

# Statutory Issue Paper No. 85

## Derivative Instruments

### STATUS

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**Original SSAP and Current Authoritative Guidance: SSAP No. 27 and SSAP No. 86**

### Type of Issue:

Common Area

### SUMMARY OF ISSUE

1. Chapter 8 of the Accounting Practices and Procedures Manuals for Life and Accident and Health and for Property and Casualty Insurance Companies (Life/A&H and P&C Accounting Practices and Procedures Manuals) contains guidance on accounting for derivative instruments. This guidance provides two alternatives for accounting for derivative instruments: (a) Hedge accounting, or (b) Immediate recognition (mark to market) accounting. Specific accounting guidance for Income Generation Transactions was adopted by the Financial Condition (EX4) Subcommittee on December 14, 1996.

2. GAAP is not applied uniformly for different types of derivatives because there is no comprehensive authoritative accounting guidance. To the extent that specific accounting guidance does not exist for some derivatives, practice is based on analogy to the literature that does exist for other derivatives. The key GAAP accounting literature applicable to derivatives, which is primarily addressed in *FASB Statement No. 80, Accounting for Futures Contracts* (FAS 80), *FASB Statement No. 52, Foreign Currency Translation* (FAS 52), and *FASB Emerging Issues Task Force Issue No. 84-36, Interest Rate Swap Transactions* (EITF 84-36), is based on hedge accounting for futures and foreign exchange contracts, settlement accounting for interest rate swaps and mark to market accounting.

3. The purpose of this issue paper is to establish statutory accounting principles for derivative instruments (hereinafter referred to as derivatives), that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

### SUMMARY CONCLUSION

4. This issue paper adopts the Derivative Instruments guidance of Chapter 8 of the Life/A&H and P&C Accounting Practices and Procedures Manuals. Paragraphs 6 through 10 herein summarize the key provisions of the guidance. Derivatives shall be defined as swaps, options, forwards, futures, caps, floors, and collars. The following are general definitions for these derivative instruments:

- a. Swaps: 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 without exchanging the instruments themselves. Swaps can be viewed as a series of forward contracts that settle in cash rather than by physical delivery. Swaps generally are negotiated over-the-counter directly between the dealer and the end user. Interest rate swaps are the most common form of swap contract. However, foreign currency and commodity swaps also are common;
- b. Options: 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;

- c. Forwards: Forward contracts are agreements (other than a 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;
- d. Futures: 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;
- e. Caps: 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;
- f. Floors: 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;
- g. Collars: A collar is a combination of a cap and a floor (one purchased and one written). A collar fixes the rate between two levels (the strike prices of the cap and the floor).

5. To the extent a derivative is in an asset position, the instrument meets the definition of an asset as defined in *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets* and, subject to certain limitations, meets the criteria for an admitted asset as specified in that same paper. To the extent a derivative is in a liability position, the instrument meets the definition of a liability as defined in *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets* (Issue Paper No 5).

6. Hedging transaction is defined as a derivative transaction which is entered into and maintained to reduce: (a) the risk of a change in the value, yield, price, cash flow, or quantity of assets or liabilities which the reporting entity has acquired or incurred or anticipates acquiring or incurring, or (b) the currency exchange rate risk or the degree of exposure as to assets or liabilities which a reporting entity has acquired or incurred or anticipates acquiring or incurring. Derivatives used by reporting entities in hedging activities shall be accounted for in a manner consistent with the item hedged. For example, if the item being hedged is accounted for at amortized cost, the hedging derivative also is accounted for at amortized cost. If the item being hedged is accounted for at market value, the hedging derivative also is accounted for at market value.

7. To qualify for hedge accounting, the derivative shall be designated as a hedge of a specific asset, liability, or anticipated transaction. The specific asset, liability, or anticipated transaction to be hedged must expose the reporting entity to a risk and the designated derivative transaction must reduce that

exposure. Examples of items that expose the reporting entity to risk include change in the value, yield, price, cash flow, or quantity of, or degree of exposure with respect to assets, liabilities, or future cash flows which a reporting entity has acquired or incurred, or anticipates acquiring or incurring. To satisfy the condition of risk reduction, the reporting entity shall demonstrate how the derivative instrument reduces risk by using an appropriate method. There are a variety of methods available that can be used to demonstrate risk reduction, including methods which analyze the correlation of gains and losses on the derivative in relation to the losses and gains on the hedged asset, liability, or future cash flow. Included in the concept of hedge accounting is the notion of settlement accounting for interest rate swaps that are matched through designation with an asset or a liability on the balance sheet. Under settlement accounting, periodic net cash settlements under the swap agreement are recognized in income when they accrue.

8. Reporting entities shall set specific criteria at the inception of the hedge as to what will be considered effective in measuring the hedge and apply those criteria in the ongoing assessment of actual hedge results. For example, if correlation is used to measure the effectiveness of a hedge, high correlation of changes in the fair value of the derivative and the fair value of the item being hedged should be probable so that such changes will substantially offset each other throughout the hedge period. Other methods used should demonstrate a similar result to be considered effective. Also, at the inception of the hedge, formal documentation of the hedging instrument and the related hedged item, including the nature of the risk being hedged, shall be drafted and retained for future reference. Upon termination of the derivative that qualifies for hedge accounting, the gain or loss shall adjust the basis of the hedged item. If the item being hedged is subject to IMR, the gain or loss on the hedging derivative instrument shall be subject to IMR upon termination. Reporting entities shall account for a derivative at estimated fair value if it ceases to be effective as a hedge (that is, the gains and losses on the derivative no longer offset the losses and gains on the hedged instrument) and recognize the gain or loss currently in earnings.

9. Alternatively, reporting entities may mark derivatives to market (immediate recognition method) from inception to termination. Generally, this alternative is used where it is impractical to allocate gains and losses to specific hedged assets, liabilities, or future cash flows. This alternative shall be used for derivatives that are entered into for other-than-hedging purposes, when a portfolio has been hedged and the reporting entity is unable to assign the hedging instrument to specific assets and liabilities, or for derivatives that are not specifically addressed elsewhere in this guidance.

10. Other-than-hedging is defined as any transaction which does not qualify for hedge accounting, including active derivatives trading by a reporting entity who enters into derivatives for purposes of generating profits on short-term differences in market movements and not for risk reduction purposes. Unrealized gains and losses cannot be deferred when categorized as other-than-hedging.

11. The reporting entity's choice between accounting methods discussed in paragraphs 6 through 9 (hedge versus immediate recognition) shall be applied consistently for each individual instrument over the life of the derivative. A change in method shall be justified by a significant change in circumstance.

### **Income Generation Transactions**

12. Income generation transactions are defined as derivative instruments 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 which it already owns).

13. Because these transactions require writing derivatives, they expose the reporting entity to potential future liabilities for which the reporting entity receives a premium up front. Because of this risk, dollar limitations and additional constraints are imposed requiring that the transactions be "covered" (i.e., offsetting assets can be used to fulfill potential obligations). To this extent, the combination of the derivative and the covering asset works like a reverse hedge where an asset owned by the reporting entity in essence hedges the derivative risk.

14. As with derivatives in general, these instruments include a wide variety of terms regarding maturities, range of exercise periods and prices, counterparties, underlying instruments, etc.
15. The principal features of income generation transactions are:
- a. Premium received is initially recorded as a deferred liability;
  - b. The accounting of the covering asset or underlying interest controls the accounting of the derivative. The covering asset/underlying interest is accounted at either mark-to-market (e.g., common stocks) or (amortized) cost (e.g., bonds);
  - c. The gain/loss on termination of the derivative is a capital item. For life insurance companies, it shall be subject to IMR treatment if interest rate related;
  - d. For options which are exercised, the remaining premium shall adjust the proceeds (cost) associated with the exercise resulting in no explicit gain or loss reported for the derivative itself.
16. The principal features of written fixed income covered call options are:
- a. The general approach is to value at cost (i.e., consideration received) without amortization over the life of the contract;
  - b. An alternative to the general approach combines the accounting of the written option with the covering asset and then uses standard accounting for callable bonds (yield to worst amortization) on the adjusted asset. This method prevents the possibility of future loss recognition upon exercise while at the same time providing recognition of the income feature of the option over time. This approach would appear most relevant for longer-lived covered European call options, which are in substance like callable bonds;
  - c. For life insurance companies, the gain or loss flows through the IMR if the covering asset or underlying interest is subject to the IMR using callable bond rules to determine the remaining life;
  - d. Reporting entities are responsible for timely recognition of any probable losses that may occur as a result of the strategy. If the exercise price is below the covering asset's book value, the asset shall be evaluated for write down or disclosure treatment in accordance with Issue Paper No. 5. All relevant factors such as whether the option is currently exercisable, the fair value of the bond relative to its exercise price, to what extent the statement value of the option premium offsets any loss on the asset, or how any IMR transaction on exercise would affect surplus and income shall be considered.

17. Written fixed income covered call options shall be accounted for as follows:

<u>STATUS OF OPTION</u>	<u>COVERING ASSET VALUED AT AMORTIZED COST</u>	<u>COVERING ASSET VALUED AT MARKET VALUE</u>
Open	Record premium as deferred liability.  Carry at consideration received. (1)  Alternatively, attach premium to covering asset and amortize (under yield to worse scenario) using standard callable bond accounting . (2)	Record premium as deferred liability.  Mark to market with changes in market value recorded as unrealized adjustments to surplus – gain/loss.
Closed – Expired	Premium received recognized as realized capital gain.  Gain from expiration to flow through IMR, if applicable.  (3)	Premium received recognized as realized capital gain.
Closed – Exercised	Adjust disposition proceeds. (Include in capital gain/loss of disposed asset.)  Gain or loss from disposition to flow through IMR, if applicable.  (3)	Adjust disposition proceeds. (Include in capital gain/loss of disposed asset.)
Closed – Terminated	Recognize net amount as realized capital gain/loss.  Gain or loss from disposition to flow through IMR, if applicable.  (3)	Recognize net amount as realized capital gain/loss.

Notes:

1. A general statement will be added to the instructions stating that reporting entities writing options for income generation purposes are responsible for the timely recognition of any probable losses that may occur as a result of the strategy due to holding and accounting for options on Schedule DB – Part B.
2. Report derivative and its market value on Schedule DB – Part B. Include accounting on Schedule D – Part 1.
3. If premium is attached to covering asset, the accounting treatment for the covering asset applies.

18. The principal features of written covered put options are:
- a. The accounting for the underlying interest instead of the covering asset governs the accounting of the written put while it is open. For example, if a reporting entity wrote a put requiring it to purchase a certain common stock (underlying interest) at a specific price, the reporting entity might cover that option by holding cash or cash equivalents (covering asset). The accounting for the common stock would govern the accounting of the option in this case;
  - b. As with covered call writing for life insurance companies, gain/loss on termination may be subject to IMR over the remaining life of the underlying interest;
  - c. As with covered call writing, reporting entities writing put options for income generation purposes are responsible for timely recognition of any probable losses that may occur as a result of the strategy;
19. Written covered put options shall be accounted for as follows:

<b>STATUS OF OPTION</b>	<b>UNDERLYING INTEREST VALUED AT AMORTIZED COST</b>	<b>UNDERLYING INTEREST VALUED AT MARKET VALUE</b>
Open	Record premium as deferred liability.  Carry at consideration received. (1)	Record premium as deferred liability.  Mark to market with changes in market value recorded as unrealized adjustments to surplus – gain/loss.
Closed – Expired	Premium received recognized as realized capital gain.  Gain from expiration to flow through IMR, if applicable.	Premium received recognized as realized capital gain.
Closed – Exercised	Adjust acquisition cost by premium received.	Adjust acquisition cost by premium received.
Closed – Terminated	Recognize net amount as realized capital gain/loss.  Gain or loss from disposition to flow through IMR, if applicable.	Recognize net amount as realized capital gain/loss.

Notes:

1. Reporting entities writing options for income generation purposes are responsible for the timely recognition of any probable losses that may occur as a result of the strategy due to holding and accounting for options on Schedule DB – Part B.

20. The principal features of written fixed income caps and floors are:
- a. The value of the premium received shall be amortized into income over the life of the contract. For caps and floors, where the reporting entity is selling off possible excess interest/income, the value of the covering asset is not relevant;
  - b. Again, gain/loss may be subject to IMR. The expected maturity would be the derivative contract's maturity.
21. Written fixed income caps and floors shall be accounted for as follows:

STATUS OF OPTION	COVERING ASSET VALUED AT AMORTIZED COST	COVERING ASSET VALUED AT MARKET VALUE
Open	Record premium as deferred liability.  Carry at amortized value. (Alternatively carry at consideration received if within 1 year of maturity.)  Amortize over life of contract to produce constant yield.  Record any interest expense as "Other Investment Income" – negative value.	Record premium as deferred liability.  Mark to market with changes in market value recorded as unrealized adjustments to surplus – gain/loss.
Closed – Matured	Would usually mature at zero amortized value.  Any remaining unamortized value recognized as ordinary income through a final amortization adjustment.	Premium received recognized as realized capital gain.
Closed – Exercised	Not applicable.	Not applicable.
Closed – Terminated	Recognize net amount as realized capital gain/loss.  Gain/loss on termination to flow through IMR, if applicable.	Recognize net amount as realized capital gain/loss.

22. Examples of accounting and presentation based on varying assumptions can be found in the October 1, 1996 minutes of the Accounting Practices and Procedures (EX4) Task Force.

**Disclosure Requirements**

23. Reporting entities shall disclose the following for all derivative contracts outstanding:
- a. Disclosures by category of instrument:
    - i. Notional or contract amounts;
    - ii. Carrying and fair values;
    - iii. A description of the accounting policies for derivatives;

- iv. A discussion of the market risk, credit risk, and cash requirements of the derivative instruments.
  - b. General Disclosures:
    - i. A description of the reporting entity's objectives for holding or issuing the derivatives, the context needed to understand those objectives, and its strategies for achieving those objectives, including the classes of derivatives used;
    - ii. A description of how each category of derivative is reported in the financial statements including the policies for recognizing (or reasons for not recognizing) and measuring the derivatives held or issued, and when recognized, where those instruments and related gains and losses are reported.
24. Reporting entities shall disclose the following for derivatives held for other-than-hedging purposes:
- a. Average fair value of the derivative instruments during the reporting period together with the related end-of-period fair value distinguishing between assets and liabilities;
  - b. Net gains or losses disaggregated by class, business activity or other category that is consistent with the management of those activities and where the net gains or losses are reported.
25. The financial statements shall disclose details of covered items and/or written transactions to allow evaluation of cash flow implications for all written covered options used for income generation.

## DISCUSSION

26. The Summary Conclusion adopts the aforementioned sections of current statutory accounting principles (Chapter 8) for derivatives including insurance futures and insurance futures options. These principles are consistent with the Statement of Concepts because they provide recognition of derivatives as assets or liabilities, and recognition of income (gains) or expense (losses) based on how the reporting entity uses the derivative to reduce risk related to an existing exposure. It also provides a consistent approach to accounting for the many types of derivatives currently available to reporting entities.

27. This issue paper clarifies that the immediate recognition method of accounting (mark to market) shall be applied in situations where a reporting entity enters into a derivative for other-than-hedging purposes, when a portfolio has been hedged, or for derivatives that are not specifically addressed elsewhere in this guidance. Other-than-hedging is defined as any transaction which does not qualify for hedge accounting, including active derivatives trading by a reporting entity who enters into derivatives for purposes of generating profits on short-term differences in market movements and not for risk reduction purposes. This clarification is added so that unrealized gains and losses, particularly losses, cannot be deferred when categorized as other-than-hedging. This is consistent with the conservatism concept in the Statement of Concepts. Further, the immediate recognition method of accounting is not precluded from being utilized in situations where the derivative qualifies for hedge accounting.

28. This issue paper also provides that the determination of hedge accounting or immediate recognition accounting shall be made for each individual instrument. A reporting entity may utilize immediate recognition accounting for certain derivatives within a category and hedge accounting for other derivatives within that same category. This is a change from current statutory accounting principles, which provide that the categories to which immediate recognition accounting treatment is applied should be consistent from period to period.

29. While there is a separate section in the current statutory accounting guidance for insurance futures and related instruments, the accounting is similar to that of other derivatives. Therefore, the conclusion does not differentiate futures or options accounting from insurance futures or insurance futures options accounting, however, the distinctions in current statutory guidance in accounting and reporting for these instruments are adopted. The separate section for insurance futures and insurance futures options was incorporated into the current Life/A&H and P&C Accounting Practices & Procedures Manuals because insurance futures are viewed by insurance regulators as insurance-related transactions and not as investment-related transactions. As a result, insurance futures and insurance futures options are reported on Schedule DC and not Schedule DB as for other non-insurance derivatives. Also, income related to insurance futures and insurance futures options is reported as an aggregate write-in for miscellaneous income not as investment income and any asset is recorded as an aggregate write-in for other-than-invested assets.

30. Current statutory accounting does not specifically address settlement accounting for interest rate swaps. Under certain conditions (as set forth in EITF Issue No. 84-36), GAAP permits settlement accounting for interest rate swaps. Therefore, EITF Issue Nos. 84-36 and 84-7 are adopted.

31. Under settlement accounting, periodic net cash settlements under the swap agreement are recognized in income when they accrue. Settlement accounting is considered a conservative approach, and in many instances, produces an accounting result which is similar to hedge accounting. Such accounting is widely accepted in practice and provides an accounting approach that is consistent with the purpose of entering into such an instrument; that is, to change the interest rate characteristics of the balance sheet item to which it is matched. When this issue paper refers to hedge accounting, it encompasses the notion of settlement accounting for interest rate swaps that are matched through designation with an asset or a liability on the balance sheet.

32. The accounting and reporting for derivative instruments used for income generation is intended to meet (1) regulatory needs focusing on company and industry solvency, (2) company needs focusing on administrative and cost considerations, and (3) the general need to provide meaningful and relevant information regarding the substance of the transactions and holdings for all users of the financial statements.

- a. The approach is conservative and reduces the potential for income manipulation. Income is not recognized early in the holding period only to be reversed by future losses. This consideration is particularly important for options which could have lower exercise prices than the combined statement values of the derivative and the covering asset;
- b. The approach is reasonably simple and consistent with Statutory accounting. It builds on accounting guidance which already exists in the NAIC Accounting Practices and Procedures Manual and in the Annual Statement Instructions regarding hedging;
- c. The approach looks to the substance of the transactions involved:
  - i. It matches the accounting of the derivative with the accounting of the covering asset or underlying interest;
  - ii. It includes an alternative treatment which combines the derivative with the covering asset. This results in a treatment analogous to callable bonds where the option feature is combined with the asset rather than in two pieces;
  - iii. It allows for recognition of the time value/interest rate factor implicit in the pricing of these instruments, particularly relevant for derivatives with longer maturities.

33. Under GAAP, although there is no authoritative accounting guidance for written covered options, written options are generally reported at fair value with changes in fair value reported in earnings because written options do not qualify for hedge accounting except to the extent of the premium received. However, certain GAAP practice considers that the writer will never sustain a loss on a written covered option if the strike price of the option exceeds the book value of the covered asset, and the writer intends to deliver the covered asset if the option is exercised instead of settling the option in cash. Under these circumstances, certain GAAP practice includes carrying the option at cost with the option premium recorded in income when the options is exercised, at its expiration, or, if designated as a hedge, deferred as an adjustment of the cost of the covered asset.

34. Based on the inconsistency in the accounting results and the uncertainty surrounding the GAAP accounting for derivatives, other GAAP pronouncements are rejected as discussed below. Although some view GAAP accounting for derivatives as more conservative because of the stricter requirements of hedge accounting, statutory requirements are sufficiently restricted so that they are consistent with the conservatism and recognition principles of the Statement of Concepts.

35. GAAP is not applied uniformly for different types of derivatives because there is no comprehensive authoritative accounting guidance. Under GAAP, there are different rules for different derivatives and there are different rules for different uses of derivatives. To the extent that specific GAAP accounting guidance does not exist for some derivatives, practice is based on analogy to the literature that does exist for other derivatives. Also, the accounting for futures, forwards, options and swaps differs depending on whether these instruments are denominated in a domestic currency or in a foreign currency. The guidance in FAS 80 is used for futures contracts, and, by analogy, for certain other derivatives when they are denominated in the domestic currency of the entity. Although certain of the notions of designation, risk reduction and correlation from FAS 80 are incorporated in this paper, FAS 80 is rejected since statutory accounting principles as clarified herein provide sufficient guidance for hedge accounting. Consistent with *Issue Paper No. 81—Foreign Currency Transactions and Translations*, FAS 52 is rejected for reasons set forth in that paper. However, some of the elements of FAS 52 have been incorporated into this paper. The guidance in FAS 52 generally is applied when these instruments are denominated in a foreign currency that is not the functional currency of the entity. Also, this issue paper rejects the following GAAP pronouncements, which are limited to very narrow situations for which the broad accounting described in this issue paper is sufficient (such pronouncements are not reproduced herein due to length and limited scope):

- *FASB Emerging Issues Task Force No. 84-14, Deferred Interest Rate Setting*
- *FASB Emerging Issues Task Force Issue No. 86-34, Futures Contracts Used as Hedges of Anticipated Reverse Repurchase Transactions*
- *FASB Emerging Issues Task Force Issue No. 87-2, New Present Value Method of Valuing Speculative Foreign Exchange Contracts*
- *FASB Emerging Issues Task Force Issue No. 88-8, Mortgage Swaps*
- *FASB Emerging Issues Task Force Issue No. 90-17, Hedging Foreign Currency Risk with Purchased Options*
- *FASB Emerging Issues Task Force Issue No. 91-1, Hedging Intercompany Foreign Currency Risks*
- *FASB Emerging Issues Task Force Issue No. 91-4, Hedging Foreign Currency Risks with Complex Options and Similar Transactions*
- *FASB Emerging Issues Task Force Issue No. 95-11, Accounting for Derivative Instruments Containing both a Written Option-Based Component and a Forward-Based Component*
- *FASB Emerging Issues Task Force Issue No. 96-11, Accounting for Forward Contracts and Purchase Options to Acquire Securities Covered Under FASB Statement No. 115*

36. Because of inconsistencies in the accounting for derivatives, the FASB has been involved in a long-term project to address the accounting for off-balance-sheet financial instruments and is currently involved in deliberations to change the current accounting for derivatives under GAAP.

### Disclosure Requirements

37. The disclosures required by FAS 105 cover financial instruments with off-balance-sheet risk of accounting loss. The scope includes derivatives with off-balance sheet risk as well as other types of financial instruments. FAS 105 is adopted for all financial instruments with off-balance-sheet risk with the following modifications:

- a. The disclosures required in paragraph 17 shall distinguish between derivatives entered into for hedging purposes and for other-than-hedging purposes;
- b. Paragraph 19 is rejected. It addresses voluntary disclosures not required by this issue paper.

38. FAS 119 extends the requirements of FAS 105 to all derivatives and requires additional disclosures. FAS 119 is adopted with the following modifications:

- a. The disclosures required in paragraph 8 shall distinguish between derivatives entered into for hedging purposes and for other-than-hedging purposes;
- b. The disclosures required for trading derivatives by paragraph 10 shall be required for derivatives entered into for other-than-hedging purposes;
- c. Only the required disclosures in FAS 119 are adopted by this issue paper not the voluntary quantitative or qualitative disclosures. Therefore, paragraphs 12 and 13 are rejected.

39. Current statutory guidance provides specific information relating to derivatives in Schedules DB and DC of the Annual Statement. GAAP requires disclosures about derivative financial instruments in accordance with FAS 119. FAS 119 requires a distinction between derivatives used for trading and other than trading purposes for purposes of disclosure in the notes to the financial statements. Other information is required in the notes, such as notional amounts, carrying and fair values by category of derivative, a description of the accounting policies for derivatives, market and credit risk as well as other optional quantitative and qualitative information. Most of the required disclosures can be derived from information provided on Schedules DB and DC of the Annual Statement. The disclosure requirements are not intended to provide duplicative presentation in the annual statement filings but are required in those circumstances where the accompanying exhibits which contain certain required disclosures are not part of the reporting entity's financial statements (e.g., annual audit report). The disclosures required by FAS 119 are modified in that the classification of the disclosures shall be based on the accounting methodology adopted for the instrument based on hedge accounting or immediate recognition accounting, rather than on the notions of trading and other than trading in FAS 119.

### Drafting Notes

- The accounting for investments in mortgage backed securities, collateralized mortgage obligations, real estate mortgage investment conduits, interest-only securities and principal-only securities, among others, is primarily addressed in *Issue Paper No. 43—Loan-Backed and Structured Securities*.
- The Invested Asset Working Group of the Valuation of Securities (EX4) Task Force met on June 2, 1996 and considered four derivatives projects. In October of 1996, the Blanks Task Force will consider incorporation of certain changes to current derivatives guidance, a summary of which is provided in paragraph 49.

**RELEVANT STATUTORY AND GAAP GUIDANCE****Statutory Accounting**

40. Chapter 8 in the Life/A&H and P&C Accounting Practices and Procedures Manuals contains the following guidance relating to derivative instruments:

Derivative Instruments

Derivative instruments are reported in Schedule DB of the annual statement using the definitions below. Specific accounting procedures for each derivative instrument will depend on the definition below that best describes the instrument. State investment laws and regulations should be consulted for applicable limitations on the use of derivative instruments.

## Definitions:

“Underlying Interest” means the asset(s), liability(ies) or other interest(s) underlying a Derivative Instrument, including, but not limited to, any one or more securities, currencies, rates, indices, commodities, Derivative Instruments or other financial market instruments.

“Option” means an agreement giving the buyer the right to buy or receive, sell or deliver, enter into, extend or terminate, or effect a cash settlement based on the actual or expected price level, performance or value of, one or more Underlying Interests.

“Cap” means an agreement obligating the seller to make payments to the buyer, each payment under which is based on the amount, if any, that a reference price, level, performance or value of one or more Underlying Interests exceeds a predetermined number, sometimes called the strike/cap rate or price.

“Floor” means an agreement obligating the seller to make payments to the buyer, each payment under which is based on the amount, if any, that a predetermined number, sometimes called the strike/floor rate or price, exceeds a reference price, level, performance or value of one or more Underlying Interests.

“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.

“Swap” means an agreement to exchange or net payments at one or more times based on the actual or expected price, level, performance or value of one or more Underlying Interests.

“Forward” means an agreement (other than a Futures) to make or take delivery of, or effect a cash settlement based on the actual or expected price, level, performance or value of, one or more Underlying Interests.

“Futures” means an agreement traded on an exchange, board of trade or contract market, to make or take delivery of, or effect a cash settlement based on the actual or expected price, level, performance or value of, one or more Underlying Interests.

## General Accounting Guidance:

## Hedging:

Derivative instruments used by insurers in hedging transactions should be accounted for in a manner consistent with the item hedged prior to termination. Upon termination, the gains and losses from the derivative instrument will adjust the basis of the hedged item.

Alternatively, companies may mark derivative instruments of a given type to market from inception to termination with gains and losses recognized currently. Generally this alternative is used where it is impractical to allocate gains and losses to specific hedged assets or liabilities. The accounting treatment and categories to which this accounting treatment is applied should be consistent from period to period. However, derivative instruments hedging items which are subject to IMR will follow hedge accounting (amortized book value) while the instruments are still open and that the gains/losses will be subject to IMR upon termination.

For a derivative instrument to qualify for hedge accounting, the item to be hedged must expose the company to a risk and the designated derivative transaction must reduce that exposure. Examples include the risk of a change in the value, yield, price, cash flow, or quantity of, or degree of exposure with respect to assets, liabilities or future cash flows which an insurer has acquired or incurred, or anticipates acquiring or incurring.

A company should set specific criteria at the inception of the hedge as to what will be considered effective in measuring the hedge and then apply those criteria in the ongoing assessment based on actual hedge results. Insurers should account for a derivative instrument at market value if it ceases to be "effective" as a hedge and recognize the gain or loss currently to the extent it has not been offset by the effects of changes on the hedged item.

#### Documentation Guidance:

An insurer shall maintain documentation and records relating to derivative instruments opened during the year, instruments outstanding at year end, and instruments terminated during the year. Minimum required documentation is as follows:

- (a) For derivative instruments opened during the year:
  - (1) A description, for each instrument, of the purpose of the transaction, including:
    - A brief description of the assets and/or liabilities hedged by the instrument.
    - A brief description of the manner in which the instrument reduces risk.
    - A reference to the company's hedge program under which such transaction is internally authorized.
  - (2) Signature of approval, for each instrument, by person(s) authorized, either by the insurer's board of directors or a committee authorized by the board, to approve such transactions.
  - (3) A description, for each instrument, of the nature of the transaction, including:
    - The date of the transaction.
    - A complete and accurate description of the specific derivative instrument, including description of the underlying securities, currencies, rates, indices, commodities, derivative instruments, or other financial market instruments.
    - Number of contracts or notional amount.
    - Date of maturity, expiry or settlement.
    - Strike price, rate or index, (opening price for futures contracts).
    - Counterparty, or exchange on which the transaction was traded.
    - Cost or consideration received, if any, for opening transaction.

- (4) A description of the company methodology used to verify that opening transactions do not exceed limitations promulgated by the insurers state of domicile.
- (b) For derivative instruments terminated during the year:
- (1) Signature of approval, for each instrument, by person(s) authorized, either by the insurer's board of directors or a committee authorized by the board, to approve such transactions.
- (2) A description, for each instrument, of the nature of the transaction, including:
- The date of the transaction.
  - A complete and accurate description of the specific derivative instrument, including description of the underlying securities, currencies, rates, indices, commodities, derivative instruments, or other financial market instruments.
  - Number of contracts or notional amount.
  - Date of maturity, expiry or settlement.
  - Strike price, rate or index, (termination price for futures contracts).
  - Counterparty, or exchange on which the transaction was traded.
  - Consideration paid or received, if any, on termination.
- (3) Description of company methodology to verify that derivative instruments were effective hedges.
- (4) Identification of any derivative instruments that ceased to be effective as hedges.
- (c) For derivative instruments open at year end:
- (1) A description of the methodology used to verify the continued effectiveness of hedges.
- (2) An identification of any derivative instruments which have ceased to be effective as hedges.
- (3) A description of company methodology to determine market values of derivative instruments.
- (4) Copy of Master Agreements, if any, where indicated on Schedule DB Part E Section 1.

#### Specific Accounting Procedures for Derivative Instruments

- (a) Call and Put Options, Caps, and Floors:
- (1) Accounting at Date of Acquisition (purchase) or Issuance (written):
- The premium paid or received for purchasing or writing a call option, put option, cap or floor shall be carried as an asset (purchase) or liability (written) on the balance sheet (Aggregate Write-in for Invested Asset (or) Liability).

## (2) Statement Value:

- Open derivative instruments hedging items carried at amortized cost (where company does not elect to recognize gain/loss currently):
  - Options, caps and floors purchased or written shall be valued at amortized cost in a manner consistent with the hedged item.
  - The amortization period and methods used should in general result in a constant effective yield over the life of the hedged item or program. (For floating rate securities, the estimated effective yield should be based on the current rate so the changes in yields attributable to changes in interest rates will be recognized in the period of change.) Specific treatment includes:
    - Holdings in derivative instruments purchased or written within a year of maturity or expiry need not be amortized;
    - For anticipatory hedges, the derivative instrument may be carried at cost until the anticipated hedged transaction occurs or it is determined that the hedge was not effective;
    - For other derivative instruments, the amortization period is usually from date of acquisition (issuance) of the derivative instrument to maturity of the hedged item or program.
  - For hedges where the cost of the derivative instrument is combined with the hedged item, the statement value would be zero. The market value of the hedging and hedged items will be determined and reported separately.
  - If during the life of the derivative instrument, it is no longer effective as a hedge, valuation at amortized cost ceases and the derivative instrument shall be valued at its current market value (marked to market) with gains and losses recognized as adjustments to surplus to the extent they ceased to be effective hedges.
  - Open derivative instruments hedging items carried at market value, (where company does not elect to recognize gain/loss currently):
    - Options, caps or floors purchased or written shall be valued at current market value (marked to market) with changes in market value recognized currently consistent with the hedged item.
    - Usually this will result in unrealized gain/loss treatment with adjustment to surplus.

- For hedges where the cost of the derivative instrument is combined with the hedged item, the market value of the hedging and hedged items will be determined and reported separately. The cost (book value) basis used to figure gain/loss on the derivative instrument will be zero.
- Companies which elect to recognize gain/loss currently on derivative instruments acting as hedges shall make that determination at the start of the transaction and shall apply the methodology consistently between periods and by category.
  - For hedges of items which are not subject to IMR, options, caps or floors purchased or written shall be valued at current market value (marked to market) with unrealized gains/losses recognized as adjustments to surplus.
  - For hedges of items which are subject to IMR, options, caps and floors purchased or written shall be valued at amortized cost as in (2)(a) above.

## (3) Cash Flows and Income:

- Where the cost of the derivative instrument is not combined with the hedged item:
  - Amortization of premium or discount on derivative instruments is an adjustment to net investment (operating) income through Exhibit 2;
  - Periodic cash flows and accruals of income/expense are to be reported in a manner consistent with the hedged item, usually as other investment income (operating income) to be reported in Exhibit 2.
- Where the cost of the derivative instrument is combined with the hedged item, the cash flows and income of the derivative instrument on Schedule DB will be zero. All related amortization and cash flow accounting will be reported with the hedged item instead of with the derivative instrument.

## (4) Gain/Loss on Termination (includes closing, exercise, maturity, and expiry):

- Exercise of an Option: The remaining book value of the derivative instrument shall become an adjustment to the cost or proceeds of the hedged item(s) received or disposed of individually or in aggregate.
- Sale, maturity, expiry, or other closing transaction of a derivative instrument which is an effective hedge — Any gain or loss on the transaction will adjust the basis (or proceeds) of the hedged item(s) individually or in aggregate.

- Gain/loss on termination of derivatives will be recognized currently in net income (realized gain/loss) to the extent they ceased to be effective hedges.
- Where it is impractical to allocate gains or losses from effective hedges to specific hedged assets or liabilities, the company may recognize (realize) the gain/loss on termination in net income. Companies which elect to recognize gain/loss on derivative instruments acting as hedges shall make that determination at the start of the derivative transaction and shall apply the methodology consistently between periods and by investment category.
  - For insurers subject to IMR the gain/loss will be subject to IMR if the hedged items are subject to IMR.

(b) Swaps, Collars and Forwards:

An interest rate swap is a contractual agreement between two parties to exchange interest rate payments (usually fixed for variable) based on a specified amount of underlying assets or liabilities (known as the notional amount) for a specified period. The swap does not involve an exchange of principal. The result of these transactions is to transform payments from a variable rate to a fixed rate, from a fixed rate to a variable rate or from one variable rate index to another variable rate index.

Interest rate swaps have historically been entered into for the purpose of lowering borrowing costs, obtaining otherwise unavailable financing terms, and/or improving asset and liability management through a reduction of an entity's exposure to interest rate risk. Banks and brokers will enter into an interest rate swap with an interested party before a swap partner is found, creating a swap portfolio. This activity allows the corporation that desires a swap transaction immediate access to the market. This secondary market also allows a swap participant a vehicle to unwind or reverse swap positions it no longer wants or receive cash if the position to be disposed of is favorable in relation to the current market.

While swaps may involve the trading of interest on liabilities or assets, insurance industry members have used swaps to match return on assets to contract obligations. Insurers also have acted as an intermediary or broker in the process of arranging a swap. Swaps may involve long periods of time and significant amounts of interest on substantial notional amounts. Unmatched or naked swaps are sometimes written where no underlying asset or liability exists.

The risk to the parties of a swap agreement is reduced by the fact that no transfer of principal is involved. The cash exchanged between the parties is usually the net interest differential only.

In general, interest rate swaps are off-balance-sheet items, disclosed in the footnotes to the financial statements. With respect to the income statement, swap payments flow through other income or expense. The recording of capital gains or losses arises only in the event that one party to a swap agreement defaults. In such a circumstance, the defaulting party is required to make a lump sum payment to the other party in exchange for the release of their obligations under the contract. The amount of the lump sum payment represents the capital gain/loss recorded by each party.

## (1) Accounting at Date of Opening Position:

Any premium paid or received at date of opening shall be carried as an asset (paid) or liability (received) on the balance sheet (Aggregate Write-in for Invested Asset (or) Liability).

## (2) Statement Value:

- Open derivative instruments hedging items carried at amortized cost (where the company does not elect to recognize gain/loss currently):
  - Swaps, collars and forwards shall be valued at amortized cost in a manner consistent with hedged item.
  - The amortization period and methods used should in general result in a constant effective yield over the life of the hedged item or program. (For floating rate securities the estimated effective yield should be based on the current rate so the changes in yields attributable to changes in interest rates will be recognized in the period of change.) Specific treatment includes:
    - Holdings in derivative instruments purchased or written within a year of maturity or expiry need not be amortized;
    - For anticipatory hedges, the derivative instrument may be carried at cost until the anticipated hedged transaction occurs or it is determined that the hedge was not effective;
    - For other derivative instruments the amortization period is usually from date of acquisition (issuance) of the derivative instrument to maturity of the hedged item or program.
  - For hedges where the cost of the derivative instrument is combined with the hedged item, the statement value would be zero. The market value of the hedging and hedged items will be determined and reported separately.
  - If during the life of the derivative instrument it is no longer effective as a hedge, valuation at amortized cost ceases and the derivative instrument shall be valued at its current market value (marked to market) with gains and losses recognized as adjustments to surplus to the extent that it ceased to be an effective hedge.
- Open derivative instruments hedging items carried at market value (where company does not elect to recognize gain/loss currently):
  - Swaps, collars or forwards shall be valued at current market value (marked to market) with changes in market value recognized currently consistent with the hedged item.

- Usually this will result in unrealized gain/loss treatment with adjustment to surplus.
- For hedges where the derivative instrument is combined with the hedged item, the market value of the hedging and hedged items will be determined and reported separately. The cost (book value) basis used to figure gain/loss on the derivative instrument will be zero.
- Open foreign currency swap and forward contracts hedging foreign currency exposure on items denominated in a foreign currency and translated into U.S. dollars (where the company does not elect to recognize gain/loss currently):
  - The foreign exchange premium (discount) on the currency contract will be amortized into income over the life of the contract. The foreign exchange premium (discount) is defined as the foreign currency (notional) amount to be received (paid) times the net of the forward rate minus the spot rate at the time the contract was opened.
    - Amortization is not required if the contract was entered into within a year of maturity.
  - A foreign currency translation adjustment should be reflected as an unrealized gain/loss (surplus adjustment) using the same procedures as done to translate the hedged item.
  - The unrealized gain/loss for the period equals the foreign currency (notional) amount to be received (paid) times the net of the current spot rate minus the prior period end spot rate.
  - The statement value of the currency contract equals the amortized (premium) discount plus the cumulative unrealized gain/(loss) on the contract. The cumulative unrealized gain/(loss) equals the foreign currency (notional) amount to be received (paid) times the net of the current spot rate minus the spot rate at the time the contract was opened.
  - Recognition of unrealized gains/losses and amortization of foreign exchange premium/discount on anticipated firm commitments may be deferred until the hedged transaction occurs. These deferred gains/losses will adjust the basis or proceeds of the hedged transaction when it occurs.
  - For hedges where the cost of the foreign currency contract is combined with the hedged item, the statement value would be zero. The market value of the hedging and hedged items will be determined and reported separately.

- If during the life of the currency contract it is not effective as a hedge, valuation at amortized cost ceases. To the extent it ceased to be an effective hedge, a cumulative unrealized gain/loss will be recognized as an adjustment to surplus equal to the notional amount times the difference between the forward rate available for the remaining maturity of the contract (i.e., the forward rate as of the balance sheet date) and the forward rate at the time it ceased to be an effective hedge.
  - Companies which elect to recognize gain/loss currently on derivative instruments acting as hedges shall make that determination at the start of the transaction and shall apply the methodology consistently between periods and by category.
    - For hedges of items which are not subject to IMR, derivative instruments shall be valued at current market value (marked to market) with unrealized gains/losses recognized as adjustments to surplus.
    - For hedges of items which are subject to IMR, derivative instruments shall be valued at amortized cost as in (2)(a) above.
- (3) Cash Flows and Income:
- Where the cost of the derivative instrument is not combined with the hedged item:
    - Amortization of premium or discount on derivative instruments is an adjustment to net investment (operating) income through Exhibit 2.
    - Periodic cash flows and accruals of income/expense are to be reported in a manner consistent with the hedged item, usually as other investment income (operating income) to be reported in Exhibit 2.
  - Where the cost of the derivative instrument is combined with the hedged item, the cash flows and income of the derivative instrument on Schedule DB will be zero. All related amortization and cash flow accounting will be reported with the hedged item instead of with the derivative instrument.
- (4) Gain/Loss on Termination (includes closing, exercise, maturity, and expiry):
- Exercise — The remaining book value of the derivative instrument shall become an adjustment to the cost or proceeds of the hedged item(s) received or disposed of individually or in aggregate.
  - Sale, maturity, expiry, or other closing transaction of a derivative instrument which is an effective hedge — Any gain or loss on the transaction will adjust the basis (or proceeds) of the hedged item(s) individually or in aggregate.

- Gain/loss on termination of derivatives will be recognized currently in net income (realized gain/loss) to the extent they ceased to be effective hedges.
- Where it is impractical to allocate gains or losses from effective hedges to specific hedged assets or liabilities, the company may recognize (realize) the gain/loss on termination in net income. Companies which elect to recognize gain/loss on derivative instruments acting as hedges shall make that determination at the start of the derivative transaction and shall apply the methodology consistently between periods and by investment category.
  - For insurers subject to IMR the gain/loss will be subject to IMR if the hedged items are subject to IMR.

(c) Futures

(1) Accounting at Date of Acquisition:

Positions in futures contracts shall be initially valued at the amount of cash deposits (i.e., basis or book value of the contract), if any, placed with a broker. Subsequent additions (reductions) in cash deposits plus changes in contract value from date of contract opening (i.e., variation margin) paid (received) will increase (decrease) the book value of the futures contract.

(2) Statement Value:

- Hedges of Items Carried at Amortized Cost (where the company does not elect to recognize gain/loss currently):
  - Futures shall be valued at book value.
  - Book value of open futures contracts need not be amortized.
  - For hedges where the cost of the futures contract is combined with the hedged item, the statement value would be equal to cash deposits outstanding. The market value of the hedging and hedged items will be determined and reported separately. Market value on futures contracts is limited to the value of the cash deposits outstanding.
  - If during the life of the futures contract it is no longer effective as a hedge, valuation at book value (deferral accounting) ceases. A gain/(loss) equal to the variation margin received (paid) shall be recognized as an adjustment to surplus to the extent it ceased to be an effective hedge. Statement value will be limited to the cash deposits outstanding.
- Hedges of Items carried at Market Value (where company does not elect to recognize gain/loss currently):

- Changes in contract value from date of contract opening (i.e., variation margin) shall be recognized currently consistent with the hedged item. Statement value will be limited to the cash deposits outstanding.
- Usually this will result in unrealized gain/loss treatment with adjustment to surplus.
- For hedges where the variation margin of the futures contract is combined with the hedged item, the market value of the hedging and hedged items will be determined and reported separately.
- Open foreign currency futures contracts hedging foreign currency exposure on item(s) denominated in a foreign currency and translated into U.S. dollars (where the company does not elect to recognize gain/loss currently):
  - The foreign exchange premium (discount) on the currency contract will be amortized into investment income over the life of the contract. The foreign exchange premium (discount) is defined as the foreign currency (notional) amount to be received (paid) times the net of the forward rate minus the spot rate at the time the contract was opened. The cumulative income recognized since the contract was opened should be reported as recognized variation margin received or (paid).
    - Amortization is not required if the contract was entered into within a year of maturity.
  - A foreign currency translation adjustment should be reflected as an unrealized gain/loss (surplus adjustment) using the same procedures as is done to translate the hedged item. The cumulative unrealized gain/(loss) which equals the foreign currency (notional) amount to be received (paid) times the net of the current spot rate minus the spot rate at the time the contract was opened should be reported as recognized variation margin received or (paid).
  - The statement value of the currency futures contract is book value, including any increase (decrease) for amortization of foreign exchange (premium) discount ((c)(i) above) plus the foreign exchange translation gain/(loss) ((c)(ii) above), which is reported as deferred variation margin.
  - Recognition of unrealized gains/losses and amortization of foreign exchange premium/discount on anticipated firm commitments may be deferred until the hedged transaction occurs. These deferred gains/losses will adjust the basis or proceeds of the hedged transaction when it occurs.

- For hedges where the variation margin of the foreign currency contract is combined with the hedged item, the statement value would equal the cash deposits outstanding. The market value of the hedging and hedged items will be determined and reported separately. Market value on futures contracts is limited to the value of the cash deposits outstanding.
- If during the life of the currency contract it is not effective as a hedge, valuation at amortized cost ceases. To the extent it ceased to be an effective hedge, a cumulative unrealized gain/loss will be recognized as an adjustment to surplus equal to the notional amount times the difference between the forward rate available for the remaining maturity of the contract (i.e., the forward rate as of the balance sheet date) and the forward rate at the time it ceased to be an effective hedge.
- Companies which elect to recognize gain/loss currently on futures contracts acting as hedges shall make that determination at the start of the transaction and shall apply the methodology consistently between periods and by category.
  - For hedges of items which are not subject to IMR, changes in contract value from date of contract opening (i.e., variation margin) shall be recognized currently as unrealized gain/loss adjustment to surplus. Statement value will be limited to the cash deposits outstanding.
  - For hedges of items which are subject to IMR, derivative instruments shall be valued at amortized cost as in (2)(a) above.

(3) Gain/Loss on Termination:

- Settlement at maturity of a futures contract — The remaining variation margin of the futures contract shall become an adjustment to the cost or proceeds of the hedged item(s) received, disposed of or held, individually or in aggregate.
- Sale or other closing transaction of a futures contract which is an effective hedge — any gain or loss on the transaction will adjust the basis (or proceeds) of the hedged item(s) individually or in aggregate.
- Gain/loss on termination of futures contracts will be recognized currently in net income (realized gain/loss) to the extent they ceased to be effective hedges.
- Where it is impractical to allocate gains or losses from effective hedges to specific hedged assets or liabilities, the company may recognize (realize) the gain/loss on termination in net income. Companies which elect to recognize gain/loss on futures contracts acting as hedges shall make that determination at the start of the derivative transaction and shall apply the methodology consistently between periods and by investment category.

- For insurers subject to IMR the gain/loss will be subject to IMR if the hedged items are subject to IMR.

41. Chapter 8 in the Life/A&H and P&C Accounting Practices and Procedures Manuals contain the following guidance relating to insurance futures and insurance future options:

#### Insurance Futures and Insurance Futures Options

The statutes, regulations and administrative rulings of the insurers domiciliary state establish the authority to engage in transactions with respect to insurance futures and insurance futures options. In the absence of specific written authority, the Insurance Department of the insurers domiciliary state should be consulted as to such authority.

In those jurisdictions which authorize transactions with respect to insurance futures and insurance futures options, an insurance company is generally permitted, subject to applicable quantitative limitations, to use such instruments to hedge against adverse development in its incurred losses. This strategy typically would involve any or a combination of (i) the purchase of insurance futures contracts, (ii) the purchase of a call option on insurance futures contracts, or (iii) the sale (writing) of a put option on insurance futures contracts.

#### Insurance Futures Contracts:

An insurance futures contract is a futures contract based on an underlying index of performance of insurance contracts (policies) or factors relating thereto. An insurance futures contract also may be defined more specifically under the statutes, regulations and administrative rulings of a particular state. In connection with a given insurance futures position, an insurer is required by the listing exchange to maintain a margin deposit with respect to the underlying insurance futures contracts purchased.

An insurer should report the amount of any margin deposit as an asset on its balance sheet, which deposit should be reflected as an aggregate write-in for other-than-invested assets. The specific statutory accounting treatment of increases or decreases in the value of the subject contracts will depend on whether the insurance futures position constitutes a hedge of the insurers incurred losses. The determination of whether an insurance futures position constitutes a hedge is typically determined pursuant to the statutes, rules and administrative rulings of an insurers domiciliary state. Although many states prohibit an insurer from taking an insurance futures position that does not constitute a hedge, the following presents both hedge accounting and other-than-hedge accounting treatment. Other-than-hedge accounting should be used in the event that an original hedge position loses its character as such, until such time as the position is terminated as required by state law.

#### Insurance Futures - Hedge Accounting:

The following treatment would be applicable to insurance futures positions that effectively hedge an insurers incurred losses. With respect to any insurance futures position which corresponds to incurred losses for the current reporting period, any increases (decreases) in the value of the insurance futures contracts should be reported as an increase (decrease) in the insurers other income, as an aggregate write-in for miscellaneous income for the subject period. With respect to any insurance futures position which corresponds to a period beyond the current reporting period, any increases (decreases) in the value of the underlying insurance futures contracts should be reported as a direct increase (decrease) in the insurers surplus, as an aggregate write-in for gains and losses in surplus. When such insurance futures position thereafter corresponds to a current reporting period, the initial increase (decrease) in direct surplus should be reversed and such amount should be appropriately reported as an increase (decrease) to the insurers other income, as an aggregate write-in for miscellaneous income for the current period, along with any current changes in value of the insurance futures contracts. In either of the foregoing instances, the increase (decrease) in the market value of the insurance futures contracts should either (i) increase (decrease) the aggregate write-in for other-than-invested assets, to the extent that such

increase (decrease) effects the corresponding margin deposit, or (ii) increase (decrease) cash or other assets, to the extent of mark-to-market payments that are not maintained as a margin deposit. When the insurance futures position is eventually closed, any corresponding margin balance (i.e., aggregate write-in for other-than-invested assets) shall be transferred to the insurers cash or other assets, as appropriate.

#### Insurance Futures – Other-Than-Hedge Accounting:

If the insurance futures position is no longer effective as a hedge, any increases (decreases) in the value of the insurance futures contracts should be reported as an aggregate write-in for miscellaneous income. When the insurance futures positions eventually close, any corresponding margin balance (i.e., aggregate write-in for other-than-invested assets) should be transferred to the insurers cash or other assets, as appropriate.

#### Options on Insurance Futures Contracts:

An insurance futures option is either a put or call option on an insurance futures contract. An insurance futures call option is a contract under which the holder has the right to purchase the underlying insurance futures contract covered by the option at a stated price (strike price) on or before a fixed expiration date. An insurance futures put option gives the holder the right to sell the underlying insurance futures contract. The consideration paid (received) for the purchase (sale) of an insurance futures option is referred to as a premium. Because all insurance futures options relate to an underlying insurance futures contract, the statutory accounting treatment of insurance futures options generally follows the treatment afforded insurance futures contracts.

An insurer should report the amount of any premium paid for an insurance futures option as an asset on its balance sheet, which premium should be reflected as an aggregate write-in for other-than-invested assets. Similarly, an insurer should report the amount of any premium received for the sale (writing) of an insurance futures option as a liability on its balance sheet, which premium should be reflected as an aggregate write-in for liabilities. The specific statutory accounting treatment of increases or decreases in the market value of the subject insurance futures option will depend on whether such position constitutes a hedge of the insurers incurred losses. As with insurance futures contracts, the determination of whether a particular position constitutes a hedge is typically determined pursuant to the statutes, rules and administrative rulings of an insurers domiciliary state. Although many states prohibit an insurer from taking an insurance futures option position that does not constitute a hedge, the following presents both hedge accounting and other-than-hedge accounting treatment. Other-than-hedge accounting should be used in the event that an original hedge position loses its characters as such, until such time as the position is terminated as required by state law.

#### Options on Insurance Futures Contracts - Hedge Accounting:

The following treatment would be applicable to insurance futures options positions that effectively hedge an insurers incurred losses.

- (a) Purchase of Call Options — With respect to any call option which corresponds to incurred losses for the current reporting period, any increases (decreases) in the market value of the option should be reported as an increase (decrease) in the insurers other income, as an aggregate write-in for miscellaneous income for the subject period. With respect to any call option which corresponds to a period beyond the current reporting period, any increases (decreases) in the market value of the underlying option should be reported as a direct increase (decrease) in the insurer's surplus, as an aggregate write-in for gains and losses in surplus. When such option thereafter corresponds to a current reporting period, the initial increase (decrease) in direct surplus should be reversed and such amount should be appropriately reported as an increase (decrease) to the insurer's other income, as an aggregate write-in for miscellaneous income for the current period, along with any current changes in the market value of the option.

If the option position is terminated through a closing transaction, the corresponding balance of the asset (i.e., aggregate write-in for other-than-invested assets) should be eliminated, with a corresponding charge to cash or other assets, as appropriate. If the option is exercised, the corresponding balance of the asset should be eliminated, with a corresponding charge to either (i) insurance futures margin (i.e., aggregate write-in for other-than-invested assets), to the extent of margin deposit requirements, or (ii) cash or other assets, as appropriate. If the option expires, the corresponding balance of the asset should be eliminated, with an appropriate decrease to the insurer's other income, as an aggregate write-in for miscellaneous income.

- (b) Sale (Writing) of Put Options — The statutory accounting treatment for the sale (writing) of insurance futures put options is essentially the mirror image of the foregoing treatment presented with respect to purchased call options. Upon termination (through a closing transaction), exercise or expiry of the put option, the corresponding balance of the liability (i.e., aggregate write-in for liabilities) should be eliminated, in the mirror image of the foregoing treatment.

Options on Insurance Futures Contracts – Other-Than-Hedge Accounting:

If the insurance futures option position is no longer effective as a hedge, any increases (decreases) in the value option should be reported as an aggregate write-in for miscellaneous income.

42. The NAIC Annual Statement Instructions for both Life, Accident and Health and Property and Casualty companies require the following disclosures for derivative instruments:

Instruction:

Disclose the following information by category of derivative financial instrument:

- a. A description of the Company's objectives for holding or issuing derivative financial instruments, the context needed to understand those objectives, and its strategies for achieving those objectives including the classes of derivative financial instrument used.
- b. The nature and terms of derivative financial instruments, including, at a minimum, a discussion of: 1) the credit and market risk of those instruments, and 2) the cash requirements of those instruments (including the effects of possible termination payments).

Illustration for Interest Rate Swaps (Companies should modify the following to reflect appropriately their own circumstances):

The Company uses interest rate swaps to reduce market risks from changes in interest rates and to alter interest rate exposures arising from mismatches between assets and liabilities. Under interest rate swaps, the Company agrees with other parties to exchange, at specified intervals, the difference between fixed-rate and floating-rate interest amounts calculated by reference to an agreed notional principal amount. Generally, no cash is exchanged at the outset of the contract and no principal payments are made by either party. A single net payment is usually made by one counterparty at each due date. See Schedule DB.

The Company is exposed to credit-related losses in the event of nonperformance by counterparties to financial instruments, but it does not expect any counterparties to fail to meet their obligations given their high credit ratings. The credit exposure of interest rate swaps is represented by the fair value (market value) of contracts with a positive fair value (market value) at the reporting date.

Illustration for All Other Derivatives Listed in Schedule DB (Caps, Collars, Futures, etc.):

The note(s) may resemble the illustration for interest rate swaps. For additional illustrations, see C.M. Antis' *Financial Accounting Series Special Report, Illustrations of Financial Instrument Disclosures* (No. 144-c), December 1994, published by the Financial Accounting Standards Board.

43. The following guidance for derivatives used for income generation was adopted by the Financial Condition (EX4) Subcommittee on December 14, 1996:

INCOME GENERATION ACCOUNTING PROJECT  
EXECUTIVE SUMMARY  
JULY 10, 1996

INTRODUCTION

Income Generation transactions are ones where the company writes (or sells) derivative instruments to generate additional income or return to the company. They include covered options, caps and floors such as when a company writes an equity call option on stock which it already owns. Currently they represent a small portion of the insurance industry's derivative activity in terms of number of companies involved, number of transactions, and dollar amounts involved. The possibility of greater company involvement in the future exists given recent guidance and inclusion in the Model Investment Law.

Because these transactions involve writing derivative transactions, they expose the company to potential future liabilities for which the company receives a premium up front. Because of this risk, state laws and the Model Investment Law impose dollar limitations and additional constraints requiring that they be "covered," i.e., that there be offsetting assets which can be used to fulfill potential obligations. To this extent the combination of instruments works like a reverse hedge where an asset owned by the company in essence hedges the derivative risk.

As with derivatives in general these instruments include a wide variety of terms regarding maturities, range of exercise periods and prices, counterparties, underlying instruments, etc.

GENERAL ATTRIBUTES

The proposed accounting and reporting approach is intended to meet (1) Regulatory needs focusing on company and Industry solvency (2) company needs focusing on administrative and cost considerations, and (3) the general need to provide meaningful and relevant information regarding the substance of the transactions and holdings for all users of the financial statements.

1. The approach is conservative and reduces the potential for income manipulation. Income is not recognized early in the holding period only to be reversed by future losses. This consideration is particularly important for options which could have lower exercise prices than the combined statement values of the derivative and the covering asset.
2. The approach is reasonably simple and consistent with Statutory accounting. It builds on accounting guidance which already exists in the *NAIC Accounting Practices and Procedures Manual* and in the *Annual Statement Instructions* regarding hedging.
3. The approach looks to the substance of the transactions involved.
  - It matches the accounting of the derivative with the accounting of the covering asset or underlying interest.

- It includes an alternative treatment which combines the derivative with the covering asset. This results in a treatment analogous to callable bonds where the option feature is combined with the asset rather than in two pieces.
- It allows for recognition of the time value/interest rate factor implicit in the pricing of these instruments, particularly relevant for derivatives with longer maturities.

## ACCOUNTING SPECIFICS

The accounting specifics attached are presented in table form. Completed sections include

- Covered Call Writing
  - Covering Item at Amortized Cost
  - Covering Item at Market
- Covered Put Writing
  - Underlying Interest at Amortized Cost
  - Underlying Interest at Market
- Covered Cap and Floor Writing
  - Covering Item at Amortized Cost
  - Covering Item at Market
- Accounting Examples
- AVR Implications
- Approval by AVR/IMR Study Group
- Formal Blanks Proposal

### General

The principal features to date are:

1. The premium received is initially recorded as a deferred liability.
2. The accounting of the covering asset or underlying interest controls the accounting of the derivative. The covering asset/underlying interest is accounted at either mark-to-market (e.g., common stocks) or (amortized) cost (e.g., for bonds).
3. The gain/loss on termination of the derivative is a capital item. For life insurance companies, it would be subject to IMR treatment if interest rate related.
4. For options which are exercised, the remaining premium would adjust the proceeds (cost) associated with the exercise resulting in no explicit gain or loss reported for the derivative itself.

Covered puts and fixed income transactions have several specific features which are presented below.

### Fixed Income Call Options

The principal specific features are:

1. The general approach is to value at cost (i.e., consideration received) without amortization over the life of the contract.
2. An alternative to the general approach combines the accounting of the written option with the covering asset and then uses standard accounting for callable bonds (yield to worst amortization) on the adjusted asset. This method prevents the possibility of future loss recognition upon exercise while at the same time providing recognition of the income

feature of the option over time. This approach would appear most relevant for longer-lived covered European call options, which are in substance like callable bonds.

3. For life insurance companies the gain or loss flows through the IMR if the underlying interest or covering asset is subject to the IMR using callable bond rules to determine the remaining life.
4. Companies writing options for income generation purposes are responsible for timely recognition of any probable losses that may occur as a result of the strategy. If the exercise price is below the covering asset's book value, the asset should be evaluated for write down or disclosure treatment along the lines of Codification Issue Paper #5 *Definition of Liabilities, Loss Contingencies, and Impairments of Assets* taking into consideration all relevant factors such as whether the option is currently exercisable, the fair value of the bond relative to its exercise price, to what extent the statement value of the option premium offsets any loss on the asset, or how any IMR transaction on exercise would affect surplus and income.

### Puts

The principal features are:

1. The accounting for the underlying interest instead of the covering asset governs the accounting of the written put while it is open. For example, if a company wrote a put requiring it to purchase a certain common stock (underlying interest) at a specific price, the company might cover that option by holding cash or cash equivalents (covering asset). The accounting for the common stock would govern the accounting of the option in this case.
2. As with covered call writing for life insurance companies, gain/loss on termination may be subject to IMR over the remaining life of the underlying interest.
3. As with covered call writing, companies writing put options for income generation purposes are responsible for timely recognition of any probable losses that may occur as a result of the strategy.

### Fixed Income Caps and Floors

The principal specific features are:

1. The value of the premium received would be amortized into income over the life of the contract. For caps and floors, where the company is selling off possible excess interest/income, the value of the covering asset is not relevant.
2. Again, gain/loss may be subject to IMR. The expected maturity would be the derivative contract's maturity.

WRITTEN CALL OPTIONS – INCOME GENERATION  
 PROPOSED STATUTORY ACCOUNTING TREATMENT  
 APPLICABLE TO ALL INSURANCE COMPANIES  
 JULY 30, 1996

STATUS OF OPTION	COVERING ASSET AT AMORTIZED COST	COVERING ASSET AT MARKET VALUE
Open	<p>Record premium as deferred liability.</p> <p>Carry at consideration received. (1)</p> <p>Alternatively, attach premium to covering asset and amortize (under yield to worse scenario) using standard callable bond accounting. (2)</p>	<p>Record premium as deferred liability.</p> <p>Mark to market with changes in market value recorded as unrealized adjustments to surplus – gain/loss.</p>
Closed – Expired	<p>Premium received recognized as realized capital gain.</p> <p>Gain from expiration to flow through IMR if applicable. (3)</p>	<p>Premium received recognized as realized capital gain.</p>
Closed – Exercised	<p>Adjust disposition proceeds. (Include in capital gain/loss of disposed asset.)</p> <p>Gain or loss from disposition to flow through IMR if applicable. (3)</p>	<p>Adjust disposition proceeds. (Include in capital gain/loss of disposed asset.)</p>
Closed – Terminated	<p>Recognize net amount as realized capital gain/loss.</p> <p>Gain or loss from disposition to flow through IMR if applicable. (3)</p>	<p>Recognize net amount as realized capital gain/loss.</p>

**NOTES**

1. A general statement will be added to the instructions stating that companies writing options for income generation purposes are responsible for the timely recognition of any probable losses that may occur as a result of the strategy due to holding and accounting for options on Schedule DB – Part B.
2. Report derivative and its market value on Schedule DB – Part B. Include accounting on Schedule D – Part 1.
3. If premium is attached to covering asset, the accounting treatment for the covering asset applies.

WRITTEN PUT OPTIONS – INCOME GENERATION  
 PROPOSED STATUTORY ACCOUNTING TREATMENT  
 APPLICABLE TO ALL INSURANCE COMPANIES  
 JULY 30, 1996

STATUS OF OPTION	UNDERLYING INTEREST AT AMORTIZED COST	UNDERLYING INTEREST AT MARKET VALUE
Open	Record premium as deferred liability.  Carry at consideration received. (1)	Record premium as deferred liability.  Mark to market with changes in market value recorded as unrealized adjustments to surplus – gain/loss.
Closed – Expired	Premium received recognized as realized capital gain.  Gain from expiration to flow through IMR if applicable.	Premium received recognized as realized capital gain.
Closed – Exercised	Adjust acquisition cost by premium received.	Adjust acquisition cost by premium received.
Closed – Terminated	Recognized net amount as realized capital gain/loss.  Gain or loss from disposition to flow through IMR if applicable.	Recognize net amount as realized capital gain/loss.

NOTES

1. A general statement will be added to the instructions stating that companies writing options for income generation purposes are responsible for the timely recognition of any probable losses that may occur as a result of the strategy due to holding and accounting for options on Schedule DB – Part B.

WRITTEN CAPS AND FLOORS – INCOME GENERATION  
 PROPOSED STATUTORY ACCOUNTING TREATMENT  
 APPLICABLE TO ALL INSURANCE COMPANIES  
 JULY 30, 1996

STATUS OF OPTION	COVERING ASSET AT AMORTIZED COST	COVERING ASSET AT MARKET VALUE
Open	<p>Record premium as deferred liability.</p> <p>Carry at amortized value. (Alternatively carry at consideration received if within 1 yr of maturity.)</p> <p>Amortize over life of contract to produce constant yield.</p> <p>Record any interest expense as “Other Investment Income” – negative value.</p>	<p>Record premium as deferred liability.</p> <p>Mark to market with changes in market value recorded as unrealized adjustments to surplus – gain/loss.</p>
Closed – Matured	<p>Would usually mature at zero amortized value.</p> <p>Any remaining unamortized value recognized as ordinary income through a final amortization adjustment.</p>	<p>Premium received recognized as realized capital gain.</p>
Closed – Exercised	<p>Not applicable.</p>	<p>Not applicable.</p>
Closed – Terminated	<p>Recognize net amount as realized capital gain/loss.</p> <p>Gain/loss on termination to flow through IMR if applicable.</p>	<p>Recognize net amount as realized capital gain/loss.</p>
Disclosure	<p>(OPEN ITEM—being addressed by other Interested Persons.)</p> <p>Details of covered items and/or written transactions to allow actuaries to evaluate cash flow implication.</p>	<p>(OPEN ITEM—being addressed by other Interested Persons.)</p> <p>Details of covered items and/or written transactions to allow actuaries to evaluate cash flow implications.</p>

### Generally Accepted Accounting Principles

44. The key GAAP literature relating to hedge accounting for derivative financial instruments is found in FAS 80. Paragraphs 3 and 4 of FAS 80 state, in part:

3. A change in the market value of a futures contract shall be recognized as a gain or loss in the period of the change unless the contract meets the criteria specified in this Statement to qualify as a hedge of an exposure to price or interest rate risk. If the hedge criteria are met, the accounting for the futures contract shall be related to the accounting

for the hedged item so that changes in the market value of the futures contract are recognized in income when the effects of related changes in the price or interest rate of the hedged item are recognized.

4. In applying this Statement, both of the following conditions shall be met for a futures contract to qualify as a hedge:
  - a. The item to be hedged exposes the enterprise to price (or interest rate) risk. In this Statement, risk refers to the sensitivity of an enterprise's income for one or more future periods to changes in market prices or yields of existing assets, liabilities, firm commitments, or anticipated transactions. To meet this condition, the item or group of items intended to be hedged must contribute to the price or interest rate risk of the enterprise. In determining if this condition is met, the enterprise shall consider whether other assets, liabilities, firm commitments, and anticipated transactions already offset or reduce the exposure. An enterprise that cannot assess risk by considering other relevant positions and transactions for the enterprise as a whole because it conducts its risk management activities on a decentralized basis can meet this condition if the item intended to be hedged exposes the particular business unit that enters into the contract.
  - b. The futures contract reduces that exposure and is designated as a hedge. At the inception of the hedge and throughout the hedge period, high correlation of changes in (1) the market value of the futures contract(s) and (2) the fair value of, or interest income or expense associated with, the hedged item(s) shall be probable so that the results of the futures contract(s) will substantially offset the effects of price or interest rate changes on the exposed item(s). In addition to assessing information about the correlation during relevant past periods, the enterprise also shall consider the characteristics of the specific hedge, such as the degree of correlation that can be expected at various levels of higher or lower market prices or interest rates. A futures contract for a commodity or a financial instrument different from the item intended to be hedged may qualify as a hedge provided there is a clear economic relationship between the prices of the two commodities or financial instruments, and provided high correlation is probable.
45. Paragraph 21 of FAS 52 states, in part:

A gain or loss on a forward contract or other foreign currency transaction that is intended to hedge an identifiable foreign currency commitment (for example, an agreement to purchase or sell equipment) shall be deferred and included in the measurement of the related foreign currency transaction...A foreign currency transaction shall be considered a hedge of an identifiable foreign currency commitment provided both of the following conditions are met:

  - a. The foreign currency transaction is designated as, and is effective, as a hedge of a foreign currency commitment.
  - b. The foreign currency commitment is firm.
46. The key GAAP literature relating to interest rate swap transactions is EITF 84-36, in which the Task Force concluded that:

...if there is an underlying debt obligation on the balance sheet of the company entering into the swap transaction, the company should account for the swap agreement like a hedge of the obligation and record interest expense using the revised interest rate, with any fees or other payments amortized as yield adjustments.
47. FAS 105, as amended by FAS 119, provides the following guidance on disclosures for financial instruments with off-balance sheet risk, including derivatives:

6. A financial instrument is cash, evidence of an ownership interest in an entity, or a contract that both:
- a. Imposes on one entity a contractual obligation<sup>1</sup> (1) to deliver cash or another financial instrument<sup>2</sup> to a second entity or (2) to exchange financial instruments on potentially unfavorable terms with the second entity
  - b. Conveys to that second entity a contractual right<sup>3</sup> (1) to receive cash or another financial instrument from the first entity or (2) to exchange other financial instruments on potentially favorable terms with the first entity.

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<sup>1</sup> *Contractual obligations* encompass both those that are conditioned on the occurrence of a specified event and those that are not. All contractual obligations that are financial instruments meet the definition of *liability* set forth in FASB Concepts Statement No. 6, *Elements of Financial Statements*, although some may not be recognized as liabilities in financial statements—may be “off-balance-sheet”—because they fail to meet some other criterion for recognition. For some financial instruments, the obligations is owed to or by a group of entities rather than a single entity.

<sup>2</sup> The use of the term *financial instrument* in this definition is recursive (because the term *financial instrument* is included in it), though it is not circular. The definition requires a chain of contractual obligations that ends with the delivery of cash or an ownership in an entity. Any number of obligations to deliver financial instruments can be links in a chain that qualifies a particular contract as a financial instrument.

<sup>3</sup> *Contractual rights* encompass both those that are conditioned on the occurrence of a specified event and those that are not. All contractual rights that are financial instruments meet the definition of *asset* set forth in Concepts Statement 6, although some may not be recognized as assets in financial statements —may be “off-balance-sheet”—because they fail to meet some other criterion for recognition. For some financial instruments, the right is held by or the obligation is due from a group of entities rather than a single entity.

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7. The risk of accounting loss<sup>4</sup> from a financial instrument includes (a) the possibility that a loss may occur from the failure of another party to perform according to the terms of a contract (credit risk), (b) the possibility that future changes in market prices may make a financial instrument less valuable or more onerous (market risk),<sup>5</sup> and (c) the risk of theft or physical loss. This Statement addresses credit and market risk only.

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<sup>4</sup> Accounting loss refers to the loss that may have to be recognized due to credit and market risk as a direct result of the rights and obligations of a financial instrument.

<sup>5</sup> A change in market price may occur (for example, for interest-bearing financial instruments) because of changes in general interest rates (interest rate risk), changes in the relationship between general and specific market interest rates (an aspect of credit risk), or changes in the rates of exchange between currencies (foreign exchange risk).

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#### Disclosure of Extent, Nature, and Terms of Financial Instruments with Off-Balance-Sheet Risk

17. For financial instruments with off-balance-sheet risk\*, except as noted in paragraphs 14 and 15, an entity shall disclose either in the body of the financial statements or in the accompanying notes the following information by category of financial instrument:<sup>12</sup>

- a. The face or contract amount (or notional principal amount if there is no face or contract amount)

- b. The nature and terms, including, at a minimum, a discussion of (1) the credit and market risk of those instruments, (2) the cash requirements of those instruments, and (3) the related accounting policy pursuant to the requirements of APB Opinion No. 22, *Disclosure of Accounting Policies*.<sup>13</sup>

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\* Similar disclosures are required for derivative financial instruments without off-balance-sheet risk in paragraph 8 of FASB Statement No. 119, *Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments*.

<sup>12</sup> In this Statement, category of financial instrument refers to class of financial instrument, business activity, risk, or other category that is consistent with the management of those instruments. If disaggregation of financial instruments is other than by class, the entity also shall describe for each category the classes of financial instruments included in that category. Practices for grouping and separately identifying—classifying—similar financial instruments in statement of financial position, in notes to financial statements, and in various regulatory reports have developed and become generally accepted, largely without being codified in authoritative literature. In this Statement, *class of financial instrument* refers to those classifications.

<sup>13</sup> Paragraph 12 of Opinion 22 as amended by FASB Statement No. 95, *Statement of Cash Flows*, says:

Disclosure of accounting policies should identify and describe the accounting principles followed by the reporting entity and the methods of applying those principles that materially affect the determination of financial position, statement of cash flows, or result of operations. In general, the disclosure should encompass important judgments as to appropriateness of principles relating to recognition of revenue and allocation of asset costs to current and future periods; in particular, it should encompass those accounting principles and methods that involve any of the following:

- a. A selection from existing acceptable alternatives.
- b. Principles and methods peculiar to the industry in which the reporting operates, even if such principles and methods are predominantly followed in that industry.
- c. Unusual or innovative applications of generally accepted accounting principles (and, as applicable, of principles and methods peculiar to the industry in which the reporting entity operates).

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The disclosures required in paragraph 17 shall distinguish between financial instruments with off-balance-sheet risk held or issued for trading purposes, included dealing and other trading activities measured at fair value with gains and losses recognized in earnings, and financial instruments with off-balance-sheet risk held or issued for purposes other than trading.

#### Disclosure of Credit Risk of Financial Instruments with Off-Balance-Sheet Credit Risk

18. For financial instruments with off-balance-sheet credit risk, except as noted in paragraphs 14 and 15, an entity shall disclose either in the body of the financial statements or in the accompanying notes the following information by category of financial instrument:

- a. The amount of accounting loss the entity would incur if any party to the financial instrument failed completely to perform according to the terms of the contract and the collateral or other security, if any, for the amount due proved to be of no value to the entity
- b. The entity's policy of requiring collateral or other security to support financial instruments subject to credit risk, information about the entity's access to that collateral or other security, and the nature and a brief description of the collateral or other security supporting those financial instruments.

19. An entity may find that disclosing additional information about the extent of collateral or other security for the underlying instrument indicates better the extent of credit risk. Disclosure of that additional information in those circumstances is encouraged.

48. FAS 119 provides the following guidance on disclosures for derivatives:

8. For options held and other derivative financial instruments not included in the scope of Statement 105 (because they do not have off-balance-sheet risk of accounting loss, as defined in Statement 105), an entity shall disclose either in the body of the financial statements or in the accompanying notes the following information by category of financial instrument:<sup>1</sup>
- a. The face or contract amount (or notional principal amount if there is no face or contract amount)<sup>2</sup>
  - b. The nature and terms, including, at a minimum, a discussion of (1) the credit and market risk of those instruments, (2) the cash requirements of those instruments, and (3) the related accounting policy pursuant to the requirements of APB Opinion No. 22, Disclosure of Accounting Policies.

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<sup>1</sup> In this Statement, *category of financial instrument* refers to class of financial instrument, business activity, risk, or other category that is consistent with the management of those instruments. If disaggregation of financial instruments is other than by class, the entity also shall describe for each category the classes of financial instruments included in that category.

<sup>2</sup> Disclosure of the face or contract amount of financial instruments, including those within the scope of Statement 105, may be misleading when the instruments are leveraged and the leverage features are not adequately disclosed. For example, the optional amounts of the interest rate swap may be misleading if the contract's settlement payments are based on a formula that multiplies the effect of interest rate changes. Disclosure of the nature and terms of those instruments requires a discussion of the leverage features and their general effects on (a) the credit and market risk, (b) the cash requirements, and (c) the related accounting policy.

9. The disclosures required in paragraph 8 of this Statement shall distinguish between derivative financial instruments held or issued for:
- a. Trading purposes, including dealing and other trading activities measured at fair value with gains and losses recognized in earnings
  - b. Purposes other than trading.
10. Entities that hold or issue derivative financial instruments for trading purposes shall disclose, either in the body of the financial statements or in the accompanying notes, the following:
- a. The average fair value of those derivative financial instruments during the reporting period<sup>3</sup>, presented together with the related end-of-period fair value, distinguishing between assets and liabilities
  - b. The net gains or losses (often referred to as net trading revenues) arising from trading activities during the reporting period disaggregated by class, business activity, risk, or other category that is consistent with the management of those activities and where those net trading gains or losses are reported in the income statement. If the disaggregation is other than by class, the entity also shall describe for each category the classes of derivative financial instruments, other financial instruments, and nonfinancial assets and liabilities from which the net trading gains or losses arose.

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<sup>3</sup> The calculation based on average fair value based on daily balances is preferable to a calculation based on less frequent intervals. It is, however, sufficient to disclose average fair value based on the most frequent interval that a trader's systems generate for management, regulatory, or other reasons.

11. Entities that hold or issue derivative financial instruments for purposes other than trading shall disclose the following:

- a. A description of the entity's objectives for holding or issuing the derivative financial instruments, the context needed to understand those objectives, and its strategies for achieving those objectives, including the classes of derivative financial instruments used<sup>4</sup>
- b. A description of how each class of derivative financial instrument is reported in the financial statements including the policies for recognizing (or reasons for not recognizing) and measuring the derivative financial instruments held or issued, and when recognized, where those instruments and related gains and losses are reported in the statements of financial position and income.

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<sup>4</sup> For example, if an entity's objective for a derivative position is to keep a risk arising from the entity's nonderivative assets below a specified level, the context would be a description of those assets and their risk, and a strategy might be purchasing put options in a specified proportion to the assets at risk.

- c. For derivative financial instruments that are held or issued and accounted for as hedges of anticipated transactions (both firm commitments and forecasted transactions for which there is no firm commitment), (1) a description of the anticipated transactions whose risks are hedged, including the period of time until the anticipated transactions are expected to occur, (2) a description of the classes of derivative financial instruments used to hedge the anticipated transactions, (3) the amount of hedging gains and losses explicitly deferred,<sup>5</sup> and (4) a description of the transactions or other events that result in the recognition in earnings of gains or losses deferred by hedge accounting.

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<sup>5</sup> For purposes of the disclosure of hedging gains and losses, the term *explicitly deferred* refers to deferrals in separate accounts in the manner required by *FASB Statement No. 80, Accounting for Futures Contract*, for hedges of anticipated transactions and by *FASB Statement No. 52, Foreign Currency Translation*, for hedges of firm commitments. Those deferrals are in contrast to implicit deferrals that are (a) embedded in related carrying amounts for hedges of recognized assets and liabilities or (b) not recorded because changes in the value of the hedging instrument are not recognized.

12. Entities are encouraged, but not required, to disclose quantitative information about interest rate, foreign exchange, commodity price, or other market risks of derivative financial instruments that is consistent with the way the entity manages or adjusts those risks and that is useful for comparing the results of applying the entity's strategies to its objectives for holding or issuing the derivative financial instruments. Quantitative disclosures about the risks of derivative financial instruments are likely to be even more useful, and less likely to be perceived to be out of context or otherwise misunderstood, if similar information is disclosed about the risks of other financial instruments or nonfinancial assets and liabilities to which the derivative financial instruments are related by a risk management or other strategy.

13. Appropriate ways of reporting the quantitative information encouraged in paragraph 12 will differ for different entities and will likely evolve over time as management approaches and measurement techniques evolve. Possibilities include disclosing (a) more details about current positions and perhaps activity during the period, (b) the hypothetical effects on equity, or on annual income, of several possible changes in market prices, (c) a gap analysis of interest rate repricing or maturity dates, (d) the duration of the financial instruments, or (e) the entity's value at risk from derivative financial instruments and from other positions at the end of the reporting period and the average value at risk during the year. This list is not exhaustive, and entities are encouraged to develop other ways of reporting the quantitative information.

## OTHER SOURCES OF INFORMATION

49. Excerpts from the Invested Asset Working Group of the Valuation of Securities (EX4) Task Force Meeting on June 2, 1996

### Derivatives Projects

Ann Bottelli (Prudential Insurance) gave a report on four derivatives projects that had been ongoing in the Invested Asset Working Group. The first report dealt with a blanks proposal to add a column to Schedule DB Part E Section 1 dealing with off-balance sheet exposure for derivatives securities. This amount is needed for risk based capital calculations. Following Ms. Bottelli's comments, a motion was made and seconded to adopt the blanks proposal and send it on to the Blanks Task Force. That motion passed. (Attachment A)

Ms. Bottelli next gave a report on the required disclosure for anticipatory hedging. The disclosure would bring NAIC disclosure in line with generally accepted accounting principles (GAAP) disclosure requirements for derivatives securities. Following Ms. Bottelli's comments on the reporting mechanisms, Larry Gorski (Ill.) pointed out that this report and blanks proposal was in no way an endorsement for the use of anticipatory hedging, which he pointed out is prohibited in certain states. Following Mr. Gorski's comments, a motion was made and seconded to adopt the blanks proposal and forward it to the Blanks Task Force. That motion passed. (Attachment B)

Next, Ms. Bottelli gave a report dealing with guidance for the interest maintenance reserve (IMR) for hedging. This guidance will appear in the Financial Examiners Handbook and will deal with IMR gains and losses from derivative hedges. A motion was made and seconded to send this proposal to the Accounting Handbook and Instructions Working Group. That motion passed. (Attachment C)

Finally, Ms. Bottelli gave a report dealing with the accounting for income generating derivative transactions. This report contained two blanks proposal items, as well as definitional material that should be added to the Accounting Practices and Procedures Handbook. Following Ms. Bottelli's comments, Mr. Gorski again pointed out that this report was in no way an endorsement of using derivatives for anything other than hedging purposes. Following some concerns by the working group members that they did not have sufficient time to review this proposal, a motion was made and seconded to receive the report by the working group. (Attachment D) That motion was passed by the working group. Ron Newton (Texas) asked if the two blanks proposals would be sent to the Blanks Task Force. Mr. Gorski responded that they would be held until a final review could be done by the Invested Asset Working Group members.

## RELEVANT LITERATURE

### Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies and for Property and Casualty Insurance Companies, Chapter 8, *Other Admitted Assets*
- Annual Statement Instructions for Property and Casualty Insurance Companies
- Annual Statement Instructions for Life, Accident and Health Insurance Companies
- *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets*
- *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets*
- *Issue Paper No. 81—Foreign Currency Transactions and Translations*
- Minutes of the December 14, 1996, meeting of the Financial Condition (EX4) Subcommittee (Minutes included the Executive Summary of the Income Generation Accounting Project dated July 10, 1996)

**Generally Accepted Accounting Principles**

- *FASB Statement No. 52, Foreign Currency Translation*
- *FASB Statement No. 80, Accounting for Futures Contracts*
- *FASB Statement No. 105, Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk*
- *FASB Statement No. 107, Disclosure about Fair Value of Financial Instruments*
- *FASB Statement No. 119, Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments*
- *FASB Emerging Issues Task Force Issue No. 84-7, Termination of Interest Rate Swaps*
- *FASB Emerging Issues Task Force Issue No. 84-14, Deferred Interest Rate Setting*
- *FASB Emerging Issues Task Force Issue No. 84-36, Interest Rate Swap Transactions*
- *FASB Emerging Issues Task Force Issue No. 86-34, Futures Contracts Used as Hedges of Anticipated Reverse Repurchase Transactions*
- *FASB Emerging Issues Task Force Issue No. 87-2, Net Present Value Method of Valuing Speculative Exchange Contracts*
- *FASB Emerging Issues Task Force Issue No. 88-8, Mortgage Swaps*
- *FASB Emerging Issues Task Force Issue No. 90-17, Hedging Foreign Currency Risk with Purchased Options*
- *FASB Emerging Issues Task Force Issue No. 91-1, Hedging Intercompany Foreign Currency Risks*
- *FASB Emerging Issues Task Force Issue No. 91-4, Hedging Foreign Currency Risks with Complex Options and Similar Transactions*
- *FASB Emerging Issues Task Force Issue No. 96-11, Accounting for Forward Contracts and Purchase Options to Acquire Securities Covered Under FASB Statement No. 115*

**Other Sources of Information**

- Minutes of the June 2, 1996 meeting of the Invested Asset Working Group of the Valuation of Securities (EX4) Task Force

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