Statistical Accounting Principles (E) Working Group
Maintenance Agenda Submission Form
Form A

Issue: Effective Derivatives – ASU 2017-12

Check (applicable entity):

	P/C	Life	Health
Modification of existing SSAP	☒	☒	☒
New Issue or SSAP	☐	☐	☐
Interpretation	☐	☐	☐

Description of Issue:
To be consistent with what is permitted under U.S. GAAP, this agenda item has been prepared to consider expanding the statutory accounting principles (SAP) guidance in *SSAP No. 86—Derivatives* in the determination of highly effective hedging derivatives. In 2017, the FASB issued *Accounting Standard Update* (*ASU) 2017-12: Derivatives and Hedging: Targeted Improvements to Accounting for Hedging Activities* to reduce complexity and align hedge accounting with risk management activities. The Working Group previously considered limited revisions from this ASU, mostly on documentation requirements, which occurred in agenda item *2018-30: SSAP No. 86 – Hedge Effectiveness Documentation*. That agenda item was identified as limited-scope and noted further consideration of ASU 2017-12, potentially in a broader derivative project, would subsequently occur. With the focus of other projects, and COVID-19 impacts, this broader derivative project is still pending.

NAIC staff have been contacted by industry and regulators requesting further consideration of ASU 2017-12, particularly with regards to the permitted derivative arrangements that U.S. GAAP allows as highly effective hedges. Due to the revisions from ASU 2017-12, there is a disconnect between U.S. GAAP and SAP regarding certain types of effective hedging relationships. This is problematic as it results in inconsistent documentation of hedging transactions, as well as hinders reporting entities in electing to enter hedging transactions as the benefits are not currently permitted to be reflected in statutory financials.

<u>Although NAIC staff agree that the determination of whether a hedge is highly effective should be consistent between U.S. GAAP and SAP, it is important to highlight that accounting for effective hedges varies greatly between U.S. GAAP and SAP</u>. The effective hedging relationships permitted under ASU 2017-12 have been identified to expand upon these differences and could result with reporting elements that were not originally intended with the statutory accounting guidance adopted under SSAP No. 86. Although consistent effective hedge assessments between U.S. GAAP and SAP are desired, NAIC staff note that it is appropriate to identify how the expanded U.S. GAAP effective hedge assessments would be reflected within statutory financials and identify areas where clarifications or modifications may be needed as part of the process to consider the expanded effective hedge provisions. To be clear, the expanded hedge relationships permitted within ASU 2017-12 do not create the statutory accounting issues identified within this agenda item, however, the expanded effective hedging relationships would exacerbate the reporting issues within SSAP No. 86. (For example, although existing SAP guidance permits derivative adjustments to the hedged item, which can be a liability, such transactions are currently limited as the maturity of the hedging instruments (derivative) likely mirrors the hedged item's maturity. This is because the matching of maturities under the current SAP guidance facilitates an easier effective hedge determination.) With the ASU's expanded provisions for "partial term hedges" (as discussed within), adjustments will occur to the hedged item prior to its maturity, resulting in direct impacts to the presentation of the hedged item in statutory financial statements – which may not be easily identifiable to users.)

Overview of U.S. GAAP and SAP Derivative Reporting:

Under U.S. GAAP, the decision to document a hedge as effective has no impact on the balance sheet measurement of the derivative. Under U.S. GAAP, all derivatives are always reported at fair value; therefore, there is no "off-balance sheet" derivative risk exposure. As highly effective hedging derivatives are an income-statement matching tool, when a fair value hedge is effective, the change in fair value of the derivative offsets the change in fair value of the hedged item in the income statement. For cash flow hedges, changes in the fair value of the derivative are reported through other comprehensive income (OCI) and amortized into earnings. When a derivative is not identified as highly effective, the matching of changes through the income statement simply does not occur. Regardless of whether a derivative is used in a highly effective hedge, under U.S. GAAP all derivatives are fully recognized on the balance sheet with fair value changes or cash flows from the derivatives fully recognized either to income or OCI.

Under SAP, the determination of an effective hedge has a significant impact on the reported value of derivatives and the presentation of derivatives in the financial statements. As the statutory guidance permits derivatives to mirror the measurement method of the hedged item, if the hedged item is reported at amortized cost, then a highly effective derivative is also reported at amortized cost. (Under U.S. GAAP, the reporting basis of the hedged item in a fair value hedge is made to match the derivative (i.e., fair value). The opposite is true under SAP.) It. should be noted that SSAP No. 86 was originally drafted based on an assumption that it would predominantly be used for the hedging of assets reported at amortized cost or fair value. Hedges of liabilities, particularly reserve liabilities valued using statutory reserve requirements, do not fit neatly into the amortized cost or fair value framework permitted by SSAP No. 86. Such liabilities are not valued using either fair value or amortized cost, therefore reporting the hedging instrument at amortized cost still creates reporting mismatches. Furthermore, adjustments to the hedged item, as permitted under SSAP No. 86, can result with a financial statement presentation that appears to show a reduction of a liability, although the reporting entity's contractual obligation has not been reduced.

If using an amortized cost measurement method, the initial recognition of the derivative is at cost (which could be zero), and subsequent changes in the fair value of the derivative are not recognized. So, if the fair value of the derivative was to move to a liability position (effectively offsetting a fair value increase in a hedged item), the derivative liability is not recognized. The derivative side of this transaction is considered an off-balance sheet surplus risk that exists until the hedging relationship expires. If a hedging relationship was no longer highly effective, the derivative would be recognized at fair value. At that time, the financial statements would reflect the derivative position that was outstanding. (For a derivative in a liability position, this would be a negative impact to surplus.) As one last point, the determination of a highly effective hedge generally permits a range between 80-125%. As such, a derivative instrument's fair value that is expected to move in conjunction within a range of 20-25% of the underlying hedged item's fair value is considered an effective hedge. Under the SAP guidance, this means that if the fair value of the hedged asset was to increase 100 and the fair value of the hedging derivative was to decrease 120, the hedge would still be considered effective and the change in the derivative fair value would not be recognized in the financial statements. At the time the asset matured, and the derivative was closed, the reporting entity would have an additional liability of $20 that was not previously recognized on the financial statements and not offset by the corresponding increase in the hedged item.

While it is important that the impact of the SAP hedging guidance be clearly understood, as initially noted, NAIC staff agree that assessments of hedge effectiveness are preferred to be consistent between U.S. GAAP and SAP. However, by expanding the SAP guidance to permit effective hedges allowed under ASU 2017-12, pursuant to the existing measurement provisions within SSAP No. 86, there would be an increase to the off-balance sheet surplus risk noted above from the hedging activity. Also note, this increase in off-balance sheet exposure does not necessarily correlate to an increase in economic risk, as the hedging relationships allowed under the GAAP ASU are expected to allow for prudent risk management strategies that would be expected to decrease economic risk. In addition, other nuances in SAP reporting have the potential to be more pronounced under the expanded effective hedge assessments. As detailed within the recommendation section, NAIC staff recommend review, with possible modification, of certain elements within SSAP No. 86 as part of this review of ASU 2017-12. However, these recommendations do not initially include a fundamental change in the SAP provisions that permit an amortized cost measurement method for highly effective derivatives if hedging an item not reported at fair value. Regulator and industry comments are welcome on whether a fundamental change to the measurement and reporting of derivatives should be considered to be consistent with U.S. GAAP. If there is support for a fair value measurement approach for all derivatives, then consideration of offsetting surplus adjustments for the fair value volatility – similar to what is permitted in *SSAP No. 108—Derivatives Hedging Variable Annuity Guarantees* would also be considered.

Review of Effect Hedge Arrangements Permitted Under ASU 2017-12:

The derivative arrangements / changes permitted under U.S. GAAP through ASU 2017-12 and addressed within this agenda item are identified as follows:

- Partial Term Hedging
- Last of Layer
- Hedges of Interest Rate Risk When the Hedged Item Can be Settled Before Scheduled Maturity
- Expansion of Excluded Derivative Components in Assessment of Hedge Effectiveness

Partial Term Hedging:
This provision allows reporting entities to enter into fair value hedges of interest rate risk for only a portion of the term of the hedged financial instrument. Prior to the ASU, these sorts of arrangements were not successful in being identified as highly effective due to offsetting changes in the fair value as a result of the difference in timing between the hedged item's principal repayment and the maturity date of the hedging derivative. Under ASU 2017-12, an entity may measure the change in the fair value of the hedged item attributable to changes in the benchmark interest rate by "using an assumed term that begins when the first hedged cash flow begins to accrue and ends when the last hedged cash flow is due and payable." Also, the hedged item's assumed maturity will be the date on which the last hedged cash flow is due and payable, therefore a principal payment will be assumed to occur at the end of the specified partial term.

The example provided under U.S. GAAP involves outstanding fixed rate debt. So, if an entity was to issue $100 million of five-year, noncallable, fixed-rate debt, the entity could designate a two-year, receive-fixed, pay variable, $100 million notional interest rate swap as a fair value hedge of the interest rate risk for the first two years of the debt's term. When calculating the change in the fair value of the debt attributable to changes in interest rate risk, the entity may assume that 1) the term of the hedged debt is two years, and 2) repayment of the outstanding debt occurs at the end of the second year. The ASU also permits use of the shortcut method to these partial-term fair value hedges of interest rate risk.

SAP Assessment – With the differences in reporting between U.S. GAAP/SAP, the key issue to highlight is that with SAP's amortized cost approach at the conclusion of the hedged period, the reporting entity would close the derivative with an offsetting entry that adjusts the basis of the hedged item. When hedging a liability (such as issued debt), if the derivative were in a liability position (satisfied with a credit to cash), the mechanics would result in an offsetting entry to reduce the debt (debit to the issued debt). However, this reduction to the debt does not reflect an actual reduction of the liability that the entity is legally obligated to pay, it just reduces the amount reported as outstanding debt in the financial statements. The debt would accrete back up to the full liability with increased entries to interest expense over the remaining term of the debt. (Ultimately, under GAAP, the fair value change in the derivative and debt are recognized concurrently in the income statement. Since SAP does not report these items at fair value, the change reduces the debt at the time of derivative close, and then the debt obligation accretes back up over time with an offsetting entry to interest expense.) Although this is in line with existing SSAP No. 86 guidance, under the past effective hedge provisions, the debt obligation maturity would likely be matched with the derivative term, so there would be no lingering financial statement impact to the debt obligation after the derivative transaction closed. With the partial term hedge, reporting entities have the potential to present an improved financial statement presentation over the remaining life of the hedge item (e.g., debt instrument) until accreted back to the full amount. The SAP guidance also has an alternative to take the adjustment directly to IMR (instead of to the hedged item). There is uncertainty on which approach is used in practice, and whether it varies based on the hedged item (e.g., hedging an asset or liability). Although there is a limited information in Schedule DB on adjustments to the hedged item, that information is only for the current year, and it does not provide detailed information on the overall impact to the financial statements.

Items to Consider: Although the current guidance in SSAP No. 86 is explicit that the effective hedge adjusts the basis of the hedged item (or is reflected in IMR), the Working Group may want to consider revising this guidance to prevent a presentation that shows a reduced outstanding liability when in fact there has been no actual reduction of the obligation. Consideration could be given to directing these derivative adjustments to a specific reporting line. Although this would not change the overall financial statements, (a more favorable presentation could still exist), the debt obligation (or any liability hedged) would still be presented as the amount that corresponds to the obligation outstanding and not reflect the impact of derivative transactions. Furthermore, if a specific line was utilized, the impact of these derivative transactions would be identifiable within the financial statements. As noted, this dynamic exists under the current SSAP No. 86 guidance, but is less pronounced as the derivative term most commonly matches the debt's obligation term. As such, the final resulting entries all occur (generally) at debt maturity. With the increased ability to establish effective hedges that do not mature at the same time as the hedged item, the impact from these derivative transactions would increase situations in which liabilities are presented that do not reflect the full outstanding obligation.

Staff Note – The adjustment to the hedged item also occurs when effectively hedging an asset item. However, in that dynamic for a fair value hedge, the assets would only be increased to reflect the fair value change. (The offsetting entry in response to a derivative in a liability position would be a debit to the hedged asset.) Although the use of effective derivatives may facilitate an ability to increase the reported value of assets to current fair value, the amount reported for the asset would still be subject to impairment and collectability assessments. NAIC staff view this dynamic differently than a hedge of a liability when the resulting transaction reduces the amount shown as an obligation on the financial statements (debit to the liability) as nothing has occurred that has actually reduced the reporting entity's obligation.

Last of Layer / Portfolio Method

Under the "last of layer" hedge method, for a closed portfolio of prepayable financial assets, the entity may designate as the hedged item, a stated amount of the asset or assets that are not expected to be affected by prepayments, defaults and other factors affecting the timing and amount of cash flows if the designation is made in conjunction with the partial term hedging election. The "last of layer" hedge provision is permitted only for a closed portfolio of prepayable financial assets, or one or more beneficial interests secured by a portfolio of prepayable financial instruments (e.g., mortgage-backed securities). Industry comment letters to FASB have requested that liabilities, particularly insurance liabilities, be added to the scope, but that is not currently permitted under U.S. GAAP.

For this option, as part of the initial hedge documentation, an analysis shall be completed and documented to support the entity's expectation that the hedged item (that is, the designated last of layer), is anticipated to be outstanding as of the hedged item's assumed maturity date in accordance with the entity's partial-term hedge election. That analysis shall incorporate the entity's current expectations of prepayments, defaults, and other events affecting the timing and amount of cash flows associated with the closed portfolio of prepayable financial assets or beneficial interests secured by a portfolio of prepayable financial instruments. For purposes of the analysis, the entity may assume that as prepayments, defaults, and other events affecting the timing and amount of cash flows occur, they first will be applied to the portion of the closed portfolio of prepayable financial assets or one or more beneficial interest that is not part of the hedged item - (i.e., not part of the designated last layer.)

Proposed amendments to the ASU are currently being considered by the FASB to provide additional clarifying guidance. One of those elements clarifies that a closed portfolio is not limited to a single hedge. Rather, there can be multiple-layer hedges utilized in a closed portfolio. In response to this proposed clarification, the FASB is changing the name of "last of layer" and renaming it the "portfolio layer method." Also, since the hedged item reflects a closed portfolio of assets, the FASB has clarified that the change in fair value (gain or loss) of the hedged item (portfolio of assets) attributed to the hedged risk shall not adjust the carrying value of the individual assets in the portfolio. Instead, that amount shall be maintained on a closed portfolio basis and amortized to earnings, with amortization beginning when the hedged item ceases to be adjusted for changes in its fair value attributable to the risk being hedged. However, the gain or loss shall be fully amortized prior to the assumed maturity date of the hedged item. *(Note: FASB has identified that allocating adjustments to individual assets may lead to uneconomic results if an asset is sold or removed from a closed portfolio. They have also noted that an allocation election would lead to a lack of comparability across entities and potential for earning management.)*

A key aspect to note is that the GAAP guidance will allow a single derivative to hedge different portfolio layers. In the event one layer was to no longer be considered highly effective, the portion of the derivative to hedge that layer would be removed, and the effective hedge for the remaining layers could continue.

<u>*SAP Assessment*</u>: For the last of layer / portfolio method, the overall accounting guidance under U.S. GAAP is consistent with existing derivative structures, just expanded on what can be designated as the hedged item and an exception that the entity shall not adjust the basis of the individual items combined into the portfolio. The biggest aspect with this change will be the assessment and documentation to confirm hedge effectiveness. This hedging option will require more work and documentation then a hedge of a single asset. However, if a reporting entity is effectively hedging under GAAP, without the SAP provisions for hedge accounting, then a reporting entity would have to recognize the hedging derivatives at fair value, which would create surplus volatility in their SAP financials.

<u>**Items to Consider:**</u> Although it seems that the derivative transaction is generally consistent with what would be anticipated under SSAP No. 86, except on a portfolio basis, there are key elements that should be addressed to facilitate the application of these methods under SAP:

- Incorporating the last of layer / portfolio method into SAP will require discussion (and likely revisions) to ensure that individual assets are not adjusted at hedge termination, and that a portfolio approach is utilized. This would be consistent with the current direction of FASB to clarify the guidance in a subsequent ASU. If revisions are not incorporated to have a "portfolio" basis for adjustment, then revisions will be needed on how to allocate the resulting gain/loss to the individual assets within the closed portfolio.

- Guidance should be considered to limit this derivative strategy to the same scope permitted under U.S. GAAP. This would require an explicit prohibition of the last of layer / portfolio method to liabilities, including insurance liabilities. Although the "framework" of U.S. GAAP derivative guidance is adopted in SSAP No. 86, statutory accounting guidance permits hedging transactions to be classified as highly effective when they would not be permitted that classification under U.S. GAAP. As such, limiting application to the same parameters of U.S. GAAP would be a new addition to SSAP No. 86.

- A key aspect of this proposed method (and of the excluded components expansion discussed below) is that under U.S. GAAP derivatives are permitted to be bifurcated in terms of effectiveness. That is, if a portion of a derivative were deemed to be highly effective in hedging an item, the fair value change related to that portion would be recognized in the income statement to match the fair value change of the hedged item. Fair value changes to other portions of the derivative that were not highly effective would still be recognized, but without the matching concept to the same reporting location as the fair value changes of the hedged item. Under SSAP No. 86, the guidance is explicit that a derivative is not bifurcated as to hedge effectiveness. So, a derivative shall be either classified as an effective hedge and permitted for amortized cost reporting (if consistent with the valuation of the hedged item) or classified as an ineffective hedge and reported at fair value. To mirror U.S. GAAP on the ability to designate a portion of a derivative, revisions would need to be considered to the current SSAP No. 86 guidance. If revisions permit the bifurcating of derivatives, then consideration would have to occur on how bifurcated derivatives would be reported in the *Schedule DB – Derivative Instruments.* (Particularly, on whether the derivative BACV should reflect a combined fair value (FV) and amortized cost (AC) reported value or whether the derivative shall be divided and reported separately based on portions held at FV and AC.) NAIC staff have heard that bifurcating derivatives does already occur in practice, as the guidance in SSAP No. 86 - Exhibit B for the exclusion of the time value of money implies that it should be permitted. From initial information received from industry, in those limited situations it is believed that the derivative is reported on a single line with a combined BACV that reflects a combination of FV and AC. However, NAIC staff believe these instances are uncommon, but would become more prominent if the last of layer / portfolio method approach was adopted for statutory accounting.

- Lastly, it is proposed that this method only be incorporated once the proposed ASU is finalized. (The last of layer is detailed in the 2017 ASU, but the clarifying guidance is in a current proposed ASU which is expected to be finalized by the end of the year.)

<u>Fair Value Hedges of Interest Rate Risk in Which the Hedged Item Can be Settled Before Scheduled Maturity:</u>
Under these U.S. GAAP revisions, an entity may consider only how changes in the benchmark interest rate affect the decision to settle the hedged item before its scheduled maturity. (For example, an entity may consider only how changes in the benchmark interest rate affect an obligor's decision to call a debt instrument - when it has a right to do so.) The entity need not consider other factors that would affect this decision (for example, credit risk) when assessing hedge effectiveness.

With this provision, U.S. GAAP guidance has also been added to specify the measurement of the hedged item. This guidance indicates that the factors incorporated for the purpose of adjusting the carrying amount of the hedged item shall be the same factors that the entity incorporated for the purpose of assessing hedge effectiveness. For example, if an entity considers only how changes in the benchmark interest rate affect an obligor's decision to prepay a debt instrument when assessing hedge effectiveness, it shall also only consider that factor when adjusting the carrying amount of the hedged item. The election to consider only how changes in the benchmark interest rate affect an obligor's decision to prepay a debt instrument does not affect an entity's election to use either the full contractual coupon cash flows or the benchmark rate component of the contractual coupon cash flows determined at hedge inception for purposes of measuring the change in fair value of the hedged item. With this guidance, an investor is not required to consider all factors that will affect the decision to settle the financial instrument before its scheduled maturity when assessing hedge effectiveness and measuring the change in fair value of the debt attributed to changes in the benchmark interest rate. This change was made as estimating the fair value of the prepayment option to the level of precision required in the current reporting and regulatory environment is virtually impossible because an entity is required to incorporate credit and all other idiosyncratic factors that would affect the prepayment option. It was noted that allowing a prepayment option to be modeled considering only the change in the benchmark interest rate more closely aligns the accounting for those hedges with an entity's risk management activities and more accurately reflects the change in the fair value of the hedged item attributable to interest rate risk.

<u>*SAP Assessment*</u>: Existing guidance in SSAP No. 86 incorporates the prior criteria for fair value hedges from U.S. GAAP, which includes guidance that has been eliminated in the ASU. The U.S. GAAP guidance has been expanded to specifically capture elements related to assessing effectiveness of prepayable instruments.

<u>**Items to Consider:**</u> Like other elements, the change in assessment of effectiveness, and determining the measurement / adjustment to the hedged item will require SAP consideration as to the offsetting measurement aspects and how those should be recognized in the financial statements.

<u>Expansion of Excluded Derivative Components from Assessment of Hedge Effectiveness</u>
Industry has also requested consideration of the FASB guidance that expands the ability to exclude components of a derivative from the assessment of hedge effectiveness. Under prior U.S. GAAP (which is adopted in SSAP No. 86), the guidance permitted the exclusion of the time value of money, and the guidance in the ASU has expanded that prior capability to also allow exclusion of the portion of the fair value of a currency swap attributable to a cross-currency basis spread.

<u>SAP Assessment</u>: The current guidance in *SSAP No. 86, Exhibit B – Assessment of Hedging Effectiveness* incorporates U.S. GAAP guidance from FAS 133, with a significant portion addressing the exclusion of a hedging instrument's time value from the assessment of hedging effectiveness. This old U.S. GAAP guidance has been revised from ASU 2017-12, to expand the potential exclusions and update the related guidance. As previously noted, the existing guidance in Exhibit B appears to contradict the guidance in SSAP No. 86 that specifically indicates that derivatives shall not be bifurcated for effectiveness. (The guidance in Exhibit B notes that changes in the excluded components would be included in unrealized gains and losses – which would represent a fair value measurement for these pieces, even if the derivative was classified as highly effective and reported at amortized cost.)

<u>Items to Consider:</u> Although the SSAP No. 86 Exhibit B guidance has incorporated prior U.S. GAAP guidance for excluding components, the guidance for these permissions does not align with the guidance in the body of SSAP No. 86. To ensure clear and consistent application, revisions would need to be considered to specify the reporting when changes in the fair value of a derivative are separated and treated differently.

Existing Authoritative Literature:
SSAP No. 86—Derivatives is the authoritative source of guidance for determining hedge effectiveness and reporting derivatives for statutory accounting. Key aspects to highlight from this SSAP for consideration as part of this agenda item:

- U.S. GAAP and SAP differ with regards to the reporting of derivatives. Under U.S. GAAP, all derivatives are reported at fair value. When a derivative represents a highly effective hedge, the process to recognize changes in fair value through the income statement in earnings or OCI is designed to mirror the recognition of fair value changes in the hedged item. (Under U.S. GAAP, highly effective hedges result in an income statement matching mechanism.) Under SAP, derivatives are reported differently based on whether they are used in a highly effective hedge. If highly effective, then the derivative measurement method mirrors the measurement method of the hedged item – which could be amortized cost. If not highly effective, then the derivative measurement method is fair value.

- Under U.S. GAAP, a fair value hedge approach requires that the hedged item be reported at fair value. (This allows for the matching of fair value changes of the hedged item and the hedging instrument (derivative) through the income statement.) This is not a required element under SAP. This GAAP-to-SAP difference makes sense as it allows companies that have highly effective hedges under U.S. GAAP to also identify those relationships as highly effective under SAP even though SAP uses an amortized cost (or other non-fair value) measurement method for hedged items.

- Assessment and determination of hedge effectiveness has generally been consistent between U.S. GAAP and SAP. The guidance in SSAP No. 86, Exhibit B – Assessment of Hedging Effectiveness, identifies the intent to remain consistent with U.S. GAAP with respect to assessing hedge effectiveness.

- Although the guidance in SSAP No. 86 prescribes the general concepts for hedges, as well as the measurement guidance for derivatives based on whether they are (or not) highly effective, the application guidance is detailed in Exhibit C – Specific Hedge Accounting Procedures for Derivatives. These procedures are SAP specific due to the fundamental differences in measurement and recognition of derivatives between U.S. GAAP and SAP.

Activity to Date (issues previously addressed by the Working Group, Emerging Accounting Issues (E) Working Group, SEC, FASB, other State Departments of Insurance or other NAIC groups):

- Agenda item 2018-30: SSAP No. 86 – Hedge Effectiveness Documentation considered the revised hedge effectiveness documentation provisions incorporated within ASU 2017-12, Derivatives and hedging. The revisions from this agenda item were adopted Nov. 15, 2018 and were effective Jan. 1, 2019, with early adoption permitted. U.S. GAAP filers could only early adopt if they also early-adopted ASU 2017-12.

- Agenda item 2017-33 was drafted to continue the overall accounting and reporting changes in ASU 2017-12 as potential substantive revisions. This item is still pending for statutory accounting. Although still pending, it is recommended that the 2021 limited-scope edits requested by industry be captured in this new agenda item, with agenda item 2017-33 retained as a broader scope project to review other derivative concepts, or subsequently disposed if no longer needed.

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

Staff Recommendation:
It is recommended that the Working Group move this agenda item to the active listing, categorized as new SAP concepts, and direct NAIC staff to work with regulators and industry in assessing and developing revisions to facilitate effective hedge assessments consistently between SAP and U.S. GAAP. As this guidance will reflect a change from the original concepts reflected in SSAP No. 86, it is recommended that the revisions be detailed in an issue paper for historical reference. This issue paper is recommended to be completed concurrently or subsequently to the consideration of SSAP revisions. The anticipated revisions from this agenda item are considered to reflect new SAP concepts as the effective hedge relationships that will be assessed have not been allowed under existing statutory accounting guidance.

As detailed within this agenda item, the discussion, and potential revisions, are expected to encompass the following elements:

- **Appropriate reporting lines for effective hedges when the hedged item is a liability.**

- **Recognition of hedged-item adjustments (to a closed portfolio) when the last-of-layer / portfolio method of hedging is used.**

- **Scope limitations of the last of layer / portfolio method to mirror U.S. GAAP.**

- **The potential bifurcation of derivatives, and how such items should be reported for statutory accounting, when only portions of derivatives are permitted to be designated as effective. (This pertains to potential mixed-measurement reporting values.)**

As detailed above, the Working Group also welcomes comments from regulators and industry on whether a fundamental change in SAP for derivative measurement (to be more consistent with U.S. GAAP) should be considered. Although specific revisions are not yet detailed, it is recommended that this agenda item be exposed to solicit comments and feedback on the overall summary and potential revisions to be considered.

Status:
On December 11, 2021, the Statutory Accounting Principles (E) Working Group moved this agenda item to the active listing, categorized as substantive, and directed NAIC staff to work with regulators and industry in assessing and developing revisions to facilitate effective hedge assessments consistently between U.S. GAAP and statutory accounting.

On April 4, 2022, the Statutory Accounting Principles (E) Working Group exposed two documents for public comment. The first document (labeled 21-20 SSAP No. 86 – Exhibit A 3-2-22), proposes revisions in the form of a new Exhibit A (which will replace both Exhibit A and Exhibit B of SSAP No. 86 that adopts with modification U.S. GAAP guidance in determining hedge effectiveness. The second document (labeled 21-20 SSAP No. 86 – Excluded Components - 3-17-22), proposes measurement methods for excluded components in hedging instruments. The Working Group also directed staff to continue to work with industry representatives on other elements within *ASU 2017-12: Derivatives and Hedging: Targeted Improvements to Accounting for Hedging Activities*.

https://naiconline.sharepoint.com/teams/FRSStatutoryAccounting/National Meetings/A. National Meeting Materials/2022/4- Spring NM/Exposures/21-20 - Effective Derivatives ASU 2017-12.docx