

Statutory Issue Paper No. 159

Special Accounting Treatment for Limited Derivatives

STATUS

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Type of Issue:

Common Area

SUMMARY OF ISSUE

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

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

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

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

SUMMARY CONCLUSION – PROPOSED NEW SSAP GUIDANCE:

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

¹ Actuarial Guideline XLIII, CARVM for Variable Annuities (AG 43) shall apply in states that have not adopted the Valuation Manual.

are met, and shall not be inferred as an acceptable statutory accounting approach for situations that do not meet the stated qualifications or that are not specifically addressed within this guidance.

Terms/Concepts (for purposes of this Issue Paper)

5. The following terms reflect concepts specific to this issue paper. (This listing only details the key concepts. Specific guidelines are reflected throughout the guidance.)
- a. **Derivative Instrument:** Means an agreement, option, instrument or series or combination thereof: (1) To make or take delivery of, or assume or relinquish, a specified amount of one or more underlying interests, or to make a cash settlement in lieu thereof; or (2) That has a price, performance, value or cash flow based primarily upon the actual or expected price, level, performance, value or cash flow of one or more underlying interests.
 - b. **Dynamic Hedging Approach:** A dynamic hedging strategy allows for the portfolio of derivatives comprising the hedging instrument to be rebalanced in accordance with changes to the hedged item in order to adhere to the specified, documented hedging strategy.
 - c. **Hedged item:** The hedged item shall consist of declared guarantee benefits on a pool, or portion thereof, of variable annuity contracts exposed to interest rate risk. The hedged item may relate to an open or flexible portfolio (e.g., group of variable annuity contracts with different characteristics and liability durations) that allows for addition of newly issued contracts, subtraction of surrenders and fluctuations in balances. The portfolio of variable annuity contracts may consist of an entire book of business or declared components thereof.
 - d. **Hedging Instrument:** The hedging instrument shall reflect a specified derivative, or a portfolio of specified derivatives, that hedges the interest rate sensitivity of the designated hedged item. The hedging instrument may reflect a dynamic hedging strategy in which a portfolio of derivatives comprising the hedging instrument is rebalanced in accordance with changes to the hedged item.

Special Accounting Provision

6. The special accounting provision within this issue paper permits reporting entities to utilize a form of “macro-hedging” in which a portfolio of variable annuity policies, which could include the entire book of business or subsections thereof, are jointly designated as the host contracts containing the hedged item, in a fair value hedge², pursuant to a Clearly Defined Hedging Strategy (throughout this issue paper also referred to as “CDHS” or “hedging strategy”). This is considered a macro-hedge, as the designated hedged item (rate sensitive guarantee benefits) may be attached to a portfolio of variable annuity contracts with different characteristics and liability durations. Under this special accounting provision, the portfolio of contracts giving rise to the hedged item is not required to be static, but can be revised to remove policies and/or include new policies to allow for continuous risk management (hedging) of the variable annuity guarantees in accordance with the specific risks being hedged and the hedge objectives of the specified, documented hedging strategy. In designating the hedged item, reporting entities are permitted to exclude specific components of the variable annuity contracts, but such exclusions must apply collectively to all policies included within the portfolio. For example, reporting entities may elect to only hedge the interest rate risk of rider cash flows, and if making this election, would define the hedged item as the “fair value of rider claims net of rider fees” for the portfolio of policies designated as giving rise to the hedged item.

7. This special accounting provision permits reporting entities to utilize a specified derivative, or a portfolio of specified derivatives, as the hedging instrument within a fair value hedge to hedge the interest

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

rate sensitively, or a specific percentage³ of the interest rate sensitivity, of the designated hedged item. The hedging instrument may reflect a dynamic hedging strategy in which a portfolio of derivatives comprising the hedging instrument is rebalanced in accordance with changes to the hedged item in order to adhere to the specified, documented hedging strategy. Although the hedging instruments must address interest rate risk, this guidance does not preclude use of derivative instruments that may offset risks other than interest rate risk from being designated as the hedging instruments. For derivative instruments that are affected by multiple risk factors, including interest rate risk, reporting entities shall apply this special accounting treatment to the change in fair value due to interest rate risk. Reporting entities shall bifurcate the change in fair value due to the various risk factors - e.g., fair value volatility due to interest rates (rho), and other risk factors, such as equity level (delta) or volatility (vega). Pursuant to paragraphs 12 and 15, fair value fluctuations not attributed to the hedged risk, including fair value changes from excluded open components, shall be recognized as unrealized gains or losses.

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

- a. Prior to implementing a hedging program for application within scope of this standard, the reporting entity must obtain explicit approval from the domiciliary state commissioner allowing use of this special accounting provision. The domiciliary state commissioner may subsequently disallow use of this special accounting provision at their discretion. Although this guidance does not restrict the state domiciliary commissioner on when to prohibit future use, disallowance should be considered upon finding that the reporting entity's documentation, controls, measurement, prior execution of strategy or historical results are not adequate to support future use.
- b. Actuarial certifications of VM-21 reserves, consistent with Valuation Manual requirements, which explicitly include the following:
 - i. Certification as to whether the hedging strategy is incorporated within the establishment of VM-21 reserves, and the impact of the hedging strategy within the VM-21 Conditional Tail Expectation Amount.
 - ii. Certification by a financial officer of the company (CFO, treasurer, CIO, or designated person with authority over the actual trading of assets and derivatives) that the hedging strategy meets the definition of a Clearly Defined Hedging Strategy within VM-21 and that the Clearly Defined Hedging Strategy is the hedging strategy being used by the company in its actual day-to-day risk mitigation efforts. This provision does not require reporting entities to use a hedging strategy in determining VM-21 reserves, nor does it require entities to use the special accounting provision within this standard. However, it does require reporting entities that use the special accounting provisions within this standard to certify that the hedging strategy within scope of this standard is a Clearly Defined Hedging Strategy and is reflected in the establishment of VM-21 reserves.

9. As identified in paragraph 4, eligibility for the special accounting provision within this standard is strictly limited to variable annuity contracts and other contracts involving certain guaranteed benefits similar to those offered with variable annuities that are reserved for in accordance with VM-21. This special

³ In identifying the hedged risk, reporting entities must identify whether they are hedging the full, or a portion of (e.g., 40%), the interest rate sensitivity.

accounting provision requires the reporting entity to engage in highly effective fair value hedges that follow a Clearly Defined Hedging Strategy, as defined in VM-21, meeting all required provisions of VM-21 allowing the reporting entity to reduce the amount of the Conditional Tail Expectation (CTE) Amount. In order to qualify as a Clearly Defined Hedging Strategy (which may be dynamic, static, or a combination thereof), the strategy must meet the principles outlined in VM-21, be in place (implemented) for at least three months⁴, and shall at a minimum, identify:

- a. Specific risks being hedged⁵,
- b. Hedge objectives,
- c. Risks not being hedged,
- d. Financial instruments that will be used to hedge the risks,
- e. Hedge trading rules, including permitted tolerances from hedging objectives,
- f. Metric(s) used for measuring hedging effectiveness,
- g. Criteria that will be used to measure effectiveness,
- h. Frequency of measuring hedging effectiveness,
- i. Conditions under which hedging will not take place, and
- j. The individuals responsible for implementing the hedging strategy.

10. While an initially documented hedging strategy may subsequently change, any change in hedging strategy, which includes a change in hedge target, shall be documented, with notification to the domiciliary state commissioner, and include an effective date of the change in strategy. Reporting entities that elect to change a documented hedging strategy prior to the end of the three-month minimum implementation timeframe shall identify the hedging strategy, and all hedging instruments executed under the strategy, as ineffective. The three-month timeframe begins with the stated effective date of the hedging strategy regardless if any hedging instruments have been executed under the hedging strategy. Changes in a documented hedging strategy that occur after the three-month implementation timeframe do not necessitate an ineffective determination as long as hedged items and hedging instruments under the revised/new strategy continue to meet the requirements of a highly effective fair value hedge. Reporting entities are permitted to have more than one hedging strategy implemented, but all implemented strategies must qualify as a component of a Clearly Defined Hedging Strategy pursuant to paragraph 9.

Assessing Hedge Effectiveness

11. The provisions within this standard require the entity to use a specific method, as detailed in paragraph 12, to assess hedge effectiveness at inception and on an ongoing basis. At a minimum, hedge effectiveness assessment is required whenever financial statements are reported, at least every three months.

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

⁵ The specific risk being hedged shall include a measure of the hedge coverage (e.g., percentage of interest rate sensitivity being hedged).

Documentation requires prospective and retrospective⁶ hedge effectiveness assessments, with on-going assessment consistent with the originally documented risk management strategy.

12. Both at inception, and on an ongoing basis, the hedging relationship must be highly effective in achieving offsetting changes in fair value attributed to the hedged risk during the period that the hedge is designated. Reporting entities electing to use this special accounting provision must calculate the fair value of the hedged item at inception and on an ongoing basis, and compare the fair value change of the hedged item to the fair value change of the hedging instruments in assessing whether the relationship is highly effective on a cumulative basis. This comparison is specific to the designated hedged risks and exposures, therefore, if only a portion of the interest rate risk is hedged or if the designated hedge only include specific components of the variable annuity policies (e.g., riders), for determining hedge effectiveness, the fair value comparisons is limited to those designated items. If an entity's defined risk management strategy for a particular hedging relationship excludes specific components of the hedging derivative from the assessment of hedge effectiveness, the excluded open components shall be reported at fair value with gains or losses recognized as unrealized gains or losses.

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

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

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

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

- a. Fair value fluctuations in the hedging instruments attributable to the hedged risk that offset the current period change in the designated portion of the VM-21 reserve liability⁷ shall be recognized as a realized⁸ gain or loss.
- b. Fair value fluctuations in the hedging instruments attributable to the hedged risk⁹ that do not offset the current period change in the designated portion of the VM-21 reserve liability

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

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

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

⁹ The change in fair value of the hedging instruments and hedged item is limited to changes driven by market factors. For example, periodic recognition of a cost owed to acquire the derivative from a counterparty (financing cost) shall not be captured as a change in the derivative instrument's fair value. The fair value of the instrument shall be determined based on the underlying derivative without inclusion of acquisition costs (or other such contractual elements that may exist with the counterparty) that do not change based on the underlying derivative interests or market factors.

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

- c. An amount equal to the net deferred asset and deferred liability (net amount from all hedging strategies/programs captured within this guidance) shall be allocated from unassigned funds to special surplus. Upon domestic regulator request, reporting entities shall provide estimations of RBC as if the special accounting provisions had not been applied. This estimation shall reflect the removal of deferred assets or deferred liabilities, and reflect the impact to unassigned funds as if the derivative gains and losses had been recognized.
- d. As detailed in paragraph 12, fair value fluctuations in the hedging instruments that are not attributable to the hedged risk, shall be recognized as unrealized gains or unrealized losses.
- e. Reporting entities shall utilize the following calculation for establishing the deferred asset (also illustrated in Exhibit A) unless a different method has been approved by the domiciliary state commissioner:
 - i. Calculate the fair value gain or loss in the hedged item attributable to the hedged risk.
 - ii. Express the quantity calculated in paragraph 15.e.i. as a percentage of the change in the full-contract fair value (i.e., with all product cash flows) attributed to interest rate movements¹⁰.
 - iii. Calculate the VM-21 liability change attributed to the hedged risk as the quantity calculated in paragraph 15.e.ii. multiplied by the VM-21 liability change attributable to interest rate.
 - iv. Establish the deferred asset or deferred liability in the amount of the fair value loss or (gain) of the designated hedging instruments attributed to the hedged risk less the VM-21 liability decrease or (increase) attributed to the hedged risk as calculated in paragraph 15.e.iii.
 - v. Allocate an amount equal to the net deferred asset and deferred liability (net amount from all hedging strategies/programs captured within this guidance) to special surplus.

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

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

¹⁰ The result of this calculation (the coverage ratio) should not exceed 100% nor drop below zero.

- b. The amount reported on the financial statement at each reporting date shall reflect the net amount (net as either a deferred asset or deferred liability) for each hedging strategy captured within scope of this guidance. (Reporting entities that have more than one hedging strategy could have both deferred assets and deferred liabilities in the financial statements based on the net position of the separate hedging strategies.)
- c. Reporting entities are permitted to amortize a greater portion of the deferred assets and/or deferred liabilities into realized gains or realized losses at any time in advance of the scheduled amortization period.
 - i. If electing to accelerate amortization, reporting entities are required to accelerate amortization equally between deferred assets and deferred liabilities within a single hedging strategy. For example, a reporting entity is not permitted to accelerate amortization of the deferred liabilities (recognizing the gains from fair value changes) and not accelerate amortization of the deferred assets (continuing to defer losses from fair value changes). If a reporting entity only has a single hedging strategy which only reflects deferred assets or deferred liabilities, the reporting entity is permitted to accelerate amortization without restrictions.
 - ii. If a reporting entity has more than one hedging strategy, and the strategies have offsetting net positions (both deferred assets and deferred liabilities are recognized in the financial statements), a reporting entity's election to accelerate amortization must be applied equally to programs with offsetting net positions. (For example, a decision to accelerate amortization of a program with a net deferred liability must be applied equally to a program with a deferred asset that best corresponds to the deferred liability¹¹.) In these situations, the guidance in paragraph 16.c.i is also applicable, whereas, the accelerated amortization must also apply equally to the deferred assets and deferred liabilities within each individual hedging program. If a reporting entity with more than one hedging strategy only has net deferred assets or net deferred liabilities recognized, the reporting entity is permitted to accelerate amortization to a single program in a manner consistent with the guidelines in paragraphs 16.c.i.

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

18. For outstanding (non-expired) derivative instruments in a hedging strategy that no longer qualifies within scope of this standard (e.g., VM-21 requirements are not met) or is no longer a highly effective hedge, any non-amortized deferred assets or deferred liabilities shall be amortized to unrealized gains or unrealized losses over the remaining amortization timeframe, not to exceed five-years. If the deferred assets/deferred liabilities have a remaining amortization period that is less than the shortened timeframe, amortization shall continue over the remaining period. If the remaining amortization period is greater than 5-years at the time of the program no longer qualifies, or is no longer highly effective, the amortization

¹¹ The intent of this guidance is to ensure that the ability to accelerate amortization does not result with elections that simply result in favorable financial statement presentation.

schedule shall be revised to require full amortization within the shortened 5-year timeframe. If elected by the reporting entity, deferred assets and deferred liabilities may be immediately recognized as unrealized gains and/or unrealized losses or have accelerated amortization (less than 5-years) as unrealized gains and/or unrealized losses. (An election to immediately eliminate or accelerate amortization must follow the provisions in paragraph 16.c.) All future fair value fluctuations for these derivative instruments would be subject to the guidance in SSAP No. 86, and shall be recognized as unrealized gains or unrealized losses unless the instrument is subsequently designated as part of a highly effective hedging strategy within scope of this issue paper. If the derivative is re-designated as part of a highly effective hedging strategy qualifying under this standard, subsequent fair value fluctuations (after the re-designation) may be accounted for under the special accounting provision detailed in this issue paper.

19. Reporting entities may elect to terminate use of this special accounting provision at any time. In those instances, if the derivative instruments are outstanding, all deferred assets and deferred liabilities shall be amortized to unrealized gains or unrealized losses over the remaining amortization timeframe, not to exceed five-years. If the deferred assets/deferred liabilities have an amortization period that is less than the shortened 5-year timeframe, amortization shall continue over the established period. If the remaining amortization period is greater than 5-years at the time of termination, the amortization schedule shall be revised to require full amortization within the shortened 5-year timeframe. If elected by the reporting entity, deferred assets and deferred liabilities may be immediately eliminated or have accelerated amortization (less than 5-years) with recognition as unrealized gains and/or unrealized losses. (An election to immediately eliminate or accelerate amortization must follow the provisions in paragraph 16.c.) Once the special accounting provision is terminated, unless re-designated by the reporting entity, subsequent accounting of the derivatives in a hedging strategy that would be captured within this issue paper shall follow the fair value accounting approach in SSAP No. 86¹².

Measurement/Recognition of Realized Gains or Losses of Expired Derivatives

20. With the ability to rebalance the hedging instrument, this guidance allows for individual derivative instruments to expire and/or be removed from the portfolio of the hedging instrument, and not immediately trigger an assessment that the overall hedging strategy is no longer highly effective. Furthermore, special allowances are included to consider the tenure differences between a hedging instrument and VM-21 liability duration. These allowances permit expired¹³ derivative instruments that were part of a highly effective hedging strategy at the time of expiration to continue amortizing the deferred gains and deferred losses over the previously established amortization timeframe even if the overall hedging strategy is subsequently terminated or subsequently identified as no longer qualifying as a highly effective hedge.

21. Pursuant to the provisions in paragraph 16.c., reporting entities are permitted to amortize a greater portion of the deferred assets and/or deferred liabilities from expired derivatives into realized gains or realized losses in advance of the scheduled amortization period.

22. Consistent with the guidance in paragraph 19, reporting entities may elect to terminate use of this special accounting provision at any time. In those instances, if the derivative instruments have expired, all deferred assets and deferred liabilities shall be amortized to realized gains or realized losses over the remaining amortization timeframe, not to exceed 5-years. If the deferred assets/deferred liabilities had an amortization period that was less than the shortened timeframe, amortization shall continue over the established period. If the amortization period was greater than 5-years at the time of termination, the amortization schedule would be revised to require full amortization within the shortened timeframe. If elected by the reporting entity, the deferred assets and deferred liabilities may be immediately eliminated,

¹² Macro-hedges and the ability to rebalance hedging instruments are not provisions permitted within “effective” hedges in scope of SSAP No. 86. As such, hedging strategies with these components accounted for under SSAP No. 86 shall follow the fair value accounting approach detailed in that standard.

¹³ Throughout this standard the use of the word “expire” is intended to capture all instances in which the derivative is no longer outstanding. It includes maturities, terminations, sales, and/or other closing transactions of a derivative.

or have accelerated amortization, with recognition as realized gains and/or realized losses. An election to immediately eliminate or accelerate amortization (less than 5 years) must follow the provisions in paragraph 16.c.)

Derivative Income

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

Disclosures

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

- a. Discussion of hedged item, including information on the guarantees sensitive to interest rate risk, along with information on the designated hedging instruments being used to hedge the risk. Discussion of the hedging instruments shall identify whether a hedging instrument is a single instrument or portfolio, as well as information on the hedging strategy (including whether there have been changes in strategy from the prior reporting period, along with detailed information on the changes), and assessment of hedging effectiveness and compliance with the “Clearly Defined Hedging Strategy” of VM-21. Identification shall occur on whether the hedged item is intended to be fully hedged under the hedging strategy, or if the strategy is only focused on a portion of the liability characteristics or a portion of the interest rate sensitivity. Hedging strategies shall be identified as highly effective or not highly effective. If the strategy for a particular hedging relationship excludes a specific component of the gain or loss, or related cash flows, from the assessment of hedge effectiveness, details on the excluded components shall be disclosed.
- b. Aggregate disclosure of the original cost and fair value of hedging instruments (including all instruments within a portfolio), including any net investment income, realized and unrealized gains and losses during the reporting period. Additionally, disclose the fair value of the hedged item, the change in fair value from the prior reporting period, and the portion of the fair value change attributed to the hedged risk.
- c. Schedule showing the aggregate fair value change from the prior reporting period for the designated components for all hedging instruments, with identification of the fair value change reflected in realized gains, realized losses, deferred assets, and deferred liabilities. This schedule shall also show the current period amortization, including any accelerated amortization elected by the reporting entity, and the future scheduled amortization of the deferred assets and deferred liabilities. This schedule shall identify the fair value of the excluded components of the hedging instruments, and the fair value change for those components reflected in unrealized gain and unrealized loss.
- d. For hedging strategies no longer identified as highly effective previously captured within scope of this standard, information on the determination of ineffectiveness, including variations from prior assessments resulting in the change from classification as a highly effective hedge. This disclosure shall also include:

- i. Identification of outstanding hedging instruments previously captured within scope of this standard and subsequently identified as no longer part of a highly effective hedging strategy. This disclosure shall identify the date in which the domiciliary state was notified that the hedging strategy had been identified by the reporting entity as no longer highly effective.
 - ii. Deferred assets and deferred liabilities previously recognized when the program was highly effective, with a schedule that shows the amortization that would have occurred if the program had remained highly effective, the amount of original amortization as well as a schedule that details the amortization that will occur as the program is no longer highly effective (maximum five-year timeframe).
 - iii. Disclosure on whether the reporting entity is electing to accelerate amortization (in advance of the remaining scheduled amortization or the maximum five-year timeframe), along with amounts immediately recognized to unrealized gains/losses, and how the election impacts the scheduled amortization.
- e. For situations in which the reporting entity has elected to terminate the hedging strategy and/or discontinue the special accounting provisions permitted within this SSAP, the reporting entity shall disclose the key elements in the reporting's entity's decision to terminate, identifying changes in the reporting entity's objectives or perspectives from initial application. This disclosure shall also include:
- i. Identification of outstanding hedging instruments previously captured within scope of this standard and the accounting impact as a result of the termination/discontinuation. (Open derivative transactions no longer captured within the special accounting provision would be subject to the accounting and reporting guidance within SSAP No. 86.) This disclosure shall identify the date in which the domiciliary state was notified that the hedging strategy or the election to use the special accounting provision in this SSAP had been terminated.
 - ii. Deferred assets and deferred liabilities previously recognized under the hedging strategy and/or program, with a schedule that shows the amortization that would have occurred if the strategy and/or program had remained highly effective, as well as a schedule that details the amortization that will occur with the termination of the strategy and/or program (maximum five-year timeframe).
 - iii. Disclosure on whether the reporting entity is electing to accelerate amortization (in advance of the remaining scheduled amortization or the maximum five-year timeframe), along with amounts immediately recognized to unrealized gains/losses, and the resulting impact to the scheduled amortization.

Effective Date and Transition of SSAP No. 108

26. *SSAP No. 108—Derivatives Hedging Variable Annuity Guarantees* (SSAP No. 108) is effective January 1, 2020 with early adoption permitted January 1, 2019¹⁴. The guidance in SSAP No. 108 is required to be applied on a prospective basis for qualifying hedge programs in place on or after the effective date. This prospective application prohibits deferred asset and deferred liability recognition from fair value

¹⁴ After adoption of this issue paper, the NAIC will release a Statement of Statutory Accounting Principle (SSAP) for comment. Users of the Accounting Practices and Procedures Manual should note that issue papers are not represented in the Statutory Hierarchy (See Section IV of the Preamble) and therefore the conclusions reached in this issue paper should not be applied until the corresponding SSAP has been adopted by the Plenary of the NAIC.

fluctuations previously recognized as unrealized gains or losses that occurred prior to the effective date of the guidance.

27. Reporting entities that have previously received permitted or prescribed practices for qualifying hedge programs, resulting with the recognition of deferred assets/deferred liabilities from unrecognized fair value fluctuations, shall work with their domiciliary state regulator to determine the appropriate method in transitioning from previously approved permitted practices. The reporting entity shall include disclosure of the transition approach approved by the domiciliary state in their financial statements in the first year of application. The approved transition approach is not considered a permitted practice as long as the reporting entity is fully compliant with the provisions of this issue paper after implementation. After the effective date of SSAP No. 108, domiciliary state provisions that differ from SSAP No. 108 must be disclosed as a permitted or prescribed practice pursuant to *SSAP No. 1—Accounting Policies, Risks & Uncertainties and Other Disclosures* (SSAP No. 1).

Proposed new General Interrogatories:

These would not be in the final SSAP. These revisions will be referred to the Blanks (E) Working Group.

- 26.1 Does the reporting entity have any hedging transactions reported on Schedule DB?
- 26.2 If yes, has a comprehensive description of the hedging program been made available to the domiciliary state? If no, attach a description with this statement.
- 26.3 Does the reporting entity utilize derivatives to hedge variable annuity guarantees subject to fluctuations as a result of interest rate sensitivity?
- 26.4 If so, does the reporting entity utilize:
- Special Accounting Provision in SSAP No. 108
- Permitted Accounting Practice
- Other Accounting Guidance
- 26.5 If the reporting entity utilizes the special accounting provision in SSAP No. 108, the reporting entity shall attest to the following:

Reporting entity has obtained explicit approval from the domiciliary state.

Hedging strategy subject to the special accounting provisions is consistent with the requirements of Actuarial Guideline 43.

Actuarial certification has been obtained which indicates that the hedging strategy is incorporated within the establishment of Actuarial Guideline 43 reserves, and provides the impact of the hedging strategy within the Actuarial Guideline Conditional Tail Expectation Amount.

Financial Officer Certification has been obtained which indicates that the hedging strategy meets the definition of a Clearly Defined Hedging Strategy within Actuarial Guideline 43 and that the Clearly Defined Hedging Strategy is the hedging strategy being used by the company in its actual day-to-day risk mitigation efforts.

EXHIBIT A – CALCULATION OF DEFERRED ASSET OR DEFERRED LIABILITY

Under the special accounting provisions within this issue paper, as detailed in paragraph 15.e., fair value fluctuations in the hedging instruments attributable to the hedged risk that do not offset the current period change in the hedged item (the change in the VM-21 reserve liability) can be recognized as deferred assets (admitted) and deferred liabilities.

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

Unless a different method has been approved by the domiciliary state commissioner, reporting entities shall utilize the following calculation (detailed in paragraph 15) for establishing the deferred asset:

- 15.e.i Calculate the fair value gain or loss in the hedged item attributable to the hedged risk (Step 1);
- 15.e.ii Express the fair value gain or loss calculated (Step 1) as a percentage of the change in the full-contract fair value (i.e., with all product cash flows) attributed to interest rate movements (Step 2)¹⁵.
- 15.e.iii Calculate the VM-21 liability change attributed to the hedged risk as the quantity calculated in Step 2 multiplied by the VM-21 liability change attributable to interest rate (Step 3).
- 15.e.iv Establish the deferred asset or deferred liability in the amount of the fair value loss or (gain) of the designated hedging instruments attributed to the hedged risk less the VM-21 liability decrease or (increase) attributed to the hedged risk as calculated in Step 3.
- 15.e.v. Allocate an amount equal to the net deferred asset and deferred liability (net amount from all hedging strategies/programs captured within this guidance) to special surplus.

To illustrate the above calculation:

Clearly Defined Hedging Strategy (CDHS) characteristics

Hedged item	Rider claims less rider fees
Hedged risk	50% of the rho (first-order IR level sensitivity)

Calculation of the deferred asset or liability

Note: positive values = increase in liability

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

¹⁵ The result of calculation (the coverage ratio) should not exceed 100% nor drop below zero.

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

Fair value gain (loss) in full-contract cash flows attributable to IR movement	(700)
15.e.ii - Quantity calculated in 15.b.i. as a % of the (700) above	36%
VM-21 liability increase (decrease) from beginning of period to end of period	400
VM-21 liability increase (decrease) attributable to interest rate movements	(100)
15.e.iii - VM-21 liability increase (decrease) attributable to the hedged risk	(36)

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

15.e.iv – Deferred asset (15.b.i less 15.b.iii) attributable to hedged risk	(214)
<i>(This is shown as a negative – to be consistent with the decrease in VM-21 liability – but represents a deferred asset. Deferred assets reflect fair value losses.)</i>	

DISCUSSION

28. The provisions within this issue paper are significantly different from what is currently allowed under SAP, U.S. Generally Accepted Accounting Principles (GAAP) and International Financial Reporting Standards (IFRS). The concept of allowing “effective hedge” accounting treatment for macro-hedges is currently not endorsed by any of the noted accounting standards. Provisions within this issue paper have been drafted with the intent to encourage risk-management transactions by insurers for limited, qualifying transactions in order to reduce non-economic surplus volatility and ensure appropriate financial statement presentation with sufficient transparency for regulator review.

Application of SSAP No. 86 Guidance

29. The concepts within scope of this issue paper, particularly the allowance for macro-hedges and dynamic (rebalancing) hedging instruments are not permitted within SSAP No. 86. Although limited comments have been received indicating that macro-hedge transactions using a dynamic (rebalancing) approach for variable annuity guarantees could occur under the current concepts of SSAP No. 86, the Statutory Accounting Principles (E) Working Group does not agree with this interpretation. The Working Group agrees that separate guidance is needed to address these limited derivative situations to comply with the Financial Condition (E) Committee charge.

30. Hedge effectiveness determinations under SSAP No. 86 require use of derivative instruments in hedging transactions that meet the criteria in SSAP No. 86. The application of the guidance in SSAP No. 86, as well as existing hedge effectiveness guidance under U.S. GAAP and IFRS, is contrary to the concept of a dynamic hedging as the existing guidance is designed primarily for static exposures in which it is necessary to identify a specific hedged item and hedging instrument, and designate them as linked in an individual hedging relationship.

31. Existing SSAP No. 86 guidance for fair value hedges does allow for similar assets or similar liabilities to be aggregated and hedged as a portfolio. With the fair value hedge portfolio guidance, a particular risk exposure is required to be designated, and the portfolio of similar assets or similar liabilities must share the risk exposure for which they are designated as being hedged. As detailed within paragraph SSAP No. 86, paragraph 23.e, “the change in fair value attributed to the hedged risk for each individual item in a hedged portfolio must be expected to respond in a generally proportionate manner to the overall change in fair value of the aggregate portfolio attributed to the hedged risk”. This guidance is adopted explicitly from U.S. GAAP. The FASB has specifically indicated that the “proportional” requirement was to be interpreted strictly, but did not require the term to reflect “identical” items. To illustrate, under a FASB example, percentage decreases within a range of 9 to 11 percent could be considered proportionate if that interest rate change reduced the fair value of the portfolio by 10 percent.

32. SSAP No. 86 does not include guidance permitting cash flow hedges involving portfolios. SSAP No. 86 guidance is explicit that the hedging relationship shall be highly effective in achieving offsetting cash flows attributable to a particular risk during the term of the hedge. The guidance identifies that this exposure may be associated with an existing recognized asset or liability, or as a forecasted transaction¹⁶.

33. With regards to forecasted transactions, SSAP No. 86 allows single transactions and groups of individual transactions to be the hedged transaction. If the hedged transaction is a group of individual transactions, the transactions must share in the same risk exposure for which they are designated as being hedged. The guidance for forecasted transactions does allow more than one risk to be hedged (for example, the risk of changes in cash flows can be related to purchase/sales price, interest rate risk, foreign currency

¹⁶ A forecasted transaction is a transaction expected to occur for which there is no firm commitment. Because no transaction or event has yet occurred and the transaction or event - when it occurs - will be at the prevailing market price, a forecasted transaction does not give an entity any present rights to future benefits or a present obligation for future sacrifices. For transactions detailed within this issue paper, the hedged items are recognized liabilities (VM-21 reserves); therefore the guidance for derivative forecasted transactions does not appear applicable for derivatives within scope of this issue paper.

change risk, or default risk), however, the occurrence of the forecasted transaction (e.g., purchase/sale, cash inflow/outflow) must be probable. (SSAP No. 86 identifies that the term probable requires a significantly greater likelihood of occurrence than the phrase more likely than not.) Once a forecasted transaction is no longer probable, hedge accounting is to immediately cease and any deferred gains or losses are to be recognized immediately. Once a pattern occurs of forecasted transactions not being probable, the entity's ability to accurately predict forecasted transactions is questioned and the entity is no longer permitted to use hedge accounting in the future for similar forecasted transactions.

34. Furthermore, existing guidance in SSAP No. 86 is drafted to reflect derivative transactions hedging invested assets. Although the scope of SSAP No. 86 does not limit the guidance to assets (or excludes hedges of liabilities), the specific provisions within the standard do not provide guidance for hedging liabilities. As noted within this issue paper, the new guidance will be specific to derivative transactions hedging the VM-21 liability.

35. The concepts reflected in the March 2016 original agenda item as the "Initial Staff Proposal for Discussion" (subsequently referred to as the "original agenda item") proposed use of a "closed" portfolio concept. As detailed within the guidance in this issue paper, the requirement of a closed portfolio has been revised to allow use of a flexible portfolio as the hedged item, providing the ability to continuously adjust the hedged item to remove policies and/or include new policies to effectively manage risk. Use of an open portfolio further differentiates the hedging programs allowed within this issue paper from what is permitted as effective hedges under SSAP No. 86, U.S. GAAP and IFRS. This issue paper reflects the conclusion that the accounting provisions within are separate and distinct from the provisions within SSAP No. 86 and should not be inferred to any derivative transaction that does not explicitly qualify within the scope of this issue paper.

Hedge Strategy

36. The guidance within this issue paper requires reporting entities to engage in highly effective fair value hedges that follow a Clearly Defined Hedging Strategy (CDHS or "hedging strategy") as defined in VM-21. The documentation required under a CDHS includes:

- a. The specific risks being hedged,
- b. The hedge objectives,
- c. The risks not being hedged,
- d. The financial instruments that will be used to hedge the risks,
- e. The hedge trading rules, including the permitted tolerances from hedging objectives,
- f. The metric(s) for measuring effectiveness,
- g. The criteria that will be used to measure effectiveness,
- h. The frequency of measuring hedging effectiveness,
- i. The condition under which hedging will not take place, and
- j. The person or persons responsible for implementing the hedging strategy.

37. While the hedging strategy may change over time, this issue paper requires each hedging strategy to be implemented for a minimum of three months, with notification to the domiciliary state when there is a change in hedging strategy. The provisions in VM-21 also require the hedging strategy to be effectively implemented for at least three months. As detailed in VM-21, reporting entities can meet the time

requirement by having evaluated the effective implementation of the hedging strategy for at least three months without actually having executed any trades indicated by the hedging strategy (e.g., mock testing or by having effectively implemented the strategy with similar annuity products for at least three months). For purposes of this issue paper, the three month time-frame is the required timeframe before a change can occur in the documented hedging strategy without an inherent determination that the hedging strategies, and the derivatives within, were not highly effective (ineffective).

38. Any change in the hedging strategy shall be clearly documented and include an effective date of the change in strategy. Determination of whether the hedging instruments were highly effective shall be made in accordance with the hedging strategy in place at the time of assessment.

39. Comments initially received identified that most companies identify a target rate sensitivity and purchase interest rate derivatives that will hedge exposure to this target. These comments noted that the target can change with changes in risk appetite and suggested a monthly reset to reflect changes in risk appetite. These comments indicated that regardless of changes in the risk appetite that may occur throughout each month, the hedging strategy would be locked at the beginning of each month. Per these comments, the monthly reset of the overall hedging strategy would not trigger ineffectiveness as long as subsequent cash flows were considered effective under the updated hedging strategy. These comments suggested that reporting entities should be required to specify the operational practices in setting or determining hedging strategies to allow for these changes. After considering these comments, the Working Group disagreed with the request to allow for a “monthly” reset of the hedge program, noting that such an element would be too permissive in determining effectiveness, particularly when coupled with provisions that allow flexible portfolios and dynamic hedges.

40. Subsequent to the initial comments, additional comments were received noting the need to differentiate between changes in hedge targets and changes in an entity’s hedging strategy. These comments identified that a “hedging strategy” is the collection of multiple elements, including risks being hedged, objectives, hedging instruments used and effectiveness measurements. Within a hedging strategy, the comments indicated that it may be necessary and appropriate to adjust the hedge target in response to changing market conditions, liability changes and other factors.

41. For the special accounting provisions in this issue paper, provisions have not been established to allow for a monthly reset of hedging strategies, or for changes in hedge targets to be considered separately from a change in hedge strategy. Instead, hedging strategies (including the hedge targets in those strategies) are required to be implemented for at least three months. As detailed within the issue paper, reporting entities are allowed to engage in a dynamic hedging strategy in which the hedging instruments may be rebalanced to accommodate changes in the hedged item (which reflects a flexible portfolio of variable annuity contracts) to adhere to a specified, documented derivative strategy. With these provisions, it seems unnecessary, and overly permissive, to incorporate provisions that allow monthly revisions and/or changes in the hedge target that are not considered changes to the hedging strategy. A three-month hedge strategy implementation timeframe still allows for timely revisions throughout a year if a company’s risk appetite was to change and is consistent with VM-21 provisions. In situations in which the hedging strategy must be revised to reflect a revised risk appetite before the three-month implementation timeframe is over, the hedge should be terminated, and deemed ineffective, with subsequent establishment of a new hedging strategy to reflect the updated risk appetite and parameters for assessing hedge effectiveness.

Hedge Designation - Fair Value Hedge Addressing Variability Attributed to Interest Rate Risk

42. The guidance within this issue paper limits the hedge designation to a fair value hedge that addresses variable annuity guarantees sensitive to interest rate risk. Although variable annuity guarantees can be sensitive to other market factors, the guidance in this issue paper is only limited to interest rate risk. This issue paper acknowledges that the initial interest rate risk limitation was a scoping consideration (and not a result from a review of other risk factors) and should not preclude subsequent consideration, if supported by the Working Group, of other risks. Unless, and until, subsequent consideration of other risks

are considered for inclusion within this guidance, hedges addressing other risks are subject to the guidance in SSAP No. 86.

43. The requirement for a fair value hedge is specific within the proposed guidance and requires assessment on whether the derivative instrument hedges changes in the fair value of hedged item (VM-21 liability or specific portion thereof) attributable to interest rate risk. In determining effectiveness, the hedging relationship shall be highly effective in offsetting changes in the fair value attributable to the hedge risk during the period in which the hedge is designated. The term highly effective describes a fair value hedging relationship where the change in fair value of the derivative hedging instrument is within 80 to 125 percent of the opposite change in the fair value of the hedged item attributable to the hedged risk. It shall also apply when an R-squared of 0.80 or higher is achieved when using a regression analysis technique.

44. The use of a fair value hedge detailed within this issue paper is intended to allow for hedging relationships that consider all relevant¹⁷ contractual cash flows in calculating the change in fair value, or if in accordance with the documented risk management hedging strategy, a designated portion of the relevant contractual cash flows from the hedged item. This is inconsistent with existing guidance in SSAP No. 86 (as well as derivative guidance under U.S. GAAP) in which all contractual cash flows of the entire hedged item must be used in calculating the change in the hedged item's fair value attributed to changes in the benchmark interest rate. However, as noted by comments received, designating a portion of the cash flows as the hedged item is crucial; otherwise effectiveness may be compromised as fair value changes in cash flows from designated instruments may be more or less than the fair value changes in cash flows from the hedged item. Revisions in the designated portion of cash flows intended to be hedged in accordance with the documented risk management hedging strategy would be considered a change in hedging strategy and subject to the guidance in this issue paper for those situations. Both SSAP No. 86 and U.S. GAAP allow designation of a specific portion of an asset or liability to be the hedged item. However, once designated, all contractual cash flows related to that specified portion must be considered in calculating the change in the hedged item's fair value attributed to changes in the benchmark interest rate being hedged to determine hedge effectiveness. Pursuant to the provisions within this issue paper, in addition to the designated portion of a specified liability, specific contractual cash flows of that explicit portion are also permitted to be designated.

45. Under SSAP No. 86 and U.S. GAAP, hedge designations are required to be static and are not permitted to be revised over the hedge term. With the provisions in this issue paper, changes are not permitted unless, and until, the reporting entity documents a new hedging strategy. Unless there is a change in hedging strategy, subsequent assessments of effectiveness shall be consistent with the originally documented risk management strategy, and the designated portion of cash flows, for the hedged item. Fair value gains or losses on the derivative instrument that do not offset the change in the fair value of the hedged item attributable to the hedged risk, as detailed within the hedging strategy, are considered ineffective elements of the hedge, and depending on the degree of ineffectiveness could trigger assessment that the entire hedge is ineffective.

46. Despite comments initially received supporting use of a cash flow hedge approach, the general nature of the hedging strategies employed for these variable annuity contracts are more representative of a fair value hedge. However, as the hedged item (VM-21 reserve) is not reported at fair value, these hedging strategies do not qualify as a fair value hedge. Based on information received, reporting entities already calculate the fair value for the VM-21 reserve and use the fair value changes in the hedged item and hedging instruments to determine hedge effectiveness. Rather than pursue the cash flow hedge designation, this issue paper has been prepared to follow the method that is intuitively applied, although the standard requirements to qualify for a fair value hedge are not met. (As the hedged item is recognized at an amount

¹⁷ The change in fair value of the hedging instruments and hedged item is limited to changes driven by market factors. For example, periodic recognition of a cost owed to acquire the derivative from a counterparty (financing cost) shall not be captured as a change in the derivative instrument's fair value. The fair value of the instrument shall be determined based on the underlying derivative without inclusion of acquisition costs (or other such contractual elements that may exist with the counterparty) that do not change based on the underlying derivative interests or market factors.

other than fair value (VM-21 reserve calculation), changes in the fair value of the hedged item do not immediately adjust the reported amount for the VM-21 reserve for the fair value change, and are not recognized currently in earnings.)

Hedged Item - Flexible Portfolio or Closed Portfolio

47. The guidance within this issue paper proposes use of a flexible portfolio as the hedged item, reflecting the possibility to include variable annuity contracts with different characteristics and different liability durations (macro-hedge). The designated portfolio would not be required to be static in a closed portfolio, but could be revised to remove policies and/or include new policies to allow for continuous risk management of the variable annuity guarantee reserves.

48. The use of a flexible portfolio approach, rather than a closed portfolio approach, reflects consideration of industry comments regarding the current aggregate approach for risk-management strategies. Furthermore, consideration was given to comments indicating that the required use of a closed portfolio approach would be operationally burdensome in accordance with documentation requirements and assessments of hedge effectiveness. Key elements noted by industry included:

- a. Open or flexible portfolio is imperative as the liability changes on a daily basis with changes to inforce business and capital market factors. Requiring the redesignation of a hedge relationship due to any change in the hedged item is operationally burdensome as new hedge documentation and assessments of effectiveness would be required frequently.
- b. A portfolio approach based on guarantee duration could result in an exorbitant amount of hedge relationships that become difficult to maintain. Sensitivity and risk profile can vary from policy to policy and within a policy by performance of the separate account underlying it. Combining policies by duration at inception of the hedge relationship is arbitrary.
- c. Multiple portfolio approach is challenging as most risk management strategies hedge at an aggregate level to capture the diversification inherent in the business. Additionally, a closed portfolio approach would require segmentation of the VM-21 calculation. As VM-21 was designed to be an aggregate projection of liabilities and assets of all variable annuity policies in force, the VM-21 calculation includes inherent diversification. The sum of a segmented VM-21 does not necessarily equal the calculation at an aggregate level and could result in entities holding greater reserves than necessary by a material amount.

49. The IASB also has a project to consider a new accounting model for dynamic risk management. This project was driven from difficulties associated with applying existing hedge accounting requirements to a dynamically managed portfolio with continuous frequent changes in the risk positions that are hedged. Within this IASB project, the IASB identifies that under current hedge accounting guidelines, open portfolios are in effect forced into closed portfolios for hedge accounting purposes, and this practice makes it difficult to reflect dynamic risk management in the financial statements.

50. Moving towards a flexible portfolio approach is intended to better reflect the key features of dynamic risk management. As detailed in the IASB discussion paper and the related April 2014 *IFRS in Focus* (Deloitte),¹⁸ when derivatives are used to hedge risks which are not measured on the same basis (i.e., hedged item and hedging instruments both measured and reported at fair value with fair value fluctuations recognized as unrealized gains or losses), volatility arises, despite the risk management objective of reducing economic volatility. Hedge accounting helps to reduce this volatility; however, hedge accounting is not well suited to the hedging of dynamic portfolios. Hedge accounting requires the specific designation of hedged items and hedging instruments and requires specific mechanics and effectiveness testing to be

¹⁸ Deloitte: *IFRS in Focus - IASB Issues Macro Hedging Discussion Paper*, April 2014

performed. Such requirements are better suited to individual hedges or hedges of static groups of items (closed portfolios) rather than hedges of portfolios that are constantly changing with new exposures added and old exposures removed (open or dynamic portfolios) and where the portfolio of hedging derivatives is also frequently changing.

51. Consistent with issues identified by the IASB, the use of closed portfolios, following the general hedge accounting model, gives rise to various issues, including:

- a. Treating open portfolios as a series of closed portfolio hedges inevitably leads to profit or loss volatility from hedge ineffectiveness that is inconsistent with the economic position and reflective of the dynamic risk management applied.
- b. As the portfolio of hedged items and hedging instruments change, hedge accounting leads to frequent de-designations and re-designations which give rise to operational difficulties regarding tracking and amortization of hedge adjustments.

52. In the original agenda item, use of a closed portfolio approach was suggested as an ever-changing portfolio of variable annuity contracts would be difficult for regulators to actively review and assess for hedge effectiveness compliance. Additionally, there was concern that allowing for a variable portfolio, particularly if coupled with a flexible hedging instrument, could allow for companies to “control” the hedge effectiveness by adjusting both the hedged item and the hedging instruments. Although these concerns still exist, provisions within the issue paper have been included to incorporate a higher degree of review and approval for these derivative transactions. Particularly, provisions have been incorporated to require explicit approval from the domiciliary state prior to implementing a hedging program within scope of this guidance, and the guidance requires certifications from both an actuary and a financial officer of the company on the use and impact of the hedging strategy on VM-21 reserves.

53. In reviewing the comments from industry, as well as the discussion elements supporting the IASB project, a closed portfolio approach may not be successful in encouraging further risk-management transactions by insurers. The operational burden in applying the concepts of closed portfolios would likely limit the general application of the special accounting provisions being considered, further perpetuating concerns that existing accounting guidance may hinder insurers from engaging in appropriate risk-management activities.

Hedging Instrument - Dynamic Hedging Strategy (Rebalancing)

54. The provisions within this issue paper permits reporting entities to utilize a specified derivative, or a portfolio of specified derivatives, as the hedging instrument. The portfolio of derivatives is allowed to be rebalanced in accordance with changes in the hedged item to adhere to a specified derivative strategy. The ability to rebalance derivatives designated as the hedging instrument is supported from comments identifying that dynamic hedging is a prevalent industry practice and widely accepted as an appropriate risk management technique. Commenters noted that a dynamic hedging strategy rebalances derivative portfolios to result in targeted market sensitivity and is not a result of a flawed hedge. Irrespective of one open or multiple closed hedged items, a dynamic instrument is fundamental in applying adequate risk management measures for variable annuities as the sensitivity changes over time and life of the policies. Comments indicated that designating one static pool at inception could result in significant hedge accounting and economic ineffectiveness, and highlighted that the instruments used to hedge a liability with a changing risk profile must be flexible.

55. Although some commenters indicated that the guidance in SSAP No. 86 supports the concept of dynamic hedging (rebalancing of hedging instruments), NAIC staff does not believe that interpretation is consistent with the intent of SSAP No. 86, nor is that interpretation consistent with derivative guidance under U.S. GAAP or IFRS. Pursuant to U.S. GAAP derivative guidance, separate financial instruments shall not be combined, and evaluated as a unit, unless two more derivative instruments in combination are

jointly designated as the hedging instrument. As previously noted, guidance in SSAP No. 86, as well as U.S. GAAP and IFRS, are designed primarily for static exposures in which it is necessary to identify a specific hedged item and hedging instrument (including a unit of combined instruments), and designate them as linked in an individual hedging relationship.

Hedging Criteria – Assessment of Effectiveness

56. Although the provisions within this issue paper incorporate new concepts for what is allowed as the hedged item and the hedging instrument, and incorporates a specific approach to determine hedge effectiveness, the concept of whether a fair value hedge is effective – and whether the hedging relationship achieves offsetting changes in fair value – is consistent with concepts established in SSAP No. 86 (as well as U.S. GAAP and IFRS) for assessing effectiveness. Key provisions include:

- a. Use of a specified method that will be used to assess hedge effectiveness at inception and on an ongoing basis, requiring hedge effectiveness assessment whenever financial statements are reported, with a minimum requirement of every three months. As detailed in the issue paper, in order to determine hedge effectiveness reporting entities must calculate the fair value of the hedged item (portion of VM-21 reserve liability) at inception and on an ongoing basis, and compare the current period fair value change of the hedged item to the current period fair value change of the hedging instruments. This comparison is specific to the designated hedged risks and exposures, therefore, if only a portion of the interest rate risk is hedged or if the designated hedge only include specific components of the variable annuity policies (e.g., riders), for determining hedge effectiveness, the fair value comparisons is limited to those designated items. The change in fair value of the hedging instruments and hedged item is limited to changes driven by market factors. For example, periodic recognition of a cost owed to acquire the derivative from a counterparty (financing cost) shall not be captured as a change in the derivative instrument's fair value. The fair value of the instrument shall be determined based on the underlying derivative without inclusion of acquisition costs (or other such contractual elements that may exist with the counterparty) that do not change based on the underlying derivative interests or market factors.
- b. Documentation is required for both prospective and retrospective effectiveness assessment, with ongoing assessment consistent with the documented risk management strategy in effect at the time of assessment. (Changes from the original hedging strategy are permitted in accordance with this issue paper.)
- c. A highly effective hedging relationship is one where the change in fair value is within 80 to 125 percent of the opposite change in fair value of the hedged item attributed to the hedged risk. A highly effective hedge also exists when an R-squared of .80 or higher is achieved when using a regression analysis.

57. Unlike the guidance in SSAP No. 86 (as well as U.S. GAAP), the guidance within this issue paper does not allow reporting entities to determine how they will assess hedge effectiveness. Rather, this issue paper specifies a particular approach for assessing whether the hedging strategy is highly effective, and in measuring hedge effectiveness. The hedging relationship is expected to be highly effective in achieving offsetting changes in fair value attributed to the hedged risk between the hedged item and the hedging instrument during the period that the hedge is designated. With the dynamic/rebalancing approach detailed within this issue paper, an individual hedging instrument is considered to be part of the effective hedge if the entire portfolio of hedging instruments achieves offsetting changes in fair value during the period in accordance with the hedging strategy. Rebalancing individual hedging instruments within a portfolio does not result with an ineffective assessment as long as the entire hedging instrument (portfolio) continues to meet the hedge effectiveness requirements under the documented hedging strategy.

58. As a continued GAAP to SAP difference, the requirements in this issue paper do not require reporting entities to separately report in the financial statements the ineffective portion of a highly-effective hedging transaction. For U.S. GAAP filers, in all instances, the actual measurement of cash flow hedge ineffectiveness is to be recognized in earnings each reporting period. The recognition of ineffectiveness is based on whether exact offset of cash flows is not achieved. This issue paper does not require measurement or disclosure of any ineffective part of the hedge.

Measurement of Open/Outstanding Derivative Instruments Hedging Criteria

59. This issue paper requires all derivative hedging instruments to be reported at fair value. Derivative instruments combined in a portfolio are also required to be separately reported at fair value. Although this is a measurement change from derivatives in effective hedges under SSAP No. 86, the fair value measurement approach is consistent with U.S. GAAP and IFRS. The FASB has identified that fair value is the only relevant measurement attribute for derivatives. Furthermore, the FASB has specifically identified that amortized cost is not a relevant measurement because the historical cost of a derivative is often zero, yet a derivative can be settled or sold at any time for an amount equivalent to its fair value. The FASB reasoning supporting “held to maturity” instruments being held at amortized cost was noted as not suitable for derivatives.

60. The requirement to use fair value under this special accounting provision is a change from SSAP No. 86 for derivatives that qualify as effective hedges. This change is appropriate under this accounting guidance for the following reasons:

- a. Fair value fluctuations in hedging instruments attributable to the hedged risk that offset changes in the VM-21 liability shall be recognized as realized gains and losses. These offsets result in a neutral financial statement impact, with the financial statements reflecting the impact of the effective hedge. This offset is only possible under a fair value measurement method in which fair value fluctuations are reflected in the financial statements. Under an amortized cost measurement method, fair value fluctuations are not recognized in the financial statements. Although the fair value change in an open derivative instrument would normally be considered an unrealized change, to avoid a statutory accounting disconnect in recognition between derivative changes and the changes in the VM-21 reserve, offsetting fair value changes will be recognized as realized changes. This is also consistent with U.S. GAAP, as offsetting changes in hedged items and hedging instruments are concurrently recognized in earnings.
- b. Provisions are established to allow for the recognition of a “deferred asset” or “deferred liability” for the portion of the fair value fluctuations of the derivative instrument, attributed to the hedged risk, that do not immediately offset the changes in the VM-21 liability. The recognition of these gains/losses as balance sheet items negates the surplus volatility from the non-offsetting fair value fluctuations. (As discussed in paragraph 60.a. offsetting positions to the changes in the VM-21 liability are recognized as realized gains and losses.) As previously discussed, the change in fair value of the hedging instruments is limited to changes driven by market factors. This issue paper does not allow deferred derivative acquisition costs (financing costs), or other such contractual costs with the derivative counterparty that are not impacted by underlying derivative interests, or market changes, to impact the fair value of the derivative instrument when determining the offset to the VM-21 reserve or the resulting deferred asset or deferred liability.
- c. Use of fair value will result with consistent measurement methods for derivatives between SAP and U.S. GAAP. Additionally, the reporting of fair value and the development of the deferred assets and deferred liabilities will clearly present derivative positions under this special accounting provision. This is particularly important for instances in which gains

and losses from expired derivatives are not immediately reflected in the financial statements, but are scheduled for amortization.

61. The provisions within this issue paper permitting recognition of a “deferred asset” and a “deferred liability” to reflect the non-offsetting portion of fair value fluctuations attributed to the hedged risk is inconsistent with U.S. GAAP derivative guidance, as well as the general definitions for what constitutes an asset or liability under both SAP and U.S. GAAP. Gains and losses resulting from changes in the fair value of derivatives are not separate assets or liabilities because they have none of the essential characteristics of assets or liabilities. As noted by the FASB, the act of designating a derivative as a hedging instrument does not convert a subsequent loss or gain into an asset or a liability. A loss is not an asset because there is no future benefit associated with it. The loss cannot be exchanged for cash, a financial asset, or a nonfinancial asset used to produce something of value, or used to settle liabilities. Similarly, a gain is not a liability because no obligation exists to sacrifice assets in the future.

62. The reporting of derivative gains and losses from effective hedges as assets or liabilities is not new under statutory accounting. Currently, in SSAP No. 86, upon the sale, maturity, or other closing transaction of a derivative, which is an effective hedge, any gain or loss on the transaction will adjust the basis (or proceeds) of the hedged item(s) individually or in the aggregate. This “adjustment to the basis of the hedged item” is, in effect, the recognition of derivative losses or gains as assets or liabilities. Although these provisions exist in SSAP No. 86, the impact is not easily identifiable in the assets or liabilities reported on the financial statements. With the exception of impairment assessments for the hedged item (pursuant to the SSAP in which the hedged item falls), increases in an asset basis of a hedged item as a result of derivative losses are not restricted, nor are they explicitly nonadmitted.

63. SSAP No. 86 also provides an alternative treatment, whereas if the item being hedged is subject to IMR, the gain or loss on the terminated hedging derivative may be realized and subject to IMR. This alternative approach also reflects the recognition of a balance sheet impact (increase or decrease in liabilities) for realized gains and losses that do not meet the definition of assets or liabilities. For IMR items, losses recognized from derivative instruments reduce the IMR liability, whereas gains from derivative instruments increase the IMR liability. With the provisions established for IMR, safeguards are in place to prevent recognition of a contra-liability (or asset) for realized losses that exceed realized gains. If realized losses exceed the IMR liability, resulting with a negative liability balance, the IMR liability is required to be shown as zero. A negative liability for IMR is not permitted to be reflected in the financial statements.

64. Although statutory accounting does not generally support the recognition of balance sheet items that do not meet the definitions of assets or liabilities, the guidance proposed in this issue paper is supported for the following reasons:

- a. The process to recognize the fair value of derivative instruments, coupled with the recognition of “deferred assets” and “deferred liabilities” (reflecting non-offsetting gains and losses attributed to the hedged risk), provides a comprehensive view of the derivative impact in the balance sheet. With this approach, the derivative is reported at fair value, but the non-economic volatility from market fluctuations (the fair value change) does not impact the entity’s solvency presentation.
 - i. For example, a derivative acquired at zero cost currently in a liability position from fair value fluctuations will be reported as a derivative liability in the financial statements. The unrealized loss from fair value fluctuations attributed to the hedged risk, which were not recognized as they did not offset VM-21 reserve changes, will be shown as a deferred asset. This deferred asset would be admitted, although it does not meet the definition of an asset, or the concept of an admitted asset under *SSAP No. 4—Assets and Nonadmitted Assets*, as it does not reflect a probable future benefit or something that would be available for policyholder benefits. However, by reporting both the derivative liability and the deferred asset,

non-economic volatility in the financial statements is mitigated, while improving presentation as the derivative obligation (derivative liability) will be presented in the financial statements. In addition, under the narrow scope of this issue paper, it is important to consider accounting that captures what is relevant and a faithful representation of the business model of variable annuity life insurers, who as indicated elsewhere within this issue paper, utilize dynamic hedging as a risk management technique that if determined to be highly effective under the requirements of this issue paper, reduces risk, and helps the industry as a whole to better serve the marketplace. Under current guidance, using an amortized cost approach, the derivative would be reported at zero, and would not be adjusted for fair value fluctuations, therefore the liability position of the derivative would not be shown in the financial statements.

- b. Recognizing derivatives at fair value is consistent with the U.S. GAAP guidance for reporting derivatives, therefore eliminating the GAAP or SAP difference on the reporting of these investments.
- c. The recognition of “deferred assets” and “deferred liabilities” and the separate amortization of these balances, outside of IMR, prevents the application of this special accounting provision from diluting or impacting the recognition of IMR. Pursuant to *SSAP No. 7—Asset Valuation Reserves and Interest Maintenance Reserve*, IMR defers recognition of realized capital gains and losses resulting from changes in the general level of interest rates. As the recognition of deferred assets and deferred liabilities proposed within this issue paper would traditionally reflect unrealized gains or losses, (and then realized gains and losses once the derivative instrument expired), using a separate amortization process of these items, and not commingling these items with IMR, retains the original intent of IMR. Under the proposed guidance within this issue paper, the recognition of gain/loss will occur with amortization of the deferred assets/deferred liabilities, and will not be subject to further deferral to IMR.
- d. With the recognition of deferred assets and deferred liabilities, this issue paper requires reporting entities to allocate to special surplus an amount equal to the net deferred asset/liability recognized under this special accounting guidance. This allocation highlights the overall financial statement impact of the deferred assets/liabilities in the financial statements, and in some states, may reduce the likelihood of dividends being paid as a result of an increase in “assets” that actually represent unrecognized losses. This reporting also provides enhanced transparency to the magnitude of these transactions and overall financial statement impact, and assists in determining if a need exists for the state to hire an outside specialist to assess the overall program.

65. The guidance in this issue paper is focused on the accounting guidance for the derivative instruments that hedges a VM-21 liability, not the impact that a Clearly Defined Hedging Strategy under the provisions of VM-21 can have on the recognized VM-21 liability. One question that arose during the development of this issue paper was whether there was any double counting of the impact of the hedge that would be recorded under this proposed issue paper and what would be recorded as part of the VM-21 liability. It was determined this was not a material issue as the amount of credit given to a hedge (the asset to the company under this proposed accounting) under VM-21 is significantly muted by the mechanics and in fact may work to the detriment of the company in VM-21 but is not considered to be material.

Amortization of Deferred Assets and Deferred Liabilities – Effective Hedging Programs

66. This issue paper requires that deferred assets and deferred liabilities from non-expired derivative contracts be amortized using a straight-line method into realized gains and losses over a finite amortization period. The amortization period shall equal the Macaulay duration of the guarantee benefit cash flows based

on the VM-21 Standard Scenario, but shall not exceed a period of 10-years. The Macaulay duration provides a weighted average length of time of the guarantee cash flows and appropriately varies by company, block and aggregation of business in force. The Macaulay duration appropriate links the amortization to the VM-21 liability and supports the goal of reducing non-economic volatility in the statutory financial statements resulting from accounting mismatches between variable annuity reserves and related hedges.

67. Although some industry commenters did not support in concept a maximum amortization period, and suggested amortization periods in excess of 10-years (20 and 25 years), the Working Group agreed to limit the deferred asset/liability amortization timeframe to 10 years. In deciding the 10-year timeframe, the Working Group noted that deferred assets/liabilities do not meet the definition of actual assets or liabilities, and the recognized “assets” (which are deferred losses) do not satisfy statutory accounting criteria for admitted assets as they do not reflect amounts that can be used to satisfy policyholder claims. Furthermore, it was identified that the impact from the application of this special accounting guidance could be material in the financial statements and could significantly impact the review and financial solvency assessment of a company. The Working Group also noted that the longer the amortization period, the longer unrecognized losses (reported as assets) are delayed from recognition. Additionally, under the issue paper provisions, as long as the hedge program is effective, derivative losses may continue to be reported as deferred assets even after the derivative instrument generating the loss has matured, sold or disposed. By limiting the amortization timeframe, the scheduling process is anticipated to be manageable, allowing for more effective regulator review.

68. The 10-year timeframe is an increase to the original proposal, which would have required a standard 5-year amortization timeframe for deferred assets/liabilities. Under that proposal, the 5-year timeframe would have been required unless a company was able to adequately demonstrate a linkage to the expected VM-21 liability, and if that was demonstrated the company would have been permitted to extend the amortization to 10-years. The original 5-year timeframe was suggested from certain industry representatives, who noted it was a significant improvement to the fair value accounting approach in SSAP No. 86, where the derivative fair value fluctuations are recognized as they occur.

69. This issue paper also allows for reporting entities to accelerate amortization or terminate use of the special accounting provision at any time. With this provision, specific guidance has been included to ensure that deferred assets and deferred liabilities are recognized in an equitable manner in the financial statements. This guidance was added in response to comments supporting the ability to accelerate amortization, but to prevent interpretations allowing amortization of only deferred assets or deferred liabilities. These comments noted concern with the opportunity to elect provisions inequitably between deferred assets and deferred liabilities, as those elections could be occur to improve the financial results of the reporting entity. The comments supported acceleration that is applied proportionately between deferred assets and deferred liabilities in order to ensure that amortization is aligned with the overall hedge relationship.

- a. Under the guidance, reporting entities are required to accelerate amortization equally between deferred assets and deferred liabilities within a single hedging strategy. This guidance prevents a reporting entity from electing to accelerate amortization of the deferred liabilities (recognizing the gains from fair value changes) without also accelerating amortization of the deferred assets (continuing to defer losses from fair value changes). If a reporting entity was allowed to only accelerate deferred liabilities, the reporting entity would have the opportunity to improve the presentation of their financial position by choosing to recognize gains, but continuing to defer losses (reported as assets). If a single hedging strategy only reflects deferred assets or deferred liabilities, the reporting entity is permitted to accelerate amortization without restrictions.
- b. If a reporting entity has more than one hedging strategy, and the strategies have offsetting net positions (both deferred assets and deferred liabilities are recognized in the financial statements), a reporting entity’s election to accelerate amortization must be applied

consistently to programs with offsetting net positions. In these situations, the other provisions for acceleration are also applicable, whereas, the accelerated amortization must also apply equally to the deferred assets and deferred liabilities within each individual hedging program. If a reporting entity with more than one hedging strategy only has net deferred assets or net deferred liabilities recognized, the reporting entity is permitted to accelerate amortization to a single program under the guidelines in paragraph 69.a.

70. The intent of the guidance in paragraph 69.b is to ensure that the elections to accelerate amortization are not one-sided approaches that result in favorable financial statement presentation.

Amortization of Deferred Assets and Deferred Liabilities – Terminated or Ineffective Programs

71. This issue paper provides guidance addressing the treatment of deferred assets and deferred liabilities, initially recognized under qualifying programs, when the hedging program no longer qualifies under the standard, no longer is identified as a highly effective hedge, or that has been terminated by the reporting entity. Pursuant to this guidance, in order to avoid an immediate impact to surplus for the full deferred asset/deferred liability recognized, provisions have been established to allow reporting entities to continue amortizing the deferred assets and deferred liabilities over the remaining amortization period, not to exceed five years. If the remaining amortization period exceeds the five-year timeframe, the amortization schedule shall be revised to require full amortization within the shortened time period. The guidance also allows reporting entities to elect to accelerate amortization, however, the provisions for equal accelerated amortization for qualifying, highly effective programs also applies.

72. The decision to allow for a shortened amortization timeframe for these programs is a compromise position that considered the underlying nature of the deferred assets/liabilities (unrecognized gains and losses from fair value fluctuations) as well as the financial statement impact that could occur with an immediate recognition to surplus. Although comments received supported continued amortization under the original established schedule, the Working Group noted that the continuation of the originally scheduled amortization of deferred assets/liabilities for these programs is inappropriate, as these items do not meet the definition of assets and liabilities and cannot be used for policyholder claims. The ability to recognize deferred assets and liabilities was based on the concept that the hedging program was effective, and the volatility mismatch was due to differing accounting measurements between the hedged item and the hedging instruments in the effective hedge. Once a program is no longer highly effective, the continued long-term deferral of the unrealized gains and losses from the hedging derivative instruments can no longer be supported. This is particularly true for an expired derivative instrument that has resulted in a loss (deferred asset). For expired derivatives the loss has actually been incurred to the reporting entity, as it has been “realized” (settled with the counterparty) and there is no potential for that derivative loss to be reversed.

73. In establishing the compromise position, the Statutory Accounting Principles (E) Working Group sent a referral in April 2017, to the Variable Annuity Issues (E) Working Group inquiring whether there is a future benefit of effective hedges offsetting a variable annuity reserve once the effective hedging program has been discontinued or becomes ineffective. This referral noted the key issue of whether the deferred assets (unrecognized losses) from previous fair value fluctuations of derivative instruments – recognized when the overall hedge strategy was in place and effective – should be perceived to offset future reserve changes even when the overall hedging strategy has been terminated or is ineffective. This referral recognized that the unrecognized losses (deferred assets) are likely going to be significant, and identified the industry concern if immediate recognition in the financial statements was required. The referral also identified that if the special accounting provisions were not established or followed, the statutory accounting provisions in SSAP No. 86, would require recognition of the hedging instruments at fair value, with changes in fair value recognized as unrealized gains or losses as incurred.

74. In August 2017, the Variable Annuities Issues (E) Working Group provided a referral response to the Statutory Accounting Principles (E) Working Group. This response suggested the compromise position – allowing for a maximum 5-year amortization timeframe – with inclusion of detailed disclosures to allow the regulators to consider the information in their ongoing monitoring of the reporting entity’s financial condition. With this referral response, it was identified that members of the Variable Annuity Issues (E) Working Group expressed no willingness to support the ACLI suggestion that the amortization schedule should continue as if the hedging program was still in place and highly effective. This referral response also provided the following detail regarding the compromise position:

The regulatory position and therefore question is driven by the concern that a regulator would have as the result of an unrecognized loss on an ineffective overall hedging strategy or one that has been disposed. More specifically, during a market uptick, when the customer base of the insurer can become disinterested with the variable annuity product. Under these circumstances the liability cash flows are mostly fees that were going to materialize on the balance sheet under the original policyholder behavior assumptions and with above expectation lapse no longer will do so to the extent previously expected. The deferral of the loss recognition was meant to make the loss recognition coincide with the fee revenue recognition. If policies lapse, so too will the future profits. However, 100% recognition of any derivatives that are currently in a loss position would be inconsistent with the remaining reduced cash flows that do materialize. This lapse effect could also materialize in idiosyncratic insurer distress scenarios even though such scenarios are relatively unlikely as they would have to occur under very favorable capital markets conditions for there to be a deferred hedge loss asset.

Rebalanced/Expired Derivative Instruments

75. With the ability to rebalance derivative hedging instruments, this issue paper allows for individual derivative instruments to be removed from the portfolio, and/or expire, and not immediately result with an ineffective hedging assessment. Comments received indicate that this approach is consistent with guidance under SSAP No. 86, as gains and losses are either allowed to be an adjustment to the hedged item, or are realized and included in IMR. However, the guidance in this issue paper allows for derivatives to be removed from the hedging strategy and not be identified as an ineffective hedge. This concept is not supported by the existing guidance within SSAP No. 86.

76. The provisions within this issue paper is only intended to encompass situations in which the overall hedging strategy is highly effective at the time that the derivative is either removed from the portfolio of hedging instruments or expires. If the hedging strategy is highly effective at that time, then regardless of future determination of effectiveness, the deferred assets or deferred liabilities recognized for the derivative instrument will continue to be amortized under the remaining amortization scheduled established when the hedge was deemed highly effective.

77. For derivatives that have not expired, but were removed from the portfolio of hedging instruments, subsequent gains and losses from fair value fluctuations shall not impact the previously recognized deferred assets or deferred liabilities, but shall be recognized directly as unrealized gains and losses. With this approach, the gains or losses identified when the derivative was part of the effective portfolio, reflected as deferred assets or liabilities, will be “locked in” once the derivative is removed from the portfolio of hedging instruments.

Measurement/Recognition of Realized and Unrealized Gains and Losses

78. The provisions within this issue paper identifying recognition through realized or unrealized gains or losses has been specifically determined for the hedge accounting programs in scope. These provisions are not consistent with the “standard” allocation between realized and unrealized that occurs under statutory accounting principles.

- a. Under traditional statutory accounting concepts, fair value fluctuations for “open” instruments held by a reporting entity are recognized as unrealized (directly to surplus) as the fair value change could reverse in subsequent periods. Once an instrument is sold, matured, terminated, etc., the unrealized gain or loss would be recognized as a realized gain or loss (impacting net income).
- b. With the traditional statutory approach, there would be a statutory disconnect between how derivative gains and losses for outstanding instruments would be recognized (unrealized to surplus) in comparison to the VM-21 reserve change (change to net income). Although this disconnect occurs under SSAP No. 86, the disconnect does not occur under U.S. GAAP. Under U.S. GAAP, offsetting fair value changes in hedged items and hedging instruments are concurrently reflected in earnings.

79. Although the recognition of the fair value fluctuations as an unrealized or realized impact does not impact overall surplus, by stipulating that the fair value fluctuation that offsets the reserve change should be recognized as a realized change, the impact of the highly effective derivative relationship is reflected in the same reporting line (net income). By reporting in the same line (and not split between net income and surplus), an improved financial statement presentation illustrating the impact of the derivative is provided.

80. In addition to the improved presentation on the Summary of Operations, by requiring all fair value fluctuations attributable to the hedged risk to be recognized as a realized impact (regardless if the derivative instrument is open), it eliminates concerns with tracking and reclassifying fair value fluctuations (from unrealized to realized) when a derivative instrument is removed from a portfolio of hedging instruments either due to rebalancing efforts, or because the derivative has matured.

81. Pursuant to the guidance reflected in the issue paper, the following concepts are intended to be followed when allocating between unrealized and realized gain/loss recognition:

- a. Realized: Fair value fluctuations in the hedging instruments attributable to the hedged risk that offset the current period change in the hedged item.
- b. Realized: Amortization of fair value fluctuations in open or expired hedging instruments attributed to the hedged item that were recognized as deferred assets or deferred liabilities for a hedging program that continues to qualify under the standard.
- c. Realized: Amortization of fair value fluctuations from expired hedging instruments attributed to the hedged item that were recognized as deferred assets or deferred liabilities for a hedging program that no longer qualifies within the standard, is no longer a highly effective hedge, or is a program that has been terminated by the reporting entity.
- d. Unrealized: Fair value fluctuations in open (non-expired) hedging instruments that are not attributed to the hedged risk, or are from excluded derivative instrument components.
- e. Unrealized: Amortization of fair value fluctuations in open (non-expired) hedging instruments attributed to the hedged item that were recognized as deferred assets or deferred liabilities for a hedging program that no longer qualifies within the standard, is no longer a highly effective hedge, or is a program that has been terminated by the reporting entity.

Derivative Income

82. This issue paper requires that all derivative income earned for all derivative instruments within scope of this guidance shall be reported as investment income.

83. U.S. GAAP derivative guidance is focused on income statement matching. As such, under U.S. GAAP, the “effective” portion of gains and losses on a derivative instrument is reported consistently between the hedging instrument and hedged item resulting with an exact offset to gains and losses attributed to the hedged risk. The “ineffective” portion directly affects earnings because there is no offsetting adjustment for the ineffective aspect of the gain or loss. Although the focus for statutory accounting is less on income statement matching, and more on the balance sheet impact of the hedged item and the derivative hedging instruments (reducing non-economic volatility), the gains and losses from offsetting fair values (between the derivative instrument and the hedged item) will be concurrently recognized as realized impacts, regardless if the derivative is still outstanding, to improve financial presentation in the Summary of Operations.

84. The provisions to recognize income earned is also consistent with the SSAP No. 86 guidance in situations in which the derivative is not combined with the hedged item. Pursuant to current guidance, periodic cash flows and accruals of income/expense are to be reported in a manner consistent with the hedged item, usually as net investment income or another appropriate caption within operating income. (SSAP No. 86 is drafted with an assumption that the hedged item is an asset, there is no guidance in SSAP No. 86 that reflects consideration of designating a liability as a hedged item.)

85. The cash flow guidance in SSAP No. 86 is different for situations in which the derivative is combined with the hedged item. Under that guidance, the income reported for the derivative on Schedule DB is zero, and the cash flows are to be reported with the hedged item instead of with the derivative. There are concerns with regards to this existing guidance (both in SSAP No. 86, as well as this issue paper), as income from derivative instruments would not be identifiable within the financial statements or Schedule DB. Although there is a perception that this allowance is not often elected under SSAP No. 86, with the need for clear reporting under this special accounting provision, this approach is not presented as an option within this issue paper.

86. Comments received supported continuation of the concepts in SSAP No. 86, in which changes in the carrying value or cash flow of the derivative shall be recognized in the same period and in the same category of income or surplus as the amortization or fair value changes of the hedged item; e.g., net gain from operations, realized capital gains and losses on investments, unrealized capital gains and losses on investments, or unrealized foreign exchange capital gain or loss. The comments received also identify that as cash flows from swaps are included in the calculation of the hedged item (e.g., projected within VM-21), swap income will be accrued and recorded when it is earned consistently with the hedge item. This issue paper does not reflect these comments. Rather, consideration of income shall be recognized as earned, and be included as a factor in determining the recognition of fair value fluctuations in the derivative instruments (e.g., the degree of offset between the VM-21 liability and the fair value fluctuations impacting the recognition of deferred assets and deferred liabilities). It is anticipated that this approach will not result in material differences in the financial statements, but will allow for proper recognition of income when earned.

Disclosures

87. The disclosure requirements in this issue paper are intended to result in a new schedule, along with new financial statement disclosures (data-captured) that specifically address the hedging strategies and related derivatives within this issue paper. The disclosure requirements also envision a schedule for all hedging instruments, with information regarding the cost, fair value, realized/unrealized gains and losses, deferred assets and deferred liabilities, and the amortization schedule. The intent of the proposed disclosures is to provide clear, transparent information regarding the use and impact of this special accounting provision within the financial statements.

Effective Date and Transition - Issue Paper Discussion

88. The guidance is proposed on a prospective basis, to allow for the change to be initially effective at the beginning of the year.

89. The guidance also requires prospective application to qualifying hedge programs that are in place on or after the effective date. This prospective application does not allow reporting entities to reverse previously recognized unrealized gains/losses from derivative instrument fair value fluctuations and recognize those fluctuations as deferred assets or deferred liabilities. Hedging transactions within scope of this guidance, which were in place prior to the effective date, would not have been considered effective hedges under SSAP No. 86. As such, unless the reporting entity had a permitted or prescribed practice for alternative accounting treatment, the hedging transactions within scope of this guidance should have been accounted for under the fair value method in SSAP No. 86. Any unrealized gains or unrealized losses recognized for a derivative instrument recognized prior to the application of this standard shall continue to be reflected, adjusted for other unrealized impacts from the derivative instrument required under this standard (e.g., excluded components of the hedging derivative) until the derivative has expired.

90. In the development of the issue paper, it was identified that some reporting entities had already received permitted and prescribed practices to incorporate concepts similar to what is permitted in this issue paper. Although the issue paper does not incorporate guidance to allow those practices to be automatically captured within scope (e.g., grandfathered), consideration occurred on how those practices could be brought into the standard without reporting entities having to eliminate the results from those permitted or prescribed practices. (The immediate recognition of deferred assets and deferred liabilities as unrealized gains and unrealized losses could have a significant impact on surplus.) After this consideration, the Working Group agreed that each reporting entity shall work with their domiciliary state regulator to determine the appropriate method in transitioning from previously approved permitted practices. The reporting entity shall include disclosure of the transition approach approved by the domiciliary state in their financial statements in the first year of application. After the effective date of the adopted statement, domiciliary state provisions that differ from that adopted statement must be disclosed as a permitted or prescribed practice pursuant to SSAP No. 1.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

91. SSAP No. 86 establishes statutory accounting guidance for derivatives and hedging, income generation and replication (synthetic asset) using selected concepts from *FAS 133, Accounting for Derivative Instruments and Hedging Activities*. The concepts presented within this issue paper on what is permitted to receive “effective hedge treatment,” and the accounting for derivative instruments involved in a highly effective hedge, are distinctly different from the guidance in SSAP No. 86. For example, derivative instruments involving macro-hedges and dynamic (rebalancing) hedging instruments do not qualify for effective hedge accounting recognition under SSAP No. 86.

92. As indicated throughout this issue paper, this guidance establishes statutory accounting principles to address certain, limited derivative transactions hedging variable annuity guarantees subject to fluctuations as a result of interest rate sensitivity. Eligibility for the special accounting provision within this standard is strictly limited to variable annuity contracts and other contracts involving certain guaranteed benefits similar to those offered with variable annuities that are reserved for in accordance with *Valuation Manual 21: Requirements for Principal-Based Reserves for Variable Annuities* (VM-21)¹⁹. The statutory accounting guidance within is considered a special accounting provision, only permitted if all the components in the standard are met, and shall not be inferred as an acceptable statutory accounting approach

¹⁹ *Actuarial Guideline XLIII, CARVM for Variable Annuities* (AG 43) shall apply in states that have not adopted the Valuation Manual.

for situations that do not meet the stated qualifications or that are not specifically addressed within this guidance.

93. Applying the provisions within this issue paper is an election by the reporting entity. Although a reporting entity may have derivative transactions that would qualify within this issue paper guidance, a reporting entity is not required to follow the provisions within this standard. A reporting entity that did not elect to follow the special accounting provisions in this issue paper would continue to report their derivative transactions based on the SSAP No. 86 guidance. As the derivative instruments that qualify for effective hedges in this issue paper would not qualify as effective hedges under SSAP No. 86, a reporting entity that follows the SSAP No. 86 guidance would be required to report these derivative instruments under the fair value accounting method. (This method requires the derivative instruments to be reported at fair value, with changes in the fair value reported as unrealized gains or losses.)

U.S. Generally Accepted Accounting Principles

94. U.S. GAAP guidance for derivatives is currently captured in *Accounting Standards Codification Topic 815*. The U.S. GAAP derivative guidance is based on four cornerstones (ASC 815-10-10-1):

- a. Derivative instruments represent rights or obligations that meet the definitions of assets or liabilities and should be reported on the financial statements.

In making this decision, the FASB noted that derivatives are assets or liabilities because they represent rights or obligations and that recognizing those assets and liabilities will make financial statements more complete and more informative. The FASB noted that prior to FAS 133, many derivatives were off-balance-sheet, because, unlike conventional financial instruments (such as stocks, bonds and loans), derivatives often reflect at their inception only a mutual exchange of promises with little or no transfer of tangible consideration. *FAS 133, BOC – 219*.

- b. Derivative instruments should be measured at fair value, and adjustments to the carrying amount of hedged items should reflect changes in their fair value (that is gains or losses) that are attributable to the risk being hedged and that arise while the hedge is in effect.

In making this decision, the FASB identified that fair value is the only relevant measurement attribute for derivatives. They noted that amortized cost is not a relevant measure for derivatives because the historical cost of a derivative often is zero, yet a derivative can be settled or sold at any time for an amount equivalent to its fair value. The reasoning for “held to maturity” instruments being held at amortized cost, was noted as not suitable for derivatives. *FAS 133, BOC - Paragraph 223*.

- c. Only items that are assets or liabilities should be reported in the financial statements.

In making this decision, the FASB identified that derivatives are assets and liabilities, but the gains and losses that result in changes in the fair value of derivatives are not separate assets or liabilities because they have none of the essential characteristics of assets or liabilities. The FASB identified that the act of designating a derivative as a hedging instrument does not convert a subsequent loss or gain into an asset or a liability. A loss is not an asset because no future economic benefit is associated with it. The loss cannot be exchanged for cash, a financial asset, or a nonfinancial asset used to produce something of value, or used to settle liabilities. Similarly, a gain is not a liability because no obligation exists to sacrifice assets in the future. *FAS 133, BOC – 229*.

- d. Special accounting for items designated as being hedged should be provided only for qualifying items. One aspect of qualification should be an assessment of the expectation of

effective offsetting changes in fair value or cash flows during the term of the hedge for the risk being hedged.

In making this decision, the FASB noted that a primary purpose of hedge accounting is to link items or transactions whose changes in fair values or cash flows are expected to offset each other. The FASB decided that one of the criteria for qualification for hedge accounting should focus on the extent to which offsetting changes in fair values or cash flows on the derivative and the hedged item or transaction during the term of the hedge are expected and ultimately achieved. *FAS 133, BOC – 230*.

95. Pursuant to the four cornerstones, as well as other components of the U.S. GAAP guidance, the provisions in this issue paper are not considered to be consistent with U.S. GAAP. Similar to SSAP No. 86, derivative instruments allowed to be considered part of an effective hedge under this issue paper, would not qualify to be considered part of an effective hedge under U.S. GAAP.

96. Key Elements of U.S. GAAP Guidance: (Only relevant excerpts are included.)

- a. An entity shall recognize all of its derivative instruments in its statement of financial position as either assets or liabilities depending on the rights and obligations under the contracts. (815-10-25-1)
- b. All derivative instruments shall be measured initially at fair value. (815-10-30-1)
- c. All derivative instruments shall be measured subsequently at fair value. (815-10-35-1)
- d. Forward contracts and purchased options within the scope of “Certain Contracts on Debt and Equity Securities” shall, at inception, be designated as held to maturity, available for sale, or trading in a manner consistent with the accounting prescribed for that category of securities. Such forward and option contracts are not eligible to be hedging instruments. (815-10-25-17)
- e. Unless offsetting guidance is met (210-20-45-1), fair value of derivative instruments in a loss position shall not be offset against the fair value of derivative instruments in a gain position. (815-10-45-4)
- f. An embedded derivative shall be separated from the host contract and accounted for as a derivative instrument if, and only if, the following criteria are met:
 - i. The economic characteristics and risks of the embedded derivative are not clearly and closely related to the economic characteristics and risks of the host contract.
 - ii. The hybrid instrument is not remeasured at fair value under otherwise applicable GAAP with changes in fair value reported in earnings as they occur.
 - iii. A separate instrument with the same terms as the embedded derivative would be a derivative instrument. (815-15-25-1)
- g. Concurrent designation and documentation of a hedge is critical; without it, an entity could retroactively identify a hedged item, a hedged transaction, or a method of measuring effectiveness to achieve a desired accounting result. To qualify for hedge accounting, there shall be, at inception of the hedge, be formal documentation of specific elements. (815-20-25-3)

- h. An asset or liability is eligible for designation as a hedged item in a fair value hedge if all of the following additional criteria are met. (Only including key excerpts) (815-20-25-12)
 - i. The hedged item presents an exposure to changes in fair value attributable to the hedged risk that could affect reported earnings.
 - ii. If the hedged item is all or a portion of a debt security (or a portfolio of similar debt securities) that is classified as held to maturity in accordance with Topic 320, the designated risk being hedged is the risk of changes in its fair value attributable to credit risk, foreign exchange risk or both.
- i. Gains and losses on fair value hedges shall be accounted for as follows: (815-25-35-1)
 - i. The gain or loss on the hedging instrument shall be recognized currently in earnings.
 - ii. The gain or loss (that is, the change in fair value) on the hedged item attributable to the hedged risk shall adjust the carrying amount of the hedging item and be recognized currently in earnings.

If the fair value is fully effective, the gain or loss on the hedging instrument, adjusted for the component (if any) of that gain or loss that is excluded from the assessment of effectiveness under the defined risk management strategy for that particularly hedging relationship, is attributable to the hedged risk. Any difference that would arise would be the effect of hedge ineffectiveness, which consequently is recognized currently in earnings. (815-25-35-2)

International Financial Reporting Standards

97. Although International Financial Reporting Standards do not have guidance permitting effective hedge treatment as presented in this issue paper, the International Accounting Standards Board (IASB) is currently working on a similar project “*Accounting for Dynamic Risk Management: A Portfolio Revaluation Approach to Macro Hedging*.” In April 2014, the IFRS released a Discussion Paper as a first step in developing an accounting model for dynamic risk management.

98. The objectives of the IFRS project is to simplify and improve the usefulness of financial statements by developing accounting requirements for hedging within the context of open portfolios that are more closely aligned with a company’s risk management activities. The IFRS identified, as a primary driver for initiating the project, the problems associated with applying hedge accounting, which is a fundamentally static concept (linking hedged instruments to hedged items) to dynamic risk management of open portfolios. As such, the IFRS decided to consider a new model for dynamic risk management of open portfolios.

99. The IASB is currently considering comments received on the exposed Discussion Paper, however, in reviewing project updates, it is anticipated that the IASB will re-issue a revised Discussion Paper for comment before even considering an exposure draft. (This is partly due to the original Discussion Paper focusing on interest rate risk management at banks, and commenters requested additional focus on the management of interest rate risk and other risks within non-bank entities.) As such, there is no expected timeframe for completion of this project at the IASB. This project is considered to be in the early stages, and it is anticipated to take a significant time before a standard is issued. In reviewing comments received by the IASB, some commenters included reference to insurance contracts, identifying that the need for a portfolio accounting model is needed to avoid accounting mismatches. These commenters supported the inclusion of hedged risks within insurance contracts being included in the IASB’s dynamic risk management project.