Statutory Accounting Principles (E) Working Group

**Maintenance Agenda Submission Form**

**Form A**

## **Issue:** Derivatives Hedging Fixed Indexed Products

**Check (applicable entity):**

P/C Life Health

Modification of Existing SSAP

New Issue or SSAP

Interpretation

Description of Issue:

This agenda item proposes the development of new guidance for the accounting and reporting of derivatives that effectively hedge the growth in interest credited for fixed indexed products (for example, fixed indexed annuity (FIA) and indexed universal life (IUL) reported in the general account. (NAIC staff is also investigating the classification of structured / registered indexed linked annuities (RILA) in the separate account, and the use of derivatives in the separate account to hedge risk related to these products. This assessment will be completed within a separate agenda item.) This agenda item is proposed to be substantive, with potential development of a new SSAP.

For purposes of discussion, the following definitions apply:

* Fixed Indexed Annuity (FIA) - Zero risk of loss to the policyholder (and subject to standard nonforfeiture minimum accumulation rates), interest credited based on performance of referenced index. *(This product is addressed in this agenda item.)*
* Registered Index-Linked Annuity (RILA) - Hybrid of a fixed indexed and variable annuity. Has risk of loss to policyholder, but subject to buffers / floors. (Components may be bifurcated between the general and separate account, but aspects captured in the separate account are not subject to nonforfeiture minimums). Subject to registration as a security with the SEC. *(This product may also be referred to as a “structured” index-linked annuity. This product will be discussed in a separate agenda item.)*

Current statutory accounting guidance for the accounting and reporting for derivatives is captured in *SSAP No. 86—Derivatives* and *SSAP No. 108—Derivatives Hedging Variable Annuity Guarantees*. The provisions of these SSAPs are briefly summarized as follows:

* SSAP No. 86 requires derivatives to be reported at fair value, with unrealized gains and losses recognized through surplus unless the derivative qualifies as an effective hedge. If the derivative qualifies as an effective hedge, the derivative follows “hedge accounting,” with the derivative reported at a measurement method that mirrors the hedged item. The types of hedging relationships, and criteria that determines effective hedge treatment, generally mirror U.S. GAAP. With these provisions, derivatives used to hedge fixed indexed annuities would often not qualify as effective hedges, so the derivatives would be reported at fair value. From initial assessments, the hedge of a portfolio of FIA/IUL contracts, as well as the identification as an embedded derivative, preclude obtaining a hedge effectiveness under existing U.S. GAAP and SAP. Although FASB has issued ASU 2017-12, which is still pending full statutory accounting review, from initial review, the revisions in that ASU do not assist in qualifying these hedges as effective.
* SSAP No. 108 was issued in 2018 for the specific intent to establish guidance for derivatives that effectively hedge variable annuity guarantees. This guidance was necessary due to financial statement volatility caused by a mismatch of reporting for the derivatives and the variable annuity guarantee reserve. With the adopted provisions, all derivatives are reported at fair value, but the change in fair value is recognized differently based on when the change offsets a change in the reserve (with the use of deferred assets). This approach mitigates the financial statement volatility caused by the fair value changes in qualifying derivatives. The guidance in SSAP No. 108 is significantly different from SSAP No. 86 and U.S. GAAP as it permits qualifying effective hedging assessments in dynamic and macro hedging programs. Use of SSAP No. 108 is restricted, and is limited to annuity contracts and other contracts involving certain guaranteed annuity 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).

Accounting / Reporting Issue

It has been identified that there is a mismatch of accounting provisions when derivatives are used to hedge the growth in interest credited to reserves (liability). Although the derivative may be an effective hedge to the interest credited for the performance of a referenced index, under the provisions of SSAP No. 86, the derivative does not qualify for hedge accounting. As such, the derivative is reported at fair value, with fair value changes recognized as unrealized gains or losses through surplus. With this reporting, the results of the effective hedge do not directly offset the change in reserve recognized in the summary of operations during the hedging period. The ultimate impact is the effective hedge is not illustrated in the company’s performance results within the financial statements, and the current reporting creates a presentation of additional surplus volatility from the use of derivatives, although they are effectively hedging the growth in interest that will be credited to the policy as a direct result of related indices.

Although specialized guidance was developed in SSAP No. 108 to address derivatives hedging variable annuity guarantees, the guidance in SSAP No. 108 cannot be easily adapted to incorporate derivatives hedging the growth in interest credited to FIA/IUL reserves. This is primarily because the fundamental hedging provisions in SSAP No. 108 utilize a fair value hedging approach. Under that approach, the fair value change of the hedging instruments is compared to the fair value change of the variable annuity reserves to determine effectiveness. However, for derivatives hedging the growth in interest credited for FIA/IUL reserves, determination of effectiveness is driven by a cash flow hedge assessment. Meaning, that the hedging derivative will produce cash flows that will offset the indexed-based interest crediting rate in the hedged reserves.

Although the programs may vary significantly by company, it is anticipated that the following elements may be present in these derivative arrangements:

* Designation of many hedged items that reflect bundles of FIA/IUL contracts with similar terms/crediting dates hedged with a single derivative (or portfolio of derivatives) to exactly mirror the terms of the crediting rate, resulting with the intent of a perfect hedge. (It is anticipated that a reporting entity would have many outstanding derivative structures to cover various bundles of FIA contracts.)
* Continuous assessment of hedge, noting deviations between the intended perfect match due to changes in the portfolio of hedged items (e.g., policy lapses) or slight issues with execution (e.g., timing delay in derivative acquisition) or maturity dates (e.g., 360 instead of 365 days).
* Incorporation of additional derivatives (macro/dynamic) as needed to overlay the entire structure to address deviations in the intended match and ensure effective coverage of risk of the FIA/IUL crediting rate.

Proposed Concepts to Address Reporting Mismatch:

This agenda item proposes to incorporate new statutory accounting guidance to establish accounting and reporting concepts that properly represent the use of effective hedges for indexed products in the general account. From an initial assessment, it appears that there are two potential approaches to consider:

1. Approach 1: Establish guidance that permits effective hedge treatment that is in line with SSAP No. 86. With this approach, the derivative would be reported at amortized cost, with direction that the fair value changes in the hedging derivative (at settlement) would be recognized to net investment income (or realized gains and losses) to offset the recognized change in FIA/IUL reserve. With this approach, the derivatives would change the SAP measurement method (from fair value to amortized cost) and result with a disconnect from U.S. GAAP in the derivative reported value as all derivatives are required to be reported at fair value under U.S. GAAP. This approach would not reflect changes in the derivative position (e.g., if in a loss or gain position) in the financials, so the actual assets / liabilities from derivative activity would not be shown on the balance sheet. However, this approach would eliminate artificial volatility in derivative fair value changes through surplus while the derivative is open. The key provisions would include:
   1. Establishing guidance that permits derivatives to qualify as effective hedges. As the hedged item is a portfolio of contracts resulting with an ongoing reserve liability, the guidance would likely need to consider concepts that permit structures that would not qualify as effective under existing SSAP No. 86 provisions.
   2. Guidance that directs the reporting of derivative changes at settlement as net investment income (or realized gains and losses) to offset the indexed-based interest credited to FIA/IUL reserves.

This approach is partly in line with the legislation prescribed by the IA Insurance Division. However, that legislation addresses both derivative measurement method and the process to recognize the reserve change. (The IA legislation guidance permits recognizing the reserve change in the same timeframe that the contract holder is credited the reserve change.) From initial industry discussion, if only derivative measurement method is addressed under SAP, this could create greater volatility, even if using an amortized cost measurement method. Additionally, the IA approach only permits certain derivatives to be reported at amortized cost under this approach (e.g., call spreads). Futures, swaps and swaptions are required to be reported at fair value even if they are part of the overall effective hedging program.

1. Approach 2: Establish guidance that permits effective hedge treatment that is in line with SSAP No. 108. With this approach, the derivative would be reported at fair value, with direction that the change in fair value is bifurcated for reporting based on whether the change is an effective hedge to the interest crediting rate change in the hedged FIA/IUL reserve. This approach would be more in line with U.S. GAAP with the use of fair value for the reported value of derivatives and would be designed to recognize the derivative and reserve change at the same time through the income statement. This approach would require assessment as to any fair value fluctuation that does not offset the crediting rate and require separate reporting guidance for those changes. The key provisions would include:
   1. Establishing guidance that permits derivatives to qualify as effective hedges. As the hedged item is a portfolio of contracts resulting with an ongoing reserve liability, the guidance would likely need to consider concepts that permit structures that would not qualify as effective under existing SSAP No. 86 provisions. *(This provision is consistent between the two options.)*
   2. Incorporation of guidance that directs the reporting of fair value changes based on whether they offset the reserve crediting rate. If mirroring the concepts of SSAP No. 108:
      1. Create a timing match to offset the reserve change in the income statement with the derivative change in fair value. This option would likely utilize the “deferred asset” concept for fair value fluctuations that occur in interim periods before settlement. For example, if the product credits interest from the index changes on an annual basis, and there are effective hedges that mirrors this timeframe, the fair value change in the interim periods would be recognized as deferred assets/liabilities, rather than as unrealized gains and losses. With the recognition of the reserve change, the deferred item would be reversed for a coinciding change to net investment income (or realized gains and losses). Although similar to SSAP No. 108, it is anticipated that deferred items would be eliminated over a shorter timeframe, with reversal immediately with the policy reserve change, and not amortized over time. It is expected that most product rate changes occur annually, but variations with 2-year, 5-year and perhaps longer stated periods may exist.
      2. Review and establish guidance (as appropriate) for the recognition of derivative fair value changes, for derivatives identified to as in effective hedges, that do not offset the reserve change from interest credited. (For example, is following concepts from SSAP No. 108, those changes would continue to be reflected as unrealized gains or losses until the derivative closed.) Discussion is expected to identify the presence of such situations and differing dynamics for derivatives hedging indexed products in comparison to variable annuity products.

Existing Authoritative Literature:

* *SSAP No. 86—Derivatives:* This SSAP 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.

Overview of SAP Accounting – SSAP No. 86

1. Derivative instruments used in hedging transactions that meet the criteria of a highly-effective hedge are considered “effective” and are permitted to be valued and reported in a manner consistent with the hedged asset or liability (referred to as hedge accounting). (P. 20)
2. Derivative instruments used in hedging transactions that do not meet, or no longer meet the criteria of a highly-effective hedge, or that meets the required criteria by the entity has chosen not to apply hedge accounting, shall be accounted for at fair value, with changes in fair value recorded as unrealized gains or unrealized losses (referred to as fair value accounting). (P. 20)
3. Entities are permitted to designate instruments to hedge changes in fair value, variations in cash flows or foreign currency exposure. Although these hedging categories are consistent with U.S. GAAP, U.S. GAAP has more restrictions than SAP for when designations may occur, and U.S. GAAP identifies specific instruments ineligible for designation as hedging instruments. (P. 23)
4. Measurement of hedge effectiveness for a particular hedging relationship shall be consistent with the entity’s risk management strategy and the method of assessing hedging effectiveness that was documented at the inception of the hedging relationship (P. 37)
5. For contracts that qualify for hedge accounting, the change in the carrying value or cash flow of the derivative is to be recorded consistently with how changes in the carrying value or cash flow of the hedged item is recorded. Upon termination of a derivative that qualifies for hedge accounting, the gain or loss shall adjust the basis of the hedged item and be recognized in income in a manner that is consistent with the hedged item. Alternatively, if the item is being hedged is subject to IMR, the gain or loss on the hedging derivative may be realized and shell be subject to IMR after termination.) Entities who choose the alternative method shall apply it consistently thereafter. (P. 22)

* *SSAP No. 108—Derivatives Hedging Variable Annuity Guarantees:* This SSAP establishes statutory accounting principles for limited derivatives hedging variable annuity guarantee benefits subject to fluctuations as a result of interest rate sensitivity. The provisions within this statement are 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. The provisions within this statement are only permitted if all of the components of the statement are met and shall not be inferred as an acceptable statutory accounting approach for derivative transactions that do not meet the state qualifications or that are not specially addressed within the guidance.

Overview of SAP Accounting – SSAP No. 108

1. All derivative instruments are recognized at fair value. (P. 12)
2. Changes in fair value attributed to the hedged risk are recognized as either immediate offsets to the change in reserve liability as realized gains/losses or recognized as deferred assets and liabilities and amortized into realized gain or losses based on the duration of benefit cash flows, not to exceed 10 years. Changes in derivatives that are not attributable to the hedged risk shall be recognized as unrealized gains or losses. (Special surplus is allocated for the net deferred asset or liability.) (P. 13-14)
3. Guidance allows entities to utilize a specified derivative, or a portfolio of specified derivative as the hedging instrument. The hedging instrument can also reflect a dynamic hedging strategy in which a portfolio of derivatives can be rebalanced in accordance with changes to the hedged item in order to adhere to a the specified, documented hedging strategy. (Meaning, the derivatives can be rebalanced to reflect the annuity reserve – taking into consideration the termination / addition of annuity contracts.) (P. 5)
4. Guidance requires specific hedge effectiveness criteria, with the hedging relationship being highly effective in achieving offsetting changes in fair value attributed to the hedge risk during the period that the hedge is designated. This requires reporting entities to calculate the fair value of the hedged item at inception and on an ongoing basis and comparing the fair value change of the hedged item to the fair value change of the hedging instruments to determine whether the relationship is highly effective on a cumulative basis. (P. 10)
5. Application of SSAP No. 108 requires explicit approval from the domiciliary commissioner as well as actuarial certifications. Specific disclosures, as well as a separately Schedule DB-E reporting schedule tracks specific information for the derivatives and the recognition of deferred assets/liabilities. (P. 6 & 23.)

Overview of U.S. GAAP Accounting – U.S. GAAP guidance is based on four cornerstones (815-10-10-1):

1. 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.*

1. 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.*

1. 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.*

1. 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.*

Activity to Date (issues previously addressed by the Working Group, Emerging Accounting Issues (E) Working Group, SEC, FASB, other State Departments of Insurance or other NAIC groups): The following items are noted as recent actions:

* SSAP No. 108 was adopted in 2018, with a Jan. 1, 2020 effective date, to establish specific guidance for derivatives hedging variable annuity guarantees.
* In August 2017, the FASB issued *ASU 2017-12, Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities* to improve the financial reporting of hedging relationships to better portray the economic results of an entity’s risk management activities in its financial statements. In addition, the amendments make certain targeted improvements to simplify the application of the hedge accounting guidance in current U.S. GAAP based on feedback received from preparers, auditors, users and other stakeholders. The ASU did not make any modifications to the four U.S. GAAP cornerstones on the accounting for derivatives in ASC 815-10-10-1. Although a separate agenda item incorporated limited provisions from this ASU into SSAP No. 86 related to hedge effectiveness (Ref #2018-30), the review of this complete ASU (and overall derivatives for SAP) is a pending item for the Working Group. Although the ASU is over 400 pages, the revisions can be briefly categorized as follows:

1. Amendments permit hedge accounting for risk components in hedging relationships involving nonfinancial risk and interest rate risk in specific scenarios.
2. Amendments change the guidance for designating fair value hedges of interest rate risk and for measuring the change in fair value of the hedged item in fair value hedges of interest rate risk.
3. Amendments align the recognition and presentation of the effects of the hedging instrument and the hedged item in the financial statements to increase the understandability of the entity’s intended hedging strategies. The revisions require an entity to present the earnings effect of the hedging instrument in the same income statement line item in which the earnings effect of the hedged item is reported. Furthermore, these amendments eliminate the separate measurements and reporting of hedge ineffectiveness.
4. Amendments expand the components in a hedging instrument allowed to be excluded in the assessment of hedge effectiveness and provide elective accounting guidance for the excluded components.
5. Amendments include targeted improvements to ease the application of assessing hedge effectiveness.
6. Amendments modify existing disclosures and incorporate a tabular disclosure related to the effect on the income statement of fair value cash flow hedges.

* In November 2018, the Working Group adopted revisions to SSAP No. 86 to incorporate revisions to reflect hedge documentation and assessment efficiencies from *ASU 2017-12, Derivatives and Hedging – Targeted Improvements to Accounting for Hedging Activities.*
* The Iowa Insurance Division has shared the following guidance that is permitted in their state:

*(Per IA, although both are permitted, a majority of their domestic companies elect to follow the legislation.)*

* + Legislation / *Chapter 97: Accounting for Certain Derivative Instruments Used to Hedge the Growth in Interest Credited for Indexed Insurance Products and Accounting for the Indexed Insurance Products Reserve*. This guidance permits, at the election of the entity, amortized cost for eligible derivative assets. (It specifically excludes derivatives that do not have an amortized cost, including futures, swaps and swaptions.) Additionally, it utilizes a reserve calculation methodology in which interest credits based upon one or more indices are included in the reserve only after those interest credits have been credited to the contract holder under the terms of the annuity contract.

<https://www.legis.iowa.gov/docs/iac/chapter/09-26-2018.191.97.pdf>

* + *Bulletin 06-01: Accounting for Derivative Instruments Used to Hedge the Growth in Interest Credited for Index Products*. This bulletin permits insurance entities to recognize changes in the fair value of derivatives in the summary of operations consistently with how changes in indexed product reserves are recorded. (Under this bulletin, derivatives continue to be reported at fair value.)

<https://iid.iowa.gov/documents/commissioners-bulletin/accounting-for-derivative-instruments-used-to-hedge-the-growth-in>

* It is anticipated that other states may also have issued legislation or bulletins addressing derivatives hedging FIA/IUL products, and NAIC staff will review those provisions throughout the discussion process.

**Information or issues (included in *Description of Issue*) not previously contemplated by the Working Group:**

None

**Convergence with International Financial Reporting Standards (IFRS):** Pursuant to ASU 2017-12, although the language used to describe hedge accounting guidance in the ASU and *IFRS 9, Financial Instruments*, differs, there are several areas of alignment between the two standards, and it is expected that many common hedge accounting strategies will have similar outcomes related to hedging components of financial instruments and nonfinancial terms and in the measurement of hedged items in fair value hedges of interest rate risk. However, differences remain between the two standards in the criteria for qualifying for hedge accounting. Additionally, IFRS 9 retained the separate measurement and reporting of hedge ineffectiveness and does not have broad guidance on presentation.

Staff Recommendation:

NAIC Staff recommends that the Working Group move this item to the active listing, initially categorized as substantive and expose the agenda item to solicit comment from state insurance regulators and industry on establishing accounting and reporting guidance for derivatives hedging the growth in interest for fixed indexed products. In addition to the two general options presented in the agenda item, NAIC staff is open for additional commentary and suggestions, and requests to work with industry throughout the process similar to the collaborative efforts that occurred when developing the guidance in SSAP No. 108. With this exposure, NAIC staff recommends notification to the Life Actuarial (E) Task Force.

Pursuant to preliminary information received, NAIC staff has an initial impression that pursuing an approach similar to SSAP No. 108 (use of fair value with deferred assets/liabilities as a mechanism to timely match effective hedge changes through the summary of operations) may be more beneficial to both industry and regulators with improved reporting in the financial statements. This is because the focus of the SAP changes will be on derivative measurement and recognition and will not encompass changing reserve calculations (or the timing of reserve impacts). NAIC staff plans to proceed with starting an issue paper during the exposure period (as time allows). As such, initial informal comments and aspects to consider are requested throughout the exposure period.

Staff Review Completed by:

Julie Gann - NAIC Staff

October 2020

**Status:**

On November 12, 2020, the Statutory Accounting Principles (E) Working Group moved this item to the active listing, categorized as substantive, and exposed the agenda item to solicit comment from state insurance regulators and industry on establishing accounting and reporting guidance for derivatives hedging the growth in interest for fixed indexed products. In addition to the two general options presented in the agenda item, the Working Group is open for additional commentary and suggestions, and directs NAIC staff to work with industry throughout the process similar to the collaborative efforts that occurred when developing the guidance in *SSAP No. 108—Derivatives Hedging Variable Annuity Guarantees*. With this exposure, notification to the Life Actuarial (E) Task Force will occur.

On March 15, 2021, the Statutory Accounting Principles (E) Working Group re-exposed this agenda item to provide additional time for interested parties to develop a proposal. NAIC staff will work with interested parties in the interim to discuss this agenda item and potential options.

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