Statutory Accounting Principles (E) Working Group

**Maintenance Agenda Submission Form**

**Form A**

## **Issue:** Accounting for “Other” Derivatives

**Check (applicable entity):**

P/C Life Health

Modification of existing SSAP

New Issue or SSAP

Interpretation

Description of Issue:

This agenda item has been drafted to consider statutory accounting guidance for derivatives that are not used in hedging transactions, income generation transactions or replication (synthetic asset) transactions. This agenda item was directed with the adoption of agenda item 2018-18, Structured Notes, as it was noted that structured notes captured within scope of *SSAP No. 86—Derivatives*, would be unlikely to be used in the transactions with existing recognition and measurement guidance in SSAP No. 86.

Although the guidance of SSAP No. 86 is limited to the derivatives captured in the noted transactions (hedging, income generation or replication), the reporting schedule for derivatives (Schedule DB) currently includes an “other” derivative reporting category. Although this agenda item clarifies the accounting (measurement) value for these derivatives, as detailed within the proposed revisions, “other” derivatives do not qualify as admitted assets under the SSAP. Derivatives classified as “other” shall only be admitted in accordance with state investment laws that provide prescribed practices that permit admittance. These prescribed practices shall be detailed in Note 1. Derivatives reported in the “hedging-other” are derivatives subject to the “hedging” guidance in SSAP No. 86 and are not intended to be captured by this agenda item. This agenda item is strictly for the derivatives reported as “other” derivatives.

Existing Authoritative Literature:

*SSAP No. 86—Derivatives* establishes statutory accounting principles for derivative instruments and hedging, income generation and replication (synthetic asset) transactions using selected concepts outlined in *FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities*.

Although the scope of SSAP No. 86 references “all derivative instruments” recognition and measurement provisions are only provided for specific transactions identified in paragraph 3:

1. This statement addresses the recognition of derivatives and measurement of derivatives used in:
2. Hedging transactions;
3. Income generation transactions; and
4. Replication (synthetic asset) transactions.
5. “Derivative instrument” means an agreement, option, instrument or a series or combination thereof:

a. To make or take delivery of, or assume or relinquish, a specified amount of one or more underlying interests, or to make a cash settlement in lieu thereof; or

b. That has a price, performance, value or cash flow based primarily upon the actual or expected price, level, performance, value or cash flow of one or more underlying interests.

Activity to Date (issues previously addressed by the Working Group, SEC, FASB, other State Departments of Insurance or other NAIC groups): Revisions have recently adopted to SSAP No. 86 and additional revisions are expected to consider *ASU 2017-12, Derivatives and Hedging*. Recent revisions include:

* Ref # 2016-48 – Incorporated disclosures for financing derivatives.
* Ref# 2018-08 – Incorporate guidance to include structured notes in scope.
* Ref #2018-30 – Incorporated hedge documentation and assessment efficiencies from ASU 2017-12.

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

**Convergence with International Financial Reporting Standards (IFRS):**

U.S. GAAP and IFRS are consistent that all derivatives are reported at fair value, with changes recognized through income unless there is an election to apply hedge accounting. With hedge accounting, under IFRS and U.S. GAAP, derivatives are still reported at fair value, but the gain/loss may be recognized through other comprehensive income (instead of income).

Staff Recommendation: NAIC staff recommends that the Working Group move this item to the active listing, categorized as nonsubstantive, and expose revisions to *SSAP No. 86—Derivatives* to include recognition and measurement guidance for derivatives that do not qualify as hedging, income generation or replication transactions. In addition to the proposed revisions specific for “other” derivatives, revisions are reflected in the headers to separate the application of existing guidance.

Working Group Question – With the language proposed, admittance of “other” derivatives under state investment laws will require a prescribed practice disclosure in Note 1. Working Group comments are requested on whether the language in the SSAP should permit admittance under state investment law. If this language was included, then a prescribed practice detailed in Note 1 would not be required.

Proposed Revisions to SSAP No. 86—Derivatives:

1. This statement addresses the recognition of derivatives and measurement of derivatives used in:
2. Hedging transactions;
3. Income generation transactions; and
4. Replication (synthetic asset) transactions.
5. Other Derivatives – (Derivatives that are not used in hedging, income generation or replication transactions.)

### Impairment

1. This statement adopts the impairment guidelines established by *SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets* (SSAP No. 5R) for the underlying financial assets or liabilities.

### Recognition of Derivatives

1. Derivative instruments represent rights or obligations that meet the definitions of assets (*SSAP No. 4—Assets and Nonadmitted Assets*) or liabilities (SSAP No. 5R)and shall be reported in financial statements. In addition, derivative instruments also meet the definition of financial instruments as defined in *SSAP No. 27—Off-Balance-Sheet and Credit Risk Disclosures* (SSAP No. 27). Should the cost basis of the derivative instrument be undefined (i.e., no premium is paid), the instrument shall be disclosed in accordance with paragraphs 44-48 of *SSAP No. 100R—Fair Value* (SSAP No. 100R). Derivative instruments used in hedging, income generation or replication (synthetic asset) transactions shall be recognized and measured in accordance with the specific provisions within this statement and are admitted assets to the extent they conform to the requirements of this statement.
2. Derivative instruments that are not used in hedging, income generation or replication (synthetic asset) transactions shall be considered “Other” derivatives. These derivatives shall be accounted for at fair value and the changes in fair value shall be recorded as unrealized gains or losses. These derivatives do not qualify as admitted assets.

### Derivatives Used in Hedging Transactions

1. Derivative instruments used in hedging transactions that meet the criteria of a highly effective hedge shall be considered an effective hedge and are permitted to be valued and reported in a manner that is consistent with the hedged asset or liability (referred to as hedge accounting). For instance, assume an entity has a financial instrument on which it is currently receiving income at a variable rate but wishes to receive income at a fixed rate and thus enters into a swap agreement to exchange the cash flows. If the transaction qualifies as an effective hedge and a financial instrument on a statutory basis is valued and reported at amortized cost, then the swap would also be valued and reported at amortized cost. Derivative instruments used in hedging transactions that do not meet or no longer meet the criteria of an effective hedge, or that meet the required criteria but the entity has chosen not to apply hedge accounting, shall be accounted for at fair value and the changes in the fair value shall be recorded as unrealized gains or unrealized losses (referred to as fair value accounting).

### Derivatives Used in Income Generation Transactions

General

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

### Derivatives Used in Replication (Synthetic Asset) Transactions

54. Replication (Synthetic Asset) transaction means a derivative transaction entered into in conjunction with other investments in order to reproduce the investment characteristics of otherwise permissible investments. A derivative transaction entered into by an insurer as a hedging or income generation transaction shall not be considered a replication (synthetic asset) transaction.

Staff Review Completed by: Julie Gann – April 2019

On May 29, 2019, the Statutory Accounting Principles (E) Working Group moved this item to the active listing, categorized as nonsubstantive, and exposed revisions to *SSAP No. 86—Derivatives*, as shown above, to include recognition and measurement guidance for derivatives that do not qualify as hedging, income generation or replication transactions.

On August 3, 2019, the Statutory Accounting Principles (E) Working Group re-exposed revisions to *SSAP No. 86—Derivatives*, as illustrated above, to clarify that “other” derivatives not used in hedging, income generation or replication shall be reported at fair value and do not qualify as admitted assets.

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