from failed contractors under capitation contracts and provision for losses incurred by contractors deemed to be related parties for which it is probable that the reporting entity will be required to provide funding;

b. Claim Adjustment Expenses for Managed Care Reporting Entities are those costs expected to be incurred in connection with the adjustment and recording of managed care claims defined in paragraph 8.a. Certain claim adjustment expenses reduce the number or cost of health services thereby resulting in lower premiums or lower premium increases. These claim adjustment expenses shall be classified as cost containment expenses.

c. Liabilities for percentage withholds ("withholds") from payments made to contracted providers;

d. Liabilities for accrued medical incentives under contractual arrangements with providers and other risk-sharing arrangements whereby the health entity agrees to share savings with contracted providers.
e. In cases where insurers advance funds to third-party administrators, management companies or other entities prior to the occurrence of the claim who then, on behalf of the insurer, adjudicate the claim and make payments to insureds or other claimants, the guidance in paragraph 9 applies.

Managed Care and Accident and Health

**Drafting Note:** New guidance is issued within par. 9, which is underlined. Existing par 9 is renumbered to par. 10, and all other pars within existing guidance (i.e., pars. 10 – 23, will be renumbered to 11 – 24, respectively.

9. In some instances, insurers advance funds to third-party administrators, management companies or other entities prior to the occurrence of the claim who then, on behalf of the insurer, adjudicate the claim and make payments to insureds or other claimants. In such cases the following guidance applies:

   a. For capitated payments under managed care contracts, the liability for claims and claim adjusting expenses shall be established in an amount necessary to adjudicate and pay all unpaid claims irrespective of payments to third-party administrators, management companies or other entities, and is reported net of capitated payments to providers.

   b. For non-capitated advance payments, the liability for unpaid losses/claims and related adjustment expenses shall be established regardless of any payments made to third-party administrators, management companies or other entities, and such payments shall be reported by the insurer as prepayments. All prepayments (i.e., variable, fixed or bundled amounts) to third party administrators, management companies, or other entities for unpaid claims, losses and losses/claims adjustment expenses, shall be initially reported as a prepaid asset and nonadmitted in accordance with SSAP No. 29—Prepaid Expenses. These payments shall not be offset against any amounts required to be reported in accordance with paragraphs 4 or 5 within this guidance. Only when loss/claim and related adjusting expense payments which are made by the third-party administrators, management companies or other entities, to the policyholder or claimant, shall the insurer’s liability (loss/claim or loss/claim adjustment expense reserves) be reduced.

   c. Prepayments to third party administrators or management companies or other entities that do not relate to services or adjusting for the underlying direct policy benefits are reported as (1) Aggregate write ins for expenses - Life/ Health (Exhibit 2 – General expenses) or (2) Aggregate write ins for expenses (General Administrative Expenses) - Health (Underwriting and Investment Exhibit Part 3).

Note that this guidance in paragraph 9 does not alter existing guidance regarding the admissibility of loans and advances to providers which apply to health insurance and managed care contracts which is addressed in SSAP No. 84—Health Care and Government Insured Plan Receivables.
Statutory Accounting Principles (E) Working Group  
Maintenance Agenda Submission Form  
Form A

Issue: Look-Through with Multiple Holding Companies

Check (applicable entity):

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<thead>
<tr>
<th>Modification of Existing SSAP</th>
<th>P/C</th>
<th>Life</th>
<th>Health</th>
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<td>New Issue or SSAP</td>
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<tr>
<td>Interpretation</td>
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Description of Issue:
This agenda item was drafted in response to Working Group direction from the 2019 Summer National Meeting. A clarification question arose while discussing agenda item 2019-13, Clarification of a Look-Through Approach. The Working Group verbalized the conclusion that a look-through is permitted through more than one downstream company so as long as each look-through entity complies with SSAP No. 97—Investment in Subsidiary, Controlled and Affiliated Entities. In response to interested party request for formal clarification, the Working Group directed a separate agenda item to provide this guidance in SSAP No. 97. This agenda item formally documents this guidance within statutory accounting.

Existing Authoritative Literature:

SSAP No. 97:

27. The process of admitting audited investments in entities owned by an unaudited downstream noninsurance holding company SCA entity will be known as a “look through.” In order to admit the investments in audited SCAs or the audited non SCA SSAP No. 48 entities owned by an unaudited downstream noninsurance holding company, a reporting entity may apply the look through approach, provided all of the following conditions are met:

   a. Downstream holding company is an 8.b.iii entity.

   b. The downstream holding company does not own any other assets which are material to the downstream holding company other than the audited SCA entities and/or audited non SCA SSAP No. 48 entities, and

   c. The downstream noninsurance holding company is not subject to liabilities, commitments, contingencies, guarantees or obligations which are material to the downstream noninsurance holding company.

If an investment in a downstream noninsurance holding company meets the requirements set forth above, the reporting entity can admit the individual audited SCA entities and/or audited non SCA SSAP No. 48 entities; however, unaudited immaterial assets of the downstream noninsurance holding company are to be carried at the lesser of the paragraph 8 valuation or nonadmitted (e.g. some equity method investments are required to be carried at a negative value due to either statutory adjustments or to parental obligations to keep funding the subsidiary).

Activity to Date (issues previously addressed by the Working Group, Emerging Accounting Issues (E) Working Group, SEC, FASB, other State Departments of Insurance or other NAIC groups): Agenda item 2019-13, Clarification of a Look-Through Approach was disposed at the Summer 2019 National Meeting. As part of the disposal action, the Statutory Accounting Principles (E) Working Group directed NAIC staff to draft a new
agenda item clarifying that a more-than-one holding company structure is permitted if each of the holding companies complies with SSAP No. 97.

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

Convergence with International Financial Reporting Standards (IFRS):
Not applicable.

Staff Recommendation:
NAIC staff recommends that the Working Group move this item to the active listing, categorized as nonsubstantive and expose revisions to SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities, to clarify that a more-than-one holding company structure is permitted as a look-through if each of the holding companies within the structure complies with the requirements in SSAP No. 97.

Proposed Revisions:

27. The process of admitting audited investments in entities owned by an unaudited downstream noninsurance holding company SCA entity will be known as a “look through.” In order to admit the investments in audited SCAs or the audited non SCA SSAP No. 48 entities owned by an unaudited downstream noninsurance holding company, a reporting entity may apply the look through approach, provided all of the following conditions are met:

   a. The downstream noninsurance holding company is an 8.b.iii entity, and

   b. The downstream noninsurance holding company does not own any other assets which are material to the downstream holding company other than the audited SCA entities and/or audited non SCA SSAP No. 48 entities, and

   c. The downstream noninsurance holding company is not subject to liabilities, commitments, contingencies, guarantees or obligations which are material to the downstream noninsurance holding company.

If an investment in a downstream noninsurance holding company meets the requirements set forth above, the reporting entity can admit the individual audited SCA entities and/or audited non SCA SSAP No. 48 entities; however, unaudited immaterial assets of the downstream noninsurance holding company are to be carried at the lesser of the paragraph 8 valuation or nonadmitted (e.g. some equity method investments are required to be carried at a negative value due to either statutory adjustments or to parental obligations to keep funding the subsidiary). If a holding company structure has more than one downstream noninsurance holding company, each downstream non-insurance holding company may be looked through, provided each downstream non-insurance holding company meets all of the conditions in paragraph 27.

Staff Review Completed by:
Fatima Sediqzad - NAIC Staff
September 2019

Status:
On December 7, 2019, the Statutory Accounting Principles (E) Working Group moved this agenda item to the active listing, categorized as nonsubstantive, and exposed revisions to SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities, as illustrated above, to clarify that a more-than-one holding company structure is permitted as a look-through if each of the holding companies within the structure complies with the requirements in SSAP No. 97.
Statutory Accounting Principles (E) Working Group
Maintenance Agenda Submission Form
Form A

Issue: Update Withdrawal Disclosures

Check (applicable entity):

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Description of Issue:
In November 2018, the Working Group updated the life, health and separate account liquidity disclosures to provide more granularity of the withdrawal characteristics by product type. These updates were developed by the Financial Stability (Ex) Task Force and were adopted in agenda item 2018-28: Updates to Liquidity Disclosures. Agenda item 2018-28 updated the liquidity disclosures in SSAP No. 51R—Life Contracts, SSAP No. 52—Deposit-Type Contracts, and SSAP No. 61R—Life, Deposit-Type and Accident and Health Reinsurance with an effective date of year-end 2019.

This agenda item proposes minor clarifying edits to the disclosures identified subsequent to the adoption of the related 2019 annual statement blanks proposal. These items include:

- Addition of separate account guaranteed products in one of the illustrations to remedy its omission. As quoted in the authoritative literature section below, SSAP No. 51R, SSAP No. 52 and SSAP No. 61R currently reference both guaranteed and nonguaranteed separate account products. This adds a consistency revision to SSAP No. 51R to ensure separate account guaranteed products are referenced in all applicable paragraphs of the withdrawal characteristics disclosures.

- Correct an identified inconsistency in one of the new disclosures that was added regarding products that will move from the reporting line of having surrender charges at 5% or more to the reporting line of surrender charges at less than 5%. A clarification is being recommended to ensure consistency in annual statement reporting.

- Add a cross-reference from SSAP No. 56—Separate Accounts to the existing disclosures by withdrawal characteristics in SSAP No. 51R and SSAP No. 61R as the disclosures include separate account products.

Existing Authoritative Literature:
The below includes excerpts of text that was updated in agenda item 2018-28.

SSAP No. 51R—Life Contracts (Bolding added for emphasis):

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

NOTE: Subparagraphs a-f omitted for brevity.
46. Disclose the amounts of account value, cash value and reserve for the breakouts of life insurance by withdrawal characteristics, separately for General Account products and Separate Account Nonguaranteed products, as follows:

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

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

   c. Total gross (Direct + Assumed)

   d. Reinsurance ceded

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

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

47. Reconcile total life insurance reserves amount disclosed to the appropriate sections of the Aggregate Reserves for Life Policies and Contracts Exhibit (Exhibit 5) of the Life, Accident and Health Annual Statement and the corresponding lines in the Separate Accounts Statement. The reconciliation is a single presentation including all amounts from the sections on Individual Life Insurance and Group Life Insurance.
SSAP No. 52—Deposit-Type Contracts (Bolding added for emphasis):

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

NOTE: Subparagraphs omitted for brevity.

SSAP No. 61R (Bolding added for emphasis):

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

NOTE: Subparagraphs omitted for brevity.

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): This agenda item proposes consistency edits related to the disclosures developed by the Financial Stability (Ex) Task Force, which were adopted in November 2018 in agenda item 2018-28: Updates to Liquidity Disclosures.

Information or issues (included in Description of Issue) not previously contemplated by the Working Group: The Blanks (E) Working Group addressed this issue for 2019 reporting in an editorial change in June 2019 and is proposing separate tables for the guaranteed and nonguaranteed separate account products for 2020 reporting in agenda item 2019-21BWG.

Convergence with International Financial Reporting Standards (IFRS): Not applicable

Staff Recommendation:

NAIC Staff recommends that the Working Group move this item to the active listing, categorized as nonsubstantive and expose revisions to SSAP No. 51R, SSAP No. 56 and SSAP No. 61R as described and illustrated below:

1. Add a consistency revision to SSAP No. 51R, to ensure separate account guaranteed products are referenced in all applicable paragraphs of the withdrawal characteristics disclosures.

2. Correct an identified inconsistency in one of the new disclosures that was added regarding products that will move from the reporting line of having surrender charges at 5% or more to the reporting line of surrender charges at less than 5%. A clarification is being recommended to ensure consistency in annual statement reporting.

3. Add a cross reference from SSAP No. 56—Separate Accounts to the existing disclosures by withdrawal characteristics in SSAP No. 51R and SSAP No. 61R as the disclosures include separate account products.
Revisions recommended for exposure are as follows:

**SSAP No. 51R—Life Contracts**

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

a. Subject to discretionary withdrawal:

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

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

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

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

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

iv. Total with adjustment or at fair value;

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

   (a) In a lump sum without adjustment;

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

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

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

b. Not subject to discretionary withdrawal;
c. Total gross;

d. Reinsurance ceded;

e. Total net.

f. Amount with current surrender charge of 5% or more included in the current year in paragraph 45.a.ii. that will have less than a 5% surrender charge (and thus be reported with the amounts at book value with minimal or no charge or adjustment noted in paragraph 45.a.v.) for the first time within the year subsequent to the balance sheet year.
(Note that percentage of total is not required for this item.)

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

a. Subject to discretionary withdrawal, surrender values, or policy loans:

i. Term Policies with Cash Value

ii. Universal Life

iii. Universal Life with Secondary Guarantees

iv. Indexed Universal Life

v. Indexed Universal Life with Secondary Guarantees

vi. Indexed Life

vii. Other Permanent Cash Value Life Insurance

viii. Variable Life

ix. Variable Universal Life

x. Miscellaneous Reserves

b. Not subject to discretionary withdrawal or no cash value:

i. Term Policies without Cash Value

ii. Accidental Death Benefits

iii. Disability – Active Lives

iv. Disability – Disabled Lives

v. Miscellaneous Reserves

c. Total gross (Direct + Assumed)

d. Reinsurance ceded

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

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

**SSAP No. 56—Separate Accounts** (Note -this revision adds a reference to the other withdrawal characteristics disclosures which included separate account products.)

Disclosures

30. Paragraphs 31-34 detail the separate account disclosure requirements that shall be included within the Life, Accident and Health Annual Statement Blank. Paragraphs 35-38 detail the separate account disclosure requirements that shall be included within the Separate Account Annual Statement Blank.

**NOTE: paragraphs 31-34 omitted for brevity.**

35. 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.

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

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

a. Subject to discretionary withdrawal:

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

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

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

ii. At book value less current surrender charge, where the withdrawal of funds is payable at all times, or at any time within one year from the statement date in a lump sum subject to a current fixed surrender charge of 5% or more and it does not contain a meaningful bail out rate as described in paragraph 69.a.v.(d) below;

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

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

(a) In a lump sum without adjustment;

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

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

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

b. Not subject to discretionary withdrawal;

c. Total gross (Direct + Assumed);

d. Reinsurance ceded;

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

f. Amount with current surrender charge of 5% or more included in the current year in paragraph 69.a.ii. that will have less than a 5% surrender charge (and thus be reported with the amounts at book value with minimal or no charge or adjustment noted in paragraph 69.a.v.) for the first time within the year subsequent to the balance sheet year. (Note that percentage of total is not required for this item.)

Staff Review Completed by:
Robin Marcotte – August 2019
NAIC Staff

Status:
On December 7, 2019, the Statutory Accounting Principles (E) Working Group moved this agenda item to the active listing, categorized as nonsubstantive, and exposed revisions to SSAP No. 51R—Life Contracts, SSAP No. 52—Deposit-Type Contracts, and SSAP No. 61R—Life, Deposit-Type and Accident and Health Reinsurance, as illustrated in the staff recommendation, to:

- Add a consistency revision to SSAP No. 51R to ensure separate account guaranteed products are referenced in all applicable paragraphs of the withdrawal characteristics disclosures;

- Correct an identified inconsistency in one of the new disclosures that was added regarding products that will move from the reporting line of having surrender charges at 5% or more to the reporting line of surrender charges at less than 5%. A clarification is being recommended to ensure consistency in annual statement reporting; and

- Add a cross-reference from SSAP No. 56 to the existing disclosures by withdrawal characteristics in SSAP No. 51R and SSAP No. 61R as the disclosure include separate account products.
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Statutory Accounting Principles (E) Working Group
Maintenance Agenda Submission Form
Form A

**Issue:** ASU 2017-11 - Financial Instruments with Down Round Features

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**Description of Issue:** ASU 2017-11, Accounting for Certain Financial Instruments with Down Round Features; Replacement of the Indefinite Deferral for Mandatorily Redeemable Financial Instruments of Certain Noncontrolling Interests with a Scope Exception to address issues identified with applying U.S. GAAP for certain financial instruments with characteristics of liabilities and equity. The purpose of this agenda item is to review ASU 2017-11 and to consider statutory accounting guidance on distinguishing liabilities from equity.

This ASU addresses the complexity of accounting for certain freestanding financial instruments (or embedded features such as a conversion option) with down round features. A down round feature is a provision in certain financial instruments (most often warrants or convertible instruments) that allows for the reduction in the strike price of the financial instrument if the issuer sells additional shares of common stock for an amount less than the financial instrument’s stated strike price, or if the issuer issues another equity-linked instrument with a strike price below the current strike price of the original financial instrument. Down (financing) rounds typically occur when additional capital is required, but the company’s valuation is now lower than it was in an earlier stock offering. Financial instruments with down round features help protect the holder from declines in the issuer’s share price because if a company issues additional equity shares at a lower price than had been previously sold, the holder is allowed to exercise its purchase option at a lower strike price than was originally stated on the financial instrument.

Existing U.S. GAAP for financial instruments with down round features requires fair value measurement of the entire instrument or conversion option. Stakeholders asserted that accounting for freestanding and embedded instruments with down round features as liabilities, subject to fair value measurement, created a reporting burden and associated income statement volatility due to changes in an entity’s share price. Stakeholders also suggested that this accounting may not reflect the economics of the down round feature, which exist to protect certain investors from declines in the issuer’s share price. With the current accounting guidance, changes in fair value of an instrument with a down round feature are recognized in earnings for both increases and decreases in share price. However, down round features are only likely to be exercised in the event the share price decreases and the issuer engages in a subsequent equity offering.

Prior to this ASU’s issuance under U.S. GAAP, a free-standing financial instrument or embedded feature was not considered indexed to the issuer’s stock if it has a down round feature. Thus, the instrument was classified as a liability and if it meets the definition of a derivative, it must be measured at fair value with changes recorded through current period earnings. ASU 2017-11 changes the guidance in that a down round feature shall no longer be considered when determining whether the instrument is indexed to a company’s stock. As a result of the ASU, if the instrument is now deemed to be indexed and settled in company stock, a free-standing or embedded equity-linked financial instrument will be classified as equity and the embedded feature that was originally bifurcated and accounted for as a derivative may qualify for scope exception to also be treated as equity.

Revisions in ASU 2017-11 also include earning per share (EPS) guidance detailing that the effect of exercising a down round feature shall be treated as a dividend to reduce the income available to common shareholders for computing and reporting basic EPS. Recognition of the value of the down round feature is calculated when triggered and is measured as the difference between the fair value of the instrument (without regarding the down round
feature) of the pre-trigger exercise price and the fair value of the instrument (again, without regarding the down round feature) using the reduced and executed exercise price.

Existing Authoritative Literature:

1. Earnings per share – Rejected as Not Applicable for Statutory Accounting:

   The concept of earnings per share (Topic 260) has previously been reviewed with the following U.S. GAAP standards rejected as not applicable in Appendix D—Nonapplicable GAAP Pronouncements:

   - FASB Statement No. 128, Earnings per Share (FAS 128)
   - EITF 07-04, Application of the Two-Class Method under FASB Statement No. 128 to Master Limited Partnerships

2. Distinguishing Liabilities from Equity / Derivatives and Hedging:

   With ASU 2017-11, entities will no longer consider a down round feature when determining whether a freestanding financial instrument is indexed to an entity’s stock. Consequently, upon adoption, these instruments which are currently being reported as a liability may be reclassified as equity. Additionally, fewer embedded features will likely have to be bifurcated and accounted for as a derivative and may qualify for scope exemption to be treated as equity.

   NAIC staff believes the spirit of freestanding down round features represents a quantifiable liability of the issuing company and should remain accounted for as a liability and not as equity. Down round features embedded in derivatives would not be separated from the host contract pursuant to SSAP No. 86—Derivatives.

   As detailed below, the down round feature satisfies the definition of a liability and recognition as a liability would be consistent with existing guidance for share-based payments.

   SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets, defines a liability with excerpts below:

   2. A liability is defined as certain or probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or to provide services to other entities in the future as a result of a past transaction(s) or event(s).

   3. A liability has three essential characteristics: (a) it embodies a present duty or responsibility to one or more other entities that entails settlement by probable future transfer or use of assets at a specified or determinable date, on occurrence of a specified event, or on demand, (b) the duty or responsibility obligates a particular entity, leaving it little or no discretion to avoid the future sacrifice, and (c) the transaction or other event obligating the entity has already happened. This includes, but is not limited to, liabilities arising from policyholder obligations (e.g., policyholder benefits, reported claims and reserves for incurred but not reported claims). Liabilities shall be recorded on a reporting entity’s financial statements when incurred.

   SSAP No. 104R—Share-Based Payments, Exhibit A – Classification Criteria: Liability or Equity, details circumstances under which certain financial instruments are to be identified as liabilities. While this guidance is limited to share-based payments, the overall accounting concepts are applicable in these situations. Specifically, Exhibit A, paragraph 7, supports recognition as a liability as the company is obligated to sell additional common stock for an amount less than the originally stated strike price as both circumstances require a unilateral outflow of assets or equity. The liability associated with a down round feature, although settled with the issuance of additional shares (without the receipt of assets), will adversely affect the economic interests of current equity shareholders by diluting ownership. Additionally, paragraph 10 broadly indicates instruments that obligate the issuer to transfer assets are to be reported as liabilities.

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Excerpts from SSAP No. 104R, Exhibit A:

Mandatorily Redeemable Financial Instruments

3. A mandatorily redeemable financial instrument shall be classified as a liability unless the redemption is required to occur only upon the liquidation or termination of the reporting entity.

4. A financial instrument that embodies a conditional obligation to redeem the instrument by transferring assets upon an event not certain to occur becomes mandatorily redeemable if that event occurs, the condition is resolved, or the event becomes certain to occur.

5. In determining if an instrument is mandatorily redeemable, all terms within a redeemable instrument shall be considered. The following items do not affect the classification of a mandatorily redeemable financial instrument as a liability:
   a. A term extension option
   b. A provision that defers redemption until a specified liquidity level is reached
   c. A similar provision that may delay or accelerate the timing of a mandatory redemption.

6. If a financial instrument will be redeemed only upon the occurrence of a conditional event, redemption of that instrument is conditional and, therefore, the instrument does not meet the definition of mandatorily redeemable financial instrument in this statement. However, that financial instrument would be assessed at each reporting period to determine whether circumstances have changed such that the instrument now meets the definition of a mandatorily redeemable instrument (that is, the event is no longer conditional). If the event has occurred, the condition is resolved, or the event has become certain to occur, the financial instrument is reclassified as a liability.

Obligations to Repurchase Issuer’s Equity Shares by Transferring Assets

7. An entity shall classify as a liability (or an asset in some circumstances) any financial instrument, other than an outstanding share, that, at inception, has both of the following characteristics:
   a. It embodies an obligation to repurchase the issuer’s equity shares, or is indexed to such an obligation, and
   b. It requires or may require the issuer to settle the obligation by transferring assets.

8. In this statement, "indexed to" is used interchangeably with "based on variations in the fair value of." The phrase "requires or may require" encompasses instruments that either conditionally or unconditionally obligate the issuer to transfer assets. If the obligation is conditional, the number of conditions leading up to the transfer of assets is irrelevant.

9. Examples of financial instruments that meet the criteria in paragraph 7 of this Exhibit include forward purchase contracts or written put options on the issuer’s equity shares that are to be physically settled or net cash settled.

10. All obligations that permit the holder to require the issuer to transfer assets result in liabilities, regardless of whether the settlement alternatives have the potential to differ.

As noted in SSAP No. 86, paragraph 16, down round features embedded in derivative contracts (such as a warrant) would not be separated from the host contract. Such features would impact the fair value accounting for derivatives (assuming fair value accounting is followed) in recognizing the derivative asset or derivative liability. Recognizing freestanding down round features as a liability (and not as equity) would be consistent with the impact of such features embedded in a derivative contract.
SSAP No. 86—Derivatives

16. 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.

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): IAS 32 – Financial Instruments outlines the accounting requirements for the presentation of certain financial instruments, particularly as to the classifications into assets, liabilities, or equity. The fundamental principle of IAS 32 is that a financial instrument should be classified as either a financial liability or as an equity instrument according to the substance of the contract, not its legal form. IAS 32.20 states a contractual right or obligation to receive or deliver a number of its own shares or other equity instruments that varies so that the fair value of the entity’s own equity instruments to be received or delivered equals the fixed monetary amount of the contractual right or obligation is a financial liability.

Staff Recommendation: NAIC staff recommends the Working Group move this item to the active listing, categorized as nonsubstantive, and expose revisions to SSAP No. 86 to reject ASU 2017-11 (Topics 480 & 815) and expose revisions to SSAP No. 5R and SSAP No. 72 to incorporate guidance on when certain freestanding instruments shall be recognized as liabilities and not equity.

1) Proposed Revisions to SSAP No. 86—Derivatives:

63. This statement adopts with modification revisions to ASC 815 as reflected within ASU 2016-05, Effect of Derivative Contract Novations on Existing Hedge Accounting Relationships. This guidance is modified to require prospective application, as such it is only applicable to future counterparty changes in derivative instruments, and this guidance cannot be used to adjust derivative transactions previously terminated. This statement adopts revisions to ASC 815-20-25-15 as reflected within ASU 2010-08, Technical Corrections to Various Topics. This statement adopts revisions to ASC 815-10-50-4K as reflected within ASU 2010-11, Derivatives and Hedging (Topic 815), Scope Exception Related to Embedded Credit Derivatives.

a. This statement but rejects all other GAAP revisions from ASU 2010-11 and ASU 2014-16, Derivatives and Hedging, Determining Whether the Host Contract in a Hybrid Financial Instrument Issued in the Form of a Share is More Akin to Debt or to Equity and ASU 2016-06, Derivatives and Hedging, Contingent Put and Call Options in Debt Instruments. These GAAP revisions are rejected as embedded derivatives are not separated from the host contract and recognized as derivatives under SSAP No. 86. Revisions are also incorporated to SSAP No. 86 to require disclosures on embedded credit derivatives that expose the holder of a financial instrument to the possibility of being required to make future payments. This disclosure is a modification to the GAAP disclosures specific to statutory accounting as embedded credit derivatives are not separately recognized under statutory accounting.
b. This statement rejects ASU 2017-11, Accounting for Certain Financial Instruments with Down Round Features; Replacement of the Indefinite Deferral for Mandatorily Redeemable Financial Instruments of Certain Noncontrolling Interests with a Scope Exception.

62-64. It should be noted that the conclusions reached in this statement are not intended to usurp the rules and regulations put forth by states in their respective investment laws. The contents of this statement are intended to provide accounting guidance on the use of derivatives as allowed by an insurer’s state of domicile. It is not intended to imply that insurers may use derivatives or cash instruments that the insurer’s state of domicile does not allow under the state’s insurance regulatory requirements, e.g., in replication transactions.

2) Proposed Revisions to SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets:

Although NAIC previously believed that instruments with both characteristics of debt and equity were not commonly issued by insurance entities, NAIC Staff has recently received a state query focused on this issue. NAIC staff recommends introducing key concepts from ASC Topic 480, Distinguishing Liabilities from Equity, Subsection 25, (which are materially identified in SSAP No. 104R—Share-Based Payments) into SSAP No. 5R.

SSAP No. 5R—Liabilities, Contingencies and Impairment of Assets.

Financial Instruments with Characteristics of both Liabilities and Equity

26. Issued, free-standing financial instruments with characteristics of both liability and equity shall be reported as a liability to the extent the instruments embodies an unconditional obligation of the issuer. (Pursuant to SSAP No. 86, embedded features in derivative contracts shall not be separated from the host contract for separate recognition.) Free-standing financial instruments that meet any of the criteria below meet the definition of a liability:

a. A mandatorily redeemable financial instrument shall be classified as a liability unless the redemption is required to occur only upon the liquidation or termination of the issuing reporting entity.

b. A financial instrument, other than an outstanding share, that at inception both 1) embodies an obligation to repurchase the issuer’s equity shares or is indexed to such an obligation and 2) requires or may require the issuer to settle the obligation by transferring assets.

c. Obligations that permit the holder to require the issuer to transfer assets.

d. A financial instrument is a liability if the issuer must settle the obligation by issuing a variable number of its equity shares and the obligation’s monetary value is based solely or predominantly on: 1) a fixed monetary amount, 2) variation in something other than the fair value of the issuer’s equity shares, or 3) variations inversely related to changes in the fair value of the issuer’s equity shares.

e. Instruments in which the counterparty (holder) is not exposed to the risks and benefits that are similar to those of a holder of an outstanding share of the entity’s equity shall be classified as a liability.

27. If a free-standing financial instrument will be redeemed only upon the occurrence of a conditional event, redemption of that instrument is conditional and, therefore, the instrument does not meet the definition of mandatorily redeemable financial instrument. However, that financial instrument shall be assessed each reporting period to determine whether circumstances have changed such that the instrument meets the definition of a mandatorily redeemable instrument (that is, the event is no longer conditional). If the event has occurred, the condition is resolved, or the event has become certain to occur, the financial instrument shall be reclassified as a liability.
28. The classification of a free-standing financial instrument as a liability or equity shall only apply to the instrument issuer. Holders or purchasers of such instruments shall refer to the appropriate investment statement for valuation and reporting.

For brevity, the remaining paragraphs for SSAP No. 5R have been omitted but will be renumbered accordingly.

3) Proposed Revisions to SSAP No. 72—Surplus and Quasi-Reorganizations:

While proposed key concepts from ASC Topic 480 are detailed in SSAP No. 5R, additional reference language for the statutory accounting of capital stock is detailed below.

**SSAP No. 72—Surplus and Quasi-Reorganizations**

**Capital Stock**

3. The articles of incorporation set forth the number of authorized shares of capital stock and the par value of each share. The capital stock account represents the number of shares issued times the par value of each share. When no par value is set forth, the reporting entity shall declare a "stated value" and record such amount in the capital stock account. Changes in the par value of a reporting entity’s capital stock shall be reflected as a reclassification between the capital stock account and gross paid-in and contributed surplus. Issued, free-standing financial instruments with characteristics of both liability and equity shall be reported as a liability to the extent described in SSAP No. 5R.

**Staff Review Completed by: Jim Pinegar – October 2019**

**Status:**
On December 7, 2019, the Statutory Accounting Principles (E) Working Group moved this agenda item to the active listing, categorized as nonsubstantive, and exposed revisions, as illustrated above, to SSAP No. 86—Derivatives to reject ASU 2017-11, Earning Per Share, Distinguishing Liabilities from Equity, Derivatives & Hedging and incorporate guidance into SSAP No. 5R—Liabilities, Contingencies and Impairment of Assets and SSAP No. 72—Surplus and Quasi-Reorganizations for when certain freestanding instruments shall be recognized as liabilities and not equity.

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

Issue: ASU 2013-11, Presentation of an Unrecognized Tax Benefit

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Description of Issue:
Topic 740, Income Taxes did not include explicit guidance for the financial statement presentation of an “unrecognized tax benefit” when a net operating loss carryforward, a similar tax loss, or a tax credit carryforward exists. An unrecognized tax benefit generally reflects a tax position that does not meet the ASC 740 more-likely-than-not recognition threshold, but to a certain extent owes their existence to an uncertain tax position. A more-likely-than-not threshold requires a recognized benefit of having a greater than 50 percent likelihood of being realized upon settlement. Prior to ASU 2013-11, Income Taxes (Topic 740): Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists, there was diversity in the U.S. GAAP presentation of unrecognized tax benefits. Some entities reported unrecognized tax benefits as a liability in certain circumstances, while others presented unrecognized tax benefits as a reduction of a deferred tax asset for net operating loss or tax credit carryforwards.

The objective of ASU 2013-11 is to eliminate the reporting diversity to better reflect the manner in which an entity would settle additional income taxes that would result from the disallowance of a tax position when a net operating loss carryforward, similar tax loss, or tax credit carryforward exists.

ASU 2013-11 states that unrecognized tax benefits should generally be presented in the financial statements as a reduction to a deferred tax asset when a net operating loss carryforward, a similar tax loss, or a tax credit carryforward exists. This presentation should be followed except in circumstances in which a net operating loss / tax credit carryforward is not available as of the reporting date to settle any additional income taxes that would result from the disallowance of a tax position, or the entity does not intend to use the deferred tax asset for such purpose. In these cases, the unrecognized tax benefit should be presented in the financial statements as a liability and not combined with deferred tax assets.

The assessment of whether a deferred tax asset is available is based on the unrecognized tax benefit and deferred tax asset that exists at the reporting date and should be made presuming disallowance of the tax position at that reporting date.

The FASB definition of an Unrecognized Tax Benefit (per the FASB Codification Glossary) is as follows:

**Unrecognized Tax Benefit** - The difference between a tax position taken or expected to be taken in a tax return and the benefit recognized and measured pursuant to Subtopic 740-10.

Existing Authoritative Literature:
By definition, unrecognized tax benefits have a lower than 50 percent likelihood of being realized upon final settlement. As required in SSAP No. 5R—Liabilities, Contingencies and Impairment of Assets and again referenced in SSAP No. 101—Income Taxes, for the purposes of determining a tax contingency, it shall be presumed that the reporting entity will be examined by a relevant taxing authority. Further, as there is a lower than 50 percent likelihood of these items being sustained, they should be recognized in current income taxes as covered in SSAP No. 101.
SSAP No. 101, paragraph 3 excerpts:

3. "Income taxes incurred" shall include current income taxes, the amount of federal and foreign income taxes paid (recovered) or payable (recoverable) for the current year. Current income taxes are defined as:

a. Current year estimates (including quarterly estimates) of federal and foreign income taxes payable or refundable, based on tax returns for the current and prior years, except as addressed in paragraph 3.b., and tax loss contingencies (including related interest and penalties) for current and all prior years, computed in accordance with SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets with the following modifications:

i. The term "probable" as used in SSAP No. 5R shall be replaced by the term "more likely than not (a likelihood of more than 50 percent)" for federal and foreign income tax loss contingencies only.

ii. For purposes of the determination of a federal and foreign income tax loss contingency, it shall be presumed that the reporting entity will be examined by the relevant taxing authority that has full knowledge of all relevant information.

iii. If the estimated tax loss contingency is greater than 50% of the tax benefit originally recognized, the tax loss contingency recorded shall be equal to 100% of the original tax benefit recognized.

b. Amounts incurred or received during the current year relating to prior periods, to the extent not previously provided, as such amounts are deemed to be changes in accounting estimates as defined in SSAP No. 3—Accounting Changes and Corrections of Errors.

c. In determining when tax loss contingencies associated with temporary differences should be included in current income taxes under paragraph 3.a., and therefore included in deferred taxes under paragraph 7, a reporting entity is not required to "gross-up" its current and deferred taxes until such time as an event has occurred that would cause a re-evaluation of the contingency and its probability of assessment, e.g., the IRS has identified the item as one which may be adjusted upon audit. Such an event could be the reporting entity’s (or its affiliate or parent in a consolidated income tax return) receipt of a Form 5701, Proposed Audit Adjustment, or could occur earlier upon receipt of an Information Document Request. At such time, the company must reassess the probability of an adjustment, reasonably re-estimate the amount of tax contingency as determined in accordance with paragraph 3.a., make any necessary adjustment to deferred taxes, and re-determine the admissibility of any adjusted gross deferred tax asset as provided in paragraph 11.

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

IFRS does not include specific guidance on the presentation of unrecognized tax benefits.

Staff Recommendation: NAIC staff recommends that the Working Group move this item to the active listing, categorized as nonsubstantive, and expose revisions to SSAP No. 101 to reject ASU 2013-11 for statutory accounting.

By definition, unrecognized tax benefits have a lower than 50 percent likelihood of being utilized (resulting in future tax savings), and as such, should be recognized in current income taxes as required by SSAP No. 101, paragraph 3. This ASU allows, as an election of the reporting entity, reporting of unrecognized tax benefits on the balance sheet.
(as a reduction to deferred tax assets) while statutory accounting requires immediate recognition through current income tax expense. As these unrecognized tax benefits are not deferred tax items and NAIC SAP tries to limit optionality in the financial statements, NAIC staff proposes to reject the ASU and retain existing statutory accounting guidance.

Proposed Revisions to SSAP No. 101:


Staff Review Completed by Jim Pinegar – August 2019

Status:
On December 7, 2019, the Statutory Accounting Principles (E) Working Group moved this agenda item to the active listing, categorized as nonsubstantive, and exposed revisions to SSAP No. 101—Income Taxes, illustrated above, to reject ASU 2013-11, Income Taxes (Topic 740): Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists for statutory accounting.

Consideration for the 2020 Spring National Meeting:
While not affecting statutory guidance, NAIC staff support the removal of the IFRS convergence statement as proposed by interested parties, in the agenda item. (This is shown as a tracked change in the agenda item and does not impact the proposed statutory accounting resolution.)
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Statutory Accounting Principles (E) Working Group
Maintenance Agenda Submission Form
Form A

Issue: Disclosure Update for Reciprocal Jurisdiction Reinsurers

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Description of Issue:
On June 25, 2019, NAIC Executive Committee and Plenary adopted revisions to the Credit for Reinsurance Model Law (#785) and the Credit for Reinsurance Model Regulation (#786) to incorporate relevant provisions from the “Bilateral Agreement Between the United States of America and the European Union on Prudential Measures Regarding Insurance and Reinsurance” and the “Bilateral Agreement Between the United States of America and the United Kingdom Regarding Insurance and Reinsurance” (collectively referred to as the Covered Agreement). The purpose of this agenda item is to revise one disclosure in SSAP No. 62R—Property and Casualty Reinsurance to reference “reciprocal jurisdictions.”

Existing Authoritative Literature:
The Credit for Reinsurance Model Law (#785) and the Credit for Reinsurance Model Regulation (#786), as they are adopted by the states are the primary legal guidance for credit for reinsurance.

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):
Revisions to Appendix A-785 were exposed at the Summer National Meeting, and a Blanks proposal will be exposed at the Reinsurance (E) Task Force at the Fall National Meeting and by the Blanks (E) Working Group after the Fall National Meeting.

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


Staff Recommendation:
NAIC Staff recommends that the Working Group move this item to the active listing, categorized as nonsubstantive and expose revisions SSAP No. 62R to incorporate disclosure updates for reinsurers from Reciprocal Jurisdictions. The proposed revisions are illustrated below:

106. Unsecured Reinsurance Recoverables:

   a. If the entity has with any individual reinsurers, authorized, reciprocal jurisdiction, unauthorized, or certified an unsecured aggregate recoverable for losses, paid and unpaid including IBNR, loss adjustment expenses, and unearned premium, that exceeds 3% of the entity’s policyholder surplus, list each individual reinsurer and the unsecured aggregate recoverable pertaining to that reinsurer; and

Staff Review Completed by: Jake Stultz—July 2019
Status:
On December 7, 2019, the Statutory Accounting Principles (E) Working Group moved this agenda item to the active listing, categorized as nonsubstantive, and exposed revisions to SSAP No. 62R—Property and Casualty Reinsurance, as illustrated above, to incorporate disclosure updates for reinsurers from Reciprocal Jurisdictions.

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

Issue: ASU 2016-14, Presentation of Financial Statements of Not-for-Profit Entities

Check (applicable entity):

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Description of Issue: The FASB issued ASU 2016-14 to provide more useful information to donors, grantors, creditors, and other financial statements users of not-for-profit (NFP) entities. This update is to improve the current net asset classification requirements and the information presented in financial statements regarding liquidity, financial performance, and cash flows. While several changes were implemented within this ASU, the main provisions include:

- The presentation of two classes of net assets – with donor restrictions and without donor restrictions. Due to complexities regarding the appropriate use of the previous three classes of net assets (unrestricted, temporarily restricted, and permanently restricted) that focused on the absence or presence of donor-imposed restrictions and whether those restrictions were temporary or permanent, this ASU designates presentation of two classes of net assets. Changes in these two classes of net assets are to be reported on the statement of activities.

- The presentation of operating cash flows may continue to use the direct or indirect method of reporting, but no longer require the presentation or disclosure of the indirect method (reconciliation) if using the direct method.

Additionally, numerous disclosures enhancements were included this update, several are highlighted below:

- The composition of net assets with donor restrictions and how the restrictions affect the use of such resources.
- For resources without donor-imposed restrictions, the applicable amounts and designated purposes, appropriations, and similar actions that result in self-imposed limits on the use of such resources.
- Information that communicates how the NFP manages liquid resources to meet its cash needs for general expenditures for one year following the balance sheet date.
- Regarding ‘underwater endowment funds’ (a fund in which its fair value is less than the original gift amount or the amount required to be maintained by donor restrictions); disclosures concerning the NFP’s policy, and any actions taken during the period concerning appropriation from underwater endowment funds and the fair value of such funds. Additionally, disclosures regarding the original gift amounts (or level required by donor or law) to be maintained and amount by which the funds are deficient.
- Use, in the absence of donor restrictions, the placed-in-service approach for reporting expirations of restrictions on gifts of cash or other assets to be used to acquire or construct a long-lived asset, thus reclassifying amounts from “net assets with donor restrictions” to “net assets without donor restrictions” as long-lived assets that have been placed in service as of the beginning of the period of adoption (eliminating the previous option to release the donor-imposed restriction over the estimated useful life of the acquired asset).
**Existing Authoritative Literature:** While there is SAP guidance for the financial statement presentation of assets, the concept of separating assets based on imposed donor restrictions and the inclusion of other similar related disclosures is not a presentation format that is applicable for statutory accounting purposes.

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

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

**Convergence with International Financial Reporting Standards (IFRS):** None - There are no specific NFP accounting and reporting standards in IFRS.

**Staff Recommendation:** NAIC staff recommends that the Working Group move this item to the active listing, categorized as nonsubstantive, and expose revisions to Appendix D—Nonapplicable GAAP Pronouncements to reject ASU 2016-14, Presentation of Financial Statements of Not-for-Profit Entities as not applicable to statutory accounting.

This item is proposed to be rejected as not applicable as statutory accounting guidance does not separately present assets based on donor restrictions. If assets are restricted, they must be identified as restricted in the investment schedules and captured in the restricted note disclosure. Furthermore, the concept of donor-restrictions for insurance reporting entities is not identified to be a prevalent concept.

**Staff Review Completed by:** Jim Pinegar – August 2019

**Status:**
On December 7, 2019, the Statutory Accounting Principles (E) Working Group moved this agenda item to the active listing, categorized as nonsubstantive, and exposed revisions to Appendix D—Nonapplicable GAAP Pronouncements to reject ASU 2016-14, Presentation of Financial Statements of Not-for-Profit Entities as not applicable to statutory accounting.

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Statement of Statutory Accounting Principles No. 32R

Preferred Stock

STATUS

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SCOPE OF STATEMENT

SUMMARY CONCLUSION

REFERENCES

EXHIBIT A – GLOSSARY

SCOPE OF STATEMENT

1. This statement establishes statutory accounting principles for preferred stock.

2. Investments in preferred stock of entities captured in SSAP No. 97—Investments in subsidiaries, controlled or affiliated entities or SSAP No. 48—Joint Ventures, Partnerships and Limited Liability Companies1, as well as preferred stock interests of certified capital companies per INT 06-02: Accounting and Reporting for Investments

1 Certain legal entities captured in SSAP No. 48, do not issue preferred stock in legal form, but instead issue identical instruments labeled preferred units, interests, or shares. These instruments shall be captured in this statement provided they meet the structural characteristics as defined in paragraph 3. Additionally, these instruments shall not be in-substance common stock is which the holder has risk and reward characteristics that are substantially similar to common stock.
in a Certified Capital Company (CAPCO) are included within the scope of this statement. The requirement to file investments in preferred stock of certain subsidiaries, controlled or affiliated entities with the NAIC pursuant to SSAP No. 97 does not affect the application of the accounting, valuation or admissibility under this statement.

SUMMARY CONCLUSION

3. Preferred stock, which may or may not be publicly traded, is a security that represents ownership of a corporation and gives the holder a claim, prior to the claim of common stockholders on earnings and also generally on assets in the event of liquidation. Most preferred stock pays a fixed dividend that is paid prior to the common stock dividend, stated in a dollar amount or as a percentage of par value. Preferred stock does not usually carry voting rights. Preferred stock has characteristics of both common stock and debt. Preferred stock shall include:

a. Redeemable preferred stock, which is preferred stock subject to mandatory redemption requirements or whose redemption is at the option of the holders. Redeemable preferred stock is any stock which 1) the issuer undertakes to redeem at a fixed or determinable price on the fixed or determinable date or dates, whether by operation of a sinking fund or otherwise; or 2) is redeemable at the option of the holders. Preferred stock which meet one or more of these criteria would be classified as redeemable preferred stock regardless of other attributes such as voting rights or dividend rights.

b. Perpetual preferred stock, which is preferred stocks which are not redeemable or for which redemption is not at the option of the holder (non-redeemable preferred stock). Perpetual preferred stock is any preferred stock which does not meet the criteria to be classified as redeemable preferred stock pursuant to paragraph 3.a.

4. The definition of preferred stock, as defined in paragraph 3 does not include fund investments. However, the following types of SVO-identified investments are captured within scope of this statement.

a. Exchange Traded Funds, which qualify for preferred stock treatment, as identified in Part Six, Section 2, of the Purposes and Procedures Manual of the NAIC Investment Analysis Office. SVO-Identified Preferred Stock ETFs shall follow the accounting provisions for perpetual preferred stock.

5. Restricted preferred stock is defined as either redeemable or perpetual preferred stock that must be traded in compliance with special Securities Exchange Commission (SEC) regulations concerning its purchase and resale. These restrictions generally result from affiliate ownership, merger and acquisition (M&A) activity and underwriting activity. Pursuant to the SEC, restricted securities are securities acquired in an unregistered, private sale from the issuing company or from an affiliate of the issuer. They typically bear a “restrictive” legend clearly stating that the holding may not resell the stock in the public marketplace unless the sale is exempt from the SEC’s registration requirements. Restricted preferred stock is generally considered an admitted asset; however, admittance may be limited based on the degree of restriction in accordance with SSAP No. 4—Assets and Nonadmitted Assets.

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2 Preferred stock shall be classified by its characteristics. For example, a preferred stock that is named “redeemable perpetual preferred stock” shall be reported as either “redeemable” or “perpetual” preferred stock based on whether the characteristics of paragraph 3a are met.

3 This definition of restricted stock does not preclude a “restricted asset” classification for any preferred stock that is restricted (e.g., not under the exclusive control of the entity) by actions of the reporting entity or others. For example, if a reporting entity has pledged preferred stock, or used preferred stock in securities lending / repo transactions, the preferred stock shall be coded and disclosed as restricted stock pursuant to SSAP No. 1.
Preferred Stock

Restricted preferred stock shall be coded as restricted in the investment schedule and disclosed pursuant to SSAP No. 1—Accounting Policies, Risks & Uncertainties, and Other Disclosures.

6. Preferred stocks meet the definition of assets as defined in SSAP No. 4—Assets and Nonadmitted Assets and are admitted assets to the extent they conform to the requirements of this statement.

Acquisitions and Sales

7. At acquisition, preferred stock shall be reported at cost, including brokerage and other related fees. Preferred stock received as dividends shall be initially recorded at fair value. Acquisitions and dispositions shall be recorded on the trade date. Private placement stock transactions shall be recorded on the funding date.

8. A reporting entity can subscribe for the purchase of stock, but not be required to make payment until a later time. Transactions of this nature are common in the formation of corporations. Preferred stock acquired under a subscription represents a conditional transaction in which a preferred stock is authorized for issuance but not yet actually issued. Such transactions are settled if and when the actual preferred stock is issued and the exchange or National Association of Securities Dealers (NASD) rules that the transactions are to be settled. Preferred stock acquired under a subscription shall be recorded as an admitted asset when the reporting entity or its designated custodian or transfer agent takes delivery of the preferred stock and the preferred stock is recorded in the name of the reporting entity or its nominee, (i.e., the accounting for such preferred stock acquisitions shall be on the settlement date).

Amortization

9. Redeemable preferred stock purchased at a premium shall be amortized to reduce the carrying value to the call or redemption value over the period to the call or earliest redemption date, whichever produces the lowest asset value (yield to worst). Redeemable preferred stock purchased at a discount shall be accreted to increase the carrying value to the redemption price over the period to maturity or the latest redemption date. Amortization (and accretion) of the premium and discount arising at acquisition shall be calculated using the interest method and shall be reported through investment income.

Balance Sheet Amount

10. Preferred stock shall be valued based on (a) the underlying characteristics (redeemable, perpetual or mandatory convertible), (b) the quality rating expressed as an NAIC designation, and (c) whether an asset valuation reserve (AVR) is maintained by the reporting entity:

a. For reporting entities that do not maintain an AVR:

i. Highest-quality or high-quality redeemable preferred stocks (NAIC designations 1 and 2) shall be valued at amortized cost. All other redeemable preferred stocks (NAIC designations 3 to 6) shall be reported at the lower of amortized cost or fair value.

ii. Perpetual preferred stocks shall be reported at fair value, not to exceed any currently effective call price.

iii. Mandatory convertible preferred stocks (regardless if the preferred stock is redeemable or perpetual) shall be reported at fair value, not to exceed any currently effective call price, in the periods prior to conversion. Upon conversion to common stock, these securities shall be in scope of SSAP No. 30R.

iv. For preferred stocks reported at fair value, unrealized gains and losses shall be recorded as a direct credit or charge to unassigned funds (surplus).
b. For reporting entities that maintain an AVR:

i. Highest-quality, high-quality or medium quality redeemable preferred stocks (NAIC designations 1 to 3) shall be valued at amortized cost. All other redeemable preferred stocks (NAIC designations 4 to 6) shall be reported at the lower of amortized cost or fair value.

ii. Perpetual preferred stocks shall be valued at fair value, not to exceed any currently effective call price.

iii. Mandatory convertible preferred stocks (regardless if the preferred stock is redeemable or perpetual) shall be reported at fair value, not to exceed any currently effective call price, in the periods prior to conversion. Upon conversion to common stock, these securities shall be in scope of SSAP No. 30R.

iv. For preferred stocks reported at fair value, the accounting for unrealized gains and losses shall be in accordance with SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve (SSAP No. 7).

Impairment of Redeemable Preferred Stock

11. An other-than-temporary \(^{(\text{INT 06-07})}\) impairment 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 preferred stock in effect at the date of acquisition. An assessment of other-than-temporary impairment shall occur whenever mandatory redemption rights or sinking fund requirements do not occur. A decline in fair value which is other-than-temporary includes situations where the reporting entity has made a decision to sell the preferred stock prior to its maturity at an amount below its carrying value (i.e., amortized cost). If it is determined that a decline in the fair value of a redeemable preferred stock is other-than-temporary, an impairment loss shall be recognized as a realized loss equal to the entire difference between the redeemable preferred stock’s carrying value and its fair value, not to exceed any currently effective call price, at the balance sheet date of the reporting period for which the assessment is made. The measurement of the impairment loss 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.

12. In periods subsequent to the recognition of other-than-temporary impairment loss for a redeemable preferred stock, the reporting entity shall account for the other-than-temporarily impaired preferred stock as if the preferred stock had been purchased on the measurement date of the other-than-temporary impairment. The fair value of the redeemable preferred stock on the other-than-temporary impairment measurement date shall become the new cost basis of the redeemable preferred stock and the new cost basis shall not be adjusted for subsequent recoveries in fair value. The discount or reduced premium recorded for the preferred stock, based on the new cost basis, shall be amortized over the remaining life of the preferred stock in the prospective manner based on the amount and timing of future estimated cash flows. The preferred stock 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.

Impairment of Perpetual Preferred Stock

13. For any decline in the fair value of perpetual preferred stock which is determined to be other-than-temporary \(^{(\text{INT 06-07})}\), the perpetual preferred stock shall be written down to fair value as the new cost basis and the amount of the write down shall be accounted for as a realized loss. For reporting entities required to maintain an AVR, realized losses shall be accounted for in accordance with SSAP No. 7. Subsequent fluctuations in fair value shall be recorded as unrealized gains or losses. Future declines which are determined to be other-than-temporary shall be recognized.
as realized losses. A decline in fair value which is other-than-temporary includes situations where the reporting entity has made a decision to sell a preferred stock at an amount below its carrying value.

**Income**

14. Dividends on preferred stock shall be recorded as investment income for dividend eligible preferred stock on the ex-dividend date with a corresponding receivable to be extinguished upon dividend settlement. Dividends received shall be recognized in the form received (e.g., cash, preferred stock, common stock) at fair value with differences between fair value and the dividend receivable recognized as gains or losses. Subsequent treatment shall follow the statement that addresses the type of asset received. For example, dividends received in the form of common stock shall be accounted for and reported in accordance with SSAP No. 30R—Unaffiliated Common Stock.

**Redemption of Preferred Stock**

15. A reporting entity that sells or redeems preferred stock back to the issuer shall recognize consideration received in excess of the book/adjusted carrying value as a realized gain or loss. This recognition shall occur regardless of whether the issuer repurchases the preferred shares at market value, or if the shares are redeemed by the issuer at a predetermined set call price.

**Exchanges and Conversions**

16. If preferred stock is exchanged or converted into other securities, the fair value of the preferred stock surrendered at the date of the exchange or conversion shall become the cost basis for the new securities with any gain or loss realized at the time of the exchange or conversion. However, if the fair value of the securities received in an exchange or conversion is more clearly evident than the fair value of the preferred stock surrendered, then it shall become the cost basis for the new securities.

**Disclosures**

17. The following disclosures regarding preferred stocks shall be made in the financial statements:

   a. Fair values in accordance with SSAP No. 100R—Fair Value (SSAP No. 100R);
   
   b. Concentrations of credit risk in accordance with SSAP No. 27;
   
   c. Basis at which the preferred stocks are stated; and
   
   d. A description, as well as the amount, of preferred stock that is restricted and the nature of the restriction.
   
   e. For each balance sheet presented, all preferred stocks in an unrealized loss position for which other-than-temporary declines in value have not been recognized
   
      i. The aggregate amount of unrealized losses (that is, the amount by which cost or amortized cost exceeds fair value) and
      
      ii. The aggregate related fair value of preferred stocks with unrealized losses.
   
   f. The disclosures in (i) and (ii) above should be segregated by those preferred stocks that have been in a continuous unrealized loss position for less than 12 months and those that have been in a continuous unrealized loss position for 12 months or longer using fair values determined in accordance with SSAP No. 100R.
g. As of the date of the most recent balance sheet presented, additional information should be included describing the general categories of information that the investor considered in reaching the conclusion that the impairments are not other-than-temporary.

h. When it is not practicable to estimate fair value, the investor should disclose the following additional information, if applicable, as of each date for which a statement of financial position is presented in its annual financial statements:
   i. The aggregate carrying value of the investments not evaluated for impairment, and
   ii. The circumstances that may have a significant adverse effect on the fair value.

18. Refer to the Preamble for further discussion regarding disclosure requirements. The disclosure requirements of paragraphs 17.b., 17.e., 17.f., 17.g. and 17.h. shall be included in the annual audited statutory financial reports only.

Relevant Literature


Effective Date and Transition

20. This statement is effective for years beginning January 1, 2001. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with SSAP No. 3—Accounting Changes and Corrections of Errors. The guidance in paragraphs 23-26 was previously included within SSAP No. 99—Accounting for Securities Subsequent to an Other-Than-Temporary Impairment and was effective for reporting periods beginning on January 1, 2009, and thereafter, with early adoption permitted. In 2010, the guidance from SSAP No. 99 was incorporated within the impacted standards, with SSAP No. 99 superseded. The original impairment guidance included in this standard, and the substantive revisions reflected in SSAP No. 99 are retained for historical purposes within Issue Paper No. 131. The guidance in paragraphs 2 and 3 to SSAP No. 32 was originally superseded January 1, 2005, by guidance included in SSAP No. 88—Investments in Subsidiaries, Controlled and Affiliated Entities, A replacement of SSAP No. 46, and then subsequently reflected in SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities. In 2011, the guidance related to preferred stock of SCAs from SSAP No. 97 was incorporated into this statement and revised to reflect a definition of preferred stock. The original guidance included in this statement, and the substantive revisions reflected in SSAP No. 88 and SSAP No. 97 (including the title change already reflected in SSAP No. 32) are retained for historical purposes within Issue Paper Nos. 32 and 118. Guidance in paragraph 17 was originally contained in INT 99-29: Classification of Step-Up Preferred Stock and was effective December 6, 1999.

21. In __________, substantive revisions, as detailed in __________ were adopted. These revisions, effective __________, update definitions of preferred stock and reporting values based on characteristics of the preferred stock.
REFERENCES

Other

- Purposes and Procedures Manual of the NAIC Investment Analysis Office

- NAIC Valuation of Securities product prepared by the Securities Valuation Office

Relevant Issue Papers

- Issue Paper No. 32—Investments in Preferred Stock (excluding investments in preferred stock of subsidiary, controlled, or affiliated companies)

- Issue Paper No. 131—Accounting for Certain Securities Subsequent to an Other-Than-Temporary Impairment

- Issue Paper No. 1XX—Preferred Stock
EXHIBIT A – GLOSSARY

Callable Preferred Stock – A preferred stock in which the issuer has the right to call or redeem the stock at a preset price after a defined date. Callable preferred stock can be either redeemable preferred stock or perpetual preferred stock depending on other characteristics of the preferred stock. For example, callable preferred stock with a maturity or a specific buyback date would be redeemable preferred stock, whereas callable preferred stock electable at the discretion of the issuer is perpetual preferred stock.

Convertible Preferred Stock – A preferred stock that is convertible into another security based on a conversion rate. For example, convertible preferred stock that is convertible into common stock on a two-for-one basis (two shares of common for each share of preferred).

Cumulative Preferred Stock – A preferred stock with a provision that missed dividend payments must be paid to cumulative preferred shareholders before other classes of preferred stock shareholders and common shareholders can receive dividend payments. Cumulative preferred stock may have different levels, with a “first” or “senior” cumulative preferred, “regular” cumulative preferred and “subordinate” cumulative preferred that determines the priority in which accumulated unpaid dividends or asset liquidation occurs. (Under SSAP No. 32R, holders of cumulative preferred stock are not permitted to recognize a receivable for unpaid cumulative dividends until declared and the reporting entity is entitled to the divided.)

Dividend Declaration Date – The date a corporation declares a dividend payment to its shareholders.

Dividend Record Date – The date that identifies the shareholders that are entitled to a declared dividend.

Dividend Payment Date – The date the declared dividend will be paid.

Ex-Dividend Date – The cut-off date of holding stock to be captured as a shareholder on record entitled to the dividend. (A shareholder that sells their stock on the ex-dividend date would continue to be identified as a shareholder on record entitled to a declared dividend. Anyone who acquires a stock on the ex-dividend date would not be a shareholder on record entitled to a declared dividend.)

Mandatory Redeemable Preferred Stock – A preferred stock that embodies an unconditional obligation requiring the issuer to redeem the instrument by transferring its assets at a specified or determinable date (or dates) or upon an event that is certain to occur. (The existence of a mandatory redemption right does not convert the holder of a preferred stock into a creditor, and an issuer may be prohibited from redeeming shares when redemption would cause an impairment of capital.)

Noncumulative Preferred Stock – A preferred stock that does not entitle the stockholder to accumulated unpaid dividends. After missing dividend payments, a corporation only has to be make current dividend payments to preferred stock holders before providing dividends to common stock holders.

Participating Preferred Stock – A preferred stock that gives the holder participation in the additional earnings of a business or liquidation rights in addition to the normal preferred stock dividend. Pursuant to the terms of the preferred stock, the participation rights may only be activated when income or operations of the issuer exceeds a certain threshold level.

Payment-in-kind (PIK) – A term of the preferred stock prospectus that identifies that dividends may take the form of securities (e.g., common stock) rather than cash.
Perpetual Preferred Stock - Preferred stocks which are not redeemable or are redeemable solely at the option of the issuer. Perpetual preferred stock is any preferred stock which does not meet the criteria to be classified as redeemable preferred stock.

Preferred stock - A security, which may or may not be publicly traded, that shows ownership of a corporation and gives the holder a claim, prior to the claim of common stockholders on earnings and also generally on assets in the event of liquidation.

 Redeemable Preferred Stock - Preferred stock subject to mandatory redemption requirements or whose redemption is outside the control of the issuer. Redeemable preferred stock is any stock which 1) the issuer undertakes to redeem at a fixed or determinable price on the fixed or determinable date or dates, whether by operation of a sinking fund or otherwise; 2) is redeemable at the option of the holders; or 3) has conditions for redemption which are not solely within the control of the issuer, such as stock which must be redeemed out of future earnings. Preferred stock which meet one or more of these three criteria is redeemable preferred stock regardless of other attributes such as voting rights or dividend rights.

 Restricted Preferred Stock - Redeemable or perpetual preferred stock that must be traded in compliance with special SEC regulations concerning its purchase and resale. These restrictions generally result from affiliate ownership, M&A activity and underwriting activity. Pursuant to the SEC, restricted securities are securities acquired in an unregistered, private sale from the issuing company or from an affiliate of the issuer. They typically bear a “restrictive” legend clearly stating that the holding may not resell the stock in the public marketplace unless the sale is exempt from the SEC’s registration requirements.

Sinking Fund – A potential component of a preferred stock charter that requires the issuer to regularly set funds aside in a separate custodial account for the exclusive purpose of redeeming preferred stock shares. Failure of an issuer to provide to the sinking fund does not create an act of default. Rather, the stock charter may implement provisions for failing to provide to the sinking fund, which could include penalties, restrictions of providing common stock dividends or the repurchase of the preferred stock.

Step-Up Preferred Stock – A potential component of a preferred stock charter that identifies whether specific terms will increase over time or with stated provisions. For example, a “step-up dividend” is a feature that increases the dividend rate. A “step-up call” is a feature that increases the call price. A “step-up conversion” increases the conversion price.

Term Preferred Stock – Preferred stock with a mandatory redemption requirement (maturity date) captured in the definition of redeemable preferred stock.
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Statutory Issue Paper No. 1XX

Preferred Stock

STATUS
Exposure Draft – December 7, 2019

Original SSAP: SSAP No. 32; Current Authoritative Guidance: SSAP No. 32R

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. The guidance within this issue paper introduces substantive revisions to SSAP No. 32—Preferred Stock pursuant to the Statutory Accounting Principles (E) Working Group’s (Working Group) Investment Classification Project. The Investment Classification Project reflects a comprehensive review to address a variety of issues pertaining to definitions, measurement and overall scope of the investment statements of statutory accounting principles (SSAPs).

2. The substantive revisions to SSAP No. 32 (illustrated in Exhibit A) under the Investment Classification Project, detailed within this issue paper, reflect the following key elements:

   a. Improves preferred stock definitions, with inclusion of information from U.S. generally accepted accounting principles (GAAP) for classifying preferred stock as redeemable or perpetual. The revisions also incorporate a new exhibit to capture various terms prevalent in preferred stock.

   b. Revises the measurement guidance to ensure appropriate, consistent measurement based on the type of preferred stock held and the terms of the preferred stock. The revisions also incorporate guidance for mandatory convertible preferred stock.

   c. Incorporates revisions to clarify impairment guidance as well as guidance for dividend recognition and redemption of preferred stock with the issuer.

DISCUSSION

3. This issue paper intends to provide information on discussions that occurred when considering revisions to SSAP No. 32 under the Investment Classification Project, as well as the adopted revisions.

Preferred Stock Definitions

4. The historical definition of preferred stock within SSAP No. 32 is “any class or shares of the holders which have any preference, either as to the payment of dividends or distribution of assets on liquidation, over the holder of common stock issued by an entity.” This definition has been identified as generally consistent with market terms, including the following NASDAQ and Financial Accounting Standards Board (FASB) definitions for common stock:

   a. NASDAQ Definition: A security that shows ownership in a corporation and gives the holder a claim, prior to the claim of common shareholders, on earnings and also generally on assets in the event of liquidation. Most preferred stock pays a fixed dividend that is paid prior to the common stock dividend, stated in a dollar amount or as a percentage of par
value. The stock does not usually carry voting rights. Preferred stock has characteristics of both equity and debt.

b. FASB Codification: A security that has preferential rights compared to common stock.

5. Comments received from interested parties in October 2019 indicated that the term “security” is not interchangeable as it pertains to preferred stock and requested all references be changed to “interest” or directly reference the type of stock under consideration. In review of the use of the term “security” in the issue paper, most instances represent existing references carried over from SSAP No. 32. NAIC staff recognizes that preferred stock is a “security,” as demonstrated by the definitions from both the NASDAQ and FASB, but NAIC staff has proposed some revisions to limit the generic use of the term. The use of the term “security” in paragraph 8, paragraphs 10-13 and in Exhibit A (as it pertains to defining specific types of preferred stock) has been revised to “preferred stock.” The use of the term “security” in paragraph 3 has been retained as this usage mirrors the FASB definition for preferred stock.

5. Additional comments from interested parties suggested the removal of certain definitional language for differentiating between redeemable and perpetual preferred stock. The interested parties’ proposed edits included removing language indicating “redemption was outside the control of the issuer” or has “conditions for redemption which are not solely within the control of the issuer, such as stock which must be redeemed out of future earnings.” NAIC staff has not incorporated these edits, as the changes would result in differences from the FASB definitions. Although these definition aspects are written from the perspective of the issuer, the holder must classify preferred stock for accounting and reporting in a manner that is consistent with the asset issuer. As such, for consistency and to prevent confusion on whether there is intended to be a change in definitions from FASB, the FASB definition of preferred stock has been retained.

6. NAIC staff’s original intent was to align various investment definitions with common industry definitions or those specified by U.S. GAAP. As a part of the investment reclassification project, this practice began with unaffiliated common stock (SSAP No. 30R) and now has expanded into preferred stock (SSAP No. 32). The definition proposed by NAIC staff was made with the understanding that preferred stock is either redeemable or perpetual. While the issue paper does mention some stock labeled as “redeemable perpetual preferred stock,” distinctions are made in the prospectus as to its true underlying characteristics (thus being redeemable or perpetual).

In general, NAIC staff continue to believe that for a majority of preferred stock issuances, a share which is redeemable at the option of the holder is by definition redeemable outside (or not solely within) the control of the issuer – thus the actions are mutually exclusive. However, interested parties cited guidance for additional circumstances in which, through legal technicalities, could create a third class of preferred shares – those redeemable outside the control of the issuer and holder. Since the definition refers to “outside the control of the issuer” as a determination for classifying a preferred share as redeemable (reported at amortized cost), certain circumstances which are technically “not solely within the issuer’s control” could cause shares to be reclassified to redeemable which were originally categorized as perpetual (reported at fair value). ASC 480-10 provides a few of these examples as: change in state law, the issuer fails to achieve certain project milestones, the issuer fails to pay specified dividends, the issuer experiences a change in credit rating, etc.

As such, NAIC staff are supportive of the changes suggested by interested parties as they align with the original objective of preferred stock classification and reflect the expected economics of the investment.

6.7. Although the historical definition of preferred stock in SSAP No. 32 is comparable to current market terms, this issue paper recommends revisions to incorporate the NASDAQ definition as it is more encompassing of the characteristics of preferred stocks.
Definitions and Classification as Redeemable or Perpetual Preferred Stock

7-8. The accounting guidance of SSAP No. 32 varies based on whether preferred stock is considered to be “redeemable” or “perpetual.” The historical definitions of redeemable and perpetual within SSAP No. 32R reflected the following:

a. Redeemable preferred stock is defined as preferred stock that must be redeemed by the issuing enterprise or is redeemable at the option of the reporting entity. It includes mandatory sinking fund preferred stock and payment-in-kind (PIK) preferred stock.

b. Perpetual preferred stock is defined as preferred stock with no redemption or sinking fund features or preferred stock redeemable at the option of the issuer.

8-9. In comparing these terms to current U.S. GAAP, the guidance in the FASB Accounting Standards Codification (ASC), which is also consistent with Securities Exchange Commission (SEC) guidance, is more detailed in identifying the requirements for classification as redeemable preferred stock:

a. Preferred Stock Subject to Mandatory Redemption Requirements or Whose Redemption is Outside the Control of the Issuer (“Redeemable Preferred Stock”). The term means any stock which (i) the issuer undertakes to redeem at a fixed or determinable price on the fixed or determinable date or dates, whether by operation of a sinking fund or otherwise; (ii) is redeemable at the option of the holders, or (iii) has conditions for redemption which are not solely within the control of the issuer, such as stocks which must be redeemed out of future earnings. Under this definition, preferred stock which meet one or more of the above criteria would be classified as redeemable preferred stock regardless of their other attributes such as voting rights, dividend rights or conversion features. (FASB ASC 480-10-S99)

b. Preferred Stocks Which Are Not Redeemable or Are Redeemable Solely at the Option of the Issuer (“Non-Redeemable Preferred Stock”). The term means any preferred stock which does not meet the criteria for classification as a "redeemable preferred stock." (FASB ASC 480-10-S99)

9-10. In reviewing these definitions, and preferred stock components that permit payment of dividends in stock instead of cash (known as payment-in-kind (PIK) stock), it was identified that preferred stock that incorporates PIK dividends is not limited to redeemable preferred stock as implied in the prior SSAP No. 32 definition for redeemable preferred stock.

10-11. To ensure classification of redeemable and perpetual preferred stock consistently with U.S. GAAP, the definitions from the FASB ASC have been incorporated into the revised SSAP No. 32.

Definition of Restricted Stock:

11-12. The historical accounting guidance in SSAP No. 32 included a definition of restricted stock as “a security for which sale is restricted by governmental or contractual requirement (other than in connection with being pledged as collateral) except where that requirement terminates within one year or if the holder has the power by contract or otherwise to cause the requirement to be met within one year.” This definition identified that “any portion of the security that can be reasonably expected to qualify for sale within one year is not considered restricted.”

12-13. In researching this restricted stock definition, it was identified that this guidance was included in the original codification of SSAP No. 32, however, there was no identification of the source of this
definition from the issue paper. In reviewing current market terms for restricted stock or restricted securities, definitions and information was noted from both NASDAQ and the SEC:

a. Restricted Stock (NASDAQ): Stock that must be traded in compliance with special SEC regulations concerning its purchase and resale. These restrictions generally result from affiliate ownership, merger and acquisition (M&A) activity, and underwriting activity.

b. Restricted Securities (SEC): Securities acquired in an unregistered, private sale from the issuing company or from an affiliate of the issuer. They typically bear a “restrictive” legend clearly stating that you may not resell them in the public marketplace unless the sale is exempt from the SEC’s registration requirements. Rule 144 under the Securities Act of 1933 provides the most commonly used exemption for holders to sell restricted securities. To take advantage of this rule, you must meet several conditions, including a six-month or one-year holding period.

Using the information from both NASDAQ and the SEC, a revised definition of restricted stock has been incorporated into the revised SSAP No. 32. Additionally, the revisions clarify that restricted stock is generally an admitted asset but highlights that nonadmittance could occur in accordance with SSAP No. 4—Assets and Nonadmitted Assets. Under SSAP No. 4, the restrictions limiting use of an asset can be determined to preclude the ability to consider the asset as available for policyholder claims. In such situations, the restricted asset would be considered nonadmitted.

Definitions or Preferred Stock Components / Characteristics

The historical guidance in SSAP No. 32 included definitions for a couple of preferred stock terms, including “mandatory sinking fund” and “step-up preferred stock,” but did not include definitions of other common preferred stock components or terms. Furthermore, in reviewing the previously included terms, it was identified that they were no longer current and should be revised or removed from SSAP No. 32. For example, the definition of “mandatory sinking fund” included references to preferred stock outstanding in 1978, and the definition of “step-up preferred stock” referred to the Purposes and Procedures Manual of the NAIC Investment Analysis Office, and there is no current accounting or valuation guidance for step-up preferred stock in that Manual.

Rather that include a variety of terms in the body of the SSAP, particularly as components may not impact overall accounting and reporting of the preferred stock, a new exhibit has been included to include a glossary of key preferred stock terms. The definitions intend to capture current market-terms for the noted components.

Accounting and Reporting of Preferred Stock

The historical guidance in SSAP No. 32 captured different accounting and reporting provisions based on whether the preferred stock was classified as redeemable or perpetual, and whether the reporting entity maintained an Asset Valuation Reserve (AVR). Although these classifications are still considered appropriate, it has been noted that additional guidance is needed for mandatory convertible preferred stock, and that a review of the various measurement methods permitted (by classification) should occur to ensure appropriate measurement in the financial statements. Specifically, the prior guidance in SSAP No. 32 explicitly permitted “cost” as an applicable measurement method, even for perpetual preferred stock. Consistent with prior conclusions from U.S. GAAP, as well as the Statutory Accounting Principles (E) Working Group, “historical cost” is generally not an acceptable measurement method. Particularly, this measurement method is not acceptable when liquidation of an asset would generally occur at market prices, such as a non-redeemable (perpetual) preferred stock.
The changes reflected in the revised SSAP No. 32 continue to differentiate accounting and reporting guidance by whether a reporting entity maintains an AVR and on the type of preferred stock (redeemable or perpetual). However, revisions have been incorporated to clarify the accounting and reporting of mandatory convertible preferred stock and to update the measurement basis for each type of preferred stock:

a. For redeemable preferred stock, the revisions continue to use NAIC designations in determining the measurement method. There was no change proposed to the measurement basis per designation. However, the revisions clarify that the measurement basis shall be either amortized cost or fair value based on NAIC designation, eliminating reference to “cost” as an measurement method that could be used by a reporting entity. For the amortization of redeemable preferred stock, revisions have also been incorporated to clarify that amortization (or accretion) of any discount or premium is reported through investment income, instead of impacting dividends collected. Recognizing this amortization through investment income is consistent with U.S. GAAP.

b. For perpetual preferred stock, the revisions have eliminated use of NAIC designations in determining measurement method and the guidance requires use of fair value, not to exceed any stated call price from the prospectus of the preferred stock. As there are no requirements for an issuer to redeem these securities, these securities can continue indefinitely until the issuing entity reacquires the preferred stock at current market rates or elects to buy-back the preferred stock in accordance with rates established in the preferred stock prospectus. In order to prevent overstatement of the securities in the financial statements, the measurement of these preferred stocks reflects fair value, not to exceed any currently effective buy-back rates (call prices) that the issuer can utilize to redeem the stock. This measurement guidance is not impacted by the type of reporting entity (AVR or non-AVR filer) and is not impacted by NAIC designation. Although not impacted by NAIC designation, this guidance does not change the requirement to report the NAIC designation as the NAIC designation impacts the risk-based capital (RBC) charge attributed to the preferred stock.

c. For mandatory convertible preferred stock, guidance has been incorporated to require measurement at fair value, not to exceed any stated call price, in the periods prior to conversion. This guidance is applicable regardless if the preferred stock would be classified as redeemable or perpetual and is applicable regardless of NAIC designation. This guidance requires the preferred stock to be measured at the same measurement basis that would be required once converted to common stock. This prevents overstatement in the financial statements at the time of conversion.

d. For exchange traded funds which qualify for preferred stock treatment from the NAIC SVO, the revisions clarify that these investments shall always be treated as perpetual preferred stock. This classification is appropriate as the fund would not qualify as a redeemable preferred stock with a stated term that allows for amortization.

Impairment of Preferred Stock

The prior guidance in SSAP No. 32 included different guidance for determining other-than-temporary impairment (OTTI) based on whether the preferred stock was redeemable or perpetual. Although this division has been retained, modifications have been reflected as follows:

1 Interested parties noted that call dates may not be effective for a period of time. As such, language regarding that only “currently effective” buy back rates (call prices) was added.
For redeemable preferred stock, guidance has been captured to require assessment of OTTI whenever mandatory redemption rights or sinking fund requirements do not occur. Although preferred stock may indicate “required” elements, failing to provide dividends, or contribute to a sinking fund, may not be considered an act of default or require liability recognition from the issuer. Not receiving preferred stock provisions does not turn the holder of preferred stock into a creditor, and a redemption right cannot force a company to redeem shares. However, if an issuer fails to comply with “required” components, reporting entities should assess whether the preferred stock is other-than-temporarily impaired.

For perpetual preferred stock, the other-than-temporary impairment guidance has been revised to mirror guidance for other equity investments (e.g., common stock). As perpetual preferred stock will be reported at fair value, upon recognition of an OTTI, any unrealized losses will be realized, and the then-current fair value will become the new cost basis. Subsequent variations in fair value are treated as unrealized gains or losses.

Comments received from interested parties noted that proposed impairment guidance for perpetual preferred stock could be enhanced if written similar to existing impairment guidance in SSAP No. 30R—Unaffiliated Common Stock. Final proposed language in Exhibit A mimics the language in SSAP No. 30R.

Preferred Stock Income / Redemption

The guidance in this issue paper incorporates revisions to clarify the reporting of dividend income from preferred stock. This guidance clarifies that dividends shall be recognized in the form received (cash, preferred stock, common stock), at fair value, with differences between fair value and the dividend receivable recognized as gains or losses. Subsequent to initial recognition, the asset received shall follow the applicable statutory accounting statement. For example, dividends received in the form of common stock shall be captured in SSAP No. 30—Unaffiliated Common Stock.

Additionally, this issue paper incorporates new guidance to clarify the reporting when preferred stock is reacquired or redeemed by the issuing entity. Pursuant to this guidance, regardless of how an issuer reacquires the stock (either at market value or pre-set call / redemption price), the reporting entity would recognize any difference between the book/adjusted carrying value and the consideration received as a realized gain or loss.

Disclosures

Although this issue paper incorporates various accounting and reporting changes for preferred stock, there have been no revisions incorporated to the existing disclosure requirements.

Effective Date

The adoption of this issue paper by the Statutory Accounting Principles (E) Working Group, and the substantively revised statement of statutory accounting principles (SSAP) occurred on _______. The substantive revisions to SSAP No. 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 Section IV of the Preamble) and therefore the conclusions reached in this issue paper should not be applied until the corresponding SSAP has been adopted by the Plenary of the NAIC.
RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

- SSAP No. 32R—Preferred Stock
EXHIBIT A - REVISIONS TO SSAP No. 32—Preferred Stock

Preferred Stock

SCOPE OF STATEMENT

1. This statement establishes statutory accounting principles for preferred stock.

2. Investments in preferred stock of entities captured in SSAP No. 97—Investments of in subsidiaries, controlled or affiliated entities or SSAP No. 48—Joint Ventures, Partnerships and Limited Liability Companies, including as well as preferred stock interests of certified capital companies (CAPCO) per INT 06-02: Accounting and Reporting for Investments in a Certified Capital Company (CAPCO) are included within the scope of this statement. The requirement to file investments in preferred stock of certain subsidiaries, controlled or affiliated entities with the NAIC pursuant to SSAP No. 97 does not affect the application of the accounting, valuation or admissibility under this statement.

SUMMARY CONCLUSION

3. Preferred stock, which may or may not be publicly traded, is a security that represents ownership of a corporation and gives the holder a claim, prior to the claim of common stockholders on earnings and also generally on assets in the event of liquidation. Most preferred stock pays a fixed dividend that is paid prior to the common stock dividend, stated in a dollar amount or as a percentage of par value. Preferred stock does not usually carry voting rights. Preferred stock has characteristics of both common stock and debt, defined as any class or series of shares the holders of which have any preference, either as to the payment of dividends or distribution of assets on liquidation, over the holder of common stock (as defined in SSAP No. 30R—Unaffiliated Common Stock) issued by an entity. Preferred stock shall include:

a. Redeemable preferred stock, which is preferred stock subject to mandatory redemption requirements or whose redemption is outside the control of the holders, is preferred stock any stock which 1) the issuer undertakes to redeem at a fixed or determinable price on the fixed or determinable date or dates, whether by operation of a sinking fund or otherwise; or 2) is redeemable at the option of the holders; or 3) has conditions for redemption which are not solely within the control of the issuer, such as stock which must be redeemed out of future earnings. Preferred stock which meet one or more of these three criteria would be classified as redeemable preferred stock regardless of other attributes such as voting rights or dividend rights, including mandatory sinking fund preferred stock and preferred stock redeemable at the option of the holder.

b. Perpetual preferred stock, which is preferred stocks which are not redeemable or for which redemption is not at the option of the holder are redeemable solely at the option of the issuer (non-redeemable preferred stock). Perpetual preferred stock is any preferred stock which does not meet the criteria to be classified as redeemable preferred stock pursuant to

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1 Certain legal entities captured in SSAP No. 48, do not issue preferred stock in legal form, but instead issue identical instruments labeled preferred units, interests, or shares. These instruments shall be captured in this statement provided they meet the structural characteristics as defined in paragraph 3. Additionally, these instruments shall not be in-substance common stock which is the holder has risk and reward characteristics that are substantially similar to common stock.

2 Preferred stock shall be classified by its characteristics. For example, a preferred stock that is named “redeemable perpetual preferred stock” shall be reported as either “redeemable” or “perpetual” preferred stock based on whether the characteristics of paragraph 3a are met.
paragraph 3.a including nonredeemable preferred stock and preferred stock redeemable at the option of the issuer; and

4. The definition of preferred stock, as defined in paragraph 3 does not include equity/fund investments. However, the following types of SVO-identified investments are captured within scope of this statement.

   a. Exchange Traded Funds, which qualify for preferred stock treatment, as identified in Part Six, Section 2, of the Purposes and Procedures Manual of the NAIC Investment Analysis Office. SVO-Identified Preferred Stock ETFs shall follow the accounting provisions for perpetual preferred stock.

5.— Redeemable preferred stock is defined as preferred stock that must be redeemed by the issuing enterprise or is redeemable at the option of the reporting entity. It includes mandatory sinking fund preferred stock and payment-in-kind (PIK) preferred stock.

6.— Mandatory sinking fund preferred stock is defined as redeemable preferred stock subject to a 100% mandatory sinking fund, annual installments of which will (a) commence not more than 10 years from the date of issue or December 31, 1978, if outstanding on that date; (b) be not less than 2% of the number of shares issued (or outstanding on December 31, 1978, if issued prior to that date); (c) provide for the redemption of the entire issue over a period not longer than 40 years from the date of issue, or December 31, 1978, if outstanding on that date. Redeemable preferred stock which is subject to a 100% mandatory sinking fund, but which does not, at date of issue or December 31, 1978, if outstanding at that time, meet one or more of the other requirements above, shall be considered as mandatory sinking fund preferred stock at the time the deficiency is cured through the passage of time or otherwise.

7.— PIK preferred stock is defined as redeemable preferred stock on which, at the option of the issuer, dividends can be paid in additional securities rather than cash.

8.— Perpetual preferred stock is defined as preferred stock with no redemption or sinking fund features or preferred stock redeemable at the option of the issuer.

9.5. Restricted preferred stock is defined as a security either redeemable or perpetual preferred stock that must be traded in compliance with special Securities Exchange Commission (SEC) regulations concerning its purchase and resale. These restrictions generally result from affiliate ownership, merger and acquisition (M&A) activity and underwriting activity. Pursuant to the SEC, restricted securities are securities acquired in an unregistered, private sale from the issuing company or from an affiliate of the issuer. They typically bear a “restrictive” legend clearly stating that the holding may not resell the stock in the public marketplace unless the sale is exempt from the SEC’s registration requirements. Restricted preferred stock is generally considered an admitted asset; however, admittance may be limited based on the degree of restriction in accordance with SSAP No. 4—Assets and Nonadmitted Assets. Restricted preferred stock shall be coded as restricted in the investment schedule and disclosed pursuant to SSAP No. 1—Accounting Policies, Risks & Uncertainties, and Other Disclosures, for which sale is restricted by governmental or contractual requirement (other than in connection with being pledged as collateral) except where that requirement terminates within one year or if the holder has the power by contract or otherwise to cause the requirement to be met within one year. Any portion of the security that can be reasonably expected to qualify for sale within one year is not considered restricted.

3 This definition of restricted stock does not preclude a “restricted asset” classification for any preferred stock that is restricted (e.g., not under the exclusive control of the entity) by actions of the reporting entity or others. For example, if a reporting entity has pledged preferred stock, or used preferred stock in securities lending / repo transactions, the preferred stock shall be coded and disclosed as restricted stock pursuant to SSAP No. 1.
10.6 Preferred stocks meet the definition of assets as defined in SSAP No. 4—Assets and Nonadmitted Assets and are admitted assets to the extent they conform to the requirements of this statement.

Acquisitions and Sales

11.7 At acquisition, preferred stock shall be reported at cost, including brokerage and other related fees. Preferred PIK stock received as dividends shall be initially recorded at fair value. Acquisitions and dispositions shall be recorded on the trade date. Private placement stock transactions shall be recorded on the funding date.

12.8 A reporting entity can subscribe for the purchase of stock, but not be required to make payment until a later time. Transactions of this nature are common in the formation of corporations. Preferred stock acquired under a subscription represents a conditional transaction in which a security—preferred stock is authorized for issuance but not yet actually issued. Such transactions are settled if and when the actual security—preferred stock is issued and the exchange or National Association of Securities Dealers (NASD) rules that the transactions are to be settled. Preferred stock acquired under a subscription shall be recorded as an admitted asset when the reporting entity or its designated custodian or transfer agent takes delivery of the security—preferred stock and the security—preferred stock is recorded in the name of the reporting entity or its nominee, (i.e., the accounting for such preferred stock acquisitions shall be on the settlement date).

Amortization

13. Redeemable preferred stock purchased at a premium shall be amortized to reduce the carrying value to the call or redemption value over the period to the call or earliest redemption date, whichever produces the lowest asset value (yield to worst). Redeemable preferred stock purchased at a discount shall be amortized—accrued to increase the carrying value to par value—the redemption price over the period to maturity or the latest redemption date.

14. PIK preferred stock shall be amortized to the lower of the call price or par value, measured in either case at the end of the stock dividend period and based on all of the shares expected to be held at the end of that period, including those received as dividends.

45.9 Amortization (and accretion) of the premium and discount arising at acquisition shall be calculated using the interest method and shall be reported as increases or decreases in dividends collected during the year through investment income.

Balance Sheet Amount

16. The NAIC Securities Valuation Office assigns preferred stocks NAIC designations (NAIC designation 1 through 6) in accordance with the Purposes and Procedures Manual of the NAIC Investment Analysis Office, and that NAIC designation is published in accordance with the SVO compilation instructions in the Purposes and Procedures Manual.

10. Preferred stock shall be valued based on (a) the underlying characteristics of the security (redeemable, or perpetual or mandatory convertible), (b) the quality rating of the security—expressed as an NAIC designation pursuant to paragraph 15, and (c) whether an asset valuation reserve (AVR) is maintained by the reporting entity.

a. For reporting entities that do not maintain an AVR:

b. Step up preferred stock (a security with the structure of a preferred stock, that has the cash flow characteristics of a debt instrument) is considered a security with characteristics of
both debt and equity, and the accounting and valuation of such securities shall be consistent with SVO guidelines as stipulated in the Purposes and Procedures Manual of the NAIC Investment Analysis Office.

17. 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 (SSAP No. 7). 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).

a. Reporting Entities That Do Not Maintain An AVR

i. Highest-quality or high-quality redeemable preferred stocks (NAIC designations 1 and 2), which have characteristics of debt securities, shall be valued at cost or amortized cost. All other redeemable preferred stocks (NAIC designations 3 to 6) shall be reported at the lower of cost, amortized cost, or fair value.

ii. Highest-quality or high-quality perpetual preferred stocks (NAIC designations 1 and 2), which have characteristics of equity securities, shall be reported at fair value, not to exceed any currently effective stated call price. All other perpetual preferred stocks (NAIC designations 3 to 6) shall be reported at the lower of cost or fair value.

iii. Mandatory convertible preferred stocks (regardless if the preferred stock is redeemable or perpetual) shall be reported at fair value, not to exceed any currently effective stated call price, in the periods prior to conversion. Upon conversion to common stock, these securities shall be in scope of SSAP No. 30R.

iv. For preferred stocks reported at fair value, unrealized gains and losses shall be recorded as a direct credit or charge to unassigned funds (surplus).

b. For reporting entities that maintain an AVR:

Reporting Entities That Do Maintain An AVR

i. Highest-quality, high-quality or medium quality redeemable preferred stocks (NAIC designations 1 to 3), which have characteristics of debt securities, shall be valued at cost or amortized cost. All other redeemable preferred stocks (NAIC designations 4 to 6) shall be reported at the lower of cost, amortized cost, or fair value.

ii. Highest-quality, high-quality or medium quality perpetual preferred stocks (NAIC designations 1 to 3), which have characteristics of equity securities, shall be valued at fair value, not to exceed any currently effective stated call price. All other perpetual preferred stocks (NAIC designations 4 to 6) shall be reported at the lower of cost or fair value.

iii. Mandatory convertible preferred stocks (regardless if the preferred stock is redeemable or perpetual) shall be reported at fair value, not to exceed any currently effective stated call price, in the periods prior to conversion. Upon conversion to common stock, these securities shall be in scope of SSAP No. 30R.
For preferred stocks reported at fair value, the accounting for unrealized gains and losses shall be in accordance with SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve (SSAP No. 7).

Impairment of Redeemable Preferred Stock

48-11. An other-than-temporary impairment 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 security—preferred stock in effect at the date of acquisition. An assessment of other-than-temporary impairment shall occur whenever mandatory redemption rights or sinking fund requirements do not occur. A decline in fair value which is other-than-temporary includes situations where the reporting entity has made a decision to sell the preferred stock prior to its maturity at an amount below its carrying value (i.e., amortized cost). If it is determined that a decline in the fair value of a redeemable preferred stock is other-than-temporary, an impairment loss shall be recognized as a realized loss equal to the entire difference between the redeemable preferred stock’s carrying value and its fair value, not to exceed any currently effective call price, at the balance sheet date of the reporting period for which the assessment is made. The measurement of the impairment loss 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.

49-12. In periods subsequent to the recognition of other-than-temporary impairment loss for a redeemable preferred stock, the reporting entity shall account for the other-than-temporarily impaired preferred stock security as if the preferred stock security had been purchased on the measurement date of the other-than-temporary impairment, and in accordance with paragraph 19 or paragraph 21, as applicable. The fair value of the redeemable preferred stock on the other-than-temporary impairment measurement date shall become the new cost basis of the redeemable preferred stock and the new cost basis shall not be adjusted for subsequent recoveries in fair value. The discount or reduced premium recorded for the preferred stock security, based on the new cost basis, shall be amortized over the remaining life of the preferred stock security in the prospective manner based on the amount and timing of future estimated cash flows. The preferred stock security 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.

Impairment of Perpetual Preferred Stock

20-13. For any decline in the fair value of perpetual preferred stock which is determined to be other-than-temporary, the then-current fair value shall reflect the new cost basis of the preferred stock, with prior unrealized losses recognized as realized losses. Subsequent fluctuations in fair value shall be recorded as unrealized gains or losses. Future declines which are determined to be other-than-temporary shall be recognized as realized losses. The perpetual preferred stock shall be written down to fair value as the new cost basis and the amount of the write down shall be accounted for as a realized loss. An impairment loss shall be recognized as a realized loss equal to the entire difference between the perpetual preferred stock’s carrying value and its fair value at the balance sheet date of the reporting period for which the assessment is made. The measurement of the impairment loss 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. Subsequent fluctuations in fair value shall be recorded as unrealized gains or losses. Future declines which are determined to be other-than-temporary shall be recognized as realized losses. A decline in fair value which is other-than-temporary includes situations where the reporting entity has made a decision to sell a preferred stock security at an amount below its carrying value.
21. In periods subsequent to the recognition of an other-than-temporary impairment loss for a perpetual preferred stock, the reporting entity shall account for the other-than-temporarily impaired security as if the security had been purchased on the measurement date of the other-than-temporary impairment, and in accordance with paragraph 20 or paragraph 22, as applicable. The fair value of the perpetual preferred stock on the measurement date shall become the new cost basis of the perpetual preferred stock and the new cost basis shall not be adjusted for subsequent recoveries in fair value. Future declines in fair value which are determined to be other-than-temporary, shall be recorded as realized losses.

Income

14. Dividends on preferred stock (whether cumulative or noncumulative), other than mandatorily redeemable preferred stock, shall be recorded as investment income for qualifying dividend eligible preferred stock on the ex-dividend date with a corresponding receivable to be extinguished upon receipt of cash dividend settlement (i.e., dividend income shall be recorded on preferred stock declared to be ex-dividend on or prior to the statement date). Dividends received shall be recognized in the form received (e.g., cash, preferred stock, common stock) at fair value with differences between fair value and the dividend receivable recognized as gains or losses. Subsequent treatment shall follow the statement that addresses the type of asset received. (For example, dividends received in the form of common stock shall be accounted for and reported in accordance with SSAP No. 30R—Unaffiliated Common Stock.)

Redemption of Preferred Stock

15. A reporting entity that sells or redeems preferred stock back to the issuer shall recognize consideration received in excess of the book/adjusted carrying value as a realized gain or loss. This recognition shall occur regardless of whether the issuer repurchases the preferred shares at market value, or if the shares are redeemed by the issuer at a predetermined set call price.

22. Dividends on mandatorily redeemable preferred stock shall be accrued to the redemption price, even if not declared, using the interest method over the period ending on the redemption date.

23. Cash dividends paid on PIK stock during the stock dividend period shall be accounted for as a reduction in the investment.

Exchanges and Conversions

24. If preferred stock is exchanged or converted into other securities, the fair value of the preferred stock surrendered at the date of the exchange or conversion shall become the cost basis for the new securities with any gain or loss realized at the time of the exchange or conversion. However, if the fair value of the securities received in an exchange or conversion is more clearly evident than the fair value of the preferred stock surrendered, then it shall become the cost basis for the new securities.

Disclosures

25. The following disclosures regarding preferred stocks shall be made in the financial statements:

a. Fair values in accordance with SSAP No. 100R—Fair Value (SSAP No. 100R);

b. Concentrations of credit risk in accordance with SSAP No. 27;

c. Basis at which the preferred stocks are stated; and
d. A description, as well as the amount, of preferred stock that is restricted and the nature of the restriction.

e. For each balance sheet presented, all preferred stocks in an unrealized loss position for which other-than-temporary declines in value have not been recognized.

i. The aggregate amount of unrealized losses (that is, the amount by which cost or amortized cost exceeds fair value) and

ii. The aggregate related fair value of preferred stocks with unrealized losses.

f. The disclosures in (i) and (ii) above should be segregated by those preferred stocks that have been in a continuous unrealized loss position for less than 12 months and those that have been in a continuous unrealized loss position for 12 months or longer using fair values determined in accordance with SSAP No. 100R.

g. As of the date of the most recent balance sheet presented, additional information should be included describing the general categories of information that the investor considered in reaching the conclusion that the impairments are not other-than-temporary.

h. When it is not practicable to estimate fair value, the investor should disclose the following additional information, if applicable, as of each date for which a statement of financial position is presented in its annual financial statements:

iii. The aggregate carrying value of the investments not evaluated for impairment, and

iv. The circumstances that may have a significant adverse effect on the fair value.

26.18. Refer to the Preamble for further discussion regarding disclosure requirements. The disclosure requirements of paragraphs 34.17.b., 34.17.e., 34.17.f., 34.17.g., and 34.17.h. shall be included in the annual audited statutory financial reports only.

**Relevant Literature**


**Effective Date and Transition**

20. This statement is effective for years beginning January 1, 2001. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with SSAP No. 3—Accounting Changes and Corrections of Errors. The guidance in paragraphs 23-26 was previously included within SSAP No. 99—Accounting for Securities Subsequent to an Other-Than-Temporary Impairment and was effective for reporting periods beginning on January 1, 2009, and thereafter, with early adoption permitted. In 2010, the guidance from SSAP No. 99 was incorporated within the impacted standards, with SSAP No. 99 superseded. The original impairment guidance included in this standard, and the substantive revisions reflected in SSAP No. 99 are retained for historical purposes within
Issue Paper No. 131. The guidance in paragraphs 2 and 3 to SSAP No. 32 was originally superseded January 1, 2005, by guidance included in SSAP No. 88—Investments in Subsidiaries, Controlled and Affiliated Entities, A replacement of SSAP No. 46, and then subsequently reflected in SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities. In 2011, the guidance related to preferred stock of SCAs from SSAP No. 97 was incorporated into this statement and revised to reflect a definition of preferred stock. The original guidance included in this statement, and the substantive revisions reflected in SSAP No. 88 and SSAP No. 97 (including the title change already reflected in SSAP No. 32) are retained for historical purposes within Issue Paper Nos. 32 and 118. Guidance in paragraph 17 was originally contained in INT 99-29: Classification of Step-Up Preferred Stock and was effective December 6, 1999.

28.21. In __________, substantive revisions, as detailed in Issue Paper No. _____ were adopted. These revisions, effective __________, update definitions of preferred stock and reporting values based on characteristics of the preferred stock.

REFERENCES

Other

- Purposes and Procedures Manual of the NAIC Investment Analysis Office
- NAIC Valuation of Securities product prepared by the Securities Valuation Office

Relevant Issue Papers

- Issue Paper No. 32—Investments in Preferred Stock (excluding investments in preferred stock of subsidiary, controlled, or affiliated companies)
- Issue Paper No. 131—Accounting for Certain Securities Subsequent to an Other-Than-Temporary Impairment
- Issue Paper No. 1XX—Preferred Stock
EXHIBIT A – GLOSSARY

Callable Preferred Stock – A preferred stock security in which the issuer has the right to call or redeem the stock at a preset price after a defined date. Callable preferred stock can be either redeemable preferred stock or perpetual preferred stock depending on other characteristics of the preferred stock. For example, callable preferred stock with a maturity or a specific buyback date would be redeemable preferred stock, whereas callable preferred stock electable at the discretion of the issuer is perpetual preferred stock.

Convertible Preferred Stock – A preferred stock security that is convertible into another security based on a conversion rate. For example, convertible preferred stock that is convertible into common stock on a two-for-one basis (two shares of common for each share of preferred).

Cumulative Preferred Stock – A preferred stock security with a provision that missed dividend payments must be paid to cumulative preferred shareholders before other classes of preferred stock shareholders and common shareholders can receive dividend payments. Cumulative preferred stock may have different levels, with a “first” or “senior” cumulative preferred, “regular” cumulative preferred and “subordinate” cumulative preferred that determines the priority in which accumulated unpaid dividends or asset liquidation occurs. (Under SSAP No. 32R, holders of cumulative preferred stock are not permitted to recognize a receivable for unpaid cumulative dividends until declared and the reporting entity is entitled to the dividend.)

Dividend Declaration Date – The date a corporation declares a dividend payment to its shareholders.

Dividend Record Date – The date that identifies the shareholders that are entitled to a declared dividend.

Dividend Payment Date – The date the declared dividend will be paid.

Ex-Dividend Date – The cut-off date of holding stock to be captured as a shareholder on record entitled to the dividend. (A shareholder that sells their stock on the ex-dividend date would continue to be identified as a shareholder on record entitled to a declared dividend. Anyone who acquires a stock on the ex-dividend date would not be a shareholder on record entitled to a declared dividend.)

Mandatory Redeemable Preferred Stock – A preferred stock security that embodies an unconditional obligation requiring the issuer to redeem the instrument by transferring its assets at a specified or determinable date (or dates) or upon an event that is certain to occur. (The existence of a mandatory redemption right does not convert the holder of a preferred stock into a creditor, and an issuer may be prohibited from redeeming shares when redemption would cause an impairment of capital.)

Noncumulative Preferred Stock – A preferred stock security that does not entitle the stockholder to accumulated unpaid dividends. After missing dividend payments, a corporation only has to be make current dividend payments to preferred stock holders before providing dividends to common stock holders.

Participating Preferred Stock – A preferred stock security that gives the holder participation in the additional earnings of a business or liquidation rights in addition to the normal preferred stock dividend. Pursuant to the terms of the preferred stock, the participation rights may only be activated when income or operations of the issuer exceeds a certain threshold level.

Payment-in-kind (PIK) – A term of the preferred stock prospectus that identifies that dividends may take the form of securities (e.g., common stock) rather than cash.
**Perpetual Preferred Stock** - Preferred stocks which are not redeemable or are redeemable solely at the option of the issuer. Perpetual preferred stock is any preferred stock which does not meet the criteria to be classified as redeemable preferred stock.

**Preferred stock** - A security, which may or may not be publicly traded, that shows ownership of a corporation and gives the holder a claim, prior to the claim of common stockholders on earnings and also generally on assets in the event of liquidation.

**Redeemable Preferred Stock** - Preferred stock subject to mandatory redemption requirements or whose redemption is outside the control of the issuer. Redeemable preferred stock is any stock which 1) the issuer undertakes to redeem at a fixed or determinable price on the fixed or determinable date or dates, whether by operation of a sinking fund or otherwise; 2) is redeemable at the option of the holders; or 3) has conditions for redemption which are not solely within the control of the issuer, such as stock which must be redeemed out of future earnings. Preferred stock which meet one or more of these three criteria is redeemable preferred stock regardless of other attributes such as voting rights or dividend rights.

**Restricted Preferred Stock** - Redeemable or perpetual preferred stock that must be traded in compliance with special SEC regulations concerning its purchase and resale. These restrictions generally result from affiliate ownership, M&A activity and underwriting activity. Pursuant to the SEC, restricted securities are securities acquired in an unregistered, private sale from the issuing company or from an affiliate of the issuer. They typically bear a “restrictive” legend clearly stating that the holding may not resell the stock in the public marketplace unless the sale is exempt from the SEC’s registration requirements.

**Sinking Fund** – A potential component of a preferred stock charter that requires the issuer to regularly set funds aside in a separate custodial account for the exclusive purpose of redeeming preferred stock shares. Failure of an issuer to provide to the sinking fund does not create an act of default. Rather, the stock charter may implement provisions for failing to provide to the sinking fund, which could include penalties, restrictions of providing common stock dividends or the repurchase of the preferred stock.

**Step-Up Preferred Stock** – A potential component of a preferred stock charter that identifies whether specific terms will increase over time or with stated provisions. For example, a “step-up dividend” is a feature that increases the dividend rate. A “step-up call” is a feature that increases the call price. A “step-up conversion” increases the conversion price.

**Term Preferred Stock** – Preferred stock with a mandatory redemption requirement (maturity date) captured in the definition of redeemable preferred stock.
Statutory Accounting Principles (E) Working Group
Maintenance Agenda Submission Form
Form A

**Issue: Update** Reporting Deposit-Type Contracts

**Check (applicable entity):**

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<tr>
<th>Modification of existing SSAP</th>
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<th>Life</th>
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<td>New Issue or SSAP</td>
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**Description of Issue:** This agenda item has been drafted in response to questions identified by the Financial Stability (EX) Task Force in developing liquidity disclosure changes to the 2019 life blank, and the noted inability to fully identify and assess deposit-type contracts - (particularly guaranteed investment contracts) - within the statutory financial statements. From information received, it appears that in some instances deposit-type contracts are being reported along with life contracts in Exhibit 5 – Aggregate Reserves for Life Contracts or in Exhibit 6 – Aggregate Reserves for Accident and Health Contracts, rather than in Exhibit 7 – Deposit-Type Contracts.

This issue has been raised as payout requests for deposit-type contracts are significantly different than payouts generated by an insured event (mortality or morbidity). The Task Force identified that information on liabilities, particularly those that can be called with little or no surrender penalty, must be known to properly complete liquidity assessments.

After various discussions, it is anticipated that guaranteed investment contracts (GICs) are reported as a life contract or accident and health contract (and not a deposit-type contract) for one of the following reasons:

- The GIC was a “supplemental” contract formed from the proceeds of a life / A&H insurance contract.
- The GIC, although absent mortality or morbidity risk, was written on a life / A&H insurance “paper.”
- The state insurance department has approved the GIC to be classified as a life / A&H insurance contract.
- Contracts may be designed as GICs, but could potentially have mortality / morbidity components, which qualifies the contract to be reported as a life or A/H insurance contract.

The purpose of this agenda item is to solicit information regarding the reporting of GICs (and other deposit-type contracts) as life or A/H contracts in the reporting exhibits, and consider revisions to statutory accounting and reporting instructions to ensure that information regarding all GICs can be separately identifiable and aggregated from the financial statements.

**Existing Authoritative Literature:**

**SSAP No. 50—Classifications of Insurance or Managed Care Contracts**

5. **Insurance contracts providing any protection against death, disability, accident or illness in which the reporting entity assumes mortality or morbidity risk shall be classified as life or accident and health contracts, as applicable.** Managed care contracts provide defined health care services to subscribers, members or policyholders, collectively referred to hereafter as subscribers, in return for fixed, periodic premiums (usually paid monthly) that are generally due at or before the beginning of the coverage period and shall be classified as health contracts. Contracts which insure against damage to property by an insured peril or damage or injury to the insured or third parties, generally over a fixed/limited period of time, shall be classified as property and casualty contracts. Contracts in which the reporting entity does not assume any mortality, morbidity, health benefit costs incurred, or casualty risk and which act exclusively as investment vehicles shall be...
classified as deposit-type contracts. Such classification shall be made at the inception of the contract and shall not change.

14. Supplementary contracts with life contingencies are a type of agreement between the insurance company and either the insured or the beneficiary, usually to provide for full or partial settlement of the amount payable upon the termination of an original contract. Generally, the proceeds are paid over the lifetime of one or more beneficiaries. **This differs from a supplementary contract without life contingencies under which the proceeds are paid over a definite period without regard to the life of the beneficiary.**

**Deposit-Type Contracts**

43. Deposit-type contracts do not incorporate insurance risk. Contracts issued by insurers that do not incorporate risk from the death or disability of policyholders (mortality or morbidity risk) are more comparable to financial or investment instruments issued by other financial institutions than to insurance contracts.

44. **Deposit-type contracts shall include contracts without any life or disability contingencies, including, but not limited to, certain types of the following policy categories:**

   a. Supplemental contracts
   b. Lottery payouts
   c. Structured settlements
   d. Guaranteed interest contracts
   e. Income settlement options
   f. Dividend and coupon accumulations
   g. Annuities certain
   h. Premium and other deposit funds
   i. Funding Agreements without well-defined class-based (e.g. age, gender) annuity purchase rates defining either specific or maximum purchase rate guarantees (see SSAP No. 15, paragraph 19, paragraph 20 of this statement and SSAP No. 52—Deposit-Type Contracts, paragraph 21.)

45. Under deposit-type contracts, the policyholder may assume all, some, or none of the investment risk, depending on the contract terms. Amounts can be deposited in lump sum, or periodically as allowed by the policy contract. Deposit-type contracts would include annuities certain, whose income payments have no reference to life contingencies and benefits are paid over a specified period (i.e., 10 years, 20 years, etc.).

**SSAP No. 51R—Life Contracts**

**Policy Reserves**

15. Statutory policy reserves shall be established for all unmatured contractual obligations of the reporting entity 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 have historically been 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. For policies issued on or after the operative date of the Valuation Manual, these formulaic calculations will be supplemented for some policies with more advanced deterministic and stochastic reserve methodologies to better reflect company experience, possible economic conditions and inherent policy
risks. Statutory policy reserves meet the definition of liabilities as defined in SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets (SSAP No. 5R). The actuarial methodologies referred to in paragraph 16 meet the criteria required for reasonable estimates in SSAP No. 5R.

16. The reserving methodologies and assumptions used in computation of policy reserves shall meet the provisions of Appendices A-820 and A-822. Policies written prior to the operative of the Valuation Manual shall additionally follow the actuarial guidelines found in Appendix C of this Manual. Policies written on or after operative of the Valuation Manual shall additionally follow the Valuation Manual and be subject to the actuarial guidelines referenced therein. Further, policy reserves shall be in compliance with those Actuarial Standards of Practice promulgated by the Actuarial Standards Board.

Supplemental Benefits

40. In addition to the basic policy benefit, the insurance contract may provide supplemental benefits. Supplemental benefits include, but are not limited to, accidental death benefits and waiver of premium benefits. If the terms of the contract provide for these benefits, appropriate reserves shall be established in accordance with the applicable standards within the Accounting Practices and Procedures Manual.

SSAP No. 52—Deposit-Type Contracts

2. As discussed in SSAP No. 50, deposit-type contracts are those contracts that do not subject the reporting entity to any risks arising from policyholder mortality or morbidity. A mortality or morbidity risk is present if, under the terms of the contract, the reporting entity is required to make payments or forego required premiums contingent upon the death or disability (in the case of life and disability insurance contracts) or the continued survival (in the case of annuity contracts) of a specific individual or group of individuals.

3. Deposit-type contracts frequently grant policyholders significant discretion over the amount and timing of deposits and withdrawals. Reporting entities are frequently granted significant discretion over amounts that accrue to or that are assessed against policyholders.

4. Due to the absence of mortality and/or morbidity risk and the discretionary characteristics noted in paragraph 3, the accounting principles for income recognition and policy reserves for deposit-type contracts differ from the accounting for life contracts set forth in SSAP No. 51R—Life Contracts, accident and health contracts established in SSAP No. 54R—Individual and Group Accident and Health Contracts, and credit insurance contracts as discussed in SSAP No. 59—Credit Life and Accident and Health Insurance Contracts.

5. Categories of contracts that may not subject the reporting entity to risks arising from policyholder mortality or morbidity include, but are not limited to, certain types of the following policy categories:

   a. Supplemental contracts
   b. Lottery payouts
   c. Structured settlements
   d. Guaranteed interest contracts
   e. Income settlement options
   f. Dividend and coupon accumulations
   g. Annuities certain
   h. Premium and other deposit funds
**Income Recognition**

6. Contracts issued by a reporting entity that do not incorporate mortality or morbidity risk shall not be accounted for as insurance contracts. Amounts received as payments for such contracts shall not be reported as revenues but shall be recorded directly to an appropriate policy reserve account.\(^{(\text{INT 00-03})}\)

**Policy Reserves**

7. Statutory policy reserves shall be established for all contractual obligations of the reporting entity arising out of the provisions of the contract. Where separate benefits are included in a contract, a reserve for each benefit shall be established as required in Appendix A-820. Statutory policy reserves meet the definition of liabilities as defined in SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets (SSAP No. 5R). The actuarial methodologies referred to in paragraph 8 meet the criteria required for reasonable estimates in SSAP No. 5R.

8. The reserving methodologies and assumptions used in computation of policy reserves shall meet the provisions of Appendices A-820 and A-822, and the actuarial guidelines found in Appendix C of this Manual. Further, policy reserves shall be in compliance with those Actuarial Standards of Practice promulgated by the Actuarial Standards Board.

9. The policy reserve for contracts without life contingencies where the future benefits are fixed and guaranteed (e.g., certain supplemental contracts, lottery payouts, structured settlements, guaranteed interest contracts, income settlement options, annuities certain, and unmatured coupon accumulations) shall be based on the present value of the future guaranteed benefits discounted at the valuation interest rate. The policy reserve for all other contracts (e.g., certain premium and other deposit funds, and dividend and matured coupon accumulations) shall be based on the accumulated amounts paid plus an income accumulation based on the contract provisions, less any withdrawals and applicable surrender charges.

10. 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.

11. Policy reserves shall be increased for reinsurance assumed and decreased for reinsurance ceded as further described in SSAP No. 61R—Life, Deposit-Type and Accident and Health Reinsurance.

**Activity to Date (issues previously addressed by the Working Group, Emerging Accounting Issues (E) Working Group, SEC, FASB, other State Departments of Insurance or other NAIC groups):**

**Agenda Item 2018-28:** Updates to Liquidity Disclosures, and proposed revisions to SSAP No. 51R—Life Contracts, SSAP No. 52—Deposit-Type Contracts and SSAP No. 61R—Life, Deposit-Type and Accident and Health Reinsurance, were adopted by the SAPWG during the Fall 2018 National Meeting. This agenda item was developed in response to Financial Stability (Ex) Task Force recommendations to enhance existing disclosures on annuity actuarial reserves and deposit-type liabilities.

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

**Convergence with International Financial Reporting Standards (IFRS):** Not applicable.

**Staff Recommendation:**
NAIC staff recommends that the Working Group move this item to the active listing, categorized as nonsubstantive, and expose this agenda item with a request for comments on why GICs, or other deposit-type contracts, are reported in Exhibit 5 – Life Contracts or Exhibit 6 – Accident and Health Contract,
instead of Exhibit 7 – Deposit Type Contracts. With exposure, a referral will be sent to the Life Actuarial Task Force to inform them of the inquiry and request their comments. Although NAIC staff recommends delaying revisions to statutory accounting or reporting instructions until better knowing why these classifications occur, it is anticipated that clarification may be considered to ensure that separate reserve recognition, which is already required in SSAP No. 51R, requires separate reporting on the appropriate exhibit.

**Staff Review Completed by:**
Julie Gann, NAIC Staff – January 2019

**Status:**
On April 6, 2019, the Statutory Accounting Principles (E) Working Group moved this item to the active listing, categorized as nonsubstantive, and exposed this agenda item with a request for comments on why guaranteed investment contracts (GICs), or other deposit-type contracts, are reported in Exhibit 5 – Life Contracts or Exhibit 6 – Accident and Health Contract, instead of Exhibit 7 – Deposit Type Contracts. With exposure, the Working Group directed a referral to the Life Actuarial (A) Task Force to inform them of the exposure and request comments.

On August 3, 2019, the Statutory Accounting Principles (E) Working Group exposed this agenda item with the inclusion of the items and questions noted below, with a request for additional comments from industry and state insurance regulators, and directed notifications of the exposure with a request for comments to the Financial Stability (EX) Task Force and the Life Actuarial (A) Task Force on the reporting of insurance contracts that do not have a mortality or morbidity risk.

1. **Classification at Issuance** – The interested parties noted that because a contract was life-contingent at issue, it is reported in Exhibit 5, and then it remains in Exhibit 5 after the death of the annuitant.

   **Question** – Is it appropriate to classify products based on original issuance when the original risks are no longer present in the contract? Is this simply past industry practice, or is there direction that prevents reclassification to the category that most appropriately reflects the risk? Preliminary information received from the Financial Stability (EX) Task Force (FSTF) staff has noted that this practice will make it more difficult to properly aggregate and assess deposit-type contracts, and that this assessment is important as the payouts for deposit-type contracts are significantly different than payouts generated by an insured event. The Task Force has identified that information on liabilities, particularly those that can be called quickly with little or no surrender penalty, is of critical importance to liquidity assessments.

2. **State Approval** – The interested parties noted that state insurance departments have the discretion to approve or require a contract to be classified as a life or A/H insurance contract.

   **Question** – If a state directs reporting differently than what is stipulated in the AP&P Manual, is that being captured as a permitted or prescribed practice? (The provisions in SSAP No. 1 require permitted / prescribed practice reporting when it results in different statutory reporting. Examples included in SSAP No. 1 include gross or net presentation, financial statement reporting lines, etc.)

3. **Annuity Guidance** – The interested parties cited existing annuity guidance in paragraph 20 of SSAP No. 50—Classifications of Insurance or Managed Care Contracts. Per this guidance, contracts containing well-defined class-based (e.g., age / gender) annuity purchase rates used in defining either a specific or maximum purchase rate guarantee would constitute an annuity contract containing a life contingency that would require it to be classified as a life contract.

   **Question** – NAIC staff agrees with the citation from interested parties on annuities in paragraph 20 of SSAP No. 50—Classifications of Insurance or Managed Care Contracts. However, with the intent to have more explicit product breakouts to allow for better assessment, is it time to clarify / revise this guidance to
result with the appropriate breakouts created by FSTF? It was noted that the current concepts were established a long time ago and there is a focus on non-traditional insurance liabilities (which includes funding agreements) for liquidity risk assessment as they can have higher run risk.

4. **Materiality of Issue** – Although the interested parties cite a “common” scenario, without information in the financial statements, there is no current ability to identify the extent contracts with no remaining mortality or morbidity risk are reflected as life contracts.

**Question** – To what extent are deposit-type contracts captured in an exhibit other than Exhibit 7? Is it possible to receive information from companies regarding this population for assessment purposes?

*Excerpt from SSAP No. 50, paragraph 20:*

1. An annuity contract is an arrangement whereby an annuitant is guaranteed to receive a series of stipulated amounts commencing either immediately or at some future date. The contract shall be issued to or for the benefit of an identifiable individual or group of individuals. **Such a contract containing well-defined class-based (e.g., age, gender) annuity purchase rates used in defining either a specific or maximum purchase rate guarantee would constitute an annuity contract containing a life contingency that would require it to be classified as a life contract.** Some examples of contracts issued for the benefit of a group of individuals include pension plan sponsors purchasing contracts for the benefit of their plan participants, employers or associations purchasing contracts for the benefit of their employees or members, and collective trusts purchasing contracts for the benefit of participating pension plans and their plan participants. **The main types of annuity contracts with life contingencies are discussed below.**

a. A deferred annuity provides for the accumulation of funds to be applied at some future period designated by the policyholder. Premium payments can be made in a lump sum amount (single premium deferred annuity), or periodically (flexible or fixed premium deferred annuity) as allowed by the policy contract. At the end of the accumulation period, the policyholder may elect to receive a lump sum distribution or may elect to receive periodic payments for life, or over a specific period, or some combination thereof;

b. A variable annuity is an annuity which includes a provision for benefit payments which vary in accordance with the rate of return of the underlying investment portfolio selected by the policyholder. The considerations for a variable annuity are usually invested in a separate account in which the value of the contract share varies according to the performance of the separate account before the commencement of annuity payments as well as after. Premium payments can be made in lump sum amounts or periodically as allowed by the policy contract. A minimum death benefit is often guaranteed during the annuity consideration accumulation period and these contracts are, therefore, classified as life contracts;

c. A straight-life annuity provides for periodic payments to the annuitant as long as the annuitant lives. Death of the annuitant constitutes completion of the contract and no further payments are made by the insurance company;

d. A life annuity with a period certain works essentially the same way as the straight-life annuity as the annuitant receives periodic payments for as long as the annuitant lives. However, if the annuitant dies before the end of the specified “certain” period, payments are continued to a beneficiary until the specified number of “certain” payments (i.e., the specified period in the contract) is completed;

e. A refund annuity is similar to the life annuity with a period certain in which the annuitant receives periodic payments for as long as the annuitant lives. There are two variants of this type of annuity. Under the cash refund annuity, a lump-sum payment is made at the death of the annuitant equal to the excess, if any, of the purchase price of the annuity over the sum of the annuity payments made to date of death. The installment refund annuity provides that
annuity payments are to continue to a beneficiary after the death of the annuitant until the sum of all payments made equals the purchase price;
f. A joint and survivorship annuity provides for the continuation of payments after the death of one of the annuitants during the lifetime of the surviving annuitant.

Updates for 2019 Fall National Meeting:

NAIC staff recommend exposing agenda item 2019-08 to: 1) request feedback on the inclusion of a footnote excerpt for Exhibit 5 to disclose cases when a mortality risk is no longer present or a significant factor – i.e. due to a policyholder electing a payout benefit, 2) request feedback on circumstances where a morbidity risk is no longer present or a significant factor for Exhibit 6 items and whether a similar footnote disclosure would be appropriate, and 3) industry input for instruction clarifications regarding the classifications of deposit-type contracts captured in Exhibit 7.

Proposed Exhibit 5 Footnote Disclosure:

<table>
<thead>
<tr>
<th></th>
<th>1 Valuation Standard</th>
<th>2 Total</th>
<th>3 Industrial</th>
<th>4 Ordinary</th>
<th>5 Credit</th>
<th>6 Group</th>
</tr>
</thead>
<tbody>
<tr>
<td>Life Insurance</td>
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<tr>
<td>Annuities</td>
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<td>Supplementary Contracts with Life Contingencies</td>
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<tr>
<td>Accidental Death Benefits</td>
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<td>Disability – Active Lives</td>
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<td>Disability – Disabled Lives</td>
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<tr>
<td>Miscellaneous Reserves</td>
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</table>

(a) Included in the above table are amounts that originally contained a mortality risk. Amounts that no longer contain a mortality risk are $__________ in Column 2 (Life Insurance), $__________ in Column 2 (Annuities), $__________ (Supplementary Contracts with Life Contingencies), $__________ (Accidental Death Benefits), $__________ (Disability – Active Lives), $__________ (Disability – Disabled Lives), $__________ (Miscellaneous Reserves).

Exhibit 7 Classification Instructions:

Instructions for Exhibit 7 (Deposit-Type Contracts) are detailed below. NAIC staff believes ambiguity exists in reporting categories and definition improvements would benefit financial statement preparers and users. NAIC staff request industry input on the definitional terms and suggestions for improvement/clarification to ensure items are appropriately captured and reported without the risk of category (column) crossover.

This exhibit is intended to capture information about the activity, before and after any reinsurance, for deposit-type contracts. Include supplementary contracts without life contingencies, annuities certain, income settlements options, premium and deposit funds, and other contracts as defined in SSAP No. 52—Deposit-Type Contracts.

- Column 2: Guaranteed Interest Contracts – contracts that do not subject the reporting entity to any mortality or morbidity risk
- Column 3: Annuities Certain – amounts settled under contracts without any mortality or morbidity risk, e.g., certain immediate annuity contracts amounts associated with lottery payouts, structured settlements, income settlement options or other amounts where payments are for a fixed period or amount. To exclude amounts reported in Column 2 or 4.

- Column 4: Supplemental Contracts (without life contingencies) - amounts resulting from proceeds settled under a settlement option provision of a life or annuity contract without any mortality or morbidity risk.

- Column 5: Dividend Accumulations or Refunds - amounts held on account related to contracts without any mortality or morbidity risk.

- Column 6: Premium and Other Deposit Funds - amounts not reported elsewhere in this exhibit for contracts that do not incorporate any mortality or morbidity risk.

On December 7, 2019, the Statutory Accounting Principles (E) Working Group exposed this agenda item to: 1) request feedback on the inclusion of a footnote excerpt for Exhibit 5 (as shown above) to disclose cases when a mortality risk is no longer present or a significant factor – i.e. due to a policyholder electing a payout benefit, 2) request feedback on circumstances where a morbidity risk is no longer present or a significant factor for Exhibit 6 items and whether a similar footnote disclosure would be appropriate, and 3) requested industry and regulator input for instruction clarifications regarding the classifications of deposit-type contracts captured in Exhibit 7. With this exposure, there are no proposed edits for statutory accounting. The Working Group directed NAIC staff to notify the Financial Stability (Ex) Task Force of this exposure.
Statutory Accounting Principles (E) Working Group
Maintenance Agenda Submission Form
Form A

Issue: Financing Derivatives

Check (applicable entity):

<table>
<thead>
<tr>
<th>Modification of existing SSAP</th>
<th>P/C</th>
<th>Life</th>
<th>Health</th>
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<tbody>
<tr>
<td>New Issue or SSAP</td>
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<tr>
<td>Interpretation</td>
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Description of Issue:
This agenda item has been prepared to reconsider the accounting and reporting of financing derivative transactions pursuant to a review of information from the 2018 year-end statutory financial statements.

Note: Although the proposed revisions in this agenda item would impact common SSAPs, from the year-end 2018 detail, there are no P/C or health entities acquiring or writing derivatives with financing arrangements. As such, the changes proposed may not impact P/C and health entities and should only impact a limited number of life insurers (16 as of year-end 2018) that engage in derivative financing arrangements.

A financing derivative transaction is one in which the premium to acquire the derivative is paid throughout the derivative term or at maturity of the derivative. With the accounting and reporting that has been utilized by some companies, the “cash flows” (the derivative obtained and the premium liability owed) are netted, generally resulting with zero-value reporting at inception. Over the course of the derivative term, an unrealized loss is recognized for changes in the present value of the premium liability (increase), which may be offset by any value change in the underlying derivative (increase or decrease). (With derivative financing, a gain would only ever be recognized if the fair value change of the derivative exceeded the cost of the derivative.) When the derivative matures, the calculation of realized gains and losses reflects the deferred cost (amount owned), adjusted for any actual fair value change.

For example, if paying $5,000 at the end of a 5-year derivative, a 1,000 unrealized loss would be recognized each year for the present value of premium due, and at maturity, the reporting entity would recognize the 5,000 as a realized loss. If the derivative had a $500 fair value gain, this would decrease the extent of the premium owed recognized as a realized loss. The financial statement presentation of a derivative with financing premiums is significantly different from traditional recognition in which the reporting entity would recognize the $5,000 derivative at acquisition and ultimately recognize a realized gain for the $500 change in fair value.

Several key concerns are noted in the agenda item; however, a few are highlighted as follows:

- Reporting is inconsistent, as not all insurers utilizing financing derivatives report using the net approach. Additionally, insurers acquiring (or writing) similar derivatives would represent the financial statement impact in substantially different ways based solely on when the cost to acquire the derivative is due.

- The amounts reported when derivative assets and liabilities are netted with financing components do not reflect actual derivative assets or liabilities, and the corresponding unrealized gains / losses do not solely reflect changes in derivative value. The amounts reported are impacted by both changes in fair value and the present value change in the premium cost for the derivative. (This approach, particularly with the recognition of unrealized losses for the premium liability owed, results with changes in AVR that do not reflect actual unrealized investment losses.)
• The impact of financing derivatives can have a significant impact on the reported derivative amounts, which impacts the assessment of derivatives and the activity reported in regulator tools (e.g., profile reports / financial analysis assessments). For example, in one instance where financing derivatives were reflected, if the derivative had been reported without the financing components, the reported derivatives assets would have increased 50%, and the derivative liabilities would have decreased 60%. These two changes would have doubled the amount of overall net derivatives used in the company’s profile report. With a net presentation, the use of financing derivatives may artificially mask derivative activity, causing difficulty in regulator review to ensure derivative limitations have not been exceeded.

• After reviewing the information reported in the 2018 year-end financial statements, it was noted that some entities both acquire and write derivatives using financing derivative components. For entities that are writing these derivatives, the entity has a receivable for the amount due, but the receivable is not subject to nonadmittance requirements as it is being commingled with the derivative. Under standard reporting (with premium provided at origination), the premium received would have been reported as a derivative liability (showcasing the obligation to perform under the derivative), but with financing derivatives, the written derivative is reported as a net asset as the receivable owed to the reporting entity is combined with the issued derivative. In the prior discussion of this topic, it was unknown that reporting entities were writing derivatives without collecting premium upon issuance or requiring collateral. This information was only identified with review of the new Schedule DB electronic columns.

• From discussions with other NAIC staff, “financing” premiums are non-standard derivative components. Derivatives with these components are generally not marketable (without the entity providing payment of any remaining deferred or financing premium), as any new party would essentially be acquiring the initial company’s debt (liability) to pay the cost of the derivative.

Proposed Accounting and Reporting Concepts:
This agenda item intends to incorporate specific direction for the accounting and reporting of derivatives with financing components that are acquired and/or written. The proposed revisions reflect the following:

• The BACV and fair value columns of derivatives acquired and/or written in Schedule DB-A or Schedule DB-B shall reflect the value without inclusion of any impact from financing provisions. With this change, the Schedule DB column that currently captures “fair value of derivative, excluding impact of financing premiums” will be revised to reflect the “fair value of the derivative, including impact of financing premiums.”

Note: This proposal will result in a change from U.S. GAAP, however, derivatives reported under SAP already vary from U.S. GAAP as statutory accounting does not currently allow offsetting in accordance with master netting agreements. Under U.S. GAAP, the cash inflows / outflows (derivative and financing components) are netted to arrive at the fair value of the derivative.

This practice is not appropriate for statutory accounting because: The netting of derivatives with financing components 1) hinders the ability to assess whether derivative activity is within state investment limitations; 2) hinders the ability to utilize financial analysis tools in assessing activity or fair value changes; 3) impacts RBC and IMR calculations and 4) does not adequately present component items for admissibility.

• Recognition of interest-related unrealized gains/losses (and then realized gains/losses at termination), shall reflect the fair value fluctuation changes in the derivative and shall not be impacted by the present value change of premium owed or premium receivable from the derivative. This will impact past practice in which present value change of the premium owed / receivable has impacted gains / losses, resulting with impacts to AVR (unrealized) and IMR (realized).
• The resulting balance sheet derivative assets and liabilities shall reflect the fair value of the derivatives without inclusion of the impact from financing derivatives unless the amount owed or the amount due from a derivative with financing elements meets the requirements for a valid right to setoff under SSAP No. 64. If this valid right of setoff exists, the amount shall be captured in Schedule DB-D with disclosures captured pursuant to SSAP No. 64.

• Amounts owed to / from the reporting entity for derivatives written or acquired shall be separately captured in the balance sheet, unless the amounts qualify under the legal right to offset. To the extent amounts owed by the reporting entity for derivatives acquired do not meet the legal right to offset, the amount shall be recognized separately from the acquired derivative as a payable for security. To the extent amounts owed to the reporting entity for derivatives written do not meet the legal right to offset, the amount shall be recognized separately from the written derivative as a receivable for security and subject to admissibility requirements in SSAP No. 5R and SSAP No. 21R.

Note: Under SSAP No. 21R, receivables for securities are not admitted if not received within 15 days from the settlement date. If the valid right to offset provisions are not met, consideration could be given to incorporate specific guidance for these derivative premium receivables.

Proposed RBC and AVR Concepts:
In addition to the changes in the Schedule DB reporting for BACV and FV and the separate reporting of the amounts due to / from, the proposed concepts in this agenda item will result with key changes to AVR and RBC:

1. **Acquired Derivatives with Amount Owed to Derivative Counterparty**
With separate reporting of the derivative asset and amount owed from the acquisition of the derivative, the BACV for the derivative asset and “net exposure” (Schedule DB-D) by counterparty will increase. (As the AVR reserve does not factor in the impact if there is legal right to offset, this AVR impact will occur regardless of offsetting provisions.) From the 2018 year-end detail reviewed, in most instances, reporting entities with financing derivatives will no longer report these derivatives as liabilities and will report the derivatives as assets.

• The AVR reserve and the RBC impact for derivatives is based on derivative counterparty “net exposure.” As such, unless other adjustments are made, the reporting entity will either need to obtain additional collateral or engage in another offsetting derivative with the counterparty to eliminate the reported increased exposure (increased RBC charge). **To address concerns with RBC, since exposure is not actually increasing, this agenda item proposes adjustments to Schedule DB-D to incorporate the amount owed by the reporting entity to the counterparty in determining net exposure.** This adjustment would eliminate the need to obtain additional collateral or engage in another offsetting derivative to reduce counterparty exposure.

(There is an RBC charge for off-balance sheet collateral (.0039) and collateral on-balance sheet is assessed the corresponding asset charge. As such, by using financing derivatives instead of acquiring collateral, the reporting entity mitigates these collateral charges.)

• With the proposed changes, the present value change of the premium owed will not be recognized as an unrealized loss in AVR (and impact the determination of realized interest-related capital losses/gains at termination in the IMR). These changes will result in a greater AVR reserve as the liability owed for the derivative recognized over time (present value over term of derivative) will no longer reduce the AVR as an unrealized loss. **The present value change of the premium owed for acquiring a derivative should not be considered an unrealized loss or impact AVR, therefore this change is appropriate.**
2. Written Derivatives with Amount Owed to Reporting Entity

With separate reporting of a derivative written by the reporting entity and the premium amount owed to the reporting entity, the BACV for the derivative asset and “net exposure” (Schedule DB-D) by counterparty will decrease. (This will likely result in a currently-reported derivative asset reversing to reflect a derivative liability.) Furthermore, the present value change of the premium due to the reporting entity will not be recognized as an unrealized gain and will no longer impact AVR (or IMR). The amount due for the written derivative will likely be considered a “receivable for security” within scope of SSAP No. 21R—Other Admitted Asset. Current guidance requires nonadmittance for these items not received within 15 days from the settlement date.

- In this situation, the derivative is currently being reported as an asset, because the amount due to the reporting entity (receivable) is increasing the derivative value. Without the amount due to the reporting entity, the derivative would be in a liability position. This approach does not seem to provide derivative RBC relief (as the RBC charge is focused on derivative assets) but the current netting approach could prevent potential nonadmittance for receivables owed to the reporting entity. In reviewing examples from the year-end 2018 reporting, premium owed to the reporting entity may not be received for a few years (until derivative maturity), which is beyond the time allotted for admittance under SSAP No. 21R. There is an RBC charge for “receivable for securities” (.014 life and 0.25 p/c & health), but this would only apply if the receivable was admitted. (This charge would be less than the charge for the derivative asset.)

- If the right to offset provisions in SSAP No. 64 are met, there would be no net impact to the financial statements by reporting the written derivative asset without the financing provisions. In these situations, the BACV and fair value on Schedule DB-A would detail the derivative without the financing components, and on Schedule DB-D, the reported amount that ties to the balance sheet would be adjusted for the offsetting receivable. With the offset, the receivable for security would be eliminated from the balance sheet. With the offset / balance sheet elimination, the receivable is essentially given “admitted asset” status (as it reduces a liability) and is not assessed for RBC. (Under SSAP No. 64, this offset would be disclosed in the financial statements.) If the right to offset provisions are not met, then the “receivable for security” would be nonadmitted after 15 days under SSAP No. 21R. This would cause a financial statement impact for any nonadmitted asset. If the asset was admitted, there would be an RBC charge for the admitted receivable.

NAIC staff is interested in whether the premium due to the reporting entity from a written derivative would generally meet the “valid right to setoff” provisions from SSAP No. 64. If the conditions would not generally be met, consideration could occur to allow offsetting presentation in Schedule DB-D for these specific situations. This would allow the amount owed to the reporting entity to decrease the derivative obligation regardless of when the amount due would be received. **If this was supported, provisions may be warranted that allow the derivative liability to be reduced to zero, but not permit the derivative to reverse into an asset position without being nonadmitted.**

**Illustration of RBC Charges to Derivative Assets / Liabilities:**

**RBC Impact – P/C and Health Entities**

As detailed below for property/casualty and health entities, the RBC charge is solely driven by the amount of derivative assets reported on the balance sheet. (This is a distinctly different from life reporting entities.) For these entities, the charge does not vary if the derivative is in a liability position or if the entity has received collateral from the counterparty. (The amount reported on balance sheet is impacted by offsetting provisions, but only if there is a valid right to offset.)

If these entities were to engage in financing derivatives, and the impact was to reverse the presentation of the derivative from an asset to a liability, this would have a direct change to the RBC calculation.
RBC Impact – Life Insurance Entities
As detailed below for life entities, the RBC charge is not driven by the amount of derivative assets reported on the balance sheet. Instead, the RBC charge is driven by the “net exposure” after considering collateral. In both situations (asset exposure and off-balance sheet exposure), if the derivative is in a liability position, there is no RBC charge. Since the removal of financing components will generally result with previously reported derivative liabilities flipping to represent derivative assets, this could have an RBC impact unless the premium owed to the reporting entity is considered as part of the RBC calculation. The proposal in this agenda item would consider amounts owed from the counterparty for the derivative in determining net exposure.

<table>
<thead>
<tr>
<th>Life</th>
<th>Admitted Assets</th>
<th>Balance Sheet</th>
<th>RBC Factor</th>
</tr>
</thead>
<tbody>
<tr>
<td>Asset</td>
<td>Liabilities</td>
<td>Balance Sheet</td>
<td>No Charge</td>
</tr>
<tr>
<td>On BS Collateral</td>
<td>Investment Schedules</td>
<td>Related Asset Charge</td>
<td></td>
</tr>
<tr>
<td>Off BS Collateral</td>
<td>Manually Entered in RBC</td>
<td>.0039 (Flat)</td>
<td></td>
</tr>
<tr>
<td>Net Exposure</td>
<td>Collateral less Net Asset</td>
<td>.0039 (NAIC 1)</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Net Asset = BACV Assets less Liabilities</td>
<td>.0126 (NAIC 2)</td>
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<tr>
<td></td>
<td>Liability &gt; Asset = No Charge</td>
<td>.0446 (NAIC 3)</td>
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<tr>
<td></td>
<td>Collateral &gt; Net Asset = No Charge</td>
<td>.0970 (NAIC 4)</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Collateral &lt; Net Assets = Charge based on NAIC designation of counterparty</td>
<td>.2231 (NAIC 5)</td>
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<td></td>
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<td>.300 (NAIC 6)</td>
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Off BS Exposure

| Ex Traded & CC | Potential Exposure is a Calculated Amount (0.5% * Notional * square root of years to maturity) | .0039 |
| Off-BS | Calculated Amount: | |
| | [Gross Assets Less Gross Liabilities Less Collateral | |
| | Add Calculated Potential Exposure] Less Exposure | |
| | Net of Collateral | |
| | | .0039 (NAIC 1) |
| | | .0126 (NAIC 2) |
| | | .0446 (NAIC 3) |
| | | .0970 (NAIC 4) |
| | | .2231 (NAIC 5) |
| | | .300 (NAIC 6) |

Existing Authoritative Literature:

- **SSAP No. 64—Offsetting and Netting of Assets and Liabilities**
- **SSAP No. 86—Derivatives**
- **SSAP No. 100—Fair Value**

Key aspects from the standards cited above:
SSAP No. 64—Offsetting and Netting of Assets and Liabilities

2. Assets and liabilities shall be offset and reported net only when a valid right of setoff exists except as provided for in paragraphs 3 and 4. A right of setoff is a reporting entity's legal right, by contract or otherwise, to discharge all or a portion of the debt owed to another party by applying an amount that the other party owes to the reporting entity against the debt. A valid right of setoff exists only when all the following conditions are met:

   a. Each of the two parties owes the other determinable amounts. An amount shall be considered determinable for purposes of this provision when it is reliably estimable by both parties to the agreement;
   b. The reporting party has the right to set off the amount owed with the amount owed by the other party;
   c. The reporting party intends to setoff; and
   d. The right of setoff is enforceable at law.

3. Assets and liabilities that meet the criteria for offset shall not be netted when prohibited by specific statements of statutory accounting principles. An example of such is in the case of reinsurance recoverables on paid losses and ceded premiums payable as provided for in SSAP No. 62R—Property and Casualty Reinsurance.

4. Netting of assets and liabilities for reporting purposes when no valid right of setoff exists shall be allowed only when provided for by specific statements of statutory accounting principles. An example of such is in the case of real estate investments required to be shown net of encumbrances as provided for in SSAP No. 40R—Real Estate Investments.

5. Amounts due to or from affiliates shall be offset and reported net only when the provisions of paragraph 2 are met.

Disclosures

6. The following quantitative information shall be disclosed (separately for assets and liabilities) at the end of each reporting period (interim and annual) when derivative, repurchase and reverse repurchase, and securities borrowing and securities lending assets and liabilities are offset and reported net in accordance with paragraph 2 (valid right to offset):

   a. The gross amounts of recognized assets and recognized liabilities
   b. The amounts offset in accordance with paragraph 2 (valid right to offset)
   c. The net amounts presented in the statement of financial positions.

7. Assets and liabilities that have a valid right to offset under paragraph 2, but are not netted as they are prohibited under paragraph 3, are not required to be captured in the disclosures in paragraph 6.

Relevant Literature

8. This statement adopts paragraphs 1, 7 and 13 of APB Opinion No. 10, Omnibus Opinion—1966 and FASB Interpretation No. 39, Offsetting of Amounts Related to Certain Contracts with modifications (1) to prohibit offsetting as provided in specific statements and require netting when provided in specific statements, and (2) to reject guidance in paragraphs 10, 10A, and 10B of FIN 39, as amended by FSP FIN 39-1, that permits a reporting entity election to offset fair value amounts recognized for derivative instruments and fair value amounts recognized for the right to reclaim cash collateral or the obligation to return cash collateral arising from the derivative instruments with the same counterparty under a master netting agreement. Offsetting for statutory accounting purposes is limited to situations meeting the
conditions in paragraph 2 and 4 of this SSAP. This statement adopts FASB Emerging Issues Task Force No. 86-25, Offsetting Foreign Currency Swaps.

9. This statement rejects FSP FIN 39-1, Amendment of FASB Interpretation 39. This statement rejects FASB Interpretation No. 41, Offsetting of Amounts Related to Certain Repurchase and Reverse Repurchase Agreements. FIN 41 has an offsetting exception for repurchase and reverse repurchase agreements and permits offsetting when the reporting parties do not intend to set off. This guidance is rejected for statutory accounting, and payables under repurchase agreements may only be offset against amounts recognized as receivables under reverse repurchase agreements if there is a valid right to offset meeting all the conditions, including the intent to offset, detailed in paragraph 2. This statement rejects ASU 2011-11, Disclosures about Offsetting Assets and Liabilities and ASU 2013-01, Clarifying the Scope of Disclosures about Offsetting Assets and Liabilities. Statutory disclosure requirements for assets and liabilities reported net under a valid right to offset are detailed in paragraph 6.

SSAP No. 86—Derivatives

11. Derivative instruments used in hedging transactions that 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 (referred to as hedge accounting). For instance, assume an entity has a financial instrument on which it is currently receiving income at a variable rate but wishes to receive income at a fixed rate and thus enters into a swap agreement to exchange the cash flows. If the transaction qualifies as an effective hedge and a financial instrument on a statutory basis is valued and reported at amortized cost, then the swap would also be valued and reported at amortized cost. Derivative instruments used in hedging transactions that do not meet or no longer meet the criteria of an effective hedge, or that meet the required criteria but the entity has chosen not to apply hedge accounting, shall be accounted for at fair value and the changes in the fair value shall be recorded as unrealized gains or unrealized losses (referred to as fair value accounting).

Disclosure Requirements

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

a. For derivative contracts with financing premiums:

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

ii. For each derivative contract with financing premiums:

(a) Whether premium cost is paid throughout the contract, or at derivative maturity;

(b) Next premium cost payment date;

(c) Total premium cost;

(d) Premium cost paid in prior years;

(e) Current year premium cost paid;

(f) Future unpaid premium cost;

(g) Fair value of derivative, excluding impact of financing premiums; and

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

c. The disclosure requirements of paragraphs 59.a., 59.b., and 59.g. shall be included in the annual statement. Refer to the Preamble for further discussion regarding interim disclosure requirements. The disclosure requirements of paragraphs 59.a. through 59.g. shall be included in the annual audited statutory financial reports. The disclosure requirements in paragraph 59.h. shall be included in statutory financial statements (annual and quarterly). Paragraph 62 of the Preamble states that disclosures made within specific schedules or exhibits to the annual statement need not be duplicated in a separate note.

**SSAP No. 100—Fair Value**

**Definition of Fair Value**

4. Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

5. Asset/Liability – A fair value measurement is for a particular asset or liability. Therefore, the measurement should consider attributes specific to the asset or liability, for example, the condition and/or location of the asset or liability and restrictions, if any, on the sale or use of the asset at the measurement date. The asset or liability might be a standalone asset or liability (for example, a financial instrument or an operating asset) or a group of assets and/or liabilities (for example, an asset group, a reporting unit, or a business).

6. Price – A fair value measurement assumes that the asset or liability is exchanged in an orderly transaction between market participants to sell the asset or transfer the liability at the measurement date. An orderly transaction is a transaction that assumes exposure to the market for a period prior to the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets or liabilities; it is not a forced transaction (for example, a forced liquidation or distress sale). The transaction to sell the asset or transfer the liability is a hypothetical transaction at the measurement date, considered from the perspective of a market participant that holds the asset or owes the liability. Therefore, the objective of a fair value measurement is to determine the price that would be received to sell the asset or paid to transfer the liability at the measurement date (an exit price).

11. Application to Assets – A fair value measurement assumes the highest and best use of the asset by market participants, considering the use of the asset that is physically possible, legally permissible, and financially feasible at the measurement date. In broad terms, highest and best use refers to the use of an asset by market participants that would maximize the value of the asset or the group of assets within which the asset would be used. Highest and best use is determined based on the use of the asset by market participants, even if the intended use of the asset by the reporting entity is different.

14. Application to Liabilities – Consideration of non-performance risk (own credit-risk) should not be reflected in the fair value calculation for liabilities (including derivative liabilities) at subsequent measurement. At initial recognition, it is perceived that the consideration of own-credit risk may be inherent in the contractual negotiations resulting in the liability. The consideration of non-performance risk for subsequent measurement is inconsistent with the conservatism and recognition concepts as well as the assessment of financial solvency for insurers, as a decrease in credit standing would effectively decrease reported liabilities and thus seemingly increase the appearance of solvency. Furthermore, liabilities reported or disclosed at “fair value” shall not reflect any third-party credit guarantee of debt.
Fair Value at Initial Recognition

15. When an asset is acquired or a liability is assumed in an exchange transaction for that asset or liability, the transaction price represents the price paid to acquire the asset or received to assume the liability (an entry price). In contrast, the fair value of the asset or liability represents the price that would be received to sell the asset or paid to transfer the liability (an exit price). Conceptually, entry prices and exit prices are different. Entities do not necessarily sell assets at the prices paid to acquire them. Similarly, entities do not necessarily transfer liabilities at the prices received to assume them.

16. In many cases, the transaction price will equal the exit price and, therefore, represent the fair value of the asset or liability at initial recognition. In determining whether a transaction price represents the fair value of the asset or liability at initial recognition, the reporting entity shall consider factors specific to the transaction and the asset or liability. For example, a transaction price might not represent the fair value of an asset or liability at initial recognition if:

   a. The transaction is between related parties.

   b. The transaction occurs under duress or the seller is forced to accept the price in the transaction. For example, that might be the case if the seller is experiencing financial difficulty.

   c. The market in which the transaction occurs is different from the market in which the reporting entity would sell the asset or transfer the liability, that is, the principal or most advantageous market. For example, those markets might be different if the reporting entity is a securities dealer that transacts in different markets, depending on whether the counterparty is a retail customer (retail market) or another securities dealer (inter-dealer market).

   d. For liabilities, differences may exist as non-performance risk (own credit risk) is not reflected in the fair value (i.e., exit price) determination of all liabilities (including derivatives).

Disclosures about Fair Value of Financial Instruments

54. A reporting entity shall disclose in the notes to the financial statements, as of each date for which a statement of financial position is presented in the quarterly or annual financial statements, the aggregate fair value or NAV for all financial instruments and the level within the fair value hierarchy in which the fair value measurements in their entirety fall. This disclosure shall be summarized by type of financial instrument, for which it is practicable to estimate fair value, except for certain financial instruments identified in paragraph 55. Fair value disclosed in the notes shall be presented together with the related admitted values in a form that makes it clear whether the fair values and admitted values represent assets or liabilities and to which line items in the Statement of Assets, Liabilities, Surplus and Other Funds they relate. Unless specified otherwise in another SSAP, the disclosures may be made net of encumbrances, if the asset or liability is so reported. A reporting entity shall also disclose the method(s) and significant assumptions used to estimate the fair value of financial instruments. If it is not practicable for an entity to estimate the fair value of the financial instrument or a class of financial instruments, and the investment does not qualify for the NAV practical expedient, the aggregate carrying amount for those items shall be reported as "not practicable" with additional disclosure as required in paragraph 48.

Activity to Date (issues previously addressed by the Working Group, Emerging Accounting Issues (E) Working Group, SEC, FASB, other State Departments of Insurance or other NAIC groups):

Agenda item 2016-48 considered accounting and reporting revisions for derivatives with financing premiums. Although discussion occurred proposing a gross accounting and reporting approach, the revisions adopted within that agenda item incorporated aggregate disclosures and new electronic columns in Schedule DB to capture the impact of financing premiums in derivative reporting. With the disclosure adoptions, the Working Group directed NAIC staff to reassess this issue once the impact identified from the data-captured disclosures would be available for review, noting that the earliest for this re-assessment would be Summer 2019.

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Agenda item 2013-07, which considered ASU 2013-01: Clarifying the Scope of Disclosures About Offsetting Assets and Liabilities, was finalized on August 24, 2013. This ASU was issued to clarify that the scope of ASU 2011-11 applies to derivatives (including embedded derivatives), repurchase and reverse repurchase agreements, and securities borrowing and securities lending transactions that are either netted as they meet the right of setoff under ASC 210-20-45 or ASC 815-10-45, or are subject to a master netting agreement or similar agreement. The SAP adopted revisions allowed reporting entities to continue offsetting derivatives, repurchase and reverse repurchase agreements, and securities borrowing and securities lending transactions with a valid right of offset, but incorporated disclosures to illustrate the netting impact. This adoption action included a referral to the Blanks (E) Working Group for annual statement instruction revisions and to recommend development of additional schedules to reconcile the amount reported gross on DB to the amount reported net on the balance sheet.

Agenda item 2012-17, which considered ASU 2011-22, Disclosures about Offsetting Assets and Liabilities, was finalized by the Working Group on November 29, 2012. This agenda item adopted revisions to SSAPs No. 64, 86 and 103. The adopted revisions, effective January 1, 2013, 1) revise and clarify that offsetting is only allowed in accordance with SSAP No. 64, paragraphs 2-4; 2) modify the adoption of FIN 39 rejecting the ability to offset in accordance with master netting agreements and rejecting FSP FIN 39-1 and FIN 41; and 3) rejecting ASU 2011-11 for statutory accounting. The Working Group deferred adoption of the disclosures proposed to paragraphs 6-8 of SSAP No. 64 in the exposure as the FASB has recently exposed guidance to narrow the scope GAAP disclosures.

Overview of ASU 2011-11:

ASU 2011-11 was issued in December 2011 to require entities to disclose both gross information and net information about both instruments and transactions eligible for offset in the statement of financial position and instruments and transactions subject to an agreement similar to a master netting agreement. This ASU was issued as the differences in the offsetting requirements between U.S. GAAP and IFRS accounted for a significant difference in the amounts presented under those standards. These differences reduce the comparability of between U.S. GAAP and IFRS, and the users of financial statements requested that these differences be addressed expeditiously. The objective of the ASU 2011-11 amendments is to facilitate comparison between entities that prepare financial statements under U.S. GAAP and those prepared under IFRS. Reporting entities are required to apply the ASU 2011-11 amendments for annual reporting periods beginning on or after Jan. 1, 2013, and interim periods within those annual periods. Entities are required to provide the disclosures required by those amendments retrospectively for all comparative periods presented.

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

Staff Recommendation:

NAIC staff recommends that statutory accounting revisions be considered to ensure consistency in the gross reporting of derivatives - without inclusion of financing components - and consistency in reporting amounts owed to / from the reporting entity from the acquisition or writing of derivatives. NAIC staff highlights that the concepts are consistent with existing statutory accounting guidelines but require clarification changes to ensure uniform application across the industry. **NAIC staff recommends that the Working Group move this item to the active listing, classified as nonsubstantive, and expose revisions to SSAP No. 86 to clarify the reporting of derivatives with financing premiums.** With the proposed revisions, NAIC staff is suggesting reporting revisions that would allow the present value of the derivative premium receivable (and payable) for financed derivatives to be factored into the counterparty risk assessment for life RBC.

In addition to the proposed revisions, comments are requested as to whether derivatives and related financing provisions would generally not meet the SSAP No. 64 right to offset criteria and if explicit guidance allowing offset should be considered. (Allowing offset only impacts the amount reported on balance
sheet and does not impact the gross amount reported on Schedule DB-A or DB-B. The offset provision would impact RBC for p/c and health companies but would not impact the RBC for life reporting entities.)

(Regulator Inquiry) - Derivative profile reports are only provided for life reporting entities. These reports provide assessments on the overall net derivative position (assets less liabilities). Would it be beneficial to regulators if derivative profile reports were available for p/c and health entities and if the reports completed assessments based on derivative assets and derivative liabilities separately? (For example, a life company with $2.1 billion in derivative assets and $2.0 billion in derivative liabilities would currently have a derivative profile report for the $100 million net derivative asset. This report would detail changes in the net asset, but if derivative assets increased to $3.1 assets and derivative liabilities increased to $3.0, the profile report would not detail the change as the net asset would still reflect $100 million) It is staff’s interpretation that the limits on derivative activity per NAIC Model 280 are anticipated to be “absolute value” of derivative assets and derivative liabilities (and not the net between assets and liabilities). The language in the Model is consistent with the Supplemental Investment Risk Interrogatory that requests “aggregate” amounts with a percentage of admitted assets, with identification that the amount should agree to Schedule DB. NAIC staff requests regulator comment on the interpretation of the word “aggregate” (and whether it is intended to be “absolute value” and whether the information in the statutory financials or ISITE tools (profile reports) provide the information needed for regulator assessments of derivative activity.

Excerpt from Model 280, Investments of Insurers Model Act (Defined Limits Version):

B. Limitations on Hedging Transactions

An insurer may enter into hedging transactions under this section if, as a result of and after giving effect to the transaction:

(1) **The aggregate statement value** of options, caps, floors and warrants not attached to another financial instrument purchased and used in hedging transactions does not exceed seven and one half percent (7.5%) of its admitted assets;

(2) **The aggregate statement value** of options, caps and floors written in hedging transactions does not exceed three percent (3%) of its admitted assets; and

(3) The aggregate potential exposure of collars, swaps, forwards and futures used in hedging transactions does not exceed six and one-half percent (6.5%) of its admitted assets.

As noted in the recommendation, the revisions are in line with existing SAP concepts. These concepts and excerpts are specifically detailed below:

1. **Gross Reporting** – SSAP No. 86, and the reporting instructions for Schedule DB, is explicit that derivatives are required to be shown gross on Schedule DB. Net reporting is permitted on the balance sheet when a valid right to offset exists, but derivatives offset under SSAP No. 64 are required to follow the disclosure requirements in SSAP No. 64:

   54.h. All derivatives are required to be shown gross on Schedule DB. However, derivatives may be reported net in the financial statements (pages 2 and 3 of the statutory financial statements) in accordance with **SSAP No. 64—Offsetting and Netting of Assets and Liabilities** (SSAP No. 64) when a valid right to offset exists. Derivatives offset in accordance with SSAP No. 64 and reported net in the financial statement shall follow the disclosure requirements in SSAP No. 64, paragraph 6. (Derivative Assets and Derivative Liabilities reported on the balance sheet shall agree to columns 5 and 6, respectively, after netting, on Schedule DB – Part D – Section 1.)
2. **Accounting at Date of Acquisition** – SSAP No. 86, and the reporting instructions for Schedule DB, is explicit that the premium paid or received for writing a derivative shall either be recorded as an asset (purchase) or liability (written) on the derivative line on the assets or liability page:

Exhibit C:

1. Call and Put Options, Warrants, Caps, and Floors:

   a. Accounting at Date of Acquisition (purchase) or Issuance (written): The premium paid or received for purchasing or writing a call option, put option, warrant, cap or floor shall either be (i) recorded as an asset (purchase) or liability (written) on the Derivative line on the Assets (or Liabilities pages or (ii) combined with the hedged item(s) individually or in the aggregate;

3. **Liability Recognition** - The deferred premium (or financing premium) is a cost to acquire / enter into the derivative contract and is not impacted by an underlying interest of the derivative agreement (the cost to acquire is not impacted by derivative instrument performance). Upon entering the derivative contract the financing premium owed by the reporting entity meets the definition of a liability under SSAP No. 5R:

   10. A liability is defined as certain or probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or to provide services to other entities in the future as a result of a past transaction(s) or event(s).

   11. A liability has three essential characteristics: (a) it embodies a present duty or responsibility to one or more other entities that entails settlement by probable\(^1\) future transfer or use of assets at a specified or determinable date, on occurrence of a specified event, or on demand, (b) the duty or responsibility obligates a particular entity, leaving it little or no discretion to avoid the future sacrifice, and (c) the transaction or other event obligating the entity has already happened. This includes, but is not limited to, liabilities arising from policyholder obligations (e.g., policyholder benefits, reported claims and reserves for incurred but not reported claims). Liabilities shall be recorded on a reporting entity’s financial statements when incurred.

**NOTE:** The deferred premium is a contractual element of the derivative contract and does not fluctuate or change as a result of the underlying derivative.

Recognizing the liability is also consistent with the Statutory Accounting Statement of Concept of Recognition detailed in the Preamble (paragraph 37):

**Recognition**

35. The principal focus of solvency measurement is determination of financial condition through analysis of the balance sheet. However, protection of the policyholders can only be maintained through continued monitoring of the financial condition of the insurance enterprise. Operating performance is another indicator of an enterprise’s ability to maintain itself as a going concern. Accordingly, the income statement is a secondary focus of statutory accounting and should not be diminished in importance to the extent contemplated by a liquidation basis of accounting.

36. The ability to meet policyholder obligations is predicated on the existence of readily marketable assets available when both current and future obligations are due. Assets having economic value other than those which can be used to fulfill policyholder obligations, or those assets which are unavailable due to encumbrances or other third party interests should not be recognized on the balance sheet but rather should be charged against surplus when acquired or when availability otherwise becomes questionable.
37. **Liabilities require recognition as they are incurred.** Certain statutorily mandated liabilities may also be required to arrive at conservative estimates of liabilities and probable loss contingencies (e.g., interest maintenance reserves, asset valuation reserves, and others).

4. **Derivative Instrument** - The deferred premium (or financing premium) is the cost to acquire a derivative and is not a “derivative instrument” per the definition in SSAP No. 86:

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

13. An “underlying” is a specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates, or other variable (including the occurrence or nonoccurrence of a specified event such as a scheduled payment under contract). An underlying may be a price or rate of an asset or liability but is not the asset or liability itself.

5. **Offsetting Disclosures:** Guidance exists in SSAP No. 64 for the offsetting when there is a valid right to offset, and this guidance specifically references derivative transactions. This disclosure was added to ensure effective comparability across reporting entities, and ensure that the gross information reported on Schedule DB could be agreed to the information reported on the balance sheet:

   6. The following quantitative information shall be disclosed (separately for assets and liabilities) at the end of each reporting period (interim and annual) when derivative, repurchase and reverse repurchase, and securities borrowing and securities lending assets and liabilities are offset and reported net in accordance with paragraph 2 (valid right to offset):
      
      d. The gross amounts of recognized assets and recognized liabilities
      
      e. The amounts offset in accordance with paragraph 2 (valid right to offset)
      
      f. The net amounts presented in the statement of financial positions.

**Staff Review Completed by:**
Julie Gann – NAIC Staff – October 2019

**October 2019 - Proposed Revisions to SSAP No. 86:**

4. “Derivative instrument” means an agreement, option, instrument or a series or combination thereof:

   a. To make or take delivery of, or assume or relinquish, a specified amount of one or more underlying interests, or to make a cash settlement in lieu thereof; or

   b. That has a price, performance, value or cash flow based primarily upon the actual or expected price, level, performance, value or cash flow of one or more underlying interests.

5. Derivative instruments include, but are not limited to; options, warrants used in a hedging transaction and not attached to another financial instrument, caps, floors, collars, swaps, forwards, futures, structured notes with risk of principal/original investment loss based on the terms of the agreement (in addition to default risk), and any other agreements or instruments substantially similar thereto or any series or combination thereof.
a. "Caps" are option contracts in which the cap writer (seller), in return for a premium, agrees to limit, or cap, the cap holder’s (purchaser) risk associated with an increase in a reference rate or index. For example, in an interest rate cap, if rates go above a specified interest rate level (the strike price or the cap rate), the cap holder is entitled to receive cash payments equal to the excess of the market rate over the strike price multiplied by the notional principal amount. Because a cap is an option-based contract, the cap holder has the right but not the obligation to exercise the option. If rates move down, the cap holder has lost only the premium paid. A cap writer has virtually unlimited risk resulting from increases in interest rates above the cap rate.

b. "Collar" means an agreement to receive payments as the buyer of an option, cap or floor and to make payments as the seller of a different option, cap or floor.

c. "Floors" are option contracts in which the floor writer (seller), in return for a premium, agrees to limit the risk associated with a decline in a reference rate or index. For example, in an interest rate floor, if rates fall below an agreed rate, the floor holder (purchaser) will receive cash payments from the floor writer equal to the difference between the market rate and an agreed rate multiplied by the notional principal amount.

d. "Forwards" are agreements (other than futures) between two parties that commit one party to purchase and the other to sell the instrument or commodity underlying the contract at a specified future date. Forward contracts fix the price, quantity, quality, and date of the purchase and sale. Some forward contracts involve the initial payment of cash and may be settled in cash instead of by physical delivery of the underlying instrument.

e. "Futures" are standardized forward contracts traded on organized exchanges. Each exchange specifies the standard terms of futures contracts it sponsors. Futures contracts are available for a wide variety of underlying instruments, including insurance, agricultural commodities, minerals, debt instruments (such as U.S. Treasury bonds and bills), composite stock indices, and foreign currencies.

f. "Options" are contracts that give the option holder (purchaser of the option rights) the right, but not the obligation, to enter into a transaction with the option writer (seller of the option rights) on terms specified in the contract. A call option allows the holder to buy the underlying instrument, while a put option allows the holder to sell the underlying instrument. Options are traded on exchanges and over the counter.

g. "Structured Notes" in scope of this statement are instruments (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.

h. "Swaps" are contracts to exchange, for a period of time, the investment performance of one underlying instrument for the investment performance of another underlying instrument, typically, but not always, without exchanging the instruments themselves. Swaps can be viewed as a series of forward contracts that settle in cash and, in some instances, physical delivery. Swaps generally are negotiated over-the-counter directly between the dealer and the end user. Interest

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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 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.
rate swaps are the most common form of swap contract. However, foreign currency, commodity, and credit default swaps also are common.

i. “Swaptions” are contracts granting the owner the right, but not the obligation, to enter into an underlying swap. Although options can be traded on a variety of swaps, the term “swaption” typically refers to options on interest rate swaps. A swaption hedges the buyer against downside risk, as well as lets the buyer take advantage of any upside benefits. That is, it gives the buyer the benefit of the agreed-upon rate if it is more favorable than the current market rate, with the flexibility of being able to enter into the current market swap rate if it is preferable. Conversely, the seller of swaptions assumes the downside risk, but benefits from the amount paid for the swaption, regardless if it is exercised by the buyer and the swap is entered into.

j. “Warrants” are instruments that give the holder the right to purchase an underlying financial instrument at a given price and time or at a series of prices and times outlined in the warrant agreement. Warrants may be issued alone or in connection with the sale of other securities, for example, as part of a merger or recapitalization agreement, or to facilitate divestiture of the securities of another business entity. Publicly traded stock warrants are captured in scope of SSAP No. 30R—Unaffiliated Common Stock. All other warrants, including non-publicly traded stock warrants, shall be captured in scope of SSAP No. 86.

6. “Derivative Premium” is the cost to acquire or write a derivative contract. Derivative premium is not an “underlying” in a derivative contract and is not impacted by changes in an underlying interest of the derivative agreement. A derivative with contract terms that finance the derivative premium, so that the cost is paid or received throughout the derivative term or at derivative maturity, does not result with an “embedded derivative” addressed in paragraph 16.

6.7. “Firm commitment” is an agreement with an unrelated party, binding on both parties and expected to be legally enforceable, with the following characteristics:

a. The agreement specifies all significant terms, including the quantity to be exchanged, the fixed price, and the timing of the transaction. The fixed price may be expressed as a specified amount of an entity’s functional currency or of a foreign currency. It may also be expressed as a specified interest rate or specified effective yield;

b. The agreement includes a disincentive for nonperformance that is sufficiently large to make performance probable; and

c. For investments in subsidiary, controlled, and affiliated entities (as defined by SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities (SSAP No. 97)) and investments in limited liability companies (as defined by SSAP No. 48—Joint Ventures, Partnerships and Limited Liability Companies) it must be probable that acquisition will occur within a reasonable period of time.

7.8. A hedging transaction is defined as a derivative(s) transaction which is entered into and maintained to reduce:

a. The risk of a change in the fair value or cash flow of assets and liabilities which the reporting entity has acquired or incurred or has a firm commitment to acquire or incur or for which the entity has forecasted acquisition or incurrence; or

b. The currency exchange rate risk or the degree of foreign currency exposure in assets and liabilities which a reporting entity has acquired or incurred or has a firm commitment to acquire or incur or for which the entity has forecasted acquisition or incurrence.

8.9. “Income generation transaction” is 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).
9.10. “Replication (Synthetic Asset) transaction” is a derivative transaction entered into in conjunction with other investments in order to reproduce the investment characteristics of otherwise permissible investments. A derivative transaction entered into by an insurer as a hedging or income generation transaction shall not be considered a replication (synthetic asset) transaction.

10.11. “Forecasted transaction” is a transaction that is expected to occur for which there is no firm commitment. Because no transaction or event has yet occurred and the transaction or event when it occurs will be at the prevailing market price, a forecasted transaction does not give an entity any present rights to future benefits or a present obligation for future sacrifices.

11.12. An “underlying” is a specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates, or other variable (including the occurrence or nonoccurrence of a specified event such as a scheduled payment under contract). An underlying may be a price or rate of an asset or liability but is not the asset or liability itself.

12.13. “Benchmark Interest Rate” is a widely recognized and quoted rate in an active financial market that is broadly indicative of the overall level of interest rates attributable to high-credit-quality obligors in that market. It is a rate that is widely used in a given financial market as an underlying basis for determining the interest rates of individual financial instruments and commonly referenced in interest-rate-related transactions. In theory, the benchmark interest rate should be a risk-free rate (that is, has no risk of default). In some markets, government borrowing rates may serve as a benchmark. In other markets, the benchmark interest rate may be an interbank offered rate. In the United States, the interest rates on direct Treasury obligations of the U.S. government, the London Interbank Offered Rate (LIBOR) swap rate, the Fed Funds Effective Rate Overnight Index Swap Rate, the Securities Industry and Financial Markets Association (SIFMA) Municipal Swap Rate, and the Secured Overnight Financing Rate (SOFR) Overnight Index Swap Rate are considered to be benchmark interest rates.

13.14. “Weather derivatives” are defined as a forward-based or option-based contract for which settlement is based on a climatic or geological variable. One example of such a variable is the occurrence or nonoccurrence of a specified amount of snow at a specified location within a specified period of time.

14.15. “Notional amount” is defined as the face value of a financial instrument in a derivatives transaction as of a reporting date which is used to calculate future payments in the reporting currency. Notional amount may also be referred to as notional value or notional principal amount. The notional amount reported should remain static over the life of a trade unless the instrument is partially unwound or has a contractually amortizing notional. The notional amount shall apply to derivative transactions as follows:

a. For derivative instruments other than futures contracts (e.g., options, swaps, forwards), the notional amount is either the amount to which interest rates are applied in order to calculate periodic payment obligations or the amount of the contract value used to determine the cash obligations. Non-U.S. dollar contracts must be multiplied or divided by the appropriate inception foreign currency rate.

b. For futures contracts, with a U.S. dollar-denominated contract size (e.g., Treasury note and bond contracts, Eurodollar futures) or underlying, the notional amount is the number of contracts at the reporting date multiplied by the contract size (value of one point multiplied by par value).

c. For equity index and similar futures, the number of contracts at the reporting date is multiplied by the value of one point multiplied by the transaction price. Non-U.S. dollar

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2 The definition in paragraph 14 is intended to be a principle for determining notional for all derivative instruments. To the extent a derivative type is not explicitly addressed in paragraph 14.a. through paragraph 14.c., notional should be reported in a manner consistent with this principle.
contract prices must be multiplied or divided by the appropriate inception foreign currency rate.

45.16. “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

46.17. 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.

Impairment

17.18. This statement adopts the impairment guidelines established by SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets (SSAP No. 5R) for the underlying financial assets or liabilities.

Derivative Premium (New Section – All Other Sections Renumbered Accordingly)

19. Derivative premium is the amount paid (acquired derivative) or received (written derivative) to enter into a derivative contract. At inception, the premium generally represents the fair value of the derivative. Derivative premium that is not paid or received at inception represents a liability or receivable for the reporting entity. Derivatives with premiums not remitted at acquisition are considered “financed derivatives.” Financed derivatives shall be reported in accordance with the following provisions:

a. At acquisition and subsequently, the gross reported fair value of the derivative shall exclude the impact of financing premiums. Only market changes in the actual fair value of the derivative shall be reflected as unrealized gains or losses.

b. At acquisition and subsequently, premiums payable (acquired derivative) and premiums receivable (written derivatives) shall be separately reported as “payable for securities” and “receivables for securities.”

c. If premium payable or receivable meet the requirement for a valid right of setoff with the derivative in accordance with SSAP No. 64, the derivative asset can be reduced by a premium payable, and a derivative liability can be reduced by a premium receivable for overall reporting on the balance sheet. This offset provision does not permit a derivative asset to be reported as a derivative liability (or vice versa) due to premium payable or receivable. Rather, once a derivative asset (or liability) is fully reduced by a premium

3 This paragraph does not include derivative premium financing arrangements. Derivatives and financed premiums are subject to separate reporting as detailed in paragraph 19.
liability (or receivable), any remaining premium liability (or receivable) shall be reported as a “payable for security” or “receivable for security” pursuant to paragraph 19.b. This net balance sheet reporting does not impact the gross presentation of open derivatives on Schedule DB-A or Schedule DB-B. If reported net on the balance sheet due to a valid right to offset, the offsetting adjustment shall be shown on schedule DB-D and the SSAP No. 64 disclosures are required.

Recognition and Measurement of Derivatives Used in Hedging Transactions

18.20. 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 (SSAP No. 27). 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 44-47 of SSAP No. 100—Fair Value (SSAP No. 100). Derivative instruments are admitted assets to the extent they conform to the requirements of this statement.

19.21. Derivative instruments used in hedging transactions that 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 (referred to as hedge accounting). For instance, assume an entity has a financial instrument on which it is currently receiving income at a variable rate but wishes to receive income at a fixed rate and thus enters into a swap agreement to exchange the cash flows. If the transaction qualifies as an effective hedge and a financial instrument on a statutory basis is valued and reported at amortized cost, then the swap would also be valued and reported at amortized cost. Derivative instruments used in hedging transactions that do not meet or no longer meet the criteria of an effective hedge, or that meet the required criteria but the entity has chosen not to apply hedge accounting, shall be accounted for at fair value and the changes in the fair value shall be recorded as unrealized gains or unrealized losses (referred to as fair value accounting).4

Staff Note: Paragraphs 22-38 not duplicated.

Documentation Guidance

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

a. A formal documentation of the hedging relationship and the entity’s risk management objective and strategy for undertaking the hedge, including identification of the hedging instrument, the hedged item, the nature of the risk being hedged, and how the hedging instrument’s effectiveness in offsetting the exposure to changes in the hedged item’s fair value or variability in cash flows attributable to the hedged risk will be assessed. There must be a reasonable basis for how the entity plans to assess the hedging instrument’s effectiveness;

b. An entity’s defined risk management strategy for a particular hedging relationship may exclude certain components of a specific hedging derivative’s change in fair value, such as time value, from the assessment of hedge effectiveness, as discussed in paragraph 38 and Exhibit B;

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

4 Pursuant to paragraph 19, the gross reported value of a derivative and the determination of unrealized gains or losses shall exclude the impact of financing premiums. Premiums payable or receivable from the acquisition or writing of a derivative shall not be reflected in the gross reporting of derivatives or in determining the fair value change in a derivative.
d. A description of the reporting entity's methodology used to verify that opening transactions do not exceed limitations promulgated by the state of domicile.

**Staff Note: Paragraphs 40-58 not duplicated.**

Disclosure Requirements

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

h. For derivative contracts with financing premiums:

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

ii. For each derivative contract with financing premiums:

(a) Whether premium cost is paid throughout the contract, or at derivative maturity;

(b) Next premium cost payment date;

(c) Total premium cost;

(d) Premium cost paid in prior years;

(e) Current year premium cost paid;

(f) Future unpaid premium cost;

(g) Fair value of derivative, excluding impact of financing premiums; and

(h) Unrealized gain/loss, excluding impact of financing premiums.

**Staff Note: With the proposed revisions to clarify gross reporting without financing premiums, these disclosures will not be considered necessary. Comments are requested whether it would be beneficial to retain these columns and capture the fair value of the derivative with the impact of financing premiums.**

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

As detailed in this agenda item, NAIC staff suggests consideration on whether premiums due to / from a counterparty should be used in determining the net derivative exposure. This approach would allow the clarifications for gross reporting (excluding financing derivatives) to not impact a life insurer’s RBC calculation for derivative activity as the financing premiums owed by the reporting entity would be considered similar to collateral received.

Below is a simplified version of Schedule DB-D with the potential column.

<table>
<thead>
<tr>
<th>Description of Exchange, Counterparty or Central Clearinghouse</th>
<th>Master Agreement (Y / N)</th>
<th>Fair Value of Acceptable Collateral</th>
<th>Present Value of Financing Premiums</th>
<th>Contracts with BACV &gt; 0</th>
<th>Contracts with BACV &lt; 0</th>
<th>Exposure Net of Collateral</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross Totals</td>
<td></td>
<td></td>
<td></td>
<td></td>
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<td></td>
</tr>
</tbody>
</table>

Offset Per SSAP No. 64
Net After Right to Offset

If this column was added, and the derivatives reported in column 5 and 6 were gross of financing premiums, the amount reported in column 7 would be determined as follows:

Column 7 – Exposure Net of Collateral (Book/Adjusted Carrying Value)

For the aggregate reporting of Exchange-Traded Derivatives (Line 0199999999), show the amount in Column 5.

For OTC counterparties, if no master agreement is in place, show the sum of the Book/Adjusted Carrying Values of all derivative instruments with the counterparty that has a positive Book/Adjusted Carrying Value, less any Acceptable Collateral and the Present Value of Financing Premiums (Column 5 – Column 4 – New Column).

For OTC counterparties with a master agreement in place and central clearinghouses, show the net sum of the Book/Adjusted Carrying Values of all derivative instruments, less any acceptable collateral and the present value of financing premiums (Column 5 + Column 6 – Column 4 – New Column).

This amount should not be less than zero.

For life insurance entities, the positive amount reported in column 7 is then accessed RBC based on the NAIC designation of the counterparty. When reporting the gross fair value of derivatives with capturing the financing premiums, the premiums due from or owed to the counterparty is factored into the calculation to reflect net counterparty exposure. This reporting will not impact P/C or Health entities (regardless if they engage in financing derivatives), as their RBC is based on derivative assets as reported on the balance sheet.

**Status:**

On December 7, 2019, the Statutory Accounting Principles (E) Working Group moved this agenda item to the active listing, categorized as nonsubstantive, and exposed revisions to *SSAP No. 86—Derivatives*, as illustrated above, to clarify the reporting of derivatives with financing premiums. The reporting revisions propose allowing...
the present value of the derivative premium receivable (and payable) for financed derivatives to be factored into the counterparty risk assessment for life RBC. (If supported, RBC changes would be subsequently referred to the Capital Adequacy (E) Task Force for consideration.) Comments are also requested as to whether derivatives and related financing provisions that would generally not meet the SSAP No. 64—*Offsetting and Netting of Assets and Liabilities* right to offset criteria and if explicit guidance allowing offset should be considered.
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Issue: Reporting of Installment Fees and Expenses

Check (applicable entity):

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

Description of Issue:
NAIC staff has recently received questions regarding whether certain fees shall be reported as policy premium. SSAP No. 53—Property Casualty Contracts—Premiums, paragraph 6, provides specific guidance that allows for installment fees that meet specified criteria to be excluded from premium and reported as other income. An installment fee is the amount the policyholder pays if they make the choice to pay their premium on an installment basis. This fee is allowed to be excluded from premium income if it is an avoidable amount by the policyholder and the policy would not be cancelled for nonpayment of the installmen fee.

NAIC staff has received regulator requested clarifications regarding potential diversity in the application of the SSAP No. 53 installment fee guidance on the following issues:

1. The first issue recommends additional language to ensure that the installment fee guidance continues to be narrowly applied, because the regulator became aware of some reporting entities seeking to analogize the application of the installment fee guidance to exclude other fees from premium income. Given the historical discussion on this paragraph, NAIC staff notes that the installment fee guidance is intended to be applied narrowly to a specific instance described in SSAP No. 53, footnote 1 and it should not be used to exclude other fees from being reported as premium.

2. The second issue pertains to the reporting of expenses related to the installment fee (other revenue). The regulator noted that while reporting entities were reporting the installment fees in other income, there was diversity in practice for the related installment fee expenses. Most entities were reporting the installment fee expenses in underwriting expenses where there are clear reporting lines for such expenses in the underwriting exhibits. Other entities were reporting the installment fee expenses either as a contra amount to finance and service charges not included in premium or as a contra amount to “aggregate write-ins for miscellaneous income.” The amounts are being reported as “contra” to other income because there is not an explicit reporting line in the property and casualty statement of income for expenses not related to underwriting (See Authoritative Literature). This agenda item requests feedback to address potential diversity in reporting.

Note that SSAP No. 35R—Guaranty Fund and Other Assessments also provides guidance regarding when a reporting entity is acting as an agent on behalf of a state or federal agency. This guidance is different than the installment fee guidance under discussion.

Existing Authoritative Literature:

SSAP No. 53—Property Casualty Contracts—Premiums (bolding added for emphasis)

3. Except as provided for in paragraph 4, written premium is defined as the contractually determined amount charged by the reporting entity to the policyholder for the effective period of the contract based on the expectation of risk, policy benefits, and expenses associated with the coverage provided by the terms of the insurance contract. Frequently, insurance contracts are subject to audit by the reporting entity and the amount of premium charged is subject to adjustment based on the actual exposure. Premium adjustments are discussed in paragraphs 10-13 of this statement.
4. For workers’ compensation contracts, which have a premium that may periodically vary based upon changes in the activities of the insured, written premiums may be recorded on an installment basis to match the billing to the policyholder. Under this type of arrangement, the premium is determined and billed according to the frequency stated in the contract, and written premium is recorded on the basis of that frequency.

5. Premiums for prepaid legal expense plans shall be recognized as income on the gross basis (amount charged to the policyholder or subscriber exclusive of copayments or other charges) when due from policyholders or subscribers, but no earlier than the effective date of coverage, under the terms of the contract. Due and uncollected premiums shall follow the guidance in SSAP No. 6—Uncollected Premium Balances, Bills Receivable for Premiums, and Amounts Due From Agents and Brokers (SSAP No. 6), to determine the admissibility of premiums and related receivables.

6. Written premiums for all other contracts shall be recorded as of the effective date of the contract. Upon recording written premium, a liability, the unearned premium reserve, shall be established to reflect the amount of premium for the portion of the insurance coverage that has not yet expired. Flat fee service charges on installment premiums1 (fees charged to policyholders who pay premiums on an installment basis rather than in full at inception of contract) are reported in the Other Income section of the Underwriting and Investment Exhibit as Finance and Service Charges. Flat fee service charges on installment premiums, which do not meet the requirements outlined in footnote 1 (e.g., policy may be cancelled for non-payment of fee or fee is refundable), shall be recorded as written premium on the effective date of the contract and subject to the unearned premium guidelines included in paragraph 8.

Footnote: 1 If the policyholder elects to pay an installment rather than the full amount or the full remaining balance, the policyholder is traditionally charged a flat fee service charge on the subsequent billing cycle(s). The amount charged is primarily intended to compensate the insurer for the additional administrative costs associated with processing more frequent billings and has no relationship to the amount of insurance coverage provided, the period of coverage, or the lost investment income associated with receiving the premium over a period of time rather than in a lump sum. As described, there is no underwriting risk associated with this service charge. If a policyholder does not pay the service charge, the policy is not cancelled (unlike non-payment of premium), but instead the policy is converted back to an annual pay plan. If a policyholder cancels coverage, the premium is returned but the service charge is not, as the service charge is not a part of premium. Clarification of finance and service charges as other income should not be construed as having any bearing on whether such charges are subject to premium taxation, which remains an issue of state law and regulation.

SSAP No. 35R—Guaranty Fund and Other Assessments

Acting as an Agent for Collection and Remittance of Fees and Assessments

15. In certain circumstances, a reporting entity acts as an agent for certain state or federal agencies in the collection and remittance of fees or assessments. In these circumstances, the liability for the fees and assessments rests with the policyholder rather than with the reporting entity. The reporting entity’s obligation is to collect and subsequently remit the fee or assessment.(INT 02-22) When both the following conditions are met, an assessment shall not be reported in the statement of operations of a reporting entity:

   a. The assessment is reflected as a separately identifiable item on the billing to the policyholder; and

   b. Remittance of the assessment by the reporting entity to the state or federal agency is contingent upon collection from the insured.

16. The impact to the statement of operations depends on the nature of the charge:
a. For charges which are the ultimate responsibility of the policyholder, follow existing guidance in paragraph 15, and pass these charges and recoveries through the balance sheet with no impact to the statement of operations.

b. For charges which are the ultimate responsibility of the reporting entity and may be recovered all or in part, apply gross or net reporting in the statement of operations as appropriate based on the nature of the charge and recovery. For example, charges which are considered in rate development or for which the recovery is classified as premium should be reported gross, charges for which recovery is considered a reduction of the expense should be reported net.

c. For collection or administrative fees, report such fees as revenue in the statement of operations as "Finance and Service Charges Not Included in Premiums" or "Aggregate Write-Ins for Miscellaneous Income."

**SSAP No. 71—Policy Acquisition Costs**

2. Acquisition costs are those costs that are incurred in the acquisition of new and renewal insurance contracts and include those costs that vary with and are primarily related to the acquisition of insurance contracts (e.g., agent and broker commissions, certain underwriting and policy issue costs, and medical and inspection fees). Acquisition costs and commissions shall be expensed as incurred. Determination of when acquisition costs and commissions have been incurred shall be made in accordance with SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets.

**Property/Casualty Annual Statement Instructions**

**Statement of Income**

Line 13 – Finance and Service Charges Not Included in Premiums

Report finances and service charges pursuant to the recognition guidance in SSAP No. 53—Property Casualty Contracts—Premiums. If a company cedes 100% of its business to an affiliate or utilizes an intercompany pooling arrangement and pools finance and service charges, include intercompany assumed and ceded amounts (i.e., report such income net of intercompany pooling). Charges should also be reported on Schedule T by jurisdiction.

Schedule T EXHIBIT OF PREMIUMS WRITTEN ALLOCATED BY STATES & TERRITORIES

Column 8 – Finance and Service Charges Not Included in Premiums

Report finance and service charges on direct business pursuant to the recognition guidance in SSAP No. 53—Property Casualty Contracts—Premiums. If a company cedes 100% of its business to an pooling arrangement and pools such charges, exclude the intercompany assumed and ceded amount incorporated in Page 4, Line 13.

**APPENDIX**

**PROPERTY AND CASUALTY LINES OF BUSINESS**

These definitions should be applied when reporting all applicable amounts for the following schedules: Underwriting and Investment Exhibit Parts 1, 1A, 1B, 2, and 2A; Exhibit of Premiums and Losses (Statutory Page 14); and the Insurance Expense Exhibit. Policy fees, service charges or membership charges are to be included with the line of business or in Other Income, as determined by SSAP No. 53—Property Casualty Contracts—Premiums.
Premium processing fee guidance is meant to be interpreted narrowly and that the payment in full or by installment applied narrowly to the specific situation described and not analogized to exclude other fees from written premium. It is recommended that the Working Group request comments on reporting installment fee expenses and expose proposed revisions to SSAP No. 53 and request comments as detailed below.

Staff Recommendation:
NAIC staff recommends that the Working Group move this item to the active listing, categorized as nonsubstantive, and expose proposed revisions to SSAP No. 53 and request comments as detailed below. In addition, it is recommended that the Working Group request comments on reporting installment fee expenses as detailed below.

1. Installment fee and services charges guidance should be applied narrowly to the specific situation described and not analogized to exclude other fees from written premium.

2. Request comments on incurred installment fee expenses and notify the Casualty Actuarial (C) Task Force and the Property and Casualty Risk Based Capital (E) Working Group of the exposure, particularly regarding installment fee expenses.

Detailed Recommendations:

Issue 1 – The installment fee and services charges guidance in SSAP No. 53—Property Casualty Contracts—Premiums, paragraph 6, footnote 1, for evaluating flat fee service charges on installment premiums, should be applied narrowly to the specific situation described and not analogized to exclude other fees from written premium.

Prior Working Group revisions (in agenda item 2001-34) to footnote 1 in SSAP No. 53 illustrate that the installment premium processing fee guidance is meant to be interpreted narrowly and that the payment in full or by installment...
is a choice by the policyholder and represents an avoidable amount. The criteria is intentionally narrow and specific to installment fees. It is incorrect to apply this guidance to other fees. **Key underlying points to this response are:**

**Reporting** - All insurance reporting entities bear the cost of issuing a policy, issuing endorsements, and cancelling or reinstating policies whether that is accomplished directly or indirectly through an outside party. SSAP No. 71 provides that policy acquisition costs are expensed as incurred. Costs of issuing and servicing a policy are part of underwriting expenses therefore most “fees” are not intended to be excluded from premium.

**Premium tax** - NAIC staff notes that classifying amounts collected from policyholders by agents / managing general agents or third-party administrators as fees, which are excluded from written or earned premium, is an issue that many jurisdictions are familiar with as an attempt to avoid paying premium taxes. In addition, SSAP No. 53, paragraph 6, footnote 1 provides that “Clarification of finance and service charges as other income should not be construed as having any bearing on whether such charges are subject to premium taxation, which remains an issue of state law and regulation.”

**Risk Based Capital** - The classification of amounts out of premium revenue and into other income and other expense instead of underwriting expenses changes the risk-based capital charges for insurance risk. The RBC charge on insurance risk is based on the loss / loss adjustment expense ratio and the combined ratio which includes underwriting expenses.

**Issue 2 – Should incurred installment fee expenses be reported in other expenses?**

- SSAP No. 53 allows for installment fee income that meets specified criteria to be excluded from premium and reported as other income with finance and service charges, however it does not separately address the related installment fee expenses incurred by the reporting entity.
- The annual statement instructions provide that the expenses that are most commonly associated with installment expense such as postage printing and stationery are reported in underwriting expenses. These expenses and their related revenue are typically immaterial for most property and casualty products but are material for some nonstandard product writers. Having a mismatch between underwriting revenue / underwriting expenses and other revenue / other expenses can affect a reporting entity’s combined ratio as the combined ratio considers the losses, loss adjusting expenses and underwriting expenses.
- From a purely conceptual basis, it might be more consistent if the installment fee expenses are reported in other expenses. This is because it is a theoretical mismatch in the annual statement to report the installment fees in other revenue and have the related expenses in underwriting expenses. While this might be better theoretical match to have both the revenue and expense in the same category, NAIC staff notes that not having “other expenses” in the property and casualty income statement seems to be an intentional choice as there are no “other expense” reporting lines. Therefore an “other expense” would have to be reported as a contra revenue.
- If incurred installment fee expenses were to be reported in other expenses, a reporting location would need to be determined as there is not an annual statement line to accommodate such reporting. If it was reported, it would most like have to be report as a contra amount in “Aggregate Write-Ins for Miscellaneous Income” (not in underwriting expenses) as netting it in Finance and service charges would not provide transparency. Further, if reported, limitations would need to be determined – i.e. expenses not to exceed installment fee revenue.

**Questions for exposure:**

a. Should the Working Group develop guidance to allow installment fee expenses associated with fees that are reported in other income according to the criteria in SSAP No. 53 be permitted reported in or as an expense in “Other Income?”

b. If included in Other Income, should the expense be classified as a contra revenue in or “Aggregate Write-Ins for Miscellaneous Income”?
c. Installment fees and expenses are often immaterial for property and casualty except for nonstandard writers. Comments are also requested on allowing diversity in reporting installment fee expenses (that is optional to report as other expense category of contra other revenue Aggregate Write-Ins for Miscellaneous Income”, particularly for immaterial amounts.

Ultimately adoption of any such guidance would also require updates to the existing annual statement instructions.

**NAIC staff recommends that the Working Group expose the following revisions to the existing footnote in SSAP No. 53:**

6. Written premiums for all other contracts shall be recorded as of the effective date of the contract. Upon recording written premium, a liability, the unearned premium reserve, shall be established to reflect the amount of premium for the portion of the insurance coverage that has not yet expired. Flat fee service charges on installment premiums1 (fees charged to policyholders who pay premiums on an installment basis rather than in full at inception of contract) are reported in the Other Income section of the Underwriting and Investment Exhibit as Finance and Service Charges. Flat fee service charges on installment premiums, which do not meet the requirements outlined in footnote 1 (e.g., policy may be cancelled for non-payment of fee or fee is refundable), shall be recorded as written premium on the effective date of the contract and subject to the unearned premium guidelines included in paragraph 8.

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1 If the policyholder elects to pay an installment rather than the full amount or the full remaining balance, the policyholder is traditionally charged a flat fee service charge on the subsequent billing cycle(s). The amount charged is primarily intended to compensate the insurer for the additional administrative costs associated with processing more frequent billings and has no relationship to the amount of insurance coverage provided, the period of coverage, or the lost investment income associated with receiving the premium over a period of time rather than in a lump sum. As described, there is no underwriting risk associated with this service charge. If a policyholder does not pay the service charge, the policy is not cancelled (unlike non-payment of premium), but instead the policy is converted back to an annual pay plan. If a policyholder cancels coverage, the premium is returned but the service charge is not, as the service charge is not a part of premium. Note that this footnote on flat fee service charges on installment premium is intentionally narrow and specific and this guidance should not be applied to other fees or service charges. Clarification reporting of installment fees in of finance and service charges as other income should not be construed as having any bearing on whether such charges are subject to premium taxation, which remains an issue of state law and regulation.

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**Staff Review Completed by:**
Robin Marcotte  - October 2019

**Status:**
On December 7, 2019, the Statutory Accounting Principles (E) Working Group moved this agenda item to the active listing, categorized as nonsubstantive, and exposed revisions to *SSAP No. 53—Property Casualty Contracts—Premiums*, as illustrated above. Comments are also requested on the reporting of installment fee expenses, as noted above. Additionally, the Casualty Actuarial (C) Task Force and Property and Casualty Risk Based (E) Working Group will be notified of this exposure.

**For 2020 Spring National Meeting Discussion:**

Because the items under discussion can impact loss ratios and information reported in Schedule P, during the 2019 Fall National Meeting exposure, the Working Group directed notice of the exposure and the request for comments to the Casualty Actuarial and Statistical (C) Task Force and the Property and Casualty Risk-Based Capital (E) Working Group. Both groups have indicated that they do not expect to have a response on the installment fee expense comments until after the Spring National Meeting. NAIC staff has forwarded the 2020 comments received to both groups.
NAIC staff recommends that the Working Group take the following actions:

1. Adopt the exposed revision with the minor edit from interested parties. This revision clarifies that existing installment fee revenue guidance should be narrowly applied.

2. When comments on the installment fee expense are received from the Casualty Actuarial and Statistical (C) Task Force and the Property and Casualty Risk-Based Capital (E) Working Group it is recommended that those comments be discussed as a separate agenda item (if needed).

6. Written premiums for all other contracts shall be recorded as of the effective date of the contract. Upon recording written premium, a liability, the unearned premium reserve, shall be established to reflect the amount of premium for the portion of the insurance coverage that has not yet expired. Flat fee service charges on installment premiums (fees charged to policyholders who pay premiums on an installment basis rather than in full at inception of contract) are reported in the Other Income section of the Underwriting and Investment Exhibit as Finance and Service Charges. Flat fee service charges on installment premiums, which do not meet the requirements outlined in footnote 1 (e.g., policy may be cancelled for non-payment of fee or fee is refundable), shall be recorded as written premium on the effective date of the contract and subject to the unearned premium guidelines included in paragraph 8.

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

**Issue:** Eliminating Financial Modeling Process

**Check (applicable entity):**

<table>
<thead>
<tr>
<th>Modification of Existing SSAP</th>
<th>P/C</th>
<th>Life</th>
<th>Health</th>
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<tbody>
<tr>
<td>New Issue or SSAP Interpretation</td>
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**Description of Issue:** In coordination with a Valuation of Securities (E) Task Force and the Blanks (E) Working Group, this agenda item proposes elimination of the multi-step modeling process (i.e. incorporating breakpoints) to determine final NAIC designations on RMBS and CMBS securities.

Current guidance allows the amortized cost basis to be used in determining the “final” NAIC designation for statutory accounting and reporting - including the assessment of AVR and for risk-based capital (RBC) purposes. By design, this practice allows for reporting diversity as identical securities, purchased a different price points (thus having different amortized/carrying values) may have differing reported NAIC designations. Thus, two identical reporting entities possessing the same security, may have differing NAIC designations.

The current RMBS/CMBS multi-step modeling practice is the only remaining approach that utilizes breakpoints to determine final NAIC designations. In March 2019, agenda item 2018-19 removed the multi-step modeling approach for modified filing exempt (MFE) securities. This change removed the carrying value from the designation determination analysis and accordingly now utilizes the original NAIC designation, without adjustment, to determine the measurement method under SSAP No. 43R and corresponding RBC charges. With this change, identical securities have an identical NAIC designation.

The implemented change for MFE securities is being proposed for expansion to RMBS and CMBS securities for several reasons. In conjunction with the upcoming designation granularity expansion, the cost, complexity and technical issues to maintain the multi-step modeling process will be substantial for reporting entities. Each individual security will be required to develop an additional 19 price breakpoints to correspond with designation granularity reporting; insurance companies will need to substantially modify their investment accounting software to determine designations and designation categories. It is important to note that the current multi-step modeling approach has the potential to increase/improve a security’s NAIC designation – thus reducing RBC and AVR charges, however, could also work in an opposite manner decreasing NAIC designation. Despite the proposal to cease the multi-step model usage, industry appears supportive of the change as the cost and usage in both today’s environment and with the upcoming granularization reporting, does not adequately justify any potential benefit. A RMBS/CMBS security can be appropriately modeled, regardless of the amortized carrying value and will provide a single, nonadjustable NAIC designation. This will provide regulators with increased efficiency of oversight and improved comparability between various reporting entities carrying identical investments.

**Existing Authoritative Literature:**

**SSAP No. 43R—Loan-backed and Structured Securities**

**Reporting Guidance for All Loan-Backed and Structured Securities**

26. Loan-backed and structured securities shall be valued and reported in accordance with this statement, the **Purposes and Procedures Manual of the NAIC Investment Analysis Office**, and the designation assigned in the **NAIC Valuations of Securities** product prepared by the NAIC Securities Valuation Office or equivalent specified procedure. The carrying value method shall be determined as follows:
a. For reporting entities that maintain an Asset Valuation Reserve (AVR), loan-backed and structured securities shall be reported at amortized cost, except for those with an NAIC designation of 6, which shall be reported at the lower of amortized cost or fair value.

b. For reporting entities that do not maintain an AVR, loan-backed and structured securities designated highest-quality and high-quality (NAIC designations 1 and 2, respectively) shall be reported at amortized cost; loan-backed and structured securities that are designated medium quality, low quality, lowest quality and in or near default (NAIC designations 3 to 6, respectively) shall be reported at the lower of amortized cost or fair value.

**Designation Guidance**

27. For RMBS/CMBS securities within the scope of this statement, the initial NAIC designation used to determine the carrying value method and the final NAIC designation for reporting purposes is determined using a multi-step process. The *Purposes and Procedures Manual of the NAIC Investment Analysis Office* provides detailed guidance. A general description of the processes is as follows:

a. Financial Modeling: The NAIC identifies securities where financial modeling must be used to determine the NAIC designation. NAIC designation based on financial modeling incorporates the insurers’ carrying value for the security. For those securities that are financially modeled, the insurer must use NAIC CUSIP specific modeled breakpoints provided by the modelers in determining initial and final designation for these identified securities. Securities where modeling results in zero expected loss in all scenarios are automatically considered to have a final NAIC designation of NAIC 1, regardless of the carrying value. The three-step process for modeled securities is as follows:

i. Step 1: Determine Initial Designation – The current amortized cost (divided by remaining par amount) of a loan-backed or structured security is compared to the modeled breakpoint values assigned to the six (6) NAIC designations for each CUSIP to establish the initial NAIC designation.

ii. Step 2: Determine Carrying Value Method – The carrying value method, either the amortized cost method or the lower of amortized cost or fair value method, is then determined as described in paragraph 26 based upon the initial NAIC designation from Step 1.

iii. Step 3: Determine Final Designation – The final NAIC designation that shall be used for investment schedule reporting is determined by comparing the carrying value (divided by remaining par amount) of a security (based on paragraph 27.a.ii.) to the NAIC CUSIP specific modeled breakpoint values assigned to the six (6) NAIC designations for each CUSIP. This final NAIC designation shall be applicable for statutory accounting and reporting purposes (including establishing the AVR charges). The final designation is not used for establishing the appropriate carrying value method in Step 2 (paragraph 27.a.ii.).

b. All Other Loan-Backed and Structured Securities: For loan-back and structured securities not subject to paragraphs 27.a. (financial modeling) follow the established designation procedures according to the appropriate section of the *Purposes and Procedures Manual of the NAIC Investment Analysis Office*. The NAIC designation shall be applicable for statutory accounting and reporting purposes (including determining the carrying value method and establishing the AVR charges). The carrying value method is established as described in paragraph 26. Examples of these securities include, but are not limited to, mortgage-referenced securities, equipment trust certificates, credit tenant loans (CTL), 5*/6* securities, interest only (IO) securities, securities with CRP ratings (excluding RMBS/CMBS), and loan-backed and structured securities with SVO assigned NAIC designations.
Activity to Date (issues previously addressed by the Working Group, Emerging Accounting Issues (E) Working Group, SEC, FASB, other State Departments of Insurance or other NAIC groups): In accordance with a Valuation of Securities (E) Task Force referral, agenda item 2018-19 eliminated the multi-step designation guidance, utilizing amortized cost basis and breakpoints for the determination of final NAIC designations of MFE securities. The revisions were adopted with an effective date of March 31, 2019, with early adoption permitted for year-end 2018.

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


Staff Recommendation:

NAIC Staff recommends that the Working Group move this item to the active listing, categorized as nonsubstantive and expose revisions to SSAP No. 43R—Loan-backed and Structured Securities to eliminate the multi-step financial modeling designation guidance in determining final NAIC designations for RMBS/CMBS securities.

Although the Working Group is recommended to proceed with exposure on this agenda item and solicit comments for consideration, final action will not occur on this item until revisions eliminating the RMBS/CMBS multi-step modeling approach has been adopted by the Valuation of Securities (E) Task Force. NAIC SAPWG staff will coordinate with the VOSTF staff to stay current on their discussion and action on this item.

Proposed Revisions to SSAP No. 43R—Loan-backed and Structured Securities

Reporting Guidance for All Loan-Backed and Structured Securities

26. Loan-backed and structured securities shall be valued and reported in accordance with this statement, the Purposes and Procedures Manual of the NAIC Investment Analysis Office, and the designation assigned in the NAIC Valuations of Securities product prepared by the NAIC Securities Valuation Office or equivalent specified procedure.\(^{10}\) The carrying value method shall be determined as follows:

a. For reporting entities that maintain an Asset Valuation Reserve (AVR), loan-backed and structured securities shall be reported at amortized cost, except for those with an NAIC designation of 6, which shall be reported at the lower of amortized cost or fair value.

b. For reporting entities that do not maintain an AVR, loan-backed and structured securities designated highest-quality and high-quality (NAIC designations 1 and 2, respectively) shall be reported at amortized cost; loan-backed and structured securities that are designated medium quality, low quality, lowest quality and in or near default (NAIC designations 3 to 6, respectively) shall be reported at the lower of amortized cost or fair value.

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\(^{10}\) Securities within scope of this statement shall be reported with NAIC designations. The process to determine the NAIC designation may vary based on type of underlying investment and is directed in accordance with the Purposes and Procedures Manual of the NAIC Investment Analysis Office. For example, certain investments may use CRP ratings in determining the equivalent NAIC designation, whereas other investments, including, but not limited to, mortgage-referenced securities, equipment trust certificates, credit tenant loans (CTL), and interest only (IO) securities, may be required to obtain the NAIC designation directly from the NAIC Valuation of Securities product. For interim reporting instructions, refer to the Purposes and Procedures Manual of the NAIC Investment Analysis Office.
Designation Guidance

27—For RMBS/CMBS securities within the scope of this statement, the initial NAIC designation used to determine the carrying value method and the final NAIC designation for reporting purposes is determined using a multi-step process. The Purposes and Procedures Manual of the NAIC Investment Analysis Office provides detailed guidance. A general description of the processes is as follows:

a. Financial Modeling: The NAIC identifies securities where financial modeling must be used to determine the NAIC designation. NAIC designation based on financial modeling incorporates the insurers’ carrying value for the security. For these securities that are financially modeled, the insurer must use NAIC CUSIP-specific modeled breakpoints provided by the modelers in determining initial and final designation for these identified securities. Securities where modeling results in zero expected loss in all scenarios are automatically considered to have a final NAIC designation of NAIC 1, regardless of the carrying value. The three-step process for modeled securities is as follows:

i. Step 1: Determine Initial Designation – The current amortized cost (divided by remaining par amount) of a loan-backed or structured security is compared to the modeled breakpoint values assigned to the six (6) NAIC designations for each CUSIP to establish the initial NAIC designation.

ii. Step 2: Determine Carrying Value Method – The carrying value method, either the amortized cost method or the lower of amortized cost or fair value method, is then determined as described in paragraph 26 based upon the initial NAIC designation from Step 1.

iii. Step 3: Determine Final Designation – The final NAIC designation that shall be used for investment schedule reporting is determined by comparing the carrying value (divided by remaining par amount) of a security (based on paragraph 27.a.ii.) to the NAIC CUSIP specific modeled breakpoint values assigned to the six (6) NAIC designations for each CUSIP. This final NAIC designation shall be applicable for statutory accounting and reporting purposes (including establishing the AVR charges). The final designation is not used for establishing the appropriate carrying value method in Step 2 (paragraph 27.a.ii.).

b. All Other Loan-Backed and Structured Securities: For loan-backed and structured securities not subject to paragraphs 27.a. (financial modeling) follow the established designation procedures according to the appropriate section of the Purposes and Procedures Manual of the NAIC Investment Analysis Office. The NAIC designation shall be applicable for statutory accounting and reporting purposes (including determining the carrying value method and establishing the AVR charges). The carrying value method is established as described in paragraph 26. Examples of these securities include, but are not limited to, mortgage-referenced securities, equipment trust certificates, credit tenant loans (CTL), 5*-6* securities, interest only (IO) securities, securities with CRP ratings (excluding RMBS/CMBS), and loan-backed and structured securities with SVO assigned NAIC designations.

Specific Interim Reporting Guidance for RMBS/CMBS Securities

28—The guidance in this paragraph shall be applied in determining the reporting method for residential mortgage-backed securities (RMBS) and commercial mortgage-backed securities (CMBS) acquired in the current year for quarterly financial statements. Securities reported as of the prior-year end shall continue to be reported under the prior-year end methodology for the current-year quarterly financial statements. For year-end reporting, securities shall be reported in accordance with paragraph 27, regardless of the quarterly methodology used.

a. Reporting entities that acquired the entire financial modeling database for the prior-year end are required to follow the financial modeling methodology (paragraph 27.a.) for all securities acquired in the subsequent year that were included in the financial modeling data acquired for the prior year-end.
b. Reporting entities that acquired identical securities (identical CUSIP) to those held and financially modeled for the prior year-end are required to follow the prior year-end financial modeling methodology (paragraph 27.a.) for these securities acquired subsequent to year-end.

c. Reporting entities that do not acquire the prior-year financial modeling information for current-year acquired individual CUSIPS and are not captured within paragraphs 28 a. or 28 b., are required to follow the analytical procedures for non-financially modeled securities (paragraph 27 b., as appropriate). Reporting entities that do acquire the individual CUSIP information from the prior-year financial modeling database shall use that information for interim reporting.

d. Reporting entities that acquire securities not previously modeled at the prior year-end are required to follow the analytical procedures for non-financially modeled securities (paragraph 27 b., as appropriate).

For brevity, the remaining SSAP has been omitted, however remaining paragraphs will be renumbered accordingly.

**EXHIBIT A – Question and Answer Implementation Guide**

This exhibit addresses common questions regarding the valuation and impairment guidance detailed in SSAP No. 43R.

**Index to Questions**

<table>
<thead>
<tr>
<th>No.</th>
<th>Question</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Are reporting entities permitted to establish an accounting policy to write down a SSAP No. 43R other-than-temporarily impaired security, for which a “non-interest” related decline exists, to fair-value regardless of whether the reporting entity intends to sell, or has the intent and ability to hold?</td>
</tr>
<tr>
<td>2</td>
<td>Can a reporting entity avoid completing a cash-flow assessment or testing for a specific other-than-temporarily impaired security when the entity believes there is a clear cash-flow shortage (i.e., non-interest related impairment) and elect to recognize a full impairment for the SSAP No. 43R security (no impairment bifurcation), with fair value becoming the new amortized cost basis, and recognition of the full other-than-temporary impairment as a realized loss?</td>
</tr>
<tr>
<td>3</td>
<td>Can reporting entities change their “intend to sell” or “unable to hold” assertions and recover previously recognized other-than-temporary impairments?</td>
</tr>
<tr>
<td>4</td>
<td>How do the regulators intend the phrase “intent and ability to hold” as used within SSAP No. 43R to be interpreted?</td>
</tr>
<tr>
<td>5</td>
<td>How do contractual prepayments affect the determination of credit losses?</td>
</tr>
<tr>
<td>6</td>
<td>Are the disclosure requirements within paragraphs 51.f. and 51.g. of SSAP No. 43R required to be completed for the current reporting quarter only, or as a year-to-date cumulative disclosures?</td>
</tr>
<tr>
<td>7</td>
<td>If an impairment loss is recognized based on the “present value of projected cash flows” in one period is the entity required to get new cash flows every reporting period subsequent or just in the periods where there has been a significant change in the actual cash flows from projected cash flows?</td>
</tr>
</tbody>
</table>

Questions 8-10 are specific to securities subject to the financial modeling process. (This process is limited to qualifying RMBS/CMBS securities reviewed by the NAIC Structured Securities Group.) The guidance in questions 8-10 shall not be inferred to other securities in scope of SSAP No. 43R.
<table>
<thead>
<tr>
<th>No.</th>
<th>Question</th>
</tr>
</thead>
<tbody>
<tr>
<td>8</td>
<td>Do LBSS purchased in different lots result in a different NAIC designation for the same CUSIP? Can reporting entities use a weighted average method determined on a legal entity basis?</td>
</tr>
<tr>
<td>9</td>
<td>The NAIC Designation process for LBSS may incorporate loss expectations that differ from the reporting entity’s expectations related to OTTI conclusions. Should the reporting entities be required to incorporate recovery values obtained from data provided by the service provider used for the NAIC Designation process for impairment analysis as required by SSAP No. 43R?</td>
</tr>
<tr>
<td>10</td>
<td>For companies that have separate accounts, can the NAIC designation be assigned based upon the total legal entity or whether it needs to be calculated separately for the general account and the total separate account?</td>
</tr>
</tbody>
</table>

8. **Question** – Do LBSS purchased in different lots result in a different NAIC designation for the same CUSIP? Can reporting entities use a weighted average method determined on a legal entity basis?

8.1 Under the financial modeling process (applicable to qualifying RMBS/CMBS reviewed by the NAIC Structured Securities Group), the amortized cost of the security impacts the “final” NAIC designation used for reporting and RBC purposes. As such, securities subject to the financial modeling process acquired in different lots can result in a different NAIC designation for the same CUSIP. In accordance with the current instructions for calculating AVR and IMR, reporting entities are required to keep track of the different lots separately, which means reporting the different designations. For reporting purposes, if a SSAP No. 43R security (by CUSIP) has different NAIC designations by lot, the reporting entity shall either 1) report the aggregate investment with the lowest applicable NAIC designation, or 2) report the investment separately by purchase lot on the investment schedule. If reporting separately, the investment may be aggregated by NAIC designation. (For example, all acquisitions of the identical CUSIP resulting with an NAIC 1 designation may be aggregated, and all acquisitions of the identical CUSIP resulting with an NAIC 3 designation may be aggregated.)

9. **Question** – The NAIC Designation process for LBSS subject to the financial modeling process may incorporate loss expectations that differ from the reporting entity’s expectations related to OTTI conclusions. Should the reporting entities be required to incorporate recovery values obtained from data provided by the service provider used for the NAIC Designation process for impairment analysis as required by SSAP No. 43R?

9.1 In accordance with INT 06-07: Definition of Phrase “Other Than Temporary,” reporting entities are expected to “consider all available evidence” at their disposal, including the information that can be derived from the NAIC designation.

10. **Question** – For companies that have separate accounts, can the NAIC designation be assigned based upon the total legal entity or whether it needs to be calculated separately for the general account and the total separate account?

10.1 The financial modeling process for qualifying RMBS/CMBS securities is required for applicable securities held in either the general or separate account.

**Staff Review Completed by:**
Jim Pinegar, NAIC Staff – September 2019

**Status:**
On December 7, 2019, the Statutory Accounting Principles (E) Working Group moved this agenda item to the active listing, categorized as nonsubstantive, and exposed revisions to SSAP No. 43R—Loan-backed and Structured Securities, as illustrated above, to eliminate the multi-step financial modeling designation guidance in determining
final NAIC designations for residential mortgage-backed securities (RMBS) / commercial mortgage-backed securities (CMBS) securities. Exposure was contingent upon the Valuation of Securities (E) Task Force’s concurrent exposure, which occurred on December 8, 2019. The Working Group noted that final action on this would not be taken until the Valuation of Securities (E) Task Force takes action on their related item.
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Statutory Accounting Principles (E) Working Group
Maintenance Agenda Submission Form
Form A

Issue: ASU 2014-17, Business Combinations – Pushdown Accounting, a Consensus of the FASB Emerging Issues Task Force

Check (applicable entity):

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

Description of Issue:

ASU 2014-17, Business Combinations – Pushdown Accounting, a Consensus of the FASB Emerging Issues Task Force (ASU 2014-17) was issued to provide guidance on whether and at what threshold an acquired entity that is a business or nonprofit activity can apply pushdown accounting in its separate financial statements. Prior to the issuance of this ASU, pushdown accounting was only required under U.S. GAAP for SEC registrants. Pursuant to the provisions in the ASU, acquirees now have the option to apply pushdown accounting. Pushdown accounting is a convention of accounting for the purchase of a subsidiary at the purchase cost rather than its historical basis. In effect, the acquiree’s assets and liabilities are written up (or down) to reflect the purchase price and, to the extent that the purchase price exceeds fair value, to recognize the excess as goodwill. In short, the total amount that is paid to purchase the subsidiary becomes the subsidiary’s new book value on its financial statements.

To illustrate the difference in applying pushdown accounting:

- Acquiree’s Book Value of Assets = $100 and Liabilities = $50.
- Acquiree’s Fair Value of Assets = $120 and Liabilities = $30.

If the purchase price was $90:

- “Normal” Purchase Accounting = Recognize SCA at $50 with the parent recognizing goodwill of $40.
- “Pushdown” Purchase Accounting = Recognize SCA at $90 with no goodwill recognized by the parent.

Under U.S. GAAP, goodwill is calculated as the purchase price of the acquiree less the market value of the acquiree. Any gains and losses associated with the new book value are “pushed down” from the acquirer’s income statement and balance sheet to the acquired company’s income statement and balance sheet. ASU 2014-17 states that an acquired entity may elect the option to apply pushdown accounting in the reporting period in which the change-in-control event occurs, but it also has the option to apply pushdown accounting in a reporting period subsequent to its most recent change-in-control event. If pushdown accounting is applied in a subsequent reporting period, it will be considered a change in accounting principle.

Under statutory accounting, a business combination is accounted for as either a statutory purchase or a statutory merger. A business combination in which one entity is acquired by another, and a parent-subsidiary relationship is created, is accounted for as a statutory purchase. The acquirer reports its investment at cost, which is defined as the sum of (a) any cash payment, (b) the fair value of other assets distributed, (c) the fair value of any liabilities assumed, and (d) any direct costs of the acquisition. For acquired subsidiary, controlled and affiliated (SCA) entities valued under an equity method of accounting, goodwill is defined as the difference between the cost of acquiring the SCA and the reporting entity’s share of the book value of the SCA. For U.S. insurance SCAs, the historical basis of the
SCA will continue to be used in preparing its statutory financial statements. As such, pushdown accounting is not permitted for this equity method of accounting.

While statutory accounting utilizes the framework that was established by U.S. GAAP, statutory accounting focuses on the balance sheet, as opposed to the income statement, and places additional emphasis on the concepts of consistency and conservatism due to this difference in reporting objectives. The use of pushdown accounting as an accounting method under statutory accounting is problematic for the reasons listed below.

- A change in the ownership of an entity should not result in a new basis of accounting for that entity in its separate financial statements as transactions affecting an entity’s stock should not affect the entity’s accounting.
- If the acquiree has entered into third-party agreements with terms related to financial statements presented on the existing basis of accounting, restatement under pushdown accounting could pose problems in determining or maintaining compliance with those requirements.
- In the event there are still minority ownership interests in the acquired entity, utilization of pushdown accounting would result in a different set of financial statements and these owners would not have a meaningful set of comparative financial statements.
- There isn’t a reasonable way to determine which owner’s transactions should qualify for pushdown accounting, in a scenario in which there are multiple owners who are deemed to control the acquiree (10%+ ownership of outstanding stock measured at the holding company level).
- Goodwill restrictions under statutory accounting, such as the admissibility of goodwill limited to 10% of the reporting entity’s surplus and amortization over a ten-year span, would essentially be eluded.

**Example of U.S. GAAP with and without Pushdown Accounting versus Statutory Accounting**

**Entity A purchases 100% of Entity Z** (which has a fair value of 200 and is on the books for $100, Assets = $200 and Liabilities = $100) for $500.

**Entity Z’s Accounting on Standalone Financials:**

<table>
<thead>
<tr>
<th></th>
<th>U.S. GAAP without Pushdown</th>
<th>U.S. GAAP with Pushdown</th>
<th>Statutory Accounting</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets</td>
<td>300</td>
<td>500</td>
<td>200</td>
</tr>
<tr>
<td>Liabilities</td>
<td>100</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>Equity</td>
<td>200</td>
<td>400</td>
<td>100</td>
</tr>
<tr>
<td>Goodwill</td>
<td>300</td>
<td>0</td>
<td>400</td>
</tr>
</tbody>
</table>

**Result:** Pushdown accounting increases the basis of the acquired entity from $100 under statutory accounting to $400 under U.S. GAAP. It also circumvents the goodwill restrictions under statutory accounting by increasing the basis of the acquired entity on its standalone financial statements.

**Actual SCA Filing**

NAIC Staff also refer to an actual SCA Sub 2 filing that was submitted during 2018 under the 8.b.iii valuation method (Non-Insurance SCA Entity under GAAP Basis). This acquisition was completed under the pushdown accounting method for U.S. GAAP. Since the existing guidance in SSAP No. 97 values 8.b.iii entities on the audited “U.S. GAAP equity of the investee,” the existing guidance does not allow for modifications/adjustments to remove the “pushdown accounting” impact. This allowed the parent reporting entity to avoid reporting goodwill for the acquired SCA. *(Entity names and values have been changed.)*
ABC purchased 50% of G for $500. G’s book value was $105 (Assets = $205 and Liabilities = $100) and fair value was $290.

**Entity G’s Accounting on Standalone Financials:**

<table>
<thead>
<tr>
<th></th>
<th>U.S. GAAP without Pushdown</th>
<th>U.S. GAAP with Pushdown</th>
<th>Statutory Accounting</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets</td>
<td>390</td>
<td>600</td>
<td>205</td>
</tr>
<tr>
<td>Liabilities</td>
<td>100</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>Equity</td>
<td>290</td>
<td>500</td>
<td>105</td>
</tr>
<tr>
<td>Goodwill</td>
<td>210</td>
<td>0</td>
<td>395</td>
</tr>
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</table>

The insurance reporting entity’s investment in G was increased due to the goodwill that was paid as part of the acquisition of G. This results in a value of G that vastly differs between U.S. GAAP where pushdown accounting is used and statutory accounting, which is much more conservative.

**Existing Authoritative Literature:**

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

**Statutory Purchases of SCA Investments**

3. The statutory purchase method of accounting is defined as accounting for a business combination as the acquisition of one entity by another. It shall be used for all purchases of SCA entities including partnerships, joint ventures, and limited liability companies. The acquiring reporting entity shall record its investment at cost. Cost is defined as the sum of: (a) any cash payment, (b) the fair value of other assets distributed, (c) the fair value of any liabilities assumed, and (d) any direct costs of the acquisition. Contingent consideration issued in a purchase business combination that is embedded in a security or that is in the form of a separate financial instrument shall be recorded by the issuer at fair value at the acquisition date.

4. For those acquired SCA entities accounted for in accordance with paragraphs 8.b.i., 8.b.ii., 8.b.iii. or 8.b.iv. of SSAP No. 97, and joint venture, partnership or limited liability company entities accounted for in accordance with paragraph 8 of SSAP No. 48, goodwill is defined as the difference between the cost of acquiring the entity and the reporting entity’s share of the book value of the acquired entity. When the cost of the acquired entity is greater than the reporting entity’s share of the book value, positive goodwill exists. When the cost of the acquired entity is less than the reporting entity’s share of the book value, negative goodwill exists. Goodwill resulting from assumption reinsurance shall be recorded as a separate write-in for other-than-invested assets. All other goodwill shall be reported in the carrying value of the investment.

5. A business combination accounted for under the statutory purchase method and in which the acquired entity is valued in accordance with paragraphs 8.b.ii., 8.b.iii. or 8.b.iv. of SSAP No. 97 shall determine the amount of positive goodwill or negative goodwill created by the combination using the reporting entity’s share of the GAAP net book value of the acquired entity, adjusted to a statutory basis of accounting in accordance with paragraph 9 of SSAP No. 97 in the case of acquired entities valued in accordance paragraphs 8.b.ii. or 8.b.iv. of SSAP No. 97. Business combinations accounted for under the statutory purchase method and in which the acquired entity is valued in accordance with paragraph 8.b.i. of SSAP No. 97 shall determine the amount of positive or negative goodwill created by the business combination using the insurer’s share of the statutory book value of the acquired entity.

6. For those acquired SCA entities accounted for in accordance with paragraph 8.b.i. of SSAP No. 97 under the statutory purchase method, the historical bases of the acquired entity shall continue to be used in preparing its statutory financial statements. Therefore, pushdown accounting is not permitted.
7. Positive goodwill recorded under the statutory purchase method of accounting shall be admitted subject to the following limitation: Positive goodwill from all sources, including life, accident and health, and deposit-type assumption reinsurance, is limited in the aggregate to 10% of the acquiring\(^1\) entity’s capital and surplus as required to be shown on the statutory balance sheet of the reporting entity for its most recently filed statement with the domiciliary state commissioner adjusted to exclude any net positive goodwill, EDP equipment and operating system software, and net deferred tax assets. Additionally, all positive goodwill shall be nonadmitted when the underlying investment in the SCA or partnership, joint venture and limited liability company is nonadmitted\(^2\). When negative goodwill exists, it shall be recorded as a contra-asset. Positive or negative goodwill resulting from the purchase of an SCA, joint venture, partnership or limited liability company shall be amortized to unrealized capital gains and losses on investments over the period in which the acquiring entity benefits economically, not to exceed 10 years. Positive or negative goodwill resulting from life, accident and health, and deposit-type assumption reinsurance shall be amortized to operations as a component of general insurance expenses over the period in which the assuming entity benefits economically, not to exceed 10 years. Goodwill shall be evaluated separately for each transaction.\(^{INT\ 01-18}\)

**SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities**

**Valuation of Investments in Downstream Holding Companies**

22. SSAP No. 48 requires the financial statements of joint ventures, partnerships, and/or limited liability companies in which the downstream noninsurance holding company has a minor ownership interest or otherwise lacks control, i.e., ownership interest is less than 10% (hereinafter referred to as “non SCA SSAP No. 48 entities”), to be valued using U.S. GAAP basis financial statements. Valuation of a downstream holding company, including its investments in SCA entities, depends upon the nature of the SCA entities and non SCA SSAP No. 48 entities it holds in accordance with paragraph 8 of this statement. All liabilities, commitments, contingencies, guarantees or obligations of the downstream noninsurance holding company, which are required to be recorded under applicable statutory accounting guidance, shall be reflected in the parent insurance reporting entity’s determination of the carrying value of the investment in the downstream noninsurance holding company, if not already recorded in the financial statements of the downstream noninsurance holding company. If an SCA investment of the downstream holding company does not meet the provisions of paragraph 8.a. or if it elects not to use the guidance in paragraph 8.a., and instead uses the guidance in paragraph 8.b., the downstream holding company would be valued as the sum of the following (if applicable):

a. Investments by a downstream holding company in U.S. insurance SCA entities are recorded based upon the guidance in paragraph 8.b.i.;

b. Investments by a downstream holding company in noninsurance SCA entities that are engaged in transactions or activities described in paragraph 8.b.ii., are recorded based upon the guidance in paragraph 8.b.ii.;

c. Investments by a downstream holding company in noninsurance SCA entities that do not qualify under paragraph 21.b. shall be recorded based upon the guidance in paragraph 8.b.iii.;

d. Investments by a downstream holding company in foreign insurance SCA entities shall be recorded based upon the guidance in paragraph 8.b.iv.; and

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\(^1\) The “acquiring” entity is intended to reflect the insurance reporting entity that reports the investment resulting in goodwill. The goodwill limitation test shall be completed at the individual reporting company level.

\(^2\) This includes, but is not limited to, situations in which the investment is nonadmitted as the audited financial statements for the SCA, joint venture, partnership or limited liability company includes substantial doubt on the entity’s ability to continue as a going concern, or on the basis/contents of the audit opinion pursuant to paragraph 21 of SSAP No. 97.
e. Any other assets and/or liabilities of the downstream holding company (not addressed in paragraphs 21.a. through 21.d.) shall be valued in accordance with the applicable SSAP.

For purposes of applying paragraphs 21-26 of this statement, a downstream holding company shall be considered to be the parent reporting entity’s investment in a SCA entity. See paragraphs 25 and 26 for a limited exception to the audited financial statements requirement for downstream noninsurance holding companies which meet specified conditions.

**Admissibility Requirements of Investments in Downstream Holding Companies**

23. To meet the admissibility requirements of this statement, unless the limited exception to the audited financial statements requirement discussed in paragraphs 25 and 26 applies, an annual audit of the financial statements of SCA entities, including the downstream holding company valued under paragraphs 8.b.i through 8.b.iv. must be obtained. The requirement for audited financial statements may be met by utilizing any one of the following methods:

a. Audited US GAAP financial statements of the downstream SCA holding company. (Consolidated or combined financial statements are allowed encompassing one or more downstream holding companies, including such holding companies that directly own U.S. insurance entities, provided that the statutory financial statements of such U.S. insurance entities are audited. Annual consolidated or combined audits are allowed for insurance entities if completed in accordance with the Model Regulation Requiring Annual Audited Reports as adopted by the SCA’s domiciliary state.) The audited financial statements of the downstream holding company shall include as other financial information, consolidating or combining balance sheet schedule(s) showing the equity of all relevant SCA entities and non-SCA SSAP No. 48 entities, and any required intercompany eliminations. The consolidating or combining balance sheet schedule shall separately present those entities owned directly by the downstream holding company. The consolidating or combining balance sheet shall then be adjusted for GAAP to SAP differences for paragraph 8.b.i., 8.b.ii. and 8.b.iv. entities owned directly or indirectly by the downstream holding company. The adjusted amount would then be the reported value of the investment in the downstream holding company at the higher-level reporting entity; or

b. Audited foreign GAAP-basis financial statements of the downstream SCA holding company. (Consolidated or combined financial statements are allowed encompassing one or more downstream holding companies, including such holding companies that directly own U.S. insurance entities, provided that the statutory financial statements of such U.S. insurance entities are audited. Annual consolidated or combined audits are allowed for insurance entities if completed in accordance with the Model Regulation Requiring Annual Audited Reports as adopted by the SCA’s domiciliary state.) The audited foreign GAAP basis financial statements shall include an audited footnote disclosure within the financial statements that reconciles each consolidated entity’s net income and equity on a foreign basis of accounting to a U.S. GAAP basis. The audited financial statements of the downstream holding company shall include as other financial information, consolidating or combining balance sheet schedule(s) showing the equity of all relevant SCA entities non SCA SSAP No. 48 entities, and any required intercompany eliminations. The consolidating or combining balance sheet schedule shall separately present those entities owned directly by the downstream holding company. The consolidating or combining balance sheet shall then be adjusted for GAAP to SAP differences of the insurance entities and paragraph 8.b.ii., and 8.b.iv. entities owned directly or indirectly by the downstream holding company. The adjusted amount would then be the reported value of the investment in the downstream holding company at the higher-level reporting entity; or

c. Individual audits of the downstream holding company and the downstream holding company’s investments in individual SCA entities.
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): During the 2019 Summer National Meeting, the Working Group received information on the history of pushdown and information from discussions with AICPA and interested party representatives. This information has been captured in the agenda item for future reference:

Comparison of SAP / GAAP Goodwill Guidance, including GAAP Pushdown:

<table>
<thead>
<tr>
<th>SCA Acquisition</th>
<th>Purchase Price: $300</th>
<th>Asset Book Value: $90</th>
<th>Asset Fair Value: $150</th>
</tr>
</thead>
<tbody>
<tr>
<td>Standard SAP Accounting:</td>
<td>Investment in SCA: $90 Goodwill: $210</td>
<td>The combined $300 is reported as the investment in SCA, but the goodwill is separately reported and is subject to the SSAP No. 68 admittance restrictions and the 10-year amortization.</td>
<td></td>
</tr>
<tr>
<td>U.S. GAAP Standard:</td>
<td>Investment in SCA: $150 Goodwill: $150</td>
<td>When pushdown is not elected, under U.S. GAAP, goodwill is calculated on the difference between fair value and the purchase price. This is different than SAP where goodwill is calculated based on the difference between book value and the purchase price.</td>
<td></td>
</tr>
<tr>
<td>U.S. GAAP Pushdown:</td>
<td>Parent Reporting: Investment in SCA: $300</td>
<td>With pushdown, the reported value at the reporting entity level simply reflects the purchase price.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>SCA Reporting: Assets: $150 Goodwill: $150</td>
<td>With pushdown, the acquired SCA increases the book value of their assets to fair value, and reports goodwill on their F/S for any remaining difference.</td>
<td></td>
</tr>
</tbody>
</table>

Preliminary information from discussions with AICPA and Industry representations

- Insurance reporting entities that were SEC filers have historically used pushdown when acquiring SCAs. This is because pushdown accounting was required for SEC filers and US GAAP allowed pushdown to prevent differences between the SEC and US GAAP.

- With ASU 2014-17, the US GAAP guidance became an election for all reporting entities. As such, more entities may have elected to use pushdown, but no information is known as to the extent pushdown accounting has been applied.

- For the SEC registrants that used pushdown, the U.S. GAAP guidance was followed. As such, at acquisition the assets and liabilities of the SCA were adjusted to fair value, and the goodwill calculated was the difference between the purchase price and the fair value of the SCA. (This is different from the goodwill calculation required under SSAP No. 68.) The goodwill was then recognized as an asset on the SCA books (and not at the insurance reporting entity level). This goodwill was subject to the U.S. GAAP impairment calculation, which requires annual testing of impairment, but was not subject to the admittance or amortization requirements of SSAP No. 68.

- For non-SEC registrants that have elected pushdown under the new GAAP provisions, it is uncertain how goodwill was calculated prior to the pushdown. (Whether it was calculated under the guidance in SSAP No. 68 or under U.S. GAAP.)
• Although U.S. GAAP now permits pushdown beyond SEC filers, pushdown is prohibited under IFRS.

• Per the discussion with interested parties’ representatives, **the acquisition of a new SCA from a non-related party is considered to be an economic transaction under SSAP No. 25.** However, if the acquisition of an SCA was from a related party, the it would not be considered an economic transaction. With classification as an economic transaction, the interested parties noted that increase of the SCA to represent fair value is consistent under SSAP No. 25.

**Historical SAP Guidance:**

The original Issue Paper No. 68 noted that pushdown should be prohibited in all SCA acquisitions. Issue Papers are not authoritative, and this guidance was not what was adopted in the original SSAP No. 68. There is no discussion in the original Issue Paper on the expansion that permitted pushdown for the “7.b.iii” entities in the issued SSAP No. 46. The expansion on the use of pushdown to all SCA entities except insurance SCA entities “8.b.i” was then reflected as a modification to SSAP No. 68 from the 2004 adoption of SSAP No. 88—**Investments in Subsidiary, Controlled and Affiliated Entities, A Replacement of SSAP No. 46.** (This revision expanded the ability to use pushdown accounting to noninsurance entities that engage in insurance “activities” and meet the revenue test under 8.b.ii.) There was no discussion in the corresponding Issue Paper (No. 118) regarding the expansion to all entities except insurance SCAs. NAIC staff suspects that as pushdown was limited to only SEC registrants under U.S. GAAP, the expansion to all entities that could use audited U.S. GAAP was not concerning as it would be applied only in the SEC-qualifying situations. This aspect of SSAP No. 68 has not been modified since the adoption of SSAP No. 88.

**Original Codification of AP&P Manual – Effective Jan. 1, 2001:**

*Issue Paper No. 68—Business Combinations and Goodwill:*

8. Under the statutory purchase method the historical bases of the acquired entity shall continue to be used in preparing its statutory financial statements except in those instances provided for in paragraph **8.b. of Issue Paper No. 46. Therefore, pushdown accounting is not permitted.**

*Issue Paper No. 46—Accounting for Investments in Subsidiary, Controlled or Affiliated Entities:*

8b. If a SCA investment does not meet the requirements for the market valuation approach in paragraph 7.a. or, if the requirements are met, but a reporting entity elects not to use that approach, investments in SCAs shall be recorded as follows:

i. Investments in insurance SCA entities shall be recorded based on the underlying statutory equity of the respective entity's financial statements, adjusted for unamortized goodwill as provided for in Issue Paper No. 68—Business Combinations and Goodwill (Issue Paper No. 68);

ii. Investments in noninsurance SCA entities that have no significant ongoing operations other than to hold assets that are primarily for the direct or indirect benefit or use of the reporting entity or its affiliates, shall be recorded based on the underlying equity of the respective entity's financial statements adjusted to a statutory basis of accounting and the resultant proportionate share of the subsidiary's adjusted surplus, adjusted for unamortized goodwill as provided for in Issue Paper No. 68. Examples include but are not limited to: 1) an insurer and a SCA entity that leases autos, furniture, office equipment, or computer equipment to the insurer, 2) an insurer and a SCA entity that owns real estate property that is leased to the insurer for office space, and 3) an insurer and an SCA entity which holds investments which an insurer could acquire directly (i.e., "look through" investment subsidiary);

iii. Investments in noninsurance SCA entities that have significant ongoing operations beyond the holding of assets that are primarily for the direct or indirect benefit or use of the reporting entity
or its affiliates, shall be recorded based on the audited GAAP equity of the investee. Examples include but are not limited to: 1) a property-casualty or life insurer and a SCA entity that is an oil and gas venture, and 2) a property-casualty or life insurer and a SCA manufacturer.

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

8. Under the statutory purchase method the historical bases of the acquired entity shall continue to be used in preparing its statutory financial statements except in those instances provided for in paragraph 7.b.iii of SSAP No. 46. Therefore, pushdown accounting is not permitted.

**SSAP No. 46—Investments in Subsidiary, Controlled and Affiliated Entities:**

7.b.iii. Investments in noninsurance SCA entities that have significant ongoing operations beyond the holding of assets that are primarily for the direct or indirect benefit or use of the reporting entity or its affiliates, shall be recorded based on the audited GAAP equity of the investee. Examples include but are not limited to: (i) a property-casualty or life insurer and a SCA entity that is an oil and gas venture, and (ii) a property-casualty or life insurer and a SCA manufacturer.

**AP&P Manual – As of March 2005:**

**SSAP No. 88—Investments in Subsidiary, Controlled and Affiliated Entities, A Replacement of SSAP No. 46 detailed the amendments adopted to SSAP No. 68:**

26. This statement supersedes paragraphs 4-6 of SSAP No. 68—Business Combinations and Goodwill as follows:

4. For those acquired SCA entities accounted for in accordance with paragraphs 8.b.i., 8.b.ii., 8.b.iii. or 8.b.iv. of SSAP No. 88, goodwill is defined as the difference between the cost of acquiring the entity and the reporting entity’s share of the book value of the acquired entity. When the cost of the acquired entity is greater than the reporting entity’s share of the book value, positive goodwill exists. When the cost of the acquired entity is less than the reporting entity’s share of the book value, negative goodwill exists. Goodwill resulting from assumption reinsurance shall be recorded as a separate write-in for other-than-invested assets. All other goodwill shall be reported in the carrying value of the investment.

5. A business combination accounted for under the statutory purchase method and in which the acquired entity is valued in accordance with paragraphs 8.b.ii., 8.b.iii. or, 8.b.iv. of SSAP No. 88 shall determine the amount of positive goodwill or negative goodwill created by the combination using the reporting entity’s share of the GAAP net book value of the acquired entity. Business combinations accounted for under the statutory purchase method and in which the acquired entity is valued in accordance with, 8 b. i. SSAP No. 88 shall determine the amount of positive or negative goodwill created by the business combination using the insurer’s share of the statutory book value of the acquired entity.

6. **For those acquired SCA entities accounted for in accordance with paragraph 8.b.i. under the statutory purchase method the historical bases of the acquired entity shall continue to be used in preparing its statutory financial statements. Therefore, pushdown accounting is not permitted.**

**Information or issues (included in Description of Issue) not previously contemplated by the Working Group:**

None

**Convergence with International Financial Reporting Standards (IFRS):**

Currently, there is no guidance in IFRS on pushdown accounting as this is not a method of accounting that is accepted under IFRS.
Staff Recommendation:
Staff recommends that the Working Group move this item to the active listing, categorized as nonsubstantive and expose the proposed revisions to SSAP No. 68—Business Combinations and Goodwill and SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities to reject ASU 2014-17, Business Combinations – Pushdown Accounting for statutory accounting. This agenda item also explicitly prohibits use of pushdown accounting under the statutory accounting basis, which includes all entities accounting for under SSAP No. 48—Joint Ventures, Partnerships and Limited Liability Companies and SSAP No. 97. These revisions will explicitly prohibit insurance reporting entities that hold SCAs valued on the basis of U.S. GAAP (8.b.ii or 8.b.iii) to utilize a value for the SCA that reflects the impact of pushdown accounting. Insurance reporting entities that hold SCAs that utilized pushdown accounting for U.S. GAAP will be required to adjust their U.S. GAAP financial statements to remove the effect of pushdown accounting, and provide audited support of their modification. The insurance reporting entity shall recognize the difference between the purchase price and the net book value of the entity (prior to pushdown accounting) as goodwill in accordance with SSAP No. 68. This goodwill shall be admitted and amortized in accordance with the limitations and provisions of SSAP No. 68. The effective date of these revisions shall be Jan. 1, 2020.

Staff Note: Staff has considered that it will be more difficult to maintain separate sets of accounting records if multiple entities are acquired, especially with the complex nature of insurance company reporting structures. Staff also notes that the election to apply pushdown accounting under U.S. GAAP is irrevocable; as such, a grandfather provision will allow any SCAs acquired prior to December 31, 2019 to continue to use pushdown accounting in its financial statements.

Staff Review Completed by:
Fatima Sediqzad - NAIC Staff
March 2019

Proposed Revisions:

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

**Business Combinations**
2. A business combination shall be accounted for as either a statutory purchase or a statutory merger. Business combinations that create a parent-subsidiary relationship shall be accounted for as a statutory purchase. Business combinations where equity of one entity is issued in exchange for the equity of another entity, which is then canceled, and prospectively only one entity exists, shall be accounted for as a statutory merger.

**Statutory Purchases of SCA Investments**
3. The statutory purchase method of accounting is defined as accounting for a business combination as the acquisition of one entity by another. It shall be used for all purchases of SCA entities including partnerships, joint ventures, and limited liability companies. The acquiring reporting entity shall record its investment at cost. Cost is defined as the sum of: (a) any cash payment, (b) the fair value of other assets distributed, (c) the fair value of any liabilities assumed, and (d) any direct costs of the acquisition. Contingent consideration issued in a purchase business combination that is embedded in a security or that is in the form of a separate financial instrument shall be recorded by the issuer at fair value at the acquisition date. **Pushdown accounting is not a permitted convention of accounting under statutory accounting, including the acquisition of an entity that follows U.S. GAAP as its basis of accounting.**

6. For those acquired SCA entities accounted for using the equity method in accordance with paragraph 8.b. of SSAP No. 97 under the statutory purchase method, the historical bases of the acquired entity shall continue to be used in preparing its statutory financial statements. Therefore, pushdown accounting is not permitted, **as noted in paragraph 20.**
This statement rejects ASU 2017-04, Simplifying the Test for Goodwill Impairment, ASU 2016-03, Intangibles—Goodwill and Other, Business Combinations, Consolidation, Derivatives and Hedging; ASU 2014-17, Business Combinations – Pushdown Accounting, a Consensus of the FASB Emerging Issues Task Force; ASU 2014-02, Accounting for Goodwill (a consensus of the Private Company Council), ASU 2012-02, Testing Indefinite-Lived Intangible Assets for Impairment, ASU 2011-08, Testing Goodwill for Impairment and ASU 2010-28, When to Perform Step 2 of the Goodwill Impairment Test for Reporting Units with Zero or Negative Carrying Amounts; Accounting Principles Board Opinion No. 16, Business Combinations; FASB Statement No. 38, Accounting for Preacquisition Contingencies of Purchased Enterprises, an amendment of APB Opinion No. 16; Accounting Principles Board Opinion No. 17, Intangible Assets; FASB Statement No. 79, Elimination of Certain Disclosures for Business Combinations by Nonpublic Enterprises; FASB Statement No. 141, Business Combinations; and FASB Statement No. 142, Goodwill and Other Intangible Assets. The following related interpretative pronouncements are also rejected:

SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities

Applying the Market Valuation, Audited Statutory Equity and Audited GAAP Equity Methods

8. The admitted investments in SCA entities shall be valued using either the market valuation approach (as described in paragraph 8.a.), or one of the equity methods (as described in paragraph 8.b.) adjusted as appropriate in accordance with the guidance in SSAP No. 25—Affiliates and Other Related Parties (SSAP No. 25), paragraph 16.d.

   a. In order to use the market valuation approach for SCA entities, the following requirements apply:

   b. If a SCA investment does not meet the requirements for the market valuation approach in paragraph 8.a. or, if the requirements are met, but a reporting entity elects not to use that approach, the reporting entity’s proportionate share of its investments in SCAs shall be recorded as follows:

   i. Investments in U.S. insurance SCA entities shall be recorded based on either 1) the underlying audited statutory equity of the respective entity’s financial statements, adjusted for any unamortized goodwill as provided for in SSAP No. 68—Business Combinations and Goodwill (SSAP No. 68)\(^3\) or 2) the underlying audited statutory equity of the respective entity’s financial statements, adjusted for any unamortized goodwill, modified to remove the impact of any permitted or prescribed accounting practices that depart from the NAIC Accounting Practices and Procedures Manual. Reporting entities shall record investments in U.S. insurance SCA entities on at least a quarterly basis, and shall base the investment value on the most recent quarterly information available from the SCA. Entities may recognize their investment in U.S. insurance SCA entities based on the unaudited statutory equity in the SCAs year-end Annual Statement if the annual SCA audited financial statements are not complete as of the filing deadline. The recorded statutory equity shall be adjusted for audit adjustments, if any, as soon as the annual audited financial statements have been completed. Annual consolidated or combined audits are allowed if completed in accordance with the Model Regulation Requiring Annual Audited Financial Reports as adopted by the SCA’s domiciliary state;

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\(^3\) If the insurance SCA employs accounting practices that depart from the NAIC accounting practices and procedures, and the reporting insurance entity has not adjusted the valuation of the insurance SCA to be consistent with the NAIC accounting practices and procedures, (i.e., retains the effect of the permitted or prescribed practice in its valuation), disclosure about those accounting practices that affect the insurance SCA’s net income and surplus shall be made pursuant to paragraph 36. If the reporting entity has adjusted the investment in the insurance SCA with the resulting valuation being consistent with the accounting principles of the AP&P Manual, the disclosures in paragraph 36 are not required.
ii. Investments in both U.S. and foreign noninsurance SCA entities that are engaged in the following transactions or activities:

(a) Collection of balances as described in SSAP No. 6—Uncollected Premium Balances, Bills Receivable for Premiums, and Amounts Due From Agents and Brokers

(b) Sale/lease or rental of EDP Equipment and Software as described in SSAP No. 16R—Electronic Data Processing Equipment and Software

(c) Sale/lease or rental of furniture, fixtures, equipment or leasehold improvements as described in SSAP No. 19—Furniture, Fixtures, Equipment and Leasehold Improvements

(d) Loans to employees, agents, brokers, representatives of the reporting entity or SCA as described in SSAP No. 20—Nonadmitted Assets

(e) Sale/lease or rental of automobiles, airplanes and other vehicles as described in SSAP No. 20—Nonadmitted Assets

(f) Providing insurance services on behalf of the reporting entity including but not limited to accounting, actuarial, auditing, data processing, underwriting, collection of premiums, payment of claims and benefits, policyowner services

(g) Acting as an insurance or administrative agent or an agent for a government instrumentality performing an insurance function (e.g. processing of state workers compensations plans, managing assigned risk plans, Medicaid processing etc).

(h) Purchase or securitization of acquisition costs

and if 20% or more of the SCA’s revenue is generated from the reporting entity and its affiliates, then the underlying equity of the respective entity’s audited U.S. Generally Accepted Accounting Principles (GAAP) financial statements shall be adjusted to a limited statutory basis of accounting in accordance with paragraphs 9 and 20FN. For purposes of this section, revenue means GAAP revenue reported in the audited U.S. GAAP financial statements excluding realized and unrealized capital gains/losses. Foreign SCA entities are defined as those entities incorporated or otherwise legally formed under the laws of a foreign country. Paragraphs 232-287 provide guidance for investments in holding companies;

New Footnote — If the audited U.S. GAAP financial statements reflect the pushdown method of accounting, the financial statements must first be modified to eliminate the effects of the pushdown accounting before applying the statutory basis adjustments.

iii. Investments in both U.S. and foreign noninsurance SCA entities that do not qualify under paragraph 8.b.ii., shall be recorded based on the audited U.S. GAAP equity of the investee, adjusted in accordance with paragraph 20. Foreign SCA entities are defined as those entities incorporated or otherwise legally formed under the laws of a foreign country. Additional guidance on investments in downstream holding companies is included in paragraphs 232-287. Additional guidance on the use of audited foreign GAAP basis financial statements for the U.S. GAAP equity valuation amount is included in paragraph 243.b.

iv. Investments in foreign insurance SCA entities shall be recorded based on the underlying U.S. GAAP equity from the audited U.S. GAAP basis financial
statements, adjusted to a limited statutory basis of accounting in accordance with paragraphs 9 and 20, if available. If the audited U.S. GAAP basis financial statements are not available, the investment can be recorded on the audited foreign statutory basis financial statements of the respective entity adjusted to a limited statutory basis of accounting in accordance with paragraph 9 and adjusted for reserves of the foreign insurance SCA with respect to the business it assumes directly and indirectly from a U.S. insurer using the statutory accounting principles promulgated by the NAIC in the Accounting Practices and Procedures Manual. The audited foreign statutory basis financial statements must include an audited footnote that reconciles net income and equity on the foreign statutory basis of accounting to the U.S. GAAP basis. Foreign insurance SCA entities are defined as alien insurers formed according to the legal requirements of a foreign country.

Pushdown Accounting

20. Pushdown accounting is a convention of accounting for the purchase of a subsidiary at the purchase cost rather than its historical cost. Under pushdown accounting, the acquiree’s assets and liabilities are written up (or down) to reflect the purchase price and, to the extent that the purchase price exceeds fair value, to recognize the excess as goodwill. As such, the total amount that is paid to purchase the subsidiary becomes the subsidiary’s new book value on its financial statements. Pushdown accounting is not permitted under statutory accounting, therefore all SCAs that utilize audited U.S. GAAP financial statements to determine the valuation method under this statement (SCAs valued in accordance with paragraphs 8.b.ii and 8.b.iii) that reflect pushdown accounting must be adjusted, in accordance with an audited reconciliation, to eliminate the effects of pushdown accounting. In addition to adjusting the equity basis of the SCA to eliminate pushdown accounting, the insurance reporting entity shall separately recognize goodwill, as appropriate based on the purchase price and net book value of the entity at acquisition (without pushdown accounting) and report the goodwill in accordance with the provisions of SSAP No. 68. Reporting entities that do not have audited support to eliminate the impact of pushdown accounting shall consider the SCA nonadmitted for statutory reporting purposes. Historical acquisitions of SCAs that have involved pushdown accounting shall continue admittance of the SCA with approval of the domiciliary commissioner. On a prospective basis for newly acquired SCAs, and for historical SCA acquisitions in which domiciliary commissioner approval is not received, reporting entities that do not have audited support to eliminate the impact of pushdown accounting shall report the SCA as a nonadmitted asset for statutory reporting purposes.

Valuation of Investments in Downstream Holding Companies

22. SSAP No. 48 requires the financial statements of joint ventures, partnerships, and/or limited liability companies in which the downstream noninsurance holding company has a minor ownership interest or otherwise lacks control, i.e., ownership interest is less than 10% (hereinafter referred to as “non SCA SSAP No. 48 entities”), to be valued using U.S. GAAP basis financial statements. Valuation of a downstream holding company, including its investments in SCA entities, depends upon the nature of the SCA entities and non SCA SSAP No. 48 entities it holds in accordance with paragraph 8 of this statement. All liabilities, commitments, contingencies, guarantees or obligations of the downstream noninsurance holding company, which are required to be recorded under applicable statutory accounting guidance, shall be reflected in the parent insurance reporting entity’s determination of the carrying value of the investment in the downstream noninsurance holding company, if not already recorded in the financial statements of the downstream noninsurance holding company. The historical basis of the acquired entity shall continue to be used in preparing its financial statements. If an SCA investment of the downstream holding company does not meet the provisions of paragraph 8.a. or if it elects not to use the guidance in paragraph 8.a., and instead uses the guidance in paragraph 8.b., the downstream holding company would be valued as the sum of the following (if applicable):

Admissibility Requirements of Investments in Downstream Holding Companies

23. To meet the admissibility requirements of this statement, unless the limited exception to the audited financial statements requirement discussed in paragraphs 26 and 27 applies, an annual audit of the financial statements of SCA entities, including the downstream holding company valued under paragraphs
8.b.i through 8.b.iv. must be obtained. The requirement for audited financial statements may be met by utilizing any one of the following methods:

- **a.** Audited US GAAP financial statements of the downstream SCA holding company, where the historical basis of the SCA has been used to prepare its financial statements. (Consolidated or combined financial statements are allowed encompassing one or more downstream holding companies, including such holding companies that directly own U.S. insurance entities, provided that the statutory financial statements of such U.S. insurance entities are audited. Annual consolidated or combined audits are allowed for insurance entities if completed in accordance with the Model Regulation Requiring Annual Audited Reports as adopted by the SCA’s domiciliary state.) The audited financial statements of the downstream holding company shall include as other financial information, consolidating or combining balance sheet schedule(s) showing the equity of all relevant SCA entities and non-SCA SSAP No. 48 entities, and any required intercompany eliminations. The consolidating or combining balance sheet schedule shall separately present those entities owned directly by the downstream holding company. The consolidating or combining balance sheet shall then be adjusted for GAAP to SAP differences for paragraph 8.b.i., 8.b.ii. and 8.b.iv. entities owned directly or indirectly by the downstream holding company. The adjusted amount would then be the reported value of the investment in the downstream holding company at the higher-level reporting entity; or

- **b.** Audited foreign GAAP-basis financial statements of the downstream SCA holding company. (Consolidated or combined financial statements are allowed encompassing one or more downstream holding companies, including such holding companies that directly own U.S. insurance entities, provided that the statutory financial statements of such U.S. insurance entities are audited. Annual consolidated or combined audits are allowed for insurance entities if completed in accordance with the Model Regulation Requiring Annual Audited Reports as adopted by the SCA’s domiciliary state.) The audited foreign GAAP basis financial statements shall include an audited footnote disclosure within the financial statements that reconciles each consolidated entity’s net income and equity on a foreign basis of accounting to a U.S. GAAP basis. The audited financial statements of the downstream holding company shall include as other financial information, consolidating or combining balance sheet schedule(s) showing the equity of all relevant SCA entities non SCA SSAP No. 48 entities, and any required intercompany eliminations. The consolidating or combining balance sheet schedule shall separately present those entities owned directly by the downstream holding company. The consolidating or combining balance sheet shall then be adjusted for GAAP to SAP differences of the insurance entities and paragraph 8.b.ii., and 8.b.iv. entities owned directly or indirectly by the downstream holding company. The adjusted amount would then be the reported value of the investment in the downstream holding company at the higher-level reporting entity; or

- **c.** Individual audits of the downstream holding company and the downstream holding company’s investments in individual SCA entities.

48. This statement rejects ASU 2014-17, Business Combinations – Pushdown Accounting, a Consensus of the FASB Emerging Issues Task Force, ASU 2011-10, Derecognition of in Substance Real Estate, APB Opinion No. 18, The Equity Method of Accounting for Investments in Common Stock, AICPA Accounting Interpretations APB 18, The Equity Method of Accounting for Investments in Common Stock: Accounting Interpretations of APB Opinion No. 18, FASB Technical Bulletin No. 79-19, Investor’s Accounting for Unrealized Losses on Marketable Securities Owned by an Equity Method Investee, FASB Emerging Issues Task Force No. 87-21, Change of Accounting Basis in Master Limited Partnership Transactions, FASB Emerging Issues Task Force No. 96-16, Investor’s Accounting for an Investee When the Investor Has a Majority of the Voting Interest but the Minority Shareholder or Shareholders Have Certain Approval or Veto Rights, FASB Emerging Issues Task Force No. 98-2: Accounting by a Subsidiary or Joint Venture for an Investment in the stock of Its Parent Company or Joint Venture Partner and FASB Staff Position No. APB 18-1, Accounting by an Investor for Its Proportionate Share of Accumulated Other Comprehensive Income of an Investee Accounted for under the Equity Method in Accordance with APB Opinion No. 18 upon a Loss of Significant Influence.
Status:
On April 6, 2019, the Statutory Accounting Principles (E) Working Group moved this agenda item to the active listing, categorized as nonsubstantive, and exposed revisions to SSAP No 68—Business Combinations and Goodwill and SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities to reject ASU 2014-17, Business Combinations – Pushdown Accounting for statutory accounting as well as explicitly prohibit the use of pushdown accounting under statutory accounting, which includes all entities accounted for under SSAP No. 48—Joint Ventures, Partnerships and Limited Liability Companies and SSAP No. 97.

On August 3, 2019, the Statutory Accounting Principles (E) Working Group exposed this agenda item with a request for comments on the three options listed below. Additionally, to ensure that goodwill resulting from an insurance reporting entity’s acquisition of an SCA when pushdown is applied is captured within the goodwill admittance limitation, the exposure includes limited revisions to reference this goodwill in SSAP No. 68—Business Combinations and Goodwill, paragraph 9. (Note: Information provided during the Summer National Meeting on the history of pushdown and information from AICPA and industry representatives has been captured within this agenda item under the “Activity to Date” section.)

The options for Working Group consideration include:

1) **Complete rejection of pushdown accounting.** As pushdown is now an election for SEC / U.S. GAAP filers, reporting entities can avoid use of pushdown if prohibited for statutory accounting. (NAIC staff would propose a prospective effective date if electing this option to avoid restatement of those entities that have previously elected pushdown.)

2) **Permission to use pushdown for all non-insurance entities.** This option would increase optionality into the statutory financial statements. If permitted, this approach would result in different SCA values and goodwill calculations for those that follow the guidance in SSAP No. 68 and those that utilize pushdown. Under SSAP No. 68, acquired SCAs do not write-up their assets or liabilities to fair value and goodwill is calculated as the difference between purchase price and book value. Under U.S. GAAP pushdown, acquired SCAs write-up their assets and liabilities to fair value, and goodwill is calculated as the difference between the purchase price and the fair value of the acquired entity. With pushdown, the goodwill is reported at the SCA level. As such, goodwill will be an indefinite asset unless it is identified as impaired. (Under U.S. GAAP, private entities and not-for-profit entities can elect to amortize goodwill over a 10-year period, but this is not an election for public entities.) **If this option is supported, NAIC staff would recommend that the goodwill admittance limitation capture goodwill from an insurance entity’s acquisition of an SCA that is reported on the SCA financial statements.** (This option would not permit pushdown for insurance SCAs (8.b.i entities).)

   (If this option is considered, NAIC staff would propose restrictions on the use of pushdown that differ from U.S. GAAP. For example, under U.S. GAAP, a reporting entity could subsequent elect pushdown accounting in any reporting period after original acquisition. If pushdown was permitted, NAIC staff would propose to require the election at original acquisition and not allow subsequent elections.)

3) **Permit pushdown if elected by SEC Registrants, excluding non-insurance entities.** Although this option would introduce different accounting by type of reporting entity, it is consistent with when pushdown would have been applied under prior statutory accounting guidance. (Under the old SEC provisions, pushdown was only permitted when meeting certain SEC requirements.) This would seemingly allow the companies that have historically utilized pushdown under the SEC rules to continue acquisitions under that prior approach. **If this option is supported, NAIC staff would recommend that the goodwill admittance limitation capture goodwill from the acquisition of an SCA that is reported on the SCA financial statements.** (Also, NAIC staff would propose restrictions to the provisions to ensure the election is made at the time of original acquisition.) (This option would not permit pushdown for insurance SCAs (8.b.i entities).)
Exposed Edits to SSAP No. 68—*Business Combinations and Goodwill*:

8. For those acquired SCA entities accounted for in accordance with paragraph 8.b.i. of SSAP No. 97 under the statutory purchase method, the historical bases of the acquired entity shall continue to be used in preparing its statutory financial statements. Therefore, pushdown accounting is not permitted.

9. Positive goodwill recorded under the statutory purchase method of accounting shall be admitted subject to the following limitation: Positive goodwill from all sources, including life, accident and health, and deposit-type assumption reinsurance and goodwill resulting from the acquisition of an SCA by the insurance reporting entity that is reported on the SCA’s financial statements (resulting from the application of pushdown accounting), is limited in the aggregate to 10% of the acquiring entity’s capital and surplus as required to be shown on the statutory balance sheet of the reporting entity for its most recently filed statement with the domiciliary state commissioner adjusted to exclude any net positive goodwill, EDP equipment and operating system software, and net deferred tax assets. Additionally, all positive goodwill shall be nonadmitted when the underlying investment in the SCA or partnership, joint venture and limited liability company is nonadmitted. When negative goodwill exists, it shall be recorded as a contra-asset. Positive or negative goodwill resulting from the purchase of an SCA, joint venture, partnership or limited liability company shall be amortized to unrealized capital gains and losses on investments over the period in which the acquiring entity benefits economically, not to exceed 10 years. Positive or negative goodwill resulting from the application of pushdown accounting to operations as a component of general insurance expenses over the period in which the assuming entity benefits economically, not to exceed 10 years. Goodwill shall be evaluated separately for each transaction.

On December 7, 2019, the Statutory Accounting Principles (E) Working Group adopted, as final, a clarification edit to SSAP No. 68—*Business Combinations and Goodwill* to clarify that all goodwill from an insurance entity’s acquisition of SCAs, regardless of whether pushdown accounting is applied, is subject to the existing 10% admittance limitation. (With adoption of this edit, paragraph 9 was split into two separate paragraphs.) The remainder of this agenda item was re-exposed to allow additional time for specific examples of pushdown accounting to be provided by interested parties, as well as consider comments received on pushdown.

**Dec. 7 - Adopted SSAP No. 68 Revisions:**

9. Positive goodwill recorded under the statutory purchase method of accounting shall be admitted subject to the following limitation: Positive goodwill from all sources, including life, accident and health, and deposit-type assumption reinsurance and goodwill resulting from the acquisition of an SCA by the insurance reporting entity that is reported on the SCA’s financial statements (resulting from the application of pushdown accounting), is limited in the aggregate to 10% of the acquiring entity’s capital and surplus as required to be shown on the statutory balance sheet of the reporting entity for its most recently filed statement with the domiciliary state commissioner adjusted to exclude any net positive goodwill, EDP equipment and operating system software, and net deferred tax assets. Additionally, all positive goodwill shall be nonadmitted when the underlying investment in

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4 The “acquiring” entity is intended to reflect the insurance reporting entity that reports the investment resulting in goodwill. The goodwill limitation test shall be completed at the individual reporting company level.

5 This includes, but is not limited to, situations in which the investment is nonadmitted as the audited financial statements for the SCA, joint venture, partnership or limited liability company includes substantial doubt on the entity’s ability to continue as a going concern, or on the basis/contents of the audit opinion pursuant to paragraph 20 of SSAP No. 97.

6 The “acquiring” entity is intended to reflect the insurance reporting entity that reports the investment resulting in goodwill. The goodwill limitation test shall be completed at the individual reporting company level.
the SCA or partnership, joint venture and limited liability company is nonadmitted. When negative goodwill exists, it shall be recorded as a contra-asset.

10. Positive or negative goodwill resulting from the purchase of an SCA, joint venture, partnership or limited liability company shall be amortized to unrealized capital gains and losses on investments over the period in which the acquiring entity benefits economically, not to exceed 10 years. Positive or negative goodwill resulting from life, accident and health, and deposit-type assumption reinsurance shall be amortized to operations as a component of general insurance expenses over the period in which the assuming entity benefits economically, not to exceed 10 years. Goodwill shall be evaluated separately for each transaction. \(^{[\text{INT 01-18}]}\)

(Remaining paragraphs will be renumbered accordingly.)

**Dec. 7 - Re-Exposure of the Agenda Item Requests Comments and Examples on the Following Options:**

1) **Complete rejection of pushdown accounting.** As pushdown is now an election for SEC / U.S. GAAP filers, reporting entities can avoid use of pushdown if prohibited for statutory accounting. (NAIC staff would propose a prospective effective date if electing this option to avoid restatement of those entities that have previously elected pushdown.)

2) **Permission to use pushdown for all non-insurance entities.** This option would increase optionality into the statutory financial statements. If permitted, this approach would result in different SCA values and goodwill calculations for those that follow the guidance in SSAP No. 68 and those that utilize pushdown. Under SSAP No. 68, acquired SCAs do not write-up their assets or liabilities to fair value and goodwill is calculated as the difference between purchase price and book value. Under U.S. GAAP pushdown, acquired SCAs write-up their assets and liabilities to fair value, and goodwill is calculated as the difference between the purchase price and the fair value of the acquired entity. With pushdown, the goodwill is reported at the SCA level. As such, goodwill will be an indefinite asset unless it is identified as impaired. (Under U.S. GAAP, private entities and not-for-profit entities can elect to amortize goodwill over a 10-year period, but this is not an election for public entities.) (This option would not permit pushdown for insurance SCAs (8.b.i entities).

(If this option is considered, NAIC staff would propose restrictions on the use of pushdown that differ from U.S. GAAP. For example, under U.S. GAAP, a reporting entity could subsequent elect pushdown accounting in any reporting period after original acquisition. If pushdown was permitted, NAIC staff would propose to require the election at original acquisition and not allow subsequent elections.)

3) **Permit pushdown if elected by SEC Registrants, excluding non-insurance entities.** Although this option would introduce different accounting by type of reporting entity, it is consistent with when pushdown would have been applied under prior statutory accounting guidance. (Under the old SEC provisions, pushdown was only permitted when meeting certain SEC requirements.) This would seemingly allow the companies that have historically utilized pushdown under the SEC rules to continue acquisitions under that prior approach. (Also, NAIC staff would propose restrictions to the provisions to ensure the election is made at the time of original acquisition.) (This option would not permit pushdown for insurance SCAs (8.b.i entities).

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7 This includes, but is not limited to, situations in which the investment is nonadmitted as the audited financial statements for the SCA, joint venture, partnership or limited liability company includes substantial doubt on the entity’s ability to continue as a going concern, or on the basis/contents of the audit opinion pursuant to paragraph 20 of SSAP No. 97.
Issue: Attribution of Goodwill

Check (applicable entity):

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Description of Issue:
This agenda item was drafted to expand the statutory guidance regarding the attribution of purchase price and goodwill from an acquisition and to add explicit language regarding the accounting treatment for these scenarios; specifically, for situations in which an insurance company acquires a holding company that owns multiple companies. There has not been consistency in the application of these scenarios in the SCA filings.

NAIC Staff has illustrated an actual SCA filing in the example below. The names of the companies and the amounts used in the example have been changed.

ABC Insurance Company purchased 100% of Holding Company D for $200 million, which resulted in goodwill of $150 million. Holding Company D owns 100% of three subsidiaries: Company X, Company Y and Company Z. Company X and Company Z are both non-insurance entities, while Company Y is a U.S. insurance entity. The attribution of purchase price and goodwill are necessary for the reasons listed below.

- **Standalone financials** - If Companies X, Y and Z present standalone financials, the purchase price and goodwill will need to be allocated down from the acquisition of Holding Company D. Company Y will present its financial statements separately in the Annual Statement it is required to file.

- **Look-through** - If Holding Company D is not audited, the goodwill from the acquisition of Holding Company D may not be admitted as part of Holding Company D’s value, but a look-through can be performed to one and/or all of the companies that D owns. With the look-through, the purchase price and goodwill would need to be allocated to each subsidiary that Holding Company D owns at the time of its
acquisition and each subsidiary’s equity could be admitted, along with the goodwill from the acquisition, subject to goodwill limitations.

- **Taxes** - The purchase price and goodwill would also need to be allocated down to each entity that Holding Company D owns for tax purposes. SSAP No. 101—*Income Taxes* permits an entity to admit its adjusted gross deferred tax assets (DTAs) against its own deferred tax liabilities (DTLs) but not against gross DTLs of other members of the affiliated or consolidated group. This must be done on an entity-by-entity basis.

- **Sale of entity** - If the insurance reporting entity subsequently sells one or more of the entities that Holding Company D owns, it would need the allocated purchase price and goodwill amount to calculate any gain or loss resulting from the sale.

**Existing Authoritative Literature:**

**Bold and underlined guidance is for emphasis.**

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

**Statutory Purchases of SCA Investments**

2. The statutory purchase method of accounting is defined as accounting for a business combination as the acquisition of one entity by another. It shall be used for all purchases of SCA entities including partnerships, joint ventures, and limited liability companies. The acquiring reporting entity shall record its investment at cost. Cost is defined as the sum of: (a) any cash payment, (b) the fair value of other assets distributed, (c) the fair value of any liabilities assumed, and (d) any direct costs of the acquisition. Contingent consideration issued in a purchase business combination that is embedded in a security or that is in the form of a separate financial instrument shall be recorded by the issuer at fair value at the acquisition date.

3. For those acquired SCA entities accounted for in accordance with paragraphs 8.b.i., 8.b.ii., 8.b.iii. or 8.b.iv. of SSAP No. 97, and joint venture, partnership or limited liability company entities accounted for in accordance with paragraph 8 of SSAP No. 48, goodwill is defined as the difference between the cost of acquiring the entity and the reporting entity’s share of the book value of the acquired entity. When the cost of the acquired entity is greater than the reporting entity’s share of the book value, positive goodwill exists. When the cost of the acquired entity is less than the reporting entity's share of the book value, negative goodwill exists. Goodwill resulting from assumption reinbursement shall be recorded as a separate write-in for other-than-invested assets. All other goodwill shall be reported in the carrying value of the investment.

4. A business combination accounted for under the statutory purchase method and in which the acquired entity is valued in accordance with paragraphs 8.b.ii., 8.b.iii. or 8.b.iv. of SSAP No. 97 shall determine the amount of positive goodwill or negative goodwill created by the combination using the reporting entity’s share of the GAAP net book value of the acquired entity, adjusted to a statutory basis of accounting in accordance with paragraph 9 of SSAP No. 97 in the case of acquired entities valued in accordance paragraphs 8.b.ii. or 8.b.iv. of SSAP No. 97. Business combinations accounted for under the statutory purchase method and in which the acquired entity is valued in accordance with, paragraph 8.b.i. of SSAP No. 97 shall determine the amount of positive or negative goodwill created by the business combination using the insurer’s share of the statutory book value of the acquired entity.

5. For those acquired SCA entities accounted for in accordance with paragraph 8.b.i. of SSAP No. 97 under the statutory purchase method, the historical bases of the acquired entity shall continue to be used in preparing its statutory financial statements. Therefore, pushdown accounting is not permitted.

7. Positive goodwill recorded under the statutory purchase method of accounting shall be admitted subject to the following limitation: Positive goodwill from all sources, including life, accident and health, and deposit-type
assumption reinsurance, is limited in the aggregate to 10% of the acquiring entity’s capital and surplus as required to be shown on the statutory balance sheet of the reporting entity for its most recently filed statement with the domiciliary state commissioner adjusted to exclude any net positive goodwill, EDP equipment and operating system software, and net deferred tax assets. **Additionally, all positive goodwill shall be nonadmitted when the underlying investment in the SCA or partnership, joint venture and limited liability company is nonadmitted.** When negative goodwill exists, it shall be recorded as a contra-asset. Positive or negative goodwill resulting from the purchase of an SCA, joint venture, partnership or limited liability company shall be amortized to unrealized capital gains and losses on investments over the period in which the acquiring entity benefits economically, not to exceed 10 years. Positive or negative goodwill resulting from life, accident and health, and deposit-type assumption reinsurance shall be amortized to operations as a component of general insurance expenses over the period in which the assuming entity benefits economically, not to exceed 10 years. Goodwill shall be evaluated separately for each transaction.

**SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities**

11. For investments in entities recorded on an equity method (paragraph 8.b.i. through 8.b.iv.) after the date of acquisition, the investment amount shall be 1) adjusted for the amortization of statutory goodwill as defined in SSAP No. 68, and 2) adjusted, with a corresponding unrealized gain or loss, for the reporting entity’s share of undistributed earnings and losses of the investee (net of dividends declared). (This results in a reduction of the investment amount when dividends declared are in excess of the undistributed accumulated earnings attributable to the investee.)

**Admissibility Requirements of Investments in Downstream Holding Companies**

22. To meet the admissibility requirements of this statement, unless the limited exception to the audited financial statements requirement discussed in paragraphs 25 and 26 applies, an annual audit of the financial statements of SCA entities, including the downstream holding company valued under paragraphs 8.b.i through 8.b.iv. must be obtained. The requirement for audited financial statements may be met by utilizing any one of the following methods:

a. Audited US GAAP financial statements of the downstream SCA holding company. (Consolidated or combined financial statements are allowed encompassing one or more downstream holding companies, including such holding companies that directly own U.S. insurance entities, provided that the statutory financial statements of such U.S. insurance entities are audited. Annual consolidated or combined audits are allowed for insurance entities if completed in accordance with the Model Regulation Requiring Annual Audited Reports as adopted by the SCA’s domiciliary state.) The audited financial statements of the downstream holding company shall include as other financial information, consolidating or combining balance sheet schedule(s) showing the equity of all relevant SCA entities and non-SCA SSAP No. 48 entities, and any required intercompany eliminations. The consolidating or combining balance sheet schedule shall separately present those entities owned directly by the downstream holding company. The consolidating or combining balance sheet shall then be adjusted for GAAP to SAP differences for paragraph 8.b.i., 8.b.ii. and 8.b.iv. entities owned directly or indirectly by the downstream holding company. The adjusted amount would then be the reported value of the investment in the downstream holding company at the higher-level reporting entity; or

b. Audited foreign GAAP-basis financial statements of the downstream SCA holding company. (Consolidated or combined financial statements are allowed encompassing one or more downstream holding companies, including such holding companies that directly own U.S. insurance entities, provided that the statutory financial statements of such U.S. insurance entities are audited. Annual consolidated or combined audits are allowed for insurance entities if completed in accordance with the Model Regulation Requiring Annual Audited Reports as adopted by the SCA’s domiciliary state.) The audited financial statements of the downstream holding company shall include as other financial information, consolidating or combining balance sheet schedule(s) showing the equity of all relevant SCA entities and non-SCA SSAP No. 48 entities, and any required intercompany eliminations. The consolidating or combining balance sheet schedule shall separately present those entities owned directly by the downstream holding company. The consolidating or combining balance sheet shall then be adjusted for GAAP to SAP differences for paragraph 8.b.i., 8.b.ii. and 8.b.iv. entities owned directly or indirectly by the downstream holding company. The adjusted amount would then be the reported value of the investment in the downstream holding company at the higher-level reporting entity; or

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1 The “acquiring” entity is intended to reflect the insurance reporting entity that reports the investment resulting in goodwill. The goodwill limitation test shall be completed at the individual reporting company level.

2 This includes, but is not limited to, situations in which the investment is nonadmitted as the audited financial statements for the SCA, joint venture, partnership or limited liability company includes substantial doubt on the entity’s ability to continue as a going concern, or on the basis/contents of the audit opinion pursuant to paragraph 20 of SSAP No. 97.

3 Dividends are recognized in investment income when declared.
entities, provided that the statutory financial statements of such U.S. insurance entities are audited. Annual consolidated or combined audits are allowed for insurance entities if completed in accordance with the Model Regulation Requiring Annual Audited Reports as adopted by the SCA’s domiciliary state. The audited foreign GAAP basis financial statements shall include an audited footnote disclosure within the financial statements that reconciles each consolidated entity’s net income and equity on a foreign basis of accounting to a U.S. GAAP basis. The audited financial statements of the downstream holding company shall include as other financial information, consolidating or combining balance sheet schedule(s) showing the equity of all relevant SCA entities non SCA SSAP No. 48 entities, and any required intercompany eliminations. The consolidating or combining balance sheet schedule shall separately present those entities owned directly by the downstream holding company. The consolidating or combining balance sheet schedule shall then be adjusted for GAAP to SAP differences of the insurance entities and paragraph 8.b.ii., and 8.b.iv. entities owned directly or indirectly by the downstream holding company. The adjusted amount would then be the reported value of the investment in the downstream holding company at the higher-level reporting entity; or

c. Individual audits of the downstream holding company and the downstream holding company’s investments in individual SCA entities.

23. If the downstream noninsurance holding company does not meet the requirements of paragraph 25, audited GAAP financial statements, as described in paragraph 22, are required for the downstream noninsurance holding company and its SCA and non SCA investments in order for the investment in the downstream noninsurance holding company to be classified as an admitted asset.

24. A purchased downstream holding company is valued in accordance with the provisions of paragraphs 21-24 and the provisions of SSAP No. 68.

SSAP No. 101—Income Taxes

Exhibit A – Implementation Questions and Answers

8.9 Parent Company P files a consolidated federal income tax return with its insurance subsidiaries, R, S and T. Assume consolidated taxes that could be recovered through loss carryback total $450. However, in the prior carryback years $200 was paid by each of the subsidiaries, R, S and T. The difference between the amount paid by the subsidiaries ($600) and the amount available through loss carryback ($150) is attributable to interest expense incurred by Company P. Pursuant to the group’s written income tax allocation agreement, in the case of loss carrybacks, taxes recoverable are limited to the consolidated taxes paid in the carryback years.

8.10 Because the adjusted gross DTA admitted under paragraph 11.a. for each reporting entity cannot exceed what each entity paid and could reasonably be expected to be refunded by P, no more than $450 in total may be admitted by the subsidiaries (under paragraph 11.a.). If the adjusted gross DTA associated with the subsidiaries’ temporary differences that reverse in the 11.a. period exceed the $450 of taxes recoverable through loss carryback on a consolidated basis, the adjusted gross DTA admitted by the insurance subsidiaries under paragraph 11.a. should be allocated among the subsidiaries, consistent with the principles of its written income tax allocation agreement. This allocation would, in most instances, be based on each subsidiary’s share of reversing temporary differences.

8.11 Under paragraph 11.c., an entity may admit its adjusted gross DTAs, after application of paragraphs 11.a. and 11.b., based upon offset against its own existing gross DTLs and not against gross DTLs of other members of the affiliated or consolidated group.

Limited Exceptions to the Audit Requirements for Downstream Noninsurance Holding Companies

25. This statement requires that investments in SCA entities be recorded using one of the valuation methods described in paragraph 8 in order to be admitted assets. Each of the paragraph 8.b. valuation methods require the financial statements of SCA entities, including downstream noninsurance holding companies, to be audited in order for the investments in SCA entities to be admitted assets. Likewise, SSAP No. 48 requires the financial statements of joint ventures, partnerships, and/or limited liability companies in which the downstream noninsurance holding
company has a minor ownership interest or otherwise lacks control, i.e., ownership interest is less than 10% to be audited (U.S. GAAP) in order to be admitted assets. There is a limited exception to the requirement to have audited financial statements of a downstream noninsurance holding company, provided that the entities owned by the downstream noninsurance holding company (paragraph 8.b.iii. entity) have audited financial statements as described in paragraphs 25 and 26.

26. The process of admitting audited investments in entities owned by an unaudited downstream noninsurance holding company SCA entity will be known as a “look through.” In order to admit the investments in audited SCAs or the audited non SCA SSAP No. 48 entities owned by an unaudited downstream noninsurance holding company, a reporting entity may apply the look through approach, provided all of the following conditions are met:

a. The downstream noninsurance holding company is an 8.b.iii entity, and

b. The downstream noninsurance holding company does not own any other assets which are material to the downstream holding company other than the audited SCA entities and/or audited non SCA SSAP No. 48 entities, and

c. The downstream noninsurance holding company is not subject to liabilities, commitments, contingencies, guarantees or obligations which are material to the downstream noninsurance holding company.

If an investment in a downstream noninsurance holding company meets the requirements set forth above, the reporting entity can admit the individual audited SCA entities and/or audited non SCA SSAP No. 48 entities; however, unaudited immaterial assets of the downstream noninsurance holding company are to be carried at the lesser of the paragraph 8 valuation or nonadmitted (e.g. some equity method investments are required to be carried at a negative value due to either statutory adjustments or to parental obligations to keep funding the subsidiary).

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

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

Convergence with International Financial Reporting Standards (IFRS): None

Staff Recommendation:
Staff recommends that the Working Group move this item to the active listing, categorized as nonsubstantive and expose revisions to SSAP No. 68—Business Combinations and Goodwill to expand statutory accounting guidance to explicitly state that the attribution of purchase price and goodwill are required for a holding company’s subsidiaries upon acquisition of said holding company. The goodwill shall still be reported on the purchasing entity’s financial statements but may be required to be nonadmitted due to the stipulations of this agenda item.

Staff Review Completed by:
Fatima Sediqzad - NAIC Staff
March 2019

Proposed Revisions:
SSAP No. 68—Business Combinations and Goodwill

Statutory Purchases of SCA Investments
3. The statutory purchase method of accounting is defined as accounting for a business combination as the acquisition of one entity by another. It shall be used for all purchases of SCA entities including partnerships, joint ventures, and limited liability companies. The acquiring reporting entity shall record its investment at cost. Cost is defined as the sum of: (a) any cash payment, (b) the fair value of other assets distributed, (c) the fair value of any
liabilities assumed, and (d) any direct costs of the acquisition. Contingent consideration issued in a purchase business combination that is embedded in a security or that is in the form of a separate financial instrument shall be recorded by the issuer at fair value at the acquisition date.

4. For those acquired SCA entities accounted for in accordance with paragraphs 8.b.i., 8.b.ii., 8.b.iii. or 8.b.iv. of SSAP No. 97, and joint venture, partnership or limited liability company entities accounted for in accordance with paragraph 8 of SSAP No. 48, goodwill is defined as the difference between the cost of acquiring the entity and the reporting entity’s share of the book value of the acquired entity. When the cost of the acquired entity is greater than the reporting entity’s share of the book value, positive goodwill exists. When the cost of the acquired entity is less than the reporting entity’s share of the book value, negative goodwill exists. Goodwill resulting from assumption reinsurance shall be recorded as a separate write-in for other-than-invested assets. All other goodwill shall be reported in the carrying value of the investment.

5. A business combination accounted for under the statutory purchase method and in which the acquired entity is valued in accordance with paragraphs 8.b.ii., 8.b.iii. or 8.b.iv. of SSAP No. 97 shall determine the amount of positive goodwill or negative goodwill created by the combination using the reporting entity’s share of the GAAP net book value of the acquired entity, adjusted to a statutory basis of accounting in accordance with paragraph 9 of SSAP No. 97 in the case of acquired entities valued in accordance with paragraphs 8.b.ii. or 8.b.iv. of SSAP No. 97. If the acquired entity is a holding company, the purchase price and goodwill shall be calculated to determine the amount of goodwill that should be attributed to the downstream entities that were acquired as part of the holding company acquisition. (This is required because a reporting entity that subsequently qualifies and elects to look-through the holding company pursuant to SSAP No. 97, paragraphs 25-26 is only permitted to admit the goodwill attributed to the downstream entities that are admitted through the SSAP No. 97 look-through approach.) Business combinations accounted for under the statutory purchase method and in which the acquired entity is valued in accordance with, paragraph 8.b.i. of SSAP No. 97 shall determine the amount of positive or negative goodwill created by the business combination using the insurer’s share of the statutory book value of the acquired entity.

6. For those acquired SCA entities accounted for in accordance with paragraph 8.b.i. of SSAP No. 97 under the statutory purchase method, the historical bases of the acquired entity shall continue to be used in preparing its statutory financial statements. Therefore, pushdown accounting is not permitted.

Status:
On April 6, 2019, the Statutory Accounting Principles (E) Working Group moved this agenda item to the active listing, categorized as nonsubstantive, and exposed revisions to SSAP No. 68—Business Combinations and Goodwill and SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities, as shown above, to explicitly state that the acquisition of a holding company requires the purchase price and goodwill amount to be attributed downstream to the entities that the holding company directly owns.

On August 3, 2019, the Statutory Accounting Principles (E) Working Group exposed revisions to SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities, as illustrated below, to clarify that the “assignment” of goodwill is a disclosure element, with revisions to the disclosure requirements for downstream holding companies. The revisions also reflect a change in terminology from “allocation” to “assignment.”

Proposed Revisions to SSAP No. 97:

5. A business combination accounted for under the statutory purchase method and in which the acquired entity is valued in accordance with paragraphs 8.b.ii., 8.b.iii. or 8.b.iv. of SSAP No. 97 shall determine the amount of positive goodwill or negative goodwill created by the combination using the reporting entity’s share of the GAAP net book value of the acquired entity, adjusted to a statutory basis of accounting in accordance with paragraph 9 of SSAP No. 97 in the case of acquired entities valued in accordance with paragraphs 8.b.ii. or 8.b.iv. of SSAP No. 97. If the acquired entity is a holding company, the purchase price and goodwill shall be calculated to determine the amount of goodwill that should be assigned to the downstream entities that were acquired as part of the holding company acquisition. This is required because a reporting entity that subsequently qualifies and elects to look-through the holding company pursuant to SSAP No. 97, paragraphs 25-26 is only permitted to admit the goodwill attributed to...
the downstream entities that are admitted through the SSAP No. 97 look-through approach. Information on the assigned goodwill shall be captured in the initial Sub 1 filing to the NAIC for all holding company acquisitions and disclosed in accordance with paragraph 42 if the reporting entity utilizes the look-through approach. Business combinations accounted for under the statutory purchase method and in which the acquired entity is valued in accordance with, paragraph 8.b.i. of SSAP No. 97 shall determine the amount of positive or negative goodwill created by the business combination using the insurer’s share of the statutory book value of the acquired entity.

41. If a reporting entity holds an investment in a downstream noninsurance holding company, the reporting entity may look-through the downstream noninsurance holding company to the value of (i) SCA entities having audited financial statements and/or (ii) joint ventures, partnerships, and/or limited liability companies having audited financial statements in which the downstream noninsurance holding company has a minor ownership interest or otherwise lacks control, i.e., ownership interest is less than 10% in lieu of obtaining an audit of the financial statements of the downstream noninsurance holding company (provided the limited exception to the audited financial statements requirement contained in paragraphs 26-27 applies).

42. If a reporting entity utilizes the look-through approach for the valuation of the downstream noninsurance holding company instead of obtaining audited financial statements of the downstream noninsurance holding company, the financial statements of the reporting entity shall include the following disclosures for each noninsurance holding company in which the look-through approach is utilized:

   d. Information that details the name of the downstream noninsurance holding company (including whether the reporting entity has looked-through more-than-one holding companies) along with details on the carrying value, goodwill and admitted value of the holding company.

   e. Information on the entities held by the noninsurance holding company that includes their carrying value, assignment of goodwill (and how this assignment was determined), whether audited financial statements were obtained, and the ultimate admitted value.

   e. The carrying value of the investment in the downstream non insurance holding company;

   f. The fact that the financial statements of the downstream noninsurance company are not audited;

   g. The fact that the reporting entity has limited the value of its investment in the downstream noninsurance holding company to the value contained in the audited financial statements, including adjustments required by this statement, of SCA entities and/or non-SCA SSAP No. 48 entities owned by the downstream noninsurance holding company and valued in accordance with paragraphs 22-25;

   h. The fact that all liabilities, commitments, contingencies, guarantees or obligations of the downstream noninsurance holding company, which are required to be recorded as liabilities, commitments, contingencies, guarantees or obligations under applicable accounting guidance, are reflected in the reporting entity’s determination of the carrying value of the investment in the downstream noninsurance holding company, if not already recorded in the financial statements of the downstream noninsurance holding company.

Example Disclosure for Inclusion in the A/S Illustrations:
(NAIC staff is not proposing to data-capture this information.)

For the year-end 2018 financial statements, the reporting entity reported the value of a downstream holding company using the look-through approach permitted in SSAP No. 97 as the downstream holding company was not supported by audited financial statements. Pursuant to the provisions in SSAP No. 97, the look-through approach is only permitted when the downstream noninsurance entity is an 8.b.iii entity, and the downstream holding company does not own any other assets which are material to the downstream holding company other than the audited/non-audited entities
held by the downstream holding company. Additionally, the downstream noninsurance holding company is not subject to liabilities, commitments, contingencies, guarantees or obligations which are materials to the downstream holding company.

In accordance with the provisions of SSAP No. 97, the investment of the downstream holding company has been limited to the value contained in the audited financial statements, including adjustments required by SSAP No. 97, of the SCA entities (and SSAP No. 48 entities) owned by the downstream noninsurance holding company pursuant to the valuation requirements detailed in SSAP No. 97, paragraphs 22-25. Detail of how the reported investment of the downstream holding company was determined using the look-through approach is shown below:

<table>
<thead>
<tr>
<th>Downstream Holding Company:</th>
<th>Carrying Value</th>
<th>Goodwill</th>
<th>Total Admitted Value</th>
<th>SSAP No. 97 Adjustments</th>
<th>Total Nonadmitted</th>
</tr>
</thead>
<tbody>
<tr>
<td>ABC Downstream**</td>
<td>$3,000,000</td>
<td>$250,000</td>
<td>$2,712,500</td>
<td>$0</td>
<td>$287,500</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Name of Look-Through Entity</th>
<th>Audited F/S (Yes / No)</th>
<th>Carrying Value</th>
<th>Assigned Goodwill %*</th>
<th>Assigned Goodwill</th>
<th>SSAP No. 97 Adjustments</th>
<th>Admitted Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>XYZ Entity</td>
<td>Yes</td>
<td>2,500,000</td>
<td>85%</td>
<td>$212,500</td>
<td>$0</td>
<td>$2,712,500</td>
</tr>
<tr>
<td>QRS Entity</td>
<td>No</td>
<td>400,000</td>
<td>10%</td>
<td>$25,000</td>
<td>$0</td>
<td>$0</td>
</tr>
<tr>
<td>MNO Entity</td>
<td>No</td>
<td>100,000</td>
<td>5%</td>
<td>$12,500</td>
<td>$0</td>
<td>$0</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td>$3,000,000</td>
<td>100%</td>
<td>$250,000</td>
<td>$0</td>
<td>$2,712,500</td>
</tr>
</tbody>
</table>

* Goodwill assignment occurred at original acquisition of the downstream holding company on the basis of the percentage of the carrying value of each look-through entity to the total carrying value.

** ABC Downstream holding company is owned by DEF nonaudited downstream holding company. The reporting entity has conducted a "more-than-one" holding company look-through as both downstream companies qualify for look-through under SSAP No. 97 as they are 8.b.iii entities holding no materials assets or liabilities in accordance with SSAP No. 97, paragraphs 26-27.

Exhibit A – SCA Reporting Process:

**Initial Reporting of SCA Investments**

53. Reporting the acquisition or formation of a new investment is accomplished by submitting a completed Sub 1 form for each investment, disclosing (i) the valuation reported or to be reported by the insurance company on its latest or next quarterly financial statement blank, (ii) which method of those described in paragraph 8 was used to arrive at the valuation, (iii) the factual context of the transaction and (iv) economic and business motivations for the transaction. If the acquired investment was a downstream noninsurance holding company, the reporting entity shall also detail the entities held by the downstream holding company and assign goodwill percentages to each of the entities held by the holding company. The submission will be processed by the NAIC only if the NAIC determines it has been provided with all material information with respect to all SCA companies of the reporting insurance company that require valuation.

54. The purpose of a Sub 1 filing is to determine whether the value claimed is reasonable. If the NAIC determines that the reported transaction meets the tests specified, it will complete the filing in the VISION database. If the NAIC determines that the transaction does not meet the tests specified, it shall not complete the filing in the VISION database and instead notifies the reporting insurance company and the state of domicile in writing of its determination.

On December 7, 2019, the Statutory Accounting Principles (E) Working Group re-exposed this agenda item to clarify that the "assignment" of goodwill is a disclosure element. The Working Group directed NAIC staff to prepare revisions to the Sub 1 Acquisition Overview template to capture this information for new SCA acquisitions.

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

Issue: Rolling Short-Term Investments

Check (applicable entity):

<table>
<thead>
<tr>
<th>Modification of existing SSAP</th>
<th>P/C</th>
<th>Life</th>
<th>Health</th>
</tr>
</thead>
<tbody>
<tr>
<td>☒</td>
<td>☐</td>
<td>☒</td>
<td>☐</td>
</tr>
</tbody>
</table>

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

Description of Issue:
This agenda item has been drafted to consider statutory accounting guidance for short-term investment structures that are being purposely designed to mature at or around 364 days (often with affiliates), with the full expectation that the investment structure would be renewed (rolled) continuously for subsequent years. This agenda item also addresses investments reported as cash equivalents, with the same dynamic, but structured to comply with the cash equivalent timeframes. It is believed these structures occur because reporting as short-term investments (or cash equivalents) results with the following benefits:

1) More-desirable risk-based capital (RBC) charge.
2) To avoid filing with either the SVO or to avoid obtaining a rating from a credit rating provider.
3) Limited affiliate reporting.

Although there are investments (e.g., repurchase and reverse repurchase) transactions that are often expected to renew, it is not appropriate to purposely structure investments to qualify for short-term or cash equivalent reporting, with an anticipation that the investment will continuously roll forward, potentially for many years and avoid filing the security for an NAIC designation and/or reporting on the schedule with more appropriate RBC charges as a long-term investment. In order to avoid unintended consequences for desirable short-term investments, the provisions of this agenda item have been structured to specifically apply to the following:

- All affiliated SSAP No. 26R investments.
- All SSAP No. 43R investments.
- All investments that would be reported on Schedule BA if they did not qualify for cash equivalent or short-term reporting. (This includes both affiliated and non-affiliated investments.)

With these restrictions, any non-affiliated investment that would qualify within SSAP No. 26R—Bonds as a long-term investment would be exempt from the proposed new concepts in determining cash equivalent / short-term investment reporting. This scope of the revisions intend to prevent inadvertent application to Treasury-bills, commercial paper, certificates of deposit, etc., where a reporting entity may continuously reacquire the same, or substantially similar short-term investment immediately after maturity of a prior short-term investment. However, any affiliated SSAP No. 26R and any investment (affiliated or non-affiliated) that would be in scope of SSAP No. 43R—Loan-backed and Structured Securities, or that would be reported as an “other invested asset” on Schedule BA is proposed to be subject to the additional concepts for reporting as a cash equivalent / short-term investment. (Repurchase and reverse repurchase transactions are also specifically excluded if they are admitted in accordance with SSAP No. 103R collateral requirements.)
Proposed additional concepts for Cash Equivalents and Short-Term Investments Captured in Scope:

- An overall principle that investments are permitted for short-term and cash equivalent reporting only if the reporting entity reasonably expects the investment duration to be realized (e.g., terminate / mature) on the designated maturity date. If the reporting entity does not expect that the investment will terminate or mature on the designated date but will be renewed / rolled beyond the cash equivalent / short-term maturity deadlines, then the investment shall not be classified within scope of SSAP No. 2R—Cash, Cash Equivalents, Drafts and Short-Term Investments. Such investments shall be reported as long-term investments on the applicable reporting schedule and shall follow the provisions (including NAIC designations and RBC calculations) for a long-term investment. (Although SAP and U.S. GAAP have different definitions for “short-term” / “current asset” reporting, the concept that the duration is “reasonably expected to be realized” is consistent with the “current asset” definition under U.S. GAAP.)

- Provisions that a cash equivalent / short-term investment (unless specifically exempted) is only permitted to be reported within those classifications for one applicable reporting period. As such, if an investment is reported as a short-term investment as of Dec. 31, 2018, and the investment does not mature on the original scheduled maturity date, the reporting entity shall not be permitted to report the investment as a short-term investment on Dec. 31, 2019. (A cash equivalent would only be permitted to be reported with that distinction for one quarter, before moving to a long-term investment schedule.) For these situations, if a security is held after the initial maturity timeframes have passed, the reporting entity shall report the investment as a long-term investment on the applicable schedule and follow all previsions (including NAIC designations and RBC calculations as required) for a long-term investment. (By default, this provision incorporates a quarter (90-day) grace period, because if the security is sold in the quarter following the initial reporting date, it will not subsequently be reported as an invested asset.)

- The sale or maturity of an investment, with a reacquisition of the same or substantially similar security within a 1-year timeframe shall preclude the reporting entity from reporting the currently held security as a cash equivalent or short-term investment regardless of the maturity date. (This one-year timeframe prevents reporting of recurring “re-acquisitions” as cash equivalents or short-term investments.)

- Although wash sales, which are sales and reacquisitions within a 30-day timeframe, of cash-equivalents and short-term investments with credit assessments of NAIC 1-2 are currently excluded from the wash-sale disclosure, modifications have been proposed to require disclosure of all wash sales, regardless of NAIC designation, if the investment or transaction involves an affiliate.

RBC Assessment of Proposed Revisions:

Life Reporting Entities: For life reporting entities, if the investment is a bond, RBC is similar between all reporting schedules in accordance with NAIC designations. If the investment is not a bond, and does not have an NAIC 1 designation, and/or is not permitted to be reported as an “underlying fixed income security” pursuant to the requirements of Schedule BA, a reporting entity receives an RBC benefit by reporting the investment as a cash equivalent or short-term investment rather than as a BA investment. Also, if a reporting entity reports a “credit assessment” for short-term or cash equivalent bonds that is a better assessment than would be received if they had received an NAIC designation, a reporting entity would receive an RBC benefit by reporting the investment as a cash equivalent or short-term investment.

<table>
<thead>
<tr>
<th>Life RBC</th>
<th>Schedule E2 Cash Equivalent*</th>
<th>Schedule DA Short-Term*</th>
<th>Schedule D1 Bond</th>
<th>Schedule BA Fixed Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bond Investment</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>NAIC 1</td>
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<tr>
<td>NAIC 3</td>
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<td>.0446</td>
<td>.0446</td>
<td>.0446</td>
</tr>
</tbody>
</table>

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* Bonds that are reported as cash equivalents or short-term investments receive RBC charges based on the “credit assessment” assigned in Schedule D-Part 1A. Although NAIC designations are not required for these investments, reporting entities are required to report them based on their own credit assessment. If a bond was reported with a higher credit assessment than what it would receive based on NAIC designation (which is required for long-term investments), then a movement from cash equivalent / short-term reporting to a long-term schedule (Schedule D-1 or Schedule BA) would have an RBC impact.

Property / Casualty and Health Reporting Entities: For property/casualty and health reporting entities, if the investment is a bond, RBC is similar between all reporting schedules in accordance with NAIC designations. If the investment is not a bond, a reporting entity receives an RBC benefit by reporting the investment as a cash equivalent or short-term investment rather than a BA investment. (P/C entities do not have the ability to report NAIC designations on Schedule BA investments for RBC purposes.) Also, if a reporting entity reports a “credit assessment” for short-term or cash equivalent bonds that is a better assessment than would be received if they had reported an NAIC designation, a reporting entity would receive an RBC benefit by reporting the investment as a cash equivalent or short-term investment.

<table>
<thead>
<tr>
<th>NAIC 1</th>
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<th>.0970</th>
<th>XXXX</th>
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<td>NAIC 6</td>
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</table>

Non-Bond Investment

<table>
<thead>
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<th>.0039</th>
<th>XXXX</th>
<th>.0039</th>
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<td>NAIC 3</td>
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<tr>
<td>NAIC 5</td>
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<td>.0039</td>
<td>XXXX</td>
<td>.2231</td>
</tr>
<tr>
<td>NAIC 6</td>
<td>.0039</td>
<td>.0039</td>
<td>XXXX</td>
<td>.3000</td>
</tr>
</tbody>
</table>

| No Designation | .0039 | .0039 | XXXX | .3000 |

* Bonds that are reported as cash equivalents or short-term investments receive RBC charges based on the “credit assessment” assigned in Schedule D-Part 1A. Although NAIC designations are not required for
these investments, reporting entities are required to report them based on their own credit assessment. If a bond was reported with a higher credit assessment than what it would receive based on NAIC designation (which is required for long-term investments), then a movement from cash equivalent / short-term reporting to a long-term schedule (Schedule D-1 or Schedule BA) would have an RBC impact.

Existing Authoritative Literature:

**SSAP No. 2R—Cash, Cash Equivalents, Drafts and Short-Term Investments**

**Cash Equivalents**

6. Cash equivalents are short-term, highly liquid investments that are both (a) readily convertible to known amounts of cash, and (b) so near their maturity that they present insignificant risk of changes in value because of changes in interest rates. Only investments with original maturities1 of three months or less qualify under this definition, with the exception of money market mutual funds, as detailed in paragraph 7. Regardless of maturity date, derivative instruments shall not be reported as cash equivalents and shall be reported as derivatives on Schedule DB. Securities with terms that are reset at predefined dates (e.g., an auction-rate security that has a long-term maturity and an interest rate that is regularly reset through a Dutch auction) or have other features an investor may believe results in a different term than the related contractual maturity shall be accounted for based on the contractual maturity at the date of acquisition, except where other specific rules within the statutory accounting framework currently exist.

7. Money market mutual funds registered under the Investment Company Act of 1940 and regulated under rule 2a-7 of the Act shall be accounted for and reported as cash equivalents for statutory accounting. Investments in money market mutual funds shall be valued at fair value or net asset value (NAV) as a practical expedient. For reporting entities required to maintain an asset valuation reserve (AVR), the accounting for unrealized capital gains and losses shall be in accordance with SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve (SSAP No. 7). For reporting entities not required to maintain an AVR, unrealized capital gains and losses shall be recorded as a direct credit or charge to surplus. Sales/reinvestments in money market mutual funds are excluded from the wash sale disclosure in SSAP No. 103R.

Footnote 1: Original maturity means original maturity to the entity holding the investment. For example, both a three-month U.S. Treasury bill and a three-year Treasury note purchased three months from maturity qualify as cash equivalents. However, a Treasury note purchased three years ago does not become a cash equivalent when its remaining maturity is three months.

**Short-Term Investments**

12. All investments with remaining maturities (or repurchase dates under repurchase agreements) of one year or less at the time of acquisition (excluding derivatives and those investments classified as cash equivalents as defined in this statement) shall be considered short-term investments. Short-term investments include, but are not limited to, bonds, commercial paper, repurchase agreements, and collateral and mortgage loans which meet the noted criteria. Short-term investments shall not include certificates of deposit. Regardless of maturity date, derivative instruments shall not be reported as short-term investments and shall be reported as derivatives on Schedule DB.

13. All short-term investments shall be accounted for in the same manner as similar long-term investments.

14. Short-term investments meet the definition of assets as defined in SSAP No. 4 and are admitted assets to the extent they conform to the requirements of this statement.

**SSAP No. 103R—Transfers and Servicing of Financial Assets and Extinguishments of Liabilities** (bolding and underlining added for emphasis)
A reporting entity shall disclose the following information for wash sales, as defined in paragraph 12, involving transactions for securities with an NAIC designation of 3 or below, or that do not have an NAIC designation (excluding all cash equivalents, derivative instruments as well as short-term investments with credit assessments equivalent to an NAIC 1-2 designation). This disclosure shall be included in the financial statements for when the investment was initially sold. For example, if the investment was sold December 20, 2017, and reacquired on January 10, 2018, the transaction shall be captured in the wash sale disclosure included in the year-end 2017 financial statements:

i. A description of the reporting entity’s objectives regarding these transactions;

ii. An aggregation of transactions by NAIC designation 3 or below, or that do not have an NAIC designation;

iii. The number of transactions involved during the reporting period;

iv. The book value of securities sold;

v. The cost of securities repurchased; and

vi. The realized gains/losses associated with the securities involved.

U.S. GAAP – FASB Codification

Master Glossary of “Current Assets”

Current assets is used to designate cash and other assets or resources commonly identified as those that are reasonably expected to be realized in cash or sold or consumed during the normal operating cycle of the business.

Activity to Date (issues previously addressed by the 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) and U.S. GAAP:
Not Applicable – NAIC staff highlights that the distinction of “short-term” under SAP is distinctly different from U.S. GAAP. Under U.S. GAAP, a “current asset” is one that is reasonably expected to be realized in cash or sold or consumed during the normal operating cycle of a business. As such, under U.S. GAAP investments move from a non-current (long-term) to current (short-term) classification. This does not occur under SAP, as the distinction of short-term is based on the maturity timeframe at the time of acquisition.

Staff Recommendation: NAIC staff recommends that the Working Group move this item to the active listing, categorized as nonsubstantive, and expose revisions to SSAP No. 2R—Cash, Cash Equivalents, Drafts and Short-Term Investments to incorporate additional principle concepts in classifying investments as cash equivalents or short-term investments.

As detailed within this agenda item, the proposed revisions will restrict classification as a cash equivalent or short-term investment for all affiliated SSAP No. 26R—Bond investments, all affiliated and nonaffiliated investments in scope of SSAP No. 43R—Loan-backed and Structured Securities and all affiliated and non-affiliated investments that would be reported on Schedule BA in accordance with the following provisions:

- The reporting entity does not reasonably expect that the investment will actually terminate or mature within the timeframe permitted for cash equivalent or short-term investment classification.
• The investment was previously reported as a cash equivalent / short-term investment and the initial maturity timeframes have passed. For example, if an investment was reported as a short-term investment as of Dec. 31, 2018, and the investment was rolled / renewed, the reporting entity will not be permitted to report the investment as a short-term investment on Dec. 31, 2019. (A cash equivalent would only be permitted to be reported for one quarter, before moving to a long-term investment schedule.) For these situations, if a security is held after the initial maturity timeframes have passed, the reporting entity shall report the investment as a long-term investment on the applicable schedule and follow all previsions (including NAIC designations and RBC calculations as required) for a long-term investment.

• The sale or maturity of an investment, with a reacquisition of the same or substantially similar security within a 1-year timeframe would preclude the reporting entity from reporting the currently held security as a cash equivalent or short-term investment regardless of the maturity date. (This one-year timeframe prevents reporting of recurring “re-acquisitions” as cash equivalents or short-term investments.) (This provision is similar to the one regarding “rolled” securities but clarifies that the “settlement” of a security with a reacquisition does not prevent application of the new concepts in determining cash equivalent or short-term reporting. (NAIC staff highlights that this restriction is necessary particularly with the use of “net settlement” structures with affiliates in which no cash is exchanged.)

• Wash sales, regardless of NAIC designation, that involve affiliated investments shall be disclosed.

The proposed revisions in this agenda item have been drafted to focus on affiliated bond investments (SSAP No. 26R), all loan-backed and structured security investments (SSAP No. 43R) and all investments that would be captured on Schedule BA. This approach has been used to exclude a variety of cash equivalent / short-term investments that are often purposely rolled / reacquired to ensure a continuous balance of available short-term liquidity (e.g., Treasury-bills, commercial paper, certificates of deposit, etc.) By excluding all non-affiliated “bonds” from the new guidance, the “normal” recurring short-term / cash equivalent investments are not expected to be impacted. The revisions capture both affiliated and nonaffiliated Schedule BA items, as the short-term structuring is more of an RBC focus. (NAIC staff does not believe there are many SSAP No. 43R securities that qualify as cash equivalents or short-term investments, but they have been specifically identified to prevent such classifications if the noted conditions are met.)

As a key item to note, the proposed revisions permit reporting entities that acquire short-term investments (based on maturity date) that are captured in scope and that they expect to roll (such as an affiliated short-term bond), to report the security as a long-term investment at acquisition. (With this approach, the investment would not have to change reporting schedules once it is rolled after initial acquisition.)

**Proposed Revisions to SSAP No. 2R—Cash, Cash Equivalents, Drafts and Short-Term Investments:**

**Cash Equivalents**

6. Cash equivalents are short-term, highly liquid investments that are both (a) readily convertible to known amounts of cash, and (b) so near their maturity that they present insignificant risk of changes in value because of changes in interest rates. Only investments with original maturities\(^1\) of three months or less can qualify under this definition, with the exception of money market mutual funds, as detailed in paragraph 78. Regardless of maturity date, derivative instruments shall not be reported as cash equivalents and shall be reported as derivatives on Schedule DB. Securities with terms that are reset at predefined dates (e.g., an auction-rate security that has a long-term maturity and an interest rate that is

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\(^1\) Original maturity means original maturity to the entity holding the investment. For example, both a three-month U.S. Treasury bill and a three-year Treasury note purchased three months from maturity qualify as cash equivalents. However, a Treasury note purchased three years ago does not become a cash equivalent when its remaining maturity is three months.
regularly reset through a Dutch auction) or have other features an investor may believe results in a
different term than the related contractual maturity shall be accounted for based on the contractual
maturity at the date of acquisition, except where other specific rules within the statutory accounting
framework currently exist.

7. Regardless of maturity date, affiliated investments that would be in scope of SSAP No. 26R—
   Bonds and all investments that would be in scope of SSAP No. 43R—Loan-backed and Structured
   Securities or that would be reported as “Other Invested Assets” shall be reported as long-term
   investments if any of the following conditions applyFN:

   a. The reporting entity does not reasonably expect the investment to terminate on the
      maturity date. This provision includes investments that are expected to be renewed (or
      rolled) with a maturity date that ends subsequent to the initial 90-day timeframe.

   b. The investment was previously reported as a cash equivalent investment and the initial
      maturity timeframe has passed. If an investment is reported as a cash equivalent and it is
      unexpectedly renewed / rolled, the reporting entity is not permitted to continue to report
      the held security as a cash equivalent regardless of the updated maturity date and shall
      report the security as a long-term investment. An investment is only permitted to be
      reported as a cash equivalent for one quarter reporting period. Meaning, if an investment
      was reported as a cash equivalent in the first quarter, it is not permitted to be reported as
      a cash equivalent in the second quarter.

   c. The reporting entity reacquired the investment (or a substantially similar investment)
      within 1 year after the original security matured or was terminated. These reacquired
      securities shall be reported as long-term investments. (These securities are also not
      permitted to be reported as short-term investments regardless of the maturity date of the
      reacquired investment.)

New Footnote 1: Repurchase and reverse repurchase transactions are excluded from these
provisions if admitted in accordance with collateral requirements pursuant to SSAP No. 103R—
Transfers and Servicing of Financial Assets and Extinguishments of Liabilities. Cash equivalents
subject to the provisions of paragraph 7 are not permitted to be subsequently reported as short-term
investments, even if the updated / reacquired maturity date is within 1 year. These investments shall
be reported as long-term investments. To avoid changes in reporting schedules, reporting entities are
permitted to report securities as long-term investments at initial acquisition regardless of the initial
maturity date.

Short-Term Investments

12. Short-term All investments are investments— that do not qualify as cash equivalents with
    remaining maturities (or repurchase dates under repurchase agreements) of one year or less at the time
    of acquisition. (excluding derivatives and those investments classified as cash equivalents as defined in
    this statement) shall be considered short-term investments. Short-term investments can include, but are
    not limited to, bonds, commercial paper, repurchase agreements, and collateral and mortgage loans.
    which meet the noted criteria. Short-term investments shall not include certificates of deposit. Regardless
    of maturity date, derivative instruments shall not be reported as short-term investments and shall be
    reported as derivatives on Schedule DB.

13. Regardless of maturity date, affiliated investments in scope of SSAP No. 26R—Bonds and all
    investments that would be in scope of SSAP No. 43R—Loan-backed and Structured Securities or
    that would be reported as “Other Invested Assets” shall be reported as long-term investments if any of the
    following conditions applyFN:

   a. The reporting entity does not reasonably expect the investment to terminate on the
      maturity date. This provision includes investments that are expected to be renewed (or
      rolled) with a maturity date that ends subsequent to the initial “less than one year”
      timeframe.
b. The investment was previously reported as a short-term investment and the initial maturity timeframe has passed. If an investment is reported as a short-term investment and it is unexpectedly renewed / rolled, the reporting entity is not permitted to continue to report the held security as a short-term investment (or as a cash equivalent) regardless of the updated maturity date and shall report the security as a long-term investment. An investment is only permitted to be reported as a short-term investment for one annual reporting period. Meaning, if an investment was reported as a short-term investment as of December 31, 2018, it is not permitted to be reported as short-term investment as of December 31, 2019.

c. The reporting entity reacquired the investment (or a substantially similar investment) within 1 year after the original security matured or was terminated. These reacquired securities shall be reported as long-term investments. (These securities are also not permitted to be reported as cash equivalent investments regardless of the maturity date of the reacquired investment.)

New Footnote 1: Repurchase and reverse repurchase transactions are excluded from these provisions if admitted in accordance with collateral requirements pursuant to SSAP No. 103R—Transfers and Servicing of Financial Assets and Extinguishments of Liabilities. Short-term investments subject to the provisions of paragraph 13 are not permitted to be subsequently reported as cash equivalents, even if the updated / reacquired maturity date is within 90-days. These investments shall be reported as long-term investments. To avoid changes in reporting schedules, reporting entities are permitted to report securities as long-term investments at initial acquisition regardless of the initial maturity date.

12.14. All short-term investments shall be accounted for in the same manner as similar long-term investments.

13.15. Short-term investments meet the definition of assets as defined in SSAP No. 4 and are admitted assets to the extent they conform to the requirements of this statement.

Proposed Revisions to SSAP No. 103R—Transfers and Servicing of Financial Assets and Extinguishments of Liabilities:

28.I. A reporting entity shall disclose the following information for wash sales, as defined in paragraph 12, for all affiliated investment transactions (including items originally classified as cash equivalents and short-term investments) and for non-affiliated involving investment transactions for securities with an NAIC designation of 3 or below, or that do not have an NAIC designation. (For non-affiliated investments, excluding all cash equivalents, derivative instruments as well as and short-term investments with credit assessments equivalent to an NAIC 1-2 designation, are excluded from this disclosure.) This disclosure shall be included in the financial statements for when the investment was initially sold. For example, if the investment was sold December 20, 2017, and reacquired on January 10, 2018, the transaction shall be captured in the wash sale disclosure included in the year-end 2017 financial statements:

i. A description of the reporting entity’s objectives regarding these transactions;

ii. An aggregation of transactions by NAIC designation 3 or below, or that do not have an NAIC designation;

iii. The number of transactions involved during the reporting period;

iv. The book value of securities sold;

v. The cost of securities repurchased; and

vi. The realized gains/losses associated with the securities involved.

Staff Review Completed by: Julie Gann – May 2019
Status:
On August 3, 2019, the Statutory Accounting Principles (E) Working Group moved this agenda item to the active listing, categorized as nonsubstantive, and exposed revisions to SSAP No. 2R—Cash, Drafts and Short-term Investments and SSAP No. 103R—Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, as illustrated above, to incorporate additional principle concepts in classifying investments as cash equivalents or short-term investments.

NAIC staff recommends exposure of proposed revisions to SSAP No. 2R—Cash, Cash Equivalents, Drafts and Short-Term Investments, which incorporate additional principle concepts in classifying investments as cash equivalents or short-term investments. Items from the original August 3, 2019 exposure are highlighted below and exclude certain qualified cash pooling arrangements (as proposed in agenda item 2019-42) from the restricted cash equivalent reporting detailed in this agenda item. Note: both agenda items (2019-20 and 2019-42) are concurrently exposed and if adopted in their current form, must be adopted simultaneously. Additionally, paragraph 8 as referenced below for cash pooling reflects the modifications proposed in agenda item 2019-42.

Proposed Revisions for Fall 2019 Discussion: to SSAP No. 2R—Cash, Cash Equivalents, Drafts and Short-Term Investments:

Cash Equivalents

6. Cash equivalents are short-term, highly liquid investments that are both (a) readily convertible to known amounts of cash, and (b) so near their maturity that they present insignificant risk of changes in value because of changes in interest rates. Only investments with original maturities of three months or less can qualify under this definition, with the exception of money market mutual funds, as detailed in paragraph 78 and cash pooling, as detailed in paragraph 8. Regardless of maturity date, derivative instruments shall not be reported as cash equivalents and shall be reported as derivatives on Schedule DB. Securities with terms that are reset at predefined dates (e.g., an auction-rate security that has a long-term maturity and an interest rate that is regularly reset through a Dutch auction) or have other features an investor may believe results in a different term than the related contractual maturity shall be accounted for based on the contractual maturity at the date of acquisition, except where other specific rules within the statutory accounting framework currently exist.

7. Regardless of maturity date, affiliated investments that would be in scope of SSAP No. 26R—Bonds and all investments that would be in scope of SSAP No. 43R—Loan-backed and Structured Securities or that would be reported as “Other Invested Assets” shall be reported as long-term investments if any of the following conditions apply:\footnote{2}

   a. The reporting entity does not reasonably expect the investment to terminate on the maturity date. This provision includes investments that are expected to be renewed (or rolled) with a maturity date that ends subsequent to the initial 90-day timeframe.

   b. The investment was previously reported as a cash equivalent investment and the initial maturity timeframe has passed. If an investment is reported as a cash equivalent and it is unexpectedly renewed / rolled, the reporting entity is not permitted to continue to report the held security as a cash equivalent regardless of the updated maturity date and shall report the security as a long-term investment. An investment is only permitted to be reported as a cash equivalent for one quarter reporting period. Meaning, if an investment was reported as a cash equivalent in the first quarter, it is not permitted to be reported as a cash equivalent in the second quarter.

\footnote{2} Original maturity means original maturity to the entity holding the investment. For example, both a three-month U.S. Treasury bill and a three-year Treasury note purchased three months from maturity qualify as cash equivalents. However, a Treasury note purchased three years ago does not become a cash equivalent when its remaining maturity is three months.
c. The reporting entity reacquired the investment (or a substantially similar investment), within 1 year after the original security matured or was terminated. These reacquired securities shall be reported as long-term investments. (These securities are also not permitted to be reported as short-term investments regardless of the maturity date of the reacquired investment.)

New Footnote 1: Repurchase and reverse repurchase transactions are excluded from these provisions if admitted in accordance with collateral requirements pursuant to SSAP No. 103R—Transfers and Servicing of Financial Assets and Extinguishments of Liabilities. Additional exclusions include cash pooling arrangements permitted under paragraph 8. Cash equivalents subject to the provisions of paragraph 7 are not permitted to be subsequently reported as short-term investments, even if the updated / reacquired maturity date is within 1 year. These investments shall be reported as long-term investments. To avoid changes in reporting schedules, reporting entities are permitted to report securities as long-term investments at initial acquisition regardless of the initial maturity date.

Short-Term Investments

12. Short-term All investments are investments that do not qualify as cash equivalents with remaining maturities (or repurchase dates under repurchase agreements) of one year or less at the time of acquisition. (excluding derivatives and those investments classified as cash equivalents as defined in this statement) shall be considered short-term investments. Short-term investments can include, but are not limited to, bonds, commercial paper, repurchase agreements, and collateral and mortgage loans which meet the noted criteria. Short-term investments shall not include certificates of deposit. Regardless of maturity date, derivative instruments shall not be reported as short-term investments and shall be reported as derivatives on Schedule DB.

13. Regardless of maturity date, affiliated investments in scope of SSAP No. 26R—Bonds and all investments that would be in scope of SSAP No. 43R—Loan-backed and Structured Securities or that would be reported as “Other Invested Assets” shall be reported as long-term investments if any of the following conditions apply:\n
a. The reporting entity does not reasonably expect the investment to terminate on the maturity date. This provision includes investments that are expected to be renewed (or rolled) with a maturity date that ends subsequent to the initial “less than one year” timeframe.

b. The investment was previously reported as a short-term investment and the initial maturity timeframe has passed. If an investment is reported as a short-term investment and it is unexpectedly renewed / rolled, the reporting entity is not permitted to continue to report the held security as a short-term investment (or as a cash equivalent) regardless of the updated maturity date and shall report the security as a long-term investment. An investment is only permitted to be reported as a short-term investment for one annual reporting period. Meaning, if an investment was reported as a short-term investment as of December 31, 2018, it is not permitted to be reported as short-term investment as of December 31, 2019.

c. The reporting entity reacquired the investment (or a substantially similar investment) within 1 year after the original security matured or was terminated. These reacquired securities shall be reported as long-term investments. (These securities are also not permitted to be reported as cash equivalent investments regardless of the maturity date of the reacquired investment.)

New Footnote 1: Repurchase and reverse repurchase transactions are excluded from these provisions if admitted in accordance with collateral requirements pursuant to SSAP No. 103R—Transfers and Servicing of Financial Assets and Extinguishments of Liabilities. Short-term investments subject to the provisions of paragraph 13 are not permitted to be subsequently reported as cash equivalents, even if the updated / reacquired maturity date is within 90-days. These investments shall be reported as
long-term investments. To avoid changes in reporting schedules, reporting entities are permitted to report securities as long-term investments at initial acquisition regardless of the initial maturity date.

42.14. All short-term investments shall be accounted for in the same manner as similar long-term investments.

43.15. Short-term investments meet the definition of assets as defined in SSAP No. 4 and are admitted assets to the extent they conform to the requirements of this statement.

**Proposed Revisions to SSAP No. 103R—Transfers and Servicing of Financial Assets and Extinguishments of Liabilities:**

28.l. A reporting entity shall disclose the following information for wash sales, as defined in paragraph 12, for all affiliated investment transactions (including items originally classified as cash equivalents and short-term investments) and for non-affiliated involving investment transactions for securities with an NAIC designation of 3 or below, or that do not have an NAIC designation. (For non-affiliated investments, excluding all cash equivalents, derivative instruments as well as and short-term investments with credit assessments equivalent to an NAIC 1-2 designation, are excluded from this disclosure.) This disclosure shall be included in the financial statements for when the investment was initially sold. For example, if the investment was sold December 20, 2017, and reacquired on January 10, 2018, the transaction shall be captured in the wash sale disclosure included in the year-end 2017 financial statements:

i. A description of the reporting entity’s objectives regarding these transactions;

ii. An aggregation of transactions by NAIC designation 3 or below, or that do not have an NAIC designation;

iii. The number of transactions involved during the reporting period;

iv. The book value of securities sold;

v. The cost of securities repurchased; and

vi. The realized gains/losses associated with the securities involved.

On December 7, 2019, the Statutory Accounting Principles (E) Working Group exposed revisions to SSAP No. 2R—Cash, Cash Equivalents, Drafts and Short-Term Investments and SSAP No. 103R—Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, as shown above in the “Proposed Revisions for Fall 2019 Discussion” to incorporate additional principle concepts in classifying investments as cash equivalents or short-term investments to prevent the “rolling” of certain investments. Fall revisions to the prior Summer National Meeting exposure incorporate guidance to exclude qualifying cash pools from the short-term rolling provisions.

With the Fall exposure, comments were requested from regulators and industry representatives on whether other investments should be included / excluded from the short-term rolling provisions. In particular, comments are requested on whether short-term lending (both collateral loans and affiliated loans) should be permitted to be continuously rolled/renewed as short-term, whether non-affiliated SSAP No. 26R investments should be subject to the short-term rolling restrictions, and whether an assessment of “re-underwriting” could be used as support to allow the rolling of short-term investments.
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Statutory Accounting Principles (E) Working Group
Maintenance Agenda Submission Form
Form A

Issue: Inclusion of Cash / Liquidity Pools - Cash Equivalents as defined in SSAP No. 2R.

Check (applicable entity):

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Description of Issue: Cash pooling, also known as liquidity bundling or liquidity pools, is a special form of liquidity management in which groups combine resources in order to make a more efficient use of idle cash. A cash pool is typically a structure in which several entities’ cash accounts are aggregated for numerous purposes, including optimizing earned interest, accessing additional short-term investments markets, and improving liquidity management. The investment goal is to optimize financial results by increasing investment access and lower transaction costs that would be incurred by each individual pool participant.

Contributed cash is typically placed in short-term investments, which may not have been previously available to a single affiliated reporting entity that possesses a lower cash balance. Affiliates with lower cash balances can leverage the financial strength of other related affiliates in order to access certain markets that contain significant initial investment requirements. Additionally, by pooling resources and making fewer (and larger) investments, transaction costs are reduced, thus giving the participants a more efficient use of cash resources.

In general, pooling is restricted to groups in which several companies are organized under the management of a single corporate entity. Individual participating companies may be legally independent, however the group acts as a strategic unit, for the purposes of cash management.

Cash pooling structures are not a new market development; however, their potential uses and organizational structures can vary significantly. Under certain pool structures, positive cash balances of one member could cover the deficit cash balance of another member. In this type of structure, surplus funds are physically concentrated into a single account in order to maximize investment return while deficit accounts are covered by transfers from the cash pool. Within these structures, individual participants lose economic independence as the cash is managed centrally and may not be available to the extent desired by the participating entity. Pooling structures have also been formed for internal financing purposes as “sharing of cash” can be used to reduce reliance on external borrowing for short-term working capital needs, again potentially reducing the cash available by certain participants.

This agenda item recommends revisions to allow specific structures that strictly hold cash, cash equivalents and short-term investments and other certain criteria, but do not meet the current requirements for cash equivalent reporting, to be reported as cash equivalents under SSAP No. 2R—Cash, Cash Equivalents, Drafts and Short-Term Investments.

Existing Authoritative Literature:

SSAP No. 2R—Cash, Cash Equivalents, Drafts and Short-Term Investments

Cash Equivalents
6. Cash equivalents are short-term, highly liquid investments that are both (a) readily convertible to known amounts of cash, and (b) so near their maturity that they present insignificant risk of changes in
value because of changes in interest rates. Only investments with original maturities of three months or less qualify under this definition, with the exception of money market mutual funds, as detailed in paragraph 7. Regardless of maturity date, derivative instruments shall not be reported as cash equivalents and shall be reported as derivatives on Schedule DB. Securities with terms that are reset at predefined dates (e.g., an auction-rate security that has a long-term maturity and an interest rate that is regularly reset through a Dutch auction) or have other features an investor may believe results in a different term than the related contractual maturity shall be accounted for based on the contractual maturity at the date of acquisition, except where other specific rules within the statutory accounting framework currently exist.

7. Money market mutual funds registered under the Investment Company Act of 1940 and regulated under rule 2a-7 of the Act shall be accounted for and reported as cash equivalents for statutory accounting. Investments in money market mutual funds shall be valued at fair value or net asset value (NAV) as a practical expedient. For reporting entities required to maintain an asset valuation reserve (AVR), the accounting for unrealized capital gains and losses shall be in accordance with SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve. For reporting entities not required to maintain an AVR, unrealized capital gains and losses shall be recorded as a direct credit or charge to surplus. Sales/reinvestments in money market mutual funds are excluded from the wash sale disclosure in SSAP No. 103R.

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): A question regarding cash pools was raised under the proposed short-term rolling provisions captured in agenda item 2019-20. With this question, it was noted that cash pools are not specifically addressed in SSAP No. 2R—Cash, Cash Equivalents, Drafts and Short-Term Investments. This agenda item proposes to incorporate specific guidance for these instruments. If revisions are adopted to clarify cash pools in scope of SSAP No. 2R, it is anticipated that revisions will also be proposed to exclude cash pools from the short-term rolling provisions, allowing qualifying cash pools to be continually reported as cash equivalents.

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


Staff Recommendation:

NAIC Staff recommends that the Working Group move this item to the active listing, categorized as nonsubstantive and expose revisions to SSAP No. 2R—Cash, Cash Equivalents, Drafts and Short-Term Investments to specify the types of cash pooling organization structures and the investments they are required to maintain in order to qualify as cash equivalents.

NAIC staff is aware a circumstance where a Limited Liability Company was used as the primary structure for a Cash / Liquidity Pool. However, NAIC staff is not proposing changes to SSAP No. 48—Joint Ventures, Partnerships and Limited Liability Companies as the legal structure of such pools will vary. Comments are requested regarding the need for a Cash / Liquidity Pool reference in SSAP No. 48.

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1 Original maturity means original maturity to the entity holding the investment. For example, both a three-month U.S. Treasury bill and a three-year Treasury note purchased three months from maturity qualify as cash equivalents. However, a Treasury note purchased three years ago does not become a cash equivalent when its remaining maturity is three months.
Proposed Revisions to SSAP No. 2R—Cash, Cash Equivalents, Drafts and Short-Term Investments

Cash Equivalents

6. Cash equivalents are short-term, highly liquid investments that are both (a) readily convertible to known amounts of cash, and (b) so near their maturity that they present insignificant risk of changes in value because of changes in interest rates. Only investments with original maturities of three months or less qualify under this definition, with the exception of cash pools that meet the requirements of paragraph 8 and money market mutual funds described in paragraph 7. Regardless of maturity date, derivative instruments shall not be reported as cash equivalents and shall be reported as derivatives on Schedule DB. Securities with terms that are reset at predefined dates (e.g., an auction-rate security that has a long-term maturity and an interest rate that is regularly reset through a Dutch auction) or have other features an investor may believe results in a different term than the related contractual maturity shall be accounted for based on the contractual maturity at the date of acquisition, except where other specific rules within the statutory accounting framework currently exist.

7. Money market mutual funds registered under the Investment Company Act of 1940 and regulated under rule 2a-7 of the Act shall be accounted for and reported as cash equivalents for statutory accounting. Investments in money market mutual funds shall be valued at fair value or net asset value (NAV) as a practical expedient. For reporting entities required to maintain an asset valuation reserve (AVR), the accounting for unrealized capital gains and losses shall be in accordance with SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve. For reporting entities not required to maintain an AVR, unrealized capital gains and losses shall be recorded as a direct credit or charge to surplus. Sales/reinvestments in money market mutual funds are excluded from the wash sale disclosure in SSAP No. 103R.

8. Cash pooling is a technique, utilized by some companies under common control by which several entities’ cash accounts are aggregated for numerous purposes, including liquidity management, optimizing interest or investment returns and reducing investment or banking transaction fees. Cash pools can have numerous functions and structures, however only those that have obtained domiciliary regulator approval and meet the requirements may look through the ownership structure to report the assets held as cash equivalents.

   a. Members or participants in the pool are limited to affiliated entities as defined in SSAP No. 25.
   b. Investments held by the pool are limited to non-affiliated investments.
   c. The pool must permit each participant to withdraw, at any time, cash up to the amount it has contributed to the pool. Each participant must own an undivided interest in the underlying assets of the pool in proportion to the aggregate amount of cash contributed. All affiliates’ interests in the pool shall be of the same class, with equal rights, preferences and privileges. All membership interests shall be fully paid and non-assessable and shall have no preemptive, conversion or exchange rights. The liability of a participant’s debts and obligations of the pool shall be limited to the amount of its contributions and no participant shall be obligated to contribute money to the pool for any reason other than to participate in the pool’s investments. Additionally, participants shall not cover the debits or credits of another participant (commonly referred to as notional cash pooling).
   d. An audited U.S. GAAP annual report of the cash pool and schedules showing each affiliate’s prorated share of investments shall be provided annually to each participant as of December 31. The reporting entity shall determine if the investments would have qualified as cash, cash equivalents or short-term investments had the entity independently acquired the investments. To the extent the pool holds investments that do not meet the definition of cash, cash equivalents, short-term investments, or if the cash pool is not supported by an audited statement, the pool does not qualify within scope of this statement.

Disclosures

15. The following disclosures shall be made for short-term investments in the financial statements:

   a. Fair values in accordance with SSAP No. 100R—Fair Value;
b. Concentrations of credit risk in accordance with SSAP No. 27—Off-Balance-Sheet and Credit Risk Disclosures;

c. Basis at which the short-term investments are stated.

d. The items in the scope of this statement are also subject to the annual audited disclosures in SSAP No. 26R—Bonds, paragraph 30.f.

16. The financial statements shall disclose the reporting entity’s share of the cash pool by asset type (cash, cash equivalents, or short-term investments).

For brevity, the remaining paragraphs of SSAP No. 2R have been omitted but will be renumbered accordingly.

Staff Review Completed by:
NAIC Staff – Jim Pinegar, September 2019

Status:
On December 7, 2019, the Statutory Accounting Principles (E) Working Group moved this agenda item to the active listing, categorized as nonsubstantive, and exposed revisions, as illustrated above, to SSAP No. 2R—Cash, Cash Equivalents, Drafts and Short-Term Investments to specify that cash pooling structures that meet specified criteria qualify as cash equivalents.
Issue: Levelized and Persistency Commission

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Description of Issue:
NAIC staff has received regulator inquiries on the application of the levelized commissions guidance in SSAP No. 71—Policy Acquisition Costs and Commissions. This agenda item is to recommend clarifications to the existing levelized commissions guidance and provide additional guidance regarding commission that is based on policy persistency. SSAP No. 71 describes that levelized commissions occur in situations in which a third party pays agents non-levelized commissions and the reporting entity pays a third party by levelized payments. The statement notes that it is intended, but not necessarily guaranteed, that the amounts paid to the agents by the third party would ultimately be repaid to the third party from the reporting entity. SSAP No. 71 identifies such arrangements as funding agreements between the reporting entity and the third party. SSAP No. 71 then identifies that the use of a commission arrangement where commission payments are not linked to traditional elements (such as premium payments and policy persistency) requires the establishment of a liability for the full amount of the unpaid principal and accrued interest which is payable to a third party related to levelized commissions is required.

The questions received by NAIC staff relate to the use of levelized commission arrangements and when the liability for commission based on annual persistency is required to be recorded as a liability in accordance with SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets.

Levelized Commission

For the example in question, a third party is paying agent commissions and receiving periodic payments. Consistent with the guidance in SSAP No. 71, paragraph 4, the third party (funding agent) is paying the agents on behalf of the reporting entity and receiving levelized payments from the reporting entity which include additional fees or interest in excess of the commissions. The agreement between the reporting entity and the funding agent specifies that the funding agent will not be reimbursed by the reporting entity if the policies that generate the commission are cancelled prior to the policy anniversary date. The regulator noted that the reporting entity was not accruing the liability to the third-party funding agent, asserting that the payments to the funding agent were theoretically avoidable until the policy had passed the anniversary year-end date.

The accounting issue is whether levelized commission arrangements that are linked to traditional elements (such as premium payments and policy persistency) requires the establishment of a liability for the full amount of the unpaid principal and accrued interest which is payable to a third party related to levelized commissions.

Persistency Commission

Also, in the noted example, the reporting entity was also asserting that the levelized commission obligations related to policy persistency commission were not required to be accrued until the policy anniversary year end had been passed. The reporting entity asserts that the liability is not required until the persistency commission was fully earned by the agent and therefore unavoidable.
The accounting issue is if the persistency commission expense should be accrued proportionately over the policy period to which the commission relates, or if it is accrued only when fully earned and unavoidable.

Existing Authoritative Literature:

Preamble provides the following (bolding added for emphasis):

37. Liabilities require recognition as they are incurred. Certain statutorily mandated liabilities may also be required to arrive at conservative estimates of liabilities and probable loss contingencies (e.g., interest maintenance reserves, asset valuation reserves, and others).

38. Revenue should be recognized only as the earnings process of the underlying underwriting or investment business is completed. Accounting treatments which tend to defer expense recognition do not generally represent acceptable SAP treatment.

SSAP No. 5 – Revised—Liabilities, Contingencies and Impairments of Assets

Liabilities

2. A liability is defined as certain or probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or to provide services to other entities in the future as a result of a past transaction(s) or event(s).

3. A liability has three essential characteristics: (a) it embodies a present duty or responsibility to one or more other entities that entails settlement by probable future transfer or use of assets at a specified or determinable date, on occurrence of a specified event, or on demand, (b) the duty or responsibility obligates a particular entity, leaving it little or no discretion to avoid the future sacrifice, and (c) the transaction or other event obligating the entity has already happened. This includes, but is not limited to, liabilities arising from policyholder obligations (e.g., policyholder benefits, reported claims and reserves for incurred but not reported claims). Liabilities shall be recorded on a reporting entity’s financial statements when incurred.

4. Estimates (e.g., loss reserves) are required in financial statements for many ongoing and recurring activities of a reporting entity. The mere fact that an estimate is involved does not of itself constitute a loss contingency. For example, estimates of losses utilizing appropriate actuarial methodologies meet the definition of liabilities as outlined above and are not loss contingencies.

Loss Contingencies or Impairments of Assets

6. For purposes of implementing the statutory accounting principles of loss contingency or impairment of an asset described below, the following additional definitions shall apply:
   a. Probable—The future event or events are likely to occur;
   b. Reasonably Possible—The chance of the future event or events occurring is more than remote but less than probable;
   c. Remote—The chance of the future event or events occurring is slight.

7. A loss contingency or impairment of an asset is defined as an existing condition, situation, or set of circumstances involving uncertainty as to possible loss to an enterprise that will ultimately be resolved when one or more future event(s) occur or fail to occur (e.g., collection of receivables).

8. An estimated loss from a loss contingency or the impairment of an asset shall be recorded by a charge to operations if both of the following conditions are met:
   a. Information available prior to issuance of the statutory financial statements indicates that it is probable that an asset has been impaired or a liability has been incurred at the date of the statutory financial statements. It is implicit in this condition that it is probable
that one or more future events will occur confirming the fact of the loss or incurrence of a liability; and
b. The amount of loss can be reasonably estimated.

SSAP No. 71—Policy Acquisition Costs and Commissions provides the following (bolding added for emphasis):

SUMMARY CONCLUSION

2. Acquisition costs are those costs that are incurred in the acquisition of new and renewal insurance contracts and include those costs that vary with and are primarily related to the acquisition of insurance contracts (e.g., agent and broker commissions, certain underwriting and policy issue costs, and medical and inspection fees). Acquisition costs and commissions shall be expensed as incurred. Determination of when acquisition costs and commissions have been incurred shall be made in accordance with SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets.

3. Contingent commission liabilities shall be determined in accordance with the terms of each individual commission agreement. Commission liabilities determined on the basis of a formula that relates to loss experience shall be established for the earned portion. Assumptions used to calculate the contingent commission liability shall be consistent with the terms of the policy contract and with the assumptions made in recording other assets and liabilities necessary to reflect underwriting results of the reporting entity such as retrospective premium adjustments and loss reserves, including incurred but not reported.

4. Levelized commissions occur in situations where agents receive normal (non-level) commissions with payments made by a third party. It is intended, but not necessarily guaranteed, that the amounts paid to the agents by the third party would ultimately be repaid (with interest explicit or implied) to the third party by levelized payments (which are less than the normal first year commissions but exceed the normal renewal commissions) from the reporting entity. These transactions are, in fact, funding agreements between a reporting entity and a third party. The continuance of the stream of payments specified in the levelized commission contract is a mechanism to bypass recognition of those expenses which are ordinarily charged to expense in the first year of the contract. Consequently, the normal link between the persistency of the policy, the continuance of the premium payment or the maintenance of the agent’s license with the reporting entity is not maintained with respect to the payment stream.

5. The use of an arrangement where commission payments are not linked to traditional elements such as premium payments and policy persistency, but rather are linked to the repayment of an advance amount requires the establishment of a liability for the full amount of the unpaid principal and accrued interest which is payable to a third party related to levelized commissions.

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

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

Convergence with International Financial Reporting Standards (IFRS): Not applicable

Staff Review Completed by:
Robin Marcotte, NAIC Staff – July 2019
Staff Recommendation:
NAIC Staff recommends that the Working Group move this item to the active listing, categorized as nonsubstantive and expose revisions to SSAP No. 71 as illustrated below. NAIC Staff recommends that revisions to the guidance clarify the following:

1. A levelized commission arrangement (whether linked to traditional or nontraditional elements) require the establishment of a liability for the full amount of the unpaid principal and accrued interest payable to a third party at the time the policy is issued.

2. The persistency commission is accrued proportionately over the policy period in which the commission relates to and is not deferred until fully earned.

These recommendations are consistent with the original intent of SSAP No. 71 as well as the Statutory Statement of Concepts focusing on Recognition (excerpts from Preamble, paragraphs 37 and 38):

- Liabilities require recognition as they are incurred.
- Accounting treatments which tend to defer expense recognition do not generally represent acceptable SAP treatment.

Proposed Revisions to SSAP No. 71:

SUMMARY CONCLUSION

2. Acquisition costs are those costs that are incurred in the acquisition of new and renewal insurance contracts and include those costs that vary with and are primarily related to the acquisition of insurance contracts (e.g., agent and broker commissions, certain underwriting and policy issue costs, and medical and inspection fees). Acquisition costs and commissions shall be expensed as incurred. Determination of when acquisition costs and commissions have been incurred shall be made in accordance with SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets. The recognition of commission expense for new and renewal insurance contracts meets the definition of a liability under SSAP No. 5R when the policy is issued or renewed. The issuance of the policy is the obligating event under SSAP No. 5R.

3. Contingent commission liabilities shall be determined in accordance with the terms of each individual commission agreement. Commission liabilities determined on the basis of a formula that relates to loss experience shall be established for the earned portion. Assumptions used to calculate the contingent commission liability shall be consistent with the terms of the policy contract and with the assumptions made in recording other assets and liabilities necessary to reflect underwriting results of the reporting entity such as retrospective premium adjustments and loss reserves, including incurred but not reported. Commission contracts that include persistency (or other such components) shall not use these clauses to defer recognition of commission expense. If a commission is based on annual policy persistency (or similar components), the commission is accrued based on experience to date for the policy period (it is inappropriate to wait until the amount is fully earned and/or unavoidable). Actual policy cancellation would reverse the accrual of the related persistency commission.

4. Levelized commissions occur in situations where agents receive normal (non-level) commissions with payments made by a third party. It is intended, but not necessarily guaranteed, that the amounts paid to the agents by the third party would ultimately be repaid (with interest explicit or implied) to the third party by levelized payments (which are less than the normal first year commissions but exceed the normal renewal commissions) from the reporting entity. These transactions are, in fact, funding agreements between a reporting entity and a third party. The continuance of the stream of payments specified in the levelized commission contract is a mechanism to bypass recognition of those expenses which are ordinarily charged to expense in the first year of the contract. Consequently, the normal link
between the persistency of the policy, the continuance of the premium payment or the maintenance of the agent's license with the reporting entity is not maintained with respect to the payment stream.

5. The use of an arrangement where commission payments are not linked to traditional elements such as premium payments and policy persistency, but rather are linked to the repayment of an advance amount requires the establishment of a liability for the full amount of the unpaid principal and accrued interest which is payable to a third party related to levelized commissions.

New Footnote – The guidance in this paragraph does not imply that levelized commissions that are linked to traditional elements do not require establishment of a liability. Rather, such levelized commissions are captured in paragraphs 3-4.

Status:
On August 3, 2019, the Statutory Accounting Principles (E) Working Group moved this agenda item to the active listing, categorized as nonsubstantive, and exposed revisions to SSAP No. 71—Policy Acquisition Costs and Commissions, as illustrated above, to clarify levelized commissions guidance and provide additional direction regarding commissions that are based on policy persistency. The revisions also clarify that the recognition of commission expense is based on experience to date.

For Fall 2019 Discussion NAIC staff has proposed updates for exposure.

Paragraph 2 - Removed previously exposed revisions as unneeded.
Paragraph 3 - Added clarifying phrases regarding persistency commission accrual. The concept is that normal persistency commission is accrued for the period it relates to unless the policy is cancelled.
Paragraph 4 - Added two clarifying phrases to assist with identifying levelized commission funding agreements.
Paragraph 5 - Added clarifying phrases regarding funding agreements.
Footnote 1 - Redrafted to remove double negative wording.

SSAP No. 71:

SUMMARY CONCLUSION

2. Acquisition costs are those costs that are incurred in the acquisition of new and renewal insurance contracts and include those costs that vary with and are primarily related to the acquisition of insurance contracts (e.g., agent and broker commissions, certain underwriting and policy issue costs, and medical and inspection fees). Acquisition costs and commissions shall be expensed as incurred. Determination of when acquisition costs and commissions have been incurred shall be made in accordance with SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets.

3. Contingent commission liabilities shall be determined in accordance with the terms of each individual commission agreement. Commission liabilities determined on the basis of a formula that relates to loss experience shall be established for the earned portion. Assumptions used to calculate the contingent commission liability shall be consistent with the terms of the policy contract and with the assumptions made in recording other assets and liabilities necessary to reflect underwriting results of the reporting entity such as retrospective premium adjustments and loss reserves, including incurred but not reported. Commission contracts that include persistency (or other such components) shall not use these clauses to defer recognition of commission expense. If a commission is based on annual policy persistency (or other similar components), the commission shall be accrued based on experience to date for the policy period that the commission relates. In regard to persistency commission, it is inappropriate to wait until the amount is fully earned and/or unavoidable to accrue experience to date commission expenses. Actual policy cancellation would reverse the accrual of the related persistency commission.

4. Levelized commissions occur in situations where agents receive normal (non-level) commissions with payments made by a third party. It is intended, but not necessarily guaranteed, that the amounts paid
to the agents by the third party would ultimately be repaid (with interest explicit or implied) to the third party by levelized payments (which are less than the normal first year commissions but exceed the normal renewal commissions) from the reporting entity. (Note: levelized repayments made by the reporting entity extend the repayment period but might not be a straight-line repayment.) These transactions are, in fact, funding agreements between a reporting entity and a third party, regardless of how the payment to the third party is characterized. The continuance of the stream of payments specified in the levelized commission contract is a mechanism to bypass recognition of those expenses which are ordinarily charged to expense in the first year of the contract. Consequently, the normal link between the persistency of the policy, the continuance of the premium payment or the maintenance of the agent's license with the reporting entity is not maintained with respect to the payment stream.

5. The use of an arrangement such as a levelized commission arrangement where commission payments are not linked to traditional elements such as premium payments and policy persistency, but rather are linked to the repayment of an advance amount paid by a third party to the agents requires the establishment of a liability by the reporting entity for the full amount of the unpaid principal and accrued interest which is payable to a third party related to levelized commissions.

New Footnote – The guidance in this paragraph notes that levelized commissions which use a third party to pay agents that are linked to traditional elements require establishment of a liability for the amounts that have been paid to the agents and any interest accumulated to date.

On December 7, 2019, the Statutory Accounting Principles (E) Working Group exposed revisions to SSAP No. 71—Policy Acquisition Costs and Commissions, as illustrated above, to include additional NAIC staff modifications regarding persistency commission and levelized commission arrangements to address certain comments received and to allow for further discussion. With this exposure, the Working Group directed a notification of the exposure to be sent to the Life Actuarial (A) Task Force.
Exposure Draft

SSAP NO. 105—WORKING CAPITAL FINANCE INVESTMENTS

<table>
<thead>
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<th>Location:</th>
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</thead>
<tbody>
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<td>2020 Spring National Meeting</td>
<td>2020 Spring National Meeting</td>
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</table>

Deadline for Written Notice of Intent to Speak: January 31, 2020

Deadline for Receipt of Written Comments: January 31, 2020

Notice of Public Hearing and Request for Written Comments

Basis for hearings. The Statutory Accounting Principles Working Group (SAPWG) will hold a public hearing to obtain information from and views of interested individuals and organizations about the standards proposed in this Exposure Draft. The SAPWG will conduct the hearing in accordance with the National Association of Insurance Commissioners (NAIC) policy statement on open meetings. An individual or organization desiring to speak must notify the NAIC in writing by January 31, 2020. Speakers will be notified as to the date, location, and other details of the hearings.

Oral presentation requirements. The intended speaker must submit a position paper, a detailed outline of a proposed presentation or comment letter addressing the standards proposed in the Exposure Draft by January 31, 2020. Individuals or organizations whose submission is not received by that date will only be granted permission to present at the discretion of the SAPWG chair. All submissions should be addressed to the NAIC staff at the address listed below.

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

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

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

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

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

Any individual or organization may send written comments addressed to the Working Group to the attention of Julie Gann at jgann@naic.org, Robin Marcotte at rmarcotte@naic.org, Jim Pinegar at jpinegar@naic.org, Fatima Sediqzad at fsediqzad@naic.org and Jake Stultz at jstultz@naic.org no later than January 31, 2020. Electronic submission is preferred. Robin Marcotte is the NAIC Staff that is the project lead for this topic.

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(816) 842-3600

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Statement of Statutory Accounting Principles No. 105

Working Capital Finance Investments

STATUS

<table>
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<th>Type of Issue</th>
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<tr>
<td>Issued</td>
<td>December 15, 2013; December 2019 exposure draft</td>
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<tr>
<td>Effective Date</td>
<td>January 1, 2014; Substantive revisions documented in IP No. 16X effective TBD</td>
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<td>Relevant Appendix A Guidance</td>
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SCOPE OF STATEMENT

1. This statement establishes statutory accounting principles for working capital finance investments held by reporting entities. This statement amends SSAP No. 20—Nonadmitted Assets (SSAP No. 20) to allow working capital finance investments as admitted assets to the extent they conform to the requirements of this statement.
SUMMARY CONCLUSION

2. Working capital finance investments represent a confirmed short-term obligation\(^1\) to pay a specified amount owed by one party (the obligor) to another (typically a supplier of goods), generated as a part of a working capital finance investment program currently designated by the NAIC Securities Valuation Office. Pursuant to the working capital finance investment program, this short-term obligation has been transferred by the entity entitled to payment (typically a supplier of goods) to a third party investor.

3. Working capital finance investments held by a reporting entity represent a right of the reporting entity to receive future payment. This Statement provides accounting and reporting guidelines for the right to receive payment under working capital finance programs that meet particular criteria.

Working Capital Finance Program - Definitions and Conditions

4. A “working capital finance program” is an open account program under which an investor may purchase interests, or evidence thereof, in commercial non-insurance receivables. A working capital finance program is created for the benefit of a commercial investment-grade obligor and its suppliers of goods or services, and facilitated by a finance agent.

5. A working capital finance program transfers a right to payment to an investor from a short term obligation and arises from transactions among:
   a. a buyer of goods or services that becomes an obligor to the supplier of goods or services,
   b. the supplier(s) of those goods or services,
   c. a finance agent, and
   d. an investor.

6. A “working capital finance investment” is an interest in payment(s) from a confirmed supplier receivable issued pursuant to a working capital finance program. The payment (maturity) date must not exceed one year from the date of invoice from the supplier to the obligor. This investment is created when the investor purchases from a working capital finance program that is currently designated as NAIC “1” or “2” by the NAIC Securities Valuation Office, any of the following:
   a. One or more confirmed supplier receivables;
   b. in case of a participation, a participation interest in one or more confirmed supplier receivables issued by the finance agent or lead lender holding confirmed supplier receivables; or
   c. a certificate, note or other interest manifestation, documented in a way that is verifiable by regulators, representing a legally enforceable interest in a right to payment either directly to the investor or from a trust, other special purpose entity or pool holding confirmed supplier receivables.

7. “Obligor” is the party that purchases the goods or services that generates the original supplier receivable (and which is the payable for that the Obligor). The obligor must be a single entity, which has have an NAIC designation of “1” or “2” or a Credit Rating Provider equivalent. The obligor must confirm the

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\(^1\) All references to short-term obligations in this statement to refer to obligations not exceeding one year.
supplier receivable described in paragraph 11 as described in the confirmation process in paragraphs 12-134.

8. “Supplier” is the party that sells the goods or services to the obligor. The supplier sells the confirmed supplier receivable in accordance with the terms of the working capital finance program designated by the NAIC Securities Valuation Office at a price agreed to by the finance agent and/or investor.

9. “Investor” is the party purchasing a working capital finance investment in accordance with the terms of the working capital finance program designated by the NAIC Securities Valuation Office.

10. The “finance agent” is a bank, financial institution, other financial intermediary, or service provider that facilitates the working capital finance program, arranges the sale, assignment or transfer of the confirmed supplier receivable to the investor for a fee and administers the payment mechanism. In the case of participation, the finance agent must inform the reporting entity investor of a default or event of default as soon as it becomes aware of such default or event of default. For the working capital finance program to qualify under this SSAP, the finance agent must meet the requirements of either paragraph 10.a or 10.b:

   a. The finance agent is directly regulated by, or falls under the supervision of, a financial regulator of its domiciliary country provided that such country appears on the Purposes and Procedures Manual of the NAIC Investment Analysis Office List of Jurisdictions Eligible for Netting and that the Securities Valuation Office determines that the regulator is the functional equivalent of the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, or the Federal Deposit Insurance Corporation; or

   b. Payments from the obligor must (i) be paid directly to the reporting entity (investor) or into an account maintained by a regulated financial institution for the benefit of investors in the working capital finance program and, in either case, cannot flow through the finance agent cannot be the beneficiary of such payment and (ii) there can be no commingling of payments or assets with those of the obligor, supplier, servicer or trust administrator or other investors.

11. A “confirmed supplier receivable” is a first priority perfected security interest or right to payment of a monetary obligation from the obligor arising from the sale of goods or services from the supplier to the obligor the payment of which has been confirmed by the obligor committing and stating that the obligations under the agreement and any payment shall not be affected by the invalidity, unenforceability, existence, performance or non-performance of the underlying commercial trade transaction or any related contract or undertaking nor that it will not protest, delay, or deny, nor offer nor assert any defenses, personal or otherwise, against payment to the supplier or any party taking claims, interests, or rights to payments made by the supplier.

   a. The confirmed supplier receivable must be sold, assigned or otherwise transferred in a manner that results in an absolute, irrevocable and legally enforceable obligation that has been confirmed by the Obligor.

   b. In the case of a participation, the certificates or other evidence of participation provide an absolute, irrevocable, and legally enforceable obligation of the finance agent or holder of the confirmed supplier receivable to pay to the reporting entity investor all of the amounts due to it under the confirmed supplier receivable, without reduction or delay arising from any claims that the finance agent may have against the reporting entity investor. The reporting entity investor’s ability to exercise its rights as creditor, or to direct the finance agent to exercise the rights of a creditor on its behalf, shall not be subject to the discretion
of the finance agent or other lenders or investors. The reporting entity investor’s ability to exercise its rights as creditor, or to direct the finance agent to exercise the rights of a creditor on its behalf, shall not be subject to, other than during a cure period not to exceed thirty days, the discretion of the finance agent or other lenders or investors.

Confirmation Process

12. In the case of a purchase, the investor shall verify, prior to the sale that the obligor has confirmed the respective amounts, payment dates and related invoice numbers’ specified dates and has waived all defenses to payment. In the case of a participation, the finance agent must verify that the obligor has confirmed the respective amounts, payment dates and related invoice reference numbers’ specified due dates, and has waived all defenses to payment in accordance with the confirmation process.

13. The obligor must commit and state that upon confirmation of a supplier receivable it is obligated to pay to the investor, the finance agent, or any third party acting as agent or trustee for the investor, a sum equal to the full amount of that confirmed supplier receivable(s) on a date certain stated in the confirmation and that it waives any right of setoff or other defenses to avoid or delay the full and timely payment of that Confirmed Supplier Receivable. The documents establishing the working capital finance program or the confirmation must state and confirm that the obligation to pay must be independent of any other contracts or claims that might be raised in defense arising from any transaction financed in connection with the WCFP/WCFI program, the confirmed supplier receivable, or any other courses of performance or courses of dealing with the supplier.

14. In the case of participation, the investor must certify that it has a commercially reasonable belief that its participation interest meets the Uniform Commercial Code’s standards for creating and preserving first priority security interests in the payments due and in the confirmed supplier receivables. Commercially reasonable belief shall mean the SVO deems the investor’s belief reasonable in light of the systems, policies, or practices commonly recognized in the field of investing in participations. The investor must be able to demonstrate to a regulator or to the SVO, upon either’s request, the basis for its commercially reasonable belief that the WCFP creates and preserves the investor’s ability to enforce a first priority perfected security interest in the confirmed supplier receivables.

15. In the case of a certificate, note, or other manifestation, capable of verification, representing a right to payment from a trust, other special purpose entity, or special purpose pool holding confirmed supplier receivables, the investor must certify that it has a commercially reasonable belief that the documents establishing and governing the working capital finance program create and preserve interests in the confirmed supplier receivables capable of being enforced by the trustee or other entity holding confirmed supplier receivables as first priority perfected security interests under the Uniform Commercial Code. The investor must be able to demonstrate the basis for such belief to a regulator or to the SVO upon either’s request. Commercially reasonable belief shall mean the SVO deems the investor’s belief reasonable in light of the systems, policies, and practices commonly recognized in the field of investing in securitizations, loan-backed, structured, or trust-issued securities.

Program Requirements

16. The working capital finance program investor must provide in its annual filing with the Securities Valuation Office an annual audit of the consolidated financial statements of which the finance agent is part, which does not report any qualifications related to servicing, and one of the following:

a. An annual independent report according to Statement on Standards for Attestation Engagements (SSAE) No. 16 (or functional equivalent), reporting on controls at a service organization related to the administration of the investment; or
b. An annual audit of the financial statements and internal controls of the consolidated group of which the finance agent is part, which does not note any material weaknesses related to servicing working capital financial investments.

The NAIC Securities Valuation Office would review the materiality of the report findings in making their determination of the assignment of a designation.

47.15 If the credit rating of the working capital finance program or obligor falls to non-investment grade (below the equivalent of NAIC designation “1” or “2”), the reporting entity shall nonadmit, the working capital finance investments obtained under the related working capital finance program and/or the related obligor. Due to the short-term nature of these investments, once an investment is nonadmitted due to the credit rating of the working capital finance program or the obligor, those investments will continue to be nonadmitted.

48.16 Reporting entity investors must have the ability to monitor the working capital finance program and the credit-related activities of the obligor. Reporting entity investors must provide information as requested to the state of domicile indicating that they have the ability to monitor on an ongoing basis the activities of the working capital finance program. Initial permission to invest in Working Capital Finance Investment Programs may be required by the domiciliary commissioner.

49.17 All contracts or agreements that are a part of or that together constitute a working capital finance program must provide that if a dispute arises among any of the parties under any of the contracts or agreements that are a part of or that together constitute the working capital finance program, each party agrees that the dispute will be submitted to a court of competent jurisdiction in the United States or a constituent state thereof or of an alternative dispute resolution process recognized thereby. All contracts or agreements that are a part of or that together constitute a working capital finance program must provide that any dispute arising under any of the contracts or agreements that are a part of or that together constitute the working capital finance program must be resolved pursuant to the laws of the United States or a constituent state thereof that address the substance of the dispute but excluding those laws addressing conflicts of law.

Exclusions

20.18 A working capital finance investment excludes any receivables financed through:

a. Factoring: the purchase of receivables in bulk from a supplier where the receivables represent the payment obligations of potentially thousands of buyers to a single supplier, in which the buyers have no relationship with or contractual obligation to pay the factor and retain all legal defenses to payment they may have against the supplier;

b. Forfaiting: the purchase of one or a series of receivables from exporters by a forfaiter to enable the exporter (seller) to finance a commercial transaction with a buyer in which the Obligor has no relationship with or contractual obligation to pay the forfaiter and retains all legal defenses to pay it may have against the seller; or

c. Invoice discounting: the advancement of funds by a finance company to a business entity with the funds advanced limited to a defined percentage of the business entity’s eligible and outstanding receivables.

21.19 Eligible Confirmed Supplier Receivables must not:

a. Include insurance or insurance related assets;

b. Be impaired or in default at the time of purchase;
Have a payment (maturity) date longer than one year from the date of the invoice from the Supplier to the Obligor giving rise to the confirmed supplier receivable, and the maturity date must not be subject to change or rolling; nor

Include any receivable of any parent or affiliate of the reporting entity investor, and neither the Obligor nor any Supplier may be affiliated with the reporting entity investor. Working Capital Finance Investments that have obligors or vendors that are affiliated with the investor are ineligible, and therefore, nonadmitted assets.

Accounting and Reporting

22.20. The right to receive payment generated by a working capital finance investment issued under a working capital finance program is considered to meet the definition of an asset as defined in SSAP No. 4—Assets and Nonadmitted Assets, and is an admitted asset to the extent the investment conforms to the requirements set forth in this Statement and the Purposes and Procedures Manual of the NAIC Investment Analysis Office. For programs that comply with all of these elements, working capital finance investments shall be valued and reported in accordance with this Statement, the Purposes and Procedures Manual of the NAIC Investment Analysis Office, and the designation assigned in the NAIC Valuations of Securities product. Programs that do not comply with the elements set forth in this Statement, or the provisions set forth in the Purposes and Procedures Manual of the NAIC Investment Analysis Office are nonadmitted. Working capital finance investments are reported as other invested assets in the financial statements.

23.21. A working capital finance investment shall be recorded on the trade date. At acquisition, the Working Capital Finance Investment shall be initially reported at cost, excluding brokerage and other related fees, and all other costs (internal costs, or costs paid for origination, purchase or commitment to purchase such investments), which shall be expensed as incurred.

24.22. After initial acquisition, the Working Capital Finance Investment shall be reported at amortized cost until the specified maturity date, unless the investment, or a portion thereof, is deemed uncollectible or when an other-than-temporary impairment has occurred. In the event that a working capital finance investment is purchased by a reporting entity investor at a premium (amount to be received by the entity under the confirmed supplier receivable is less than the price paid for the investment), the excess paid by the reporting entity investor in comparison to the amount receivable under the confirmed supplier receivable must be immediately expensed.

25.23. For reporting entities required to maintain an Interest Maintenance Reserve (IMR), the accounting for realized capital gains and losses from working capital finance investments shall be in accordance with SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve (SSAP No. 7). For reporting entities not required to maintain an IMR, realized gains and losses from working capital finance investments shall be reported as net realized capital gains or losses in the statement of income. 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).

26.24. A Working Capital Finance Investment may provide for a prepayment penalty or acceleration fee in the event the working capital finance investment is liquidated prior to its scheduled termination date. Such fees shall be reported as investment income when received.

27.25. SSAP No. 34—Investment Income Due and Accrued shall be followed for determining and recording investment income earned on working capital finance investments acquired at a discount. In accordance with SSAP No. 34—Investment Income Due and Accrued, investment income shall be reduced for amounts that have been determined to be uncollectible, however amounts more than 15 days overdue are nonadmitted.
Default

28.26. A working capital finance investment payment that is uncollected by the reporting entity within fifteen-thirty days after the due date shall be considered in default and nonadmitted. If the reporting entity has any other working capital finance investment assets from the same defaulting counterparty, all other working capital finance investments from that counterparty shall be nonadmitted. All working capital finance investments from a counterparty identified in default shall be evaluated for impairment.

Impairment

29.27. An other-than-temporary impairment(\textsuperscript{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 a confirmed supplier receivable including the payment on the established due date. Pursuant to this guidance, assessment of other-than-temporary impairment shall include an evaluation of the financial condition and short-term prospects of the obligor. If it is determined that a decline in the fair value of a working capital finance investment below book/adjusted carrying value is due to an other-than-temporary impairment, an impairment loss shall be recognized as a realized loss equal to the entire difference between the working capital finance investment’s carrying value and fair value as of the reporting period for which the assessment is made. Fair value shall be determined in accordance with SSAP No. 100—\textit{Fair Value} (SSAP No. 100R), and reflect the price to sell the asset in an orderly market between market participants. As such, the fair value shall reflect the assumptions market participants will use in pricing the asset, including assumptions about risk.

30.28. For reporting entities required to maintain an AVR/IMR, the entire amount of the realized loss from the other-than-temporary impairment shall be recorded through the AVR, in accordance with SSAP No. 7.

31.29. Upon recognition of an other-than-temporary impairment, the fair value of the working capital finance investment on the measurement date shall become the new cost basis of the working capital finance investment and the new cost basis shall not be adjusted for subsequent recoveries in fair value. Once an investment is determined to be other-than-temporarily impaired, until all expected payments are received, the reporting entity must re-evaluate the investment quarterly and reassess fair value, with recognized realized losses for the difference between the book/adjusted carrying value and the current fair value. This process shall continue until either all expected payments are received, or the entity has recognized a realized loss for the entire uncollected carrying value.

Disclosures

32.30. The financial statements shall include the following disclosures:

a. Fair value in accordance with SSAP No. 100R.

b. Concentrations of credit risk in accordance with SSAP No. 27—\textit{Off-Balance-Sheet and Credit Risk Disclosures} (SSAP No. 27) in the annual audited statutory financial reports only.

c. Information regarding the aggregate book/adjusted carrying value of working capital finance investment by designation including gross assets with nonadmitted and net admitted amounts annually. (Note that programs designated 3-6 are nonadmitted.)
### Working Capital Finance Investments

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**d.** Annual and quarterly information regarding the aggregate book/adjusted carrying value maturity distribution on the underlying working capital finance investments by the categories of maturities up to 180 days and 181 to 365 days.

**e.** Any events of default of working capital finance investments during the reporting period.

**33.31** Refer to the Preamble for further discussion regarding disclosure requirements.

### Effective Date and Transition

**34.32** This statement is effective for years on or after January 1, 2014. 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. Substantive revisions documented in IP No. 16X effective for financial reporting periods TBD.

### REFERENCES

#### Relevant Issue Papers

- Issue Paper No. 147—Working Capital Finance Investments
- Issue Paper No. 16X—Working Capital Finance Investments Updates

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Statutory Issue Paper No. 16X

Working Capital Finance Investment Updates

STATUS
Discussion Draft: March 2020

Original SSAP: 105; Current Authoritative Guidance: SSAP No. 105R

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. This issue paper introduces substantive revisions to SSAP No. 105—Working Capital Finance Investments to change some of the existing accounting and program requirements. This item is specific for Working Capital Finance investments (WCFI) which comply with the program requirements and have been designated by the NAIC Securities Valuation Office (SVO).

SUMMARY CONCLUSION

2. The substantive revisions to SSAP No. 105 (illustrated in Exhibit A), reflect the following elements:

   a. Functionally Equivalent Foreign Regulators – Removed the requirement that the SVO determine if the International Finance Agent is the functional equivalent of the U.S. Regulator.
   
   b. Commingling Prohibitions – Removed the finance agent prohibitions on commingling.
   
   c. Requirements for Filer to Certify First Priority Perfected Interest – Removed requirements, with revisions allowing the SVO to determine if first priority perfected interest has been obtained.
   
   d. Finance Agent Validation Requirements – The independent review requirements were broadened to allow independent review of the finance agent by either audit or through an internal control report.
   
   e. Default Date – Changed the default provisions from 15 to 30 days so the default date and the cure period are consistent. This has the effect of changing the date of nonadmission for an investment in default for a period up to 30 days instead of up to 15 days.
   
   f. Investor Rights Edit – Removed duplicative text regarding exercise of investor rights.

3. This issue paper provides historical information on the consideration of revisions for working capital finance program issuances acquired as investments, as well as some of the initially adopted guidance. SSAP No. 105 permits admittance of NAIC Securities Valuation Office designated WCFI programs that meet specific requirements.
Working Capital Finance Investments Overview

4. Bills receivable, in general, are an asset class that has been historically nonadmitted by statutory accounting. They were nonadmitted prior to codification and explicitly nonadmitted in SSAP No. 20—Nonadmitted Assets.

5. When SSAP No. 105 was developed, SSAP No. 20 was amended to allow working capital finance investments as admitted assets to the extent they conform to the requirements of SSAP No. 105 (see Relevant Statutory Accounting). Some of the WCFI program requirements are to provide protections that help to distinguish these programs from factoring, forfaiting, invoice discounting and other similar programs which have been historically nonadmitted in SSAP No. 20. SSAP No. 105 details that eligible confirmed supplier receivables must not: include insurance or insurance related assets; be impaired or in default at the time of purchase; or have a maturity longer than one year from the date of invoice. In addition, there are restrictions that preclude admission of affiliated WCFI investments.

6. SSAP No. 105 provides that working capital finance investments represent a confirmed short-term obligation to pay a specified amount owed by one party (the obligor) to another (typically a supplier of goods), generated as a part of a working capital finance investment program currently designated by the NAIC Securities Valuation Office (SVO). Pursuant to the long-term working capital finance investment program, a short-term obligation has been transferred by the entity entitled to payment (typically a supplier of goods) to a third-party investor.

7. Working capital finance investments held by a reporting entity represent a right for the reporting entity to receive future payments. This issue paper provides details on the updates to the SSAP No. 105 accounting and reporting guidelines for the right to receive payment under working capital finance programs that meet particular criteria.

Background

8. SSAP No. 105 requires an SVO program designation of NAIC 1 or NAIC 2 (See definitions in relevant statutory accounting) in order to admit working capital finance investments. This was an intentional choice by the Working Group and the Valuation of Securities (E) Task Force during the initial development of guidance in 2012 to limit the admissibility to high quality programs and obligors. High quality programs in existence at the time of the original development of SSAP No. 105 and the some of the requirements of these programs which were administered by larger banks were reviewed.

9. During the original development of SSAP No. 105, the single group reporting entities that had been successfully investing in these types of assets for a number of years, agreed that a high level of investor sophistication to enter and monitor the transactions is required. Also during the original development of SSAP No. 105, some regulators expressed concerns regarding the ability of smaller entities to monitor the investments in such programs on an ongoing basis. That concern was the basis of the recommendation reflected in the original Issue Paper No. 147 presented to the Working Group to note that such investments which do not fit into traditional categories, may require department of insurance approval.

10. When SSAP No. 105 was developed, the Capital Adequacy (E) Task Force also determined a capital charge for the receivables which varied based on the NAIC designations on the new Schedule BA reporting lines which were developed for these investments.

11. The subsequent industry 2019 proposal developed under discussion by the Working Group proposed to move the investments to Schedule DA — Short-term Investments. During the subsequent review, the Working Group indicated a preference to maintain the long-term programs on annual statement

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1 All references to short-term obligations in this issue paper refer to obligations not exceeding one year.
BA where lines and columns would allow proper reporting of the risk-based capital charge. While the program issuances are limited to short-term investments, the long-term program which continually has new balances is what receives the designation.

DISCUSSION

Development of Statutory Accounting Guidance

12. SSAP No. 105 was originally effective in 2014 and was controversial as it was developed at the request of a single life entity. At that time, some Working Group members objected to the development of a new SSAP, reporting changes and specific asset class risk-based capital (RBC) charges at the behest of a single company. The discussion at that time noted that the permitted practice concept was intended to address such situations.

13. In 2018, the reporting entity that participates in these programs requested modifications to the adopted program and submitted a proposal for consideration.

14. As of year-end 2018, WCFI reported in the annual statement Schedule BA - Other Invested Assets was limited to the same life entity that originally requested the development of SSAP No. 105. This company reported a total of $258 million in a total of seven WCFI programs for 2017 and $224 million in a total of six WCFI programs for 2018. The total of these amounts is immaterial to the reporting entity. No reporting entities disclosed any prescribed or permitted practices varying from SSAP No. 105 in annual statement Note 1 for 2017 or 2018.

15. The Valuation of Securities (E) Task Force exposed the industry proposal and held discussion on in the third quarter of 2018. The Task Force approved referral to the Statutory Accounting Principles (E) Working Group, which was also supported by the life industry at the 2019 Spring National Meeting. The referral was also forwarded to the Working Group with Valuation of Securities (E) Task Force Memos.

16. The industry proposed ten revisions to SSAP No. 105 affecting the following key aspects:
   a. Changes to program and or obligor credit quality requirements
   b. Changes to program administration and/or documentation
   c. Changes to regulatory compliance requirements
   d. Changes to statutory reporting requirements.

17. On August 3, 2019, the Working Group received the referral from the Task Force and directed NAIC staff to proceed with drafting revisions for subsequent exposure using six of the ten industry recommendations.

Review of Items Not Supported by the Working Group:

18. During the August 2019 discussion the following four industry proposed revisions were presented, but not captured in the direction for revisions to SSAP No. 105.
   a. Possible Domestic Regulator Approval – The statement that the reporting entity may need to seek approval from the domestic regulator was maintained.
   b. Only High-Quality Obligors – The current requirement which restricts designations of programs and obligors to being of high quality (NAIC 1 or NAIC 2) was maintained.
c. Unrated subsidiaries / Credit substitution - The industry proposed credit substitution methodology for unrated subsidiaries was not incorporated in the exposed revisions. The industry proposal had two aspects:

i. Credit substitution for unrated subsidiary obligors of a rated obligor – Industry proposed to attribute the credit strength of the rated parent to the unrated subsidiary obligor without the rated parent being a guarantor of the unrated subsidiary’s WCFI obligations. This aspect envisions the rated entity having some of its own obligations in the program

ii. Credit Substitution of rated obligor for its unrated subsidiaries which are key transaction participants, but not obligors. The industry proposal was to create criteria to allow the “program” to obtain an acceptable NAIC designation by evaluating if the unrated “key transaction participant” is able to perform its functions. Industry proposed several different ways to attribute the rated entity’s credit rating to the unrated entity including:

(a) Documented operational control of unrated obligor, or

(b) An important inter-relationship with unrated obligor, or

(c) If the unrated key transaction participants are reasonably expected to perform their functions.

d. Change Reporting Schedule - The Working Group did not change the reporting requirements to move the WCFI investments from Schedule BA – Other Assets, to Schedule DA – Short term Investments.

19. Some of the discussion points that were discussed which resulted in the Working Group not directing the inclusion of four of the industry proposed revisions were as follows:

a. Possible Domestic Regulator Approval – The statement that the reporting entity may need to seek approval from the domestic regulator was maintained as previously noted in Issue Paper No. 147. The Issue Paper documents the possible requirement for domestic regulator approval was an intentional decision because of concerns regarding the ability of smaller entities to monitor the investments in such programs on an ongoing basis.

i. It was also noted that the current guidance in SSAP No. 105 is not an explicit requirement, but only identifies that a domiciliary commissioner may require a company to receive initial permission.

ii. The agenda item noted that the industry proposal noted:

(a) that these investments may not fit into the normal investment law categories.

(b) the asset class is not for most insurers as it requires relationships with finance agents beyond the traditional dealer insurer.

(c) the investor needs specialized knowledge, asset management operations and the ability to book and supervise the assets.
(d) the filing fees require sizable commitments to justify the costs, which would make it cost prohibitive for smaller players.

iii. As a counterpoint to the decision not to change the guidance in the SSAP No. 105, the Fall 2019 industry comments noted that state approval is not a practical risk mitigant. In addition, the speaker present at the meeting commented that he questioned the evaluation criteria that would be used by a state.

b. Only High-Quality Obligors – The current requirement which restricts designations of programs and obligors to being of high quality was maintained. The Working Group was not in favor of lowering the credit quality of the acceptable obligors from NAIC 1 (highest quality) and NAIC 2 (high quality) to allow NAIC designations of 3 (medium quality) and NAIC 4 (low quality) (See definitions in relevant statutory accounting).

i. The descriptions of NAIC designations in the Purposes and Procedures Manual of the Investment Analysis Office note that both NAIC designations of 3 and 4 have speculative elements.

ii. Assets that reflect “factored receivables” are nonadmitted in statutory accounting. This program is the sole exception to the factored receivable rule. By lowering the allowable credit standards, an expanded class of factored receivables would be admitted, further deviating from statutory accounting concepts.

iii. The SAPWG created SSAP No. 105 to allow admission for only high-quality programs, from high quality obligors. Allowing obligors with lower credit assessments would be a fundamental change in program requirements.

c. Unrated subsidiaries / Credit substitution – The industry proposed credit substitution methodology for unrated subsidiaries was not incorporated in the exposed revisions. The industry proposal was noted in the discussion as complex, broad and difficult to apply. Further, credit substitution does not adequately address credit risk for an unrated affiliate. SVO staff memos also highlighted the difficulty in applying the industry proposed credit substitution methodology. Excerpts from the Valuation of Securities (E) Task Force October 2018 memo to the Working Group note the following:

SVO evaluated whether analytical discretion would enable it to designate WCFI programs with unrated obligors of a rated or designated parent. SVO evaluated whether operational and strategic linkages between a rated parent and unrated obligor can provide a basis to attribute the credit rating of one entity to the other. It concluded that no principle exists to permit an assumption that a legal entity can be held responsible for the debt of another without having contractually agreed to do so. While WCFI arrangements may be inherently different than the credit situations SVO assesses SVO lacks the experiential basis to opine on the idea that the difference permits attribution.

d. Change Reporting Schedule – The Working Group did not change the reporting requirements to move the WCFI investments from Schedule BA – Other Assets, to Schedule DA – Short term Investments. Key points noted were:

i. Reporting on Schedule BA was intentional because the long-term programs are designated, even though the different investments are short-term. Issue Paper No. 147, documents the VOSTF recommendation for Schedule BA reporting. The Task Force discussed the relative benefits between Schedule BA and DA and concluded that WCFIs should be reported as Other Invested Assets and that Schedule BA
provides an enhanced disclosure framework deemed more appropriate for the investment.

ii. Annual statement lines and RBC charges have already been established on Schedule BA.

iii. Capital Adequacy (E) Task Force reviewed the asset class and requires specific designations (relatively low - just slightly higher than a bond of similar credit risk). RBC charges are based on the NAIC SVO WCFI program designation. The current RBC charges based on program designation would not be functional if the reporting was moved to Schedule DA, because that schedule does not include designations which are needed for RBC.

Review of Items Proposed for Inclusion in SSAP No. 105:

20. On December 7, 2019, the Working Group exposed substantive revisions to SSAP No. 105 to incorporate industry revisions to program requirements, as previously directed by the Working Group during the 2019 Summer National Meeting.

21. The substantive revisions to SSAP No. 105 that were exposed for comment reflected the following elements:

a. Functionally Equivalent Foreign Regulators - Removed the requirement that the SVO determine if the International Finance Agent is the functional equivalent of the U.S. Regulator. Removing this element was supported by the SVO, which noted that determining functional equivalence is not an analytical issue.

b. Commingling Prohibitions - Removed the finance agent prohibitions on commingling. Removal of this requirement was supported by the SVO. SVO staff noted if commingling were not a requirement it would consider commingling risk, when present, as a structural deficiency and balance it against the requirement that the Finance Agent be NAIC 1 or NAIC 2.

c. Investor Rights Edit - Removed duplicative text regarding exercise of investor rights. This revision was to improve readability and eliminate redundancy.

d. Requirements for filer to Certify Perfected Interest – Removed requirements, with revisions allowing the SVO to determine if a first priority perfected interest in accordance with uniform commercial code (UCC) requirements for each annual submission has been obtained. In deciding to make this revision the following key points were deemed relevant:

i. It was noted that the SVO staff has indicated that UCC first priority perfected interest criteria are typically determined when contracting a program and similar objectives can be accomplished in more ways than the UCC lien process. Requiring the UCC lien process was viewed as overly prescriptive.

ii. The definition in SSAP No. 105 of a confirmed supplier receivable requires a first priority perfected interest and, SVO analytical staff should be able to determine if first priority interest has been achieved.

e. Finance Agent Validation Requirements – The independent review requirements were broadened to allow independent review of the finance agent by either audit or through one
of two types of internal control report. This is a lower threshold, than the existing requirements, but one that still provides some type of independent program review.

f. Default Date - Changed the default provisions from 15 to 30 days so the default date and the cure period are consistent. This has the effect of changing the date of nonadmission for an investment in default for a period up to 30 days instead of up to 15 days. Key discussion points are:

i. Waiting 30 days for a short-term asset can be material in relation to the life of the asset.

ii. Fifteen (15) days was previously chosen to be consistent with settlement guidance in SSAP No. 21—Other Admitted Assets, which nonadmits and reclassifies receivables for securities not settled within 15 days.

iii. The “cure period” on confirmed supplier receivables is not to exceed 30 days, therefore, the Working Group agreed that it may make sense for the default date and the end of the cure period to be consistent.

22. At the 2020 Spring National Meeting, the Working Group reviewed the issue paper and the January 2020 comments on the exposed item. Comments received from industry advocated for inclusion of the four items that the Working Group opted to exclude from the additional revisions to the revised Statement. Key elements noted in the industry comments included the following:

a. Absent all 10 of the industry proposed revisions, investments in working capital finance programs will remain low.

b. Industry advocated that its proposed credit substitution mechanism to allow unrated subsidiaries was suitable for NAIC implementation to allow not only lower rated subsidiaries but also un-rated subsidiaries. The commenters maintained that the absence of mention of non-rated subsidiaries as acceptable obligors, did not preclude them from allowing unrated obligors. However, the current SSAP No. 105 program requirements explicitly require obligors to be of high credit quality,

c. The industry comments advocated that lower rated investments should be allowed as the as statutory risk-based capital requirements reflect investment quality decisions in capital calculations.

d. The industry comments advocated that domiciliary regulator prior approval for investment is a transfer of transaction review from staff to state insurance departments. The commenters noted that when, if regulators are concerned about the asset class, they can uniformly limit investment as a whole. Given the high costs to a small industry investor, coupled with the fact that dealers would unlikely choose to document such investments bilaterally with small industry investors, already limits access to the assets to large industry investors.

e. The industry commented that Schedule BA reporting is both cumbersome and expensive and in the view of the industry commenters, the more appropriate schedule would be Schedule DA.

23. During the 2020 Spring National Meeting, after considering the interested parties’ comments, the Working Group adopted the exposed revisions to SSAP No.105, incorporating explicit guidance for the
accounting and reporting of structured settlements. As part of the adoption action, the Working Group identified the revisions as a substantive change, and designated an effective date for the revisions of TBD. In addition, this Issue Paper was exposed for comment.

RELEVANT STATUTORY ACCOUNTING


25. SSAP No. 20—Nonadmitted Assets was amended by SSAP No. 105 to allow working capital finance investments as admitted assets to the extent they conform to the requirements of SSAP No. 105.

4. Consistent with paragraph 2, the following assets shall be nonadmitted:

a. Deposits in Suspended Depositories—Amounts on deposit with suspended depositories may not be fully recoverable. Any amounts not reasonably expected to be recovered shall be written off in accordance with SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets (SSAP No. 5R). Amounts in excess of that written off shall be nonadmitted as they are not available to satisfy obligations to policyholders;

b. Bills Receivable Not for Premium and Loans Unsecured or Secured by Assets That Do Not Qualify As Investments—In accordance with SSAP No. 5R, amounts determined to be uncollectible or otherwise impaired shall be written off. Amounts in excess of that written off are not considered to be properly collateralized as there are no underlying assets which would otherwise be admitted assets. Such amounts shall be nonadmitted as they may be of questionable economic value if needed to fulfill policyholder obligations. Receivables arising from working capital finance programs designated by the Securities Valuation Office are subject to the guidance in SSAP No. 105;

(Rest of paragraph omitted for brevity)

26. Purposes and Procedures Manual of the NAIC Investment Analysis Office provides the following on NAIC Designations:

a. NAIC 1 is assigned to obligations exhibiting the highest quality. Credit risk is at its lowest and the issuer’s credit profile is stable. This means that interest, principal or both will be paid in accordance with the contractual agreement and that repayment of principal is well protected. An NAIC 1 obligation should be eligible for the most favorable treatment provided under the NAIC Financial Regulation Standards and Accreditation Program.

b. NAIC 2 is assigned to obligations of high quality. Credit risk is low but may increase in the intermediate future and the issuer’s credit profile is reasonably stable. This means that for the present, the obligation’s protective elements suggest a high likelihood that interest, principal or both will be paid in accordance with the contractual agreement, but there are suggestions that an adverse change in circumstances or economic, financial or business conditions will affect the degree of protection and lead to a weakened capacity to pay. An NAIC 2 obligation should be eligible for relatively favorable treatment under the NAIC Financial Regulation Standards and Accreditation Program.

c. NAIC 3 is assigned to obligations of medium quality. Credit risk is intermediate and the issuer’s credit profile has elements of instability. These obligations exhibit speculative elements. This means that the likelihood that interest, principal or both will be paid in accordance with the contractual agreement is reasonable for the present, but an exposure to an adverse change in circumstances or economic, financial or business conditions would create an uncertainty about the issuer’s capacity to make timely payments. An NAIC 3 obligation should be eligible for less favorable treatment under the NAIC Financial Regulation Standards and Accreditation Program.
d. NAIC 4 is assigned to obligations of low quality. Credit risk is high and the issuer’s credit profile is volatile. These obligations are highly speculative, but currently the issuer has the capacity to meet its obligations. This means that the likelihood that interest, principal or both will be paid in accordance with the contractual agreement is low and that an adverse change in circumstances or business, financial or economic conditions would accelerate credit risk, leading to a significant impairment in the issuer’s capacity to make timely payments. An NAIC 4 obligation should be accorded stringent treatment under the NAIC Financial Regulation Standards and Accreditation Program.

Effective Date

27. 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. 105 during the TBD National Meeting.

Note: These substantive revisions to SSAP No. 105 were adopted during the TBD National Meeting with an effective date of TBD. This issue paper has been prepared for historical documentation.

Statement of Statutory Accounting Principles No. 105

Working Capital Finance Investments

SCOPE OF STATEMENT

1. This statement establishes statutory accounting principles for working capital finance investments held by reporting entities. This statement amends SSAP No. 20—Nonadmitted Assets (SSAP No. 20) to allow working capital finance investments as admitted assets to the extent they conform to the requirements of this statement.

SUMMARY CONCLUSION

2. Working capital finance investments represent a confirmed short-term obligation to pay a specified amount owed by one party (the obligor) to another (typically a supplier of goods), generated as a part of a working capital finance investment program currently designated by the NAIC Securities Valuation Office. Pursuant to the working capital finance investment program, this short-term obligation has been transferred by the entity entitled to payment (typically a supplier of goods) to a third-party investor.

3. Working capital finance investments held by a reporting entity represent a right of the reporting entity to receive future payment. This Statement provides accounting and reporting guidelines for the right to receive payment under working capital finance programs that meet particular criteria.

Working Capital Finance Program - Definitions and Conditions

4. A “working capital finance program” is an open account program under which an investor may purchase interests, or evidence thereof, in commercial non-insurance receivables. A working capital finance program is created for the benefit of a commercial investment-grade obligor and its suppliers of goods or services, and facilitated by a finance agent.

5. A working capital finance program transfers a right to payment to an investor from a short term obligation and arises from transactions among:
   a. a buyer of goods or services that becomes an obligor to the supplier of goods or services,
   b. the supplier(s) of those goods or services,
   c. a finance agent, and
   d. an investor.

1 All references to short-term obligations in this statement to refer to obligations not exceeding one year.
A “working capital finance investment” is an interest in payment(s) from a confirmed supplier receivable issued pursuant to a working capital finance program. The payment (maturity) date must not exceed one year from the date of invoice from the supplier to the obligor. This investment is created when the investor purchases from a working capital finance program that is currently designated as NAIC “1” or “2” by the NAIC Securities Valuation Office, any of the following:

a. One or more confirmed supplier receivables;

b. in case of a participation, a participation interest in one or more confirmed supplier receivables issued by the finance agent or lead lender holding confirmed supplier receivables; or

c. a certificate, note or other interest manifestation, documented in a way that is verifiable by regulators, representing a legally enforceable interest in a right to payment either directly to the investor or from a trust, other special purpose entity or pool holding confirmed supplier receivables.

“Obligor” is the party that purchases the goods or services that generates the original supplier receivable (and which is the payable for that the Obligor). The obligor must be a single entity, which has have an NAIC designation of “1” or “2” or a Credit Rating Provider equivalent. The obligor must confirm the supplier receivable described in paragraph 11 as described in the confirmation process in paragraphs 12-1344.

“Supplier” is the party that sells the goods or services to the obligor. The supplier sells the confirmed supplier receivable in accordance with the terms of the working capital finance program designated by the NAIC Securities Valuation Office at a price agreed to by the finance agent and/or investor.

“Investor” is the party purchasing a working capital finance investment in accordance with the terms of the working capital finance program designated by the NAIC Securities Valuation Office.

The “finance agent” is a bank, financial institution, other financial intermediary, or service provider that facilitates the working capital finance program, arranges the sale, assignment or transfer of the confirmed supplier receivable to the investor for a fee and administers the payment mechanism. In the case of participation, the finance agent must inform the reporting entity investor of a default or event of default as soon as it becomes aware of such default or event of default. For the working capital finance program to qualify under this SSAP, the finance agent must meet the requirements of either paragraph 10.a. or 10.b.:

a. The finance agent is directly regulated by, or falls under the supervision of, a financial regulator of its domiciliary country provided that such country appears on the Purposes and Procedures Manual of the NAIC Investment Analysis Office List of Jurisdictions Eligible for Netting and that the Securities Valuation Office determines that the regulator is the functional equivalent of the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, or the Federal Deposit Insurance Corporation; or

b. Payments from the obligor must be paid directly to the reporting entity (investor) or into an account maintained by a regulated financial institution for the benefit of investors in the working capital finance program and, in either case, cannot flow through the finance agent cannot be the beneficiary of such payment and 2) there can be no commingling of payments or assets with those of the obligor, supplier, servicer or trust administrator or other investors.
11. A “confirmed supplier receivable” is a first priority perfected security interest or right to payment of a monetary obligation from the obligor arising from the sale of goods or services from the supplier to the obligor, the payment of which has been confirmed by the obligor committing and stating that the obligations under the agreement and any payment shall not be affected by the invalidity, unenforceability, existence, performance or non-performance of the underlying commercial trade transaction or any related contract or undertaking nor that it will not protest, delay, or deny, nor offer nor assert any defenses, personal or otherwise, against payment to the supplier or any party taking claims, interests, or rights to payments made by the supplier.

   a. The confirmed supplier receivable must be sold, assigned or otherwise transferred in a manner that results in an absolute, irrevocable and legally enforceable obligation that has been confirmed by the Obligor.

   b. In the case of a participation, the certificates or other evidence of participation provide an absolute, irrevocable, and legally enforceable obligation of the finance agent or holder of the confirmed supplier receivable to pay to the reporting entity investor all of the amounts due to it under the confirmed supplier receivable, without reduction or delay arising from any claims that the finance agent may have against the reporting entity investor. The reporting entity investor’s ability to exercise its rights as creditor, or to direct the finance agent to exercise the rights of a creditor on its behalf, shall not be subject to the discretion of the finance agent or other lenders or investors. The reporting entity investor’s ability to exercise its rights as creditor, or to direct the finance agent to exercise the rights of a creditor on its behalf, shall not be subject to, other than during a cure period not to exceed thirty days, the discretion of the finance agent or other lenders or investors.

Confirmation Process

12. In the case of a purchase, the investor shall verify, prior to the sale that the obligor has confirmed the respective amounts, payment dates and related invoice numbers’ specified dates and has waived all defenses to payment. In the case of a participation, the finance agent must verify that the obligor has confirmed the respective amounts, payment dates and related invoice reference numbers’ specified due dates, and has waived all defenses to payment in accordance with the confirmation process.

13. The obligor must commit and state that upon confirmation of a supplier receivable it is obligated to pay to the investor, the finance agent, or any third party acting as agent or trustee for the investor, a sum equal to the full amount of that confirmed supplier receivable(s) on a date certain stated in the confirmation and that it waives any right of setoff or other defenses to avoid or delay the full and timely payment of that Confirmed Supplier Receivable. The documents establishing the working capital finance program or the confirmation must state and confirm that the obligation to pay must be independent of any other contracts or claims that might be raised in defense arising from any transaction financed in connection with the WCFP/WCFI program, the confirmed supplier receivable, or any other courses of performance or courses of dealing with the supplier.

14. In the case of participation, the investor must certify that it has a commercially reasonable belief that its participation interest meets the Uniform Commercial Code’s standards for creating and preserving first priority security interests in the payments due and in the confirmed supplier receivables. Commercially reasonable belief shall mean the SVO deems the investor’s belief reasonable in light of the systems, policies, or practices commonly recognized in the field of investing in participations. The investor must be able to demonstrate to a regulator or to the SVO, upon either’s request, the basis for its commercially reasonable belief that the WCFP creates and preserves the investor’s ability to enforce a first priority perfected security interest in the confirmed supplier receivables.
15. In the case of a certificate, note, or other manifestation, capable of verification, representing a right to payment from a trust, other special purpose entity, or special purpose pool holding confirmed supplier receivables, the investor must certify that it has a commercially reasonable belief that the documents establishing and governing the working capital finance program create and preserve interests in the confirmed supplier receivables capable of being enforced by the trustee or other entity holding confirmed supplier receivables as first priority perfected security interests under the Uniform Commercial Code. The investor must be able to demonstrate the basis for such belief to a regulator or to the SVO upon either’s request. Commercially reasonable belief shall mean the SVO deems the investor’s belief reasonable in light of the systems, policies, and practices commonly recognized in the field of investing in securitizations, loan backed, structured, or trust issued securities.

Program Requirements

16.14. The working capital finance program investor must provide in its annual filing with the Securities Valuation Office an annual audit of the consolidated financial statements of which the finance agent is part, which does not report any qualifications related to servicing, and one of the following:

a. An annual independent report according to Statement on Standards for Attestation Engagements (SSAE) No. 16 (or functional equivalent), reporting on controls at a service organization related to the administration of the investment; or

b. An annual audit of the financial statements and internal controls of the consolidated group of which the finance agent is part, which does not note any material weaknesses related to servicing working capital financial investments.

The NAIC Securities Valuation Office would review the materiality of the report findings in making their determination of the assignment of a designation.

17.15. If the credit rating of the working capital finance program or obligor falls to non-investment grade (below the equivalent of NAIC designation “1” or “2”), the reporting entity shall nonadmit, the working capital finance investments obtained under the related working capital finance program and/or the related obligor. Due to the short-term nature of these investments, once an investment is nonadmitted due to the credit rating of the working capital finance program or the obligor, those investments will continue to be nonadmitted.

18.16. Reporting entity investors must have the ability to monitor the working capital finance program and the credit-related activities of the obligor. Reporting entity investors must provide information as requested to the state of domicile indicating that they have the ability to monitor on an ongoing basis the activities of the working capital finance program. Initial permission to invest in Working Capital Finance Investment Programs may be required by the domiciliary commissioner.

19.17. All contracts or agreements that are a part of or that together constitute a working capital finance program must provide that if a dispute arises among any of the parties under any of the contracts or agreements that are a part of or that together constitute the working capital finance program, each party agrees that the dispute will be submitted to a court of competent jurisdiction in the United States or a constituent state thereof or of an alternative dispute resolution process recognized thereby. All contracts or agreements that are a part of or that together constitute a working capital finance program must provide that any dispute arising under any of the contracts or agreements that are a part of or that together constitute the working capital finance program must be resolved pursuant to the laws of the United States or a constituent state thereof that address the substance of the dispute but excluding those laws addressing conflicts of law.
Exclusions

20.18 A working capital finance investment excludes any receivables financed through:

a. Factoring: the purchase of receivables in bulk from a supplier where the receivables represent the payment obligations of potentially thousands of buyers to a single supplier, in which the buyers have no relationship with or contractual obligation to pay the factor and retain all legal defenses to payment they may have against the supplier;

b. Forfaiting: the purchase of one or a series of receivables from exporters by a forfaiter to enable the exporter (seller) to finance a commercial transaction with a buyer in which the Obligor has no relationship with or contractual obligation to pay the forfaiter and retains all legal defenses to pay it may have against the seller; or

c. Invoice discounting: the advancement of funds by a finance company to a business entity with the funds advanced limited to a defined percentage of the business entity’s eligible and outstanding receivables.

21.19 Eligible Confirmed Supplier Receivables must not:

a. Include insurance or insurance related assets;

b. Be impaired or in default at the time of purchase;

c. Have a payment (maturity) date longer than one year from the date of the invoice from the Supplier to the Obligor giving rise to the confirmed supplier receivable, and the maturity date must not be subject to change or rolling; nor

d. Include any receivable of any parent or affiliate of the reporting entity investor, and neither the Obligor nor any Supplier may be affiliated with the reporting entity investor. Working Capital Finance Investments that have obligors or vendors that are affiliated with the investor are ineligible, and therefore, nonadmitted assets.

Accounting and Reporting

22-20 The right to receive payment generated by a working capital finance investment issued under a working capital finance program is considered to meet the definition of an asset as defined in SSAP No. 4—Assets and Nonadmitted Assets, and is an admitted asset to the extent the investment conforms to the requirements set forth in this Statement and the Purposes and Procedures Manual of the NAIC Investment Analysis Office. For programs that comply with all of these elements, working capital finance investments shall be valued and reported in accordance with this Statement, the Purposes and Procedures Manual of the NAIC Investment Analysis Office, and the designation assigned in the NAIC Valuations of Securities product. Programs that do not comply with the elements set forth in this Statement, or the provisions set forth in the Purposes and Procedures Manual of the NAIC Investment Analysis Office are nonadmitted. Working capital finance investments are reported as other invested assets in the financial statements.

23-21 A working capital finance investment shall be recorded on the trade date. At acquisition, the Working Capital Finance Investment shall be initially reported at cost, excluding brokerage and other related fees, and all other costs (internal costs, or costs paid for origination, purchase or commitment to purchase such investments), which shall be expensed as incurred.
24.22. After initial acquisition, the Working Capital Finance Investment shall be reported at amortized cost until the specified maturity date, unless the investment, or a portion thereof, is deemed uncollectible or when an other-than-temporary impairment has occurred. In the event that a working capital finance investment is purchased by a reporting entity investor at a premium (amount to be received by the entity under the confirmed supplier receivable is less than the price paid for the investment), the excess paid by the reporting entity investor in comparison to the amount receivable under the confirmed supplier receivable must be immediately expensed.

25.23. For reporting entities required to maintain an Interest Maintenance Reserve (IMR), the accounting for realized capital gains and losses from working capital finance investments shall be in accordance with SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve (SSAP No. 7). For reporting entities not required to maintain an IMR, realized gains and losses from working capital finance investments shall be reported as net realized capital gains or losses in the statement of income. 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).

26.24. A Working Capital Finance Investment may provide for a prepayment penalty or acceleration fee in the event the working capital finance investment is liquidated prior to its scheduled termination date. Such fees shall be reported as investment income when received.

27.25. SSAP No. 34—Investment Income Due and Accrued shall be followed for determining and recording investment income earned on working capital finance investments acquired at a discount. In accordance with SSAP No. 34—Investment Income Due and Accrued, investment income shall be reduced for amounts that have been determined to be uncollectible, however amounts more than 15 days overdue are nonadmitted.

Default

28.26. A working capital finance investment payment that is uncollected by the reporting entity within fifteen-thirty days after the due date shall be considered in default and nonadmitted. If the reporting entity has any other working capital finance investment assets from the same defaulting counterparty, all other working capital finance investments from that counterparty shall be nonadmitted. All working capital finance investments from a counterparty identified in default shall be evaluated for impairment.

Impairment

29.27. 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 a confirmed supplier receivable including the payment on the established due date. Pursuant to this guidance, assessment of other-than-temporary impairment shall include an evaluation of the financial condition and short-term prospects of the obligor. If it is determined that a decline in the fair value of a working capital finance investment below book/adjusted carrying value is due to an other-than-temporary impairment, an impairment loss shall be recognized as a realized loss equal to the entire difference between the working capital finance investment’s carrying value and fair value as of the reporting period for which the assessment is made. Fair value shall be determined in accordance with SSAP No. 100R—Fair Value (SSAP No. 100R), and reflect the price to sell the asset in an orderly market between market participants. As such, the fair value shall reflect the assumptions market participants will use in pricing the asset, including assumptions about risk.

30.28. For reporting entities required to maintain an AVR/IMR, the entire amount of the realized loss from the other-than-temporary impairment shall be recorded through the AVR, in accordance with SSAP No. 7.
31.29 Upon recognition of an other-than-temporary impairment, the fair value of the working capital finance investment on the measurement date shall become the new cost basis of the working capital finance investment and the new cost basis shall not be adjusted for subsequent recoveries in fair value. Once an investment is determined to be other-than-temporarily impaired, until all expected payments are received, the reporting entity must re-evaluate the investment quarterly and reassess fair value, with recognized realized losses for the difference between the book/adjusted carrying value and the current fair value. This process shall continue until either all expected payments are received, or the entity has recognized a realized loss for the entire uncollected carrying value.

Disclosures

32.30 The financial statements shall include the following disclosures:

a. Fair value in accordance with SSAP No. 100R.

b. Concentrations of credit risk in accordance with SSAP No. 27—Off-Balance-Sheet and Credit Risk Disclosures (SSAP No. 27) in the annual audited statutory financial reports only.

c. Information regarding the aggregate book/adjusted carrying value of working capital finance investment by designation including gross assets with nonadmitted and net admitted amounts annually. (Note that programs designated 3-6 are nonadmitted.)

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<th>WCFI Designation</th>
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d. Annual and quarterly information regarding the aggregate book/adjusted carrying value maturity distribution on the underlying working capital finance investments by the categories of maturities up to 180 days and 181 to 365 days.

e. Any events of default of working capital finance investments during the reporting period.

33.31 Refer to the Preamble for further discussion regarding disclosure requirements.

Effective Date and Transition

32 This statement is effective for years on or after January 1, 2014. 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. Substantive revisions documented in IP No. 16X effective for financial reporting periods TBD.
• Issue Paper No. 147—Working Capital Finance Investments
• Issue Paper No. 16X—Working Capital Finance Investments Updates

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

Issue: SSAP No. 25 – Disclosures

Check (applicable entity):

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Description of Issue:
This agenda item has been drafted to data-capture disclosures from SSAP No. 25—Affiliates and Other Related Parties. Currently, all disclosures from SSAP No. 25 are completed in a narrative (pdf) format. With the proposal to data-capture disclosures, the regulators can aggregate and query related party relationships.

This item is separate from an agenda item (Ref #2019-34) that is considering revisions to SSAP No. 25 to clarify the identification of related parties and consider enhanced disclosures for when there is a disclaimer of control approved by a domiciliary state and when a company outside of the holding company group owns more than 10% of the insurance reporting entity. This agenda item will follow a separate work stream to allow for year-end 2020 data capturing. If the revisions being considered under the separate agenda item are adopted by June 2020 (blanks deadline), then those disclosures may modify or expand the data templates proposed in this agenda item.

Existing Authoritative Literature:
(Note: The entire SSAP No. 25 has been included for ease of reference of existing guidance.)

SSAP No. 25—Affiliates and Other Related Parties

1. Related party transactions are subject to abuse because reporting entities may be induced to enter transactions that may not reflect economic realities or may not be fair and reasonable to the reporting entity or its policyholders. As such, related party transactions require specialized accounting rules and increased regulatory scrutiny. This statement establishes statutory accounting principles and disclosure requirements for related party transactions.

2. This statement shall be followed for all related party transactions, even if the transaction is also governed by other statutory accounting principles. Furthermore, this statement shall be followed in all transactions which involve unrelated parties as intermediaries between related parties. In determining whether a transaction is a related party transaction, consideration shall be given to the substance of the agreement and the parties whose actions or performance materially impact the insurance reporting entity under the transaction. For example, an investment acquired from a non-related intermediary in which the investment return is predominantly contingent on the performance of a related party shall be considered a related party investment. As a general principle, it is erroneous to conclude that the mere inclusion of a non-related intermediary eliminates the requirement to assess and properly identify the related party transaction in accordance with the provisions of this statement. It is also erroneous to conclude that the presence of non-related assets in a structure predominantly comprised of related party investments eliminates the requirement to assess and identify the investment transaction as a related party arrangement.

3. If a company receives the stock of an affiliated company as a capital contribution rather than through a purchase, the transaction shall be accounted for according to SSAP No. 25—Affiliates and Other Related Parties, SSAP No. 95—Nonmonetary Transactions, or SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities, based on the details of each transaction. The statutory purchase method within SSAP No. 68—Business Combinations is not applicable for stock received as a capital contribution.
SUMMARY CONCLUSION

4. Related parties are defined as entities that have common interests as a result of ownership, control, affiliation or by contract. Related parties shall include but are not limited to the following:

a. Affiliates of the reporting entity, as defined in paragraph 5;

b. Trusts for the benefit of employees, such as pension and profit-sharing trusts and Employee Stock Ownership Plans that are managed by or under the trusteeship of management of the reporting entity, its parent or affiliates;

c. The principal owners of the reporting entity;

d. The management of the reporting entity, its parent or affiliates (including directors);

e. Members of the immediate families of principal owners and management of the reporting entity, its parent or affiliates and their management;

f. Parties with which the reporting entity may deal if either party directly or indirectly controls or can significantly influence the management or operating policies of the other to an extent that one of the transacting parties might be prevented from fully pursuing its own separate interest;

g. A party which can, directly or indirectly, significantly influence the management or operating policies of the reporting entity, which may include a provider who is contracting with the reporting entity. This is not intended to suggest that all provider contracts create related party relationships;

h. A party which has an ownership interest in one of the transacting parties and can significantly influence the other to an extent that one or more of the transacting parties might be prevented from fully pursuing its own separate interests;

i. Attorney-in-fact of a reciprocal reporting entity or any affiliate of the attorney-in-fact; and


5. An affiliate is defined as an entity that is within the holding company system or a party that, directly or indirectly, through one or more intermediaries, controls, is controlled by, or is under common control with the reporting entity. An affiliate includes a parent or subsidiary and may also include partnerships, joint ventures, and limited liability companies as defined in SSAP No. 48—Joint Ventures, Partnerships and Limited Liability Companies. Those entities are accounted for under the guidance provided in SSAP No. 48, which requires an equity method for all such investments. An affiliate is any person that is directly or indirectly, owned or controlled by the same person or by the same group of persons, that, directly or indirectly, owns or controls the reporting entity.

6. Control is defined as the possession, directly or indirectly, of the power to direct or cause the direction of the management and policies of the investee, whether through the (a) ownership of voting securities, (b) by contract other than a commercial contract for goods or nonmanagement services, (c) by contract for goods or nonmanagement services where the volume of activity results in a reliance relationship (d) by common management, or (e) otherwise. Control shall be presumed to exist if a reporting entity and its affiliates directly or indirectly, own, control, hold with the power to vote, or hold proxies representing 10% or more of the voting interests of the entity.

7. Control as defined in paragraph 6 shall be measured at the holding company level. For example, if one member of an affiliated group has a 5% interest in an entity and a second member of the group has an 8% interest in the same entity, the total interest is 13%, and therefore, each member of the affiliated group shall be presumed to have control. This presumption will stand until rebutted by an evaluation of all the facts and circumstances relating to the investment based on the criteria in FASB Interpretation No.
35, Criteria for Applying the Equity Method of Accounting for Investments in Common Stock, an Interpretation of APB Opinion No. 18. The corollary is required to demonstrate control when a reporting entity owns less than 10% of the voting securities of an investee. The insurer shall maintain documents substantiating its determination for review by the domiciliary commissioner. Examples of situations where the presumption of control may be in doubt include the following:

a. Any limited partner investment in a limited partnership, unless the limited partner is affiliated with the general partner.

b. An entity where the insurer owns less than 50% of an entity and there is an unaffiliated individual or group of investors who own a controlling interest.

c. An entity where the insurer has given up participation rights as a shareholder to the investee.

8. **Transactions between related parties must be in the form of a written agreement. The written agreement must provide for timely settlement of amounts owed, with a specified due date.** Amounts owed to the reporting entity over ninety days from the written agreement due date shall be nonadmitted, except to the extent this is specifically addressed by other statements of statutory accounting principles (SSAPs). **If the due date is not addressed by the written agreement, any uncollected receivable is nonadmitted.**

**Related Party Loans**

9. Loans or advances (including debt, public or private) made by a reporting entity to its parent or principal owner shall be admitted if approval for the transaction has been obtained from the domiciliary commissioner and the loan or advance is determined to be collectible based on the parent or principal owner's independent payment ability. An affiliate's ability to pay shall be determined after consideration of the liquid assets or revenues available from external sources (i.e., determination shall not include dividend paying ability of the subsidiary making the loan or advance) which are available to repay the balance and/or maintain its account on a current basis. Evaluation of the collectibility of loans or advances shall be made periodically. If, in accordance with **SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets**, it is probable the balance is uncollectible, any uncollectible receivable shall be written off and charged to income in the period the determination is made. Pursuant to SSAP No. 72—Surplus and Quasi-Reorganization, forgiveness by a reporting entity of any debt, surplus note or other obligation of its parent or other stockholder shall be accounted for as a dividend.

10. Loans or advances by a reporting entity to all other related parties shall be evaluated by management and nonadmitted if they do not constitute arm's-length transactions as defined in paragraph 13. Loans or advances made by a reporting entity to related parties (other than its parent or principal owner) that are economic transactions as defined in paragraph 13 shall be admitted. This includes financing arrangements with providers of health care services with whom the reporting entity contracts with from time to time. Such arrangements can include both loans and advances to these providers. Evaluation of the collectibility of loans or advances shall be made periodically. If, in accordance with SSAP No. 5R, it is probable the balance is uncollectible, any uncollectible receivable shall be written off and charged to income in the period the determination is made.

11. Any advances under capitation arrangements made directly to providers, or to intermediaries that represent providers, that exceed one month’s payment shall be nonadmitted assets.

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1 The term “participating rights” refers to the type of rights that allows an investor to effectively participate in significant decisions related to an investee's ordinary course of business and is distinguished from the more limited type of rights referred to as “protective rights”. Refer to the sections entitled: “Protective Rights” and “Substantive Participating Rights” in EITF 96-16, *Investor's Accounting for an Investee When the Investor Owns a Majority of the Voting Stock but the Minority Shareholder or Shareholders Have Certain Approval or Veto Rights*. The term “participating rights” shall be used consistent with the discussion of substantive participating rights in this EITF.
12. Indirect loans are loans or extensions of credit to any person who is not an affiliate, where the reporting entity makes loans or extensions of credit with the agreement or understanding that the proceeds of the transactions, in whole or in substantial part, are to be used to make loans or extensions of credit to, to purchase assets of, or to make investments in, any affiliate of the reporting entity making the loans or extensions of credit. The admissibility of indirect loans made by a reporting entity for the benefit of its parent or principal owner shall be determined in accordance with the guidelines in paragraph 9. Indirect loans or advances made for the benefit of all other related parties shall be evaluated and accounted for consistent with loans or advances to related parties as described in paragraph 10 and paragraph 11.

Transactions Involving the Exchange of Assets or Liabilities

13. An arm’s-length transaction is defined as a transaction in which willing parties, each being reasonably aware of all relevant facts and neither under compulsion to buy, sell, or loan, would be willing to participate. A transaction between related parties involving the exchange of assets or liabilities shall be designated as either an economic transaction or non-economic transaction. An economic transaction is defined as an arm’s-length transaction which results in the transfer of the risks and rewards of ownership and represents a consummated act thereof, i.e., “permanence.” The appearance of permanence is also an important criterion in assessing the economic substance of a transaction. In order for a transaction to have economic substance and thus warrant revenue (loss) recognition, it must appear unlikely to be reversed. If subsequent events or transactions reverse the effect of an earlier transaction prior to the issuance of the financial statements, the reversal shall be considered in determining whether economic substance existed in the case of the original transaction. Subsequent events are addressed in SSAP No. 9—Subsequent Events. An economic transaction must represent a bonafide business purpose demonstrable in measurable terms. A transaction which results in the mere inflation of surplus without any other demonstrable and measurable betterment is not an economic transaction. The statutory accounting shall follow the substance, not the form of the transaction.

14. In determining whether there has been a transfer of the risks and rewards of ownership in the transfer of assets or liabilities between related parties, the following—and any other relevant facts and circumstances related to the transaction—shall be considered:

   a. Whether the seller has a continuing involvement in the transaction or in the financial interest transferred, such as through the exercise of managerial authority to a degree usually associated with ownership;

   b. Whether there is an absence of significant financial investment by the buyer in the financial interest transferred, as evidenced, for example, by a token down payment or by a concurrent loan to the buyer;

   c. Whether repayment of debt that constitutes the principal consideration in the transaction is dependent on the generation of sufficient funds from the asset transferred;

   d. Whether limitations or restrictions exist on the buyer’s use of the financial interest transferred or on the profits arising from it;

   e. Whether there is retention of effective control of the financial interest by the seller.

15. A transaction between related parties may meet the criteria for treatment as an economic transaction at one level of financial reporting, but may not meet such criteria at another level of financial reporting. An example of such a transaction is a reporting entity purchasing securities at fair value from an affiliated reporting entity that carried the securities at amortized cost. This transaction meets the criteria of an economic transaction at this level of financial reporting, and therefore, the selling reporting entity would record a gain and the acquiring reporting entity would record the securities at their cost (fair value on the transaction date). At the common parent level of reporting, this transaction has resulted in the mere inflation of surplus, and therefore, is a non-economic transaction. The parent reporting entity shall defer the net effects of any gain or increase in surplus resulting from such transactions by recording a deferred gain and an unrealized loss. The deferred gain shall not be recognized by the parent reporting entity.
entity unless and until arms-length transaction(s) with independent third parties give rise to appropriate recognition of the gain.

16. A non-economic transaction is defined as any transaction that does not meet the criteria of an economic transaction. Similar to the situation described in paragraph 15, transfers of assets from a parent reporting entity to a subsidiary, controlled or affiliated entity shall be treated as non-economic transactions at the parent reporting level because the parent has continuing indirect involvement in the assets.

17. When accounting for a specific transaction, reporting entities shall use the following valuation methods:

   a. Economic transactions between related parties shall be recorded at fair value at the date of the transaction. To the extent that the related parties are affiliates under common control, the controlling reporting entity shall defer the effects of such transactions that result in gains or increases in surplus (see paragraph 15);

   b. Non-economic transactions between reporting entities, which meet the definition of related parties above, shall be recorded at the lower of existing book values or fair values at the date of the transaction;

   c. Non-economic transactions between a reporting entity and an entity that has no significant ongoing operations other than to hold assets that are primarily for the direct or indirect benefit or use of the reporting entity or its affiliates, shall be recorded at the fair value at the date of the transaction; however, to the extent that the transaction results in a gain, that gain shall be deferred until such time as permanence can be verified;

   d. Transactions which are designed to avoid statutory accounting practices shall be reported as if the reporting entity continued to own the assets or to be obligated for a liability directly instead of through a subsidiary.

Examples of transactions deemed to be non-economic include security swaps of similar issues between or among affiliated companies, and swaps of dissimilar issues accompanied by exchanges of liabilities between or among affiliates.

Transactions Involving Services

18. Transactions involving services between related parties can take a variety of different forms. One of the significant factors as to whether these transactions will be deemed to be arm’s length is the amount charged for such services. In general, amounts charged for services are based either on current market rates or on allocations of costs. Determining market rates for services is difficult because the circumstances surrounding each transaction are unique. Unlike transactions involving the exchange of assets and liabilities between related parties, transactions for services create income on one party’s books and expense on the second party’s books, and therefore, do not lend themselves to the mere inflation of surplus. These arrangements are generally subject to regulatory approval.

19. Transactions involving services provided between related parties shall be recorded at the amount charged. Regulatory scrutiny of related party transactions where amounts charged for services do not meet the fair and reasonable standard established by Appendix A-440, may result in (a) amounts charged being recharacterized as dividends or capital contributions, (b) transactions being reversed, (c) receivable balances being nonadmitted, or (d) other regulatory action. Expenses that result from cost allocations shall be allocated subject to the same fair and reasonable standards, and the books and records of each

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2 The amount charged shall be reviewed when there are any modifications or waivers subsequent to the establishment of the contract terms. If waivers or modifications to amounts charged occur, the related party transaction shall be reassessed to determine whether the contract continues to reflect fair and reasonable standards. If the transaction was with a parent or other stockholder and the charge for services has been fully waived, then the guidance in SSAP No. 72 for recognition as contributed capital (forgiveness of reporting entity obligation) or as a dividend (forgiveness of amount owed to the reporting entity) shall apply.
party shall disclose clearly and accurately the precise nature and details of the transaction. See SSAP No 70—Allocation of Expenses for additional discussion regarding the allocation of expenses.

Disclosures

20. The financial statements shall include disclosures of all material related party transactions. In some cases, aggregation of similar transactions may be appropriate. Sometimes, the effect of the relationship between the parties may be so pervasive that disclosure of the relationship alone will be sufficient. If necessary to the understanding of the relationship, the name of the related party should be disclosed. Transactions shall not be purported to be arm’s-length transactions unless there is demonstrable evidence to support such statement. The disclosures shall include:

a. The nature of the relationships involved;

b. A description of the transactions for each of the periods for which financial statements are presented, and such other information considered necessary to obtain an understanding of the effects of the transactions on the financial statements. Exclude reinsurance transactions, any non-insurance transactions which involve less than ½ of 1% of the total admitted assets of the reporting entity, and cost allocation transactions. The following information shall be provided if applicable:

   i. Date of transaction;
   
   ii. Explanation of transaction;
   
   iii. Name of reporting entity;
   
   iv. Name of affiliate;
   
   v. Description of assets received by reporting entity;
   
   vi. Statement value of assets received by reporting entity;
   
   vii. Description of assets transferred by reporting entity; and
   
   viii. Statement value of assets transferred by reporting entity.

c. The dollar amounts of transactions for each of the periods for which financial statements are presented and the effects of any change in the method of establishing the terms from that used in the preceding period;

d. Amounts due from or to related parties as of the date of each balance sheet presented and, if not otherwise apparent, the terms and manner of settlement;

e. Any guarantees or undertakings, written or otherwise, shall be disclosed in accordance with the requirements of SSAP No. 5R. In addition, the nature of the relationship to the beneficiary of the guarantee or undertaking (affiliated or unaffiliated) shall also be disclosed;

f. A description of material management or service contracts and cost-sharing arrangements involving the reporting entity and any related party. This shall include, but is not limited to, sale lease-back arrangements, computer or fixed asset leasing arrangements, and agency contracts, which remove assets otherwise recordable (and potentially nonadmitted) on the reporting entity's financial statements;

g. The nature of the control relationship whereby the reporting entity and one or more other enterprises are under common ownership or control and the existence of that control could result in operating results or financial position of the reporting entity significantly
different from those that would have been obtained if the enterprises were autonomous. The relationship shall be disclosed even though there are no transactions between the enterprises; and

h. The amount deducted from the value of an upstream intermediate entity or ultimate parent owned, either directly or indirectly, via a downstream subsidiary, controlled, or affiliated entity, in accordance with the Purposes and Procedure Manual of the NAIC Investment Analysis Office, “Procedures for Valuing Common Stocks and Stock Warrants.”

Current Annual Statement Illustrations for Completing Disclosures:

Illustration:


D. At December 31, 20___, the Company reported $_________ as amounts due to the Parent Company, The ABC Insurance Company. The terms of the settlement require that these amounts be settled within 30 days.

E. The Company has given XYZ Inc., an affiliated company, a standing commitment until January 1, 20___, in the form of guarantees in the event of a default of XYZ on various of its debt issues as disclosed in Note 14.

F. The Company has agreed to provide the Parent Company, The ABC Insurance Company, certain actuarial investment services with respect to the administration of certain large group insurance contracts that are subject to group experience rating procedures.

The Parent Company has agreed to provide collection services for certain contracts for the Company.

G. All outstanding shares of The Company are owned by the Parent Company, The ABC Insurance Company, an insurance holding company domiciled in the State of ______________.

H. The Company owns shares of the stock of its ultimate parent, The ABC Insurance Company. A wholly owned subsidiary of the Company, The XYZ Insurance Company, owns shares of The ABC Insurance Company. In accordance with Securities Valuation Office guidelines, the asset value of The ABC Insurance Company has been reduced by $__________ and the asset value of the XYZ Insurance Company has been reduced by $__________.

I. The Company owns a_______ % interest in ABC Non-Insurance Company, whose carrying value is equal to or exceeds 10% of the admitted assets of The Company. The Company carries ABC Non-Insurance Company at GAAP equity plus the remaining Goodwill balance of $ ________. Goodwill is amortized on a straight-line basis over a ten-year period.

At 12/31/20___, The Company’s interest in ABC Non-Insurance Company per the New York Stock Exchange quoted price was valued at $__________, that was $________ in excess of the carrying value.

Based on The Company’s ownership percentage of ABC Non-Insurance Company, the statement value of ABC Non-Insurance Company assets and liabilities as of 12/31/20___ were $_________ and $__________, respectively.

The Company’s share of net income of ABC Non-Insurance Company was $________ for the year ended 12/31/20__.
The Company has a 25% limited partnership interest in XYC Real Estate Partners. The partnership investment in office properties in the NE United States has been adversely affected by corporate restructuring. This has affected the value of the properties that resulted in the write-down of the Company's investment in XYC Real Estate Partners of $_______ for the year ended 12/31/20__. The amount of the impairment was determined using appraisals from third parties.

Activity to Date (issues previously addressed by the Working Group, SEC, FASB, other State Departments of Insurance or other NAIC groups): On August 3, 2019, the Working Group adopted revisions to SSAP No. 25—Affiliates and Other Related Parties, SSAP No. 26R—Bonds, SSAP No. 32—Preferred Stock, SSAP No. 43R—Loan-backed and Structured Securities, and SSAP No. 48—Joint Ventures, Partnerships and Limited Liability Companies to clarify the application of SSAP No. 25, as well as an “affiliated” classification, when a transaction is in substance a related party transaction. The revisions to SSAP No. 25 clarified that when determining a related party transaction, consideration shall be given to the substantive of the agreements, and the parties whose actions or performance materially impact the insurance reporting entity under the transaction. From these revisions, the following guidance was added as a new paragraph 2 to SSAP No. 25:

2. This statement shall be followed for all related party transactions even if the transaction is also governed by other statutory accounting principles. Furthermore, this statement shall be followed in all transactions which involve unrelated parties as intermediaries between related parties. In determining whether a transaction is a related party transaction, consideration shall be given to the substance of the agreement, and the parties whose actions or performance materially impact the insurance reporting entity under the transaction. For example, an investment acquired from a non-related intermediary, in which the investment return is predominantly contingent on the performance of a related party, shall be considered a related party investment. As a general principle, it is erroneous to conclude that the mere inclusion of a non-related intermediary eliminates the requirement to assess and properly identify the related party transaction in accordance with the provisions of this statement. It is also erroneous to conclude that the presence of non-related assets in a structure predominantly comprised of related party investments, eliminates the requirement to assess and identify the investment transaction as a related party arrangement.

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

Convergence with International Financial Reporting Standards (IFRS) and U.S. GAAP: None

Staff Recommendation: NAIC staff recommends that the Working Group move this item to the active listing, categorized as nonsubstantive, and expose the proposed data-capture templates. A blanks proposal to expose is anticipated to occur concurrently with the Working Group exposure. With inclusion of the data templates, narrative (pdf) reporting shall still occur to provide additional information regarding the related party transactions. NAIC staff notes that the current narrative illustrations are fairly simple. NAIC staff requests comments on whether more robust illustrations are necessary, or whether the disclosures that historically have been provided in the financial statements have included the extent of information necessary and more detailed illustrations are not necessary in the annual statement instructions. Note: Transactions with affiliates detailed in Schedule Y – Part 2, Summary of Insurer’s Transactions with Any Affiliates would not need to be duplicated in these data-captured charts. Narrative disclosure information regarding the transactions captured in Schedule Y-2 shall continue to be reported consistently with past reporting.

Proposed Data Capture Templates:

1) **Detail of Material Related Party Transactions**

   This data-template includes aspects from paragraphs 20, 20.b.i, 20.b.ii, 20.b.iii, 20.b.iv and 20.c.
Note – The information regarding the written agreement and due date are not specifically named in the SSAP No. 25 disclosure listing but are addressed in paragraph 7 of SSAP No. 25. Since paragraph 7 requires a written agreement with an established due date for admittance, these components are anticipated elements that would be disclosed in the 20.b provisions that require “description of the transactions for each of the periods in which financial statements are presented, and other such information considered necessary to obtaining an understanding of the effect of the transactions on the financial statements.”

Material related party transactions shall be captured in this template each year until the agreement / transaction has termination. (For example, if the agreement is a material service contract, it shall be disclosed in this template each year after origination of the contract until the contract is terminated.)

**Proposed Data-Capturing Templates:**

Each Material Related Party Transaction Listed Separately:
(Related parties may be listed more than once if more than one material related party transaction.)

Note: Transactions involving affiliates captured on Schedule Y-2 do not need to be duplicated in these charts.

<table>
<thead>
<tr>
<th>Date of Transaction</th>
<th>Name of Related Party</th>
<th>Nature of Relationship</th>
<th>Type of Transaction</th>
<th>Written Agreement (Y/N)</th>
<th>Due Date</th>
<th>Reporting Period Date</th>
<th>Amount Due From</th>
<th>Amount Due To</th>
</tr>
</thead>
</table>

Options for Type of Transaction:
- Loan
- Exchange of Assets or Liabilities (e.g., buys, sells and secured borrowing transactions)
- Management Services
- Cost-Sharing Agreement
- Other Transactions Involving Services
- Guarantee (e.g., guarantees to related parties, on behalf of, and when beneficiary is related party)
- Other

2) **Detail of Material Related Party Transactions Involving Services**

This data-template includes aspects from paragraphs 20, 20.b.ii, 20.c and 20.f. (This chart provides additional information on service arrangements captured in chart 1.)

Note – The information regarding the amount charged, and whether the amount charged was based on an allocation of costs or market rates are not specifically named in the SSAP No. 25 disclosure listing but are addressed in paragraph 17 of SSAP No. 25. These components are anticipated elements that would be addressed in disclosure 20f with the “description of material management or service contracts and cost-sharing arrangements involving the reporting entity and any related party.”

**Transactions Involving Services:**
Include transactions involving management services, cost-sharing agreements and other transactions involving services.

| Name of Overview | Amount | Amount Based | Amount |
3) **Detail of Material Related Party Transactions Involving Exchange of Assets and Liabilities**

This data-template includes aspects from paragraphs 20, 20.b.ii, 20.b.v, 20.b.vi, 20.b.vii, 20.b.viii, and 20.c. (This chart provides additional information on asset/liability exchanges captured in chart 1.)

**Transactions Involving Exchange of Assets and Liabilities:**
*Include loans, buys, sells and secured borrowing transactions.*

<table>
<thead>
<tr>
<th>Name of Related Party</th>
<th>Overview Description</th>
<th>Description of Assets Received</th>
<th>Description of Assets Transferred</th>
<th>Statement Value of Assets Received</th>
<th>Statement Value of Assets Transferred</th>
<th>Have Terms Changed from Preceding Period? (Y/N)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

4) **Detail of Amounts Owed To/From a Related Party**

This data-template includes aspects from paragraph 20d. This data template shall include each related party that is identified with material transactions in chart 1 but shall include the total amount due from / to from that related party. If there are transactions with the related party that were not captured in Chart 1 (perhaps as they were not material), they should be captured in the overall amount due from / to the related party.

This chart shall include related parties with immaterial transactions (not captured in Chart 1), if the aggregation of all transactions with the related party would be material to the reporting entity. (It is not required to include related parties in this chart if the transactions with the related party were individually immaterial and immaterial in the aggregate.)

Note: Pursuant to SSAP No. 64, paragraph 5 amounts due to or from affiliates shall be offset and reported net only when the provisions of paragraph 2 (valid right of setoff exists).

**Aggregate Reporting by Related Party**

<table>
<thead>
<tr>
<th>Name of Related Party</th>
<th>Aggregate Reporting Period Amount Due From</th>
<th>Aggregate Reporting Period (Amount Due To)</th>
<th>Amount Offset in Financial Statement (if qualifying)</th>
<th>Net Amount Recoverable / (Payable) by Related Party</th>
<th>Admitted Recoverable</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

- Each related party shall be included only once.

**Staff Review Completed by: Julie Gann – October 2019**

**Status:**

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On December 7, 2019, the Statutory Accounting Principles (E) Working Group moved this agenda item to the active listing, categorized as nonsubstantive, and exposed the proposed data-capture templates, as illustrated above. This exposure does not propose revisions to SSAP No. 25.
Statutory Accounting Principles (E) Working Group
Maintenance Agenda Submission Form
Form A

Issue: Related Parties, Disclaimers of Affiliation and Variable Interest Entities

Check (applicable entity):

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

Description of Issue:
The intent of this agenda item is to clarify identification of related parties and affiliates in SSAP No. 25—Affiliates and Other Related Parties and to incorporate new disclosures to ensure regulators have the full picture of complicated business structures.

The proposed SSAP revisions intend to address the following key aspects:

- Clarify the identification of related parties and ensure that any related party identified under U.S. generally accepted accounting principles (GAAP) or Securities Exchange Commission (SEC) reporting requirements would be considered a related party under statutory accounting principles (SAP).

- Clarify that non-controlling ownership over 10% results in a related party classification regardless of any disclaimer of control or disclaimer of affiliation.

- Clarify the impact of a disclaimer of control or disclaimer of affiliate under SAP. As detailed, such disclaimers impact holding company group allocation and reporting as an SCA under SSAP No. 97, but do not eliminate the classification as a “related party” and the disclosure of material transactions as required under SSAP No. 25.

- Proposes rejection of several U.S. GAAP standards addressing variable interest entities.

NAIC staff noted that the requirements for the SEC filings do not allow for a disclaimer of affiliation, as is allowed in the Insurance Holding Company System Regulatory Act (#440) and the Insurance Holding Company System Model Regulation (#450) and included in Appendix A-440. As a result, the statutory financial statements do not provide the full picture of some complicated business structures, which can be common among insurance companies. This agenda item intends to propose revisions to have the related party and affiliate reporting more closely match that of SEC filings. This will be done by adding language from SEC laws and regulation and clarifying the disclaimer of affiliation or control from a statutory reporting standpoint.

Additionally, this agenda item addresses the FASB Accounting Standards Updates (ASU) related to Variable Interest Entities (VIE) and Consolidation (Topic 810).

FASB defines a VIE as an entity (the investee) in which the investor holds a controlling interest that is not based on the majority of voting rights. This agenda item discusses several ASUs that established the initial guidance for VIEs and all subsequent ASUs to update and clarify this guidance. As a fundamental issue, the concept of consolidation has been rejected for statutory accounting. As such, the main concepts included in the ASUs that are discussed in this agenda item are proposed to be rejected for statutory accounting. While this agenda item is not intended to change the concept of consolidation for statutory accounting,
NAIC staff believe that there is a need and justification for enhanced disclosures to supplement the reporting process of related parties and affiliates within a company structure. The proposed additions will ensure state insurance regulators have a full picture of the companies that they are regulating.

A brief description of the ASUs that are addressed in this agenda item are included below:

- **ASU 2009-17, Consolidations (Topic 810)—Improvements to Financial Reporting by Enterprises Involved with Variable Interest Entities** clarifies and establishes the basis of U.S. GAAP accounting for consolidation and VIEs. This ASU is a result of FASB Statement No. 167, Amendments to FASB Interpretation No. 46(R).
- **ASU 2010-02, Consolidation (Topic 810)—Accounting and Reporting for Decreases in Ownership of a Subsidiary—a Scope Clarification** addresses implementation issues related to the changes in ownership provisions in Subtopic 810-10, originally issued as FASB Statement No. 160, Noncontrolling Interests in Consolidated Financial Statements, which establishes the accounting and reporting guidance for noncontrolling interests and changes in ownership interests of a subsidiary.
- **ASU 2010-10, Consolidations (Topic 810)—Amendments for Certain Investment Funds** defers consolidation requirements for a reporting entity’s interest in an entity that has all the attributes of an investment company or for which it is industry practice to apply measurement principles for financial reporting purposes that are consistent with those followed by investment companies.
- **ASU 2014-07, Consolidation (Topic 810)—Applying Variable Interest Entities Guidance to Common Control Leasing Arrangements** permits a private company lessee (the reporting entity) to elect an alternative not to apply VIE guidance to a lessor entity in certain situations.
- **ASU 2015-02, Consolidation (Topic 810)—Amendments to the Consolidation Analysis** includes updates to limited partnerships and similar legal entities, evaluating fees paid to a decision maker or a service provider as a variable interest, the effect of fee arrangements on the primary beneficiary determination, the effect of related parties on the primary beneficiary determination, and certain investment funds.
- **ASU 2016-17, Consolidation (Topic 810)—Interests Held through Related Parties That Are under Common Control** provides that if a reporting entity satisfies the first characteristic of a primary beneficiary (such that it is the single decision maker of a VIE), these amendments require that reporting entity, in determining whether it satisfies the second characteristic of a primary beneficiary, to include all of its direct variable interests in a VIE and, on a proportionate basis, its indirect variable interests in a VIE held through related parties, including related parties that are under common control with the reporting entity.
- **ASU 2018-17, Consolidation (Topic 810)—Targeted Improvements to Related Party Guidance for Variable Interest Entities** includes updated VIE guidance for private companies and considers if indirect interests held through related parties under common control for determining whether fees paid to decision makers and service providers are variable interests.

**Existing Authoritative Literature:** Statutory accounting guidance is in SSAP No. 25—Affiliates and Other Related Parties, model law and regulation provisions are included in Insurance Holding Company System Regulatory Act (#440) and the Insurance Holding Company System Model Regulation (#450).

From Model #440

**Section 4. Registration of Insurers**

**K. Disclaimer.** Any person may file with the commissioner a disclaimer of affiliation with any authorized insurer or a disclaimer may be filed by the insurer or any member of an insurance holding company system. The disclaimer shall fully disclose all material relationships and bases for affiliation between the person and the insurer as well as the basis for disclaiming the affiliation. A disclaimer of affiliation shall be deemed to have been
granted unless the commissioner, within thirty (30) days following receipt of a complete disclaimer, notifies the filing party the disclaimer is disallowed. In the event of disallowance, the disclaiming party may request an administrative hearing, which shall be granted. The disclaiming party shall be relieved of its duty to register under this section if approval of the disclaimer has been granted by the commissioner, or if the disclaimer is deemed to have been approved.

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 2010, in response to the issuance of FAS 166, Accounting for Transfers of Financial Assets—an amendment of FASB Statement No. 140 and FAS 167, Amendments to FASB Interpretation No. 46(R), the SAPWG formed the “SAPWG FAS 166/167 Subgroup. FAS 167 was issued in June 2009 and revised the scope of the FASB consolidation guidance to ensure that entities previously considered qualifying special purpose entities were included within the GAAP consolidation. Additionally, FAS 167 requires consolidation for entities (variable interest entities) in which the reporting entity has the “controlling financial interest”. Those situations are specific to when the entity is not controlled by contract, but the reporting entity has: (1) the power to direct the activities of the entity that most significantly impact the entity’s economic performance; and (2) the obligation to absorb losses or receive benefits of the entity that could be potentially significant to the entity. Although the concept of consolidation was not supported for SAP, the Subgroup discussion was focused on considering new disclosures for variable interest entities. The discussion of this Subgroup was deferred as Agenda Item 2011-16, Definition of a Related Party in SSAP No. 25 was considering changes to clarify the relationships that should be considered related parties. Discussion on this agenda item was halted in 2012 and 2015 as FASB issued new ASUs pertaining to VIEs. With the issuance of this new agenda item (2019-34), it is recommended that the 2011 agenda item be disposed.

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


Staff Recommendation:
NAIC Staff recommends that the Working Group move this item to the active listing, categorized as nonsubstantive and expose revisions to SSAP No. 25—Affiliates and Other Related Parties, to clarify the types of entities or persons that are included as related parties, to clarify that a non-controlling ownership interest greater than 10% is a related party and is subject to the related party disclosures, to clarify the guidance for disclaimers of affiliation and control for statutory accounting, to clarify that the reporting entity must disclose if they knowingly engaged in any non-arms-length transactions with any entity, individual or company that has not been previously identified as a related party and to reject the seven FASB Accounting Standards Updates listed in the agenda item as not applicable for statutory accounting in SSAP No. 25.

Staff Review Completed by:
Jake Stultz, NAIC Staff – November 2019

Status:
On December 7, 2019, the Statutory Accounting Principles (E) Working Group moved this agenda item to the active listing, categorized as nonsubstantive, and exposed revisions to SSAP No. 25—Affiliates and Other Related Parties, to clarify the following:

- The types of entities or persons that are included as related parties;
- That a non-controlling ownership interest greater than 10% is a related party and is subject to the related party disclosures; and
• The guidance for disclaimers of affiliation and control for statutory accounting.

This agenda item also rejects seven FASB Accounting Standards Updates, listed above, for statutory accounting. With exposure, an intent is included to dispose of agenda item 2011-16: Definition of Related Party, which is a historical item drafted to consider the SSAP No. 25 definition. The Working Group also directed notice of the exposure to be sent to the Group Solvency Issues (E) Working Group.

G:\FRS\DATA\Stat Acctg\3. National Meetings\A. National Meeting Materials\2020\Spring\Hearing\25 - 19-34 - Related Parties, Disclaimers of Affiliation and Variable Interest Entities.docx
Statement of Statutory Accounting Principles No. 25

Affiliates and Other Related Parties

STATUS

Type of Issue
Common Area

Issued
Initial Draft, November 2019 discussion draft

Effective Date
January 1, 2001

Affects
Supersedes SSAP No. 96 with guidance incorporated August 2011; Nullifies and incorporates INT 03-16

Affected by
No other pronouncements

Interpreted by
No other pronouncements

Relevant Appendix A Guidance
A-440

SCOPE OF STATEMENT

1. Related party transactions are subject to abuse because reporting entities may be induced to enter transactions that may not reflect economic realities or may not be fair and reasonable to the reporting entity or its policyholders. As such, related party transactions require specialized accounting rules and increased regulatory scrutiny. This statement establishes statutory accounting principles and disclosure requirements for related party transactions.

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2. This statement shall be followed for all related party transactions, even if the transaction is also governed by other statutory accounting principles. Furthermore, this statement shall be followed in all transactions which involve unrelated parties as intermediaries between related parties. In determining whether a transaction is a related party transaction, consideration shall be given to the substance of the agreement and the parties whose actions or performance materially impact the insurance reporting entity under the transaction. For example, an investment acquired from a non-related intermediary in which the investment return is predominantly contingent on the performance of a related party shall be considered a related party investment. As a general principle, it is erroneous to conclude that the mere inclusion of a non-related intermediary eliminates the requirement to assess and properly identify the related party transaction in accordance with the provisions of this statement. It is also erroneous to conclude that the presence of non-related assets in a structure predominantly comprised of related party investments eliminates the requirement to assess and identify the investment transaction as a related party arrangement.

3. If a company receives the stock of an affiliated company as a capital contribution rather than through a purchase, the transaction shall be accounted for according to SSAP No. 25—Affiliates and Other Related Parties, SSAP No. 95—Nonmonetary Transactions, or SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities, based on the details of each transaction. The statutory purchase method within SSAP No. 68—Business Combinations is not applicable for stock received as a capital contribution.

**SUMMARY CONCLUSION**

4. Related parties are defined as entities that have common interests as a result of ownership, control, affiliation or by contract. Related parties shall include but are not limited to the following:

- a. Any person or entity that has been identified under U.S. GAAP or SEC reporting as a related party;
- b. Affiliates of the reporting entity, as defined in paragraph 5;
- c. Trusts for the benefit of employees, such as pension and profit-sharing trusts and Employee Stock Ownership Plans that are managed by or under the trusteeship of management of the reporting entity, its parent or affiliates;
- d. The principal owners, directors, officers who are engaged directly or indirectly in the activities of the reporting entity;
- e. Any immediate family member of a principal owner, director or executive officer of the reporting entity, which means any child, stepchild, parent, stepparent, spouse, sibling, mother-in-law, father-in-law, son-in-law, daughter-in-law, brother-in-law, or sister-in-law, or individual related by blood or marriage whose close association is equivalent to a family relationship of such director, executive officer or nominee for director, or any person (other than a tenant or employee) sharing the household of such director, executive officer or nominee for director;
- f. Companies and entities which share common control, such as principal owners, directors, or officers, including situations where a principal owners, directors, or officers have a controlling stake in another reporting entity;
- g. Any non-controlling ownership greater than 10% results in a related party classification regardless of any disclaimer of control or disclaimer of affiliation.
- h. The management of the reporting entity, its parent or affiliates (including directors);
Affiliates and Other Related Parties

e-i. Members of the immediate families of principal owners and management of the reporting entity, its parent or affiliates and their management;

f-j. Parties with which the reporting entity may deal if either party directly or indirectly controls or can significantly influence the management or operating policies of the other to an extent that one of the transacting parties might be prevented from fully pursuing its own separate interest;

g-k. A party which can, directly or indirectly, significantly influence the management or operating policies of the reporting entity, which may include a provider who is contracting with the reporting entity. This is not intended to suggest that all provider contracts create related party relationships;

h-l. A party which has an ownership interest in one of the transacting parties and can significantly influence the other to an extent that one or more of the transacting parties might be prevented from fully pursuing its own separate interests;

i-m. Attorney-in-fact of a reciprocal reporting entity or any affiliate of the attorney-in-fact; and


5. An affiliate is defined as an entity that is within the holding company system or a party that, directly or indirectly, through one or more intermediaries, controls, is controlled by, or is under common control with the reporting entity. An affiliate includes a parent or subsidiary and may also include partnerships, joint ventures, and limited liability companies as defined in SSAP No. 48—Joint Ventures, Partnerships and Limited Liability Companies. Those entities are accounted for under the guidance provided in SSAP No. 48, which requires an equity method for all such investments. An affiliate is any person that is directly or indirectly, owned or controlled by the same person or by the same group of persons, that, directly or indirectly, own or control the reporting entity.

6. Control is defined as the possession, directly or indirectly, of the power to direct or cause the direction of the management and policies of the investee, whether through the (a) ownership of voting securities, (b) by contract other than a commercial contract for goods or nonmanagement services, (c) by contract for goods or nonmanagement services where the volume of activity results in a reliance relationship (d) by common management, or (e) otherwise. Control shall be presumed to exist if a reporting entity and its affiliates directly or indirectly, own, control, hold with the power to vote, or hold proxies representing 10% or more of the voting interests of the entity.

7. Control as defined in paragraph 6 shall be measured at the holding company level. For example, if one member of an affiliated group has a 5% interest in an entity and a second member of the group has an 8% interest in the same entity, the total interest is 13%, and therefore, each member of the affiliated group shall be presumed to have control. This presumption will stand until rebutted by an evaluation of all the facts and circumstances relating to the investment based on the criteria in FASB Interpretation No. 35, Criteria for Applying the Equity Method of Accounting for Investments in Common Stock, an Interpretation of APB Opinion No. 18. The corollary is required to demonstrate control when a reporting entity owns less than 10% of the voting securities of an investee. The insurer shall maintain documents substantiating its determination for review by the domiciliary commissioner. A non-controlling ownership interest greater than 10% is a related party and is subject to the related party disclosures within this statement. Examples of situations where the presumption of control may be in doubt include the following:

a. Any limited partner investment in a limited partnership, unless the limited partner is affiliated with the general partner.
b. An entity where the insurer owns less than 50% of an entity and there is an unaffiliated individual or group of investors who own a controlling interest.

An entity where the insurer has given up participation rights\(^1\) as a shareholder to the investee.

8. The Insurance Holding Company System Regulatory Act (#440) and the Insurance Holding Company System Model Regulation (#450) include a provision that allows for the disclaimer of affiliation and/or the disclaimer of control for members of an insurance holding company system. The disclaimer must be filed with the state insurance commissioner. Entities whose relationship is subject to a disclaimer of affiliation or a disclaimer of control are related parties and are subject to the related party disclosures within this statement. Such a disclaimer does not eliminate a “related party” distinction or disclosure requirements for material transactions pursuant to SSAP No. 25.

8-9. Transactions between related parties must be in the form of a written agreement. The written agreement must provide for timely settlement of amounts owed, with a specified due date. Amounts owed to the reporting entity over ninety days from the written agreement due date shall be nonadmitted, except to the extent this is specifically addressed by other statements of statutory accounting principles (SSAPs). If the due date is not addressed by the written agreement, any uncollected receivable is nonadmitted.

**Related Party Loans**

9. Loans or advances (including debt, public or private) made by a reporting entity to its parent or principal owner shall be admitted if approval for the transaction has been obtained from the domiciliary commissioner and the loan or advance is determined to be collectible based on the parent or principal owner’s independent payment ability. An affiliate’s ability to pay shall be determined after consideration of the liquid assets or revenues available from external sources (i.e., determination shall not include dividend paying ability of the subsidiary making the loan or advance) which are available to repay the balance and/or maintain its account on a current basis. Evaluation of the collectibility of loans or advances shall be made periodically. If, in accordance with SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets, it is probable the balance is uncollectible, any uncollectible receivable shall be written off and charged to income in the period the determination is made. Pursuant to SSAP No. 72—Surplus and Quasi-Reorganization, forgiveness by a reporting entity of any debt, surplus note or other obligation of its parent or other stockholder shall be accounted for as a dividend.

10. Loans or advances by a reporting entity to all other related parties shall be evaluated by management and nonadmitted if they do not constitute arm’s-length transactions as defined in paragraph 14. Loans or advances made by a reporting entity to related parties (other than its parent or principal owner) that are economic transactions as defined in paragraph 14 shall be admitted. This includes financing arrangements with providers of health care services with whom the reporting entity contracts with from time to time. Such arrangements can include both loans and advances to these providers. Evaluation of the collectibility of loans or advances shall be made periodically. If, in accordance with SSAP No. 5R, it is probable the balance is uncollectible, any uncollectible receivable shall be written off and charged to income in the period the determination is made.

11. Any advances under capitation arrangements made directly to providers, or to intermediaries that represent providers, that exceed one month’s payment shall be nonadmitted assets.

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\(^1\) The term "participating rights" refers to the type of rights that allows an investor to effectively participate in significant decisions related to an investee's ordinary course of business and is distinguished from the more limited type of rights referred to as "protective rights". Refer to the sections entitled: “Protective Rights” and “Substantive Participating Rights” in EITF 96-16, *Investor’s Accounting for an Investee When the Investor Owns a Majority of the Voting Stock but the Minority Shareholder or Shareholders Have Certain Approval or Veto Rights*. The term “participating rights” shall be used consistent with the discussion of substantive participating rights in this EITF.

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Indirect loans are loans or extensions of credit to any person who is not an affiliate, where the reporting entity makes loans or extensions of credit with the agreement or understanding that the proceeds of the transactions, in whole or in substantial part, are to be used to make loans or extensions of credit to, to purchase assets of, or to make investments in, any affiliate of the reporting entity making the loans or extensions of credit. The admissibility of indirect loans made by a reporting entity for the benefit of its parent or principal owner shall be determined in accordance with the guidelines in paragraph 109. Indirect loans or advances made for the benefit of all other related parties shall be evaluated and accounted for consistent with loans or advances to related parties as described in paragraph 1140 and paragraph 1244.

Transactions Involving the Exchange of Assets or Liabilities

An arm’s-length transaction is defined as a transaction in which willing parties, each being reasonably aware of all relevant facts and neither under compulsion to buy, sell, or loan, would be willing to participate. A transaction between related parties involving the exchange of assets or liabilities shall be designated as either an economic transaction or non-economic transaction. An economic transaction is defined as an arm’s-length transaction which results in the transfer of the risks and rewards of ownership and represents a consummated act thereof, i.e., “permanence.” The appearance of permanence is also an important criterion in assessing the economic substance of a transaction. In order for a transaction to have economic substance and thus warrant revenue (loss) recognition, it must appear unlikely to be reversed. If subsequent events or transactions reverse the effect of an earlier transaction prior to the issuance of the financial statements, the reversal shall be considered in determining whether economic substance existed in the case of the original transaction. Subsequent events are addressed in SSAP No. 9—Subsequent Events. An economic transaction must represent a bonafide business purpose demonstrable in measurable terms. A transaction which results in the mere inflation of surplus without any other demonstrable and measurable betterment is not an economic transaction. The statutory accounting shall follow the substance, not the form of the transaction.

In determining whether there has been a transfer of the risks and rewards of ownership in the transfer of assets or liabilities between related parties, the following—and any other relevant facts and circumstances related to the transaction—shall be considered:

a. Whether the seller has a continuing involvement in the transaction or in the financial interest transferred, such as through the exercise of managerial authority to a degree usually associated with ownership;

b. Whether there is an absence of significant financial investment by the buyer in the financial interest transferred, as evidenced, for example, by a token down payment or by a concurrent loan to the buyer;

c. Whether repayment of debt that constitutes the principal consideration in the transaction is dependent on the generation of sufficient funds from the asset transferred;

d. Whether limitations or restrictions exist on the buyer’s use of the financial interest transferred or on the profits arising from it;

e. Whether there is retention of effective control of the financial interest by the seller.
15.16. A transaction between related parties may meet the criteria for treatment as an economic transaction at one level of financial reporting, but may not meet such criteria at another level of financial reporting. An example of such a transaction is a reporting entity purchasing securities at fair value from an affiliated reporting entity that carried the securities at amortized cost. This transaction meets the criteria of an economic transaction at this level of financial reporting, and therefore, the selling reporting entity would record a gain and the acquiring reporting entity would record the securities at their cost (fair value on the transaction date). At the common parent level of reporting, this transaction has resulted in the mere inflation of surplus, and therefore, is a non-economic transaction. The parent reporting entity shall defer the net effects of any gain or increase in surplus resulting from such transactions by recording a deferred gain and an unrealized loss. The deferred gain shall not be recognized by the parent reporting entity unless and until arms-length transaction(s) with independent third parties give rise to appropriate recognition of the gain.

16.17. A non-economic transaction is defined as any transaction that does not meet the criteria of an economic transaction. Similar to the situation described in paragraph 16.15, transfers of assets from a parent reporting entity to a subsidiary, controlled or affiliated entity shall be treated as non-economic transactions at the parent reporting level because the parent has continuing indirect involvement in the assets.

17.18. When accounting for a specific transaction, reporting entities shall use the following valuation methods:

a. Economic transactions between related parties shall be recorded at fair value at the date of the transaction. To the extent that the related parties are affiliates under common control, the controlling reporting entity shall defer the effects of such transactions that result in gains or increases in surplus (see paragraph 16.15);

b. Non-economic transactions between reporting entities, which meet the definition of related parties above, shall be recorded at the lower of existing book values or fair values at the date of the transaction;

c. Non-economic transactions between a reporting entity and an entity that has no significant ongoing operations other than to hold assets that are primarily for the direct or indirect benefit or use of the reporting entity or its affiliates, shall be recorded at the fair value at the date of the transaction; however, to the extent that the transaction results in a gain, that gain shall be deferred until such time as permanence can be verified;

d. Transactions which are designed to avoid statutory accounting practices shall be reported as if the reporting entity continued to own the assets or to be obligated for a liability directly instead of through a subsidiary.

Examples of transactions deemed to be non-economic include security swaps of similar issues between or among affiliated companies, and swaps of dissimilar issues accompanied by exchanges of liabilities between or among affiliates.

**Transactions Involving Services**

18.19. Transactions involving services between related parties can take a variety of different forms. One of the significant factors as to whether these transactions will be deemed to be arm’s length is the amount charged for such services. In general, amounts charged for services are based either on current market rates or on allocations of costs. Determining market rates for services is difficult because the circumstances surrounding each transaction are unique. Unlike transactions involving the exchange of assets and liabilities between related parties, transactions for services create income on one party’s books and expense on the second party’s books, and therefore, do not lend themselves to the mere inflation of surplus. These arrangements are generally subject to regulatory approval.
Transactions involving services provided between related parties shall be recorded at the amount charged. Regulatory scrutiny of related party transactions where amounts charged for services do not meet the fair and reasonable standard established by Appendix A-440, may result in (a) amounts charged being recharacterized as dividends or capital contributions, (b) transactions being reversed, (c) receivable balances being nonadmitted, or (d) other regulatory action. Expenses that result from cost allocations shall be allocated subject to the same fair and reasonable standards, and the books and records of each party shall disclose clearly and accurately the precise nature and details of the transaction. See SSAP No 70—Allocation of Expenses for additional discussion regarding the allocation of expenses.

Disclosures

The financial statements shall include disclosures of all material related party transactions. In some cases, aggregation of similar transactions may be appropriate. Sometimes, the effect of the relationship between the parties may be so pervasive that disclosure of the relationship alone will be sufficient. If necessary to the understanding of the relationship, the name of the related party should be disclosed. Transactions shall not be purported to be arm’s-length transactions unless there is demonstrable evidence to support such statement. The disclosures shall include:

a. The nature of the relationships involved;

b. A description of the transactions for each of the periods for which financial statements are presented, and such other information considered necessary to obtain an understanding of the effects of the transactions on the financial statements. Exclude reinsurance transactions, any non-insurance transactions which involve less than ½ of 1% of the total admitted assets of the reporting entity, and cost allocation transactions. The following information shall be provided if applicable:

i. Date of transaction;

ii. Explanation of transaction;

iii. Name of reporting entity;

iv. Name of affiliate;

v. Description of assets received by reporting entity;

vi. Statement value of assets received by reporting entity;

vii. Description of assets transferred by reporting entity; and

viii. Statement value of assets transferred by reporting entity.

c. The dollar amounts of transactions for each of the periods for which financial statements are presented and the effects of any change in the method of establishing the terms from that used in the preceding period;

The amount charged shall be reviewed when there are any modifications or waivers subsequent to the establishment of the contract terms. If waivers or modifications to amounts charged occur, the related party transaction shall be reassessed to determine whether the contract continues to reflect fair and reasonable standards. If the transaction was with a parent or other stockholder and the charge for services has been fully waived, then the guidance in SSAP No. 72 for recognition as contributed capital (forgiveness of reporting entity obligation) or as a dividend (forgiveness of amount owed to the reporting entity) shall apply.
d. Amounts due from or to related parties as of the date of each balance sheet presented and, if not otherwise apparent, the terms and manner of settlement;

e. Any guarantees or undertakings, written or otherwise, shall be disclosed in accordance with the requirements of SSAP No. 5R. In addition, the nature of the relationship to the beneficiary of the guarantee or undertaking (affiliated or unaffiliated) shall also be disclosed;

f. A description of material management or service contracts and cost-sharing arrangements involving the reporting entity and any related party. This shall include, but is not limited to, sale lease-back arrangements, computer or fixed asset leasing arrangements, and agency contracts, which remove assets otherwise recordable (and potentially nonadmitted) on the reporting entity’s financial statements;

g. The nature of the control relationship whereby the reporting entity and one or more other enterprises are under common ownership or control and the existence of that control could result in operating results or financial position of the reporting entity significantly different from those that would have been obtained if the enterprises were autonomous. The relationship shall be disclosed even though there are no transactions between the enterprises; and

h. The amount deducted from the value of an upstream intermediate entity or ultimate parent owned, either directly or indirectly, via a downstream subsidiary, controlled, or affiliated entity, in accordance with the Purposes and Procedure Manual of the NAIC Investment Analysis Office, “Procedures for Valuing Common Stocks and Stock Warrants.”

24-22 Refer to the Preamble for further discussion regarding disclosure requirements.

Relevant Literature

22-23 This statement adopts FASB Statement No. 57, Related Party Disclosures with a modification to paragraph 4 to require disclosure of compensation arrangements, expense allowances, and other similar items in the ordinary course of business.


24-25 Guidance in paragraph 98 was incorporated from SSAP No. 96 as discussed in Issue Paper No. 128—Settlement Requirements for Intercompany Transactions, An Amendment to SSAP No. 25—Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties. SSAP No. 96 was nullified in 2011 with the guidance from that SSAP retained within this SSAP.
Effective Date and Transition

25.26 This statement is effective for years beginning January 1, 2001. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with SSAP No. 3—Accounting Changes and Corrections of Errors.

26.27 Guidance reflected in paragraph 98, incorporated from SSAP No. 96, is effective for reporting periods ending December 31, 2007. Early adoption is permitted. A change resulting from the application of this paragraph shall be accounted for as a change in accounting principle in accordance with SSAP No. 3—Accounting Changes and Corrections of Errors. Guidance reflected in paragraph 3, incorporated from INT 03-16: Contribution of Stock, was originally effective December 7, 2003.

REFERENCES

Other

• Purposes and Procedures Manual of the NAIC Investment Analysis Office

Relevant Issue Papers

• Issue Paper No. 25—Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties

• Issue Paper No. 128—Settlement Requirements for Intercompany Transactions, An Amendment to SSAP No. 25—Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties

© 2020 National Association of Insurance Commissioners 13
TO: Dale Bruggeman (OH), Chair of the Statutory Accounting Principles (E) Working Group  
FROM: Justin Schrader (NE), Chair of the Group Solvency Issues (E) Working Group  
DATE: February 11, 2020  
RE: Response to Referral on Agenda Item # 2019-34

The Group Solvency Issues (E) Working Group has recently noted several challenges in identifying and tracking the various affiliatedRELATED parties within insurance groups, as well as the relationships an insurance group may have with other insurance groups. At the same time, regulators have noted an increased number of situations where the solvency and liquidity of insurers were negatively impacted by affiliated investments and relationships. Given the above-mentioned issues and concerns, the Working Group would like to express its support for the changes to SSAP No. 25—Affiliates and Other Related Parties that are proposed in agenda item 2019-34.

The Working Group agrees that each of the clarifications provided within the proposed revisions are valuable and will assist insurers and regulators in understanding the proper accounting treatment and disclosure requirements in this area. However, the Working Group notes that there may be additional disclosures necessary to clearly understand the nature of relationships across insurance groups. For example, Working Group members have found it difficult to understand and track relationships between insurers that are not affiliated (i.e., not under common control) but that share some level of common ownership. The Working Group recommends consideration of a new statutory disclosure that would provide information on minority ownership interests, as well as significant relationships between minority owners and other U.S. domestic insurersGROUPS.

Thank you for involving the Working Group in the review of this exposure and for your consideration of this additional disclosure request. Please feel free to contact me or NAIC staff support for the Working Group with any additional questions.
Statutory Accounting Principles (E) Working Group
Maintenance Agenda Submission Form
Form A

Issue: Expand MGA and TPA Disclosures

Check (applicable entity):

<table>
<thead>
<tr>
<th>Modification of Existing SSAP</th>
<th>P/C</th>
<th>Life</th>
<th>Health</th>
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<tbody>
<tr>
<td>New Issue or SSAP</td>
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<tr>
<td>Interpretation</td>
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**Description of Issue:**
Two states have requested that the existing annual statement disclosure regarding managing general agents or third-party administrators be expanded to include additional information.

The enhanced note would list any managing general agent (MGA) and third-party administrator (TPA) and the respective core service(s) provided to the insurer or authority granted by the insurer. Additionally, the affiliated, related party or unaffiliated relationship would be disclosed, along with whether the entity is independently audited and/or bonded. The disclosure is specific to legal names for TPAs and MGAs to ensure consistency in reporting and allow for aggregation assessment.

State insurance regulators and policyholders should be able to fully understand the level and extent core services and binding authority are provided by TPAs and MGAs. The state sponsors have advocated that this understanding would also help in the assessment of the Enterprise Risk Management (ERM) framework, Own Risk Solvency Assessment (ORSA) report, market analysis reviews, operational risks, group analysis, and recovery and resolution considerations.

**Existing Authoritative Literature:**

All of the following statements contain the same disclosure regarding managing general agents or third-party administrators.

- **SSAP No. 51R—Life Contracts**, paragraph 50;
- **SSAP No. 53—Property Casualty Contracts—Premiums**, paragraph 19;
- **SSAP No. 54R—Individual and Group Accident and Health Contracts**, paragraph 33 and
- **SSAP No. 59—Credit Life and Accident and Health Insurance Contracts**, paragraph 19

The disclosure in each of these paragraphs is as follows:

Disclose the aggregate amount of direct premiums written through managing general agents or third party administrators. For purposes of this disclosure, a managing general agent means the same as in Appendix A-225. If this amount is equal to or greater than 5% of surplus, provide the following information for each managing general agent and third party administrator:

- **a.** Name and address of managing general agent or third party administrator;
- **b.** Federal Employer Identification Number;
- **c.** Whether such person holds an exclusive contract;
- **d.** Types of business written;
- **e.** Type of authority granted (i.e., underwriting, claims payment, etc.);
- **f.** Total premium written.
Activity to Date (issues previously addressed by the Working Group, Emerging Accounting Issues (E) Working Group, SEC, FASB, other State Departments of Insurance or other NAIC groups): None

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

Convergence with International Financial Reporting Standards (IFRS): None

Sponsors:
Trey Hancock - Tennessee Department of Commerce and Insurance
Debbie Doggett - Missouri Department of Commerce and Insurance

Staff Review Completed by:
Robin Marcotte - NAIC Staff, November 2019

Staff Recommendation:
NAIC Staff recommends that the Working Group move this item to the active listing, categorized as nonsubstantive and expose revisions to the following statements to expand the MGA/TPA note (as the wording is the same in each paragraph, for brevity, it will be only illustrated once.)

1. SSAP No. 51R—Life Contracts, paragraph 50;
2. SSAP No. 53—Property Casualty Contracts—Premiums, paragraph 19;
3. SSAP No. 54R—Individual and Group Accident and Health Contracts, paragraph 33 and
4. SSAP No. 59—Credit Life and Accident and Health Insurance Contracts, paragraph 19.
5. Annual Statement illustration updates

The disclosures in this paragraph should be completed regarding Disclose the aggregate amount of direct premiums written through following regarding managing general agents (MGAs) or third-party administrators (TPAs) that write direct policies or provide claims adjusting or other services. For purposes of this disclosure, a managing general agent means the same as in Appendix A-225. If the premium written amount is equal to or greater than 5% of surplus, or if the claims adjusting services are greater than 5% of annual average claims volume provide the following information for each managing general agent and third-party administrator:

a. Disclose the aggregate amount of direct premiums written through the MGA or TPA and the total premium written by those MGAs or TPAs.
b. Disclose the aggregate amount of claims payments processed by agent or administrator and the total claims processed by such agents or administrators.
c. Licensed name and address (city and state only) of managing general agent or third-party administrator;
d. Federal Employer Identification Number;
e. Whether such person holds an exclusive contract;
f. Types of business written;
g. Type of authority granted and services provided (i.e., underwriting, claims payment, etc.); and
h. Whether the MGA or TPA is affiliated, a non-affiliate related party or unaffiliated.
i. Whether the MGA or TPA is independently audited, and/or bonded.
j. Total premium written.
The following is an illustration of the draft revisions to the current annual statement note tables are proposed for annual statement Note 19 to allow for data capture of the MGA and TPA disclosure which would be forwarded to the Blanks (E) Working Group.

**Managing general agents (MGA) and third-party administrators (TPA) who either write more than 5% of premium or process greater than 5% of claims.**

<table>
<thead>
<tr>
<th>Licensed Name</th>
<th>Address (City and State Only) of Managing General Agent or Third-Party Administration</th>
<th>FEIN Number</th>
<th>Exclusive Contract (Yes/No)</th>
<th>Type of Business Written</th>
<th>Type of Authority and/or Service Granted (Multiple Codes Allowed)</th>
<th>Independently Audited (Yes/No)</th>
<th>Bonded Status (Yes/No)</th>
<th>Direct Written Premium/Produced By</th>
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</table>

**Information regarding Independent Audit, Bonded, status:**

Independent Audit - subject to annual independent audit

Bonded – The work of the entity is bonded by either a fiduciary or surety bond

<table>
<thead>
<tr>
<th>Licensed Name</th>
<th>FEIN Number</th>
<th>Affiliated, Non-Affiliate Related Party, or Unaffiliated</th>
<th>Direct Written Premium/Produced</th>
<th>Claims Payments Processed by Agent or Administrator</th>
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**Codes for types of MGA/TPA Services and/or Authority:**

Authority/Service Codes Sample Listing:

C  Claims Payment
CA Claims Adjustment  
R  Reinsurance Ceding
B  Binding Authority
P  Premium Collection
U  Underwriting

O  Other (Write-in) If other explain in the table below

<table>
<thead>
<tr>
<th>Licensed Name</th>
<th>Explanation of other codes regarding type of authority granted</th>
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</table>
Status:
On December 7, 2019, the Statutory Accounting Principles (E) Working Group moved this agenda item to the active listing, categorized as nonsubstantive, and exposed revisions to SSAP No. 51R—Life Contracts, paragraph 50, SSAP No. 53—Property Casualty Contracts—Premiums, paragraph 19, SSAP No. 54R—Individual and Group Accident and Health Contracts, paragraph 33 and SSAP No. 59—Credit Life and Accident and Health Insurance Contracts, paragraph 19, as illustrated in the staff recommendation above, to expand the MGA/TPA note as follows:

- Aggregate direct written premium and total premium written by MGA/TPA;
- Aggregate dollar amount of claims process / total claims processed by MGA/TPA; and
- Information on related party / affiliate status and if the MGA/TPA is independently audited and / or bonded.

For 2020 Spring National Meeting Discussion

NAIC staff recommends that the Working Group adopt the exposed revisions with the modifications illustrated below. In addition, the Working Group should direct that the modification to the annual statement illustration be forwarded to the Blanks (E) Working Group to coordinate on its concurrent exposure. The additional revisions are drafted to address interested parties’ comments as follows:

1. Consistent with interested parties’ recommendation, TPA has been defined to be consistent with the NAIC Model Guideline, VI-1090 Registration and Regulation of Third-Party Administrators (TPAs).

2. The sponsors of the agenda item indicated that they preferred to maintain a claims measure for determining which TPAs to be disclosed, instead of a written premium measure suggested by interested parties. However, to address the interested parties’ operational concerns the language has been revised from “claims adjusting services are greater than 5% of annual average claims volume” to “if the total count of claims processed by the TPA /MGA are greater than 5% of the total count of claims processed.”

Revisions for:
1. SSAP No. 51R—Life Contracts, paragraph 50;
2. SSAP No. 53—Property Casualty Contracts—Premiums, paragraph 19;
3. SSAP No. 54R—Individual and Group Accident and Health Contracts, paragraph 33 and
4. SSAP No. 59—Credit Life and Accident and Health Insurance Contracts, paragraph 19.

The disclosures in this paragraph should be completed regarding Disclose the aggregate amount of direct premiums written through following regarding managing general agents (MGAs) or third-party administrators (TPAs) that write direct policies or provide claims adjusting or other services. For purposes of this disclosure, a managing general agent means the same as in Appendix A-225. For purposes of this disclosure a third-party administrator is consistent with NAIC Model Guideline, VI-1090 Registration and Regulation of Third-Party Administrators (TPAs). If the premium written amount is equal to or greater than 5% of surplus, or if the total count of claims processed by the TPA or MGA are greater than 5% of the total count of claims processed, provide the following information for each managing general agent and third-party administrator:

a. Disclose the aggregate amount of direct premiums written through the MGA or TPA and the total premium written by those MGAs or TPAs.
b. Disclose the aggregate amount of claims payments processed by agent or administrator and the total claims processed by such agents or administrators.
   a.c. Licensed name and address (city and state only) of managing general agent or third-party administrator;
b.d. Federal Employer Identification Number;
c.e. Whether such person holds an exclusive contract;
d.f. Types of business written;
e.g. Type of authority granted and or services provided (i.e., underwriting, claims payment, etc.); and
h. Whether the MGA or TPA is affiliated, a non-affiliate related party or unaffiliated, and
Annual Statement illustration updates

The following is an illustration of the draft revisions to the current annual statement note tables are proposed for annual statement Note 19 to allow for data capture of the MGA and TPA disclosure which would be forwarded to the Blanks (E) Working Group

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Managing general agents (MGA) and third-party administrators (TPA) who either whose premium written amount is equal to or greater than 5% of surplus or if the total count of claims processed by the TPA / MGA are greater than 5% of the total count of claims processed.

Information regarding Independent Audit, Bonded, status

Independent Audit - subject to annual independent audit
Bonded – The work of the entity is bonded by either a fiduciary or surety bond

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MGA/TPA Services and/or Authority:
Authority/Service Codes Sample Listing:
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O Other (Write-in) If other explain in the table below

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

Issue: Surplus Notes – Enhanced Disclosures

Check (applicable entity):

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<th>Modification of Existing SSAP</th>
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Description of Issue:
Surplus notes are unique statutory accounting items which have the characteristics of both debt and equity addressed in SSAP No. 41R—Surplus Notes. Surplus notes are debt instruments that are required to be subordinated to policyholders, claimants and all other creditors; with interest and principal repayments requiring approval by the domiciliary commissioner. As such, surplus notes are reported as equity for statutory accounting purposes. (This treatment is specific to statutory accounting. Surplus notes are reported as debt under U.S. GAAP.) Pursuant to the requirements of SSAP No. 41R, proceeds received by the issuer of a surplus note must be in the form of cash or other admitted assets meeting both value and liquidity requirements of the state of domicile’s commissioner.

In conjunction with agenda item 2018-07, originally a referral from the Reinsurance (E) Task Force, the Statutory Accounting Principles (E) Working Group has been discussing surplus notes where an “associated” asset is received by the surplus note issuer. These discussions have questions whether a surplus note that does not result with an exchange of cash flows (as the cash flows of offset with an associated asset), shall be considered surplus notes under SSAP No. 41R. Although the discussion on how to treat these surplus notes will occur in agenda item 2018-07, the Working Group has directed that additional disclosures shall be captured in SSAP No. 41R. The intent of this agenda item is to consider new disclosures involving surplus notes to better identify these situations in the statutory financial statements.

Existing Authoritative Literature:
Authoritative guidance is detailed in SSAP No. 41R—Surplus Notes. Current guidance does not require disclosure if a surplus note has been issued with the structure as described where little or no actual cashflows are exchanged.

Current Surplus Note Disclosures under SSAP No 41R:

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 of the assets received;
   c. Holder of the note or if public the names of the underwriter and trustee;
   d. 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. Interest and/or principal paid in the current year;
   j. Total interest and/or principal paid on surplus notes;
k. Subordination terms;
l. Liquidation preference to the reporting entity’s common and preferred shareholders;
m. The repayment conditions and restrictions.

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): Discussions on linked surplus notes is occurring within agenda item 2018-07. The Working Group directed NAIC staff to collect information via a data-call on “linked” surplus notes as of Sept. 30, 2019. This information is requested by Dec. 31, 2019. Improved disclosures on surplus notes in SSAP No. 41R will reduce the need for subsequent data-call collection.

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, categorized as nonsubstantive and expose revisions to SSAP No. 41R to provide enhanced disclosures to identify when a surplus note has been issued in which anticipated or typical cashflows have been partially or fully offset through the terms of the asset provided by the note holder.

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;
   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/or principal recognized as “paid” with identification of the amount of approved interest and/or principal remitted to the holder of the surplus note (actual transfer of cash / assets) and the amount of approved interest and/or principal not remitted to the holder of the surplus note (no transfer of cash / assets);
   j. Information regarding a 3rd party liquidity source including name, identification if a related party, cost of the liquidity guarantee, and maximum amount available should a triggering event occur.
   k. Subordination terms;
   l. Liquidation preference to the reporting entity’s common and preferred shareholders;
   m. The repayment conditions and restrictions.

19. If a reporting entity is not remitting actual cash or assets to the holder of the surplus note for approved interest or principal (as reported under paragraph 18.h), because the reporting entity is offsetting
the amount owed under the surplus note with an amount receivable from a reported asset, the following information shall be disclosed regarding the offsetting asset:

a. Identification of asset, including the investment schedule where the asset is reported and reported NAIC designation.

b. Book/ adjusted carrying value of asset and interest income recognized in the current year.

c. Amount of principle return and interest income from the asset not received by the reporting entity as the amounts were offset with approved amounts owed by the reporting entity’s issued surplus note.

20. 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.

Updates to the Blanks are proposed as a result of the SSAP No. 41R revisions. For readability and due to the amount of proposed changes, both the current and proposed Blanks revisions are detailed below.

Current Blanks Disclosures:

<table>
<thead>
<tr>
<th>Date Issued</th>
<th>Interest Rate</th>
<th>Par Value (Face Amount of Notes)</th>
<th>Carrying Value of Note</th>
<th>Interest And / Or Principal Paid Current Year</th>
<th>Total Interest And / Or Principal Paid</th>
<th>Unapproved Interest And / Or Principal</th>
<th>Date of Maturity</th>
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Proposed Blanks Disclosures:

<table>
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<tr>
<th>Date Issued</th>
<th>Interest Rate</th>
<th>Original Issue Amount of Note</th>
<th>Fair Value of Assets Received Upon Issuance</th>
<th>Type of Assets Received Upon Issuance</th>
<th>Carrying Value of Note Prior Year</th>
<th>Carrying Value of Note Current Year</th>
<th>Unapproved Interest And / Or Principal</th>
<th>Approved Interest Recognized Current Year</th>
<th>Life-To-Date Interest Remitted (Actual Transfer of Cash/Assets)</th>
<th>Life-To-Date Principal (Actual Transfer of Cash/Assets) Remitted</th>
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Current Year Approved Principal Remitted (Actual Transfer of Cash/Assets)  
Current Year Approved Interest Not Remitted Since Issuance (No Transfer of Cash/Assets)  
Current Year Approved Principal Not Remitted Since Issuance (No Transfer of Cash/Assets)  
Is Non-Remitted Interest or Principal Offset with Amounts Owed from Surplus Note Holder? (Y/N)  
Does Remitted Interest or Principal Payments Result with Acquisition of a Source of Liquidity Through the Surplus Note Holder? (Y/N)  
Is Surplus Note Holder a Related Party (Y/N)

* Include amounts offset with amounts owed from the holder of the surplus note.

<table>
<thead>
<tr>
<th>Name of 3rd Party Liquidity Source Acquired</th>
<th>Is Liquidity Source a Related Party to the Surplus Note Issuer?</th>
<th>Current Year Total Cost of Liquidity Source</th>
<th>Current Year Cost of Liquidity Source Reported as Surplus Note Interest</th>
<th>Total Cost of Liquidity Source Since Acquisition</th>
<th>Total Cost of Liquidity Source Reported as Surplus Note Interest Since Acquisition</th>
<th>Maximum Amount Surplus Note Issuer Can Receive from Liquidity Source</th>
</tr>
</thead>
</table>
Status:
On December 7, 2019, the Statutory Accounting Principles (E) Working Group moved this agenda item to the active listing, categorized as nonsubstantive, and exposed revisions to SSAP No. 41—Surplus Notes to provide enhanced disclosures to identify when an issued surplus note’s anticipated or typical cash flows have been partially or fully offset through an asset held by the surplus note issuer.

Spring 2020 National Meeting discussion

Interested Parties submitted comments and suggested edits on the prior exposure; NAIC staff agree that the proposed edits, as they in essence, require disclosure of the desired items as detailed in the original agenda item. Additionally, in some cases, suggested proposed edits expanded surplus note structure disclosures requirements.

NAIC staff added one disclosure item to be data captured in the Blanks

NAIC staff recommends that the Working Group expose this agenda item, with revisions as proposed by interested parties, and as further modified by NAIC staff. These revisions will require additional disclosures regarding the issuance of Surplus Notes – specifically those that are structured in a manner in which typical cashflows have been reduced or eliminated

Changed from the original exposure are highlighted in grey below.

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;
   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 recognized and/or principal paid recognized
      i. Percentage interest payments offset through ‘administrative offsetting’ (not inclusive of amounts paid to a 3rd party liquidity provider). I.E. if $100 in interest was recognized through the year, $10 of which was remitted to a 3rd party liquidity provider and the reminder $90 was offset, the reporting entity shall report 100% as offset;
   j. Disclosure of whether the surplus note was issued as paid part of a transaction with identification 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 amount of approved
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, (actual transfer of cash / assets) and the amount of approved interest and/or principal not remitted to the holder of the surplus note (no transfer of cash / assets).

h. Information regarding a 3rd-party liquidity source including name, identification if a related party, cost of the liquidity guarantee, and maximum amount available should a triggering event occur.

k. Principal amount 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.

ko. 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 not remitting actual cash or assets to a related party as part of a reinsurance transaction in which the surplus note meets any of the criteria in 18. j above, the ceding entity shall provide a description of the transaction, including whether the criteria in 18. j above 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 for approved interest or principal (as reported under paragraph 18.h), because the reporting entity is offsetting the amount owed under the surplus note with an amount receivable from a reported asset, the following information shall be disclosed regarding the offsetting asset/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 and interest income recognized as of the current year-reporting date.

c. Amount of principle return and interest income from the asset not received by the reporting entity as the amounts were offset with approved amounts owed by the reporting entity’s issued surplus note. 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 Blanks Disclosures:

<table>
<thead>
<tr>
<th>Date Issued</th>
<th>Interest Rate</th>
<th>Original Issue Amount of Note</th>
<th>Fair Value of Assets Received Upon Issuance</th>
<th>Is Surplus Note Holder a Related Party (Y/N)</th>
<th>Carrying Value of Note Prior Year</th>
<th>Carrying Value of Note Current Year</th>
<th>Unapproved Interest And/or Principal</th>
<th>Approved Interest Recognized Current Year</th>
<th>Current Year Interest Expense Recognized</th>
</tr>
</thead>
<tbody>
<tr>
<td>1311999</td>
<td>XXX</td>
<td>Total</td>
<td>XXX</td>
<td>XXX</td>
<td>XXX</td>
<td>XXX</td>
<td>XXX</td>
<td>XXX</td>
<td>XXX</td>
</tr>
</tbody>
</table>
Statutory Accounting Principles (E) Working Group
Maintenance Agenda Submission Form
Form A

Issue: Acceptable Collateral - Counterparty Exposure for Derivative Instruments.

Check (applicable entity):

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

Summary of Issue:
Potential misinterpretation for Blank instructions on Schedule DB-D, section 1, column 4 (Fair Value of Acceptable Collateral) exist as collateral is reported as 1) the fair value of collateral pledged by a counterparty, or 2) for central clearinghouses as the **net positive variation margin** received by the reporting entity.

NAIC staff believes the intent of **net positive variation margin** was originally meant to reflect **net realizable margin**. For example, if a reporting entity originally paid $5k as collateral to initiate a position, then subsequently received $15k in variation margin true-up, the reporting entity should report $10k in the fair value of acceptable collateral (assuming the counterparty has the legal right to offset the original $5k received). With the legal right to offset, in this example the holder can only realize a net $10k in collateral if liquidation were to occur. As the instructions indicate “net positive variation margin,” the variation collateral of $15k could be reported, disregarding the $5k initial margin.

Conversely, had the reporting entity received $5k in initial margin, and a subsequent $20k in variation margin, a total of $25k should be reported as collateral, thus giving credit for the initial margin received. NAIC staff believe this intent is articulated in SSAP No. 86, as collateral is defined in the disclosures as “net assets held.”

This agenda item included proposed clarification language that states collateral shall be determined by the summation of any assets held less any collateral paid/pledged from collateral received, if the counterparty has a legal right to offset as defined in SSAP No. 64.

Further Background:
Schedule DB – Part D, Section 1 of the Blanks facilitates reporting of counterparty exposure from open derivative instruments. As described in the Blanks instructions, counterparty exposure is credit risk associated with certain types of transactions; in relation to schedule DB, it is the credit risk associated with the use of derivative instruments. Schedule DB-D, Section 1 displays the book/adjusted carrying value and the fair value of counterparty exposure, net of acceptable collateral held by or pledged to the reporting entity. Due to the nature of risk being calculated and displayed net of collateral, this Form A is to facilitate a discussion regarding the technical definition regarding determination of value as it relates to collateral.

In 2012, the Blanks (E) Working Group adopted modifications to numerous derivative statements and related instructions. These updates were driven by differing clearing and collateral requirements for certain types of derivative investments as well as the need to ensure consistent and accurate reporting of derivative investment activity of insurers.

Various concepts were introduced including Schedule DB – Part D, Section 2, which captures detailed collateral information for open derivative instruments. Collateral held or received through a pledge typically covers some or all of the credit risk the holder possesses due to transactions exchanged with a counterparty. In terms of derivative contracts, **collateral may be pledged** to exchanges, counterparties, clearing brokers or central clearinghouses **by the reporting entity or** pledged from these organizations **to the reporting entity**. While the specific items that are
considered acceptable collateral are detailed herein, a common term for collateral is “margin.” There are typically three types of margin that apply to these financial instruments, broadly defined as:

- Initial Margin - the minimum amount of equity that must be held/pledged to initiate a position.
- Maintenance Margin - the minimum amount of equity that must be maintained in order to not have the position forcibly liquidated. Also defined as the net sum of initial and variation margin.
- Variation Margin - payments generally made based on adverse price movements, often paid by clearing members to reduce exposures created by open derivative positions. Variation margin could also be as a result of changes in maintenance margin requirements. The term Variation Margin for statutory purposes is defined below.

In the normal course of business, all applicable cashflows are typically utilized in the reporting of an activity. In the instance of margin, initial margin plus/minus variation margin equals total margin. Remaining within SSAP No. 86—Derivatives, there are many instances that demonstrate this principal. As described for the initial carrying value of a futures contact (reported as an asset), paraphrased guidance states that positions should be valued at the initial amount of cash deposits plus/minus any subsequent cash flows. Additionally, options, warrants, caps, and floors are initially valued at total premium paid or received. While subsequent valuations may differ (amortized cost or fair value depending on the reporting of the item being hedged), all associated cash flows were utilized for reporting.

Existing Authoritative Literature:
While described in general terms above, statutory accounting guidance for variation margin is as follows:

SSAP No. 86 – Derivatives
15. “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.

Blanks instructions regarding the reporting of acceptable collateral, as it relates to counterparty exposures from open derivative investments, is as follows:

Schedule DB – Part D – Section 1, Column 4 (Fair Value of Acceptable Collateral)

- Fair Value of Acceptable Collateral
- Leave blank for the aggregate reporting of Exchange-Traded Derivatives (Line 0199999999).
- For OTC counterparties, show the Fair Value of acceptable collateral pledged by the counterparty.
- For central clearinghouses, this amount would be the net positive variation margin received by the reporting entity.

“Acceptable collateral” means cash, cash equivalents, securities issued or guaranteed by the United States or Canadian governments or their government-sponsored enterprises, letters of credit, publicly traded obligations designated 1 by the SVO, government money market mutual funds, and such other items as may be defined as acceptable collateral in the Purposes and Procedures Manual of the NAIC Investment Analysis Office. For purposes of this definition, the term “letter of credit” means a clean, irrevocable and unconditional letter of credit issued or confirmed by, and payable and presentable at, a financial institution on the list of financial institutions meeting the standards for issuing such letter of credit.
SSAP No. 86 defines several disclosure items related to collateral. The primary intent of such disclosures is to reflect amounts available to cover exposure in the event the liquidation of collateral assets occurs. Key areas are highlighted herein.

**Disclosure Requirements**

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

   e. A seller of credit derivatives shall disclose information about its credit derivatives and hybrid instruments that have embedded credit derivatives to enable users of financial statements to assess their potential effect on its financial position, income and cash flows. The seller of a credit derivative shall disclose the following information for each credit derivative, or each group of credit derivatives, even if the likelihood of the seller’s having to make any payments under the credit derivative is remote. With respect to hybrid instruments that have embedded credit derivatives, the seller of the embedded credit derivative shall disclose the required information for the entire hybrid instrument, not just the embedded credit derivative.

   i. The nature of the credit derivative, including the approximate term of the credit derivative, the reason(s) for entering into the credit derivative, the events or circumstances that would require the seller to perform under the credit derivative, and the current status (that is, as of the date of the statement of financial position) of the payment/performance risk of the credit derivative. For example, the current status of the payment/performance risk of a credit derivative could be based on either recently issued external credit ratings or current internal groupings used by the seller to manage its risk. An entity that uses internal groupings shall disclose how those groupings are determined and used for managing risk.

   ii. The maximum potential amount of future payments (undiscounted) the seller could be required to make under the credit derivative. That maximum potential amount of future payments shall not be reduced by the effect of any amounts that may possibly be recovered under recourse or collateralization provisions in the credit derivative (which are addressed under paragraph 59.e.iv.). If the terms of the credit derivative provide for no limitation to the maximum potential future payments under the contract, that fact shall be disclosed. If the seller is unable to develop an estimate of the maximum potential amount of future payments under the credit derivative, the seller shall disclose the reasons why it cannot estimate the maximum potential amount.

   iii. The fair value of the credit derivative as of the date of the statement of financial position.

   iv. The nature of (1) any recourse provisions that would enable the seller to recover from third parties any of the amounts paid under the credit derivative and (2) any assets held either as collateral or by third parties that, upon the occurrence of any specified triggering event or condition under the credit derivative, the seller can obtain and liquidate to recover all or a portion of the amounts paid under the credit derivative. The seller shall indicate, if estimable, the approximate extent to which the proceeds from liquidation of those assets would be expected to cover the maximum potential amount of future payments under the credit derivative. In its estimate of potential recoveries, the seller of credit protection shall consider the effect of any purchased credit protection with identical underlying(s).

   f. A holder of a financial instrument with an embedded credit derivative that exposes the holder to the possibility (however remote) of being required to make future payments (not merely receive reduced cash inflows) because the possibility of those future payments is not caused by subordination (such as the subordination of one beneficial interest to another tranche of a securitization, thereby redistributing credit risk) shall provide the following disclosures for the entire hybrid instrument, not just the embedded credit derivative:
i. The nature of the embedded credit derivative, including the approximate term of the embedded credit derivative, the events or circumstances that would require the holder to perform under the embedded credit derivative, and the current status (that is, as of the date of the statement of financial position) of the payment/performance risk of the embedded credit derivative.

ii. The maximum potential amount of future payments (undiscounted) the holder could be required to make under the embedded credit derivative. That maximum potential amount of future payments shall not be reduced by the effect of any amounts that may possibly be recovered under recourse or collateralization provisions in the embedded credit derivative (which are addressed under paragraph 59.f.iv.). If the terms of the embedded credit derivative provide for no limitation to the maximum potential future payments under the contract, that fact shall be disclosed. If the holder is unable to develop an estimate of the maximum potential amount of future payments under the embedded credit derivative, the holder shall disclose the reasons why it cannot estimate the maximum potential amount.

iii. The fair value of the hybrid instrument containing the embedded credit derivative as of the date of the statement of financial position.

iv. The nature of (1) any recourse provisions that would enable the holder to recover from third parties any of the amounts paid under the embedded credit derivative and (2) any assets held either as collateral or by third parties that, upon the occurrence of any specified triggering event or condition under the embedded credit derivative, the holder can obtain and liquidate to recover all or a portion of the amounts paid under the credit derivative. The holder shall indicate, if estimable, the approximate extent to which the proceeds from liquidation of those assets would be expected to cover the maximum potential amount of future payments under the embedded credit derivative. In its estimate of potential recoveries, the holder of credit protection shall consider the effect of any purchased credit protection with identical underlying(s).

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 recommends that the Working Group move this item to the active listing, categorized as nonsubstantive and expose revisions to SSAP No. 86 to clarify that the fair value of collateral received or held, for derivative disclosure purposes, shall be reported net of collateral paid/pledged, in the event a counterparty has the legal right to offset against as defined in SSAP No. 64. Further, minor updates to applicable annual statement instructions are proposed to be concurrently exposed.

Disclosure Requirements

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

e. A seller of credit derivatives shall disclose information about its credit derivatives and hybrid instruments that have embedded credit derivatives to enable users of financial statements to assess their potential effect on its financial position, income and cash flows.

A seller of credit derivatives shall disclose information about its credit derivatives and hybrid instruments that have embedded credit derivatives to enable users of financial statements to assess their potential effect on its financial position, income and cash flows. The seller of a credit derivative shall disclose the following
information for each credit derivative, or each group of credit derivatives, even if the likelihood of the seller’s having to make any payments under the credit derivative is remote. With respect to hybrid instruments that have embedded credit derivatives, the seller of the embedded credit derivative shall disclose the required information for the entire hybrid instrument, not just the embedded credit derivative.

i. The nature of the credit derivative, including the approximate term of the credit derivative, the reason(s) for entering into the credit derivative, the events or circumstances that would require the seller to perform under the credit derivative, and the current status (that is, as of the date of the statement of financial position) of the payment/performance risk of the credit derivative. For example, the current status of the payment/performance risk of a credit derivative could be based on either recently issued external credit ratings or current internal groupings used by the seller to manage its risk. An entity that uses internal groupings shall disclose how those groupings are determined and used for managing risk.

ii. The maximum potential amount of future payments (undiscounted) the seller could be required to make under the credit derivative. That maximum potential amount of future payments shall not be reduced by the effect of any amounts that may possibly be recovered under recourse or collateralization provisions in the credit derivative (which are addressed under paragraph 59.e.iv.). If the terms of the credit derivative provide for no limitation to the maximum potential future payments under the contract, that fact shall be disclosed. If the seller is unable to develop an estimate of the maximum potential amount of future payments under the credit derivative, the seller shall disclose the reasons why it cannot estimate the maximum potential amount.

iii. The fair value of the credit derivative as of the date of the statement of financial position.

iv. The nature of (1) any recourse provisions that would enable the seller to recover from third parties any of the amounts paid under the credit derivative and (2) any assets held either as collateral¹ or by third parties that, upon the occurrence of any specified triggering event or condition under the credit derivative, the seller can obtain and liquidate to recover all or a portion of the amounts paid under the credit derivative. The seller shall indicate, if estimable, the approximate extent to which the proceeds from liquidation of those assets would be expected to cover the maximum potential amount of future payments under the credit derivative. In its estimate of potential recoveries, the seller of credit protection shall consider the effect of any purchased credit protection with identical underlying(s).

f. A holder of a financial instrument with an embedded credit derivative that exposes the holder to the possibility (however remote) of being required to make future payments (not merely receive reduced cash inflows) because the possibility of those future payments is not caused by subordination (such as the subordination of one beneficial interest to another tranche of a securitization, thereby redistributing credit risk) shall provide the following disclosures for the entire hybrid instrument, not just the embedded credit derivative:

i. The nature of the embedded credit derivative, including the approximate term of the embedded credit derivative, the events or circumstances that would require the holder to perform under the embedded credit derivative, and the current status (that is, as of the date of the statement of financial position) of the payment/performance risk of the embedded credit derivative.

ii. The maximum potential amount of future payments (undiscounted) the holder could be required to make under the embedded credit derivative. That maximum potential amount of future payments shall not be reduced by the effect of any amounts that may possibly be recovered under recourse or collateralization provisions in the embedded credit derivative.

¹ Collateral, as calculated on an individual derivative instrument basis, shall be determined by deducting collateral paid/pledged from collateral received if the counterparty has a legal right to offset as defined in SSAP No. 64.
(which are addressed under paragraph 59.f.iv.). If the terms of the embedded credit derivative provide for no limitation to the maximum potential future payments under the contract, that fact shall be disclosed. If the holder is unable to develop an estimate of the maximum potential amount of future payments under the embedded credit derivative, the holder shall disclose the reasons why it cannot estimate the maximum potential amount.

iii. The fair value of the hybrid instrument containing the embedded credit derivative as of the date of the statement of financial position.

iv. The nature of (1) any recourse provisions that would enable the holder to recover from third parties any of the amounts paid under the embedded credit derivative and (2) any assets held either as collateral or by third parties that, upon the occurrence of any specified triggering event or condition under the embedded credit derivative, the holder can obtain and liquidate to recover all or a portion of the amounts paid under the credit derivative. The holder shall indicate, if estimable, the approximate extent to which the proceeds from liquidation of those assets would be expected to cover the maximum potential amount of future payments under the embedded credit derivative. In its estimate of potential recoveries, the holder of credit protection shall consider the effect of any purchased credit protection with identical underlying(s).

Proposed Blank Instructions Updates – Schedule DB-B, Section 1, Column 4

Fair Value of Acceptable Collateral

Leave blank for the aggregate reporting of Exchange-Traded Derivatives (Line 0199999999).

For OTC counterparties, show the Fair Value of acceptable net collateral pledged by the counterparty.

For central clearinghouses, this amount would be the total net positive variation margin received by the reporting entity.

Staff Review Completed by: Jim Pinegar, October 2019

Status:
On December 7, 2019, the Statutory Accounting Principles (E) Working Group moved this agenda item to the active listing, categorized as nonsubstantive, and exposed revisions to SSAP No. 86—Derivatives, as illustrated above, to clarify that the fair value of collateral received or held, for derivative disclosure purposes, shall be reported net of collateral paid/pledged, in the event a counterparty has the legal right to offset against, as defined in SSAP No. 64—Offsetting and Netting of Assets and Liabilities. Minor updates to the applicable annual statement instructions were also proposed to be concurrently exposed.

2 See footnote 1.
Issue: Grade in of Variable Annuity Reserves

Check (applicable entity):  
- Modification of Existing SSAP
- New Issue or SSAP
- Interpretation

P/C  Life  Health

At the 2019 Summer National Meeting, the NAIC Executive and Plenary adopted revisions drafted by the Life Actuarial (A) Task Force to Section 21 of the *Valuation Manual Requirements for Principle-Based Reserves for Variable Annuities (VM-21)* which provides comprehensive updates to the Commissioners' Annuity Reserve Valuation Method of reserving for variable annuities. The revisions adopted to VM-21 represent an accounting change that must be recognized as a change in valuation basis under SSAP No. 51R—Life Contracts. Updates to SSAP No. 51R are needed to coordinate with the recent revisions to the variable annuity reserving methodology. In addition, the proposed revisions recommend deferring to VM-21 regarding future variable annuity reserving methodology phase-ins along with disclosure on phase in details.

The enhancements to the variable annuity framework resulting in revisions to AG 43 and VM-21 centered around the following:

- Reforming the standard scenario to enhance regulatory oversight of companies’ actuarial assumptions
- Mitigating asset-liability accounting mismatch between hedge instruments and statutory liabilities
- Improving interpretability of framework results and simplicity of calculations
- Facilitating greater harmonization across insurers and products for greater comparability

To achieve this focus the determination of the Conditional Tail Expectation (CTE) amount, Standard Scenario and the Standard Scenario amount has changed significantly resulting in the revised variable annuity reserves methodology.

The revisions to VM-21 in combination with the revisions to Actuarial Guideline XLIII CARVM For Variable Annuities (AG 43) applies retroactively to contracts issued between 1981 and Dec. 31, 2019 as follows:

- VM-21 changes affect reserving for contracts issued Jan. 1, 2017 through Dec. 31, 2019
- AG 43 changes affect reserving for contracts issued to 1981 through Dec. 31, 2016

These changes to the variable annuity reserving framework updated the principles and methodology and apply retroactively (see Authoritative Literature). Under SSAP No. 55 a change in valuation basis is recognized as a change in surplus rather than an increase in reserves recognized through income.

The VM-21 allows the following choices for phasing in the change in reserving valuation basis necessitated by variable annuity reserving methodology changes. Early adoption, beginning Dec. 31, 2019

- Adoption in full beginning Jan. 1, 2020
- A reporting entity election to grade in over 3 years.
- An election to grade in over 7 years, subject to commissioner discretion.

In addition, it provides the following acceleration provisions:
Early termination and full recognition,

If there is a material decrease in the book of business by sale or reinsurance ceded, the company shall adjust the amount of the grade-in provision. The grade-in amount ($C = R1 - R2$, as described below) must be scaled down in proportion to the reduction in the excess reserve, measured on the effective transaction date as the reserve amount in excess of cash surrender value before and after the impact of the transaction.

The company must obtain approval for any other modification of the remaining grade-in amount.

Existing Authoritative Literature:

Valuation Manual – Section 21

Effective Date and Phase-In These requirements apply for valuation dates on or after Jan. 1, 2020. A company may elect to phase in these requirements over a 36-month period beginning Jan. 1, 2020. A company may elect a longer phase-in period, up to seven years, with approval of the domiciliary commissioner. The election of whether to phase in and the period of phase-in must be made prior to the Dec. 31, 2020, valuation. At the company’s option, a phase-in may be terminated prior to the originally elected end of the phase-in period; the reserve would then be equal to the unadjusted reserve calculated according to the requirements of VM-21 applicable for valuation dates on or after Jan. 1, 2020. If there is a material decrease in the book of business by sale or reinsurance ceded, the company shall adjust the amount of the phase-in provision. The phase-in amount ($C = R1 - R2$, as described below) must be scaled down in proportion to the reduction in the excess reserve, measured on the effective transaction date as the reserve amount in excess of cash surrender value before and after the impact of the transaction. The company must obtain approval for any other modification of the remaining phase-in amount. The method to be used for the phase-in calculation is as follows:

SSAP No. 51R—Life Contracts

Change In Valuation Basis

36. A change in valuation basis for reserves determined under paragraphs 18-21, except for reserves defined under Actuarial Guideline XLIII—CARVM: For Variable Annuities (AG 43), as detailed in Appendix C of this Manual, shall be defined as a change in the interest rate, mortality assumption, or reserving method (e.g., net level, preliminary term, etc.) or other factors affecting the reserve computation of policies in force and meets the definition of an accounting change as defined in SSAP No. 3—Accounting Changes and Corrections of Errors (SSAP No. 3).

37. Changes in reserves developed under paragraph 22 or AG 43 shall be reviewed to determine whether the change represents a change in valuation basis and if it meets the definition of a change in accounting as defined in SSAP No. 3.

a. Changes in principle-based reserving assumptions are often the result of updating assumptions and other factors required by the existing reserving methodology. Reserve changes resulting from the application of principle-based reserving methodology including, but not limited to, updating assumptions based on reporting entity, industry or other experience, and having the reported reserve transition between net premium reserve, deterministic reserve or stochastic reserve, as required under existing guidance, shall not be considered a change in valuation basis. These types of changes also include, but are not limited to, periodic updates in Valuation Manual tables, such as industry valuation basic tables, asset spread tables and default cost tables.

b. A change in valuation basis for principle-based reserves shall include cases where the required reserve methodology has changed or the insurer makes a voluntary decision to choose one allowable reserving method over another. These types of changes include, but are not limited to, new standardized mortality tables such as Commissioners Standard Ordinary tables and regulatory changes in methodology.
38. Consistent with SSAP No. 3, any increase (strengthening) or decrease (destrengthening) in actuarial reserves resulting from such a change in valuation basis shall be recorded directly to surplus (under changes to surplus in the change in valuation basis annual statement line) rather than as a part of the reserve change recognized in the summary of operations.

39. The impact of a change in valuation basis on surplus is based on the difference between the reported reserve under the old and new methods as of the beginning of the year. This difference shall not be graded in over time unless this statement prescribes a new method and a specific transition that allows for grading. Some changes will meet the definition of a change in accounting as defined in SSAP No. 3 and a change in valuation basis as described in paragraphs 36-38 of this statement, but the adjustment to surplus will be zero. This can happen when the change in valuation basis is prospective and only applies to new policies and reserves meaning that policies inforce for the prior year-end are not affected, or situations in which the change in reserving methodology did not change the reserves reported in the financial statements. The changes remain subject to the disclosures prescribed in SSAP No. 3. The Valuation Manual is effective prospectively for policies written on or after the operative date. Therefore, upon the initial prospective adoption of principle-based reserving, the change in valuation basis reflected as an adjustment to surplus will be zero. After initial adoption of the Valuation Manual, changes in valuation basis will need to be evaluated to determine the amount of any surplus adjustments.

SSAP No. 3—Accounting Changes and Corrections of Errors

Disclosures

13. Disclosure of material changes in accounting and correction of errors shall include:

   a. A brief description of the change, encompassing a general disclosure of the reason and justification for change or correction;

   b. The impact of the change or correction on net income, surplus, total assets, and total liabilities for the two years presented in the financial statements (i.e., the balance sheet and statement of income and operations); and

   c. The effect on net income of the current period for a change in estimate that affects several future periods, such as a change in the service lives of depreciable assets or actuarial assumptions affecting pension costs. Disclosure of the effect on those income statement amounts is not necessary for estimates made each period in the ordinary course of accounting for items such as uncollectible accounts; however, disclosure is recommended if the effect of a change in the estimate is material; and

   d. When subsequent financial statements are issued containing comparative restated results as a result of the filing of an amended financial statement, the reporting entity shall disclose that the prior period has been restated and the nature and amount of such restatement.

14. Refer to the Preamble for further discussion regarding disclosure requirements.

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

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

Convergence with International Financial Reporting Standards (IFRS): Not applicable

Staff Review Completed by:
Robin Marcotte, NAIC Staff - November 2019

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Staff Recommendation:

NAIC staff recommends that the Working Group move this item to the active listing, categorized as nonsubstantive and expose the revisions described and illustrated below to SSAP No. 51R—Life Contracts, and adding reference to the additional grade-in disclosure requirements in SSAP No. 3—Accounting Changes and Corrections of Errors for reporting years beginning Jan. 1, 2020. In addition, NAIC staff plans a future agenda item regarding exercise of Commissioner Discretion in the VM. Proposed revisions detailed in the current agenda item:

1. Revises the existing guidance, which prohibits grading-in changes in valuation basis unless provided for in the statement, to allow a grade-in for changes in valuation basis if permitted by the statement or the Valuation Manual in section VM-21 Requirements for Principle-Based Reserves for Variable Annuities (VM-21). Historically choosing effective dates for major reserving changes for the Accounting Practices and Procedures Manual has been determined by Working Group, for example the 2001 CSO table (adopted in 2002) was effective for policies January 1, 2004 in Appendix A-820. This has been to promote consistent implementation and reporting. By deferring to the VM-21 on grade-in options with many varied features, there will be less comparability in reporting, because there is more optionality in reserve reporting. Therefore, additional disclosure regarding grade-in has been proposed.

2. A change in valuation basis under SSAP No. 51R is recognized through surplus. As the unrecognized graded-in reserve represents an unrecognized adjustment to surplus, the revisions require the unrecognized grade-in amount from a change in valuation basis, if resulting with an increase in reserves (decrease from surplus), to be reported as an allocation from unassigned funds to special surplus until the amount has been fully graded into unassigned funds. The reclassification from unassigned funds to special surplus does not reduce total surplus. This is to provide transparency regarding the increased reserve amount that has not been reflected into surplus. As amounts are graded-in to reduce surplus, the amount in special surplus is reclassified to unassigned funds.

3. The proposed revisions to SSAP No. 51R expand the disclosure for changes in valuation basis as a change in accounting principle under SSAP No. 3 to also include details regarding grade-ins of changes in valuation basis, including the grade-in period applied, the remaining amount to be graded-in, remaining time for the grade-in period and the initial grade-in amount and any adjustments to the original amount.

4. Adds a reference in SSAP No. 3 regarding additional disclosures of grade-in features.

NAIC staff plans to propose a new agenda item to address commissioner discretion in the VM. The exercise of commissioner discretion has been typically removed from Appendix A – Excerpts of Model Laws so that if it is exercised, it is disclosed as a permitted or prescribed difference in Note 1 to provide transparency and comparability. As the Valuation Manual incorporates Commissioner discretion that might not be reported as a prescribed or permitted practice, NAIC staff also recommends a future agenda item, regarding how to provide transparency on the use of commissioner discretion.

SSAP No. 51R:

Change In Valuation Basis

36. A change in valuation basis for reserves determined under paragraphs 18-21, except for reserves defined under Actuarial Guideline XLIII—CARVM: For Variable Annuities (AG 43), as detailed in Appendix C of this Manual, shall be defined as a change in the interest rate, mortality assumption, or reserving method (e.g., net level, preliminary term, etc.) or other factors affecting the reserve computation of policies in force and meets the definition of an accounting change as defined in SSAP No. 3—Accounting Changes and Corrections of Errors (SSAP No. 3).
37. Changes in reserves developed under paragraph 22 or AG 43 shall be reviewed to determine whether the change represents a change in valuation basis and if it meets the definition of a change in accounting as defined in SSAP No. 3.

a. Changes in principle-based reserving assumptions are often the result of updating assumptions and other factors required by the existing reserving methodology. Reserve changes resulting from the application of principle-based reserving methodology including, but not limited to, updating assumptions based on reporting entity, industry or other experience, and having the reported reserve transition between net premium reserve, deterministic reserve or stochastic reserve, as required under existing guidance, shall not be considered a change in valuation basis. These types of changes also include, but are not limited to, periodic updates in Valuation Manual tables, such as industry valuation basic tables, asset spread tables and default cost tables.

b. A change in valuation basis for principle-based reserves shall include cases where the required reserve methodology has changed, or the insurer makes a voluntary decision to choose one allowable reserving method over another. These types of changes include, but are not limited to, new standardized mortality tables such as Commissioners Standard Ordinary tables and regulatory changes in methodology.

38. Consistent with SSAP No. 3, any increase (strengthening) or decrease (destrengthening) in actuarial reserves resulting from such a change in valuation basis shall be recorded directly to surplus (under changes to surplus in the change in valuation basis annual statement line) rather than as a part of the reserve change recognized in the summary of operations.

39. The impact of a change in valuation basis on surplus is based on the difference between the reported reserve under the old and new methods as of the beginning of the year. This difference shall not be graded in over time unless this statement or the Valuation Manual section VM-21 Requirements for Principle-Based Reserves for Variable Annuities (VM-21) prescribes a new method and a specific transition that allows for grading. If the grading permitted by this statement or Valuation Manual section VM-21 represents an increase in the reserve liabilities, the unrecognized change in valuation basis reserve increase shall initially be reflected as an allocation from unassigned funds to special surplus until fully recognized in reserving and unassigned funds. The reclassification from unassigned funds to special surplus does not reduce total surplus, but highlights the ungraded in amount for transparency as it represents an unrecognized adjustment (decrease) to total surplus. The allocation to special surplus is reversed to unassigned funds as the grading of the increase in reserving is recognized as a decrease to total surplus. Some changes will meet the definition of a change in accounting as defined in SSAP No. 3 and a change in valuation basis as described in paragraphs 36-38 of this statement, but the adjustment to surplus will be zero. This can happen when the change in valuation basis is prospective and only applies to new policies and reserves meaning that policies in force for the prior year end are not affected, or situations in which the change in reserving methodology did not change the reserves reported in the financial statements. The changes remain subject to the disclosures prescribed in SSAP No. 3. Effective January 1, 2020, if the Valuation Manual section VM-21 (on variable annuities) or this statement prescribes or permits a grading in period or provides the option of multiple grading periods, reporting entities shall also include in the change in accounting disclosures required by SSAP No. 3, disclosure of the following:

a. the grade in period being applied, and the remaining time period of the grade in

b. any adjustments to the grade in period.

c. amount of change in valuation basis grade in, which has been recognized in unassigned funds and

d. the remaining amount to be graded-in (reflected in special surplus if the ungraded in amount represents an increase in reserving).
40. Some changes will meet the definition of a change in accounting as defined in SSAP No. 3 and a change in valuation basis as described in paragraphs 36-38 of this statement, but the adjustment to surplus will be zero. This can happen when the change in valuation basis is prospective and only applies to new policies and reserves meaning that policies in force for the prior year-end are not affected, or situations in which the change in reserving methodology did not change the reserves reported in the financial statements. The Valuation Manual is effective prospectively for policies written on or after the operative date, however, as the CARVM methodology was already principles based, some changes to the CARVM methodology in section VM-21 (on variable annuities) and to the related AG 43 may result in retroactive application to the reserving for existing contracts. Therefore, upon the initial prospective adoption of principle-based reserving, the change in valuation basis reflected as an adjustment to surplus will be zero. After initial adoption of the Valuation Manual, changes in valuation basis will need to be evaluated to determine the amount of any surplus adjustments.

SSAP No. 3—Accounting Changes and Corrections of Errors

Disclosures

13. Disclosure of material changes in accounting and correction of errors shall include:

a. A brief description of the change, encompassing a general disclosure of the reason and justification for change or correction;

b. The impact of the change or correction on net income, surplus, total assets, and total liabilities for the two years presented in the financial statements (i.e., the balance sheet and statement of income and operations); and

c. The effect on net income of the current period for a change in estimate that affects several future periods, such as a change in the service lives of depreciable assets or actuarial assumptions affecting pension costs. Disclosure of the effect on those income statement amounts is not necessary for estimates made each period in the ordinary course of accounting for items such as uncollectible accounts; however, disclosure is recommended if the effect of a change in the estimate is material;

d. Changes in accounting that are changes in reserve valuation basis as described in SSAP No. 51R—Life Contracts which have grade in or other optional application features, shall also include in the change in accounting disclosures information regarding the application of any grade in as provided for in SSAP No. 51R, and

e. When subsequent financial statements are issued containing comparative restated results as a result of the filing of an amended financial statement, the reporting entity shall disclose that the prior period has been restated and the nature and amount of such restatement.

Status:
On December 7, 2019, the Statutory Accounting Principles (E) Working Group moved this agenda item to the active listing, categorized as nonsubstantive, and exposed revisions to SSAP No. 51R—Life Contracts and SSAP No. 3—Accounting Changes and Corrections of Errors as illustrated above. The revisions add reference, disclosures and accounting for Section 21 of the Valuation Manual, Requirements for Principle-Based Reserves for Variable Annuities, and grade-in requirements for reporting changes in the valuation basis for years beginning January 1, 2020.
For Spring National Meeting Discussion,

NAIC Staff recommends that the Working Group adopt the exposed revisions, incorporating interested parties proposed edits of removing the reclassification to special surplus as summarized and illustrated in the agenda item and below. The proposed text for adoption does not incorporate all of the interested parties’ revisions. If preferred, the Working Group could have a short re-exposure, but such a deferral may raise first quarter reporting concerns.

NAIC Staff does not propose to incorporate the following revisions requested by Interested Parties:

- SSAP No. 51, paragraph 39, 40 and SSAP No. 3 - Keep the exposed grade in guidance as which defers only to the VM 21 CARVM grade in guidance and requires coordination on future VM grade in proposals.
- SSAP No. 51, paragraph 40 – did not add industry proposed language on retroactivity.

NAIC Staff illustration incorporates the following revisions requested by Interested Parties:

- SSAP No. 51, paragraph 39 and subparagraphs c and d – Delete the exposed reclassification to special surplus until the grade in for reserving amount is fully recognized. Most entities will have a short-term impact (three years) and disclosure should be adequate.
- SSAP No. 51, paragraph 39/40 – Maintain the existing language on changes in accounting in paragraph 39 instead of moving it paragraph 40 as proposed in the exposure.
- SSAP No. 51, paragraph subparagraphs and SSAP No. 3 – editorial - Change “grade-in” to “phase in” as suggested by interested parties to maintain consistency with SSAP No. 51 and the Valuation Manual.

Note that Shaded revisions are edits to prior exposure

**SSAP No. 51R**

39. The impact of a change in valuation basis on surplus is based on the difference between the reported reserve under the old and new methods as of the beginning of the year. This difference shall not be **grade phased** in over time unless this statement or the Valuation Manual in section VM-21 Requirements for Principle-Based Reserves for Variable Annuities (VM-21) prescribes a new method and a specific transition that allows for grading. If the grading permitted by this statement or Valuation Manual section VM-21 represents an increase in the reserve liabilities, the unrecognized change in valuation basis reserve increase shall initially be reflected as an allocation from unassigned funds to special surplus until fully recognized in reserving and unassigned funds. The reclassification from unassigned funds to special surplus does not reduce total surplus, but highlights the ungraded in amount for transparency as it represents an unrecognized adjustment (decrease) to total surplus. The allocation to special surplus is reversed to unassigned funds as the grading of the increase in reserving is recognized as a decrease to **total surplus**. Some changes will meet the definition of a change in accounting as defined in SSAP No. 3 and a change in valuation basis as described in paragraphs 36-38 of this statement, but the adjustment to surplus will be zero. This can happen when the change in valuation basis is prospective and only applies to new policies and reserves meaning that policies inforce for the prior year-end are not affected, or situations in which the change in reserving methodology did not change the reserves reported in the financial statements. The changes remain subject to the disclosures prescribed in SSAP No. 3. Effective January 1, 2020, if the Valuation Manual section VM-21 (on variable annuities) or this statement prescribes or permits a grading in period or provides the option of multiple grading periods, reporting entities shall also include in the change in accounting disclosures required by SSAP No. 3, disclosure of the following:

a. **the phase in period being applied, and the remaining time period of the phase in**
b. any adjustments to the **phase in period**.

c. amount of change in valuation basis phase in, which has been recognized in unassigned funds and

d. the remaining amount to be phased-in (reflected in special surplus if the ungraded in amount represents an increase in reserving).

40. The Valuation Manual is effective prospectively for policies written on or after the operative date, however, as the CARVM methodology was already principles based, some changes to the CARVM methodology in section VM-21 (on variable annuities) and to the related AG 43 may result in retroactive application to the reserving for existing contracts. Therefore, upon the initial prospective adoption of principle-based reserving, the change in valuation basis reflected as an adjustment to surplus for most entities will be zero. After initial adoption of the Valuation Manual, changes in valuation basis will need to be evaluated to determine the amount of any surplus adjustments.

**SSAP No. 3—Accounting Changes and Corrections of Errors**

13d. Changes in accounting that are changes in reserve valuation basis as described in **SSAP No. 51R—Life Contracts** which have elected phase in provided for in the Valuation Manual Section VM 21 or other optional application features, shall also include in the change in accounting disclosures information regarding the application of any phase in as provided for in SSAP No. 51R. and

“Clean version” of revisions tracked only to SSAP 51R and SSAP No. 3 with shading new wording

**SSAP No. 51R**

39. The impact of a change in valuation basis on surplus is based on the difference between the reported reserve under the old and new methods as of the beginning of the year. This difference shall not be **grading phased** in over time unless this statement or the Valuation Manual in section VM-21 Requirements for Principle-Based Reserves for Variable Annuities (VM-21) prescribes a new method and a specific transition that allows for grading. Some changes will meet the definition of a change in accounting as defined in SSAP No. 3 and a change in valuation basis as described in paragraphs 36-38 of this statement, but the adjustment to surplus will be zero. This can happen when the change in valuation basis is prospective and only applies to new policies and reserves meaning that policies inforce for the prior year-end are not affected, or situations in which the change in reserving methodology did not change the reserves reported in the financial statements. The changes remain subject to the disclosures prescribed in SSAP No. 3. Effective January 1, 2020, if the Valuation Manual section VM-21 (on variable annuities) or this statement prescribes or permits a grading in period or provides the option of multiple grading periods, reporting entities shall also include in the change in accounting disclosures required by SSAP No. 3, disclosure of the following:

e. the phase in period being applied, and the remaining time period of the phase in

f. any adjustments to the phase in period.

g. amount of change in valuation basis phase in, and

h. the remaining amount to be phased-in.

40. The Valuation Manual is effective prospectively for policies written on or after the operative date, however, as the CARVM methodology was already principles based, some changes to the CARVM methodology in section VM-21 (on variable annuities) and to the related AG 43 may result in retroactive application to the reserving for existing contracts. Therefore, upon the initial prospective adoption of
principle-based reserving, the change in valuation basis reflected as an adjustment to surplus for most entities will be zero. After initial adoption of the Valuation Manual, changes in valuation basis will need to be evaluated to determine the amount of any surplus adjustments.

**SSAP No. 3—Accounting Changes and Corrections of Errors**

**Disclosures**

13. Disclosure of material changes in accounting and correction of errors shall include:

   a. A brief description of the change, encompassing a general disclosure of the reason and justification for change or correction;

   b. The impact of the change or correction on net income, surplus, total assets, and total liabilities for the two years presented in the financial statements (i.e., the balance sheet and statement of income and operations); and

   c. The effect on net income of the current period for a change in estimate that affects several future periods, such as a change in the service lives of depreciable assets or actuarial assumptions affecting pension costs. Disclosure of the effect on those income statement amounts is not necessary for estimates made each period in the ordinary course of accounting for items such as uncollectible accounts; however, disclosure is recommended if the effect of a change in the estimate is material;

   d. Changes in accounting that are changes in reserve valuation basis as described in SSAP No. 51R—Life Contracts which have elected phase in provided for in the Valuation Manual Section VM 21, shall also include in the change in accounting disclosures information regarding the application of any phase in as provided for in SSAP No. 51R.

   e. When subsequent financial statements are issued containing comparative restated results as a result of the filing of an amended financial statement, the reporting entity shall disclose that the prior period has been restated and the nature and amount of such restatement.
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Accounting Principles (E) Working Group
Maintenance Agenda Submission Form
Form A

Issue: Retroactive Reinsurance Exception

Check (applicable entity):

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Description of Issue:
At the 2019 Summer National Meeting, the Statutory Accounting Principles (E) Working Group, the Casualty Actuarial and Statistical (C) Task Force and the Surplus Lines (C) Task Force received a request from the Committee on Property and Liability Financial Reporting (COPLFR) of the American Academy of Actuaries Working Group. The request was to clarify the accounting and reporting for retroactive reinsurance which meets the SSAP No. 62R—Property and Casualty Reinsurance exceptions to be accounted for as prospective reinsurance. The request specifically asked for the NAIC groups to:

- Provide consistent guidance on the reporting treatment to both the ceding entity and assuming entity, where both are members of the same group and are consolidated in the same Combined Annual Statement.

- Clarify the reporting method to be used if the ceding entity and assuming entity are not in the same group.

This agenda item is to address the inconsistencies in application of the reinsurance accounting and reporting guidance, particularly the impact on Schedule P – Analysis of Losses and Loss Expenses (Schedule P) that were highlighted in the request.

The request indicated that COPLFR has noted that the guidance for portfolio retroactive reinsurance that meets the exceptions to be accounted for as prospective reinsurance (SSAP 62R, paragraph 36) but that does not meet the definition of Run-Off Agreements (SSAP 62R, paragraphs 102-105) is ambiguous regarding reporting requirements, and specifically the reporting in the NAIC Statutory Annual Statement’s Schedule P. The ambiguity has led to materially different presentations in Schedule P. The letter requested that this ambiguity in Schedule P presentation should be addressed, given that industry Schedule P is utilized for risk-based capital (RBC) purposes as well as other purposes, and given the increased propensity for companies to entertain partial loss portfolio transfers that do not fully meet the requirements of “Run-Off Agreements.”

Attached to the letter were two insurance company examples of publicly filed Schedule P’s illustrating this ambiguity. This resulted in different reporting in Schedule P of intercompany retroactive reinsurance agreements that met the intercompany exception for prospective accounting. Note that COPLFR did not state a preference for the approach and the impact on annual statement Schedule P.

- Entity A in the retroactive cession (accounted for prospectively) initially reported the reinsurance premium paid as current calendar year ceded earned premium. Initially, entity A included all of the ceded losses in accident year 2015. However, for the following year, entity A recorded the ceded losses across the subject accident years

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1 SSAP 62R gives guidance on the accounting treatment of “Run-Off Agreements,” but that definition only applies to situations where an insurer exits “essentially all the risks ... of a specific line” and no longer writes business in that line. That guidance does not address the increasingly common situation where an insurer cedes reserves from all or a portion of prior writings for a line but continues to write new/renewal business for that line, i.e., partial portfolio transfers.
This approach distorted the initial calendar year and accident year loss ratios and the loss development patterns for accident years 2015 and 2012 and prior years.

- Entity G in the year of the retroactive cession (accounted for prospectively) to a parent reported the reinsurance premium paid as ceded earned premium spread to prior calendar years (based on the allocation of loss reserves by accident year as of January 1, 2014), with the ceded losses also spread across prior accident years. This avoided distorting the calendar year / accident year loss ratios but distorted the loss development patterns.

COPLFR noted that:

Attached to this letter are two insurance company examples of filed Schedule P's illustrating this ambiguity. We note that the Schedule P information is publicly available data.

In 2015 Allianz Global Risks US Insurance Company ("Allianz") ceded much of its 2012 & prior Workers Compensation ("WC") business to a U.S. affiliate, San Francisco Reinsurance ("San Francisco Re"). San Francisco Re is now named Allianz Reinsurance of America, Inc. ("Allianz Re"). In doing so it treated all the consideration paid as calendar year ("CY") 2015 ceded earned premium. Initially, as of December 31, 2015, Allianz included all of the ceded losses in accident year ("AY") 2015. However, for the following year (as of December 31, 2016), Allianz recorded the ceded losses across the subject AYs 2012 and prior. This approach distorted the 2015 CY and AY loss ratios and the loss development patterns for AYs 2015 and 2012 and prior. We have attached the relevant Schedule P excerpts from Allianz’s 2015 and 2016 Annual Statements as Attachment A. Descriptions of the transaction are described in the Allianz Re Statement of Actuarial Opinion as of December 31, 2018, also a public document, in Attachment A1SAO. The Management Discussion and Analysis for Allianz Re as of December 31, 2018, is attached as Attachment A2MDA.

In 2014, Government Employees Insurance Company ("GEICO") ceded half of its loss and Loss Adjustment Expense (hereinafter collectively referred to as "loss") reserves as of January 1, 2014, to its indirect parent, National Indemnity Company ("NICO"). In doing so it treated the consideration paid as ceded earned premium spread to prior CYs (based on the allocation of loss reserves by AY as of January 1, 2014), with the ceded losses also spread across prior AYs. This avoided distorting the CY/AY loss ratios but did distort the loss development patterns. We have attached the Schedule P and Note 21 excerpts from the 2014 GEICO Annual Statement as Attachment B.

Both transactions had the potential to materially distort industry totals with regard to loss development. They also most likely did distort data used in the RBC calculations for those companies. We note that it is unclear from either SSAP 62R or Schedule P instructions whether either should have done anything different. Whether to record ceded earned premium all to one CY, or to all the CYs with impacted AYs, appears to be up to the individual company’s option. We also note that these transactions can distort other schedules on the Annual Statement such as Page 3, the Underwriting and Investment Exhibits, and Schedule F.

For those agreements meeting the definition of “Run-Off Agreements” in SSAP 62R (paragraph 81), the required accounting is clear. The ceded earned premium from such agreements is to be recorded as a negative paid loss, so as not to distort the incurred development data by AY. But neither the GEICO nor the Allianz agreements were “run-off” agreements as they transferred only a portion of the prior book (and the ceding companies were still writing new business for that line/market).

We suggest that the NAIC expand the Annual Statement Instructions, and recommend SSAP 62R be clarified, as follows:

- Provide consistent guidance on the reporting treatment in these situations to both the ceding entity and assuming entity, where both are members of the same group and are consolidated in the same Combined Annual Statement.
Clarify the reporting method to be used if the ceding entity and assuming entity are not in the same group.

We note that the treatment of these transactions impacts the industry RBC calculation. If both sides handle the transaction the same way and both are U.S. reporting entities, the industry RBC calculation might not be impacted. However, the industry RBC calculation would be impacted if the two sides handle the transaction differently, or if one side was a U.S. company and the other side was a non-U.S. company. Therefore, we recommend clarification to the Annual Statement Instructions and SSAP 62R.

Existing Authoritative Literature:

SSAP No. 62R

Accounting for Retroactive Reinsurance Agreements

33. Certain reinsurance agreements which transfer both components of insurance risk cover liabilities which occurred prior to the effective date of the agreement. Due to potential abuses involving the creation of surplus to policyholders and the distortion of underwriting results, special accounting treatment for these agreements is warranted.

34. All retroactive reinsurance agreements entered into, renewed or amended on or after January 1, 1994 (including subsequent development of such transactions) shall be accounted for and reported in the following manner:

a. The ceding entity shall record, without recognition of the retroactive reinsurance, loss and loss expense reserves on a gross basis on the balance sheet and in all schedules and exhibits;

b. The assuming entity shall exclude the retroactive reinsurance from loss and loss expense reserves and from all schedules and exhibits;

c. The ceding entity and the assuming entity shall report by write-in item on the balance sheet, the total amount of all retroactive reinsurance, identified as retroactive reinsurance reserve ceded or assumed, recorded as a contra-liability by the ceding entity and as a liability by the assuming entity;

d. The ceding entity shall, by write-in item on the balance sheet, restrict surplus resulting from any retroactive reinsurance as a special surplus fund, designated as special surplus from retroactive reinsurance account;

e. The surplus gain from any retroactive reinsurance shall not be classified as unassigned funds (surplus) until the actual retroactive reinsurance recovered exceeds the consideration paid;

f. The special surplus from retroactive reinsurance account for each respective retroactive reinsurance agreement shall be reduced at the time the ceding entity begins to recover funds from the assuming entity in amounts exceeding the consideration paid by the ceding entity under such agreement, or adjusted as provided in paragraph 34.j.;

g. For each agreement, the reduction in the special surplus from retroactive reinsurance account shall be limited to the lesser of (i) the actual amount recovered in excess of consideration paid or (ii) the initial surplus gain resulting from the respective retroactive reinsurance agreement. Any remaining balance in the special surplus from retroactive reinsurance account derived from any such agreement shall be returned to unassigned funds (surplus) upon elimination of all policy obligations subject to the retroactive reinsurance agreement;
h. The ceding entity shall report the initial gain arising from a retroactive reinsurance transaction (i.e., the difference between the consideration paid to the reinsurer and the total reserves ceded to the reinsurer) as a write-in item on the statement of income, to be identified as Retroactive Reinsurance Gain and included under Other Income;

i. The assuming entity shall report the initial loss arising from a retroactive reinsurance transaction, as defined in the preceding paragraph 34.g., as a write-in item on the statement of income, to be identified as Retroactive Reinsurance Loss and included under Other Income;

j. Any subsequent increase or reduction in the total reserves ceded under a retroactive reinsurance agreement shall be reported in the manner described in the preceding paragraphs 34.h. and 34.i., in order to recognize the gain or loss arising from such increase or reduction in reserves ceded. The Special Surplus from Retroactive Reinsurance Account write-in entry on the balance sheet shall be adjusted, upward or downward, to reflect such increase or reduction in reserves ceded. The Special Surplus from Retroactive Reinsurance Account write-in entry shall be equal to or less than the total ceded reserves under all retroactive reinsurance agreements in-force as of the date of the financial statement. Special surplus arising from a retroactive reinsurance transaction shall be considered to be earned surplus (i.e., transferred to unassigned funds (surplus)) only when cash recoveries from the assuming entity exceed the consideration paid by the ceding entity as respects such retroactive reinsurance transaction; and

k. The consideration paid for a retroactive reinsurance agreement shall be reported as a decrease in ledger assets by the ceding entity and as an increase in ledger assets by the assuming entity.

(For an illustration of ceding entity accounting entries see question 31 in Exhibit A.)

35. Portfolio reinsurance is the transfer of an insurer’s entire liability for in force policies or outstanding losses, or both, of a segment of the insurer’s business. Loss portfolio transactions are to be accounted for as retroactive reinsurance.

36. The accounting principles for retroactive reinsurance agreements in paragraph 34 shall not apply to the following types of agreements (which shall be accounted for as prospective reinsurance agreements unless otherwise provided in this statement):

a. Structured settlement annuities for individual claims purchased to implement settlements of policy obligations;

b. Novations, (i.e., (i) transactions in which the original direct insurer’s obligations are completely extinguished, resulting in no further exposure to loss arising on the business novated or (ii) transactions in which the original assuming entity’s obligations are completely extinguished) resulting in no further exposure to loss arising on the business novated, provided that (1) the parties to the transaction are not affiliates (or if affiliates, that the transaction has the prior approval of the domiciliary regulators of the parties) and (2) the accounting for the original reinsurance agreement will not be altered from retroactive to prospective;

c. The termination of, or reduction in participation in, reinsurance treaties entered into in the ordinary course of business;

d. Intercompany reinsurance agreements, and any amendments thereto, among companies 100% owned by a common parent or ultimate controlling person provided there is no gain in surplus as a result of the transaction; or

e. Reinsurance/retrocession agreements that meet the criteria of property/casualty run-off agreements described in paragraphs 102-105.
37. Retroactive reinsurance agreements resulting in surplus gain to the ceding entity (with or without risk transfer) entered into between affiliates or between insurers under common control (as those terms are defined in Appendix A-440) shall be reported as follows:

   a. The consideration paid by the ceding entity shall be recorded as a deposit and reported as a nonadmitted asset; and

   b. No deduction shall be made from loss and loss adjustment expense reserves on the ceding entity’s balance sheet, schedules, and exhibits.

38. The accounting and reporting provisions applicable to retroactive reinsurance apply to all transactions transferring liabilities in connection with a court-ordered rehabilitation, liquidation, or receivership. The requirement to include stipulated contract provisions in the reinsurance agreements shall not apply to these transactions, with written approval of the ceding entity’s domiciliary commissioner.

39. Novations meeting the requirements of paragraph 36.b. shall be accounted for as prospective reinsurance agreements. The original direct insurer, or the original assuming insurer, shall report amounts paid as a reduction of written and earned premiums, and unearned premiums to the extent that premiums have not been earned. Novated balances (e.g., loss and loss adjustment expense reserves) shall be written off through the accounts, exhibits, and schedules in which they were originally recorded. The assuming insurer shall report amounts received as written and earned premiums, and obligations assumed as incurred losses in the statement of income.

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): This request was received at the 2019 Summer National Meeting by the Statutory Accounting Principles (E) Working Group, the Casualty Actuarial and Statistical (C) Task Force and the Surplus Lines Task Force.

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

Convergence with International Financial Reporting Standards (IFRS): not applicable

Staff Recommendation:
NAIC staff agrees that there is diversity in practice and improved accounting and reporting guidance, with examples, would be beneficial. NAIC staff recommends that the Working Group move this item to the active listing, categorized as nonsubstantive and expose a request for comments and for industry and regulator volunteers to assist with developing guidance. The goal is to clarify both the accounting and reporting for retroactive contracts which are accounted for prospectively, including:

- Both the ceding entity and assuming entity, where both are members of the same group and are consolidated in the same Combined Annual Statement.
- The reporting method to be used if the ceding entity and assuming entity are not in the same group.

Comments are specially requested regarding the preferred approaches to reporting and the advantages and disadvantages to each approach being used, including both the Schedule P (and related loss analysis) and risk-based capital impacts.

NAIC staff also recommends that the Working Group direct a referral to notify the Casualty Actuarial (C) Task Force of the request for comments and the need for coordination.

Staff Review Completed by:
Robin Marcotte - NAIC Staff
Status:
On December 7, 2019, the Statutory Accounting Principles (E) Working Group moved this agenda item to the active listing, categorized as nonsubstantive, with a request for comments on the preferred approaches to reporting and the advantages and disadvantages to each approach being used, including impacts on the Schedule P (and related loss analysis) and risk-based capital. Industry and state insurance regulator volunteers are requested to assist with developing guidance to clarify both the accounting and reporting for retroactive contracts which are accounted for prospectively. The Working Group directed NAIC staff to notify the Casualty Actuarial and Statistical (C) Task Force of the request for comments.
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January 31, 2020

Mr. Dale Bruggeman, Chairman  
Statutory Accounting Principles Working Group  
National Association of Insurance Commissioners  
1100 Walnut Street, Suite 1500  
Kansas City, MO 64106-2197

RE: Items Exposed for Comment During the NAIC Winter National Meeting with Comments due January 31

Dear Mr. Bruggeman:

Interested parties appreciate the opportunity to comment on the exposure drafts released for comment by the Statutory Accounting Principles (E) Working Group (the “Working Group”), during the NAIC Fall National Meeting in Austin. We offer the following comments:

**Ref #2018-26: SCA Loss Tracking – Accounting Guidance**

The Working Group exposed revisions, with modifications suggested by interested parties to SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets to expand guidance regarding financial guarantees and the use of the equity method for when losses exceed the equity value of an SCA investment. With the revisions, the equity value of an SCA would not go negative, and guaranteed liabilities would be reported to the extent that there is a financial guarantee or commitment. The “Illustration of the Application of INT 00-24” will also be inserted into SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities.

Interested parties have no comment on this item.

**Ref #2018-38: Prepayments to Service and Claims Adjusting Providers**

NAIC Staff recommended that the Working Group expose revisions incorporating the majority of interested parties’ comments to SSAP No. 55 (rather than the changes reflected in the draft for the Summer 2019 exposure). Interested parties’ comments primarily delete the exposed guidance and move the same or similar concepts into the broad product guidance for property and casualty, life and health or health in SSAP No. 55. These revisions are to reinstate annual statement references by entity type and to adjust scoping language and make the SSAP No. 29
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prepaid guidance consistent. (Staff proposed variations in wording are shaded to differentiate from the interested parties proposed wording that accomplishes a similar intent.)

The exposed revisions to SSAP No. 55—Unpaid Claims, Losses and Loss Adjustment Expenses incorporate interested parties’ previous recommendations to separate the guidance by product type and emphasize guidance that loss and loss adjusting expense liabilities are established regardless of payments to third parties (except for capitated health claim payments). The revisions emphasize existing guidance that claims related liabilities are not recognized as paid until the losses are paid to claimants or claims are adjusted.

Interested parties have no comment on this item.

Ref #2019-04: SSAP No. 32 – Investment Classification Project

The Working Group exposed a revised Issue Paper No. 1XX—Preferred Stock and a substantively-revised draft SSAP No. 32—Preferred Stock as part of the Investment Classification Project.

Interested parties substantially agree with the objectives of the proposal and appreciate Staff’s inclusion of revisions for previously communicated comments. We have the following additional comments related to the issue paper:

Scope

Interested parties note that the scope retains, albeit edited, the guidance that preferred stock of subsidiary, controlled and affiliated entities is included and therefore accounted for under the guidance for preferred stock regardless of their SCA character. We acknowledge the current exposure added the requirement to file investments in response to our request. The existing wording in SSAP No. 32 and the exposed language for SSAP No. 32 is below with interested parties suggested clarifying sentence and additional wording (underlined).

Existing language in SSAP No. 32:

SCOPE OF STATEMENT

1. This statement establishes statutory accounting principles for preferred stock.

2. Investments in preferred stock of subsidiaries, controlled or affiliated entities, including preferred stock interests of certified capital companies (CAPCO) per INT 06-02: Accounting and Reporting for Investments in a Certified Capital Company (CAPCO) are included within the scope of this statement.

Exposed language in SSAP No. 32 and interested parties suggested additional sentence (underlined):
SCOPE OF STATEMENT

1. This statement establishes statutory accounting principles for preferred stock.

2. Investments in preferred stock of entities captured in SSAP No. 97—Investments in Subsidiaries, Controlled or Affiliated Entities or SSAP No. 48—Joint Ventures, Partnerships and Limited Liability Companies, as well as preferred stock interests of certified capital companies per INT 06-02: Accounting and Reporting for Investments in a Certified Capital Company (CAPCO) are included within the scope of this statement. The requirement to file investments in preferred stock of certain subsidiaries, controlled or affiliated entities with the NAIC pursuant to SSAP No. 97 does not affect the application of the accounting, valuation or admissibility under this statement.

Definitions

We are opposed to the proposed edits to the definitions of redeemable and perpetual preferred stock for the following reasons:

a. The change would create a divergence from GAAP that does not exist under the current definitions. Both the definition and accounting for redeemable securities under the current definition aligns with the GAAP definition and accounting for debt securities. Preferred stock accounted for as debt securities under GAAP are those where ability for the holder to collect repayment is assured by the contract terms. We have not identified any benefit to diverging from this view for statutory reporting. The NAIC guidance is different from the GAAP ASC 480 guidance for issuers in multiple ways:

- Preferred stock redeemable at the option of the holder for GAAP is classified as equity (mezzanine equity for SEC filers) but under statutory reporting currently (and proposed) is classified as debt-like in valuation. This conflicts with GAAP ASC 480 guidance for issuers and so it is more straightforward to use the GAAP ASC guidance for holders.
- Alignment of statutory accounting with the ASC 320 guidance for holders results in more equity-like classification in valuation of preferred stock which is generally more conservative than debt-like classification in valuation.
- Preferred stock redeemable for other reasons outside of issuer’s control is equity (mezzanine equity for SEC filers) for GAAP but equity-like in valuation under current statutory reporting and debt-like in valuation under the proposed statutory reporting.

b. The definition that the NAIC staff has proposed to align to is used in GAAP only for compliance with SEC Regulation S-X, Rule 5-02, which is relevant only to the issuer of preferred stock and does not apply to nonpublic companies. Further, the definitions under Rule 5-02 were designed to include preferred stock with redemption features outside of the control of the issuer in order to provide investors information regarding

outside of the control of the issuer in order to provide investors information regarding
potential future cash obligations. This is not a relevant consideration for the holder of preferred stock, which is why GAAP does not consider this from the holder’s perspective. From the holder’s perspective, the only relevant consideration is whether the holder is able to redeem its investment, either through a fixed and determinable date, or through a redemption option that the holder can control.

c. Evaluation of whether there are any features that are outside the control of the issuer is a very complex and cumbersome analysis, even on an infrequent basis as is the case under GAAP (as it only applies to issuers). This is because there are a vast number of potential features that could be outside the control of the issuer (i.e., change in control, lapse in SEC registration, failure to pay dividend, etc.). Insurance companies frequently invest in preferred stock and often purchase many such securities each reporting period. Evaluating every preferred stock investment at this level of detail would be operationally burdensome and would provide no additional benefit as the investor is often economically indifferent to many of these low-probability redemption features that are outside of the control of both the issuer and investor.

As a result, we propose the following edits to the proposed definitions:

a. Redeemable preferred stock, which is preferred stock subject to mandatory redemption requirements or whose redemption is outside the control at the option of the issuer-holders. Redeemable preferred stock is any stock which 1) the issuer undertakes to redeem at a fixed or determinable price on the fixed or determinable date or dates, whether by operation of a sinking fund or otherwise; or 2) is redeemable at the option of the holders; or 3) has conditions for redemption which are not solely within the control of the issuer, such as stock which must be redeemed out of future earnings. Preferred stock which meet one or more of these three-two criteria would be classified as redeemable preferred stock regardless of other attributes such as voting rights or dividend rights;

b. Perpetual preferred stock, which is preferred stocks which are not redeemable or for which redemption is not at the option of the holder are redeemable solely at the option of the issuer (non-redeemable preferred stock). Perpetual preferred stock is any preferred stock which does not meet the criteria to be classified as redeemable preferred stock pursuant to paragraph 3.a.

Balance Sheet Amount

The issue paper discusses carrying perpetual preferred at fair value capped by any stated call price. However, it did not provide guidance on timing for application of the cap. Because the call may not be effective for a period of time, and to ensure that purchases of perpetual preferred stock could still be carried at values greater than par (assuming market values remain above par), we recommend the following revisions to paragraph 10.a.ii, 10.b.ii and the correspondingly to paragraph 11 (underlined):

Paragraphs 10.a.ii and 10.b.ii:
i. Perpetual preferred stocks shall be valued at fair value, not to exceed any currently effective call price.

Paragraph 11:

11. An other-than-temporary (INT 06-07) impairment 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 preferred stock in effect at the date of acquisition. An assessment of other-than-temporary impairment shall occur whenever mandatory redemption rights or sinking fund requirements do not occur. A decline in fair value which is other-than-temporary includes situations where the reporting entity has made a decision to sell the preferred stock prior to its maturity at an amount below its carrying value (i.e., amortized cost). If it is determined that a decline in the fair value of a redeemable preferred stock is other-than-temporary, an impairment loss shall be recognized as a realized loss equal to the entire difference between the redeemable preferred stock’s carrying value and its fair value, not to exceed any currently effective call price, at the balance sheet date of the reporting period for which the assessment is made. The measurement of the impairment loss 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.

Income

The issue paper clarifies the guidance on dividends on preferred stock. Specifically, paragraph 14 states:

“14. Dividends on preferred stock shall be recorded as investment income for qualifying preferred stock on the ex-dividend date with a corresponding receivable to be extinguished upon dividend settlement.”

Interested parties request clarification on the use of the term “qualifying” preferred stock as the term is not defined within the issue paper or within the new glossary of terms. If the inclusion of the word “qualifying” was unintentional, interested parties recommend deleting the word from paragraph 14 to avoid confusion.

Ref #2019-08: Update Reporting Deposit-Type Contracts

The Working Group exposed this agenda item to: 1) request feedback on the inclusion of a footnote excerpt for Exhibit 5 to disclose cases when a mortality risk is no longer present or a significant factor – i.e., due to a policyholder electing a payout benefit, 2) request feedback on circumstances where a morbidity risk is no longer present or a significant factor for Exhibit 6 items and whether a similar footnote disclosure would be appropriate, and 3) requested industry and regulator input for instruction clarifications regarding the classifications of deposit-type
contracts captured in Exhibit 7. With this exposure, there are no proposed edits for statutory accounting. The Working Group directed NAIC staff to notify the Financial Stability (Ex) Task Force of this exposure.

Interested parties support the proposed Exhibit 5 footnote which, among other things, would provide clarification on contracts where a mortality risk is no longer present or a significant factor.

With respect to the implementation of additional disclosures for Exhibit 6, interested parties believe that the current product disaggregation in Exhibit 6 is sufficient to analyze the risks present in the subject contracts, and would suggest no changes.

Interested parties have no additional clarifications for Exhibit 7 instructions – we believe the current instructions are sufficiently clear for deposit type contracts.

Ref #2019-12: ASU 2014-17, Business Combinations – Pushdown Accounting, a Consensus of the FASB Emerging Issues Task Force

The Working Group adopted, as final, a clarification edit to SSAP No. 68—Business Combinations and Goodwill to clarify that all goodwill from an insurance entity’s acquisition of SCAs, regardless of whether pushdown accounting is applied, is subject to the existing 10% admittance limitation. (With adoption of this edit, paragraph 9 was split into two separate paragraphs with the additional wording shown below.) The remainder of this agenda item was re-exposed to allow additional time for specific examples of pushdown accounting to be provided by interested parties, as well as consider comments received on pushdown.

9. Positive goodwill recorded under the statutory purchase method of accounting shall be admitted subject to the following limitation: Positive goodwill from all sources, including life, accident and health, and deposit-type assumption reinsurance and goodwill resulting from the acquisition of an SCA by the insurance reporting entity that is reported on the SCA’s financial statements (resulting from the application of pushdown accounting), is limited in the aggregate to 10% of the acquiring entity’s capital and surplus as required to be shown on the statutory balance sheet of the reporting entity for its most recently filed statement with the domiciliary state commissioner adjusted to exclude any net positive goodwill, EDP equipment and operating system software, and net deferred tax assets. Additionally, all positive goodwill shall be nonadmitted when the underlying investment in the SCA or partnership, joint venture and limited liability company is nonadmitted. When negative goodwill exists, it shall be recorded as a contra-asset.

Interested parties is working on developing examples to illustrate the various ways in which goodwill can be generated and suggested approaches to how the statutory limitations could be applied. As a result of these efforts, we request an extension for this and the following item.
Ref #2019-14: Attribution of Goodwill

The Working Group re-exposed this agenda item to clarify that the “assignment” of goodwill is a disclosure element. The Working Group directed NAIC staff to prepare revisions to the Sub 1 Acquisition Overview template to capture this information for new SCA acquisitions.

Please see the comments on the preceding item.

Ref #2019-20: Rolling Short-Term Investments

The Working Group exposed revisions to SSAP No. 2R—Cash, Cash Equivalents, Drafts and Short-Term Investments and SSAP No. 103R—Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, as shown in the “Proposed Revisions for Fall 2019 Discussion” to incorporate additional principle concepts in classifying investments as cash equivalents or short-term investments to prevent the “rolling” of certain investments. Fall revisions to the prior Summer National Meeting exposure incorporate guidance to exclude qualifying cash pools from the short-term rolling provisions.

With the Fall exposure, comments were requested from regulators and industry representatives on whether other investments should be included / excluded from the short-term rolling provisions. In particular, comments are requested on whether short-term lending (both collateral loans and affiliated loans) should be permitted to be continuously rolled/renewed as short-term, whether non-affiliated SSAP No. 26R investments should be subject to the short-term rolling restrictions, and whether an assessment of “re-underwriting” could be used as support to allow the rolling of short-term investments.

Interested parties appreciate the staff’s exclusion of qualifying cash pools from the provisions of the short-term rolling re-exposure. There remain two types of short-term lending arrangements within the scope of the re-exposure that should be addressed separately. We respectfully request that the Working Group give consideration to the broader implications discussed below prior to moving forward with this proposal. Specifically, it might be advantageous to split the exposure into two work streams – one for affiliated investments and another for unaffiliated investments

Non-affiliate Short-Term Lending

In the case of non-affiliated loans (i.e., Schedule BA Other Invested Assets), in order to provide appropriate flexibility to both the lender and the borrower, a loan facility may be structured as a short-term obligation. Such short-term obligations permit an insurer to more efficiently deploy its capital and streamline its underwriting process. Specifically, short term, non-affiliated loans: (a) provide the insurer with the ability to review and consider credit and collateral on a regular basis, (b) allow the insurer to reevaluate each investment at maturity and make new investments based on current market conditions if desired, and (c) allow the insurer to consider a renewal with an existing base of knowledge about the borrower and collateral, making the underwriting
process more streamlined and allowing for better informed credit decisions. As with any investment, diligent underwriting of the borrower and the collateral, and structuring of the investment with appropriate safeguards is critical and should not deviate from standards used for longer-term investments. These facilities fill a market need for borrowers that require short-term or warehouse-type financings on assets prior to reaching the window for securitization and provide the insurer with attractive risk-adjusted returns relative to other short-term investments.

In this context, interested parties propose that all non-affiliated short-term obligations, obligations in scope of either SSAP No. 26 or SSAP No. 43R, where the counterparty is not an affiliate or related party of the reporting entity, including collateral loans, which meet certain objective criteria should be defined, reported, and monitored in the existing Schedule DA as a non-affiliated short-term investment. In order for a non-affiliated transaction to qualify as short term for reporting purposes, such investment must include the following features:

1) The loan includes a maturity date less than one year from closing at which the borrower has an unconditional repayment obligation and on which the lender has a reasonable expectation that the investment can be terminated and repaid if so desired by the insurer; and
2) Any subsequent renewal is only completed in the sole discretion of BOTH the borrower and the lender.

Given that the transaction is between unaffiliated counterparties, interested parties believe the terms of these transactions, including the interest rate and advance rate, are on arms’ length terms.

Finally, with no obligation at any time to renew a transaction, the reporting entity is required to re-evaluate and re-underwrite the transaction at maturity. If any of the relevant underwriting criteria have changed, the insurer can require repayment or can request adjustments to the terms and conditions to conform to market conditions. If, but only if, both the borrower and lender agree to renew the transaction on the same or adjusted terms, the transaction may be renewed. This process, however, requires an independent credit decision and results in a new transaction.

Interested parties acknowledges the NAIC staff’s concern about the ability of auditors and regulators to discern between renewals that have been re-underwritten and those that have not; however, without an appreciation for the nuanced economic differences of these transactions, interested parties have concerns about unintended consequences of the re-exposure. Consider a transaction in which an entity purchases a GNMA with less than a one-year maturity, which was classified as a short-term investment or cash equivalent and matures/is settled as expected. Shortly after, that entity decides to purchase another GNMA with less than a one-year maturity. As proposed, the guidance precludes short-term investment or cash equivalent reporting for reacquired investments (or substantially similar investments) when purchased within one year from the initial investment. Without further clarification regarding substantially similar investments, or alternative objective criteria like those proposed above, we anticipate that diversity in practice could result. Additionally, regarding the example described, operationally burdensome tracking requirements would be required for entities to ensure appropriate reporting.
Therefore, we believe that unaffiliated SSAP No. 26 investments should be excluded from the scope of this exposure for the reasons discussed above. The scope of this exposure should also continue to exclude other unaffiliated SSAP No. 26 investments such as treasury bills, commercial paper, certificates of deposits and other similar short-term investments since such investments are used for short-term liquidity and do not have long-term investment risk.

**Affiliate Short-Term Lending**

Interested parties believe that the same principles discussed above and in our previous letter apply to affiliated short-term investments to merit continued classification as short term in nature, even when a subsequent short-term investment is re-underwritten to the same borrower within a year. We believe there is already sufficient regulatory oversight on the fundamental objectives, usage and risks of material affiliated transactions to validate the alignment of these vehicles with the fundamental characteristics implied by the statutory short-term investment classification. In this case, prudently managed, governed and executed liquidity optimization across an insurance holding company system can be observed with the current regulatory oversight mechanisms. While re-underwriting may be warranted based on liquidity needs, the risk profile continues to be commensurate with that of short-term investments.

**NAIC Guidance should not supersede regulatory oversight.** The domiciliary commissioners already have authority to disapprove of material affiliated transactions as deemed necessary. The NAIC Model Holding Company Act (the “Act”), which has been broadly incorporated into state laws, requires filing and domiciliary commissioner approval of affiliated transactions over certain materiality thresholds. As the Act was promulgated by the NAIC, interested parties believe that through use of the Act, commissioners put in place filing and approval requirements they deemed satisfactory to address their regulatory needs. Through these filings, state regulators have oversight over both the risk elements considered and the methodology utilized by companies in underwriting each material extension of credit within the holding company system. It would run counter to state authority to implement requirements resulting in NAIC guidance that would effectively supersede the authority of domiciliary commissioners or cast doubt, even implicitly, upon states’ ability to appropriately regulate the domiciled insurers with which they are intimately familiar. Principally, the Act allows regulators to verify the appropriateness of the short-term classification of material affiliated investments, providing oversight to ensure consistency in classification between affiliated and unaffiliated short-term investments.

Prudent and appropriately governed liquidity management within a holding company structure enhances insurance company solvency. Appropriately managed, governed and regulator-approved affiliate lending programs create opportunities for liquidity optimization across a holding company system, essentially sharing objectives similar to that of affiliated liquidity pools. This management is necessary due to diversification of product offerings as timing of cash receipts and disbursements will vary across such products and different entities within a holding company system. The ability to prudently draw upon excess liquidity surplus within one entity at a time when another entity has a short-term need for liquidity serves as an immediate buffer against uneconomic alternatives such as forced asset sales or relatively costly external short-term
financing. If adopted as written, the exposed guidance could result in entities foregoing this powerful in-house liquidity tool, which enables companies within a holding company system to more effectively manage inherent cash flow timing mismatches, and instead resort to alternatives that would result in an unnecessary drain on capital available to support policyholder obligations.

SSAP 43R—Loan-backed and Structured Securities

Investments in the scope of SSAP 43R, *Loan-backed and Structured Securities*, have payments that are driven by underlying collateral with modifications that are driven by the performance of the underlying assets and typically overseen by a collateral manager or otherwise laid out in deal documents. In many cases, these instruments also have clean-up call provisions that would remove the investment from the market while the remaining underlying collateral may be repackaged into a re-securitization. The concept of rolling a short-term investment that would be in the scope of SSAP 43R is often-times outside the control of investors in these instruments and possibly part of the normal life cycle of a small portion of the underlying collateral. Because of these characteristics, the interested parties propose that any non-affiliated investment that would qualify within SSAP 43R—Loan-backed and Structured Securities be exempt from the proposed new concepts like what is proposed for non-affiliated investment that would qualify within SSAP 26R—Bonds. Further consideration of affiliated investments that fall within SSAP 43R is recommended, given the underlying assets drive these investments and the other considerations for affiliate short-term lending outlined previously in this response.

Interested parties respectfully requests that the Working Group give consideration to these broader implications prior to moving forward with this proposal. If the Working Group has lingering concerns or appetite for additional elaboration as to the character and traditional efficacy of existing regulatory oversight mechanisms, interested parties would request that staff work with industry to draft materials for future dialogue and examination of this topic.

**Ref #2019-24: Levelized and Persistency Commission**

The Working Group exposed revisions to *SSAP No. 71—Policy Acquisition Costs and Commissions*, to include additional NAIC staff modifications regarding persistency commission and levelized commission arrangements to address certain comments received and to allow for further discussion. With this exposure, the Working Group directed a notification of the exposure to be sent to the Life Actuarial (A) Task Force.

Interested parties appreciate staff’s availability to discuss the proposed revisions. Based on that discussion and the discussion at the Fall Meeting, interested parties propose suggested edits that we believe achieve the goal of a nonsubstantive change and clarify the original intent of SSAP 71. (Note: the *NAIC Accounting Practices and Procedures Manual-Life* which was in force prior to the effective date of current SAP includes the same wording as current SSAP No. 71). The suggested edits add a clear definition of a funding agreement. This will clarify the distinction between funding agreements and persistency-based commissions, without unintentionally changing the existing accounting. We welcome the opportunity to discuss the suggested edits further with the Working Group.
Ref #2019-25: Working Capital Finance Notes (WCFN)

The Working Group exposed substantive revisions to SSAP No. 105—Working Capital Finance Investments (SSAP No. 105) to incorporate industry revisions to program requirements, as previously directed by the Working Group during the Summer National Meeting. The Working Group directed NAIC staff to prepare an issue paper.

In 2016, the American Council of Life Insurers (ACLI) advised the NAIC that the implementation of SSAP No. 105 was not successful and that adoption had been low. ACLI began a dialogue with staff and regulators about both the shortcomings of the 2013 adopted rules and outlined required changes to make the rules suitable. As part of that process, ACLI marked up both the SSAP and NAIC SVO Purposes and Procedures Manual (P&P Manual) with the suggested changes which have subsequently been characterized as "10 required items", which staff have in turn opined on, and noted that four of the items are not supported by staff. Absent all 10 required items, WCFI adoption will remain low. Staff have noted an immaterial number of programs have been filed with only a subset of those approved, resulting in limited investments made. The existing Exposure provided to staff and regulators by ACLI and was utilized by staff to produce the current proposal, without addressing the proposed language by ACLI on the four required items not supported by staff.

Objections to the four required changes are:

1) evaluating non-rated subsidiaries of obligors (even though the existing SSAP already provides guidance to do).
2) expanding covered investment credit quality to include NAIC 3 and 4 investments,
3) requiring domiciliary regulator authorization for investment, and
4) requiring reporting on Schedule BA even though the asset class qualifies for look through RBC treatment.

In the ACLI draft provided to the NAIC, ACLI proposed an evaluation mechanism that is suitable for NAIC implementation on un-rated subsidiaries. With regard to NAIC objection on lower rated investments, such position is inexplicable as statutory RBC requirements reflect investment quality decisions in capital calculations limiting Industry investments to compliant assets. Domiciliary regulator prior approval for investment is a transfer of transaction review from staff to state insurance departments when, if regulators are concerned about the asset class, they can uniformly limit investment as a whole. Finally, Schedule BA reporting is both cumbersome and expensive for industry further exacerbating adoption without useful purpose. Regulators can track any specific asset class or investment by requiring the use of a specific investment code on the appropriate accounting schedule, which in the case of WCFI is Schedule DA).

Interested parties note that private placements, as opposed to public investments, are typically available only to large industry participants and that the economic impact of a $10,000 industry filing fee per issue per filing entity has an operating impact on a $1,000,000 investment in
WCFI, which for the avoidance of doubt would be sizable for most industry investors, of 1% of the investment income in year 1 of that investment. Current investment yields for NAIC 1 and 2 investments in WCFI offer gross returns of 2 – 2.5%. Such a high cost to a small industry investor, coupled with the fact that dealers would unlikely choose to document such investments bilaterally with small industry investors, limits access to the assets to large industry investors. In summary, interested parties request that regulators re-consider ACLI markup with the additional four requirements as originally submitted by ACLI and ultimately, after appropriate exposure and review, to direct staff to implement these changes.

Ref #2019-32: Look-Through with Multiple Holding Companies

The Working Group moved this agenda item to the active listing and exposed revisions to SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities, to clarify that a more-than-one holding company structure is permitted as a look-through if each of the holding companies within the structure complies with the requirements in SSAP No. 97.

Interested parties have no comment on this item.

Ref #2019-33: SSAP No. 25 – Disclosures

The Working Group moved this agenda item to the active listing and exposed the proposed data-capture templates. This exposure does not propose revisions to SSAP No. 25.

Interested parties believe that clarifications to paragraph 20 of SSAP No. 25 are necessary. We believe that the aggregation of similar transactions may result in immaterial transactions becoming material, meeting the threshold of 1/2 of 1% of the total admitted assets of the reporting entity. Therefore, we propose the edits highlighted below to ensure that aggregation occurs subsequent to the application of the criteria in paragraph 20.b. for materially identified transactions.

Proposed Edits to the exposure

Disclosures
20. The financial statements shall include disclosures of all material related-party transactions. In some cases, aggregation of similar transactions, that on a stand-alone basis are not material, may be appropriate. Sometimes, the effect of the relationship between the parties may be so pervasive that disclosure of the relationship alone will be sufficient. If necessary to the understanding of the relationship, the name of the related party should be disclosed. Transactions shall not be purported to be arm’s-length transactions unless there is demonstrable evidence to support such statement. The disclosures shall include:

a. The nature of the relationships involved:
   A description of the transactions for each of the periods for which financial statements are presented, and such other information considered necessary to obtain an understanding of the effects of the
transactions on the financial statements. Exclude reinsurance transactions, any non-insurance transactions which involve less than ½ of 1% of the total admitted assets of the reporting entity, and cost allocation transactions. The following information shall be provided if applicable:

Ref #2019-34: Related Parties, Disclaimers of Affiliation and Variable Interest Entities

The Working Group Staff exposed revisions to SSAP No. 25—Affiliates and Other Related Parties. Key elements for discussion in the exposure draft are to:

- Clarify the identification of related parties and ensure that any related party identified under U.S. generally accepted accounting principles (GAAP) or Securities Exchange Commission (SEC) reporting requirements would be considered a related party under statutory accounting principles (SAP).

- Clarify that non-controlling ownership over 10% results in a related party classification regardless of any disclaimer of control or disclaimer of affiliation.

- Clarify the impact of a disclaimer of control or disclaimer of affiliate under SAP. As detailed, such disclaimers impact holding company group allocation and reporting as an SCA under SSAP No. 97, but do not eliminate the classification as a “related party” and the disclosure of material transactions as required under SSAP No. 25.

- Incorporate a new disclosure of known non-arm’s-length transactions with any entity not identified as a related party.

- Propose rejection of several U.S. GAAP standards addressing variable interest entities.

Interested parties understand and agree with the need for transparency in disclosures of related party transactions. However, we have significant concerns with the proposal as it is not very clear based on the proposed changes to SSAP No. 25 what it is that will be required going forward based on the expansion of the definition of a related party. We include some of our observations below.

Interested parties would like clarity around the new proposed wording that states that non-controlling ownership over 10% results in a related party classification regardless of any disclaimer of control or disclaimer of affiliation. One of our concerns in this area relates to limited partnership/joint ventures/limited liability company (LPs/JVs/LLCs) investments where the insurer owns more than 10% of the equity of the investee but has no affiliation to the investee’s general partner/asset manager. SSAP No. 97 currently includes a possible scope exception in paragraph 6 for these types of investments so that they are not considered affiliated or controlled investees of the insurer. It is not clear from the proposal what the expected impact is from now having to consider all investments in unaffiliated LPs/JVs/LLCs where the insurer owns more than 10% of the equity but has no other affiliation, as related parties. If the intent is just to have insurers disclose material transactions with these entities other than the equity
investment held in each entity, we believe that this needs to be more clearly stated in the proposal so that there is no misrepresentation of what needs to be disclosed or whether these investments need to be reported in a different section of Schedule BA (i.e., affiliated vs. non-affiliated).

Another, but similar concern relates to certain entities consolidated under U.S. GAAP based on the Variable Interest Entity (VIEs) guidance. For some of these consolidated VIEs, the insurer has no control or affiliation with the VIE other than its debt investment in the entity. The insurer is simply a passive investor in the structure. However, under the VIE rules, the insurer must consolidate the entity as the insurer may be able to make decisions for the VIE if there is ever an event of default of the assets at some point in the future. These rights are given to certain classes of bonds issued by the securitization as a protection to the investors, but do not give the investors any type of power or control over the VIE at inception or on a day-to-day basis. It is important to note that consolidation rules under FASB Codification Topic 810 are very complex with some insurers concluding consolidation is required under a set of fact and circumstances and others concluding consolidation is not required under the same set of facts and circumstances. In the example just shared, some insurers have concluded consolidation is required because when no day-to-day decisions are being made for the VIE, decisions upon the occurrence of a certain event which may be unlikely to occur, rise to the point where they are the decisions that have the most significant impact on the economic results of the VIE. We believe that even though insurers have to consolidate these entities, there is no true related party affiliation. The proposal requires that any entity identified as a related party under U.S. GAAP will also be considered a related party for statutory reporting. Since these entities are consolidated for GAAP, the presumption would be that they are a related party of the insurer. If these entities will be considered related parties on a statutory basis going forward, the exposure needs to clarify that the inclusion of these types of entities only impacts related party disclosures for any material transactions held with these entities other than the debt investment held by the insurer in the VIE and that the debt instrument is still reported on Schedule D as unaffiliated.

Interested parties also have concerns with SSAP No. 25 including references to U.S. GAAP and SEC reporting for mutual insurers that do not prepare U.S. GAAP financial statements and do not file with the SEC. Therefore, interested parties recommend that the specific guidance from the GAAP and SEC be stated in SSAP No. 25 (rather than incorporated by reference) so that any future changes in GAAP and SEC guidance are subject to NAIC review prior to being applicable. Also, it is important to note that even when an entity is considered a related party under U.S. GAAP, disclosure of that relationship is only required when there are material transactions with that party. U.S. GAAP allows reporting entities to evaluate the significance of a relationship and determine when disclosure of that relationship is material/significant enough for disclosure to a user of the financial statements. As a result, we suggest this be clarified in the exposure as well so that it is clear that the reference to related parties under GAAP and SEC rules is only relevant if the insurer has material transactions with such parties outside of the insurer’s investment in the entity.
Ref #2019-35: Update Withdrawal Disclosures

The Working Group moved this agenda item to the active listing and exposed revisions to SSAP No. 51R—Life Contracts, SSAP No. 52—Deposit-Type Contracts, and SSAP No. 61R—Life, Deposit-Type and Accident and Health Reinsurance, as illustrated in the staff recommendation, to:

- Add a consistency revision to SSAP No. 51R to ensure separate account guaranteed products are referenced in all applicable paragraphs of the withdrawal characteristics disclosures;

- Correct an identified inconsistency in one of the new disclosures that was added regarding products that will move from the reporting line of having surrender charges at 5% or more to the reporting line of surrender charges at less than 5%. A clarification is being recommended to ensure consistency in annual statement reporting; and

- Add a cross-reference from SSAP No. 56 to the existing disclosures by withdrawal characteristics in SSAP No. 51R and SSAP No. 61R as the disclosure include separate account products.

Interested parties have no comment on this item.

Ref #2019-36: Expand MGA and TPA Disclosures

The Working Group moved this agenda item to the active listing and exposed revisions to SSAP No. 51R—Life Contracts, paragraph 50, SSAP No. 53—Property Casualty Contracts—Premiums, paragraph 19, SSAP No. 54R—Individual and Group Accident and Health Contracts, paragraph 33 and SSAP No. 59—Credit Life and Accident and Health Insurance Contracts, paragraph 19, as illustrated in the staff recommendation above, to expand the MGA/TPA note as follows:

- Aggregate direct written premium and total premium written by MGA/TPA;
- Aggregate dollar amount of claims process / total claims processed by MGA/TPA; and
- Information on related party / affiliate status and if the MGA/TPA is independently audited and / or bonded.

Interested parties note that the proposal does not define a TPA. It just states that TPAs “that write direct policies or provide claims adjusting or other services”. That is overly broad and could include a variety of entities that provide services. The NAIC model (NAIC Third Party Administrator Act, or NAIC model) guidelines define TPAs as it relates to life/health and workers compensation. Also, the NAIC model definition has a long list of activities that are excluded from the definition, such as self-insured employers administering its own workers’ compensation, insurers administering coverage, producers engaged in selling insurance, attorneys handling claims, MGAs, etc. We recommend that the proposed disclosure reference the NAIC model so that there is consistency in the definition used in applying the guidance.
Additionally, it is unclear how the reporting threshold should be applied. The reporting applies to TPAs if “the claims adjusting services are greater than 5% of annual average claims volume”. Is that threshold based on the amount of claim dollars paid or the number of claims handled? Is that measured across all lines of business for the company? Would claims paid within insureds’ deductibles/SIRs be included? Depending on how this is defined, it could be quite burdensome for insurers to monitor. We recommend that the threshold be based on written premium, consistent with how other thresholds have been applied.

Ref #2019-37: Surplus Notes – Enhanced Disclosures

During the 2018 Spring National Meeting, the Working Group exposed revisions to SSAP No. 41R – Surplus Notes (“SSAP No. 41R”) to indicate that surplus notes, where the proceeds from the issuance of the surplus note were used to purchase an asset directly or indirectly from the holder of the surplus note, are not subordinate and do not qualify for reporting as surplus and should be classified as debt. Furthermore, the exposure draft stated that these assets were not considered available for policyholder claims and should be non-admitted. The exposure was the result of a referral from a Subgroup of the Reinsurance Task Force that was more narrowly focused on whether specific securities could be considered Primary Securities.

At the 2019 Summer National Meeting, the Working Group agreed to have an industry data call, due by December 31, 2019, to determine what financing structures existed that utilized the types of surplus notes described above.

At the 2019 Fall National Meeting, the Working Group exposed additional disclosures that should be captured in SSAP No. 41R. The Working Group does intend, later in 2020, to continue discussions on how to treat surplus notes where an associated asset is received by the surplus note issuer. This discussion will occur after a review and analysis of the data call.

General Comments

Interested parties understand regulators’ concerns that the details of certain transactions involving surplus notes may not be transparent to regulators who were not involved in the initial approval or ongoing review of such transactions. However, these transactions and the related pricing represent confidential information that we believe is inappropriate for public disclosure and may be misleading if presented in the proposed format.

Our concerns with the proposed disclosures are outlined in detail below, followed by our suggested revisions.

The proposed disclosures may not provide the desired transparency or consistency

Throughout the discussion on any potential revisions to SSAP No. 41R over the past twenty-two months, interested parties have agreed that robust disclosures should be added to SSAP No. 41R to fully reflect situations where a reporting entity receiving proceeds from the issuance of surplus notes used those proceeds to purchase an asset directly or indirectly from the holder of the
surplus note. However, we also believe that these disclosures should be included in the financial statements of a ceding company, which would provide a much greater level of transparency and consistency in disclosure. We believe that in most situations where a surplus note issuer uses proceeds from the issuance to purchase an asset directly or indirectly from the holder of the surplus note, the surplus note issuer is an affiliated captive reinsurer. As some captive financial statements are not provided to the NAIC, we believe disclosure in the financial statements of the ceding company would provide a much greater level of transparency and consistency in disclosure for these transactions. Our proposed revisions include suggested language for this disclosure requirement.

*The proposed disclosure goes beyond the stated regulatory concern and requires additional information that may be incorrectly interpreted.*

We believe that the proposed disclosure departs from the original regulatory concern expressed in the public meetings of the Working Group, namely that a reporting entity should not be permitted to circumvent regulatory authority as it relates to the preservation of capital at a regulated entity by contractually linking the cash outflows associated with a surplus note to cash inflows from another financial instrument held by the surplus note issuer. However, rather than identify such transactions, the proposed disclosure would require detailed information about surplus note interest regardless of whether cash flows are contractually linked. We are concerned that the operational burden of compiling this information for all surplus notes with netting provisions exceeds the benefit to regulators of providing information on the few transactions of concern.

Interested parties note that the scope of the proposed disclosure is substantially identical to that of the recent surplus note data call issued by the NAIC. The stated intent of this data call was to obtain information on surplus note transactions without regard to whether offsetting of cash flows was due to: a) contractual linkage or b) administrative offset provisions. While we agree that this scope was appropriate to assess the universe of affected transactions, we do not believe it is the appropriate scope for an Annual Statement disclosure and could be misleading in certain cases as outlined below.

*The proposed disclosure includes confidential information that is not appropriate for public filings.*

The proposal would require the disclosure of surplus note interest paid, net of any payments made by the surplus note holder. As a practical matter, for many captive structures, this amount often corresponds to the fees paid to the financing provider(s) to provide liquidity in the event of adverse experience or other conditions with respect to the subject policies, as defined in the applicable agreement.

The pricing and terms of the subject transactions were heavily vetted, negotiated, and submitted to state regulators for approval with the reasonable understanding that this information was subject to robust confidentiality protections. We do not object to this information being made available to regulators in the context of a confidential data call or regulator communication.
However, we are concerned with its inclusion in public filings. The primary focus should be on whether the surplus note issuer is statutorily solvent rather than its surplus note pricing terms.

The net presentation of interest paid could be misleading for some transactions

We also believe that the change to the current disclosure to replace surplus note interest paid with interest paid net of amounts offset is problematic. We believe this disclosure could be misleading for many of the transactions in the scope of the disclosure, given that the full amount of surplus note interest paid was/would be due regardless of whether a portion is offset pursuant to an administrative netting arrangement.

Proposed Revisions

Interested parties recommend revisions to the proposed disclosures which would provide regulators who are not involved in the approval and ongoing review of a surplus note transaction with information to assess the nature of the transaction and to determine whether more detailed review is needed. Specifically, our revisions would require disclosure of whether cash flows are offset but would differentiate between administrative offsetting and the contractual “linkage” that is of concern to regulators. These revisions would also remove information that we believe is confidential in nature and would not be appropriate for public disclosure. Finally, we have proposed several additions to the required disclosures, which we believe would provide useful information about transactions involving surplus notes.

Our suggested revisions to the disclosures are included in Exhibit A and summarized below. For ease of review, revisions proposed by NAIC staff have been accepted, and interested parties’ comments are presented as tracked changes.

Summary of Proposed Revisions

- Expand the disclosure requirement to the financial statements of the ceding company as well as the surplus note issuer.
- Retain the current disclosure of total interest paid (gross of any administrative or other netting)
- Replace quantitative disclosure of “interest remitted” and “cost of liquidity” with three Y/N disclosure columns which correspond to the criteria used in the data call scoping:
  1. Do surplus note / associated asset terms negate or reduce cash flow exchanges, and/or are amounts payable under surplus notes and amounts receivable under other agreements contractually linked? (For example, the asset provides interest payments only when the surplus note provides interest payments.)
  2. 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.)?

3. 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?

- Replace confidential information about 3rd party liquidity (e.g. maximum liquidity amount and cost of liquidity source) with a description of terms under which liquidity would be provided should a triggering event occur.
- Add requirement for narrative disclosure of any related guarantees or support agreements.

Ref #2019-38: Financing Derivatives

The Working Group moved this agenda item to the active listing and exposed revisions to SSAP No. 86—Derivatives, to clarify the reporting of derivatives with financing premiums. The reporting revisions propose allowing the present value of the derivative premium receivable (and payable) for financed derivatives to be factored into the counterparty risk assessment for life RBC. (If supported, RBC changes would be subsequently referred to the Capital Adequacy (E) Task Force for consideration.) Comments are also requested as to whether derivatives and related financing provisions that would generally not meet the SSAP No. 64—Offsetting and Netting of Assets and Liabilities right to offset criteria and if explicit guidance allowing offset should be considered.

Interested parties request the exposure be given an effective date of at least January 1, 2021. The exposure represents a significant change to how certain companies account for derivatives and must be implemented in our investment systems prior to adoption. Interested parties do not believe the assets and liabilities under this exposure meet the right to offset criteria in SSAP No. 64—Offsetting and Netting of Assets and Liabilities, because they originate within the same contract. Additionally, we believe the netting guidance outlined in paragraph 19c would be difficult to implement and recommend it be removed.

Ref #2019-39: Acceptable Collateral - Counterparty Exposure for Derivative Instruments

The Working Group moved this agenda item to the active listing and exposed revisions to SSAP No. 86—Derivatives, to clarify that the fair value of collateral received or held, for derivative disclosure purposes, shall be reported net of collateral paid/pledged, in the event a counterparty has the legal right to offset against, as defined in SSAP No. 64—Offsetting and Netting of Assets and Liabilities. Minor updates to the applicable annual statement instructions were also proposed to be concurrently exposed.

Interested parties fully support the appropriate depiction within the statutory financial statements and schedules of the availability of insurance company assets to fulfill policyholder obligations, including consideration of a reporting entity’s access to and control over the assets and any contingencies pertaining to the attendant rights & benefits of ownership. We appreciate the opportunity to dialogue further on this matter and ensure the regulatory objective is achieved.
regarding both financial statement presentation and the risk-based assessment of capital. The ability to make efficient use of derivative instruments as part of hedging transactions, income generation transactions and replication (synthetic asset) transactions, in accordance with SSAP No. 86 – *Derivatives* (“SSAP No. 86”), is a crucial component of insurers’ ability to effectively manage risk and prudently maintain yields in support of our ability to deliver on promises to our policy and contract holders. With broader federal regulation now driving a migration for many of the interest rate and credit derivatives insurers use to these ends towards the central clearinghouse or “cleared” space, the significance of appropriately depicting the specific economic substance and attendant risks associated with each of the various forms of collateral posted to central clearinghouses has never been greater.

Given this backdrop, our concerns with exposure 2019-39 are as follows:

1) The language in the proposal does not provide clear, consistent definition of scope or objective(s);
2) The exchange of initial margin on cleared trades represents a contingency distinct from that associated with the exchange of variation margin; and
3) The existing statutory accounting, reporting and risk-based capital models already appropriately depict the economic substance and inherent risk associated with the exchange of initial margin, and the proposed changes would result in inappropriate duplication of risk-based capital charges.

In terms of intended scope, the narrative commentary and proposed updates to existing guidance make it unclear as to whether the proposal aims to refine accounting & reporting guidance for:

- initial margin, variation margin, or both;
- bilateral (over-the-counter, “OTC”) trades, trades executed with central clearinghouses, or both;
- exchanges of cash collateral, non-cash collateral (e.g. securities) or both.

The summary introduction to the proposal appears to target a perceived issue with the Schedule DB-D, Section 1 reporting of initial margin exchanged with central clearinghouses. The narrative commentary provided does not identify specific concerns pertaining to the reporting of collateral associated with bilateral OTC trades or variation margin. However, the attendant proposed edits to SSAP No. 86 and the Blank Instructions for Schedule DB-D, Section 1 encompass collateral exchanges with both bilateral OTC counterparties and central clearinghouses...inherently scoping in both OTC and cleared trades as well as all forms of collateral (variation margin, initial margin and traditional margin on legacy bilateral OTC trades). In addition, the proposal makes no clear distinction between proposed updates regarding exchanges of cash collateral vs exchanges of non-cash collateral, often using the terms collectively and interchangeably, whereas the guidance within the AP&P Manual makes clear distinctions regarding their respective accounting and reporting - as they have distinct implications for users of statutory financial statements. The guidance for cash collateral exchanges under SSAP No. 103R – *Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (“SSAP 103R”) paragraphs 19 & 20 is distinct from that of non-
cash collateral exchanges, which is also further detailed in INT 01-31 – *Assets Pledged as Collateral* (“INT 01-31”). Anecdotally, though the SSAP No. 86 Appendix C guidance for the initial carrying value on futures paraphrased in the 2019-39 exposure commentary applies to exchange traded derivatives (which do not appear to be within the scope of this current exposure), it maintains conceptual symmetry with the distinct cash collateral guidance from SSAP No. 103R; classifying only cash postings of initial margin as a form of basis deposit necessitating distinct accounting and financial statement presentation. Additional clarification regarding both the perceived issue(s) and the objective(s) underlying the proposed updates is requested in order to ensure industry can assist in fully and appropriately addressing each underlying concern in light of the applicable regulatory objective(s).

The exchange of initial margin with central clearinghouses is clearly distinct in function from the exchange of variation margin. As referenced in the proposal, initial margin is a minimum amount of equity that must be provided to a clearinghouse to initiate a position. It effectively represents the deposit of chips required to play at the table (“table stakes”), and is required from both respective parties entering into the derivative transaction as protection for the clearinghouse against the potential that either respective party will not make good on its respective commitments (i.e., initial and continuing participation in the transaction and the associated exchanges of variation margin driven by the derivative price movements until expiry or novation) – leaving the clearinghouse exposed, as intermediary, to the remaining party. Once such a trade expires or is novated, assuming the respective party has made good on all its variation margin payments during the course of the trade being open, the asset(s) posted to the clearinghouse as initial margin is returned to that exiting party. In the instance that a party exiting the derivative transaction has not stayed current with its respective variation margin obligations, the clearinghouse will return the remaining value of the initial margin after settling up the unpaid variation margin obligations. As such, the contingencies associated with maintenance of exclusive control over the rights and benefits of asset ownership for an entity posting initial margin are primarily a function of the entity’s continuing involvement in the trade with the clearinghouse, which is distinct from the derivative price movement contingencies directly associated with variation margin.

Reporting entities often utilize non-cash collateral (e.g., US Treasuries) for posting as initial margin to clearinghouses, as the required initial margin value can be comparatively high (driven by risk adjusted trailing price volatility of the underlying derivative and overcollateralization conventions) but the reporting entity maintains the full rights & benefits of ownership over an already held yield generating asset – in many instances preferable to locking up a chunk of otherwise investible cash. The ability to maintain full control over the rights and benefits of ownership on this yield generating non-cash collateral posted (e.g., avoiding forced sales of the non-cash collateral to satisfy unfulfilled variation margin obligations) also incentivizes a reporting entity to remain current on variation margin obligations while the trade remains open. Existing statutory accounting guidance (e.g., the previously referenced SSAP No. 103R and INT 01-31) already provides for appropriate classification, measurement and presentation of collateral posted as initial margin. In the much more likely instance that non-cash collateral has been posted to a clearinghouse as initial margin, the pledging insurer continues to record the pledged collateral as an admitted asset until they have committed a contract default that has not
been cured. In the unlikely instance that the non-cash collateral has to be liquidated in order to satisfy unmet variation margin payment obligations associated with a trade being exited, any associated realized loss would be recognized and the reclassification of the remaining initial margin value due back from the clearing house will be recorded – likely as either cash or a receivable - in accordance with applicable statutory guidance. The Blanks instructions require that any such non-cash or cash collateral posted as initial margin be marked as such on the attendant investment schedule, identified at the specific asset level on Schedule DB-D Section 2 (complete with an identifier indicating that the posting represents initial margin) and summarized within Note 5 (Restricted Assets). As such, the availability of the assets to fulfill policyholder obligations, as well as identification at the specific asset level of the unique and specific contingencies associated with initial margin posting are already presented appropriately for the consideration of financial statement users. Altering the presentation of initial margin postings on the summary Schedule DB-D Section 1 would not augment a financial statement user’s understanding of the reporting entity’s solvency or financial condition, as the “net realizable margin” associated with the open derivative contracts is already appropriately presented – initial margin posted is not directly or typically subject to the derivative price movement contingencies inherent in arriving at an appropriate “Exposure Net of Collateral” total on Schedule DB-D Section 1.

Equally as important, incorporation of initial margin posted into the “Exposure Net of Collateral” total on Schedule DB-D Section 1 would lead to inappropriate and misleading downstream consequences for a reporting entity’s Risk Based Capital calculation. Any collateral (whether non-cash or cash) posted as initial margin is already captured in the Life RBC formula on LR017 (Off Balance Sheet and Other Items), where all collateral postings are pulled directly from Schedule DB-D Section 2 and assessed RBC charges associated with the specific contingency of pledging of the assets to an external counterparty. Thus, netting initial margin postings into the “Exposure Net of Collateral” total on Schedule DB-D Section 1 would make the total derivative exposure (net of collateral) that flows through to LR012 in the Life RBC formula too high – inappropriately double counting the RBC charges associated with the posting of initial margin to a clearinghouse. In addition, the understatement of net realizable collateral (Fair Value of Acceptable Collateral) on Schedule DB-D Section 1 would also, in many instances, mechanically carry through to overstate the “Off Balance Sheet Exposure” reported on the same schedule – which would result in even further overstatement of RBC charges as this “Off Balance Sheet Exposure” flows through the Life RBC formula to be assessed charges on LR017. Doubling, and possibly tripling the RBC charges associated with the posting of initial margin to a central clearinghouse is not an appropriate depiction of true risk for such margin.

Given the ambiguities in the exposure language, the appropriate depiction of economic substance and inherent risk associated with exchanging initial margin within the existing statutory accounting, reporting and RBC frameworks, and the importance of maintaining insurers’ ability to utilize cleared derivatives to effectively manage risk and prudently support yields, we respectfully request that the Working Group withdraw the current proposal and direct NAIC Staff to collaborate with industry to specify and appropriately address any remaining concerns. We stand ready to work through any lingering misgivings the Working Group may have with regard to financial statement presentation but request that such endeavors be empirically
grounded in specific observed instances of incomplete or inappropriate reporting.

Ref #2019-40: Reporting of Installment Fees and Expenses

The Working Group proposed revisions to SSAP No. 53 – Property and Casualty Contracts (SSAP No. 53) to clarify that the installment fee reporting guidance should be narrowly applied. Comments are also requested on whether guidance should be developed to allow expenses associated with installment fees to be reported as a contra revenue in “aggregate write-ins for miscellaneous income” and whether diversity should be permitted in reporting installment fee expenses. Additionally, the Casualty Actuarial (C) Task Force and Property and Casualty Risk Based (E) Working Group will be notified of this exposure.

With regard to the proposed change to emphasize that current guidance in SSAP No. 53 should be interpreted narrowly, interested parties recommend the following revision to the last sentence of the proposed wording in the footnote to SSAP No. 53 paragraph 6:

Clarification: Reporting of installment fees in finance and service charges as other income should not be construed as having any bearing on whether such charges are subject to premium taxation, which remains an issue of state law and regulation.

Although interested parties did not survey companies, we believe the assertion by NAIC staff that expenses associated with installment fees are often immaterial is reasonable. We also believe that current reporting of the related installment fee expenses in other underwriting expenses is appropriate. For practical purposes, we do not see the benefit of isolating the expense related to processing the relatively small fee component of a premium billing for separate expense reporting purposes. We believe the reporting of expenses should be consistent and would not support the reporting of the related expenses as an “aggregate write-ins for miscellaneous income” or as a contra revenue to “finance and service charges not included in premiums.”

Ref #2019-41: Eliminating Financial Modeling Process

The Working Group moved this agenda item to the active listing and exposed revisions to SSAP No. 43R—Loan-backed and Structured Securities, to eliminate the multi-step financial modeling designation guidance in determining final NAIC designations for residential mortgage-backed securities (RMBS) / commercial mortgage-backed securities (CMBS) securities. Exposure was contingent upon the Valuation of Securities (E) Task Force’s concurrent exposure, which occurred on December 8, 2019. The Working Group noted that final action on this would not be taken until the Valuation of Securities (E) Task Force takes action on their related item.

Interested parties have no comment on this item at this time.
Ref #2019-42: Inclusion of Cash / Liquidity Pools - Cash Equivalents as defined in SSAP No. 2R

The Working Group moved this agenda item to the active listing and exposed revisions to SSAP No. 2R—Cash, Cash Equivalents, Drafts and Short-Term Investments to specify that cash pooling structures that meet specified criteria qualify as cash equivalents.

Interested parties appreciate that a separate Form A (Ref #2019-42) was written related to Cash/Liquidity Pools ("pools") to clarify the accounting associated with them. We agree with the addition of a paragraph, similar to paragraph 8, to SSAP No. 2R to provide guidance related to pools; however, given that the characteristics of pools differ by company, we propose some modifications to paragraph 8 in order to address those varied characteristics.

Interested parties’ comments related to the proposed paragraph 8 are as follows:

1) Regarding the proposal to look through the ownership structure to report the assets held as cash equivalents, we agree that look through is appropriate. Some pools, as approved by regulators, consist of assets that meet the Statutory definition of cash equivalents and thus the interest held in the pools are reported as cash equivalents on Schedule E2. However, other pools, also approved by regulators, include assets that meet the definition of short-term investments in SSAP No. 2 and thus the interest held in the pools are reported as short-term investments on Schedule DA. Some pools may include both short-term investments and cash equivalents.

Given the varied characteristic discussed above, we recommend paragraph 8 be modified to state that, if the requirements of paragraph 8 are met, the reporting entity may look through the ownership structure and report the assets as either cash equivalents or short-term assets based on the predominant characteristic of the underlying assets. This would allow companies the flexibility to report their investments in the pools in the Statutory statement schedule that is more reflective of the type of underlying investments in their pool and prevent the need for companies to reclassify/change their existing reporting to Schedule E2 from DA if they currently report the pools in DA due to the underlying assets.

2) Regarding paragraph 8d (i.e., the requirement to produce annual U.S. GAAP audited report of the pools including schedules showing each affiliate’s prorata share of the investments), insurance companies already receive an independent audit under Statutory Accounting Principles ("SAP"), which would include the insurance company’s investment in a pool. Requiring cash pools to be separately audited under U.S. GAAP would come at a cost, in time and resources, to insurers with pools. In addition, some insurers have pools which are not in the form of legal entities.

An alternative to the U.S. GAAP audit requirement of paragraph 8d is to require a footnote disclosure at the reporting date for each insurer that participates in a pool, which identifies that the insurer is invested in a cash pool, provides the reporting entity’s share
of the pool, and the insurers dollar share of cash equivalents and short-term investments in the pool. This disclosure would be subject to audit on an SAP basis of accounting. IPs believe the audit of the disclosure along with the audit of the insurance company would be adequate to meet the objectives of ensuring that the pool allocation process is accurate. Other alternatives include targeted financial examination procedures for pools, which could include procedures to confirm the balance of the pool and verify the individual legal entities’ balances for participating in the pool.

3) We note that the addition of the proposed pool language in SSAP No. 2 does not specifically address the reporting and accounting for the interests held in the pool. We recommend, if the pool is managed on a fair value basis (i.e., interest in the pool are bought and sold at fair value), that the book/adjusted carrying value for the interest held in the pool would be reported at fair value with changes in fair value reported in unrealized gains and losses. If the pool is not managed on a fair value basis, the interest held in the pool would be reported at amortized cost. It is important to note that pools managed on a fair value basis may use amortized cost as the best estimate of fair value, depending on the characteristics of the underlying assets.

Finally, in the issue paper, NAIC staff questioned whether changes to SSAP No. 48, Joint Ventures, Partnerships and Limited Liability Companies are needed, since many pools are held in a Limited Liability Company (“LLC”). Interested parties do not believe such changes are needed to SSAP No. 48; however, it would be helpful to users of the SSAPs to add a footnote to paragraph 8 of proposed SSAP No. 2R stating that pools may be held in LLCs, for example, and if so, SSAP No. 2 is to be applied and not SSAP No. 48.

Ref #2019-43: ASU 2017-11 - Financial Instruments with Down Round Features

The Working Group moved this agenda item to the active listing and exposed revisions to SSAP No. 86—Derivatives to reject ASU 2017-11, Earning Per Share, Distinguishing Liabilities from Equity, Derivatives & Hedging and incorporate guidance into SSAP No. 5R—Liabilities, Contingencies and Impairment of Assets and SSAP No. 72—Surplus and Quasi-Reorganizations for when certain freestanding instruments shall be recognized as liabilities and not equity.

Interested parties have no comment on this item.

Ref #2019-45: ASU 2013-11, Presentation of an Unrecognized Tax Benefit

The Working Group moved this agenda item to the active listing and exposed revisions to SSAP No. 101—Income Taxes to reject ASU 2013-11, Income Taxes (Topic 740): Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists for statutory accounting.

Interested parties support adoption of this item but note that the following statement should be removed from the document as it is incorrect (see IFRC 23, Uncertainty over Income Tax Treatments):
Convergence with International Financial Reporting Standards (IFRS):
IFRS does not include specific guidance on the presentation of unrecognized tax benefits.

Ref #2019-46: *ASU 2016-14, Presentation of Financial Statements of Not-for-Profit Entities*

The Working Group moved this agenda item to the active listing and exposed revisions to Appendix D—Nonapplicable GAAP Pronouncements to reject *ASU 2016-14, Presentation of Financial Statements of Not-for-Profit Entities* as not applicable to statutory accounting.

Interested parties have no comment on this item.

Ref #2019-47: *Grade in of Variable Annuity Reserves*

The Working Group moved this agenda item to the active listing and exposed revisions to *SSAP No. 51R—Life Contracts* and *SSAP No. 3—Accounting Changes and Corrections of Errors*. The revisions add reference, disclosures and accounting for Section 21 of the *Valuation Manual*, Requirements for Principle-Based Reserves for Variable Annuities, and grade-in requirements for reporting changes in the valuation basis for years beginning January 1, 2020.

This exposure consists of several parts, some of which we agree with and others we find both confusing and unnecessary. We agree that documentation of the choices made among the options for phase-in in VM-21 and the impact of those choices is important. The exposed edits focus on the adoption of the new reserve requirements for variable annuities (revised VM-21 and AG-43). Information on those choices and impacts will be provided to regulators through the PBR Actuarial Memorandum required by VM-31. This includes highlighting the elements of any Phase-in in the executive summary of the PBR Actuarial Memorandum. Given the current requirements of SSAP3 and SSAP51, documentation in the notes to the Annual Statement is also appropriate.

In Recommendation #2, the proposal would require the amounts from the Phase-in to be designated as “special surplus”. We disagree with this recommendation for the following reasons:

- This is a new requirement whose need has not been established. Disclosure of the amounts will provide information necessary for users of the financial statements to understand the basis of the reported financials.
- SSAP72 defines Special Surplus as amounts designated for specific contingencies. Recommendation #2 would be a change to the definition and purpose of special surplus that is inappropriate and would create an undesirable precedent.

Finally, the proposed language is unnecessary, and possibly confusing. VM-21 defines the minimum reserve requirement. Within that requirement, the company has the option to compute the reserves using the Phase-in provision of Section 2.B. Whichever option is elected, VM-21 defines the reserve. SSAP51 defines the amount of the “Change in Basis” as the difference
between the amount under the prior VM-21 and the amount required by the current VM-21 as of 1/1/2020. If the Phase-in has been elected, that difference will generally be zero. The change in basis amount as defined in SSAP51 paragraph 39 is not being graded in – it is what it is following the VM-21 reserve requirements as stated. As such, SSAP51 does not need to make provision for a grade in. We propose the attached language as being clearer in defining the amounts to be disclosed, to use language consistent with VM-21, and to recognize the role of VM-21 to define the reserve requirement.

**Ref #2019-48: Disclosure Update for Reciprocal Jurisdiction Reinsurers**

The Working Group moved this agenda item to the active listing and exposed revisions to *SSAP No. 62R—Property and Casualty Reinsurance*, to incorporate disclosure updates for reinsurers from Reciprocal Jurisdictions.

Interested parties have no comment on this item.

**Ref #2019-49: Retroactive Reinsurance Exception**

The Working Group moved this agenda item to the active listing with a request for comments on the preferred approaches to reporting and the advantages and disadvantages to each approach being used, including impacts on the Schedule P (and related loss analysis) and risk-based capital. Industry and state insurance regulator volunteers are requested to assist with developing guidance to clarify both the accounting and reporting for retroactive contracts which are accounted for prospectively. The Working Group directed NAIC staff to notify the Casualty Actuarial and Statistical (C) Task Force of the request for comments.

With regard to retroactive portfolio transfer deals within the same group that qualify for prospective treatment, interested parties identified the following issues related to reporting transactions in Schedule P.

**Main Issues**

- Should there be a requirement to have offsetting entries for the ceding and assuming entity within the group, such that the group Schedule P is not impacted (and industry Schedule P is not impacted)? (If so, then the ceding entity can’t record ceded amounts for prior AYs while the assuming company records assumed amounts all in the current CY/AY.)
- Should retroactive changes in previous premium amounts be allowed? (If no, and there is a desire to have both entities record the ceded/assumed in the affected older AYs, then the reinsurance premium would need to be treated as a paid loss – positive paid for the ceding entity and negative paid for the assuming entity.)
- Should the reporting prevent “cliffs” in the historic development reported in Schedule P. (If the cede transaction is reported as a premium and spreading to prior CYs, effectively changing prior values retroactively, then the prior incurred loss amounts in
Schedule P, Part 2 would need to be adjusted to avoid a “cliff”. Note that cliffs in Schedule P, Part 2 can have a material RBC impact with regard to the company experience adjustment.

Two Alternative Approaches

Interested parties identified two alternative approaches to recording intercompany, retroactive reinsurance:

- Record the reinsurance premium as a paid loss (positive paid for the cedant, negative for the assuming company), spreading the “premium” to the same AYs as the ceded losses. This avoids cliffs and avoids restating past CY Earned Premium, although it produces unusual results for the assuming company’s Schedule P.

- Record the reinsurance premium as premium, restating prior CY Earned Premium. Spread losses to the impacted AYS. This would create cliffs in Schedule P unless prior AYS are restated for the impact by AY of the reinsurance contract at inception.

* * *

Thank you for considering interested parties’ comments. If you have any questions in the interim, please do not hesitate to contact us.

Sincerely,

D. Keith Bell

Rose Albrizio
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;
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/or principal recognized;
j. Disclosure of whether the surplus note was issued as “paid” part of a transaction with identification any of the amount of approved following attributes:
i. Do surplus note / associated asset terms negate or reduce cash flow exchanges, and/or are amounts payable under surplus notes and amounts receivable under other agreements contractually linked (For example, the asset provides interest and/or principal remitted 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 (actual transfer of cash / assets) and the amount of approved interest and/or principal not remitted to the holder of the surplus note (no transfer of cash / assets)? If so, was the asset issuer a related party per SSAP 25?

k. Principal 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.

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1 Interest and principal reported pursuant to 18.i include amounts offset by amounts receivable under other agreements, unless the reporting entity has a legal right of offset. Such offsetting arrangements shall be disclosed pursuant to paragraph 18.i.i through 18.i.iii
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 not remitting actual cash or assets to a related party as part of a reinsurance transaction in which the surplus note meets any of the criteria in 18.j above, the ceding entity shall provide a description of the transaction, including whether the criteria in 18.j above 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.

19.20. 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 for approved interest or principal (as reported under paragraph 18.h), because the reporting entity is offsetting the amount owed under the surplus note with an amount receivable from a reported asset, the following information shall be disclosed regarding the offsetting assets:

a. Identification of asset, including the investment schedule where the asset is reported and reported NAIC designation;

b. Book/ adjusted carrying value of asset and interest income recognized in as of the current year.

c. Amount of principle return and interest income from the asset not received by the reporting entity as the amounts were offset with approved amounts owed by the reporting entity’s issued surplus note date.

c. A description of terms under which liquidity would be provided should a triggering event occur.

20.21. 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 Blanks Disclosures:

<table>
<thead>
<tr>
<th>Date Issued</th>
<th>Interest Rate</th>
<th>Original Issue Amount of Note</th>
<th>Is Surplus Note Holder a Related Party (Y/N)</th>
<th>Carrying Value of Note Prior Year</th>
<th>Carrying Value of Note Current Year</th>
<th>Unapproved Interest And Or Principal</th>
<th>Approved Interest Recognized Interest Paid Current Year</th>
<th>Life-To-Date Total Interest Remitted (Actual Transfer of Cash/Assets) Paid</th>
<th>Principal Paid Current Year</th>
<th>Life-To-Date Total Principal (Actual Transfer of Cash/Assets) Remitted Paid</th>
<th>Date of Maturity</th>
</tr>
</thead>
<tbody>
<tr>
<td>1311999</td>
<td>XXX</td>
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<td>XXX</td>
<td>XXX</td>
</tr>
</tbody>
</table>

XXX
<table>
<thead>
<tr>
<th>Current Year Approved Interest Remitted (Actual Transfer of Cash/Assets) Are Surplus Note payments contractually linked? (Y/N)</th>
<th>Current Year Approved Principal Remitted (Actual Transfer of Cash/Assets) Are Surplus Note payments subject to administrative offsetting provisions? (Y/N)</th>
<th>Current Year Approved Interest Not Remitted Since Issuance (No Transfer of Cash/Assets) Were Surplus Note proceeds used to purchase an asset directly from the holder of the surplus note? (Y/N)</th>
<th>Current Year Approved Principal Not Remitted Since Issuance (No Transfer of Cash/Assets) Is Asset Issuer a Related Party? (Y/N)</th>
<th>Type of Assets Received Upon Issuance (Are Non-Remitted Interest or Principal Offset with Amounts Owed from Surplus Note Holder? (Y/N)</th>
<th>Does Remitted Interest or Principal Payments Result with Acquisition of a Source of Liquidity Through the Surplus Note Holder? (Y/N)</th>
<th>Principal Amount of Assets Received Upon Issuance</th>
<th>Book/Adjusted Carry Value of Assets to Surplus Note Holder a Related Party? (Y/N)</th>
</tr>
</thead>
</table>

* Include amounts offset with amounts owed from the holder of the surplus note.

<table>
<thead>
<tr>
<th>Name of 3rd Party</th>
<th>Is Liquidity Source a Related Party to the Surplus Note Issuer?</th>
<th>Current Year Total Cost of Liquidity Source</th>
<th>Current Year Cost of Liquidity Source Reported as Surplus Note Interest</th>
<th>Total Cost of Liquidity Source Since Acquisition</th>
<th>Total Cost of Liquidity Source Reported as Surplus Note Interest Since Acquisition</th>
<th>Maximum Amount Surplus Note Issuer Can Receive from Liquidity Source</th>
</tr>
</thead>
</table>

Exhibit A: DRAFT – Markup of Disclosure and Table
SSAP No. 51R:

Change In Valuation Basis

36. A change in valuation basis for reserves determined under paragraphs 18-21, except for reserves defined under Actuarial Guideline XLIII—CARVM: For Variable Annuities (AG 43), as detailed in Appendix C of this Manual, shall be defined as a change in the interest rate, mortality assumption, or reserving method (e.g., net level, preliminary term, etc.) or other factors affecting the reserve computation of policies in force and meets the definition of an accounting change as defined in SSAP No. 3—Accounting Changes and Corrections of Errors (SSAP No. 3).

37. Changes in reserves developed under paragraph 22 or AG 43 shall be reviewed to determine whether the change represents a change in valuation basis and if it meets the definition of a change in accounting as defined in SSAP No. 3.

   a. Changes in principle-based reserving assumptions are often the result of updating assumptions and other factors required by the existing reserving methodology. Reserve changes resulting from the application of principle-based reserving methodology including, but not limited to, updating assumptions based on reporting entity, industry or other experience, and having the reported reserve transition between net premium reserve, deterministic reserve or stochastic reserve, as required under existing guidance, shall not be considered a change in valuation basis. These types of changes also include, but are not limited to, periodic updates in Valuation Manual tables, such as industry valuation basic tables, asset spread tables and default cost tables.

   b. A change in valuation basis for principle-based reserves shall include cases where the required reserve methodology has changed, or the insurer makes a voluntary decision to choose one allowable reserving method over another. These types of changes include, but are not limited to, new standardized mortality tables such as Commissioners Standard Ordinary tables and regulatory changes in methodology.

38. Consistent with SSAP No. 3, any increase (strengthening) or decrease (destrengthening) in actuarial reserves resulting from such a change in valuation basis shall be recorded directly to surplus (under changes to surplus in the change in valuation basis annual statement line) rather than as a part of the reserve change recognized in the summary of operations.

39. The impact of a change in valuation basis on surplus is based on the difference between the reported reserve under the old and new methods as of the beginning of the year. This difference shall not be graded in over time unless this statement or the Valuation Manual in section VM 21—Requirements for Principle-Based Reserves for Variable Annuities (VM-21) prescribes a new method and a specific transition that allows for
grading. If the grading permitted by this statement or Valuation Manual section VM-21 represents an increase in the reserve liabilities, the unrecognized change in valuation basis reserve increase shall initially be reflected as an allocation from unassigned funds to special surplus until fully recognized in reserving and unassigned funds. The reclassification from unassigned funds to special surplus does not reduce total surplus, but highlights the ungraded in amount for transparency as it represents an unrecognized adjustment (decrease) to total surplus. The allocation to special surplus is reversed to unassigned funds as the grading of the increase in reserving is recognized as a decrease to total surplus. Some changes will meet the definition of a change in accounting as defined in SSAP No. 3 and a change in valuation basis as described in paragraphs 36-38 of this statement, but the adjustment to surplus will be zero. This can happen when the change in valuation basis is prospective and only applies to new policies and reserves meaning that policies in force for the prior year-end are not affected, or situations in which the change in reserving methodology did not change the reserves reported in the financial statements. Some changes will meet the definition of a change in accounting as defined in SSAP No. 3 and a change in valuation basis as described in paragraphs 36-38 of this statement, but the adjustment to surplus will be zero. This can happen when the change in valuation basis is prospective and only applies to new policies and reserves meaning that policies in force for the prior year-end are not affected, or situations in which the change in reserving methodology did not change the reserves reported in the financial statements as of 1/1. The changes remain subject to the disclosures prescribed in SSAP No. 3. Effective January 1, 2020, if the phase-in provision of the Valuation Manual section VM-21 (on variable annuities) is elected or this statement prescribes or permits a grading in period or provides the option of multiple grading periods, reporting entities shall also include in the change in accounting disclosures required by SSAP No. 3, disclosure of the following:

a. the grade-phase-in period being applied, and the remaining time period of the grade-phase-in

b. any adjustments to the grade-phase-in period.

c. The phase-in amount as defined in VM-21 of change in valuation basis grade in, which has been recognized in unassigned funds and

d. the remaining amount to be graded phase-in amount (reflected in special surplus if the ungraded in amount represents an increase in reserves).

40. Some changes will meet the definition of a change in accounting as defined in SSAP No. 3 and a change in valuation basis as described in paragraphs 36-38 of this statement, but the adjustment to surplus will be zero. This can happen when the change in valuation basis is prospective and only applies to new policies and reserves meaning that policies in force for the prior year-end are not affected, or situations in which the change in reserving methodology did not change the reserves reported in the financial statements. While the Valuation Manual is effective prospectively for policies written on or after the operative date, subsequent changes may be applied retroactively to all business issued since that operative date however, as the CARVM methodology was already principles-based, some changes to the CARVM methodology in section VM-21 (on variable annuities) and
Exhibit B: 2019-47 Marked changes

to the related AG 43, which may result in retroactive application to the reserving for existing contracts. Therefore, upon the initial prospective adoption of principle based reserving, the change in valuation basis reflected as an adjustment to surplus will be zero. After initial adoption of the Valuation Manual, changes in valuation basis will need to be evaluated to determine the amount of any surplus adjustments.

**SSAP No. 3—Accounting Changes and Corrections of Errors**

**Disclosures**

Disclosure of material changes in accounting and correction of errors shall include:

a. A brief description of the change, encompassing a general disclosure of the reason and justification for change or correction;

b. The impact of the change or correction on net income, surplus, total assets, and total liabilities for the two years presented in the financial statements (i.e., the balance sheet and statement of income and operations); and

c. The effect on net income of the current period for a change in estimate that affects several future periods, such as a change in the service lives of depreciable assets or actuarial assumptions affecting pension costs. Disclosure of the effect on those income statement amounts is not necessary for estimates made each period in the ordinary course of accounting for items such as uncollectible accounts; however, disclosure is recommended if the effect of a change in the estimate is material;

d. Changes in accounting that are changes in reserve valuation basis as described in SSAP No. 51R—Life Contracts which have elected grade phase-in or other optional application features defined in the Valuation Manual, shall also include in the change in accounting disclosures information regarding the application of any grade-phase-in as provided for in SSAP No. 51R, and

e. When subsequent financial statements are issued containing comparative restated results as a result of the filing of an amended financial statement, the reporting entity shall disclose that the prior period has been restated and the nature and amount of such restatement.
February 18, 2020

Mr. Dale Bruggeman, Chairman  
Statutory Accounting Principles Working Group  
National Association of Insurance Commissioners  
1100 Walnut Street, Suite 1500  
Kansas City, MO 64106-2197

RE: Items Exposed for Comment During the NAIC Winter National Meeting with Comments due January 31 Regarding Goodwill

Dear Mr. Bruggeman:

Interested parties appreciate the opportunity to comment on the exposure drafts regarding the recognition of goodwill for statutory accounting that was released for comment by the Statutory Accounting Principles (E) Working Group (the “Working Group”), during the NAIC Fall National Meeting in Austin.

Interested parties note that in October 2018, the FASB decided to add to its technical agenda a broad project to revisit the subsequent accounting for goodwill. In 2019, the FASB issued an Invitation to Comment, *Identifiable Intangible Assets and Subsequent Accounting for Goodwill*, and held public roundtable meetings to discuss the topics included in the Invitation to Comment. The FASB is still in the initial deliberations phase of this project. Given the broad scope of the FASB project and the potential for changes to the current GAAP goodwill accounting model, interested parties recommend that any changes to statutory accounting that impact the accounting for goodwill be limited in their nature in recognition that the Working Group will need to consider the applicability of the changes to GAAP accounting for goodwill once the FASB completes the project.

We offer the following comments to the exposure drafts released for comment by the Working Group:

**Ref #2019-12: ASU 2014-17, Business Combinations – Pushdown Accounting, a Consensus of the FASB Emerging Issues Task Force**
The Working Group adopted, as final, a clarification edit to SSAP No. 68—Business Combinations and Goodwill to clarify that all goodwill from an insurance entity’s acquisition of SCAs, regardless of whether pushdown accounting is applied, is subject to the existing 10% admittance limitation. (With adoption of this edit, paragraph 9 was split into two separate paragraphs.) The remainder of this agenda item was re-exposed to allow additional time for specific examples of pushdown accounting to be provided by interested parties, as well as consider comments received on pushdown accounting.

Interested parties recommend that paragraph 5 of SSAP No. 68 be revised further as marked below to clarify the appropriate valuation that should be used for an acquired entity:

5. A business combination accounted for under the statutory purchase method and in which the acquired entity is valued in accordance with paragraphs 8.b.ii., 8.b.iii. or, 8.b.iv. of SSAP No. 97 shall determine the amount of positive goodwill or negative goodwill created by the combination using the reporting entity’s share of the GAAP net book value of the acquired entity, adjusted to a statutory basis of accounting in accordance with paragraph 9 of SSAP No. 97 in the case of acquired entities valued in accordance paragraphs 8.b.ii. or 8.b.iv. of SSAP No. 97. The GAAP net book value of the acquired entity used in this determination shall reflect the acquisition-date fair values of identifiable assets acquired and liabilities assumed, and goodwill, as recognized in the post pushdown GAAP financial statements of the acquired entity, if applicable. Business combinations accounted for under the statutory purchase method and in which the acquired entity is valued in accordance with, paragraph 8.b.i. of SSAP No. 97 shall determine the amount of positive or negative goodwill created by the business combination using the insurer's share of the statutory book value of the acquired entity.

**Pushdown Accounting**

Interested parties note that the GAAP guidance in ASU 2014-17, which was adopted by the SEC in Staff Accounting Bulletin (SAB) 115, provides clear guidance that an acquired entity has the option to apply pushdown accounting in its separate financial statements upon the occurrence of an event in which an acquirer obtains control of the acquired entity. Under applicable GAAP guidance, control generally results when one entity obtains, either directly or indirectly, more than 50 percent of the outstanding voting shares of another entity. This differs from the definition of control under statutory guidance which uses a threshold of 10 percent or more of voting control. As such, under GAAP, there would not be a scenario where an entity would be controlled by multiple owners with 10% or more ownership of outstanding shares.

Whether a company chooses to apply pushdown accounting depends on the facts and circumstances of a particular transaction. In certain situations, pushdown is preferable to eliminate the basis difference between an acquirer and the acquired entity. In other situations, a company may prefer pushdown accounting to better reflect the actual values of the acquired assets and assumed liabilities based on the purchase price of the entity.

When the SEC required pushdown for SEC registrants, there was limited guidance for non-
registrants under GAAP which resulted in some non-registrants also applying the SEC pushdown guidance. We believe retaining the *optionality* for statutory reporting allows for consistency and comparability across both SEC registrants and non-registrants and provides operational efficiency.

The option of not allowing subsequent elections for pushdown accounting is not practicable for SEC registrants that previously elected to use pushdown accounting. In order for such companies to discontinue use of pushdown accounting, a preferability letter would be required for a change in accounting policy to discontinue the use of pushdown accounting. Given that an election to discontinue use of pushdown accounting is not likely preferable, the insurer would be in the position of having to continue using pushdown accounting in order to receive a clean audit opinion on the GAAP financial statements of the SCA. Additionally, while ASC 805, *Business Combinations*, allows the election to be made for each change in control event, acquirers that report consolidated results may as a practical matter choose pushdown accounting at the subsidiary level to avoid separately tracking assets, and liabilities at two different values in two different ledgers.

As noted in the examples below, and in accordance with the guidance adopted during the December 7, 2019 Working Group meeting, interested parties understand the guidance clarified that all goodwill from an insurance entity’s acquisition of SCAs, regardless of whether pushdown accounting is applied, is subject to the existing 10% admittance limitation. Interested parties have summarized the interpretation of this clarification for an insurance entity’s acquisition of an 8.b.i (example 1), 8.b.ii (example 2a and 2b), 8.b.iii (example 3a and 3b) or 8.b.vi (example 2a and 2b) entity as follows:

<table>
<thead>
<tr>
<th>Example</th>
<th>Type of acquired SCA</th>
<th>Is Pushdown elected?</th>
<th>Where does Goodwill resides?</th>
<th>Admissibility of goodwill limited to 10% of</th>
<th>Is Goodwill required to be amortized?</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>8.b.i</td>
<td>Not permitted per SSAP No. 68 para 6</td>
<td>Insurance entity (Statutory goodwill)</td>
<td>Insurance Entity’s Surplus per SSAP No. 68 para 7</td>
<td>Yes per SSAP No. 68 para 8</td>
</tr>
<tr>
<td>2a</td>
<td>8.b.ii or 8.b.iv</td>
<td>No</td>
<td>Insurance entity (Statutory goodwill)</td>
<td>Insurance Entity’s Surplus per SSAP No. 68 para 7</td>
<td>Yes per SSAP No. 68 para 8</td>
</tr>
<tr>
<td>2b</td>
<td>8.b.ii or 8.b.iv</td>
<td>Yes</td>
<td>SCA (GAAP goodwill)</td>
<td>SCA’s GAAP equity per SSAP No. 97 para 9.d</td>
<td>Yes per SSAP No. 97 para 9.c.iii</td>
</tr>
<tr>
<td>3a</td>
<td>8.b.iii</td>
<td>No</td>
<td>Insurance entity (Statutory goodwill)</td>
<td>Insurance Entity’s Surplus per SSAP No. 68 para 7</td>
<td>Yes per SSAP No. 68 para 8</td>
</tr>
<tr>
<td>3b</td>
<td>8.b.iii</td>
<td>Yes</td>
<td>SCA (GAAP goodwill)</td>
<td>Insurance Entity’s Surplus per SSAP No. 68 para 7</td>
<td>No *</td>
</tr>
</tbody>
</table>

* See further discussion below related to amortization
After evaluating the accounting for goodwill from the various entities described in paragraph 8.b, we concluded that the NAIC should continue to allow insurers to elect pushdown accounting for acquisitions of non-insurance entities (Option 2) for the following reasons:

1. Statutory goodwill, created when the insurer is the acquirer, is subject to an existing 10% admittance limitation as clarified in the changes adopted by the Working Group during the Fall National Meeting and demonstrated above; therefore, the resulting goodwill from pushdown accounting is subject to the statutory thresholds.

2. Pushdown accounting is consistent with GAAP, prior to ASU 2014-17, for SEC registrants and non-registrants that used pushdown accounting. As noted above, it is not practical to discontinue use of pushdown accounting as an insurer would need to continue the use of pushdown accounting in order to obtain a clean audit opinion on the GAAP financial statements of the SCA.

3. It is important to maintain consistency with current GAAP. Under ASU 2014-17, pushdown accounting may be elected in a later reporting period, after the initial acquisition date. We understand that there may be concerns with electing pushdown at a later reporting period after goodwill was originally determined and reported at initial acquisition date. However, rather than disallowing a later election to apply pushdown accounting, which creates a variance to GAAP, we suggest this could be addressed through changes to SSAP No. 97 to ensure that goodwill is not subsequently increased for statutory reporting, in the event pushdown accounting is elected after the initial acquisition date.

4. The recommendations above would allow the continued use of audited GAAP equity as the statutory carrying value for all non-insurance entities for insurers that previously elected pushdown accounting (both SEC registrants and non-registrants). Additionally, the ability to elect pushdown accounting for future acquisitions retains GAAP equity as the statutory valuation basis for SCAs and avoids restrictions that can impact insurers’ ability to obtain an unqualified opinion on the stand-alone financial statements of SCAs.

If a restriction were placed on the use of pushdown accounting at a future date, those entities that have previously elected pushdown will be forced to separately track assets, and liabilities at two different values in two different ledgers as well as address the issue of making a change in accounting policy that may not have preferability.

As a separate point, we suggest changing the heading for Option 2 from “Permission to use pushdown for all non-insurance entities” to “Use of pushdown for all non-insurance entities”, as the term “permission” implies that use of pushdown accounting is a permitted practice under the statutory accounting framework.
Amortization

Interested parties reiterate the concern that the revisions from the adopted language (new SSAP No. 68 paragraph 10) would inadvertently require amortization of pushdown goodwill. While staff has noted that amortization may be the proper approach, interested parties believes as it relates to paragraph 8.b.iii entities acquired by an insurance entity where pushdown is applied, there has been diversity in practice.

Interested parties concur with the NAIC’s staff’s position described in the December 2019 Public Hearing Agenda materials:

“(As detailed in the earlier discussion, the minor edit being discussed only focuses on nonadmittance for insurer entity acquired SCAs that have been pushdown. The edit would not mandate amortization for those pushdown situations. The discussion on whether amortization should be required for those situations is proposed to occur after the next exposure.)”

Ref #2019-14: Attribution of Goodwill

The Working Group re-exposed this agenda item to clarify that the “assignment” of goodwill is a disclosure element. The Working Group directed NAIC staff to prepare revisions to the Sub 1 Acquisition Overview template to capture this information for new SCA acquisitions.

Recommended Action:

NAIC staff identifies that the comments received on the proposed disclosure enhancement under this agenda item are limited, but generally request additional time before adoption. NAIC staff believes the disclosure information requested under this agenda item will be necessary regardless of the decision involving pushdown accounting. As a reminder, the proposed disclosure only details the amount of goodwill recognized from the acquisition of a downstream holding company and the assignment of the goodwill to the entities owned by the holding company. This information is necessary in determining the amount of goodwill that would need to be nonadmitted, or derecognized, if an underlying company in the downstream holding company was nonadmitted or sold.

Interested parties note that the December 2019 Public Hearing Agenda materials state:

“It is important to highlight that the clarification edit proposed for adoption consideration is specific to insurance entity acquisitions of SCAs. As such, if an acquisition occurred downstream from the insurance company (by a non-insurance holding company), and the holding company applied pushdown accounting, so that the goodwill was reported at the holding company’s acquired SCA, the proposed edit would not require that push down goodwill to be brought up to the insurance entity’s level and included in the 10% limit.”

Requiring attribution would be onerous and misleading to the users of the financial statements, particularly if the disclosure included detailing GAAP goodwill that is not subject to the 10%
Interested parties do not believe it is necessary to “attribute” goodwill to downstream SCAs of downstream holding companies. We believe that any concerns about the carrying value of the downstream holding company being overstated because it did not push down GAAP goodwill to a downstream SCA that was subsequently sold is mitigated by the fact that GAAP already requires the attribution and derecognition of goodwill associated with the business or SCA that is sold.\(^1\) To layer in a statutory attribution of goodwill is not necessary, overly complex, and may distort the accounting impact of a sale of a downstream SCA.

Therefore, we recommend that the disclosure of GAAP goodwill attributed to downstream SCAs of downstream holding companies focus on actual GAAP goodwill that was pushed down to the downstream SCAs and any statutory goodwill that occurred when the insurer is the acquirer, subject to the existing 10% admittance limitation as illustrated and discussed in the examples above.

** * * * **

Thank you for considering interested parties’ comments. If you have any questions in the interim, please do not hesitate to contact us.

Sincerely,

D. Keith Bell  
Rose Albrizio

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\(^1\) ASC 350-20-40, *Intangibles – Goodwill and Other - Goodwill – Derecognition*, paragraphs 1 and 2:

40-1: When a reporting unit is to be disposed of in its entirety, goodwill of that reporting unit shall be included in the carrying amount of the reporting unit in determining the gain or loss on disposal.

40-2: When a portion of a reporting unit that constitutes a business (see Section 805-10-55) or nonprofit activity is to be disposed of, goodwill associated with that business or nonprofit activity shall be included in the carrying amount of the business or nonprofit activity in determining the gain or loss on disposal.
January 31, 2020

Dale Bruggeman, Chair
Statutory Accounting Principles (E) Working Group
National Association of Insurance Commissioners

Re: Ref #2019-20, Rolling Short-Term Investments

Dear Mr. Bruggeman:

The American Property Casualty Insurance Association (APCIA) appreciates the opportunity to comment on the Statutory Accounting Principles (E) Working Group’s exposed revisions to SSAP No. 2R—Cash, Cash Equivalents, Drafts and Short-Term Investments and SSAP No. 103R—Transfers and Servicing of Financial Assets and Extinguishments of Liabilities relating to rolling short-term investments. APCIA is the primary national trade association for home, auto, and business insurers. APCIA promotes and protects the viability of private competition for the benefit of consumers and insurers, with a legacy dating back 150 years. APCIA members represent all sizes, structures, and regions—protecting families, communities, and businesses in the U.S. and across the globe.

APCIA writes to highlight our support for the recommendations on this proposal provided in the comment letter of the “Interested Parties” coalition. APCIA and our members regularly participate in the Interested Parties’ discussions and drafting process.

SSAP No. 2R generally requires debt obligations with a maturity date of less than one year to be reported on Schedule DA. However, the proposed revisions to SSAP No. 2R would specify that any investment reported as a short-term obligation which was renewed or extended past its original maturity date would need to be reported as a long-term obligation, and a reporting entity would not be permitted to acquire the same or a substantially similar security within a 1-year time frame unless such security is reported as a long-term obligation. APCIA believes appropriate safeguards already exist, or could be put in place, to address the concerns underlying this proposal. We support the recommendations of the Interested Parties in the context of both unaffiliated and affiliated short-term loans.

Unaffiliated short-term loans provide important flexibility and efficiencies for insurers. So long as the lender has a reasonable expectation that the investment can terminate and be repaid on the maturity date, and both the borrower and lender have the ability to reevaluate and renew the loan at maturity, we believe unaffiliated short-term loans are properly reported on Schedule DA as a short-term risk asset. As such, APCIA supports the objective criteria proposed by the Interested Parties for determining when an unaffiliated loan qualifies as short term:

1) The loan includes a maturity date less than one year from closing at which the borrower has an unconditional repayment obligation and on which the lender has a reasonable expectation that the investment can be terminated and repaid if so desired by the insurer; and
2) Any subsequent renewal is only completed in the sole discretion of both the borrower and the lender.

In the context of short-term loans between affiliates, the Model Holding Company Act already requires regulatory filing and approval of loans exceeding a materiality threshold. Further, as the Interested Parties’ letter also points out, loans between affiliates are an important mechanism for meeting short-term liquidity needs for an entity within a broader group. Given the importance of insurers being able to utilize loans from affiliates to meet short-term needs and the regulatory oversight of these transactions that already exists, APCIA agrees with Interested Parties that short-term loans between affiliates should continue to be classified as short term.
Thank you for considering our comments. If you have any questions or would like to discuss this further, please contact Steve Broadie at steve.broadie@apci.org or 847.553.3606.

Sincerely,

Stephen W. Broadie
Vice President, Financial & Counsel
Dale Bruggeman  
Chair of Statutory Accounting Principles (E) Working Group

We have reviewed the proposed changes to SSAP No. 71 – Policy Acquisition Costs and Commissions as outlined in Ref. #2019-24 as revised on December 7, 2019.

The most effective way to appreciate the unintended consequences of the proposal is to start with a basic understanding of a typical distribution structure. Reporting entities execute distribution agreements, including compensation structure, with distribution partners (IMO, BGA, TPM, MGA, BD, for example). These distribution partners recruit, contract, train, supervise, and compensate smaller organizations (agencies, selling groups, brokerages, etc.) and individual producers (agents, brokers, etc.).

SSAP No. 71 proscribes statutory accounting treatment for reporting entity compensation agreements entered for the sale, distribution, and servicing of policies. The revisions proposed in Exposure Draft 2019-24 (as revised December 7, 2019) focus on two areas: (1) levelized commissions or “trail” payments paid directly to distribution partners or individual producers by a reporting entity and (2) levelized commissions or other installment payments paid to “third parties” by the reporting entity solely in exchange for the third party making non-levelized payments to the distribution partners or individual producers in place of the reporting entity (sometimes called “funding agreements”).

The proposed Exposure Draft relating to the first are in Paragraph 2 and call for “…commission shall be accrued based on experience to date for the policy period that the commission relates.” This specifically relates to the required timing or obligating event of a reporting entity’s liability for the cost of a commission payment specifically linked to persistency or policy renewal upon the anniversary of a policy issue date or some other future date or event.

The proposed Exposure Draft revisions relating to the second are (a) in paragraph 4, “…regardless of how the payment to the third party is characterized.”, (b) in paragraph 5, “...paid by a third party to the agents...by the reporting entity.”, and (c) in a footnote to paragraph 5, “The guidance in this paragraph notes that levelized commissions which use a third party to pay agents that are linked to traditional elements require establishment of a liability for the amounts that have been paid to the agents and any interest accumulated to date.”

The proposed revisions have different implications for different constituencies. We have endeavored to capture the essence of the concern from each party below. The proposed revisions have substantive implications for each of the noted constituencies, contrary to the non-substantive assertion in the revised exposure draft 2019-24. As a direct result of the inequity of the proposed changes upon various constituencies and the potential for substantial
financial and economic harm incurred by the adoption of these changes to a variety of constituencies, we strongly recommend and request that the proposal not go forward.

Reporting Entity/Carrier perspective:

1. Levelized commission programs are economic equivalents to “normal (non-level) commissions.” Levelized commission programs are preferable as they create a virtuous cycle linking the interests of consumers, agents, distribution partners and carriers to maintain ongoing servicing relationships, improving consumer support and policy persistency. Distribution relationships are multi-faceted, including agent recruitment and oversight, sales, sales support, underwriting support, premium collection, policy delivery and agent payment. Characterizing distribution partners as a ‘third party’ under the proposed footnote to paragraph 5 of SSAP No. 71 discounts the complexity of these relationships and the value of these vital roles dramatically altering carrier dynamics with distribution partners.

2. Reporting entities or carriers will be unduly penalized for economic transactions negotiated under existing accounting principles as a direct result of this proposal. The value of those transactions is retroactively altered by the introduction of a modified accounting principle which neither party initially anticipated, negotiated or priced.

3. Higher required capital and lower returns resulting from an arbitrary modification to an existing accounting practice will drive product design reviews and likely product redesigns modifying or eliminating levelized commission options or reducing value to the consumer through higher premiums and/or lower benefits.

4. The proposal to require reserves for future persistency based levelized commissions creates a disconnect with GAAP accounting where there is no reserve requirement. Moreover, the proposal creates new uncertainty around which other, long-standing accounting treatment will be changed next.

Distributor/Agent perspective

1. The trail compensation approach incentivizes all parties to maintain a long-term relationship based upon ongoing agent support of consumer needs. Reducing or removing recurring compensation in the form of persistency based levelized commissions, shifts distributor economic motivation to new product sales, further degrading product level returns for the carrier. Reducing benefit levels or increasing premiums for the same benefit levels will lower the value proposition for effected products very likely reducing sales and consumer protection delivered by the products.

Consumer perspective:

1. The fallout from the changes will diminish value of insurance products through higher premiums and/or lower benefits enacted by carriers seeking to make up lost economic value and from lower service levels provided by brokers or agents as their incentives shift from ongoing consumer service relating to in-force policies to selling new policies (whether to the individual policyholder or other prospective clients).
January 30, 2020

Dale Bruggeman, Chair
Statutory Accounting Principles Working Group
National Association of Insurance Commissioners
1100 Walnut Street
Kansas City, MO 64106

Re: SSAP No. 71—Policy Acquisition Costs and Commissions

Dear Mr. Bruggeman:

Thank you for the opportunity to provide comments on Proposal 2019-24 from the Statutory Accounting Principles Working Group regarding Policy Acquisition Costs and Commissions. The Working Group voted to re-expose revisions to SSAP 71 – Policy Acquisition Costs and Commissions - for comment at the NAIC Fall Meeting on December 7, 2019, continued to categorize the revisions as non-substantive, and further clarified levelized commission guidance and direction regarding certain commission obligations. I offer comments on behalf of our client, DRB Insurance Solutions, LLC, a licensed insurance producer (“DRB”).

SSAP No. 71 provides that levelized commissions occur in situations in which a third party, such as a funding agent, pays agents non-levelized commissions and the reporting entity pays the third party by levelized payments. The Working Group notes that it is intended, but not necessarily guaranteed, that the amounts paid to the agents by the third-party would ultimately be repaid to the third-party from the reporting entity. SSAP No. 71 identifies such arrangements as “funding agreements” between the reporting entity and the third-party. SSAP No. 71 further provides that the use of a commission arrangement where commission payments are not linked to traditional elements (such as premium payments and policy persistency) requires the establishment of a liability for the full amount of the unpaid principal and accrued interest which is payable to a third-party related to levelized commissions.

While revisions were made to several paragraphs and footnote 1 in the initial proposal at the Working Group’s meeting in December, the current exposure language remains overly broad to address the issue identified and intended to be clarified by the Working Group. Regulators have identified levelized commissions as funding arrangements to bypass recognition of acquisition costs by insurers and believe recognizing the full acquisition expense at the time of policy issuance is appropriate accounting treatment pursuant to SSAP No. 5R and the Statement of Concepts
focusing on Recognition. Notably, the Working Group intended to restrict intercompany and affiliated transfers of trailing commission structures as pure accounting transactions solely for the purpose of deferring expense recognition of commission obligations, which is a laudable goal.

However, the language exposed to classify trailing commission transactions as funding arrangements is so broad, it encompasses practically every broker contract with an insurer that allows for any alternative payment arrangement between the broker and the issuing agent. DRB Insurance Solutions is an independent third-party master producer which uses various contracts between DRBIS and its sub-agents for commission payment, including trailing, heaped, partially heaped and trailing commissions, etc. The agreements between DRBIS and reporting entities are arms-length transactions, include the transfer of lapse risk, mortality risk and the commission expense obligation. The proposal requiring all insurers to accrue the full commission expense under these circumstances is illogical when the insurer no longer has the legal obligation to pay the expense and therefore, no longer has legally incurred the expense.

While regulators have opined that affiliated transactions shrouded as commission arrangements appear to circumvent accrual of commission expense at policy issuance, the goal to affect those transactions may continue to be addressed while narrowing the language to clarify that non-affiliated third-party contracts are not included. Accordingly, DRBIS offers the following amendment to the exposure draft to narrow the applicability to those affiliated transactions. Suggested language for Paragraph 4 and the footnote to Paragraph 5 is shown as shaded text as follows:

4. Levelized commissions occur in situations where agents receive normal (non-level) commissions with payments made by a third party under the control of the reporting entity, its parent, and/or any subsidiary or affiliate of the reporting entity or its parent. It is intended, but not necessarily guaranteed, that the amounts paid to the agents by the third party would ultimately be repaid (with interest explicit or implied) to the third party by levelized payments (which are less than the normal first year commissions but exceed the normal renewal commissions) from the reporting entity. (Note: levelized repayments made by the reporting entity extend the repayment period but might not be a straight-line repayment.) These transactions are, in fact, funding agreements between a reporting entity and a third party, regardless of how the payment to the third party is characterized. The continuance of the stream of payments specified in the levelized commission contract is a mechanism to bypass recognition of those expenses which are ordinarily charged to expense in the first year of the contract. Consequently, the normal link between the persistency of the policy, the continuance of the premium payment or the maintenance of the agent’s license with the reporting entity is not maintained with respect to the payment stream.

5. The use of an arrangement such as a levelized commission arrangement where commission payments are not linked to traditional elements such as premium payments and policy persistency, but rather are linked to the repayment of an advance amount paid by a third party under the control of the reporting entity, its parent, and/or any subsidiary or affiliate of the reporting entity or its parent to the agents requires the establishment of a liability by the reporting entity for the full amount of the unpaid principal and accrued interest which is payable to a third party under the control of the reporting entity, its parent, and/or any subsidiary or affiliate of the reporting entity or its parent related to levelized commissionsFN.

New Footnote – The guidance in this paragraph notes that that levelized commissions which use a third party to pay agents does not imply that levelized commissions that are linked to traditional...
elements do not require establishment of a liability for the amounts that have been paid to the agents and any interest accumulated to date. Rather, such levelized commission obligations should be accrued for as set forth in paragraph 3.

The proposed language requires recognition of commission expense in situations where affiliated companies trade lapse and mortality risk amongst and between affiliated reporting entities using a commonly owned master producer while excepting unaffiliated third-party transactions from similar treatment. In these unaffiliated contractual arrangements, where risk and liability is transferred, the reporting entity may not even be aware of the payment schedule between the master producer and its sub-agents and certainly should not be required to accrue the full amount of the commission expense at policy issuance when the insurer is no longer legally required to pay that expense.

Non-Substantive Change
Finally, DRBIS would like to restate its opposition to consideration of the exposure draft as a non-substantive change. As previously stated, levelized commission programs began over thirty years ago, before the 1998 publication of Statutory Issue Paper No. 71 and the January 1, 2001 codification of Statutory Accounting Principles. The primary objectives of a levelized commission structure include aligning the interests of the customer, the agent, and the company and improved persistency from providing ongoing customer service. There is a duty to act in the best interests of the policyholder, as well as a compensation incentive, to make sure policies are well serviced so they stay in-force.

The proposed revisions to SSAP No. 71 are designated as non-substantive and deemed to be a clarification of intent of the codified statutory guidance. However, levelized commission programs were implemented more than a decade before the codification in 2001. Therefore, this is a material change to historical accounting practices and not a clarification of original intent. Even after codification, levelized commission programs continued for years and were not identified as applying statutory accounting incorrectly.

In conclusion, the current exposure draft of SSAP 71 is clearly not “non-substantive” and would have substantial unintended consequences without the amendments proposed above. Additionally, the expansive effect of this policy decision should be subject to open deliberation and public comment as the Working Group considers adoption. Thank you for the opportunity to comment.

Very truly yours

GREENBERG TRAURIG, P.A.

Julie Mix McPeak

Julie Mix McPeak
January 14, 2020

Mr. Dale Bruggeman, Chair
NAIC Statutory Accounting Principles (E) Working Group
1100 Walnut Street, Suite #1500
Kansas City, MO 64106-2197

RE: REPORTING OF INSTALLMENT FEES AND EXPENSES – REQUESTS FOR COMMENTS

Dear Mr. Dale Bruggeman,

At the December 2019 meeting, the NAIC exposed and requested comments on the “Reporting of Installment Fees and Expenses” in the financial statements. This guidance allows for installment fees that meet specified criteria to be excluded from premium income, if it is an avoidance amount by the policyholder and the policy would not be cancelled for nonpayment of the installment fees. The guidance is consistent with the footnote in SSAP No.53 (“Property Casualty Contracts – Premiums”) and in line with our current industrywide reporting of this item in the financial statements.

With respect to the reporting of the corresponding “Installment fees related Expenses”, we believe that these associated Expenses should be reported as part of the Other Underwriting Expenses Incurred (“OUE”) on Line 4 of the Statement of Income and as an ancillary to the normal underwriting activities primarily due to immateriality. Such a presentation will allow insurers to report and reconcile the gross Installment fees amount to the corresponding balance reflected in Schedule T, Column 8 as well as in the Write-ins amount on the Statutory Page 14, along with premium tax payments. Currently, there is inconsistency in reporting in the industry, with some companies reflecting these associated Expenses as part of the Other Underwriting Expenses Incurred on Line 4 of the Statement of Income while others reflect such Expenses as part of the Aggregate write-ins for miscellaneous income on Line 14 of the Statement of Income.

However, as we believe others have also pointed out, this guidance specifically addresses fees charged on Installment premiums, but there are other equally nonrefundable “Other fees” charged by many companies, as part of the billing and collection process, but that are not specifically mentioned in this guidance. That is to say, there are “Other Fees” charged by insurers as part of the collection process, all of which, like Installment fees, are not only non-refundable, but are also avoidance amount by the policyholder and would not be cancelled for non-payment of the installment fees, similar to Installment fees.

These nonrefundable “Other fees”, include, but are not limited to:

1. Late fees - fees and expenses charged on flexible/installment plans that are received after a specified cut-off period e.g. 30 days
2. Non-sufficient funds ("NSF") fees - fees and expenses collected on returned payments due to non-sufficient funds

3. Reinstatement fees - fees and expenses received on policies that expired and are subsequently reinstated, among others etc.

Currently, there is divergence in reporting in this area of this relatively immaterial amounts for nonstandard and standard writers and therefore need for clarification for consistency in reporting going in.

The reporting issue here then is, where and how to report all of these “Other fees”, excluding Installment fees. Should all these “Other fees” be reported as part of:

a) Other underwriting expense incurred on Line 4 of the Statement of Income
b) Finance and service charges on Line 13 of the Statement of income, akin to installment fees

c) Aggregate write-ins for miscellaneous income on Line 14 of the Statement of income

Typically, most companies report these nonrefundable “Other fees” as “Other income” on Line 14 of the Statement of Income

Consistent with current practice, we also believe all these “Other fees”, net of applicable expenses, if any, should be reported as part of the Aggregate-write-ins for miscellaneous income on Line 14 of the Statement of Income. However, if for some reason this first preference is determined to be untenable, then we believe the next viable alternative could be the “Other underwriting expenses incurred” on Line 4 of the Statement of Income, under the assumption that all these other fees are ancillary to the normal underwriting activities, but defer ultimately decision to the NAIC staff for review and consideration.

We appreciate the opportunity to comment on this and related issues. Thank you.

Sincerely,

Joseph Hammond, CPA, FLMI
Director of P&C Accounting
Farmers Insurance Group
(818) 876-7924

“Internal Use Only”

cc: Robin Marcotte       File
February 27, 2020

Dale Bruggeman, Chair
Statutory Accounting Principles (E) Working Group
National Association of Insurance Commissioners

Via email

Dear Mr. Bruggeman:

I am writing on behalf of the American Academy of Actuaries\(^1\) Committee on Property and Liability Financial Reporting (COPLFR). We are following up on previous correspondence regarding Schedule P Instructions for Retroactive Reinsurance between Affiliates and Non-Affiliates.

COPLFR appreciates that the Statutory Accounting Principles Working Group (SAPWG) is looking into certain inconsistencies that were identified in our May 21, 2019, letter to you. In July, Julie Lederer, acting in her capacity as a member of the Casualty Actuarial and Statistical (C) Task Force, posed several questions about specific details in our initial comment letter. Her comments and COPLFR’s replies are presented here.

**Julie Lederer’s Comment**

1. I’m not sure what Allianz/Allianz Re agreement the letter is referring to. The letter suggests that this agreement was enacted in 2015 and that the accounting changed between year-ends 2015 and 2016, but Allianz Re’s 2018 MD&A (which is said to be included as an attachment to COPLFR’s letter but is not) suggests that the agreements between Allianz and Allianz Re weren’t enacted until 2016. Allianz Re did assume retroactive business from a different entity, Fireman’s Fund, in 2015:

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\(^1\) The American Academy of Actuaries is a 19,500-member professional association whose mission is to serve the public and the U.S. actuarial profession. For more than 50 years, the Academy has assisted public policymakers on all levels by providing leadership, objective expertise, and actuarial advice on risk and financial security issues. The Academy also sets qualification, practice, and professionalism standards for actuaries in the United States.
a. There’s hardly any workers comp data in Allianz’s 2015 Schedule P. There’s a lot of WC data at year-end 2016, which appears to be due to the addition of Firemen’s Fund to the pooling agreement.

b. When I compare Allianz Re’s 2015 and 2016 Schedule Ps, I don’t see major changes. There is significant assumed premium reported in CY 2015 in both statements, and both statements show assumed reserves only for AYs 2012 and prior. I think this is related to Allianz Re’s transaction with FFIC (as mentioned in the MD&A above), not with Allianz.

**COPLFR’s Response**

The May 21, 2019, COPLFR letter is referring to the July 1, 2015, reinsurance agreement between FFIC and Allianz Reinsurance America (“Allianz Re”), where Allianz Re agreed to reinsure certain workers’ compensation (WC) and construction defect liabilities. The 2015 Schedule P, Part I of Allianz Re (page 4 of the May 21 letter PDF) shows $1.1 billion of 2015 accident year direct and assumed WC earned premium, presumably this Loss Portfolio Transfer. The 2016 Schedule P of Allianz Global Risk US Ins Co. (“Allianz or FFIC”) (page 7 of the May 21 letter PDF) shows $1.1 billion of 2015 accident year WC ceded earned premium, about equal to the assumptions of the Allianz Re premium discussed in the prior sentence. Allianz Global Risk US is synonymous with FFIC, as we understand it.

In our May 21, 2019, letter, we did state that “Initially, as of December 31, 2015, Allianz included all of the ceded losses in accident year (‘AY’) 2015.” We did only include the 2016 Allianz Schedule P; it would have been clearer to include the 2015 Allianz Schedule P as well, which we have attached as page 15 of the May 21 letter PDF (Attachment A). We agree with the comment in a. above that the additional data is due to the addition of Fireman’s Fund in the pooling agreement. Similarly, for b., we only show Allianz Re’s 2015 Schedule P.; we should additionally obtain Allianz Re’s 2016 Schedule P. We would not expect much change from the 2015 to 2016 Schedule P. Finally, our comments were not intended to suggest that the agreement between Allianz and Allianz Re was not enacted until 2016. We did, however, want to point out that as of Dec. 31, 2015, Allianz included all of the ceded losses in AY 2015, and in the following year, as of Dec. 31, 2016, Allianz recorded the ceded losses across the subject AYs 2012 and prior, as shown in Schedule P, Part 2 of Allianz (see page 8 of the PDF).

**Julie Lederer’s Comment**

2. I believe some of the attachments noted in the letter are missing:
   a. The letter includes Allianz Re’s 2015 Schedule P and Allianz’s 2016 Schedule P, but the text of the letter suggests that Allianz’s 2015 and 2016 Schedule Ps are included.
i. Regardless, it’s pretty hard to compare Allianz’s 2015 and 2016 Schedule Ps anyway, since Fireman’s Fund was added to the intercompany pool in 2016 and the historical AYs in Allianz’s 2016 Schedule P were adjusted accordingly.

ii. When I compare Allianz Re’s 2015 and 2016 Schedule Ps, I don’t see major changes. The assumed premium is reported in CY 2015 in both statements, and both statements show assumed reserves only for AYs 2012 and prior.

b. Attachment A1SAO (Allianz Re’s 2018 SAO) is missing. I looked up the SAO myself and found this passage, which is rather vague, doesn’t name the counterparties, and doesn’t discuss the accounting for the agreements:

The Company entered into several significant reinsurance arrangements during calendar years 2015 – 2018, some of which serve to mitigate the risk factors discussed above.

1. Effective January 1, 2015, the Company entered into a reinsurance agreement whereby the Company assumed and agreed to reinsure certain A&E reserves. Effective July 1, 2015, the Company further assumed and agreed to reinsure certain WC and CD reserves.

2. Effective January 1, 2016, the Company entered into a reinsurance agreement by which the Company ceded 50% of the Company’s carried A&E, WC, and CD liabilities acquired in 2015.

Additionally, effective January 1, 2016, the Company entered into reinsurance agreements whereby the Company assumed and agreed to reinsure certain Professional Healthcare liabilities and certain A&E, GL/Excess and WC liabilities. Effective July 1, 2016, the Company entered into another reinsurance agreement by which the Company assumed and agreed to reinsure certain GL/Excess exposure.

c. Attachment A2MDA (Allianz Re’s 2018 MD&A) is missing. I looked this up myself and included a relevant passage above in item #1.

COPLFR’s Response

The attachments were in the Academy’s submission to the CASTF and were in the CASTF materials for a call in June, but apparently were omitted by NAIC staff in materials provided for subsequent calls and referrals.

We too consider the excerpt you provided to be vague. To help clarify the issue, we are attaching MD&As from 2015 and 2016 that include Fireman’s Fund Insurance Company in their scope (attachments B and C). One of the difficulties in tracking this issue is the series of actions taken by Allianz since 2015.

Julie Lederer’s Comment

3. GEICO’s Note 21, included as an attachment, is useful, but it’s not clear what we should take away from GEICO’s 2014 Schedule P alone. It might have been useful to attach the 2013 Schedule P as well. By comparing the 2013 and 2014 Schedule Ps, it’s clear that GEICO made significant cessions in 2014 and that these were spread among older AYs.

COPLFR’s Response

Our takeaway from GEICO’s 2014 Schedule P alone is that Schedule P, Part 2 (page 13 of the PDF) shows $3.3 billion of decreased development. This is a distortion as we understand it and is supported by the 2013 and 2014 comparison noted above. That distortion would carry over to the RBC filings of the respective entities (based on our understanding of the RBC formula and
related instructions). Industry Schedule P data can also be distorted based on what is and is not included in industry totals based on the data scrubbing performed.

We believe that this additional information clarifies our original comments and will help SAPWG to move forward with its own analysis. If you have additional questions, contact Marc Rosenberg, the Academy’s senior casualty policy analyst, at 202-785-7865 or roenberg@actuary.org.

Sincerely,

Kathy Odomirok, MAAA, FCAS
Chairperson, COPLFR
American Academy of Actuaries

3 attachments
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