

Draft: 8/17/22

Statutory Accounting Principles (E) Working Group
Portland, Oregon
August 10, 2022

The Statutory Accounting Principles (E) Working Group of the Accounting Practices and Procedures (E) Task Force met in Portland, OR, Aug. 10, 2022. The following Working Group members participated: Dale Bruggeman, Chair (OH); Kevin Clark, Vice Chair (IA); Sheila Travis (AL); Kim Hudson and Susan Bernard (CA); William Arfanis (CT); Rylynn Brown (DE); Susan Berry (IL); Melissa Gibson (LA); Judy Weaver (MI); Doug Bartlett (NH); Bob Kasinow (NY); Melissa Greiner, Matt Milford, and Diana Sherman (PA); Amy Garcia and Jamie Walker (TX); Greg Chew, Doug Stolte, and David Smith (VA); and Amy Malm (WI).

1. Adopted its July 18, May 24, and Spring National Meeting Minutes

The Working Group met July 18 and May 24. During its July 18 meeting, the Working Group exposed proposed reporting changes to Schedule D-1: Long-Term Bonds, which included a proposal for separate schedules for issuer obligations and asset-backed securities (ABS), proposed to be named Schedule D-1-1 and Schedule D-1-2, respectively. The exposure also included granular reporting lines, column additions, and instructional changes to improve consistency and transparency in the information reported.

During its May 24 meeting, the Working Group adopted statutory accounting principle (SAP) clarifications to: 1) *Statement of Statutory Accounting Principles (SSAP) No. 25—Affiliates and Other Related Parties* and *SSAP No. 43R—Loan-Backed and Structured Securities* to clarify the identification and reporting requirements for affiliated transactions and incorporate new reporting codes in various investment schedules to identify investments that involve related parties; and 2) *Interpretation (INT) 22-01: Freddie Mac When-Issued K-Deal (WI Trust) Certificates* to clarify that from that date of origination, investments in the Freddie Mac “When Issued K-Deal” (WI) Program are in scope of SSAP No. 43R. Additionally, the Working Group adopted agenda item 2022-03: Premium Adjustments Allocated to Jurisdictions, which did not result in statutory revisions but expressed support for a corresponding blanks proposal—2022-10BWG—that included instructional changes to Schedule T, the State Page, and Accident and Health Policy Experience Exhibit (AHPEE), clarifying guidance for premium adjustments.

The Working Group also met Aug. 4 in regulator-to-regulator session, pursuant to paragraph 3 (specific companies, entities or individuals) and paragraph 6 (consultations with NAIC staff related to NAIC technical guidance) of the NAIC Policy Statement on Open Meetings to discuss its Summer National Meeting agenda.

Ms. Walker made a motion, seconded by Ms. Malm, to adopt the Working Group’s July 18 (Attachment One-A), May 24 (Attachment One-B), and April 4 (see *NAIC Proceedings – Spring 2022, Accounting Practices and Procedures (E) Task Force, Attachment One*) minutes. The motion passed unanimously.

2. Adopted Non-Contested Positions

The Working Group held a public hearing to review comments (Attachment One-C) on previously exposed items.

Mr. Hudson made a motion, seconded by Mr. Clark, to adopt the SAP clarifications detailed below as non-contested statutory accounting revisions. The motion passed unanimously.

a. Agenda Item 2022-04

Mr. Bruggeman directed the Working Group to agenda item 2022-04: ASU 2021-10, Government Assistance (Attachment One-D). Jim Pinegar (NAIC) stated that this agenda item reviews *Accounting Standard Update (ASU) 2021-10, Government Assistance: Disclosures by Business Entities about Government Assistance*, which increases transparency on certain types of government assistance by increasing disclosures in the financial statements. He stated that due to the rarity of such disclosures, this agenda item proposed SAP clarifications to *SSAP No. 24—Discontinued Operations and Unusual or Infrequent Items*, incorporating limited disclosures from ASU 2021-10. The proposed additions will require identification and the terms and provisions of assistance received.

b. Agenda Item 2022-05

Mr. Bruggeman directed the Working Group to agenda item 2022-05: ASU 2021-09, Leases, Discount Rate for Lessees (Attachment One-E). Jake Stultz (NAIC) stated that this agenda item reviews *ASU 2021-09, Leases (Topic 842), Discount Rate for Lessees That Are Not Public Business Entities*, which states that when the rate implicit in the lease is readily determinable for any individual lease, the lessee should use that rate, rather than a risk-free rate or an incremental borrowing rate, regardless of whether it has made the risk-free rate election. As statutory accounting generally requires that all leases be classified as operating leases, this agenda item proposed SAP clarifications to reject ASU 2021-09 in *SSAP No. 22R—Leases* for statutory accounting.

c. Agenda Item 2022-06

Mr. Bruggeman directed the Working Group to agenda item 2022-06: ASU 2021-07, Compensation – Stock Compensation (Attachment One-F). Mr. Pinegar stated that this agenda item reviews *ASU 2021-07, Compensation – Stock Compensation (Topic 718), Determining the Current Price of an Underlying Share for Equity-Classified Share-Based Awards*, which offers nonpublic companies a practical expedient to one of the inputs necessary—current price input—for option-price modeling. He stated that when equity share options or similar instruments are granted in a share-based payment transaction, the fair value, which is used to determine expense recognition at inception and during any subsequent award modifications, is estimated using an option-pricing model valuation technique. ASU 2021-07 provides a third practical expedient for nonpublic companies, and it is the third practical expedient permitted under U.S. generally accepted accounting principles (GAAP), of which the two other practical expedients are currently permitted under *SSAP No. 104R—Share-Based Payments*. Accordingly, this agenda item proposed SAP clarifications to SSAP No. 104R to incorporate this third new practical expedient.

d. Agenda Item 2022-07

Mr. Bruggeman directed the Working Group to agenda item 2021-07: ASU 2021-08, Business Combinations (Attachment One-G). Mr. Pinegar stated that this agenda item reviews *ASU 2021-08, Business Combinations, Accounting for Contract Assets and Contract Liabilities from Contracts with Customers*, which requires acquiring entities to apply the “Revenue from Contracts with Customers” guidance (Topic 606) when valuing and recognizing contract-related assets and liabilities in a business combination. Prior to the issuance of ASU 2021-08, acquirers would generally recognize items using the fair value on the date of acquisition; however, that approach would generally result in lower liability recognition than required under Topic 606. Mr. Pinegar stated that in keeping with historical precedent, this agenda item proposed SAP clarifications to reject ASU 2021-08 in *SSAP No. 47—Uninsured Plans*. However, as ASU 2021-08 is related to business combinations, the agenda item also proposes to reject ASU 2021-08 in *SSAP No. 68—Business Combinations and Goodwill*, noting that rejection does not impact the determination of U.S. GAAP book value in an acquired entity.

3. Reviewed Comments on Exposed Items – Minimal Discussion

a. Agenda Item 2021-20

Mr. Bruggeman directed the Working Group to agenda item 2021-20: Effective Derivatives – ASU 2017-12. Julie Gann (NAIC) stated that during the 2021 Fall National Meeting, the Working Group exposed an agenda item that summarized the key changes detailed in *ASU 2017-12: Derivatives and Hedging: Targeted Improvements to Accounting for Hedging Activities* with a request for comments on the extent revisions were needed in SSAP No. 86—*Derivatives*. She stated that ASU 2017-12 was originally reviewed in 2017; however, the Working Group only adopted certain disclosure provisions with the intent to review the full ASU subsequently. During the Spring National Meeting, the Working Group exposed additional guidance from ASU 2017-12, proposing a new SSAP No. 86, Exhibit A on assessing hedge effectiveness, which would replace the current Exhibit A and Exhibit B. Ms. Gann stated that these proposed revisions would align U.S. GAAP guidance with statutory accounting so there would be consistency in the determination of hedge effectiveness. In addition, the exposure included revisions to what is permitted as excluded components and explicit measurement methods for each type of excluded component. She stated that the proposed revisions would be considered an adoption, with modification, from U.S. GAAP on the hedge effectiveness guidance from ASU 2017-12, as statutory specific measurement guidance is needed for excluded components due to the different measurement concepts between U.S. GAAP and SAP. She stated that NAIC staff recommended adoption of the exposed revisions to SSAP No. 86, along with guidance to detail an effective date of Jan. 1, 2023, with early adoption permitted, and the guidance adopted from U.S. GAAP. She stated that companies that elect to early adopt would have different financial results for year-end 2022 from those that adopt in 2023; however, most companies are anticipated to early adopt, and the 2023 time frame is only for companies that need additional time for system changes. In addition, it was recommended that the Working Group sponsor a blanks proposal to incorporate new disclosures and electronic column reporting fields in Schedule DB for year-end 2023. However, as the new data-captured elements will not be available until 2023, any company electing to adopt these provisions in 2022 will be required to complete the disclosures in narrative form. She stated that as the modifications to SSAP No. 86 are new SAP concepts, NAIC staff recommend drafting an issue paper to document the revisions captured in this agenda item, as well as other derivative revisions from the review of ASU 2017-12, as certain elements from the ASU are still pending statutory accounting review.

Mr. Hudson made a motion, seconded by Mr. Kasinow, to adopt the exposed new SAP concept revisions to SSAP No. 86, incorporating the Jan. 1, 2023, effective date, with early adoption permitted, and relevant literature language proposed by NAIC staff. The motion included direction to sponsor a blanks proposal and draft an issue paper to document the revisions (Attachments One-H, One-I, and One-J). The motion passed unanimously.

b. Agenda Item 2022-02

Mr. Bruggeman directed the Working Group to agenda item 2022-02: SSAP No. 48 – Alternative Valuation of Minority Ownership Interests. Mr. Pinegar stated that this agenda item reviews the audited U.S. tax equity exception provided in *SSAP No. 48—Joint Ventures, Partnerships and Limited Liability Companies*. He stated that this agenda item arose trying to address questions regarding at which level the audited U.S. tax basis should apply, as there was ambiguity on whether the insurer's audit would suffice or if the audit should reside at the investee level. He stated that informal comments from a representative of the American Institute of Certified Public Accountants (AICPA) indicated that they were not aware of anyone using the audited U.S. tax basis method, which is permitted as an exception if audited U.S. GAAP basis financial statements were not available. They further indicated that they were not aware of anyone issuing U.S. tax basis equity audits. Mr. Pinegar stated that this agenda item proposed two options for consideration. The first option sought input as to whether the audited U.S. tax basis exception was being used, and if not, whether it should be removed as a permissible exception to audited U.S. GAAP basis in SSAP No. 48. The second option proposed an SAP clarification that if the audited U.S. tax basis

exception is retained, the audit is required at the investee (investment) level. He stated that in response to comments received from interested parties, which indicated that insurers are using the audited U.S. GAAP basis exception, NAIC staff recommended the retention of the audited U.S. tax equity exception in SSAP No. 48 but also clarification that the audit is required at the investee level.

Mr. Clark made a motion, seconded by Mr. Chew, to adopt the exposed SAP clarification to retain the U.S. tax equity exception permitted in SSAP No. 48 but also to clarify that the audit is required to occur at the investee level (Attachment One-K). The motion passed unanimously.

4. Reviewed Comments on Exposed Items

a. Agenda Item 2022-01

Mr. Bruggeman directed the Working Group to agenda item 2022-01: Conceptual Framework – Updates. Mr. Pinegar stated that this agenda item reviews Financial Accounting Standards Board (FASB) Concepts Statement No. 8, *Conceptual Framework for Financial Reporting—Chapter 4, Elements of Financial Statements* (Chapter 4) and Concepts Statement No. 8, *Conceptual Framework for Financial Reporting—Chapter 7, Presentation* (Chapter 7) for their impact on statutory accounting. He stated that the final topic reviewed Chapter 7 and proposed a minor SAP clarification to the Preamble, updating a paragraph reference to *Statement of Financial Accounting Concept 5*, which was superseded by Chapter 7. He stated that Chapter 7 describes what information should be included in the financial statements and how appropriate presentation can contribute to the objective of financial reporting. However, Chapter 7 concepts were not expected to modify current guidance, other than to update references to superseded accounting concepts.

Mr. Pinegar stated that Chapter 4 introduced revised definitions for the terms “asset” and “liability,” simplifying their descriptions and redefining their essential characteristics. He stated that the historical definitions no longer include the term “probable” or the phrase “as the result of past transactions or events,” citing that the rationale for their removal has been documented in the agenda item and the related issue papers. He stated that as statutory accounting references these definitions, this agenda item proposed SAP clarifications to SSAP No. 4—*Assets and Nonadmitted Assets* and SSAP No. 5R—*Liabilities, Contingencies and Impairments of Assets* to reflect the FASB’s updated definitions. He stated that in addition, the Working Group exposed two issue papers, each articulating the changes for SSAP No. 4 and SSAP No. 5R, the FASB’s rationale for the changes, and discussion as to why the updates are proposed to be SAP clarifications in nature. He stated that while interested parties did not have any comments on the asset definitional change, or its related issue paper, they did offer comments on the recommended changes to the definitional change of a liability. He stated that interested parties recommended an SSAP-by-SSAP review to ensure that there would not be any unintended consequences, specifically the requirement to now recognize a liability for an item that had not previously been recognized as such. He stated that in response, NAIC staff are of the opinion that combined with the concept of conservatism as detailed in the Preamble, an item meeting the definition of a liability, either under the current or new proposed definition, should likely be reported as a liability for statutory accounting. If there are specific circumstances or instruments that do not warrant recognition as a liability, those should be identified by industry with a request for an individual evaluation by the Working Group. To permit time for a further assessment by industry before considering adoption of the exposed revisions, Mr. Pinegar stated that NAIC staff would recommend a re-exposure of the proposed liability revisions and its related issue paper.

Mr. Bruggeman stated that as statutory accounting integrates these terms at the standard level, they have a higher authority level than U.S. GAAP, as they only reference the terms in concept statements; thus, there is a differentiation in the accounting hierarchy. In response to interested parties requesting an SSAP-by-SSAP review, he said he would be supportive of a re-exposure of the liability portion of the agenda item so interested parties

can present specific instruments or items of consideration. Michael M. Monahan (American Council of Life Insurers—ACLI) stated that interested parties support the re-exposure so they can review for specific instances that may warrant the Working Group's review.

Mr. Hudson made a motion, seconded by Ms. Walker, to adopt the exposed SAP clarifications to the Preamble and the updated definition of an asset in SSAP No. 4 and its related issue paper, *Statutory Issue Paper No. 166—Updates to the Definition of an Asset* (Attachments One-L and One-M). The motion passed unanimously.

In a separate action, Mr. Hudson made a motion, seconded by Ms. Walker, to re-expose the proposed definition change of a liability in SSAP No. 5R and its related issue paper. The motion passed unanimously.

5. Considered Maintenance Agenda – Pending Listing – Exposures

Mr. Hudson made a motion, seconded by Ms. Malm, to move agenda items 2022-09 through 2022-13 to the active listing and expose all items for a public comment period ending Oct. 7. The motion passed unanimously.

a. Agenda Item 2022-09

Mr. Bruggeman directed the Working Group to agenda item 2022-09: ASU 2022-01: Fair Value Hedging – Portfolio Layer Method. Ms. Gann stated that ASU 2017-12 incorporated a “last-of-layer” method to make portfolio fair value hedge accounting more accessible for specific assets. Under a last-of-layer approach, for a closed portfolio of prepayable financial assets or one or more beneficial interests secured by a portfolio of payable financial instruments, entities were allowed to hedge a stated amount of the assets or assets in a closed portfolio that is anticipated to be outstanding for the designated hedge period. However, since the issuance of ASU 2017-12, the FASB has issued another update in ASU 2022-01, *Fair Value Hedging – Portfolio Layer Method* to expand the last-of-layer approach for additional instruments. Ms. Gann stated that this agenda item proposed new SAP concepts to incorporate portfolio layer method hedging for statutory accounting. She stated that this guidance would be limited to recognized assets, which is consistent with U.S. GAAP. In addition, this agenda item would permit partial term hedging, a method that permits entities to enter fair value hedges of interest rate risk for only a portion of the term of the hedged financial instrument. She stated that while this is proposed to be allowed for statutory accounting, it is proposed to be limited to recognized assets. While U.S. GAAP permit this approach for both assets and liabilities, if permitted for statutory accounting, partial term hedges for liabilities may reduce the carrying cost of the liability when in fact the liability has not been extinguished. Ms. Gann stated that industry suggested the difference to U.S. GAAP to permit the partial term hedging approach to be incorporated for statutory accounting for recognized assets. Subsequent consideration to expand the partial term approach to liabilities could occur as part of a broader topic to review how basis adjustments are reflected under the existing derivative guidance. Ms. Gann stated that the proposed revisions would introduce additional new SAP concepts into SSAP No. 86, and if adopted, they would be integrated into the issue paper being drafted to encompass all revisions to SSAP No. 86.

b. Agenda Item 2022-10

Mr. Bruggeman directed the Working Group to agenda item 2022-10: ASU 2022-02: Troubled Debt Restructuring and Vintage Disclosures. Ms. Gann stated that this agenda item reviews ASU 2022-02: *Troubled Debt Restructurings and Vintage Disclosures*, which effectively eliminated prior U.S. GAAP guidance for troubled debt restructurings in support of using an allowance for credit losses pursuant to ASU 2016-13: *Measurement of Credit Losses on Financial Instruments*. She stated that this agenda item proposes rejecting ASU 2022-03 in SSAP No. 36—*Troubled Debt Restructuring* to maintain the current guidance. She stated that although the guidance is retained, the exposure includes revisions in SSAP No. 36 to detail U.S. GAAP versus SAP differences for the

accounting of troubled debt restructurings for creditors, and the SSAP would no longer converge with authoritative U.S. GAAP guidance.

c. Agenda Item 2022-11

Mr. Bruggeman directed the Working Group to agenda item 2022-11: Collateral for Loans. Robin Marcotte (NAIC) stated that this agenda item proposes revisions to *SSAP No. 21R—Other Admitted Assets* to clarify that the invested assets pledged as collateral for admitted collateral loans must qualify as admitted assets. She noted that the proposed revisions would address consistency differences between *SSAP No. 20—Nonadmitted Assets* and *SSAP No. 21R*.

d. Agenda Item 2022-12

Mr. Bruggeman directed the Working Group to agenda item 2022-12: Review of INT 03-02: Modification to an Existing Intercompany Pooling Arrangement. Ms. Marcotte stated that this agenda item proposes to nullify *INT 03-02: Modification to an Existing Intercompany Pooling Arrangement*, as it contains historical guidance that conflicts with *SSAP No. 25*. She stated that INT 03-02 directs certain transfers, including economic transfers, between affiliates to be recorded at book value, rather than fair value, as is directed in *SSAP No. 25*. Mr. Bruggeman stated that INTs are typically issued for specific situations, and while this INT was issued in 2003, the rationale for having this accounting direction has likely lapsed, and review of INT 03-02 is warranted.

e. Agenda Item 2022-13

Mr. Bruggeman directed the Working Group to agenda item 2022-13: Related Parties – Footnote Updates. Mr. Stultz stated that this agenda item was drafted in response to comments received on agenda item 2021-21: Related Party Reporting, which was adopted by the Working Group on May 24. During that meeting, interested parties suggested extending the exemption to foreign open-end investment funds governed and authorized in accordance with regulations established by the applicable foreign jurisdiction, which are within the scope of *SSAP No. 30R—Unaffiliated Common Stock*. Mr. Stultz stated that in response to comments received, the Working Group directed NAIC staff to draft an agenda item to propose footnote revisions to *SSAP No. 25* and *SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities*, which would make these items consistent with *SSAP No. 30R*.

6. Considered Maintenance Agenda – Active Listing

a. Agenda Item 2021-25

Mr. Bruggeman directed the Working Group to agenda item 2021-25: Leasehold Improvements After Lease Termination. Mr. Stultz stated that this agenda item proposed SAP clarifications to *SSAP No. 19—Furniture, Fixtures, Equipment and Leasehold Improvements* and *SSAP No. 73—Health Care Delivery Assets and Leasehold Improvements in Health Care Facilities* to address questions about the treatment of leasehold improvements in situations where a leased property is purchased by the lessee during the lease term. He stated that the revisions propose to clarify that in any scenario in which a lease terminates early, all remaining leasehold improvements shall be immediately expensed, even if the lessee purchases the leased property. This proposed guidance was initially exposed at the 2021 Fall National Meeting, from which interested parties provided comments requesting consideration of an exception in specific circumstances. Mr. Stultz stated that in response, the Working Group directed staff to further work with interested parties on this guidance. He stated that NAIC staff have updated the proposed language to allow companies that provide direct health care to exclude situations where the real estate lease agreement has a purchase option that contains language that allows leasehold improvements necessary for

the functionality of specific health care delivery assets to be excluded from the purchase price of the real estate. In these limited scenarios, after purchase, the leasehold improvements necessary for the functionality of health care delivery assets would follow existing guidance for health care delivery assets in SSAP No. 73.

Mr. Hudson made a motion, seconded by Ms. Travis, to expose agenda item 2021-25 for a public comment period ending Oct. 7. The motion passed unanimously.

b. Agenda Item 2019-21

Mr. Bruggeman directed the Working Group to agenda item 2019-21: Proposed Bond Definition. Ms. Gann stated that this agenda item reflects efforts between industry and state insurance regulators to principally define a bond for reporting on Schedule D-1. She stated that this agenda contains several items for exposure, summarized as follows:

- An updated principles-based bond definition, which has been revised to reflect limited changes as directed by the Working Group during its July 18 meeting.
- An updated issue paper, which reflects the overall discussion from the Working Group's July 18 meeting, as well as noted edits to the guidance. For example, the draft issue paper includes discussion on feeder funds and how the assessment of these funds, for reporting purposes, should focus on the substance of the underlying investments in determining bond classification.
- Proposed revisions to SSAP No. 26R—*Bonds* and SSAP No. 43R to incorporate the principles-based bond definition in authoritative accounting guidance. SSAP No. 26R is proposed to contain the principal bond definition; however, SSAP No. 43R contains several proposed revisions, including a name change to "Asset Backed Securities."

Ms. Gann stated that this agenda item also has a current exposure of proposed reporting changes to Schedule D-1 and related instruction revisions. She stated that although the current items reflect the bulk of the anticipated edits for the principles-based bond definition, additional revisions will be necessary, specifically to restrict ABS from the scope of SSAP No. 2R—*Cash, Cash Equivalents, Drafts and Short-Term Investments* and other various references in SSAP No. 103R—*Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. Mr. Bruggeman stated that NAIC staff have spent considerable time evaluating the proposed modifications, including the option to combine SSAP No. 26R and SSAP No. 43R into one SSAP. However, due to distinct differences, maintaining two separate SSAPs appears to be the best approach. In addition, due to the extent of the revisions, and the blanks deadlines, the earliest these revisions are likely to be in effect is Jan. 1, 2025; although, the potential still exists for Jan. 1, 2024. Mr. Bruggeman reminded the Working Group that these revisions are focused on accounting and reporting changes, and elements pertaining to NAIC designations or risk-based capital (RBC) charges would be addressed by the respective groups. In a response to an inquiry from Mr. Monahan, Mr. Bruggeman stated that the comment deadline is Oct. 7; however, due to the extent of the revisions, an extension could be requested, if needed.

Ms. Weaver made a motion, seconded by Mr. Clark, to expose agenda item 2019-21, which includes the updated principle-based bond definition, updated issue paper, and proposed revisions to SSAP No. 26R and SSAP No. 43R for a public comment period ending Oct. 7. The motion passed unanimously.

7. Discussed Other Matters

a. Review of U.S. GAAP Exposures

Ms. Marcotte stated that there were two current FASB exposures; however, NAIC staff recommend reviewing the final ASUs under the SAP Maintenance Process, as detailed in *Appendix F—Policy Statements*. Ms. Gann stated that NAIC staff are monitoring the Inflation Reduction Act of 2022 for any potential impact to insurers, specifically its impact on deferred tax assets/liabilities and subsequent events for financial reporting purposes. Mr. Monahan stated that industry is also monitoring the Inflation Reduction Act of 2022 closely, as it will likely affect several insurers. Jonathan Rodgers (National Association of Mutual Insurance Companies—NAMIC) stated that NAMIC is attempting, either through legislation or an interpretation from the U.S. Department of the Treasury (Treasury Department), that the financial statements of record, which are used to determine a minimum tax per the act, should be statutory statements, rather than U.S. GAAP financial statements. He stated that if changes are needed in *SSAP No. 101—Income Taxes* because of this legislation, NAMIC would request an effective date to occur no earlier than the fourth quarter of 2023.

b. Update for Life Actuarial (A) Task Force Coordination

Ms. Marcotte stated that the Working Group was provided with a listing of the amendments made to the *Valuation Manual* by the Life Actuarial (A) Task Force since the 2021 Summer National Meeting. She stated that there were not any items identified that require Working Group action (Attachment One-N).

c. Received a Referral from the Macroprudential (E) Working Group

Mr. Bruggeman stated that the Working Group has received a referral from the Macroprudential (E) Working Group (Attachment One-O), which includes its work plan (*see NAIC Proceedings – Summer 2022, Financial Stability Task Force, Attachment One-B*). He stated that the referral has several items, some of which are in progress.

Having no further business, the Statutory Accounting Principles (E) Working Group adjourned.

https://naiconline.sharepoint.com/sites/naicsupportstaffhub/member%20meetings/e%20cmte/apptf/2022summernm/1_sapwg/minutes/sapwg%20minutes%208.10.22%20-%20after%20tpr.docx

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Statutory Accounting Principles (E) Working Group

Virtual Meeting

July 18, 2022

The Statutory Accounting Principles (E) Working Group of the Accounting Practices and Procedures (E) Task Force met July 18, 2022. The following Working Group members participated: Dale Bruggeman, Chair (OH); Carrie Mears and Kevin Clark, Co-Vice Chairs (IA); Sheila Travis (AL); Kim Hudson and Susan Bernard (CA); William Arfanis and Michael Estabrook (CT); Tom Hudson and Rylynn Brown (DE); Cindy Andersen and Eric Moser (IL); Melissa Gibson (LA); Judy Weaver (MI); Doug Bartlett and Pat Gosselin (NH); Bob Kasinow (NY); Melissa Greiner (PA); Jamie Walker (TX); Doug Stolte and David Smith (VA); and Amy Malm and Elena Vetrina (WI).

1. Considered Maintenance Agenda – Active Listing

The Working Group held a public hearing to review comments (Attachment One-A1) on the bond definition and issue paper exposed March 2.

a. Agenda Item 2019-21

Mr. Bruggeman directed the Working Group to agenda item 2019-21: Proposed Bond Definition. Julie Gann (NAIC) provided an overview of the project stating that an updated principles-based bond definition and a draft issue paper were exposed March 2 for a public comment period ending May 6. She stated that comments were received from interested parties as well as the industry named Lease-Backed Securities Working Group. She identified that the materials provide a review of comments received, with an NAIC staff recommended response to each comment. Ms. Gann summarized each item as follows:

- Interested parties proposed to remove the footnote that details U.S. Treasury Inflation-Indexed Securities are in scope of *Statement of Statutory Accounting Principles (SSAP) No. 26R—Bonds*. The footnote was originally proposed to clarify that TIPS shall be considered bonds for statutory accounting reporting. Ms. Gann stated that these investments have returns that may vary based on an outside variable (inflation), and rather than delete the footnote, she would recommend revising the footnote to detail why these investments should remain in scope of SSAP No. 26R, despite them having the possibility of varied returns. She stated proposed revisions identify that these investments possess plain vanilla inflation adjustment mechanisms and are not intended to be captured within the provisions that restrict bond classification to securities that have principal and interest payments that vary based on an underlying reference variable. In addition, Ms. Gann noted that the bond definition referred to “equity-interests” for situations in which varying contractual principal or interest had to be assessed. She stated that this provision is not intended to be limited to certain types of debt investments, and the principle concept should be applied broadly. She noted that the recommendation is to revise the guidance to reflect “referenced variables.” Michael Reis (Northwestern Mutual), representing interested parties stated that interested parties are supportive of U.S. Treasury Inflation-indexed securities remaining in scope of SSAP No. 26R; however, they have not had an opportunity to review the proposed guidance in detail, so they will submit further comments in conjunction with the updated exposure, which is anticipated to occur at the Summer National Meeting.
- Interested parties recommended changes to the proposed bond definition to include reference that Securities Valuation Office (SVO)-identified credit tenant loans (CTLs) are bonds. Ms. Gann stated that SVO-identified CTLs are, by definition, not bonds; however, they are proposed to be specifically named in

scope of SSAP No. 26R and remain eligible for bond reporting. She stated that SVO-identified CTLs are mortgage loans, not securities, and are therefore initially captured in *SSAP No. 37—Mortgage Loans*. However, if the mortgage loan meets certain criteria after review by the SVO, the investment is captured in scope of SSAP No. 26R. Ms. Gann stated that separating items that qualify as bonds within the bond definition and named inclusions for bond reporting, such as SVO-identified exchange-traded funds (ETFs) or CTLs, is purposeful to prevent inadvertent inference to other investments. Mr. Bruggeman stated that this distinction was previously addressed, as SVO-identified CTLs are not securities, they are mortgage loans, and while the bond definition requires investments in scope to be securities, this named inclusion to SSAP No. 26R will ensure that qualifying non-security CTLs remain in scope. Mr. Reis, representing interested parties, stated that the inclusion of SVO-identified CTLs by name meets the needs of industry, and they do not recommend additional changes at this time. John Garrison (Lease-Backed Securities Working Group) stated agreement with Mr. Reis and inquired for clarification that SVO-identified CTLs, as well as lease-backed securities that meet the safe harbor rule, which allows up to a 5% balloon payment, qualify for reporting in scope of SSAP No. 26R as an issuer obligation. Mr. Clark stated that the nuance being discussed is that the principles-based bond definition applies to securities. As it is currently written, a lease-backed security where the full repayment of principal is supported by a lease to a single operating entity, which allows up to a 5% balloon payment, would qualify as an issuer obligation under the bond definition. Lease-backed securities that do not meet the safe harbor provision are required to be assessed as asset-backed securities (ABS) and only reported as bonds if they qualify. These bond definition components do not apply to SVO-identified CTLs, which are mortgage loans, as these items are reported as bonds only after verification from the SVO that set criteria has been obtained.

- Interested parties proposed to clarify that the assessment of “all returns” in excess of principal repayments are required to be considered interest should only apply to equity-backed ABS. Ms. Gann stated that the inclusion of excess returns as interest should not be limited, as restricting the analysis based on naming convention or broad security classifications would likely result in the misapplication of the guidance. Accordingly, the interested parties’ proposed change to restrict consideration of “all returns” to equity-backed ABS was not recommended, but revisions were proposed to clarify that the restrictions for variations in principal or interest payments applies to any debt investment in scope and can be in response to any underlying reference variable.
- Interested parties’ proposed revisions to clarify that a first loss position, and not just issued tranches, can be considered when assessing substantive credit enhancements. Ms. Gann stated that the initial read of the interested parties’ proposed edits could be interpreted to impact the residual guidance previously adopted, which requires residual tranches to be reported on Schedule BA—Other Long-Term Invested Assets. However, NAIC staff agree that whether a loss position is issued as a separate tranche or retained by the issuer does not impact the assessment of whether the loss position provides substantive credit enhancement to debt tranche holders. Ms. Gann stated that the interested parties’ revisions were reflected, with modifications to clarify that debt tranches are required to have contractual principal and interest payments to be considered for bond reporting. Mr. Reis, on behalf of interested parties, stated that NAIC staff’s proposed modification encompasses the spirit of their request; however, they will review in detail in conjunction with the upcoming exposure. Mr. Bruggeman stated that the proposed modification clarifies that the first issued debt tranche may not necessarily represent the first loss tranche, but there must be substantive credit enhancement to ensure that any issued tranche is eligible for bond reporting.

- Interested parties recommended guidance to address feeder funds, specifically a clarification that explicitly states that reporting entities should determine the source and terms of collateral in determining whether an investment represents a creditor relationship and qualifies for bond reporting. A feeder fund is an arrangement where debt is issued from one fund (feeder fund), but that fund has an equity interest in another fund (secondary fund) that holds the underlying collateral. If the secondary fund holds qualifying debt instruments generating bond cash flows that are passed through to the holder, then the investment held from the feeder fund could in-substance be considered debt. However, if the underlying collateral in the secondary fund is equity interests, the reporting entity would have to: 1) consider the substance of the equity interests in the secondary fund in supporting the debt from the feeder fund; 2) assess whether the creditor relationship criteria is met; and 3) conclude that the investment does not reflect an in-substance equity relationship. Ms. Gann recommended that the issue paper guidance be expanded to address feeder funds. Mr. Bruggeman stated that the basic structure of feeder funds is described in the interested parties' comments, and the revisions proposed by NAIC staff capture the particularities of these structures. Mr. Clark stated that in response to comments received by industry, their proposed edits went beyond the intent and outcomes of the small group discussions and could be read to imply that the fund intermediary could be ignored as long as the ultimate collateral were fixed income. As a result, revisions to the industry proposed language are proposed by staff to make it clear that the investor should consider the terms of the structure to ensure that the passthrough of underlying cash flows is supported. If the insertion of a feeder fund would alter the amount or timing of cashflows, that would need to be assessed in determining bond classification. Mr. Reis stated that the proposed edits appear to agree with industry requests; however, they will review in detail during the next exposure.
- Interested parties recommended that Appendix I of the bond definition, which has been reduced to two examples that do not reflect in-substance creditor relationships, be codified within the guidance instead of in an appendix. The Working Group directed NAIC staff to work with interested parties on the best approach to integrate the examples into the body of the guidance.
- Interested parties provided comments on the exposed guidance to restrict the reporting of ABS as short-term or cash equivalent investments. Ms. Gann stated support for the reporting of all ABS on the bond schedule to ensure that an avenue is not created that allows investments to bypass the bond assessments and still be reported as a short-term or cash equivalent bond. She stated that short-term and cash equivalent investments receive favorable treatment, as there is a minimal risk-based capital (RBC) factor and there is no need to obtain an NAIC designation or credit rating provider (CRP) rating. She stated that this favorable reporting is in line with a concept that there is insignificant risk for short-term and cash equivalent investments due to the time acquired in proximity to the maturity date. However, as ABS could have elements of principal repayment contingent on sale or refinancing at maturity, or other performance factors, these securities should not be permitted to be reported as short-term or cash equivalent investments regardless of how close the maturity date is after the reporting entity acquires the investment. She stated that there is a perception that short-term ABS are not prevalent, and the only example provided so far is "Asset-Backed Commercial Paper" (ABCP). She informed that although these designs have "commercial paper" in their name, it would be erroneous to assume that these ABS resemble "commercial paper" investments. ABCP structures are very different and represent a short-term vehicle issued by a bank or other financial institution that is backed by the company's physical assets and issued on a discount or interest-bearing basis. She said that an ABCP can be created from any type of asset-backed security, including subprime mortgages or other high-risk performing assets. She stated that it is recommended that all ABS be excluded from the short-term or cash equivalent schedules. This will require

that all ABS be assessed under the bond principles and reported, if qualifying, on the bond schedule in the appropriate ABS category.

Ms. Gann stated that the industry Lease-Backed Securities Working Group letter was consistent with its July 15, 2021, comment letter, and the ultimate request is to allow “simple secured loans” issued in security form to be in scope of SSAP No. 26R as issuer credit obligations. She stated that this would likely permit all such designs, regardless of structure, contingent factors, or residual/balloon payments, to be afforded bond treatment without further analysis. She stated that if permitted, investments would likely be in scope of SSAP No. 26R that may not be in line with the goals of the principles-based bond definition. In addition, the comment letter stated a perceived inequity between municipal revenue bonds and non-municipal revenue (project finance) bonds issued by operating entities and other lease-backed structures. Ms. Gann stated that despite the concern noted by the industry Lease-Backed Securities Working Group, NAIC staff did not believe revisions were required due to the differentiation of these investments already detailed in the draft issue paper. However, if the Working Group agreed that project finance bonds issued by operating entities and lease-backed securities with balloon payments are too similar to warrant classification differences between issuer credit obligations and ABS, then NAIC staff would recommend that the Working Group identify that project finance bonds are not considered to be issued by operating entities for bond reporting purposes. If a structure is not considered to be issued by an operating entity, then the investment would be required to follow the guidance for an ABS classification, including assessments for substantive credit enhancement and meaningful cash flows.

Mr. Clark stated that the distinction between an issuer obligation and ABS is that issuer obligations have repayment that is supported by the creditworthiness of an operating entity. However, for lease-backed securities, the ultimate repayment is generally reliant upon other avenues – generally liquidation or refinancing of the underlying collateral. Mr. Clark stated that those that are not fully supported by an operating entity would be required to review the ABS criteria. However, in terms of project finance, while the investment may appear similar to an ABS, many times, the debt is issued from a standalone operating entity. He stated that the guidance differentiates between the two types of investments; however, if the distinction is too difficult to apply, then all project finance would need to be evaluated using the ABS criteria.

Mr. Garrison stated that the Lease-Backed Securities Working Group’s comments intend to request that simple, structured loans be considered issuer credit obligations. He stated that the repayment of these investments is primarily dependent upon the contractual obligation of a single rated payer, which closely mimics the proposed guidance in the principle-based bond definition. These investments may either be unsecured or secured by a claim on an asset. If these investments are issued in the form of a security, they do not represent structured securities, as they reflect debt instruments that pass through unaltered contractual cashflows to investors. Mr. Garrison stated that even if issued from a trust, the asset owned is the debt instrument, not the underlying collateral. In essence, the debt is a form of security that is not altered by the presence or the attachment to underlying collateral. Additionally, these investments do not create a structured security or transfer equity risk into debt risk. Mr. Garrison stated that classifying some unstructured investments as ABS because of a claim on an asset will cause confusion in the market. He stated that structured investments mean the underlying cashflow of an investment has been structured so that cashflows have been redistributed and that credit has been altered by creating priority and subordinate classes. These investments are primarily supported by the credit worthiness of an operating entity and do not reflect typical structured finance investments. Mr. Garrison stated that certain investments, with similar characteristics, appear to have different treatment and recommend that all credit obligations, which rely primarily on an obligation of an operating entity, be held to the same standard. He stated that as an example, lease-backed securities are typically issued by a special purpose entity and are based on the cashflows from nonfinancial assets backed by a lease or other contract with an operator. If these contractual payments, which are secured by a lien on the asset, do not at least cover 100% of the interest and 95% of the

contractual principal payment, they are not considered issuer credit obligations; however, no other investments are subject to these requirements. Mr. Garrison stated that all similar asset types (project finance, equipment trust certificates, etc.) should all be treated similarly. He clarified that the comment letter was intended to be limited to simple unstructured debt, which relies primarily on a contractual repayment obligation of a single credit rated obligor and was not intended to open the door to other investments falling into scope of SSAP No. 26R. These investments are what many lenders consider to be optimal debt structures, as they offer the most protections to lenders. However, if state insurance regulators wish to have these investments subject to the ABS standard, then they would request a clarification that the ABS standard applies to both ABS and simple secured loans. In a response to an inquiry from Mr. Bruggeman, Mr. Garrison stated that project finance should be treated similar to other assets with comparable risks, and he added that rating agencies state that revenue bonds are also not to be considered debt of the municipality, which is a further example of disparate treatment of similar asset types.

Mr. Reis, representing interested parties, stated that the exposed bond guidance represents the prior discussions with the small group involving interested parties; however, Mr. Garrison's discussion represents asset classification between issuer obligations and ABS, not the determination of what a bond. He stated that interested parties support the previously exposed language, as they believe it best represents assets that fall along a continuum, ones that do not cleanly fit in one particular category.

Mr. Clark stated that Mr. Garrison's comments that categorization as ABS occurs because a loan is secured by assets is not a correct statement. He stated that the reason many of these investments are considered ABS is because recourse of the debt instrument to the operating entity does not provide full repayment of the debt. Even if the operating entity fully performs on its payment obligations, there would still be remaining principal outstanding that relies on the underlying collateral to repay. This is why these investments require review under the ABS criteria because repayment of the debt generally requires reliance on the underlying collateral. Mr. Clark stated that the other types of issuer obligations like corporate bonds or treasuries are issued directly from with full recourse to the issuing operating entities. Lease-backed investments are issued by special purpose vehicles (SPVs), with the repayment obligation being shifted to an operating entity through a lease contract. However, if repayment is not fully shifted to an operating entity through the lease, they should be precluded from being considered issuer credit obligations. Mr. Clark stated that it is his view that it makes perfect sense for this to be where the distinguishing line is drawn between issuer obligations and ABS. Ms. Gann stated that NAIC staff recommend retaining the guidance as previously exposed and not direct that project finance bonds that are issued by operating entities be required to follow the ABS criteria.

Ms. Gann stated that interested parties also provided comments on the classification of non-bond investments to Schedule BA and the appropriate measurement method for those investments. She stated that NAIC staff request direction from the Working Group to develop statutory accounting revisions to incorporate principles-based guidance for the measurement and admittance of different types of investments. Additionally, she stated that interested parties had proposed to capture New Markets Tax Credit (NMTC) investments in scope of the bond project. She recommended that NMTCs be reviewed in a separate agenda item. Mr. Bruggeman stated that he views the NMTCs similarly to federal Low-Income Housing Tax Credits (LIHTCs), and a separate discussion for these investments is most appropriate. Mr. Reis stated that interested parties support drafting guidance for investments that move to Schedule BA and support a NMTC agenda item to clarify the accounting and reporting requirements.

Mr. Clark made a motion, seconded by Mr. Bartlett, to direct NAIC staff to: 1) draft revisions as discussed during the meeting to the principles-based bond definition and issue paper, where applicable, regarding TIPS and varying contractual principal and interest payments, clarifying guidance for first loss positions in providing substantive credit enhancement; and 2) add guidance for feeder funds. It is anticipated that a revised packet, which includes

the updated bond definition, issue paper, and proposed revisions to incorporate the bond concepts in SSAP No. 26R and *SSAP No. 43R—Loan-Backed and Structured Securities* (to be renamed “Asset Backed Securities”) will be presented for exposure at the Summer National Meeting. Additionally, the motion included direction for NAIC staff to: 1) draft measurement and admittance guidance for investments that will move from the bond schedule to Schedule BA; and 2) consider NMTCS in a separate agenda item. The motion passed unanimously.

2. Considered Maintenance Agenda – Pending Listing – Exposures

a. Agenda Item 2019-21

Mr. Bruggeman directed the Working Group to agenda item 2019-21: Bond Proposal Reporting Revisions. Ms. Gann stated that a key element of the principles-based bond project is to improve transparency and granularity to the state insurance regulators regarding investment types and investment structure. This aspect of this agenda item includes two documents for exposure summarized as follows:

- Proposed Reporting Lines – This document proposes annual statement general instructions (reporting line descriptions) for suggested reporting lines to capture issuer credit obligations and ABS on Schedule D-1. The general classifications that currently exist are proposed to be deleted, and new granular reporting lines are suggested. This document shows tracked changes to the current “Annual Statement General Instructions”; however, the document only includes revisions related to Schedule D-1. It is anticipated that other schedules are likely to be impacted by these new reporting lines, and those revisions will be drafted after considering the comments from this initial exposure.
- Schedule D-1 Annual Statement Instructions – This document details the overall approach to add a new bond reporting schedule to expand Schedule D-1 into two components. Schedule D-1-1 would reflect issuer credit obligations (items proposed to be captured in scope of SSAP No. 26R) and Schedule D-1-2 would reflect ABS (items proposed to be captured in scope of SSAP No. 43R). This separation of schedules is supported to enable different reporting columns based on the type of security. Columns that are proposed to be specific to issuer obligations and ABS are noted within the document. In addition to creating new columns, this document also details revisions to existing columns and instructions.

Ms. Gann stated that at this time, NAIC staff are not recommending a referral to the Blanks (E) Working Group, as the intent of this exposure is to gather initial feedback regarding the proposed direction, specifically adding a new schedule specific to ABS investments. Mr. Bruggeman stated that separate schedules for issuer credit obligations and ABS was the result of ongoing discussions with interested parties regarding the most efficient way to capture information elements specific to each investment type. Tip Tipton (Thrivent) stated that interested parties have been working behind the scenes to understand the goals of state insurance regulators and the changes proposed. He stated that interested parties look forward to collaborating with state insurance regulators and NAIC staff in the ultimate adoption of this proposal.

Mr. Hudson made a motion, seconded by Mr. Clark, to move agenda item 2019-21 to the active listing and expose it for a public comment period ending Oct. 7. Also included in the motion was direction to NAIC staff to notify all working groups and task forces of use of Schedule D-1 for any analysis of this exposure, so that any group affected will have an opportunity to offer input regarding the proposed revisions. The motion passed unanimously.

3. Discussed Other Matters

a. Memorandum of Support from the Financial Condition (E) Committee

Ms. Gann stated that Financial Condition (E) Committee distributed a memorandum of support (Attachment One-A2) for several current, interrelated initiatives focused on asset risk or spread risk within the task forces and working groups of the Committee. She stated that the clarification of investments permitted to be reported as long-term bonds, with improved transparent accounting and RBC reporting, was specifically identified. Mr. Bruggeman identified that the memorandum would be noted as received by the Working Group. Having no further business, the Statutory Accounting Principles (E) Working Group adjourned.

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one-a_sapwg minutes 7.18.22tpr.docx](https://naiconline.sharepoint.com/sites/naicsupportstaffhub/member%20meetings/e%20cmte/apptf/2022summernm/1_sapwg/minutes/attachment-one-a_sapwg%20minutes%207.18.22tpr.docx)

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May 6, 2022

Mr. Dale Bruggeman, Chairman
Statutory Accounting Principles Working Group
National Association of Insurance Commissioners
1100 Walnut Street, Suite 1500
Kansas City, MO 64106-2197

RE: Principles-Based Bond Definition and Draft Issue Paper – Comments Due May 6, 2022

Dear Mr. Bruggeman:

Interested parties appreciate the opportunity to comment on the exposed Principles-Based Bond Definition (the Proposed Bond Definition) and Draft Issue Paper that were released for comment by the NAIC Statutory Accounting Principles (E) Working Group (the Working Group).

Interested parties believe this effort is resulting in a workable and high-quality bond definition and we look forward to our continued collaborative effort as the project proceeds toward finalization. Interested parties also would like to commend NAIC staff for a well thought out and documented Draft Issue Paper.

The interested parties' comments are organized in two sections – 1) Comments on the Proposed Bond Definition and Draft Issue Paper and 2) Comments on the Specific Questions Posed in the Draft Issue Paper.

Comments on the Proposed Bond Definition and Draft Issue Paper

- 1) Interested parties suggest a slight modification to paragraph 2a, on page 2, of the Proposed Bond Definition. While interested parties are supportive of proposed edits to include U.S. Treasury Inflation-Indexed Securities in paragraph 2a, we do not believe the following subscript is appropriate or warranted.

The inclusion of U.S. Treasury Inflation-Indexed Securities identifies these securities as an explicit exception to the principles-based bond definition that prohibits securities from being reported on Schedule D-1 that have variable principal or interest due to the underlying equity appreciation or depreciation, or an equity-based derivative.

Interested parties believe U.S. Treasury Inflation-Indexed Securities are more accurately adjusted for inflation rather than adjusted for “underlying equity appreciation or depreciation, or an equity-based derivative.”

- 2) Interested parties believe a small change is need on Page 2, paragraph 2g of the Proposed Bond Definition, to be consistent with both regulator intent, and current practice, related to loan form CTLs, that would otherwise be reported on Schedule B, Mortgage Loans, under SSAP No. 37. Paragraph 2g, as written, is only inclusive of security form CTLs which excludes certain loan form CTLs currently permitted to be reported on Schedule D in guidance adopted by the NAIC during 2021. Specifically, interested parties propose the following changes (underlined) to paragraph 2g:

Investments in the form of securities for which repayment is fully supported by an underlying contractual obligation of a single operating entity (e.g., Credit Tenant Loans (CTLs), Equipment Trust Certificates (ETCs), other lease backed securities, Funding Agreement Backed Notes (FABNs), etc.). For purposes of applying this principle-based concept, repayment is fully supported by the underlying operating entity obligation if it provides cash flows for the repayment of all interest and at least 95% of the principal of the security. In addition, mortgage loans in scope of SSAP No. 37 that qualify under a SVO structural assessment are in scope of this statement as CTLs.

- 3) Interested parties note there is new language included within paragraph 3b, on page 3, of the Proposed Bond Definition. Interested parties agree with what we believe to be the intent (i.e., close a potential “loophole” related to equity backed securities). We therefore propose the following technical edit (underlined) to ensure it is not potentially interpreted more broadly:

For clarification purposes, all returns from an equity backed ABS in excess of principal repayment are required to be considered as interest. Therefore, investments with “stated” interest and then “additional returns” to which the holder of the debt instrument is entitled are collectively considered as interest and shall be assessed together in determining whether the investment has variable principal or interest due to underlying equity interests.

- 4) Interested parties propose the following changes (underlined) to the Substantive Credit Enhancement Language included within the glossary of the Proposed Bond Definition. The proposed changes are meant to clarify that there could be a first loss tranche, owned by an insurer, where there is a substantial credit enhancement that still qualifies the first loss tranche for Schedule D reporting (e.g., a Single Asset Single Borrower (SASB) CMBS security with substantial overcollateralization). For example, a SASB could be collateralized

by a single real estate asset (e.g., \$100 collateral value) where the loan being collateralized is only a fraction of the collateral value (e.g., \$60). In such an instance, the first loss tranche security may be owned by an insurance company, but the first loss position is borne by the sponsor (i.e., the first \$40 of losses). Interested parties believe the below proposed edits will help provide clarity for such a security, or other similar securities, and is consistent with the spirit of the proposed principles included therein.

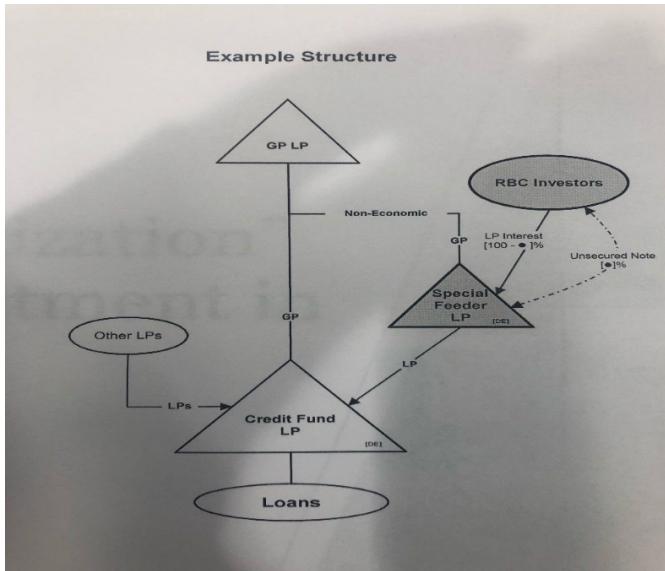
The first loss tranche position (or tranches if the first tranche is not itself substantive) may be issued as part of the securitization in the form of debt or equity interest, or it may be retained by the sponsor and not issued as part of the securitization. If the first loss tranche position (or a more senior position(s), if the first loss position(s) lack a substantive credit enhancement) is issued as part of the securitization, and does not have a substantive credit enhancement and is held by a reporting entity, the accounting should follow the guidance applicable to the type of instrument (i.e., debt vs. equity); however, regardless of the type of instrument, it does not qualify as a Schedule D bond and should be reported on Schedule BA.

Additionally, interested parties question whether the accounting (highlighted above) for Schedule BA Assets should be codified within the Substantive Criteria of the Bond Definition. In principle it doesn't seem appropriate there and it may also conflict with, or add confusion around, any accounting guidance determined to be appropriate for such assets (see interested party comments in section 2 of this letter).

- 5) Interested parties note that “feeder funds” were a focal point of discussions during development of the Proposed Bond Definition. In large part, this was in the context of the “stapling” concern, which was de-escalated, as residual tranches have been moved to Schedule BA with the desire of regulators to assess appropriate capital charges. The below is a representative structure of a feeder fund, structured for various legal reasons, which we understand is not viewed as problematic. To ensure the Draft Issue Paper is wholly inclusive of discussions held on feeder funds, and further clarify the principle-based approach, we suggest the following language, and example structure, be included in the Draft Issue Paper. An appropriate spot might be right after paragraph 26.

The assessment of equity backed securities should be looked at, not only in form, but in substance. For example, a feeder fund arrangement where the debt is issued from the feeder fund, that has an equity interest in another fund that holds debt instruments, should not be viewed as holding one equity interest (i.e., in this case a pass-through entity) if the substance is the debt is backed by debt instruments. Similarly, if the “credit” fund were an “equity” fund, backed by equity interests, the debt of the feeder fund would have to meet the requirements of paragraph 26 while looking at the substance of equity interests supporting the debt. Of course, such an arrangement would have to meet the other

relevant parts of the standard (e.g., have a substantive credit enhancement, etc.). Substance over form should be the determining factor in these and similar situations.



- 6) Interested parties note that examples 1 & 2 of Appendix I are less explicit, as they have evolved over time, than the examples in Appendix II. For example, example 2 has many variables and really doesn't address a specific debt instrument, rather it lays out principles. Using a specific security in the example would not be particularly helpful as there are too many variables and any one example would therefore be of limited use. Interested parties therefore suggest the standard might have better flow if examples 1 & 2 become codified as part of the standard itself, with potentially minor edits for purposes of flow only. Instead of referencing Appendix 1, in paragraph 1, it might make sense to codify these examples at the end of paragraph 1. The end of paragraph 3 would potentially be another area to embed these principles within the standard itself. If regulators agree that there is value in this suggestion, interested parties would be more than willing to work with regulators and NAIC staff in that regards.
- 7) Interested parties note that paragraph 67 of the Draft Issue Paper includes a concept that is not in the Proposed Bond Definition, and which interested parties do not recall being discussed in any meaningful way. Therefore, interested parties question the appropriateness of its inclusion in the Draft Issue Paper. The stated concern appears to be "to allow for full assessment of the extent of ABS by regulators." The proposed solution is to remove all such investments from within the Scope of SSAP No. 2R, *Cash, Cash Equivalents, Drafts and Short-Term Investments*. Interested parties believe a less disruptive solution would be to just disclose, or have a separate reporting line, of any ABS short-term investments (e.g., ABS Commercial Paper) on the Short-Term investment schedules. If there is a broader concern that regulators feel needs to be addressed, interested parties believe that should be a separate

project, as it appears outside of the Proposed Bond Definition Project, and should be addressed separately and therefore not included in the Draft Issue Paper for the Proposed Bond Definition.

Comments on the Specific Questions Posed in the Draft Issue Paper

Paragraph 105 of the Draft Issue Paper notes that it is anticipated that guidance will be drafted to recommend the use of Schedule BA for most investments that do not qualify as bonds under the Proposed Bond Definition, with comments requested in three areas. Interested parties' comments are immediately following each of the three questions asked and enumerated below:

- 1) Are there investments that will not qualify as bonds that should be considered for reporting on a different schedule other than Schedule BA? Comments on key investment characteristics that would appropriately distinguish these investments are requested.

Interested parties have not identified anything to date, that will not qualify as a bond under the Proposed Bond Definition, for which we have identified an alternative reporting schedule to Schedule BA.

- 2) For investments that are captured on Schedule BA, should consideration occur to permit an amortized cost approach rather than a lower of cost or fair value measurement? For investments in which an amortized cost approach is supported, what characteristics can be used to identify / support this measurement method? Should use of NAIC designations be permitted to drive the Schedule BA measurement method for these securities?

Interested parties note that there are likely investments that do not qualify as Schedule D, Bonds (e.g., non-agency guaranteed pass-through mortgage-back securities) that are not considered bad investments (i.e., they are considered good investments, by both interested parties and regulators, just not appropriate as bonds on Schedule D). Further, in the case of non-agency guaranteed pass-through mortgage-backed securities, the securities are not considered bonds because they have no substantive credit enhancement, which therefore are akin to mortgages that have a designated reporting schedule. While this example, in theory, could be reported on the Schedule B – Mortgage Loans, it may not be practical to report them on Schedule B because Schedule B RBC formulas would need to substantially be revised. Further, revisions to SSAP No. 37 would be necessary since securities are not permitted as mortgage loans. The question implies that the default measurement method on Schedule BA would be lower of cost or fair value, which itself seems to imply they are “bad” investments. Interested parties therefore recommends taking a close look at this assumption for all investments that may have to be reported on Schedule BA simply because they do not meet the definition of a bond under the Proposed Bond Definition. For example, specifically related to non-agency guaranteed pass-through mortgage-backed securities, like mortgages, amortized cost seems to be the appropriate accounting.

In addition to amortized cost, fair value or lower of cost or fair value may be appropriate in other situations. For example, fair value may be appropriate for equity-linked bonds as they exhibit equity like characteristics. Lower of cost or fair value may be appropriate for Principal Protected Notes, if regulators believe lower of cost or fair value appropriately captures the non-payment risk they have identified as a concern.

Also, as noted in the “feeder fund example”, and previously discussed in this letter, the “residual tranche” is in a limited partnership form. In general, limited partnership interests are accounted for under the equity method of accounting, and subject to impairment. It may be that such accounting is determined to be appropriate in this instance. If not, interested parties would like to discuss with regulators and NAIC staff any distinctions which may need to be made when a limited partnership interest is a residual tranche or the equity component of a SSAP No. 48/97 investment that issues debt.

Lastly, interested parties are very supportive of the SVO’s outstanding exposure, and shared (with interested parties) objective, on designating additional Schedule BA assets, that exhibit fixed income characteristics, with the goal of obtaining commensurate risk-based-capital charges. With that said, interested parties do not necessarily see the connection for having NAIC designations drive the measurement method (accounting) of investments on Schedule BA.

SSAP No. 26R *Bonds* includes in its scope debt instruments issued by Certified Capital Companies (CAPCOs). As defined in INT 06-02 *Accounting and Reporting for Investments in a Certified Capital Company*, CAPCOs are state legislated venture capital firms for which investors who invest cash to acquire an equity interest or qualified debt instrument receive state premium tax credit or income tax credit.

As currently exposed, the Proposed Bond Definition will continue to include debt investments in CAPCOs in the scope of SSAP No. 26R. Therefore, it is expected that these investments will continue to be reported on Schedule D as bonds.

This question has also raised a question on debt investments whose returns are earned solely through federal tax credits – should they be reported on Schedule D since these investments are similar to debt investments in CAPCOs?

For example, there is a program referred to as the New Markets Tax Credit (NMTC) program whose goal is to stimulate regeneration of low-income and impoverished communities across the United States. Capital raised by NMTC programs is used to drive expansion of investment, job creation and economic opportunities in distressed communities. The NMTC program provides federal tax credits to reporting entities that invest in the development entities which make direct investments in these communities. An investor is required to make a debt and equity investment into the development entity. We believe that debt investments in this program are akin to debt investments in CAPCOs. The only differences of which we are aware is that CAPCOs benefit from state tax credits whereas NMTC programs benefit from federal tax credits and CAPCOs do not require investors to also make

an equity investment. Some of the similarities between CAPCOs and NMTC programs are as follows:

1. **Fixed schedule for one or more future payments** – The schedule and timing of tax credits to be earned is fixed from day 1. In addition, the par amount of the notes is paid back in cash upon maturity of the deal.
2. **Return is based on tax credits** – The return on NMTC investments is earned solely through tax credits. Similar to CAPCOs, where there is usually no cash interest earned on the debt investment, NMTC deals do not pay cash interest.
3. **Significant premiums** – These investments are purchased at significant premiums. Premiums are amortized pro-rata throughout the life of the deal in proportion to the tax credits earned.
4. **Operating entity guarantee** – It is common for debt investments in these deals to have a guarantee by an operating entity such as a financial institution. The guarantee would ensure that if the tax credits do not emerge, the investor gets its investment back.

Based on these similarities, we believe that debt investments in NMTC programs and other similar programs should also qualify for Schedule D reporting. Interested parties would like to discuss these investments with regulators and NAIC staff as to whether they qualify for Schedule D reporting and/or if specific language should be added to paragraph 2.k.iii with CAPCOs.

- 3) Revisions are also expected to SSAP No. 2R, to address the ABS restrictions, as well as SSAP No. 103R, to clarify that only beneficial interests that qualify as ABS will be accounted for under SSAP No. 43R. Comments are requested on whether other SSAPs will also be impacted and need to be revised.

Please see our comments above related to SSAP No. 2R on ABS restrictions. In relation to any changes to SSAP No. 103R, interested parties think this potentially relates to proposed changes being drafted in SSAP No. 43R, which are not part of the Draft Issue Paper, and believe it is appropriate to see such proposed changes prior to commenting. It may be appropriate to develop the accounting guidance for securities discussed in question 2 above and/or securities not meeting the substantive criteria of the Proposed Bond Definition (see also the interested party response 4 in section I of this comment letter). It may be appropriate to include this guidance in another SSAP such as SSAP No. 21, *Other Admitted Assets*.

One further comment relates to adoption of the standard, specifically as it relates to the meaningful and/or substantive credit enhancement requirements, which require stepping back in time “as if” one was looking forward at that time. Upon adoption, this could require looking back for a considerable period, perhaps decades. It may be necessary, for example, to allow an insurance entity to use hindsight in instances in which assumptions in a prior period are unobservable or otherwise unavailable and cannot be independently substantiated. Interested

parties would like to continue discussions with regulators on this topic which, while discussed, the issue of a “practical expedient” was never fully discussed through to full resolution.

* * *

Thank you for considering interested parties’ comments. If you have any questions in the interim, please do not hesitate to contact us.

Sincerely,

D. Keith Bell

Rose Albrizio

cc: NAIC staff
Interested parties

The Lease-Backed Securities Working Group

May 5, 2022

Mr. Dale Bruggeman, Chairman
Statutory Accounting Principles Working Group
National Association of Insurance Commissioners
1100 Walnut Street, Suite 1500
Kansas City, MO 64106-2197

RE: Ref #2019-24 – SSAP No. 26R & 43R, Proposed Bond Definition

Dear Mr. Bruggeman:

Our group, the *Lease-Backed Securities Working Group*, would like to thank the Statutory Accounting Principles Working Group (SAPWG) for the opportunity to comment on the exposure Reference #2019-24 – SSAP No. 26R & 43R, Proposed Bond Definition (the “Proposed Bond Definition” or “Exposure”) as well the attached Statutory Issue Paper No. 1XX (the “Issue Paper”).

We fully support the attempt to clarify the accounting standards for bonds and structured assets, and we appreciate the immense effort that has gone into this project by both the regulators and various industry groups. While we believe much work remains to be done, our group looks forward to assisting in any way we can as this project continues to evolve. We also anticipate the opportunity to comment on the draft revisions to the two SSAPs when the language is submitted for exposure later this year. At this point, we are limiting our comments to several ‘high-level’ observations:

In particular, we worry that the designation of *some* simple unstructured single-borrower securities backed by secured loans as 26R “issuer credit obligations” and *others* as 43R “asset-backed securities” will cause confusion in the markets and will result in inconsistent filing by insurance company investors.

Our group was involved over twelve years ago when investments were originally separated between 26R and 43R. At that time, a decision was made -- which we did not agree with -- that even simple un-structured single-borrower securities should be included in 43R, along with “structured securities”, if they had been issued by a trust or SPV. For that reason, it was determined that 43R would include “Loan-Backed and Structured Securities” (“LBASS”). However, as the Issue Paper notes, that decision led to confusion in the markets as “many insurers had different interpretations of the adopted 2010 revisions.”

This is because market participants distinguish between two basic types of transactions, based on the source of the credit:

- 1.) Simple unstructured debt transactions where the credit depends primarily on the contractual obligation of *a single rated-credit payor*. These transactions may either be “unsecured” or “secured” by a lien on an asset. If issued in security form by a Trust or special-purpose issuer, the cash flows from the underlying loan are simply “passed-through” unaltered to investor, and the credit risk of the securities is identical to that of the underlying loan.

and
- 2.) “Asset-Backed” or “Structured Securities” where the credit of each security is not based fundamentally on the credit characteristics of the underlying collateral -- which is typically unrated -- but instead is determined by the “structure” that has been imposed on the transaction, & which

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fundamentally alters the cash-flows to investors. In these transactions, determining the “credit” of each security depends on a detailed analysis of the structure.

For this reason, the 2010 revisions were confusing to market participants, and many, assuming that 43R was meant to be for “structured securities”, continued to file simple single credit-based transactions under SSAP 26R. Other investors filed anything issued by an SPE Trust -- even if backed by a single loan to a single borrower -- under 43R. This led to inconsistent filing of transactions.

Seeking to address this confusion, the current Proposed Bond Definition seeks once again to clarify for investors which types of transactions should be reported in scope of 26R (now to be designated as “issuer credit obligations”) and which fall more properly into 43R, (now labeled as “asset-backed securities”) -- or even potentially what types of investments would not be admitted as “bonds” under either Schedule and would have to be reported on Schedule BA, “Other Admitted Assets”.

This determination would be made first based on whether the issuer was considered to be an ‘operating entity’ or an SPE “ABS Issuer”. If the transaction was determined to be issued by an “ABS Issuer”, there would be a second distinction based on the degree of “asset risk” implicit in the transaction. Those with very little “asset risk” could still qualify as an “issuer credit obligations”; while those with higher exposures, would be either designated as “asset-backed securities” -- or even potentially as “non-bond” BA assets. For simple secured loans, “asset risk” would be measured by the size of the unamortized residual or final “balloon” payment supported by a lien on the asset -- as a proportion of the original principal balance.

The implied concept behind this framework seems to be that being secured by a lien on an asset implies a level of “equity risk” for the lender. We disagree, for several reasons:

As every lender knows, having a lien on an asset does not convey an “equity” or ownership interest in that asset.

The lien securing the loan is in almost all cases represents a “first priority” claim on the asset, and the final payment secured by that lien is typically only a fraction of the total estimated value of the asset at the maturity of the loan. The correct metric for assessing the risk of that priority claim is the size of the claim relative to the value of the asset (and the predictability of that value), not the size of the final payment as a proportion of the total loan. Determining this risk is an essential part of the credit analysis that all secured lenders -- and rating agencies -- undertake, and is definitely not equivalent to the risk associated with owning the asset outright.

From an accounting standpoint, the only proper time to assign “equity risk” to a lender is when the lender becomes the owner of the asset, via foreclosure or otherwise depending on the terms of the credit agreement.

The result of applying this framework is that *some* simple secured single-borrower loans such as those listed in 1.) above -- even if issued by an SPV Trust or “ABS Issuer” -- would now be designated to be “issuer credit obligations” while *others* would be “asset-backed securities” -- or, depending on the degree of “asset risk”, even potentially BA assets:

Some simple secured transactions supported by cash flows from a non-financial asset via a lease or other form of contract with the credit payor -- for example, project finance loans or municipal lease-revenue bonds -- even if they were issued as securities through a “trust” or “SPV” by an “ABS Issuer” -- would now be re-classified as “issuer credit obligations” *regardless of the size of the residual asset exposure in the transaction*.

The Lease-Backed Securities Working Group

Other identical structures, i.e. loans secured by leases to corporate entities, equipment trust certificates, funding agreement notes, etc. would *either* be classified as “issuer credit obligations” *or* “asset backed securities” depending on the amount of residual “asset risk” in the transaction. Those with minimal residual asset exposure (less than 5%) would now qualify as “issuer credit obligations”. Those with higher exposures would be designated as either “asset backed securities” or even, depending on the size of the exposure, potentially as Schedule BA assets. (That determination would depend on the specifics of each individual transaction.)

Those secured loans designated as “asset backed securities” would have additional credit requirements regarding “credit enhancement” and the demonstration of a “meaningful” level of cash flows to service the debt (if supported by “non-financial assets” - see below) -- requirements which would not apply to those designated as issuer credit obligations.

This framework is bound to create confusion for investors and lead once again to inconsistencies and errors in reporting. The confusion is made worse by the two additional requirements for a transaction to qualify as a Schedule D-1 asset backed security:

The first requirement is that in order to qualify as an asset-backed security, a transaction must benefit from “Substantive Credit Enhancement” sufficient to place the holder of the debt *“in a different position than if the holder owned the ABS Issuer’s assets directly”*. (Paragraph 41 of the Issue Paper states that “To qualify as a bond under this standard, there is a requirement that there are *substantive credit enhancements within the structure that absorb losses before the debt instrument being evaluated would be expected to absorb losses.*”) [emphases added]

To begin with, the determination of “expected losses” is a subjective determination which is an essential part of credit analysis, not an accounting distinction.

More fundamentally, there are many simple secured loan transactions where the issuer of the securities (the ABS Issuer) has no equity or ownership interest in the asset being financed. In these transactions the “asset” held by the issuer is the loan itself, a financial instrument that unambiguously represents a “creditor relationship” with the borrower, not an equity interest. In these simple “pass-through securities”, there is no intervening structure and the cashflows from the underlying loan are simply passed-through *unaltered* to the holders of the securities. In other words, the holder of the securities is in *exactly* the same position “as if it owned the ABS Issuer’s assets (underlying loan) directly”. While this may not be the intent of the drafters, interpreted literally, it would disqualify all simple pass-through secured loans as ABS securities -- and implicitly, as bonds.

The second requirement to qualify as an “asset backed security” is that those deals secured by “cash-generating non-financial assets” must demonstrate a “meaningful” source of cash flows for the repayment of the bond (i.e.: other than through the sale or re-financing of the assets). However, as the exposure itself admits, determining what constitutes a “meaningful” source of cash flows is once again subjective, depending largely on the specifics of each individual transaction, requiring numerous “examples” to serve as guidance, but no firm metrics.

Conclusion:

Secured lending is as old as lending itself, and does not represent a new or exotic innovation. Simple secured loans, even if issued in security form by a trust or SPV -- allowing investors to participate *pari-*

The Lease-Backed Securities Working Group

passu in the underlying loan -- have long been accepted insurance company investments, as codified in SSAP 43R for many years -- and indeed before that, as 26R "bonds".

While in one sense every secured loan issued in security form can be considered an "asset-backed security", this not the common understanding in the market. The term "Asset-Backed Security" is broadly used by market participants (including the SEC and organizations such as SIFMA) to refer to "structured securities": pools of assets which have been carved-up, or "tranched" into multiple securities, and for which the payments received by investors are not "directly proportional" to the payments flowing from the underlying assets.

The current version of 43R states clearly that it covers both "loan-backed" and "structured" securities. (It appears that the term "asset-backed security is not used in the current 43R.) If the current terminology is dropped, and some simple secured loans are now to be designated as "asset-backed securities", we feel it is important that additional language be added to the standard making it clear that they are not subject to the same requirements as "structured securities" -- the most common use of the term "asset-backed securities".

Our group continues to believe that a much clearer division between the two SSAPs, 26R and 43R – one which would avoid much of the ambiguity in the current Exposure – would be to assign *all* single-credit payor/single obligor transactions – whether secured or unsecured – to be in scope of SSAP 26R as "issuer credit obligations". This would allow for SSAP 43R to be used exclusively for true *structured securities*, where the credit is not based on the underlying loans or assets – which are frequently not rated entities – but instead credit is determined by the structure of the transaction.

This reflects the common understanding in the market, which draws a fundamental distinction between simple (i.e.: unstructured) debt relying primarily on the creditworthiness of a single rated-credit payor, and "structured securities", where the credit has been modified through the introduction of multiple classes of securities, each with its own credit characteristics, and where the underlying cash flows have been altered by the structure, thus putting investors in a different economic position from having direct credit exposure to the underlying loans or assets backing the transaction (the most common use of the term "Asset-Backed Securities").

If the current framework is adopted, we would suggest that additional language needs be supplied to 43R making it clear -- as does the current version of 43R -- that it covers simple secured loan-backed transactions as well as "structured securities".

We thank you for the opportunity to offer these comments, and are happy to answer any questions or discuss our comments further with the regulator community.

Thank you for considering our comments,

John Garrison
On behalf of *The Lease-Backed Securities Working Group*



MEMORANDUM

TO: Interested Parties of the Financial Condition (E) Committee

FROM: Financial Condition (E) Committee

DATE: May 23, 2022

RE: Memorandum of Support

Since the great financial crisis, interest rates have generally been in a downward trend for nearly 15 years, resulting in reduced spreads for life insurers and otherwise putting pressure on many members of the industry that depend upon longer-dated, lower risk debt instruments. In addition, recent inflationary pressures and increasing uncertainty resulting from the Russia/Ukraine crisis are exacerbating other challenges for the industry. Members of the Committee remain particularly concerned that macroeconomic trends are likely to continue to drive an increase in asset risk for at least some members of the industry.

This memorandum is being issued by the Committee to express its support for several current, interrelated initiatives focused on asset risk or spread risk within the task forces and working groups of the Committee as well as other related work within the task forces and working groups of other Committees, including the Life Insurance and Annuities (A) Committee. The Committee recognizes the range of risk management practices within the industry and the critical importance of maintaining a fair and competitive marketplace by establishing standards if necessary to address issues that could translate into material risks if not properly and timely considered within the NAIC solvency framework.

Although the Committee has not yet reviewed specific proposals from these various groups, it is aware of the underlying objectives of many of the proposals under discussion, including, without limitation:

- A more risk-sensitive Life Risk Based Capital (RBC) charge for certain structured securities and other asset-backed securities that carry a greater tail risk;
- Clarification of investments permitted to be reported on Schedule D-1: Long-Term Bonds, particularly focused on improved transparent accounting and RBC reporting for certain loan-backed and structured securities to capture the more risk-sensitive features of these types of assets;
- Consideration of changes to the current policies of the Valuation of Securities (E) Task Force as they pertain to possible use of or reduction of reliance on rating agencies, where deemed appropriate, and possible use of other risk identifiers such as market data;
- A modified economic scenario generator that more appropriately captures the low interest rates experienced during the past few years; and
- Consideration of certain “high-yielding” assets within the annual asset adequacy analysis testing.

The Committee is grateful to all the States and staff members that are currently participating in the important work of these groups and welcomes the input of industry and other stakeholders in the development of proposals. Although this work is ongoing, the Committee encourages all States and the Securities Valuation Office (SVO) to continue to take all appropriate actions under existing rules and standards.

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Statutory Accounting Principles (E) Working Group
Virtual Meeting
May 24, 2022

The Statutory Accounting Principles (E) Working Group of the Accounting Practices and Procedures (E) Task Force met May 24, 2022. The following Working Group members participated: Dale Bruggeman, Chair (OH); Kevin Clark and Carrie Mears, Co-Vice Chairs (IA); Sheila Travis (AL); Kim Hudson (CA); Michael Estabrook (CT); Rylynn Brown and Tom Hudson (DE); Eric Moser (IL); Judy Weaver (MI); Doug Bartlett and Pat Gosselin (NH); Bob Kasinow (NY); Melissa Greiner (PA); Jamie Walker and Shawn Frederick (TX); David Smith (VA); and Amy Malm (WI).

1. Reviewed Comments on Exposed Items

The Working Group held a public hearing to review comments (Attachment One-B1) on previously exposed items.

a. Agenda Item 2022-03

Mr. Bruggeman directed the Working Group to agenda item 2022-03: Premium Adjustment Allocated to Jurisdictions. Robin Marcotte (NAIC) stated that while this agenda item does not propose statutory revisions, it proposes blanks instructional changes to Schedule T, the State Page, and the Accident and Health Policy Experience Exhibit (AHPEE) to clarify guidance for premium adjustments. She stated that NAIC staff received inquiries regarding a minor number of entities that primarily wrote health business related to the federal Affordable Care Act (ACA), who did not properly allocate premium adjustments by jurisdiction but instead reported the adjustments on the “aggregate other alien line” in the statutory financial statements. The proposed instruction changes clarify that all premium adjustments, both increases and decreases, including but not limited to, ACA premium adjustments related to the risk adjustment program, shall be allocated as premium in the respective jurisdiction and are effective for year-end 2022 reporting.

Ms. Malm made a motion, seconded by Mr. Hudson, to adopt agenda item 2022-03 (Attachment One-B2), noting that the agenda item did not result in statutory revisions; however, it expressed support for the sponsored Blanks (E) Working Group proposal 2022-10BWG. The motion passed unanimously.

b. Agenda Item 2022-08

Mr. Bruggeman directed the Statutory Accounting Principles (E) Working Group to agenda item 2022-08: Treatment of Freddie Mac WI Certificates and the related *Interpretation (INT) 22-01T: Freddie Mac When-Issued K-Deal (WI Trust) Certificates*. Julie Gann (NAIC) stated that this sponsored agenda item is to address the accounting and reporting for Freddie Mac When-Issued K-Deal (WI Trust) Certificates. This program, in essence, creates an additional trust where the investor buys certificates in the WI trust, which is initially backed by cash; and within 90 days, the WI trust uses the cash to purchase the mortgage securities from the real estate mortgage investment conduit trust. Ms. Gann stated that although there is a short delay in acquiring the mortgage-backed securities, the performance of the investment is guaranteed by Freddie Mac. The tentative statutory accounting interpretation clarifies that investments in the Freddie Mac WI Program shall be captured in scope of *Statement of Statutory Accounting Principles (SSAP) No. 43R—Loan-Backed and Structured Securities* from initial acquisition.

Mr. Hudson made a motion, seconded by Ms. Greiner, to adopt the exposed INT 22-01 to clarify that Freddie Mac When-Issued K-Deal (WI Trust) Certificates are in scope of SSAP No. 43R from acquisition (Attachments One-B3 and One-B4). The motion passed unanimously.

c. Agenda Item 2021-21

Mr. Bruggeman directed the Working Group to agenda item 2021-21: Related Party Reporting. Jake Stultz (NAIC) stated that this agenda item was drafted in response to recent discussions on the reporting and disclosure requirements for investments that involve related parties. He stated that the agenda item proposes revisions to SSAP No. 25—*Affiliates and Other Related Parties* and SSAP No. 43R, clarifying related party and affiliate guidance, as well as requiring new reporting information for investments that are acquired from a related party, regardless of whether the investment is captured on the affiliate reporting line. He stated that the main goals are to: 1) clarify the reporting of affiliate transactions within existing reporting lines in the investment schedules; and 2) incorporate new reporting requirements for investment transactions with related parties using new reporting codes. He stated that interested parties requested the deletion of a proposed addition to SSAP No. 43R; i.e., an addition that seeks to clarify that investments with arrangements that result in a direct or indirect control shall be reported as affiliated. He stated that in response to these comments, pursuant to existing guidance in the *Insurance Holding Company System Regulatory Act* (#440) and SSAP No. 25, affiliation is determined through direct or indirect control, and that control can be based on voting rights, management and policies, contract, or otherwise. He also stated that the addition to SSAP No. 43R does not modify the current affiliation designation process. He stated that NAIC support staff recommended retaining the sentence requested for deletion; however, they modified it slightly to clarify that these scenarios are examples and not limitations in the determination of control. He stated that NAIC staff recommended that the Working Group adopt this agenda item and confirm that:

1. The new disclosures are effective for year-end 2022 reporting, as this date is in line with other state insurance regulators' initiatives, including the Macroprudential (E) Working Group.
2. The related party new electronic code column is effective for all noted investment schedules: B—Mortgage Loans, D—Long-Term Bonds, DB—Derivatives, BA—Other Long-Term Invested Assets, DA—Short-Term Investments, E2—Cash Equivalents, and DL—Securities Lending Collateral Assets.
3. The related party new electronic code column shall be completed for all investments on any reporting line.
4. The Statutory Accounting Principles (E) Working Group supports the inclusion of Code 6 (no related party relationship), as exposed by the Blanks (E) Working Group (2021-22 BWG), to eliminate potential confusion on whether the absence of a code represents incomplete reporting or a non-related party relationship.

Mr. Stultz stated that information contained in the interested parties' comment letter regarding the determination of affiliation under Model #440, and that it is solely based on voting rights of an equity holder, is incorrect. He stated that although ownership of 10% of voting securities results in a presumption of control, voting securities are not the sole basis for determining control. Determination of the affiliation of an investment is based on an evaluation of control of the investee, whether through voting interests or other means; accordingly, this agenda item does not propose to change the affiliate determination or definition. Mr. Stultz stated that interested parties also recommended other revisions to SSAP No. 25 and SSAP No. 97—*Investments in Subsidiary, Controlled and Affiliated Entities* to include open-ended foreign regulated investments that are currently captured in SSAP No. 30R—*Unaffiliated Common Stock*; however, it was recommended that any other changes to the exposed language be considered in a separate agenda item.

Angelica Tamayo-Sanchez (New York Life), representing interested parties, stated that there remain interpretation questions regarding the objectives of the agenda item versus what reporting will result upon adoption. She stated that while interested parties agree that guidance states that control can be achieved through means other than ownership, specific questions remain regarding collateral loan obligations (CLOs). She stated that language being

proposed for adoption implies that CLOs managed by an affiliated party would be deemed to be an affiliated transaction; i.e., an interpretation that differs from industry's interpretation of current reporting requirements. She stated that most insurance companies would not have reported CLOs as affiliated investments if the underlying investments do not have affiliated credit exposure, despite it being managed or originated by a related party. She stated that while the agenda item states that it is not intended to change current affiliated reporting requirements, if these investments should be deemed affiliated, most insurers have likely misinterpreted the guidance regarding their reporting. Discussions among industry indicate that if it is the will of the Statutory Accounting Principles (E) Working Group to classify these investments as affiliated, it will be a change from current, prevalent practice. In addition, there is a presumption that affiliated investments are required to be reviewed by the NAIC Securities Valuation Office (SVO), and if certain CLOs are required to be reported as affiliated, they could lose their filing exempt (FE) status. If FE status is lost, the SVO may need to develop additional procedures, as it does not currently have a methodology to designate this type of asset-backed security investment structure.

Mr. Clark stated that there is a mistaken interpretation that affiliation designation based on securitizations should be based on the affiliated credit exposure of the underlying collateral. He stated this interpretation is not consistent with Model #440 or SSAP No. 25. The affiliate designation is determined based on the ability to direct activities, not credit exposure. If an entity can control the activities of another entity, then all transactions, regardless of credit exposure, should be deemed affiliated. Mr. Clark stated that there is nothing in Model #440 that would scope out securitizations, and to exclude them for any purpose, including through the insertion of an unaffiliated intermediary, is incorrect. He stated that investments without an affiliated credit exposure that are originated or managed through an affiliated entity should be deemed affiliated. The need to distinguish between affiliated and unaffiliated credit exposure, despite being on an affiliated reporting line, is an important goal of this agenda item and is achieved through the new, supplemental reporting codes. Currently, since affiliation is based on control, without the use of these reporting codes, there is no way to differentiate between various types of credit exposure. In addition, some investments could be structured in a manner that the control threshold is not met, thus an investment would not be classified as affiliated; however, it does have underlying affiliated investment involvement; i.e., affiliated origination. This agenda item would assist state insurance regulators in the identification of such circumstances. Mr. Clark stated that the specificity proposed for SSAP No. 25 does not imply that any affiliated involvement causes an investment to become affiliated; it only clarifies that a control evaluation is still required by the insurer. He stated that as an example, for affiliated investment managers who originate investments that are ultimately determined not to be affiliated, the fee structure is certainly an affiliated transaction and should have been reviewed by the state of domicile through an appropriate Model #440 filing. He stated that he would support a referral to the Valuation of Securities (E) Task Force to address FE questions regarding CLOs, as the intent was not to modify FE status of these investments.

Keith Bell (Travelers), representing interested parties, stated that the language as proposed will likely not yield the results desired by state insurance regulators, specifically the reporting of certain investments as affiliated if they are managed by an affiliated asset manager. He stated that Model #440 was drafted prior to the prevalence of securitizations, and the emphasis of the model is on equity investments, not debt investments. He stated that debt investments are the rights to contractual cashflows, which do not represent equity investments; thus, determining control based on a debt investment for the determination of affiliate classification is not consistent with current practice. He stated that interested parties do not disagree with the objectives of state insurance regulators, but they believe the added language changes the scope of affiliated transactions, and if that is the ultimate wish of state insurance regulators, alternate guidance should be considered. Mr. Bruggeman stated that the spirit of the model is that if the underlying entity is affiliated, all associated transactions should also be deemed affiliated. However, increased reporting granularity of underlying credit exposure would be achieved through the new proposed reporting codes. The proposed language is only to clarify control, and it is not modifying Model

#440, nor modifying affiliated reporting requirements. Mr. Clark stated that he agrees with Mr. Bruggeman in that if a company is deemed to be affiliated, all transactions, debt, equity, or other should also be reported as affiliated transactions. He also stated that the proposed language only clarifies when control exists, not necessarily how to determine if control exists. He stated that if there is a desire to further clarify how to determine control, that would need to be in a project separate from this agenda item. Ms. Weaver stated that the interpretive disconnect of industry could leave open the possibility of other investments to not be reported as affiliated, and she inquired if interested parties have suggestions to the proposed revisions. Mr. Bell stated that interested parties do not have any suggestions but believe the current language is not sufficient to meet the needs of state insurance regulators, as there will still be ambiguity in reporting requirements. Rose Albrizio (Equitable), representing interested parties, stated that she concurs with Mr. Bell, and there will be difficulty for industry with applying the clarified affiliated reporting standard.

In response to Mr. Clark's comments regarding determination of control for consolidated reporting purposes, Ms. Tamayo-Sanchez stated that U.S. generally accepted accounting principles (GAAP) generally require the determination of who controls the significant activities or economics in the initial determination of control for consolidated reporting purposes. She stated that if U.S. GAAP were used as a basis to determine if a CLO should be reported as affiliated due to exercising control, they would likely not be deemed as affiliates; however, industry struggles with how to define control of these instruments for statutory reporting purposes. As the insurer likely has a very passive involvement in the underlying investment and is only involved in the investment in the event of certain default situations, an affiliated designation for statutory accounting purposes is not consistent with current processes. Accordingly, many insurers will likely need to now move many debt investments to affiliated reporting lines.

Mr. Bruggeman stated that the challenge is that the intent of the agenda item is not to change affiliated reporting requirements; however, as many insurers believe this is a change, this likely represents an interpretation disconnect between insurers and state insurance regulators. He stated that this agenda will likely: 1) communicate the scope of affiliation determination and the associated reporting desires of state insurance regulators; and 2) supplement the reporting of all investments with the proposed reporting codes. The agenda item is not changing related party or affiliation determination pursuant to Model #440, especially as some states have adopted slight variations to the model. Mr. Clark stated that he agrees with Mr. Bruggeman, and he added that the determination of control has not changed. If detailed guidance regarding the evaluation of control were desired, it should be considered in a separate agenda item; however, insurers should continue to consult with their domestic regulators in the determination of affiliation designation. Mr. Bell stated that Mr. Bruggeman's summation of the challenge was accurate; however, many in industry would not report affiliated debt investments as affiliated transactions, as they interpret Model #440 to be limited to equity interests. He stated that the interpretation of state insurance regulators is that investments originated through, or debt issued by, an affiliated entity is an approach not commonly interpreted by industry. Mr. Clark stated that his interpretation is that if an entity is determined to be affiliated, all transactions—i.e., debt or equity issued by an affiliate—would also be classified as affiliated; and to the extent that this has not been done previously, he supports corrected reporting going forward. Ms. Tamayo-Sanchez stated that the interpretation of industry based on today's discussion was wrong, as they believe Model #440 only requires affiliated reporting if the investment has underlying affiliated credit exposure or if the insurer has control in the underlying investment, not an asset manager who originates the investment. Ms. Albrizio stated that the guidance should be supplemented using examples to clarify which investments should be reported as affiliated, as interested parties do not believe the current guidance is adequate to ensure that the reporting desired by state insurance regulators will be achieved. Mr. Bruggeman stated he appreciates the comments of industry to help articulate the interpretation differences; however, state insurance regulators believe that if an entity is deemed to be affiliated, all investments—debt or equity—should be reported as affiliated, regardless of

underlying affiliated credit exposure. With the agenda item, the investments would have supplemental reporting to help further differentiate those with varying degrees of underlying related party credit exposure. Ms. Tamayo-Sanchez, not speaking on behalf of interested parties, stated that the interpretation of applying the affiliated designation to debt instruments only when there was an underlying affiliated credit exposure was incorrect and not in line with state insurance regulator expectations. She stated that for insurers who have not been a party to the discussions related to this agenda item, they would likely continue existing practices for the determination of affiliation designation.

Mr. Clark made a motion, seconded by Mr. Smith, to:

1. Adopt the exposed revisions in SSAP No. 25; exposed revisions, with minor edits, in SSAP No. 43R; and new reporting disclosures for investments acquired from a related party, regardless of whether the investment is captured on an “affiliate” reporting line (Attachment One B5).
2. Confirm that the new reporting codes applicable for investment schedules B, D, DB, BA, DA, E2, and DL shall apply to all investments on any reporting line and are effective for year-end 2022 reporting.
3. Confirm support for the inclusion of Code 6 (no related party relationship), as exposed by the Blanks (E) Working Group (2021-22 BWG) to eliminate potential confusion on whether the absence of a code represents incomplete reporting or a non-related party relationship.
4. Direct NAIC staff to draft the following for future Statutory Accounting Principles (E) Working Group discussion: 1) possible footnote revisions pursuant to interested parties’ comments; and 2) examples for possible inclusion in SSAP No. 43R to further clarify investments that should be classified as affiliated.
5. Send a referral to the Valuation of Securities (E) Task Force, notifying of this adopted agenda item, and assess whether corresponding edits are needed to the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (P&P Manual) regarding CLO investments that may now be classified as affiliated.

The motion passed unanimously.

Ms. Gann stated that as a reminder, the Blanks (E) Working Group has a public call scheduled for May 25, and the Statutory Accounting Principles (E) Working Group has a public call scheduled for July 18 to hear comments on the exposed bond definition and related issue paper.

Having no further business, the Statutory Accounting Principles (E) Working Group adjourned.

https://naiconline.sharepoint.com/sites/naicsupportstaffhub/member%20meetings/e%20cmte/apptf/2022summernm/1_sapwg/minutes/attachment-one-b_sapwg%20minutes%205.24.22tpr.docx

Statutory Accounting Principles (E) Working Group**May 24, 2022 – Interim Call****Comment Letters Received****TABLE OF CONTENTS**

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May 6, 2022

Mr. Dale Bruggeman, Chairman
Statutory Accounting Principles Working Group
National Association of Insurance Commissioners
1100 Walnut Street, Suite 1500
Kansas City, MO 64106-2197

RE: Items Exposed for Comment by the Statutory Accounting Principles Working Group on April 4, 2022, with Comments due May 6th.

Dear Mr. Bruggeman:

Interested parties appreciate the opportunity to comment on the exposure drafts released for comment by the NAIC Statutory Accounting Principles (E) Working Group (the Working Group) during its meeting on April 4 in Kansas City.

We offer the following comments:

Ref #2019-21: Proposed Bond Definition

Pursuant to the direction from the Working Group in October 2020, a small group of regulators and industry have been meeting regularly to draft a bond definition for consideration. The intent of this project is to clarify what should be considered a bond (whether captured in SSAP No. 26R—*Bonds* or SSAP No. 43R—*Loan-Backed and Structured Securities*) and reported on Schedule D-1: Long-Term Bonds. This exposure is specific to the proposed bond definition included in the exposed Form A, along with the glossary (page 5) and appendices (pages 6-12), but comments on future developments (such as reporting changes, accounting and reporting guidance for items that do not qualify as bonds, transition guidance, etc.) may also be submitted to assist in the development of these items.

Interested parties are providing comments in a separate letter for this item due to the number of issues involved.

Ref #2022-03: *Premium Adjustments Allocated to Jurisdictions*

The Working Group moved this item to the active listing and exposed proposed revisions to be incorporated into a Blanks (E) Working Group proposal (2022-10BWG) which would modify the instructions for Schedule T, the State Page and Accident and Health Policy Experience Exhibit (AHPEE). The proposed revisions clarify that all premium adjustments shall be allocated as premium in each respective jurisdiction. This agenda item did not propose statutory revisions. This item was exposed with a shortened comment period ending May 6 to permit consideration for a year-end 2022 effective date of the reporting revisions.

Interested parties have no comment on this item.

Ref #2022-08: *Treatment of Freddie Mac WI Certificates*

The Working Group moved this agenda item to the active listing and exposed a tentative interpretation INT 22-01: Freddie Mac When-Issued K-Deal (I Trust) Certificates to clarify that investments in the Freddie Mac “When Issued K-Deal” (WI) Program are in scope of SSAP No. 43R. This item has a shortened comment deadline of May 6.

Interested parties support the conclusions reached on this interpretation.

Ref #2021-21: *Related Party Reporting*

The Working Group exposed this agenda item, incorporating proposed revisions after considering comments from interested parties shown highlighted in gray below. The changes from the prior exposure only clarify previous components of the proposed revisions. Similar changes to the blanks proposal are also concurrently exposed by the Blanks (E) Working Group in their corresponding agenda item (2021-22BWG) to allow for a year-end 2022 effective date. This item was exposed with a shortened comment period ending May 6.

Interested parties appreciate the opportunity to provide additional comments for this item regarding Related Party Reporting (the “Related Party Exposure”), which was re-exposed by the Working Group (the “SAPWG”) on April 4, 2022.

As stated in our original comment letter on this item, we understand that one of the goals of the proposal is to identify investments that are originated, managed, sponsored, or serviced by an affiliate or related party of the insurer (referred to as managed by affiliates for the remainder of this letter). Interested parties agree that this information can be useful for the regulators, but we continue to stress that it is critical to differentiate investments where there is direct credit exposure to an affiliate from those investments that are only managed by affiliates with no underlying credit exposure to the affiliate of the insurer.

In addition to the above, we have the following additional comments on the re-exposure:

1. **SSAP No. 25** - The Related Party Exposure is proposing to add the paragraph below, which would require a look through of affiliated investment structures to identify entities over which the insurer may have indirect control. To address Interested Parties' comments, the Working Group has added the footnote in red below to clarify that the look-through requirement is not required for SEC-registered mutual funds and ETFs.

"For entities not controlled by voting interests, such as limited partnerships, trusts and other special purpose entities, control may be held by a general partner, servicer, or by other arrangements. The ability of the reporting entity or its affiliates to direct the management and policies of an entity through such arrangements shall constitute control as defined in paragraph 6. Additionally, a reporting entity or its affiliates may have indirect control of other entities through such arrangements. For example, if a limited partnership were to be controlled by an affiliated general partner, and that limited partnership held greater than 10% of the voting interests of another company (FN10), indirect control shall be presumed to exist. If direct or indirect control exists, whether through voting securities, contracts, common management or otherwise, the arrangement is considered affiliated under paragraph 5. Consistent with paragraph 8, a disclaimer of affiliation does not eliminate a "related party" distinction or disclosure requirements for material transactions pursuant to SSAP No. 25."

FN10 Consistent with SSAP No. 97, footnote 1, investments in an exchange traded fund (ETF) or a mutual fund (as defined by the SEC) does not reflect ownership in an underlying entity, regardless of the ownership percentage the reporting entity (or the holding company group) has of the ETF or mutual fund unless ownership of the ETF actually results in "control" with the power to direct or cause the direction of management of an underlying company. ETFs and mutual funds are comprised of portfolios of securities subject to the regulatory requirements of the federal securities laws.

Interested parties' comments on the amendments are as follows:

- We agree that the look-through requirement should not extend to SEC registered mutual funds and ETFs as those investments are subject to many regulatory requirements. However, the exemption should also extend to foreign open-end investment funds governed and authorized in accordance with regulations established by the applicable foreign jurisdiction, which are within the scope of SSAP No. 30 - *Unaffiliated Common Stock* and which are very similar to open-end mutual funds in the United States.
- As stated on our previous comment letter, doing a look-through of the underlying investments of investment funds managed by affiliates to determine if there is indirect control will be a significant operational change as information will need to be requested from affiliated funds regarding their underlying investments along with percentage ownership. Once the information is obtained, insurers will need to go through each investment where the affiliated fund owns more than 10% of the equity of another company to document whether the presumption of control is

overcome or not. We kindly request again for a 2023 implementation date to be considered.

- Interested parties would like to confirm our understanding of the look through proposal. We believe an insurer would be required to look through to the underlying investments only in the situation where the entity (managed by an affiliate) in which the insurer owns equity instruments (e.g., private equity funds and CFOs). For example, if the insurer owns debt tranches of a CFO managed by an affiliate, we assume the look through analysis would be applied since the underlying investments of the CFO are equities. However, if the insurer owns an interest (debt or equity) in a CLO investment where the underlying assets are loans, we would not expect the look through to be applied since the CLO loans do not usually give an investor any control. As the look through paragraph is being inserted into SSAP 25 (which applies to all types of instruments), we believe clarification may be needed.
 - We also suggest adding the new footnote that was added to the new proposed paragraph 9 of SSAP No. 25 to the new codes being proposed to the investment schedules so that there is consistency regarding the types of assets for which the insurer would have to do a look-through of underlying investments of an affiliated fund.
2. ***Proposed changes to SSAP No. 43R to clarify that investments managed by affiliates are viewed as affiliated even if the underlying assets in the structure do not have any credit exposure to an affiliate*** – As stated above and in our previous comment letter, many insurers own asset management subsidiaries which manage securitization transactions. There is no question that the asset manager itself is a Subsidiary, Controlled and Affiliate (SCA) of the insurer and such asset managers are reported on Schedule Y as affiliates of the insurer and in the related party disclosures. However, when any debt tranches purchased from those securitization vehicles do not have any credit exposure to SCAs of the insurer, the debt tranches are not reported in the affiliated section of Schedule D and not filed as affiliated debt investments with the Securities Valuation Office (SVO) since they do not have affiliated credit risk exposure, even if the securitization vehicle is managed by a related party.

It is very important to interested parties that this distinction is understood for Schedule D bond investments. Schedule D bond investments should not be reported in the affiliated section of Schedule D if they do not have affiliated credit exposure. We believe that the new codes that are being proposed should provide the regulators with information regarding investments that have credit risk exposure to affiliates versus those investments that are only managed by affiliates or other related parties. If the intent is to change how investments are actually reported between affiliated and non-affiliated lines in the schedules, additional changes would need to be made to the current guidance, including the annual statement instructions and the SVO Purposes and Procedures (P&P) Manual, so that this is clear to all insurers. If all unaffiliated investments which are managed by

an affiliate were required to be reported as affiliated, updates would have to be made to the SVO P&P manual to clarify that those investments continue to be Filing Exempt since the SVO does not provide designations on asset-backed securities and the manual requires filing for all affiliated debt investments. Furthermore, our understanding of the definition of affiliates and control under the Holding Company act is that they are based on voting rights of an equity holder. Therefore, asset managers that that meet the definition of affiliates under the Holding Company Act are reported as affiliates on Schedule Y and any agreements with those affiliates are reported in the related party disclosure. However, investments that are simply managed by such affiliate with no credit risk exposure to an affiliate and where the underlying borrowers are not affiliates, would not meet the definition of an affiliate under the Holding Company Act.

All the language included in the exposure with the exception of the last sentence in the new paragraph 6b being proposed in SSAP No.43R support the view that unaffiliated investments managed by an affiliate shall be reported as unaffiliated. The last sentence in 6b indicates that “any arrangement that results in direct or indirect control, including control through a servicer” should be considered affiliated. While this statement is meant to make it clear, it is confusing as it relates to unaffiliated investments (where the insurer has no credit risk exposure to the underlying borrower), that are managed by an affiliate (either a subsidiary of the insurer or an entity under common control with the insurer). Interested parties request that the final sentence be removed as this sentence will only add confusion and will create inconsistency in reporting depending on how each insurer interprets these rules. As stated throughout the letter, the presence of certain arrangements such as an affiliated servicer do not usually mean that the investments managed are affiliated. A determination of direct or indirect control over the ultimate obligor pursuant to SSAP No. 25 is still required.

b. A loan-backed or structured security may involve a relationship with a related party but not be considered an affiliated investment. This may be because the relationship does not result in direct or indirect control of the issuer or because there is an approved disclaimer of control or affiliation. Regardless of whether investments involving a related party relationship are captured in the affiliated investment reporting lines, these securities shall be identified as related party investments in the investment schedules. Examples of related party relationships would include involvement of a related party in sponsoring or originating the loan-backed or structured security or any type of underlying servicing arrangement. For the avoidance of doubt, investments from any arrangement that results in direct or indirect control, including control through a servicer or other controlling arrangement, shall be reported as affiliated in accordance with SSAP No. 25—Affiliates and Other Related Parties.

As stated above, we are more than happy to provide the transparency that the regulators are looking for, which we believe will be accomplished through the new codes that will flag these investments as being managed by related parties.

3. ***Proposed annual statement changes to add a new electronic-only column to the investment schedules to identify investments involving related parties*** –The new codes being proposed in the related party exposure are as follows:

1. Direct loan or direct investment (excluding securitizations) in a related party, for which the related party represents a direct credit exposure.
2. Securitization or similar investment vehicles such as mutual funds, limited partnerships and limited liability companies involving a relationship with a related party as sponsor, originator, manager, servicer, or other similar influential role and for which 50% or more of the underlying collateral represents investments in or direct credit exposure to related parties.
3. Securitization or similar investment vehicles such as mutual funds, limited partnerships and limited liability companies involving a relationship with a related party as sponsor, originator, manager, servicer, or other similar influential role and for which less than 50% (including 0%) of the underlying collateral represents investments in or direct credit exposure to related parties.
4. Securitization or similar investment vehicles such as mutual funds, limited partnerships, and limited liability companies in which the structure reflects an in-substance related party transaction but does not involve a relationship with a related party as sponsor, originator, manager, servicer, or other similar influential role.
5. The investment is identified as related party, but the role of the related party represents a different arrangement than the options provided in choices 1-4.

Interested parties offer the following additional comments on the proposed codes:

- We understand that the codes will be required on all investment schedules. However, most of the codes appear to be more applicable to Schedule D and Schedule BA investments where investments can be made through an investment vehicle. For example, when we think of the relevancy of the codes to the mortgage loan schedule, it would appear that the only code that may potentially apply is code No. 1 if the insurer has issued a mortgage loan to a related party. Codes 2-5 do not seem applicable since mortgage loans reported on Schedule B can only be reported on Schedule B if the insurer has issued the mortgage loan directly to a borrower. The same would likely be true for Schedule DB.
- It is unclear to interested parties what “in-substance” related party transactions are referred to in code 4. Perhaps some examples can be provided as to the types of

structures this is referring to so that insurers know what to report under this category.

- When reviewing the Blanks exposure on this item, we noted that the Blanks exposure added an additional code 6 for investments that have no related party relationship. We question the need for such code as a significant majority of insurers' investments will probably be coded as such. There are other columns that are populated only if the code applies to that investment (e.g., Column 3 – Code; Column 5 – Bond Characteristics). Perhaps leaving the code blank will accomplish the same objective.

* * *

Thank you for considering interested parties' comments. If you have any questions in the interim, please do not hesitate to contact us.

Sincerely,

D. Keith Bell

Rose Albrizio

cc: NAIC staff
Interested parties

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

Issue: Premium Adjustments Allocated to Jurisdictions

Check (applicable entity):

	P/C	Life	Health
Modification of Existing SSAP	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>
New Issue or SSAP	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Interpretation	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>

Description of Issue:

This agenda item has been drafted to propose blanks instructional changes primarily to Schedule T which reflects premiums, allocated by states and territories. NAIC staff received inquiries from 3 states in the fourth quarter of 2021 regarding a minor number of entities that primarily wrote health business related to the Affordable Care Act (ACA) which are believed to have not properly allocated premium adjustments by jurisdiction on the statutory financial statement. The states identified that a minority of entities reported some portion of their U.S.-based premium in the category of “aggregate other alien.” The aggregate other alien line is for non-U.S. premium therefore, reporting U.S.-based ACA premium as alien is problematic. The purpose of this agenda item is to add additional annual statement instructions to address this reporting inconsistency. Regardless of the cause of this specific issue, the proposed revisions intend to clarify that premium adjustments (both increases and decreases) shall be reflected in the appropriate jurisdiction. This proposal is to address this current issue as well as future situations.

The specific premium identified is understood to be ACA premium written in the U.S. and its territories. Based on the descriptions provided, most of the amounts are presumed to be from premium redistribution as a result of the risk adjustment program of the ACA. All of the premium adjustments from the ACA risk adjustment program, and the risk corridor program, are noted as premium in *SSAP No. 107—Risk-Sharing Provisions of the Affordable Care Act*. (Although the risk corridor program ended in 2016, distributions related to 2015-2016 plan years have been received in the last two years due to a U.S. Supreme Court decision.)

The ACA risk adjustment premium redistribution calculations are calculated by plan and by jurisdiction. Therefore, the jurisdictions are known. The ACA risk adjustment program redistributes premium from plans that have relatively healthier insureds and gives to plans with relatively less healthy insureds based on risk scores. SSAP No. 107 directs reporting the premium adjustments in the ACA risk adjustment program as premium subject to redetermination, which requires accruing the adjustments based on policy experience as described in the authoritative literature section below.

NAIC staff understanding is that most states would treat the premium after adjustments (both increases and decreases) as the amount subject to premium tax. However, preliminary conversations some health entities have asserted that they believe their state only subjects the premium prior to adjustment to premium tax. In the statutory annual statement, the premium including adjustments should be reported as premium subject to redetermination as identified in SSAP No. 107. If a jurisdiction treats premium differently for tax purposes, that would be addressed on the jurisdiction’s premium tax return.

Because of the way the ACA risk adjustment program premium adjustments calculation works, an insurer can have both payables and receivables in different plans in the same jurisdiction. For example, they could be a receiver in the bronze plan in state A and a payor in the silver plan in state A. Total premium in the state is redistributed among

plans at the same level in the state, no new funds are added. In the examples below the total premium columns are what is reported in the state A and B lines of Schedule T.

State A	Premium			State B	Premium			
	Initial Premium	Adjustments/ Redistribution	Total Premium		Initial Premium	Adjustments/ Redistribution	Total Premium	
Bronze	\$ 100	\$ 40	\$ 140	Bronze	\$ 100	\$ 20	\$ 120	
Silver	\$ 100	\$ (25)	\$ 75	Silver	\$ 100	\$ (25)	\$ 75	
<u>Gold</u>	<u>\$ 100</u>	<u>\$ -</u>	<u>\$ 100</u>	<u>Gold</u>	<u>\$ 100</u>	<u>\$ (15)</u>	<u>\$ 85</u>	
total	\$ 300	\$ 15	\$ 315	total	\$ 300	\$ (20)	\$ 280	

Existing Authoritative Literature (bolding added for emphasis):

- ***Uniform Deposit Law Model 300:***

“Alien insurer” means an insurer incorporated or organized under the laws of any country other than the United States.

- ***SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities:***

8.b.iv. Investments in foreign insurance SCA entities shall be recorded based on the underlying U.S. GAAP equity from the audited U.S. GAAP basis financial statements, adjusted to a limited statutory basis of accounting in accordance with paragraph 9, if available. If the audited U.S. GAAP basis financial statements are not available, the investment can be recorded on the audited foreign statutory basis financial statements of the respective entity adjusted to a limited statutory basis of accounting in accordance with paragraph 9 and adjusted for reserves of the foreign insurance SCA with respect to the business it assumes directly and indirectly from a U.S. insurer using the statutory accounting principles promulgated by the NAIC in the *Accounting Practices and Procedures Manual*. The audited foreign statutory basis financial statements must include an audited footnote that reconciles net income and equity on the foreign statutory basis of accounting to the U.S. GAAP basis. **Foreign insurance SCA entities are defined as alien insurers formed according to the legal requirements of a foreign country.**

- ***SSAP No. 107—Risk-Sharing Provisions of the Affordable Care Act:***

Risk Adjustment Program – Accounting Treatment

14. Premium adjustments pursuant to the risk adjustment program will be based upon the risk scores (health status) of enrollees, participating in risk adjustment covered plans rather than the actual loss experience of the insured. This program bears some similarities to the Medicare Advantage risk adjustment program¹ under which the plan receives additional funding (or pays additional amounts)

¹ The ACA program also has significant differences from the Medicare Advantage risk adjustment program, which is retrospective, administered as a single national program, with most enrollees administered by the federal government. By contrast, the ACA risk adjustment is not retrospective, and is administered by each entity by state and by plan.

based on adjustments to risk scores of enrollees (see *INT 05-05: Accounting for Revenues Under Medicare Part D Coverage*).

15. The risk adjustment payables and receivables shall be accounted for as premium adjustments subject to redetermination as specified in this statement. Effective beginning with 2018 benefit plan years, the risk adjustment assessments and distributions are calculated including the high-cost risk pool aspect of this program and should be reported on a net basis.

- a. Risk adjustment payables meet the definition of liabilities as set forth in SSAP No. 5R—*Liabilities, Contingencies and Impairments of Assets*. Risk adjustment receivables meet the definition of an asset and are admissible to the extent that they meet all of the criteria in this statement.
- b. Risk adjustment payables and receivables shall be estimated based on experience to date. The method used to estimate the payables and receivables shall be reasonable and consistent between reporting periods. Reporting entities shall be aware of the significant uncertainties involved in preparing estimates and be both diligent and conservative in their estimations. In exercising the judgment required to prepare reasonable estimates for the financial reporting of risk adjustment program payables and receivables, the statutory accounting concept of conservatism shall be followed. In addition, reporting entities are required to have sufficient data to determine a reasonable estimate. Ensuring sufficient data requires that the reporting entity's estimate is based on demonstrated knowledge of the marketplace and annual information which includes patient encounter and diagnosis code data to determine the differences in the actuarial risk profile of the reporting entity's insureds versus the market participants in the particular market and state risk pool. Sufficient data shall incorporate patient default scores, if applicable, under the terms of the risk adjustment program. In addition, the estimates shall be consistent with other financial statement assertions and the pricing scenarios used by the reporting entity.
- c. Premium revenue adjustments for the risk adjustment program are estimated for the portion of the policy period that has expired and shall be reported as an immediate adjustment to premium. Accrued risk adjustment receivables shall be recorded in premium and considerations receivable, with a corresponding entry to written premiums. Accrued risk adjustment payables shall be recorded as a liability² with a corresponding entry to written premiums. Reporting entities shall record additions or reductions to revenue resulting from the risk adjustment program in the period in which the changes in risk scores of enrollees result in reasonably estimable additions or reductions. The risk adjustment program receivables shall be reported gross of payables.
- d. The risk adjustment receivables are administered through a federal governmental program. Once amounts are collected by the governmental entity, there is an obligation to distribute the funds. Amounts over 90 days due shall not cause the receivable to be treated as a nonadmitted asset based solely on aging.
- e. Provided that the risk adjustment receivables due the reporting entity are determined in a manner that is consistent with the requirements of this statement, the receivables are admitted assets until determination of impairment or payment denial is received from the governmental entity or government-sponsored entity administering the

² The annual statement liability lines will vary by the type of annual statement the reporting entity files. Managed care/accident and health reporting entities report as aggregate health policy reserves; life and accident and health reporting entities report as aggregate reserves for accident and health contracts; and property and casualty reporting entities report as aggregate write-ins for liabilities.

program. Upon notification that payments to be paid to the reporting entity will be less than the recorded receivables, any amount in excess of the confirmed amount shall be written off and charged to income, except for amounts that are under appeal. Any receivable for risk adjustment amounts under appeal shall be reflected as a nonadmitted asset.

- f. Evaluation of the collectibility of all amounts receivable from the risk adjustment program shall be made for each reporting period. If, in accordance with SSAP No. 5R, it is probable that the risk adjustment receivables are uncollectible, any uncollectible receivable shall be written off and charged to income in the period the determination is made. If it is reasonably possible that a portion of the balance determined in accordance with this paragraph is not anticipated to be collected and is therefore not written off, the disclosure requirements outlined in SSAP No. 5R shall be followed.

Risk Adjustment Program – High-Cost Risk Pool – Accounting Treatment

16. The individual and small group high-cost risk pools of the ACA risk adjustment program shall be accounted for consistent with the rest of the ACA risk adjustment program. Reporting entity issuers in the individual or small group markets need to account for the following risk adjustment payables and receivables including the impairment and aging guidance reflected in paragraph 15 and paragraph 16:

- a. **The high-cost risk pool assessment payable by the reporting entity, which is the percent-of-premium charge to the issuer in order to fund reimbursements across all issuers of claims above the high cost risk pool threshold, shall be accounted for as decreases to written premium subject to redetermination.**
- b. **High-cost risk pool distributions, which represent proportionate reimbursement for the issuer's claims above the high cost risk pool threshold, would be accounted for as increases to written premium subject to redetermination.**
- c. As the risk adjustments and distributions described in paragraphs 4-9 are calculated after excluding the percentage of costs above the threshold specified in the high-cost risk pool aspect of this program, the payments described in paragraphs 4-9 will continue to be accounted for consistent with guidance in paragraph 15 and paragraph 16 (i.e., as a premium adjustment subject to redetermination).

Note that Schedule T, part 1 has slightly different names by annual statement type, but it reflects premiums, allocated by states and territories. Schedule T, Part 2 Interstate Compact- Exhibit of Premiums Written Allocated By States and Territories is the same name for all annual statement types.

- **Annual Statement Instructions Schedule T, Part 1 – Premiums and Other Considerations Allocated By States and Territories – Health:**

Details of Write-ins Aggregated at Line 58 for Other Alien

List separately each alien jurisdiction for which there is no pre-printed line on Schedule T.

If the premium from an alien jurisdiction is due to relocation of current policyholders, the amount may be aggregated and reported as "Other Alien." Premiums from jurisdictions in which there is active writing must be reported by jurisdiction and include premium from relocated policyholders residing in the respective jurisdiction.

Identify each alien jurisdiction by using a **three-character (ISO Alpha 3) country code followed by the name of the country (e.g., DEU Germany)**. For premium that can be aggregated and

reported as "Other Alien" as stated in the previous paragraph, use "ZZZ" for the country code and "Other Alien" for the country name. A comprehensive listing of country codes is available in the appendix of these instructions.

Include summary of remaining write-ins for Line 58 from the Overflow page on the separate line indicated.

- **Annual Statement Instructions Schedule T, Part 1 – Premiums and Annuity Considerations Allocated By States and Territories Life and Fraternal:**

Line 58 – Aggregate Other Alien

Enter the total of the write-ins listed in schedule "Details of Write-ins Aggregated at Line 58 for Other Alien." **All U.S. business must be allocated by state regardless of license status.**

Details of Write-ins Aggregated on Line 58 for Other Alien

List separately each alien jurisdiction for which there is no pre-printed line on Schedule T.

If the premium from an alien jurisdiction is due to relocation of current policyholders, the amount may be aggregated and reported as "Other Alien." Premiums from jurisdictions in which there is active writing must be reported by jurisdiction and include premium from relocated policyholders residing in the respective jurisdiction.

Identify each alien jurisdiction by using a three-character (ISO Alpha 3) country code followed by the name of the country (e.g., DEU Germany). For premium that can be aggregated and reported as "Other Alien" as stated in the previous paragraph, use "ZZZ" for the country code and "Other Alien" for the country name. A comprehensive listing of country codes is available in the appendix of these instructions.

Include summary of remaining write-ins for Line 58 from the Overflow page on the separate line indicated.

- **Annual Statement Instructions Schedule T , Part 1 – Property and Casualty:**

Line 58 – Aggregate Other Alien

Enter the total of the write-ins listed in Schedule Details of Write-ins Aggregated at Line 58 for Other Alien.

All U.S. business must be allocated by state regardless of license status.

Details of Write-ins Aggregated at Line 58 for Other Alien

List separately each alien jurisdiction for which there is no pre-printed line on Schedule T.

If the premium from an alien jurisdiction is due to relocation of current policyholders, the amount may be aggregated and reported as "Other Alien." Premiums from jurisdictions in which there is active writing must be reported by jurisdiction and include premium from relocated policyholders residing in the respective jurisdiction.

Identify each alien jurisdiction by using a **three-character (ISO Alpha 3) country code followed by the name of the country (e.g., DEU Germany)**. For premium that can be aggregated and

reported as "Other Alien" as stated in the previous paragraph, use "ZZZ" for the country code and "Other Alien" for the country name. A comprehensive listing of country codes is available in the appendix of these instructions.

Include summary of remaining write-ins for Line 58 from the Overflow page on the separate line indicated.

Schedule T, Part 2 Uniform instructions:

Line 58 – Aggregate Other Alien

Enter the total of all alien business in the appropriate columns. Details by countries are not required.

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): None

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

Convergence with International Financial Reporting Standards (IFRS): Not applicable

Staff Recommendation: NAIC staff recommends that the Working Group move this item to the active listing, categorized as a SAP clarification, and concurrently expose an annual statement blanks proposal for 2022 annual reporting. The sponsored blanks proposal has been forwarded to the Blanks (E) Working Group to modify the instructions for Schedule T, the State Page and Accident and Health Policy Experience Exhibit (AHPEE) to clarify guidance for premium adjustments to ensure that entities are reporting premium by jurisdiction. This agenda item does not result in SSAP revisions. The proposed additions to the blanks instructions are shown below.

1. Schedule T, part 1 annual statement instructions for Health (This revision will make Health instructions consistent with the property casualty and life fraternal annual statement instructions.)

[Line 58 – Aggregate Other Alien](#)

Enter the total of the write-ins listed in schedule "Details of Write-ins Aggregated at Line 58 for Other Alien." All U.S. business shall be allocated by state regardless of license status.

Details of Write-ins Aggregated at Line 58 for Other Alien

List separately each alien jurisdiction for which there is no pre-printed line on Schedule T.

If the premium from an alien jurisdiction is due to relocation of current policyholders, the amount may be aggregated and reported as "Other Alien." Premiums from jurisdictions in which there is active writing must be reported by jurisdiction and include premium from relocated policyholders residing in the respective jurisdiction.

Identify each alien jurisdiction by using a **three-character (ISO Alpha 3) country code followed by the name of the country (e.g., DEU Germany)**. For premium that can be aggregated and reported as "Other Alien" as stated in the previous paragraph, use "ZZZ" for the country code and "Other Alien" for the country name. A comprehensive listing of country codes is available in the appendix of these instructions.

2. Schedule T, part 1 annual statement instructions for Health; Life and Fraternal and Property and Casualty

Add to general instructions:

All premium adjustments (both increases and decreases), including but not limited to Affordable Care Act (ACA) premium adjustments related to the risk adjustment program, shall be allocated as premium in the respective jurisdiction.

3. Schedule T, Part 2 Uniform instructions:

Line 58 – Aggregate Other Alien

Enter the total of all alien business in the appropriate columns. Details by countries are not required.

All premium adjustments (both increases and decreases), including but not limited to Affordable Care Act (ACA) premium adjustments related to the risk adjustment program, shall be allocated as premium in the respective jurisdiction.

4. Add additional instructions to line 58 - Aggregate Other Alien to the annual statement instructions for Health; Life and Fraternal and Property and Casualty

All premium adjustments (both increases and decreases), including but not limited to Affordable Care Act (ACA) premium adjustments related to the risk adjustment program, shall be allocated as premium in the respective jurisdiction.

5. State Page - general instructions to the annual statement instructions for Health; Life and Fraternal and Property and Casualty

All premium adjustments (both increases and decreases), including but not limited to Affordable Care Act (ACA) premium adjustments related to the risk adjustment program, shall be allocated as premium in the respective jurisdiction.

6. Accident and Health Policy Experience Exhibit (AHPEE) to the annual statement instructions for Health; Life and Fraternal and Property and Casualty

All premium adjustments (both increases and decreases), including but not limited to Affordable Care Act (ACA) premium adjustments related to the risk adjustment program, shall be allocated as premium in the respective jurisdiction.

Staff Review Completed by: Robin Marcotte– NAIC Staff, February 2022

Recommendation:

NAIC staff recommends that the Working Group move this item to the active listing, categorized as a SAP clarification, and concurrently expose an annual statement blanks proposal for 2022 annual reporting. The sponsored blanks proposal has been forwarded to the Blanks (E) Working Group to modify the instructions for Schedule T, the State Page and Accident and Health Policy Experience Exhibit (AHPEE) to clarify guidance for premium adjustments. This agenda item does not result in SSAP revisions. The proposed additions to the blanks instructions are shown in the agenda item, but the primary instructional revision is as follows:

Ref #2022-03

All premium adjustments (both increases and decreases), including but not limited to Affordable Care Act (ACA) premium adjustments related to the risk adjustment program, shall be allocated as premium in the respective jurisdiction.

Status:

On April 4, 2022, the Statutory Accounting Principles (E) Working Group moved this item to the active listing and exposed proposed revisions to be incorporated into a Blanks (E) Working Group proposal (2022-10BWG) which would modify the instructions for Schedule T, the State Page and Accident and Health Policy Experience Exhibit (AHPEE). The proposed revisions clarify that all premium adjustments shall be allocated as premium in each respective jurisdiction. This agenda item did not propose statutory revisions. This item was exposed with a shortened comment period ending May 6 to permit consideration for a year-end 2022 effective date of the reporting revisions.

On May 24, 2022, the Statutory Accounting Principles (E) Working Group adopted this agenda item, which did not result in statutory accounting revisions, however the adoption expressed support for the corresponding Blanks (E) Working Group exposure (2022-10BWG), which modifies the instructions for Schedule T, the State Page and the Accident and Health Policy Experience Exhibit (AHPEE), clarifying the guidance for premium adjustments.

https://naiconline.sharepoint.com/sites/NAICSSupportStaffHub/Member Meetings/E CMTE/APPTF/2022SummerNM/1_SAPWG/Minutes/Att One-B2_22-03 - Premium Adj by Jurisdiction.docx

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

Issue: Treatment of Freddie Mac WI Certificates

Check (applicable entity):

	P/C	Life	Health
Modification of existing SSAP	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
New Issue or SSAP	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>
Interpretation	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>

Description of Issue:

Freddie Mac “When Issued K-Deal” certificates (“WI”) are backed by an asset pool held in trust, but those assets do not initially include any mortgages or mortgage-backed assets. Rather these assets include cash from the sale of the WI certificates and a commitment by Freddie Mac to deliver one or more structured pass through certificates (SPCs) in exchange for the WI trust’s cash within approximately 90 days of settlement. The date on which this delivery occurs is referred to as the “Subsequent Transfer Date.”

Prior to the Subsequent Transfer Date, the WI trusts pay fixed coupons to certificate holders which are funded from a Freddie Mac guarantee on the WI certificates. After the Subsequent Transfer Date the WI trust will hold the promised SPCs which are backed by mortgages and guaranteed by Freddie Mac. Additionally, after this date the WI trust becomes a pass-through of the underlying trust. The WI certificates have an optional exchange right where they can be exchanged for the underlying SPCs, but if not exchanged, the WI certificates after the Subsequent Transfer Date will still be backed by the SPCs.

The issue is the statutory accounting treatment of WI certificates prior to the Subsequent Transfer Date.

Existing Authoritative Literature:

SSAP No. 43R—Loan-Backed and Structured Securities, paragraphs 2-4:

2. Loan-backed securities are defined as securitized assets not included in structured securities, as defined below, for which the payment of interest and/or principal is directly proportional to the payments received by the issuer from the underlying assets, including but not limited to pass-through securities, lease-backed securities, and equipment trust certificates.
3. Structured securities are defined as loan-backed securities which have been divided into two or more classes for which the payment of interest and/or principal of any class of securities has been allocated in a manner which is not proportional to payments received by the issuer from the underlying assets.
4. Loan-backed securities are issued by special-purpose corporations or trusts (issuer) established by a sponsoring organization. The assets securing the loan-backed obligation are acquired by the issuer and pledged to an independent trustee until the issuer's obligation has been fully satisfied. The investor only has direct recourse to the issuer's assets, but may have secondary recourse to third parties through insurance or guarantee for repayment of the obligation. As a result, the sponsor and its other affiliates may have no financial obligation under the instrument, although one of those entities may retain the responsibility for servicing the underlying assets. Some sponsors do guarantee the performance of the underlying assets.

SSAP No. 86—Derivatives. Key excerpts from SSAP No. 86 are as follows:

The definition of a derivative instrument and forwards from SSAP No. 86, paragraph 4 and 5d:

4. “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.

5.d. “Forwards” are agreements (other than futures) between two parties that commit one party to purchase and the other to sell the instrument or commodity underlying the contract at a specified future date. Forward contracts fix the price, quantity, quality, and date of the purchase and sale. Some forward contracts involve the initial payment of cash and may be settled in cash instead of by physical delivery of the underlying instrument.

Guidance on TBAs from the Annual Statement Instructions:

“To Be Announced” securities (commonly referred to as TBAs) are to be reported in Schedule D unless the structure of the security more closely resembles a derivative, as defined within *SSAP No. 86—Derivatives*, in which case the security should be reported on Schedule DB. The exact placement of TBAs in the investment schedules depends upon how a company uses TBA.

Excerpt from Annual Statement Instructions, Schedule D, Part 3 and 4 on Disposals / Acquisitions:

This schedule should include a detailed listing of all securities that were purchased/acquired during the current reporting year that are still owned as of the end of the current reporting year (amounts purchased and sold during the current reporting year are reported in detail on Schedule D, Part 5 and only in subtotal in Schedule D, Part 3). This should include all transactions that adjust the cost basis of the securities. **Thus, it should not be used for allocations of TBAs to specific pools subsequent to initial recording in Schedule D, Part 3 or other situations such as CUSIP number changes.**

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):
Reporting entity has filed a RTAS with the NAIC SVO.

Information or issues (included in *Description of Issue*) not previously contemplated by the Working Group:
The inaugural offering was the WI-K132 transaction (CUSIP: 3137H2NM2) which settled on September 28th, 2021 with the promised K-deal certificates being the K-132’s AM class. The K-132 class AM certificates (CUSIP: 3137H3EW8) were settled and delivered to the WI-K132 trust on October 14th, 2021. The purpose of this request is to evaluate the structure of the WI offering more broadly but the WI-K132 transaction may serve as a helpful example for evaluation. To that end the offering documents for both the WI-K132 and the related K-132’s certificate offerings are linked below. The webpage housing the base offering documents for the WI and K-Deal programs are also linked for ease of reference along with informational materials further detailing the WI program.

WI-K132 Offering Circular Supplement: <http://capitalmarkets.freddiemac.com/mba/data/wik132oc.pdf>

K132 Offering Circular Supplement: <http://capitalmarkets.freddiemac.com/mba/data/k132oc.pdf>

WI/K-Deal Base Offering Documents: <http://capitalmarkets.freddiemac.com/mba/legal/>

Ref #2022-08

WI Program Page: <https://mf.freddiemac.com/investors/when-issued-k-deals.html>

WI Investor Presentation: https://mf.freddiemac.com/docs/wi_investor_presentation.pdf

WI Frequently Asked Questions: https://mf.freddiemac.com/docs/wi_frequently_asked_questions.pdf

Video Overview of the WI Program: <https://www.youtube.com/watch?v=Lv7YaPvNspo&feature=youtu.be>

Recommended Conclusion or Future Action on Issue:

Sponsoring entity requests statutory accounting guidance to confirm that WI Trust SPCs shall be reported in scope of *SSAP No. 43R—Loan-Backed and Structured Securities* and not as a forward contract under *SSAP No. 86—Derivatives*.

Recommending Party:

State Farm Mutual Automobile Insurance Company

Mark Ludy, Staff Finance Analyst

Mark.E.Ludy.GC98@StateFarm.Com

March 8, 2022

Staff Recommendation:

NAIC staff recommends that the Working Group expose a tentative statutory accounting interpretation to clarify that investments in the Freddie Mac WI Program shall be captured in scope of *SSAP No. 43R—Loan-Backed and Structured Securities* from initial acquisition. Key elements for this recommendation include:

- The WI Program is fully guaranteed by Freddie Mac and ensures that the investor will receive pass-through certificates, backed by mortgage loans held in trust, that reflect the terms of the investment set at original acquisition. In the event that the K-Deal certificates cannot be acquired, Freddie Mac is guaranteed to provide payment to the investor that reflects the full principal and interest per the original terms of the agreement, which reflects the payments that would have been received overtime if K-Deal certificates had been acquired.
- The definition of a forward contract in SSAP No. 86 reflects an agreement between two parties that commit one party to purchase and another party to sell the instrument underlying the contract at a specified future date. With the WI Trust Program, the investor does not have a future commitment to acquire securities, as the investor acquires the WI Trust certificate on day one of the transaction and the investor is not required to convert the WI Trust certificates at any time. This WI Trust certificate is not a derivative instrument, as at the time of acquisition, the certificate reflects a tradeable investment in a trust structure backed by cash and a Freddie Mac guarantee of cash flows in accordance with terms established at original acquisition. In addition to having no variation to the investor as a result of an underlying interest, there is no requirement on the investor to take delivery of a different investment. The ability to convert the WI Trust certificate to a K-Deal certificate is strictly an election to the investor and is not a requirement to receive the pass-through cash flows per the terms of the initial investment.
- The WI Program, and resulting obligation of Freddie Mac, ultimately reflects an investment where the investor receives pass-through cash flows generated from mortgage loans acquired and held in trust. This is within the scope of *SSAP No. 43R—Loan-Backed and Structured Securities*, paragraphs 2-4.
- The WI Program, and treatment as a SSAP No. 43R security, is consistent with the current guidance for TBA securities when an insurer intends to take possession of the resulting mortgage-backed security. A TBA security reflects the pre-purchase of mortgage-backed securities prior to the finalization of the security issuance. Pursuant to the annual statement instructions, TBA securities are to be reported on Schedule D-1: Long-Term Bonds unless the structure more closely resembles a derivative. This determination depends

Ref #2022-08

on how a company uses the TBA. (For example, if a company intended to assume the mortgage-backed security once issued, the TBA would be captured on Schedule D-1 at initial acquisition. If a reporting entity was to continually trade/roll TBA exposures, this would be more characteristics of a derivative and would be captured on Schedule DB as a derivative.)

Staff Review Completed by: Julie Gann, NAIC Staff – March 14, 2022

Status:

On April 4, 2022, the Statutory Accounting Principles (E) Working Group moved this agenda item to the active listing and exposed a tentative interpretation *INT 22-01: Freddie Mac When-Issued K-Deal (WI Trust) Certificates* to clarify that investments in the Freddie Mac “When Issued K-Deal” (WI) Program are in scope of SSAP No. 43R. This item has a shortened comment deadline of May 6.

On May 24, 2022, the Statutory Accounting Principles (E) Working Group adopted *INT 22-01: Freddie Mac When-Issued K-Deal (WI Trust) Certificates* to clarify that investments in the Freddie Mac “When Issued K-Deal” (WI) Program are in scope of SSAP No. 43R—*Loan-Backed and Structured Securities* from the date of initial acquisition.

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Interpretation of the Statutory Accounting Principles (E) Working Group

INT 22-01: Freddie Mac When-Issued K-Deal (WI Trust) Certificates

INT 22-01 Dates Discussed

April 4, 2022; May 24, 2022

INT 22-01 References

SSAP No. 43R—Loan-Backed and Structured Securities

SSAP No. 86—Derivatives

INT 22-01 Issue

1. This interpretation is to address questions on the accounting and reporting for Freddie Mac “When-Issued K-Deal (WI Trust) Certificates” (WI Program). Ultimately, the question is whether the structure should be initially captured in scope of *SSAP No. 43R—Loan-Backed and Structured Securities* or as a forward contract in scope of *SSAP No. 86—Derivatives*.
2. The design of the WI Program is summarized as follows:
 - a. Investor acquires WI Trust certificates, which are backed by cash held in the WI Trust and pay a fixed coupon amount funded from a Freddie Mac guarantee.
 - b. Within 90 days, the trust uses the cash to acquire newly issued K-Deal structured pass-through certificates (SPCs) meeting certain pooling parameters laid out in the respective WI Offering Circular Supplement. K-Deal SPC(s) are Freddie Mac-issued structured pass-through certificates backed by the corresponding class of certificates issued by a separate REMIC trust that holds multifamily fixed-rate mortgage loans. The cash flows from the mortgage loans held by the REMIC trust provide pass-through payments to holders of the K-Deal SPCs.
 - c. An investor can choose to continue to hold the WI Trust certificates or exchange dollar-for-dollar their WI-securities into the underlying K-Deal SPCs. In either case, the investor receives a pass-through of cash flows generated by the mortgages held in the REMIC trust and the performance of the K-Deal SPCs is guaranteed by Freddie Mac. If continuing to hold the WI Trust certificates – rather than convert the certificates to K-deal SPCs – the K-Deal SPCs are held by the WI Trust, who in turn passes the cashflows to WI Trust investors. The WI Trust certificates benefit from Freddie Mac payment guarantee which guarantees that any cashflows collected from the K-Deal SPCs will be paid to the WI certificate holders.
3. Additional characteristics on this program include the following:
 - a. The WI Trust certificates are public securities and tradeable shortly after pricing.
 - b. The WI Trust certificates are backed by a Freddie Mac guarantee from acquisition.
 - c. From acquisition of the WI Trust certificates, the investor receives fixed coupon amounts reflective of the investment terms of the K-Deal SPCs.

- d. The WI Trust is obligated to acquire, and Freddie Mac is required to sell, the K-Deal SPCs at the amount stated at the time of initial investment. Meaning, the investor is not at a risk of loss, nor will experience any variation in outcome due to underlying variables that occur from the time of initial investment in the WI Trust until the K-Deal SPCs are acquired. If market forces change the purchase price of the K-Deal SPCs during the 90-days after initial acquisition of the WI Trust certificates, then Freddie Mac is still required to sell the K-Deal certificates at the terms agreed to at original investment. Ultimately, the investor is guaranteed an investment in K-Deal SPCs that reflects the notional value of the WI Trust-certificates and coupon terms at initial acquisition. (For example, if the investor acquired \$100 million of WI Trust certificates at acquisition, when the K-Deals are subsequently acquired, the entity will receive \$100 million of K-Deal SPCs with the same payment terms regardless of any market impacts.)
- e. In the event that Freddie Mac is unable to acquire the K-Deal SPCs within the 90-day period, Freddie Mac is required to return the principal to the investor as well as provide a yield maintenance payment calculated using the full coupon payments that would have been received over the course of the investment.
- f. In the event that the investor elects to exchange the WI Trust certificates to the K-Deal SPCs, the investor receives an equivalent principal amount of the K-Deal SPCs of the same class. Although the investment will have a change in CUSIP, any such exchange is not deemed to be a taxable event as described in the respective Offering Circular Supplements for the WI Certificates. As such investors will not recognize a gain or loss on the exchange and investors will be treated as continuing to own the interests that were owned immediately prior to the exchange. Stated differently, any gains or losses on the exchanged WI-Certificates are “rolled into” the investors’ new K-Deal Certificate position.

4. The question of whether the structure is a loan-backed or structured security, or a derivative is primarily focused on the initial acquisition and the 90-day (or less) timeframe before the WI Trust acquires K-Deal certificates. The question is whether the initial 90-day acquisition of the WI Trust certificate, prior to the trust’s acquisition of the K-Deal certificates, represents a forward contract required to be accounted for under SSAP No. 86—*Derivatives*. Key excerpts from SSAP No. 86 are as follows:

- a. The definition of a derivative instrument from SSAP No. 86, paragraph 4:
 - 4. “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.
- b. The definition of a forward contract from SSAP No. 86, paragraph 5.d.:
 - 5.d. “Forwards” are agreements (other than futures) between two parties that commit one party to purchase and the other to sell the instrument or commodity underlying the contract at a specified future date. Forward contracts fix the price, quantity, quality, and date of the purchase and sale. Some forward contracts involve the

initial payment of cash and may be settled in cash instead of by physical delivery of the underlying instrument.

5. This interpretation intends to clarify whether investments in the Freddie Mac WI Program shall be initially captured in scope of *SSAP No. 86—Derivatives* or captured in scope of *SSAP No. 43R—Loan-Backed and Structured Securities*.

INT 21-01 Discussion

6. This interpretation clarifies that investments in the Freddie Mac WI Program shall be captured in scope of *SSAP No. 43R—Loan-Backed and Structured Securities* from initial acquisition, and not as a derivative forward contract, for the following reasons:

- a. The WI Program is fully guaranteed by Freddie Mac and ensures that the investor will receive pass-through certificates, backed by mortgage loans held in trust, that reflect the terms of the investment set at original acquisition. In the event that the K-Deal certificates cannot be acquired, Freddie Mac is guaranteed to provide payment to the investor that reflects the full principal and interest per the original terms of the agreement, which reflects the payments that would have been received overtime if K-Deal certificates had been acquired.
- b. The definition of a forward contract in *SSAP No. 86* reflects an agreement between two parties that commit one party to purchase and another party to sell the instrument underlying the contract at a specified future date. With the WI Trust Program, the investor does not have a future commitment to acquire securities, as the investor acquires the WI Trust certificate on day one of the transaction and the investor is not required to convert the WI Trust certificates at any time. This WI Trust certificate is not a derivative instrument, as at the time of acquisition, the certificate reflects a tradeable investment in a trust structure backed by cash and a Freddie Mac guarantee of cash flows in accordance with terms established at original acquisition. In addition to having no variation to the investor as a result of an underlying interest, there is no requirement on the investor to take delivery of a different investment. The ability to convert the WI Trust certificate to a K-Deal certificate is strictly an election to the investor and is not a requirement to receive the pass-through cash flows per the terms of the initial investment.
- c. The WI Program, and resulting obligation of Freddie Mac, ultimately reflects an investment where the investor receives pass-through cash flows generated from mortgage loans acquired and held in trust. This investment dynamic is within the scope of *SSAP No. 43R—Loan-Backed and Structured Securities*, paragraphs 2-4:
 2. Loan-backed securities are defined as securitized assets not included in structured securities, as defined below, for which the payment of interest and/or principal is directly proportional to the payments received by the issuer from the underlying assets, including but not limited to pass-through securities, lease-backed securities, and equipment trust certificates.
 3. Structured securities are defined as loan-backed securities which have been divided into two or more classes for which the payment of interest and/or principal of any class of securities has been allocated in a manner which is not proportional to payments received by the issuer from the underlying assets.
 4. Loan-backed securities are issued by special-purpose corporations or trusts (issuer) established by a sponsoring organization. The assets securing the loan-

backed obligation are acquired by the issuer and pledged to an independent trustee until the issuer's obligation has been fully satisfied. The investor only has direct recourse to the issuer's assets, but may have secondary recourse to third parties through insurance or guarantee for repayment of the obligation. As a result, the sponsor and its other affiliates may have no financial obligation under the instrument, although one of those entities may retain the responsibility for servicing the underlying assets. Some sponsors do guarantee the performance of the underlying assets.

- d. The WI Program, and treatment as a SSAP No. 43R security, is consistent with the current guidance for TBA securities when an insurer intends to take possession of the resulting mortgage-backed security. A TBA security reflects the pre-purchase of mortgage-backed securities prior to the finalization of the security issuance. Pursuant to the annual statement instructions, TBA securities are to be reported on Schedule D-1: Long-Term Bonds unless the structure more closely resembles a derivative. This determination depends on how a company uses the TBA. (For example, if a company intended to assume the mortgage-backed security once issued, the TBA would be captured on Schedule D-1 at initial acquisition. If a reporting entity was to continually trade/roll TBA exposures, this would be more characteristics of a derivative and would be captured on Schedule DB as a derivative.)

INT 22-01 Consensus

5. The Statutory Accounting Principles (E) Working Group reached a consensus that investments in the WI Trust Program shall be captured in scope of *SSAP No. 43R—Loan-Backed and Structured Securities* from initial acquisition.

6. If a reporting entity elects to convert WI Trust SPC securities into K-Deal SPC securities, the guidance in the Annual Statement Instructions, Schedule D, Part 3 and Part 4 shall be followed. Per that guidance, the transition from a WI Trust to a K-Deal shall not be reported as a disposal or acquisition. As the terms and cost basis of the SPC certificates would be identical, and the change would only reflect a CUSIP number change, a disposal and reacquisition shall not be recorded.

7. Excerpt from Annual Statement Instructions, Schedule D, Part 3 and 4:

This schedule should include a detailed listing of all securities that were purchased/acquired during the current reporting year that are still owned as of the end of the current reporting year (amounts purchased and sold during the current reporting year are reported in detail on Schedule D, Part 5 and only in subtotal in Schedule D, Part 3). This should include all transactions that adjust the cost basis of the securities. Thus, it should not be used for allocations of TBAs to specific pools subsequent to initial recording in Schedule D, Part 3 or other situations such as CUSIP number changes.

INT 22-01 Status

8. No further discussion is planned.

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

Issue: Related Party Reporting

Check (applicable entity):

	P/C	Life	Health
Modification of Existing SSAP	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>
New Issue or SSAP	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Interpretation	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>

Description of Issue: This agenda item has been drafted in response to recent discussions on the reporting and disclosure requirements for investments with related parties. This agenda item intends to encompass two main goals:

1. Clarify the reporting of affiliate transactions within existing reporting lines in the investment schedules. This clarification intends to be consistent with the definition of an “affiliate” pursuant to the *Insurance Holding Company System Regulatory Act* (Model #440), SSAP No. 25—Affiliates and Other Related Parties and SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities.
2. Incorporate new reporting requirements for investment transactions with related parties. Pursuant to recent discussions, regulators desire additional information on investment transactions involving related parties, regardless of whether the related party is “affiliated” pursuant to Model #440. To preserve the affiliate definition and reporting categories, these additional proposed reporting elements will be captured outside of the current affiliate reporting requirements.

Affiliate Definition and Identified Reporting Issues:

The *Insurance Holding Company System Regulatory Act* (Model #440) defines “affiliate” and “control” as:

- **Affiliate:** An “affiliate” of, or person “affiliated” with, a specific person, is a person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, the person specified.
- **Control:** The term “control” (including the terms “controlling,” “controlled by” and “under common control with”) means the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract other than a commercial contract for goods or nonmanagement services, or otherwise, unless the power is the result of an official position with or corporate office held by the person. Control shall be presumed to exist if any person, directly or indirectly, owns, controls, holds with the power to vote, or holds proxies representing, ten percent (10%) or more of the voting securities of any other person. This presumption may be rebutted by a showing made in the manner provided by Section 4K that control does not exist in fact. The commissioner may determine, after furnishing all persons in interest notice and opportunity to be heard and making specific findings of fact to support the determination, that control exists in fact, notwithstanding the absence of a presumption to that effect.

The guidance / concepts from Model #440 are reflected in SSAP No. 25, paragraphs 5-7 and SSAP No. 97, paragraphs 5-7 and are summarized as follows:

- An affiliate is defined as an entity that is within the holding company system or a party that, directly or indirectly, through one or more intermediaries, controls, is controlled by, or is under common control with the reporting entity. An affiliate includes a parent or subsidiary and may also include partnerships, joint ventures, and limited liability companies as defined in *SSAP No. 48—Joint Ventures, Partnerships and Limited Liability Companies*. An affiliate is any person that is directly or indirectly, owned or controlled by the same person or by the same group of persons, that, directly or indirectly, own or control the reporting entity.
- Control is defined as the possession, directly or indirectly, of the power to direct or cause the direction of the management and policies of the investee, whether through the (a) ownership of voting securities, (b) by contract other than a commercial contract for goods or nonmanagement services, (c) by contract for goods or nonmanagement services where the volume of activity results in a reliance relationship (d) by common management, or (e) otherwise. Control shall be presumed to exist if a reporting entity and its affiliates directly or indirectly, own, control, hold with the power to vote, or hold proxies representing 10% or more of the voting interests of the entity.
- Control shall be measured at the holding company level. For example, if one member of an affiliated group has a 5% interest in an entity and a second member of the group has an 8% interest in the same entity, the total interest is 13%, and therefore, each member of the affiliated group shall be presumed to have control. This presumption will stand until rebutted by an evaluation of all the facts and circumstances relating to the investment based on the criteria in *FASB Interpretation No. 35, Criteria for Applying the Equity Method of Accounting for Investments in Common Stock, an Interpretation of APB Opinion No. 18*. The corollary is required to demonstrate control when a reporting entity owns less than 10% of the voting securities of an investee. The insurer shall maintain documents substantiating its determination for review by the domiciliary commissioner. Examples of situations where the presumption of control may be in doubt include the following:
 1. Any limited partner investment in a limited partnership, unless the limited partner is affiliated with the general partner.
 2. An entity where the insurer owns less than 50% of an entity and there is an unaffiliated individual or group of investors who own a controlling interest.
 3. An entity where the insurer has given up participation rights as a shareholder to the investee.

The Annual Statement Instructions identifies what is captured in the reporting lines for “Parent, Subsidiary and Affiliates” as “Defined by *SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities*.”

Under the existing guidance, the following investments would likely not be reported as affiliated unless a domiciliary state has directed otherwise:

- Qualifying affiliated investments for which the domiciliary state has approved a disclaimer of affiliation or disclaimer of control from the affiliated entity. Once a disclaimer has been granted, the qualifying affiliate relationship is no longer considered an affiliate and any investments issued or held from the entity would not be reported as affiliated.
- Investments held from entities that do not qualify as affiliates, even if the entity qualifies as a related party. The determination of an affiliate is based on direct or indirect control. If the control determinants are not met, investments held from related parties are not reported as affiliated.

- Any investments acquired that were sponsored / originated by an affiliate, but the actual investment is not in the affiliate or other companies within the controlled holding company structure.

Model #440 explicitly excludes the purchase of securities solely for investment purposes from the determination of a change in control, so long as the securities are not used by voting or otherwise to cause or attempt to cause the substantial lessening of competition in any insurance market in the state. This guidance further states that if the purchase of securities results in a presumption of control, then the acquisition of securities would not be considered solely for investment purposes unless the commissioner of the insurer's state of domicile accepts a disclaimer of control or affirmatively finds that control does not exist.

Proposed Related Party Revisions

Although the affiliate definition may preclude certain investments from being captured in the “affiliated” reporting lines, there is a regulator desire to have improved information on investments with non-affiliated related parties as well as investments acquired from affiliates and non-affiliated related parties that do not reflect an investment within the affiliate/related party. For example, if the affiliate/related party was to sponsor or originate the investment, such investment would likely not be captured in the designated affiliate reported lines. This agenda item proposes revisions to SSAP No. 25 and SSAP No. 43R, as well as proposed concepts for an annual statement reporting change to capture information on these investments. Additionally, the proposed revisions would provide clarity, consistent with the existing affiliate definition, on scenarios that would qualify as affiliated transactions.

As an additional item, the existing reference in SSAP No. 25 to *FASB Interpretation No. 35, Criteria for Applying the Equity Method of Accounting for Investments in Common Stock, an Interpretation of APB Opinion No. 18* (FIN 35) has been proposed to be removed. Although the intent was to originally update the U.S. GAAP reference to reflect the current Accounting Standards Codification (ASC) citations, it was noted that the original provisions in FIN 35 (captured now in ASC 323-10-15-8, 323-10-15-10 and 323-10-15-11) only reiterate that the presumption that the investor has the ability to exercise significant influence over the investee's operating and financial policies based on ownership of voting stock stands until overcome by prominent evidence to the contrary. The ASC includes the following indicators originally in FIN 35 for when investors would be unable to exercise significant influence over the operating and financial policies of an investee:

- Opposition by the investee, such as litigation or complaints to government regulatory authorities, challenges the investor's ability to exercise significant influence.
- The investor and investee sign an agreement (such as a standstill agreement) under which the investor surrenders significant rights as a shareholder.
- Majority ownership of the investee is concentrated among a small group of shareholders who operate the investee without regards to the views of the investor.
- The investor wants or needs more financial information to apply the equity method than is available to the investee's other shareholders, tries to obtain that information, and fails. (The ASC example is a request for quarterly info when the investee only provides public information annually.)
- The investor tries and fails to obtain representation on the investee's board of directors.

The ASC also notes that these situations are just indicators and are not all-inclusive and that none of the individual circumstances are necessarily conclusive that the investee is unable to exercise significant influence over the investee's operating and financial policies. Rather, if any of these situations exist, an investor with controlling voting ownership shall evaluate all facts and circumstances related to the investment to reach a judgment about

whether the presumption that the investor has the ability to exercise significant influence over the investee's operating and financial policies is overcome. Furthermore, the guidance indicates that it may be necessary to evaluate the facts and circumstances over a period of time before reaching a judgment.

After a review of the ASC / FIN 35 guidance, it is proposed that the reference be deleted from SSAP No. 25. The general concepts for a review of all facts and circumstances, as well as example indicators, are already reflected directly in SSAP No. 25. Lastly, the reference to FIN 35 / ASC could be confusing as U.S. GAAP utilizes a different (higher) percentage of voting ownership than statutory accounting.

Existing Authoritative Literature:

- *Insurance Holding Company System Regulatory Act* (Model #440) – This model is an accreditation standard and is adopted by all states in a substantially similar manner. Only the territories of America Samoa, Guam and the Northern Mariana Islands do not have this model adopted.
- *SSAP No. 25—Affiliates and Other Related Parties* establishes statutory accounting principles and disclosure requirements for related party transactions. This statement shall be followed for all related party transactions, even if the transaction is also governed by other statutory accounting principles. As detailed in paragraph 1, related party transactions are subject to abuse as reporting entities may be induced to enter transactions that may not reflect economic realities or may not be fair and reasonable to the reporting entity or its policyholders. As such, related party transactions require specialized accounting rules and increased regulatory scrutiny. The guidance in paragraphs 4-8 include the definition of related parties and affiliates:

4. Related parties are defined as entities that have common interests as a result of ownership, control, affiliation or by contract. Related parties shall include but are not limited to the following:

- a. Affiliates of the reporting entity, as defined in paragraph 5;
- b. Trusts for the benefit of employees, such as pension and profit-sharing trusts and Employee Stock Ownership Plans that are managed by or under the trusteeship of management of the reporting entity, its parent or affiliates;
- c. The principal owners, directors, officers of the reporting entity;
- d. Any immediate family member of a principal owner, director or executive officer of the reporting entity, which means any child, stepchild, parent, stepparent, spouse, sibling, mother-in-law, father-in-law, son-in-law, daughter-in-law, brother-in-law, or sister-in-law, or individual related by blood or marriage whose close association is equivalent to a family relationship of such director, executive officer or nominee for director, or any person (other than a tenant or employee) sharing the household of such director, executive officer or nominee for director;
- e. Companies and entities which share common control, such as principal owners, directors, or officers, including situations where principal owners, directors, or officers have a controlling stake in another reporting entity;
- f. Any direct or indirect ownership greater than 10% of the reporting entity results in a related party classification regardless of any disclaimer of control or disclaimer of affiliation;
- g. The management of the reporting entity, its parent or affiliates (including directors);

- h. Members of the immediate families of principal owners and management of the reporting entity, its parent or affiliates and their management;
 - i. Parties with which the reporting entity may deal if either party directly or indirectly controls or can significantly influence the management or operating policies of the other to an extent that one of the transacting parties might be prevented from fully pursuing its own separate interest;
 - j. A party which can, directly or indirectly, significantly influence the management or operating policies of the reporting entity, which may include a provider who is contracting with the reporting entity. This is not intended to suggest that all provider contracts create related party relationships;
 - k. A party which has an ownership interest in one of the transacting parties and can significantly influence the other to an extent that one or more of the transacting parties might be prevented from fully pursuing its own separate interests;
 - l. Attorney-in-fact of a reciprocal reporting entity or any affiliate of the attorney-in-fact; and
 - m. A U.S. manager of a U.S. Branch or any affiliate of the U.S. manager of a U.S. Branch.
5. An affiliate is defined as an entity that is within the holding company system or a party that, directly or indirectly, through one or more intermediaries, controls, is controlled by, or is under common control with the reporting entity. An affiliate includes a parent or subsidiary and may also include partnerships, joint ventures, and limited liability companies as defined in SSAP No. 48—Joint Ventures, Partnerships and Limited Liability Companies. Those entities are accounted for under the guidance provided in SSAP No. 48, which requires an equity method for all such investments. An affiliate is any person that is directly or indirectly, owned or controlled by the same person or by the same group of persons, that, directly or indirectly, own or control the reporting entity.
6. Control is defined as the possession, directly or indirectly, of the power to direct or cause the direction of the management and policies of the investee, whether through the (a) ownership of voting securities, (b) by contract other than a commercial contract for goods or nonmanagement services, (c) by contract for goods or nonmanagement services where the volume of activity results in a reliance relationship (d) by common management, or (e) otherwise. Control shall be presumed to exist if a reporting entity and its affiliates directly or indirectly, own, control, hold with the power to vote, or hold proxies representing 10% or more of the voting interests of the entity.
7. Control as defined in paragraph 6 shall be measured at the holding company level. For example, if one member of an affiliated group has a 5% interest in an entity and a second member of the group has an 8% interest in the same entity, the total interest is 13%, and therefore, each member of the affiliated group shall be presumed to have control. This presumption will stand until rebutted by an evaluation of all the facts and circumstances relating to the investment based on the criteria in FASB Interpretation No. 35, Criteria for Applying the Equity Method of Accounting for Investments in Common Stock, an Interpretation of APB Opinion No. 18. The corollary is required to demonstrate control when a reporting entity owns less than 10% of the voting securities of an investee. The insurer shall maintain documents substantiating its determination for review by the domiciliary commissioner. Examples of situations where the presumption of control may be in doubt include the following:

- a. Any limited partner investment in a limited partnership, unless the limited partner is affiliated with the general partner.
- b. An entity where the insurer owns less than 50% of an entity and there is an unaffiliated individual or group of investors who own a controlling interest.

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- c. An entity where the insurer has given up participation rights¹ as a shareholder to the investee.
- d. Agreements where direct or indirect non-controlling ownership interest is less than 10% where the parties have structured the arrangement in this structure to avoid the 10% threshold in paragraph 4.f. and paragraph 8.

8. Any direct or indirect ownership interest of the reporting entity greater than 10% results in a related party classification regardless of any disclaimer of control or disclaimer of affiliation. The *Insurance Holding Company System Regulatory Act* (#440) and the *Insurance Holding Company System Model Regulation* (#450) include a provision that allows for the disclaimer of affiliation and/or the disclaimer of control for members of an insurance holding company system. The disclaimer must be filed with the state insurance commissioner. Entities whose relationship is subject to a disclaimer of affiliation or a disclaimer of control are related parties and are subject to the related party disclosures within this statement. Such a disclaimer does not eliminate a “related party” distinction or disclosure requirements for material transactions pursuant to SSAP No. 25.

- *SSAP No. 48—Joint Ventures, Partnerships and Limited Liability Companies* establishes guidance for these investments. The guidance in this SSAP provides different guidance when there is a “more than minor” or “minor ownership interest.” Pursuant to existing guidance, reporting entities must also identify whether the investment is a related-party transaction.

9. Investments in these ventures, except for joint ventures, partnerships and limited liability companies with a minor ownership interest¹, shall be reported using an equity method as defined in *SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities*, paragraphs 8.b.i. through 8.b.iv. (The equity method calculation may result with a negative valuation of the investment; therefore, the SSAP No. 97 equity method calculation shall occur regardless of whether the investment is supported by an audit and the reporting entity will nonadmit the investment.) A reporting entity whose shares of losses in a SSAP No. 48 entity exceeds its investment in the SSAP No. 48 entity shall disclose the information required by SSAP No. 97, paragraph 35.a.

Footnote: With the identification of whether the reporting entity has a minor ownership interest, reporting entities must also identify whether the investment is a related-party transaction. Pursuant to the concepts reflected in *SSAP No. 25—Affiliates and Other Related Parties*, consideration shall be given to the substance of the transaction and the parties whose action or performance materially impacts the insurance reporting entity holding the security. For example, if the underlying assets within a SSAP No. 48 entity represent assets issued by an affiliate, then the SSAP No. 48 entity shall be considered a related party (affiliate) investment, with the transaction subject to the accounting and reporting provisions of SSAP No. 25. As identified in SSAP No. 25, it is erroneous to conclude that the inclusion of a non-related intermediary, or the presence of non-related assets in a structure predominantly comprised of related party investments, eliminates the requirement to identify and assess the investment transaction as a related party arrangement.

- *SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities* establishes statutory accounting principles for investments in subsidiaries, controlled and affiliated entities. The guidance in paragraphs 3-6 include the definitions for parent, subsidiary, and affiliate. (The definition for an affiliate and control is identical

¹ The term “participating rights” refers to the type of rights that allows an investor to effectively participate in significant decisions related to an investee’s ordinary course of business and is distinguished from the more limited type of rights referred to as “protective rights”. Refer to the sections entitled: “Protective Rights” and “Substantive Participating Rights” in EITF 96-16, *Investor’s Accounting for an Investee When the Investor Owns a Majority of the Voting Stock but the Minority Shareholder or Shareholders Have Certain Approval or Veto Rights*. The term “participating rights” shall be used consistent with the discussion of substantive participating rights in this EITF.

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to SSAP No. 25.) (As noted, the Annual Statement reporting lines for “Parent, Subsidiary and Affiliates” refers to the definition within SSAP No. 97. If an investment is held for an entity that does not meet the SSAP No. 97 definitions, or for which a disclaimer of control or affiliation has been received, then the investment would not be captured within the Parent, Subsidiary or Affiliate reporting line.)

3. Parent and subsidiary are defined as follows:

- a. Parent—An entity that directly or indirectly owns and controls the reporting entity;
- b. Subsidiary—An entity that is, directly or indirectly, owned and controlled by the reporting entity.

4. An affiliate is defined as an entity that is within the holding company system or a party that, directly or indirectly, through one or more intermediaries, controls, is controlled by, or is under common control with the reporting entity. An affiliate includes a parent or subsidiary and may also include partnerships, joint ventures, and limited liability companies as defined in *SSAP No. 48—Joint Ventures, Partnerships and Limited Liability Companies*. Those entities are accounted for under the guidance provided in SSAP No. 48, which requires an equity method for all such investments.

5. Control is defined as the possession, directly or indirectly, of the power to direct or cause the direction of the management and policies of the investee, whether through the (a) ownership of voting securities, (b) by contract other than a commercial contract for goods or nonmanagement services, (c) by common management, or (d) otherwise. Control shall be presumed to exist if a reporting entity and its affiliates directly or indirectly, own, control, hold with the power to vote, or hold proxies representing 10% or more of the voting interests of the entity².

6. Control as defined in paragraph 5 shall be measured at the holding company level. For example, if one member of an affiliated group has a 5% interest in an entity and a second member of the group has an 8% interest in the same entity, the total interest is 13% and therefore each member of the affiliated group shall be presumed to have control. This presumption will stand until rebutted by an evaluation of all the facts and circumstances relating to the investment based on the criteria in *FASB Interpretation No. 35, Criteria for Applying the Equity Method of Accounting for Investments in Common Stock, an Interpretation of APB Opinion No. 18*. The corollary is required to demonstrate control when a reporting entity owns less than 10% of the voting securities of an investee. The insurer shall maintain documents substantiating its determination for review by the domiciliary commissioner. An investment in an SCA entity may fall below the level of ownership described in paragraph 5, in which case, the reporting entity would discontinue the use of the equity method, as prescribed in paragraph 13.g. Additionally, through an increase in the level of ownership, a reporting entity may become qualified to use the equity method of accounting (paragraph 8.b.), in which case, the reporting entity shall add the cost of acquiring additional interest to the current basis of the previously held interest and shall apply the equity method prospectively, as of the date the investment becomes qualified for equity method accounting. Examples of situations where the presumption of control may be in doubt include the following:

² Investments in an exchange traded fund (ETF) or a mutual fund (as defined by the SEC) does not reflect ownership in an underlying entity, regardless of the ownership percentage the reporting entity (or the holding company group) has of the ETF or mutual fund unless ownership of the ETF actually results in “control” with the power to direct or cause the direction of management of an underlying company. ETFs and mutual funds are comprised of portfolios of securities subject to the regulatory requirements of the federal securities laws. ETFs and mutual funds held by a reporting entity shall be reported as common stock, unless the ETF qualifies for bond or preferred stock treatment per the *Purposes and Procedures Manual of the NAIC Investment Analysis Office*. Reporting entities are not required to verify that SCAs (subject to SSAP No. 97) are represented in the portfolio of securities held in ETFs or mutual funds or to adjust the value of SCAs as a result of investments in ETFs or mutual funds.

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- a. Any limited partner investment in a limited partnership, unless the limited partner is affiliated with the general partner.
- b. An entity where the insurer owns less than 50% of an entity and there is an unaffiliated individual or group of investors who own a controlling interest.
- c. An entity where the insurer has given up participating rights³ as a shareholder to the investee.

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): In March 2021, the Statutory Accounting Principles (E) Working Group adopted revisions to SSAP No. 25 pursuant to agenda item 2019-34: Related Parties, Disclaimers of Affiliation and Variable Interest Entities. Additionally, a new reporting Schedule Y, Part 3 was adopted by the Blanks (E) Working Group in proposal 2020-37BWG, with an initial effective date of Dec. 31, 2021, to capture information on all entities with ownership greater than 10%, the ultimate controlling parties of those owners and other entities that the ultimate controlling party controls.

The adopted revisions to SSAP No. 25 from agenda item 2019-34 are summarized as follows:

- Clarify the identification of related parties and ensure that any related party identified under U.S. GAAP or SEC reporting requirements would be considered a related party under statutory accounting principles.
- Clarify that non-controlling ownership over 10% results in a related party classification regardless of any disclaimer of control or disclaimer of affiliation.
- Clarify the impact of a disclaimer of control or disclaimer of affiliate under SAP. As detailed, such disclaimers impact holding company group allocation and reporting as an SCA under SSAP No. 97, but do not eliminate the classification as a “related party” and the disclosure of material transactions as required under SSAP No. 25.
- Rejected several U.S. GAAP standards addressing variable interest entities.

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

Convergence with International Financial Reporting Standards (IFRS): Not applicable.

Staff Recommendation:

NAIC staff recommends that the Working Group move this item to the active listing, categorized as a nonsubstantive change, and expose revisions to SSAP No. 25 and SSAP No. 43R to clarify application of the existing affiliate definition as well as to incorporate new disclosure requirements for investments acquired through, or in, related parties, regardless of if they meet the affiliate definition. (Staff Note: Pursuant to the

³ The term "participating rights" refers to the type of rights that allows an investor to effectively participate in significant decisions related to an investee's ordinary course of business and is distinguished from the more limited type of rights referred to as "protective rights". Refer to the sections entitled: "Protective Rights" and "Substantive Participating Rights" in EITF 96-16, *Investor's Accounting for an Investee When the Investor Has a Majority of the Voting Interest but the Minority Shareholder or Shareholders Have Certain Approval or Veto Rights*. The term "participating rights" shall be used consistent with the discussion of substantive participating rights in this EITF.

NAIC Policy Statement on Maintenance of Statutory Accounting Principles, new disclosures and modifications to existing disclosures are considered nonsubstantive changes.)

Proposed edits to SSAP No. 25: (New paragraph 9. Remaining paragraphs would be renumbered.)

This new paragraph 9 clarifies the application of the existing affiliate and control definitions to limited partnerships, trusts and other special purpose entities when control is held by an affiliated general partner, servicer or other arrangement. (The proposed deletion of FIN 35 is discussed earlier in the agenda item, but is noted as not necessary with the existing statutory accounting guidance.)

5. An affiliate is defined as an entity that is within the holding company system or a party that, directly or indirectly, through one or more intermediaries, controls, is controlled by, or is under common control with the reporting entity. An affiliate includes a parent or subsidiary and may also include partnerships, joint ventures, and limited liability companies as defined in SSAP No. 48—Joint Ventures, Partnerships and Limited Liability Companies. Those entities are accounted for under the guidance provided in SSAP No. 48, which requires an equity method for all such investments. An affiliate is any person that is directly or indirectly, owned or controlled by the same person or by the same group of persons, that, directly or indirectly, own or control the reporting entity.

6. Control is defined as the possession, directly or indirectly, of the power to direct or cause the direction of the management and policies of the investee, whether through the (a) ownership of voting securities, (b) by contract other than a commercial contract for goods or nonmanagement services, (c) by contract for goods or nonmanagement services where the volume of activity results in a reliance relationship (d) by common management, or (e) otherwise. Control shall be presumed to exist if a reporting entity and its affiliates directly or indirectly, own, control, hold with the power to vote, or hold proxies representing 10% or more of the voting interests of the entity.

7. Control as defined in paragraph 6 shall be measured at the holding company level. For example, if one member of an affiliated group has a 5% interest in an entity and a second member of the group has an 8% interest in the same entity, the total interest is 13%, and therefore, each member of the affiliated group shall be presumed to have control. This presumption will stand until rebutted by an evaluation of all the facts and circumstances relating to the investment ~~based on the criteria in FASB Interpretation No. 35, Criteria for Applying the Equity Method of Accounting for Investments in Common Stock, an Interpretation of APB Opinion No. 18. The corollary is required to demonstrate control when a reporting entity owns less than 10% of the voting securities of an investee.~~ The insurer shall maintain documents substantiating its determination for review by the domiciliary commissioner. Examples of situations where the presumption of control may be in doubt include the following:

- a. Any limited partner investment in a limited partnership, unless the limited partner is affiliated with the general partner.
- b. An entity where the insurer owns less than 50% of an entity and there is an unaffiliated individual or group of investors who own a controlling interest.
- c. An entity where the insurer has given up participation rights⁴ as a shareholder to the investee.

⁴ The term "participating rights" refers to the type of rights that allows an investor to effectively participate in significant decisions related to an investee's ordinary course of business and is distinguished from the more limited type of rights referred to as "protective rights". Refer to the sections entitled: "Protective Rights" and "Substantive Participating Rights" in EITF 96-16, *Investor's Accounting for an Investee When the Investor Owns a Majority of the Voting Stock but the Minority Shareholder or Shareholders Have Certain Approval or Veto Rights*. The term "participating rights" shall be used consistent with the discussion of substantive participating rights in this EITF.

8. Any direct or indirect ownership interest of the reporting entity greater than 10% results in a related party classification regardless of any disclaimer of control or disclaimer of affiliation. The *Insurance Holding Company System Regulatory Act* (#440) and the *Insurance Holding Company System Model Regulation* (#450) include a provision that allows for the disclaimer of affiliation and/or the disclaimer of control for members of an insurance holding company system. The disclaimer must be filed with the state insurance commissioner. Entities whose relationship is subject to a disclaimer of affiliation or a disclaimer of control are related parties and are subject to the related party disclosures within this statement. Such a disclaimer does not eliminate a “related party” distinction or disclosure requirements for material transactions pursuant to SSAP No. 25.

9. For entities not controlled by voting interests, such as limited partnerships, trusts and other special purpose entities, control may be held by a general partner, servicer, or by other arrangements. The ability of the reporting entity or its affiliates to direct the management and policies of an entity through such arrangements shall constitute control as defined in paragraph 6. Additionally, a reporting entity or its affiliates may have indirect control of other entities through such arrangements. For example, if a limited partnership were to be controlled by an affiliated general partner, and that limited partnership held greater than 10% of the voting interests of another company, indirect control shall be presumed to exist. If direct or indirect control exists, whether through voting securities, contracts, common management or otherwise, the arrangement is considered affiliated under paragraph 5. Consistent with paragraph 8, a disclaimer of affiliation does not eliminate a “related party” distinction or disclosure requirements for material transactions pursuant to SSAP No. 25.

Proposed edits to SSAP No. 43R:

These revisions move the existing guidance in paragraph 4.a. to paragraph 6 and notes the requirement to identify related party investments in the investment schedules. (Note Footnote 5 is just moved to a new paragraph.)

4. Loan-backed securities are issued by special-purpose corporations or trusts (issuer) established by a sponsoring organization. The assets securing the loan-backed obligation are acquired by the issuer and pledged to an independent trustee until the issuer's obligation has been fully satisfied. The investor only has direct recourse to the issuer's assets, but may have secondary recourse to third parties through insurance or guarantee for repayment of the obligation. As a result, the sponsor and its other affiliates may have no financial obligation under the instrument, although one of those entities may retain the responsibility for servicing the underlying assets. Some sponsors do guarantee the performance of the underlying assets.

a. ~~In determining whether a loan-backed structure is a related party investment, consideration shall be given to the substance of the transaction, and the parties whose action or performance materially impacts the insurance reporting entity holding the security. For example, although a loan-backed security may be acquired from a non-related issuer, if the assets held in trust predominantly⁶ reflect assets issued by affiliates of the insurance reporting entity, and the insurance reporting entity only has direct recourse to the assets held in trust, the transaction shall be considered an affiliated investment, and the transaction shall also subject to the accounting and reporting provisions in SSAP No. 25—Affiliates and Other Related Parties.~~

⁶ In applying this guidance, a reporting entity is not required to complete a detailed review of the assets held in trust to determine the extent, if any, the assets were issued by related parties. Rather, this guidance is a principle concept intended to prevent situations in which related party transactions (particularly those involving affiliates) is knowingly captured in a SSAP No. 43R structure and not identified as a related party transaction (or not reported as an affiliated investment on the investment schedule) because of the involvement of a non-related trustee or SSAP No. 43R-security issuer. As identified in SSAP No. 25—Affiliates and Other Related Parties, it is erroneous to conclude that the inclusion of a non-related intermediary, or the presence of non-related assets in a structure predominantly comprised of related party investments, eliminates the requirement to identify and assess the investment transaction as a related party arrangement.

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5. Mortgage-referenced securities do not meet the definition of a loan-backed or structured security but are explicitly captured in scope of this statement. In order to qualify as a mortgage-referenced security, the security must be issued by a government sponsored enterprise⁶ or by a special purpose trust in a transaction sponsored by a government sponsored enterprise in the form of a “credit risk transfer” in which the issued security is tied to a referenced pool of mortgages and the payments received are linked to the credit and principal payment risk of the underlying mortgage loan borrowers captured in the referenced pool of mortgages. For these instruments, reporting entity holders may not receive a return of their full principal as principal repayment is contingent on repayment by the mortgage loan borrowers in the referenced pool of mortgages. Unless specifically noted, the provisions for loan-backed securities within this standard apply to mortgage-referenced securities.

6. Investments within the scope of this statement issued by a related party or acquired through a related party transaction or arrangement are also subject to the provisions admittance assessments and disclosure requirements of SSAP No. 25. In determining whether a security is a related party investment, consideration should be given to the substance of the transaction, and the parties whose action or performance materially impacts the insurance reporting entity holding the security if the SSAP No. 43R transaction is a related party arrangement⁷. Loan-backed and structured securities meet the definition of assets as defined in SSAP No. 4—Assets and Nonadmitted Assets and are admitted assets to the extent they conform to the requirements of this statement and SSAP No. 25.

- a. Although a loan-backed or structured security may be acquired from a non-related issuer, if the assets held in trust predominantly⁸ reflect assets issued by affiliates of the insurance reporting entity, and the insurance reporting entity only has direct recourse to the assets held in trust, the transaction shall be considered an affiliated investment. In such situations where the underlying collateral assets are issued by related parties that do not qualify as affiliates, these securities shall be identified as related party investments in the investment schedules.
- b. A loan-backed or structured security may involve a relationship with a related party but not be considered an affiliated investment. This may be because the relationship does not result in direct or indirect control of the issuer or because there is an approved disclaimer of control or affiliation. Regardless of whether investments involving a related party relationship are captured in the affiliated investment reporting lines, these securities shall be identified as related party investments in the investment schedules. Examples of related party relationships would include involvement of a related party in sponsoring or originating the loan-backed or structured security or any type of underlying servicing arrangement. For the avoidance of doubt, investments from any arrangement that results in direct or indirect control, including control through a servicer or other controlling arrangement, shall be reported as affiliated in accordance with SSAP No. 25—Affiliates and Other Related Parties.

⁶ Currently, only Fannie Mae and Freddie Mac are the government sponsored entities that either directly issue qualifying mortgage-referenced securities or sponsor transactions in which a special purpose trust issues qualifying mortgage-reference securities. However, this guidance would apply to mortgage-referenced securities issued by any other government sponsored entity that subsequently engages in the transfer of mortgage credit risk.

⁷ As discussed in paragraph 4.a. of this statement, a SSAP No. 43R security may still be considered a related party transaction even if the asset trustee or security issuer is a non-related party.

⁸ In applying this guidance, a reporting entity is not required to complete a detailed review of the assets held in trust to determine the extent, if any, the assets were issued by related parties. Rather, this guidance is a principle concept intended to prevent situations in which related party transactions (particularly those involving affiliates) is knowingly captured in a SSAP No. 43R structure and not identified as a related party transaction (or not reported as an affiliated investment on the investment schedule) because of the involvement of a non-related trustee or SSAP No. 43R security issuer. As identified in SSAP No. 25—Affiliates and Other Related Parties, it is erroneous to conclude that the inclusion of a non-related intermediary, or the presence of non-related assets in a structure predominantly comprised of related party investments, eliminates the requirement to identify and assess the investment transaction as a related party arrangement.

Proposed Annual Statement Reporting Changes: (*These will be captured in a blanks proposal.*)

These reflect a new electronic-only column for the investment schedules and the related instructions.

Column XX: Investments Involving Related Parties:

Required for all investments involving related parties including, but not limited to, those captured as affiliate investments. This disclosure intends to capture information on investments held that reflect interactions involving related parties, regardless of whether the related party meets the affiliate definition, or the reporting entity has received domiciliary state approval to disclaim control / affiliation.

Enter one of the following codes to identify the role of the related party in the investment.

1. Direct loan or direct investment (excluding securitizations) in a related party, for which the related party represents a direct credit exposure.
2. Securitization or similar investment involving a relationship with a related party as sponsor, originator, manager, servicer, or other similar influential role and for which 50% or more of the underlying collateral represents investments in or direct credit exposure to related parties.
3. Securitization or similar investment involving a relationship with a related party as sponsor, originator, manager, servicer, or other similar influential role and for which less than 50% (including 0%) of the underlying collateral represents investments in or direct credit exposure to related parties.
4. Securitization or similar investment in which the structure reflects an in-substance related party transaction but does not involve a relationship with a related party as sponsor, originator, manager, servicer, or other similar influential role.
5. The investment is identified as related party, but the role of the related party represents a different arrangement than the options provided in choices 1-4.

Staff Review Completed by: Julie Gann, NAIC Staff – October 2021

Status:

On December 11, 2021, the Statutory Accounting Principles (E) Working Group moved this agenda item to the active listing, categorized as nonsubstantive, and exposed revisions to SSAP No. 25 and SSAP No. 43R, as illustrated above, to clarify application of the existing affiliate definition and incorporate disclosure requirements for all investments that involve related parties, regardless of if they meet the affiliate definition. In addition, draft annual statement reporting revisions were also exposed, in anticipation of incorporating those revisions into a Blanks (E) Working Group proposal.

On April 4, 2022, the Statutory Accounting Principles (E) Working Group exposed this agenda item, incorporating proposed revisions after considering comments from interested parties shown highlighted in gray below. The changes from the prior exposure only clarify previous components of the proposed revisions. Similar changes to the blanks proposal are also concurrently exposed by the Blanks (E) Working Group in their corresponding agenda item (2021-22BWG) to allow for a year-end 2022 effective date. This item was exposed with a shortened comment period ending May 6.

Proposed edits to SSAP No. 25: (New paragraph 9. Remaining paragraphs would be renumbered.)

This new paragraph 9 clarifies the application of the existing affiliate and control definitions to limited partnerships, trusts and other special purpose entities when control is held by an affiliated general partner, servicer or other arrangement. (The proposed deletion of FIN 35 is discussed earlier in the agenda item, but is noted as not necessary with the existing statutory accounting guidance.)

5. An affiliate is defined as an entity that is within the holding company system or a party that, directly or indirectly, through one or more intermediaries, controls, is controlled by, or is under common control with the reporting entity. An affiliate includes a parent or subsidiary and may also include partnerships, joint ventures, and limited liability companies as defined in SSAP No. 48—Joint Ventures, Partnerships and Limited Liability Companies. Those entities are accounted for under the guidance provided in SSAP No. 48, which requires an equity method for all such investments. An affiliate is any person that is directly or indirectly, owned or controlled by the same person or by the same group of persons, that, directly or indirectly, own or control the reporting entity.

6. Control is defined as the possession, directly or indirectly, of the power to direct or cause the direction of the management and policies of the investee, whether through the (a) ownership of voting securities, (b) by contract other than a commercial contract for goods or nonmanagement services, (c) by contract for goods or nonmanagement services where the volume of activity results in a reliance relationship (d) by common management, or (e) otherwise. Control shall be presumed to exist if a reporting entity and its affiliates directly or indirectly, own, control, hold with the power to vote, or hold proxies representing 10% or more of the voting interests of the entity.

7. Control as defined in paragraph 6 shall be measured at the holding company level. For example, if one member of an affiliated group has a 5% interest in an entity and a second member of the group has an 8% interest in the same entity, the total interest is 13%, and therefore, each member of the affiliated group shall be presumed to have control. This presumption will stand until rebutted by an evaluation of all the facts and circumstances relating to the investment ~~based on the criteria in FASB Interpretation No. 35, Criteria for Applying the Equity Method of Accounting for Investments in Common Stock, an Interpretation of APB Opinion No. 18. The corollary is required to demonstrate control when a reporting entity owns less than 10% of the voting securities of an investee.~~ The insurer shall maintain documents substantiating its determination for review by the domiciliary commissioner. Examples of situations where the presumption of control may be in doubt include the following:

- a. Any limited partner investment in a limited partnership, unless the limited partner is affiliated with the general partner.
- b. An entity where the insurer owns less than 50% of an entity and there is an unaffiliated individual or group of investors who own a controlling interest.
- c. An entity where the insurer has given up participation rights⁹ as a shareholder to the investee.

8. Any direct or indirect ownership interest of the reporting entity greater than 10% results in a related party classification regardless of any disclaimer of control or disclaimer of affiliation. The *Insurance Holding Company System Regulatory Act* (#440) and the *Insurance Holding Company System Model Regulation* (#450) include a provision that allows for the disclaimer of affiliation and/or the disclaimer of control for

⁹ The term "participating rights" refers to the type of rights that allows an investor to effectively participate in significant decisions related to an investee's ordinary course of business and is distinguished from the more limited type of rights referred to as "protective rights". Refer to the sections entitled: "Protective Rights" and "Substantive Participating Rights" in EITF 96-16, *Investor's Accounting for an Investee When the Investor Owns a Majority of the Voting Stock but the Minority Shareholder or Shareholders Have Certain Approval or Veto Rights*. The term "participating rights" shall be used consistent with the discussion of substantive participating rights in this EITF.

members of an insurance holding company system. The disclaimer must be filed with the state insurance commissioner. Entities whose relationship is subject to a disclaimer of affiliation or a disclaimer of control are related parties and are subject to the related party disclosures within this statement. Such a disclaimer does not eliminate a “related party” distinction or disclosure requirements for material transactions pursuant to SSAP No. 25.

9. For entities not controlled by voting interests, such as limited partnerships, trusts and other special purpose entities, control may be held by a general partner, servicer, or by other arrangements. The ability of the reporting entity or its affiliates to direct the management and policies of an entity through such arrangements shall constitute control as defined in paragraph 6. Additionally, a reporting entity or its affiliates may have indirect control of other entities through such arrangements. For example, if a limited partnership were to be controlled by an affiliated general partner, and that limited partnership held greater than 10% of the voting interests of another company¹⁰, indirect control shall be presumed to exist unless the presumption of control can be overcome as detailed in paragraph 7. If direct or indirect control exists, whether through voting securities, contracts, common management or otherwise, the arrangement is considered affiliated under paragraph 5. Consistent with paragraph 8, a disclaimer of affiliation does not eliminate a “related party” distinction or disclosure requirements for material transactions pursuant to SSAP No. 25.

Proposed edits to SSAP No. 43R:

These revisions move the existing guidance in paragraph 4.a. to paragraph 6 and notes the requirement to identify related party investments in the investment schedules. (Note Footnote 5 is just moved to a new paragraph.)

4. Loan-backed securities are issued by special-purpose corporations or trusts (issuer) established by a sponsoring organization. The assets securing the loan-backed obligation are acquired by the issuer and pledged to an independent trustee until the issuer's obligation has been fully satisfied. The investor only has direct recourse to the issuer's assets, but may have secondary recourse to third parties through insurance or guarantee for repayment of the obligation. As a result, the sponsor and its other affiliates may have no financial obligation under the instrument, although one of those entities may retain the responsibility for servicing the underlying assets. Some sponsors do guarantee the performance of the underlying assets.

a. ~~In determining whether a loan-backed structure is a related party investment, consideration shall be given to the substance of the transaction, and the parties whose action or performance materially impacts the insurance reporting entity holding the security. For example, although a loan backed security may be acquired from a non-related issuer, if the assets held in trust predominantly¹¹ reflect assets issued by affiliates of the insurance reporting entity, and the insurance reporting entity only has direct recourse to the assets held in trust, the transaction~~

¹⁰ Consistent with SSAP No. 97, footnote 1, investments in an exchange traded fund (ETF) or a mutual fund (as defined by the SEC) does not reflect ownership in an underlying entity, regardless of the ownership percentage the reporting entity (or the holding company group) has of the ETF or mutual fund unless ownership of the ETF actually results in “control” with the power to direct or cause the direction of management of an underlying company. ETFs and mutual funds are comprised of portfolios of securities subject to the regulatory requirements of the federal securities laws.

¹¹ In applying this guidance, a reporting entity is not required to complete a detailed review of the assets held in trust to determine the extent, if any, the assets were issued by related parties. Rather, this guidance is a principle concept intended to prevent situations in which related party transactions (particularly those involving affiliates) is knowingly captured in a SSAP No. 43R structure and not identified as a related party transaction (or not reported as an affiliated investment on the investment schedule) because of the involvement of a non-related trustee or SSAP No. 43R-security issuer. As identified in SSAP No. 25—Affiliates and Other Related Parties, it is erroneous to conclude that the inclusion of a non-related intermediary, or the presence of non-related assets in a structure predominantly comprised of related party investments, eliminates the requirement to identify and assess the investment transaction as a related party arrangement.

~~shall be considered an affiliated investment, and the transaction shall also subject to the accounting and reporting provisions in SSAP No. 25—Affiliates and Other Related Parties.~~

5. Mortgage-referenced securities do not meet the definition of a loan-backed or structured security but are explicitly captured in scope of this statement. In order to qualify as a mortgage-referenced security, the security must be issued by a government sponsored enterprise¹² or by a special purpose trust in a transaction sponsored by a government sponsored enterprise in the form of a “credit risk transfer” in which the issued security is tied to a referenced pool of mortgages and the payments received are linked to the credit and principal payment risk of the underlying mortgage loan borrowers captured in the referenced pool of mortgages. For these instruments, reporting entity holders may not receive a return of their full principal as principal repayment is contingent on repayment by the mortgage loan borrowers in the referenced pool of mortgages. Unless specifically noted, the provisions for loan-backed securities within this standard apply to mortgage-referenced securities.

6. Investments within the scope of this statement issued by a related party or acquired through a related party transaction or arrangement are also subject to the provisions, admittance assessments and disclosure requirements of SSAP No. 25. In determining whether a security is a related party investment, consideration should be given to the substance of the transaction, and the parties whose action or performance materially impacts the insurance reporting entity holding the security if the SSAP No. 43R transaction is a related party arrangement¹³. Loan-backed and structured securities meet the definition of assets as defined in SSAP No. 4—Assets and Nonadmitted Assets and are admitted assets to the extent they conform to the requirements of this statement and SSAP No. 25.

- a. Although a loan-backed or structured security may be acquired from a non-related issuer, if the assets held in trust predominantly¹⁴ reflect assets issued by affiliates of the insurance reporting entity, and the insurance reporting entity only has direct recourse to the assets held in trust, the transaction shall be considered an affiliated investment. In such situations where the underlying collateral assets are issued by related parties that do not qualify as affiliates, these securities shall be identified as related party investments in the investment schedules.
- b. A loan-backed or structured security may involve a relationship with a related party but not be considered an affiliated investment. This may be because the relationship does not result in direct or indirect control of the issuer or because there is an approved disclaimer of control or affiliation. Regardless of whether investments involving a related party relationship are captured in the affiliated investment reporting lines, these securities shall be identified as related party investments in the investment schedules. Examples of related party relationships would include involvement of a related party in sponsoring or originating the loan-backed or structured security or any type of underlying servicing arrangement. For the avoidance of doubt, investments from any arrangement that results in direct or indirect

¹² Currently, only Fannie Mae and Freddie Mac are the government sponsored entities that either directly issue qualifying mortgage-referenced securities or sponsor transactions in which a special purpose trust issues qualifying mortgage-reference securities. However, this guidance would apply to mortgage-referenced securities issued by any other government sponsored entity that subsequently engages in the transfer of mortgage credit risk.

¹³ As discussed in paragraph 4.a. of this statement, a SSAP No. 43R security may still be considered a related party transaction even if the asset trustee or security issuer is a non-related party.

¹⁴ In applying this guidance, a reporting entity is not required to complete a detailed review of the assets held in trust to determine the extent, if any, the assets were issued by related parties. Rather, this guidance is a principle concept intended to prevent situations in which related party transactions (particularly those involving affiliates) is knowingly captured in a SSAP No. 43R structure and not identified as a related party transaction (or not reported as an affiliated investment on the investment schedule) because of the involvement of a non-related trustee or SSAP No. 43R security issuer. As identified in SSAP No. 25—Affiliates and Other Related Parties, it is erroneous to conclude that the inclusion of a non-related intermediary, or the presence of non-related assets in a structure predominantly comprised of related party investments, eliminates the requirement to identify and assess the investment transaction as a related party arrangement.

Ref #2021-21

control, including control through a servicer or other controlling arrangement, shall be reported as affiliated in accordance with SSAP No. 25—Affiliates and Other Related Parties.

Proposed Annual Statement Reporting Changes: (These in a blanks proposal 2021-22BWG.)

These reflect a new electronic-only column for the investment schedules and the related instructions.

Column XX: Investments Involving Related Parties:

Required for all investments involving related parties including, but not limited to, those captured as affiliate investments. This disclosure intends to capture information on investments held that reflect interactions involving related parties, regardless of whether the related party meets the affiliate definition, or the reporting entity has received domiciliary state approval to disclaim control / affiliation.

Enter one of the following codes to identify the role of the related party in the investment.

1. Direct loan or direct investment (excluding securitizations) in a related party, for which the related party represents a direct credit exposure.
2. Securitization or similar investment vehicles such as mutual funds, limited partnerships and limited liability companies involving a relationship with a related party as sponsor, originator, manager, servicer, or other similar influential role and for which 50% or more of the underlying collateral represents investments in or direct credit exposure to related parties.
3. Securitization or similar investment vehicles such as mutual funds, limited partnerships and limited liability companies involving a relationship with a related party as sponsor, originator, manager, servicer, or other similar influential role and for which less than 50% (including 0%) of the underlying collateral represents investments in or direct credit exposure to related parties.
4. Securitization or similar investment vehicles such as mutual funds, limited partnerships and limited liability companies in which the structure reflects an in-substance related party transaction but does not involve a relationship with a related party as sponsor, originator, manager, servicer, or other similar influential role.
5. The investment is identified as related party, but the role of the related party represents a different arrangement than the options provided in choices 1-4.

On May 24, 2022, the Statutory Accounting Principles (E) Working Group took the following actions:

1. Adopted, as final, the exposed revisions to SSAP No. 25 and SSAP No. 43R, as illustrated below, to clarify application of the existing affiliate definition and incorporate disclosure requirements for all investments that involve related parties, regardless of if they meet the affiliate definition. The revisions to SSAP No. 43R also included additional minor edits to paragraph 6.b., clarifying that the investments from any arrangements that results in direct or indirect control, which include but are not limited to control through a servicer, shall be reported as affiliated investments.
2. In addition, to the adopted revisions, the Statutory Accounting Principles (E) Working Group expressed support for the corresponding Blanks (E) Working Group proposal (2021-22BWG), which will incorporate 6 reporting codes to identify the role of the related party in any investment, on any reporting line, in

schedules: B – Mortgage Loans, D – Long-Term Bonds, DB – Derivatives, BA – Other Long-Term Invested Assets, DA – Short-Term Investments, E2 – Cash Equivalents, and DL – Securities Lending Collateral Assets, with an effective date of December 31, 2022.

3. Direct NAIC staff to draft the following for future Working Group discussion: 1) possible footnote revisions pursuant to interested parties' comments, and 2) examples for possible inclusion in SSAP No. 43R, to further clarify investments that should be classified as affiliated. and
4. Send a referral to the Valuation of Securities (E) Task Force, notifying of this adopted agenda item, and to assess whether corresponding edits are needed to the *Practices and Procedures Manual of the NAIC Investment Analysis Office* regarding CLO investments that may now be classified as affiliated.

Adopted revisions to SSAP No. 25: (New paragraph 9. Remaining paragraphs would be renumbered.)

This new paragraph 9 clarifies the application of the existing affiliate and control definitions to limited partnerships, trusts and other special purpose entities when control is held by an affiliated general partner, servicer or other arrangement. (The proposed deletion of FIN 35 is discussed earlier in the agenda item, but is noted as not necessary with the existing statutory accounting guidance.)

5. An affiliate is defined as an entity that is within the holding company system or a party that, directly or indirectly, through one or more intermediaries, controls, is controlled by, or is under common control with the reporting entity. An affiliate includes a parent or subsidiary and may also include partnerships, joint ventures, and limited liability companies as defined in SSAP No. 48—Joint Ventures, Partnerships and Limited Liability Companies. Those entities are accounted for under the guidance provided in SSAP No. 48, which requires an equity method for all such investments. An affiliate is any person that is directly or indirectly, owned or controlled by the same person or by the same group of persons, that, directly or indirectly, own or control the reporting entity.

6. Control is defined as the possession, directly or indirectly, of the power to direct or cause the direction of the management and policies of the investee, whether through the (a) ownership of voting securities, (b) by contract other than a commercial contract for goods or nonmanagement services, (c) by contract for goods or nonmanagement services where the volume of activity results in a reliance relationship (d) by common management, or (e) otherwise. Control shall be presumed to exist if a reporting entity and its affiliates directly or indirectly, own, control, hold with the power to vote, or hold proxies representing 10% or more of the voting interests of the entity.

7. Control as defined in paragraph 6 shall be measured at the holding company level. For example, if one member of an affiliated group has a 5% interest in an entity and a second member of the group has an 8% interest in the same entity, the total interest is 13%, and therefore, each member of the affiliated group shall be presumed to have control. This presumption will stand until rebutted by an evaluation of all the facts and circumstances relating to the investment ~~based on the criteria in FASB Interpretation No. 35, Criteria for Applying the Equity Method of Accounting for Investments in Common Stock, an Interpretation of APB Opinion No. 18. The corollary is required to demonstrate control when a reporting entity owns less than 10% of the voting securities of an investee.~~ The insurer shall maintain documents substantiating its determination for review by the domiciliary commissioner. Examples of situations where the presumption of control may be in doubt include the following:

- a. Any limited partner investment in a limited partnership, unless the limited partner is affiliated with the general partner.

Ref #2021-21

- b. An entity where the insurer owns less than 50% of an entity and there is an unaffiliated individual or group of investors who own a controlling interest.
 - c. An entity where the insurer has given up participation rights¹⁵ as a shareholder to the investee.
8. Any direct or indirect ownership interest of the reporting entity greater than 10% results in a related party classification regardless of any disclaimer of control or disclaimer of affiliation. The *Insurance Holding Company System Regulatory Act* (#440) and the *Insurance Holding Company System Model Regulation* (#450) include a provision that allows for the disclaimer of affiliation and/or the disclaimer of control for members of an insurance holding company system. The disclaimer must be filed with the state insurance commissioner. Entities whose relationship is subject to a disclaimer of affiliation or a disclaimer of control are related parties and are subject to the related party disclosures within this statement. Such a disclaimer does not eliminate a "related party" distinction or disclosure requirements for material transactions pursuant to SSAP No. 25.
9. For entities not controlled by voting interests, such as limited partnerships, trusts and other special purpose entities, control may be held by a general partner, servicer, or by other arrangements. The ability of the reporting entity or its affiliates to direct the management and policies of an entity through such arrangements shall constitute control as defined in paragraph 6. Additionally, a reporting entity or its affiliates may have indirect control of other entities through such arrangements. For example, if a limited partnership were to be controlled by an affiliated general partner, and that limited partnership held greater than 10% of the voting interests of another company¹⁶, indirect control shall be presumed to exist unless the presumption of control can be overcome as detailed in paragraph 7. If direct or indirect control exists, whether through voting securities, contracts, common management or otherwise, the arrangement is considered affiliated under paragraph 5. Consistent with paragraph 8, a disclaimer of affiliation does not eliminate a "related party" distinction or disclosure requirements for material transactions pursuant to SSAP No. 25.

Adopted revisions SSAP No. 43R:

These revisions move the existing guidance in paragraph 4.a. to paragraph 6 and notes the requirement to identify related party investments in the investment schedules. (Note Footnote 5 is just moved to a new paragraph.)

4. Loan-backed securities are issued by special-purpose corporations or trusts (issuer) established by a sponsoring organization. The assets securing the loan-backed obligation are acquired by the issuer and pledged to an independent trustee until the issuer's obligation has been fully satisfied. The investor only has direct recourse to the issuer's assets, but may have secondary recourse to third parties through insurance or guarantee for repayment of the obligation. As a result, the sponsor and its other affiliates may have no financial obligation under the instrument, although one of those entities may retain the responsibility for servicing the underlying assets. Some sponsors do guarantee the performance of the underlying assets.

¹⁵ The term "participating rights" refers to the type of rights that allows an investor to effectively participate in significant decisions related to an investee's ordinary course of business and is distinguished from the more limited type of rights referred to as "protective rights". Refer to the sections entitled: "Protective Rights" and "Substantive Participating Rights" in EITF 96-16, *Investor's Accounting for an Investee When the Investor Owns a Majority of the Voting Stock but the Minority Shareholder or Shareholders Have Certain Approval or Veto Rights*. The term "participating rights" shall be used consistent with the discussion of substantive participating rights in this EITF.

¹⁶ Consistent with SSAP No. 97, footnote 1, investments in an exchange traded fund (ETF) or a mutual fund (as defined by the SEC) does not reflect ownership in an underlying entity, regardless of the ownership percentage the reporting entity (or the holding company group) has of the ETF or mutual fund unless ownership of the ETF actually results in "control" with the power to direct or cause the direction of management of an underlying company. ETFs and mutual funds are comprised of portfolios of securities subject to the regulatory requirements of the federal securities laws.

a. In determining whether a loan-backed structure is a related party investment, consideration shall be given to the substance of the transaction, and the parties whose action or performance materially impacts the insurance reporting entity holding the security. For example, although a loan-backed security may be acquired from a non-related issuer, if the assets held in trust predominantly¹⁷ reflect assets issued by affiliates of the insurance reporting entity, and the insurance reporting entity only has direct recourse to the assets held in trust, the transaction shall be considered an affiliated investment, and the transaction shall also subject to the accounting and reporting provisions in SSAP No. 25—Affiliates and Other Related Parties.

5. Mortgage-referenced securities do not meet the definition of a loan-backed or structured security but are explicitly captured in scope of this statement. In order to qualify as a mortgage-referenced security, the security must be issued by a government sponsored enterprise¹⁸ or by a special purpose trust in a transaction sponsored by a government sponsored enterprise in the form of a “credit risk transfer” in which the issued security is tied to a referenced pool of mortgages and the payments received are linked to the credit and principal payment risk of the underlying mortgage loan borrowers captured in the referenced pool of mortgages. For these instruments, reporting entity holders may not receive a return of their full principal as principal repayment is contingent on repayment by the mortgage loan borrowers in the referenced pool of mortgages. Unless specifically noted, the provisions for loan-backed securities within this standard apply to mortgage-referenced securities.

6. Investments within the scope of this statement issued by a related party or acquired through a related party transaction or arrangement are also subject to the provisions, admittance assessments and disclosure requirements of SSAP No. 25. In determining whether a security is a related party investment, consideration should be given to the substance of the transaction, and the parties whose action or performance materially impacts the insurance reporting entity holding the security if the SSAP No. 43R transaction is a related party arrangement¹⁹. Loan-backed and structured securities meet the definition of assets as defined in SSAP No. 4—Assets and Nonadmitted Assets and are admitted assets to the extent they conform to the requirements of this statement and SSAP No. 25.

a. Although a loan-backed or structured security may be acquired from a non-related issuer, if the assets held in trust predominantly²⁰ reflect assets issued by affiliates of the insurance reporting entity, and the insurance reporting entity only has direct recourse to the assets held in trust, the transaction shall be considered an affiliated investment. In such situations where the underlying collateral assets are issued by related parties that do not qualify as

¹⁷ In applying this guidance, a reporting entity is not required to complete a detailed review of the assets held in trust to determine the extent, if any, the assets were issued by related parties. Rather, this guidance is a principle concept intended to prevent situations in which related party transactions (particularly those involving affiliates) is knowingly captured in a SSAP No. 43R structure and not identified as a related party transaction (or not reported as an affiliated investment on the investment schedule) because of the involvement of a non-related trustee or SSAP No. 43R security issuer. As identified in SSAP No. 25—Affiliates and Other Related Parties, it is erroneous to conclude that the inclusion of a non-related intermediary, or the presence of non-related assets in a structure predominantly comprised of related party investments, eliminates the requirement to identify and assess the investment transaction as a related party arrangement.

¹⁸ Currently, only Fannie Mae and Freddie Mac are the government sponsored entities that either directly issue qualifying mortgage-referenced securities or sponsor transactions in which a special purpose trust issues qualifying mortgage-reference securities. However, this guidance would apply to mortgage-referenced securities issued by any other government sponsored entity that subsequently engages in the transfer of mortgage credit risk.

¹⁹ As discussed in paragraph 4.a. of this statement, a SSAP No. 43R security may still be considered a related party transaction even if the asset trustee or security issuer is a non-related party.

²⁰ In applying this guidance, a reporting entity is not required to complete a detailed review of the assets held in trust to determine the extent, if any, the assets were issued by related parties. Rather, this guidance is a principle concept intended to prevent situations in which related party transactions (particularly those involving affiliates) is knowingly captured in a SSAP No. 43R structure and not identified as a related party transaction (or not reported as an affiliated investment on the investment schedule) because of the involvement of a non-related trustee or SSAP No. 43R security issuer. As identified in SSAP No. 25—Affiliates and Other Related Parties, it is erroneous to conclude that the inclusion of a non-related intermediary, or the presence of non-related assets in a structure predominantly comprised of related party investments, eliminates the requirement to identify and assess the investment transaction as a related party arrangement.

affiliates, these securities shall be identified as related party investments in the investment schedules.

- b. A loan-backed or structured security may involve a relationship with a related party but not be considered an affiliated investment. This may be because the relationship does not result in direct or indirect control of the issuer or because there is an approved disclaimer of control or affiliation. Regardless of whether investments involving a related party relationship are captured in the affiliated investment reporting lines, these securities shall be identified as related party investments in the investment schedules. Examples of related party relationships would include involvement of a related party in sponsoring or originating the loan-backed or structured security or any type of underlying servicing arrangement. For the avoidance of doubt, investments from any arrangement that results in direct or indirect control, which include but are not limited to control through a servicer or other controlling arrangement, shall be reported as affiliated in accordance with SSAP No. 25—Affiliates and Other Related Parties.

Supported Annual Statement Reporting Changes: (Reflected in 2021-22BWG.)

These reflect a new electronic-only column for the investment schedules and the related instructions.

Column XX: Investments Involving Related Parties:

Required for all investments involving related parties including, but not limited to, those captured as affiliate investments. This disclosure intends to capture information on investments held that reflect interactions involving related parties, regardless of whether the related party meets the affiliate definition, or the reporting entity has received domiciliary state approval to disclaim control / affiliation.

Enter one of the following codes to identify the role of the related party in the investment.

1. Direct loan or direct investment (excluding securitizations) in a related party, for which the related party represents a direct credit exposure.
2. Securitization or similar investment vehicles such as mutual funds, limited partnerships and limited liability companies involving a relationship with a related party as sponsor, originator, manager, servicer, or other similar influential role and for which 50% or more of the underlying collateral represents investments in or direct credit exposure to related parties.
3. Securitization or similar investment vehicles such as mutual funds, limited partnerships and limited liability companies involving a relationship with a related party as sponsor, originator, manager, servicer, or other similar influential role and for which less than 50% (including 0%) of the underlying collateral represents investments in or direct credit exposure to related parties.
4. Securitization or similar investment vehicles such as mutual funds, limited partnerships and limited liability companies in which the structure reflects an in-substance related party transaction but does not involve a relationship with a related party as sponsor, originator, manager, servicer, or other similar influential role.
5. The investment is identified as related party, but the role of the related party represents a different arrangement than the options provided in choices 1-4.
6. The investment does not involve a related party.

Statutory Accounting Principles (E) Working Group
2022 Summer National Meeting
Comment Letters Received

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June 3, 2022

Mr. Dale Bruggeman, Chairman
Statutory Accounting Principles Working Group
National Association of Insurance Commissioners
1100 Walnut Street, Suite 1500
Kansas City, MO 64106-2197

RE: Items Exposed for Comment by the Statutory Accounting Principles Working Group on April 4, 2022, with Comments due June 3

Dear Mr. Bruggeman:

Interested parties appreciate the opportunity to comment on the exposure drafts released for comment by the NAIC Statutory Accounting Principles (E) Working Group (the Working Group).

We offer the following comments:

Ref #2021-20: Effective Derivatives – ASU 2017-12

The 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 Ref # 2021-20. 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.

Interested parties support the changes and we look forward to working with the staff on the further updates.

Ref #2022-01: Conceptual Framework – Updates

The Working Group moved this agenda item to the active listing, categorized as a SAP

clarification, and exposed revisions to the Preamble, SSAP No. 4—*Assets and Nonadmitted Assets* and SSAP No. 5R—*Liabilities, Contingencies and Impairment of Assets* to incorporate 1) updates from FASB Concepts Statement No. 8, Conceptual Framework for Financial Reporting—Chapter 7, Presentation which identifies factors to consider when deciding how items should be displayed on the financial statements, and 2) Concepts Statement No. 8, Conceptual Framework for Financial Reporting—Chapter 4, Elements of Financial Statements, which updates the definitions of an asset and a liability. The Working Group also exposed two draft issue papers for historical documentation of these SAP clarifications.

Interested parties request an additional 30 days to review this item.

Ref #2022-02: SSAP No. 48 – Alternative Valuation of Minority Ownership Interests

The Working Group moved this agenda item to the active listing, categorized as a SAP clarification, and exposed two possible options for the U.S. GAAP audit exception in SSAP No. 48—*Joint Ventures, Partnerships and Limited Liability Companies*. The options are described below:

Option #1 proposes to delete the audited U.S. tax basis equity as a permissible valuation method as this method does not appear to be utilized by insurers.

Option #2 proposes to retain the audited U.S. tax basis equity valuation method but clarifies that the audit must reside at the investee level.

Interested parties recommend that Option #2 be adopted as there are insurers who use this approach for investments in some partnerships.

Ref #2022-04: ASU 2021-10, Government Assistance

The Working Group moved this agenda item to the active listing, categorized as a SAP clarification, and exposed revisions to SSAP No. 24—*Discontinued Operations and Unusual or Infrequent Items* which incorporate certain disclosures from ASU 2021-10 to supplement existing disclosures regarding unusual or infrequent items.

Interested parties have no comment on this item.

Ref #2022-05: ASU 2021-09, Leases (Topic 842), Discount Rate for Lessees That Are Not Public Business Entities

The Working Group moved this item to the active listing, categorized as a SAP clarification, and exposed revisions to reject ASU 2021-05 in SSAP No. 22R—*Leases*.

Interested parties have no comment on this item.

Ref :2022-06: ASU 2021-07, Compensation – Stock Compensation

The Working Group moved this agenda item to the active listing, categorized as a SAP clarification, and exposed revisions to SSAP No. 104R—*Share-Based Payments* to incorporate a practical expedient for the current price input, a required component for option-pricing models which are utilized in the determination of fair value for share-based payments.

Interested parties have no comment on this item.

Ref #2022-07: ASU 2021-08, Business Combinations

The Working Group moved this agenda item to the active listing, categorized as a SAP clarification, and exposed revisions to SSAP No. 47—*Uninsured Plans* and SSAP No. 68—*Business Combinations and Goodwill* to reject ASU 2021-08 for statutory accounting. In addition, the proposed revisions to SSAP No. 68 include notations that the rejection of ASU 2021-08 does not impact the determination of U.S. GAAP book value in an acquired entity.

Interested parties have no comment on this item.

* * *

Thank you for considering interested parties' comments. If you have any questions in the interim, please do not hesitate to contact us.

Sincerely,

D. Keith Bell

Rose Albrizio

cc: NAIC staff
Interested parties

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July 19, 2022

Mr. Dale Bruggeman, Chairman
Statutory Accounting Principles Working Group
National Association of Insurance Commissioners
1100 Walnut Street, Suite 1500
Kansas City, MO 64106-2197

RE: Ref# 2022-01: Conceptual Framework – Updates

Dear Mr. Bruggeman:

Interested parties appreciate the extension of the comment deadline and the opportunity to comment on Ref# 2022-01 that was released for comment by the NAIC Statutory Accounting Principles (E) Working Group (the Working Group) during its meeting on April 4 in Kansas City.

We offer the following comments:

Ref #2022-01: Conceptual Framework – Updates

Liability

Interested parties are concerned with the change for the liability definition as the FASB notes it will change the definition of a liability, expanding the population of liabilities and it will need to be reviewed on a standard basis. On expanding the population of liabilities, paragraph 12 states that the FASB recognized “the revised definition potentially expands the population of liabilities to include certain obligations to issue or potentially issue an entity’s own shares rather than settle an obligation exclusively with assets. In essence, clarifying that instruments with characteristics of both liabilities and equity may in fact be classified as liabilities in certain situations.”

We noted that there is not an analysis by the SAPWG of the impact on the various SSAP's of incorporating the guidance. The FASB states that *needs* to be done “Thus, the FASB concluded that the specific facts and circumstances at the standards level (or in the case of statutory accounting, at the SSAP level) must be utilized to determine whether the entity has created a constructive obligation and must recognize a liability.” Please see the shaded text from the FASB

excerpts below.

From the Liability Paper:

9. The updated liability definition from Concept Statement No. 8 no longer includes the term *probable* or the phrase *in the future* and *as a result of past transactions or events*. The FASB concluded that the term *probable* has historically been misunderstood as implying that a future obligation must meet a probability to a certain threshold before the definition of a liability was met. Thus, if the probability of a future transfer of an asset (or the requirement to provide a service) was low, a liability would likely not be recognized. In removing the term *probable* (and replacing it with “present obligation”), FASB concluded that in almost all situations, the presence of an obligation will be apparent. It stated that most present obligations are legally enforceable, including obligations arising from binding contracts, agreements, statutes, or other legal or contractual means. Chapter 4 also discusses the prevalence of certain business risks and how to assess if they result in the recognition of a liability. The FASB concluded that while certain businesses have a risk that a future event will cause them to transfer an economic benefit (an asset), the risk itself does not represent a present obligation because exposure to a potential negative consequence does not constitute a present obligation.

10. However, the FASB also stated that situations lacking clear legal or contractual evidence of a present obligation may pose particular challenges that may make it difficult to discern whether a present obligation exists. In these settings, the FASB stated that constructive obligations or other noncontractual obligations are created by circumstance rather than by explicit agreement. In the absence of an explicit agreement, sufficient information to distinguish a present obligation is likely only available at the specific standards level. Thus, the FASB concluded that the specific facts and circumstances at the standards level (or in the case of statutory accounting, at the SSAP level) must be utilized to determine whether the entity has created a constructive obligation and must recognize a liability.

12. When reviewing the substance of the revisions, the FASB concluded that the updated definition resulted in a clearer and more precise definition. Furthermore, while it did not fundamentally change the historical concept of a liability, the revised definition potentially expands the population of liabilities to include certain obligations to issue or potentially issue an entity’s own shares rather than settle an obligation exclusively with assets. In essence, clarifying that instruments with characteristics of both liabilities and equity may in fact be classified as liabilities in certain situations.

13. In general, the FASB did not anticipate that the liability definition revisions would result in any material changes in instrument reclassification (e.g., items now being classified as a liability when previously they were not considered liabilities). Again, FASB Concept Statements are not authoritative and thus the guidance in any specific standard will still be utilized for instrument measurement and classification. For statutory accounting purposes, the updated definition should be viewed similarly, that is it does not change fundamental concepts, change current practices, or introduce a new, original or a

modified accounting principle. The revisions to the definition of a liability clarify the definitional language and do not modify the original intent of SSAP No. 5R and thus the changes are deemed to be a statutory accounting principle clarification.

Consistent with the FASB approach that an evaluation needs to be done at the standards level, interested parties recommend that for the case of statutory accounting the Working Group complete an SSAP-by-SSAP analysis to identify potential effects prior to amending the definition of liability to avoid unintended consequences.

* * *

Thank you for considering interested parties' comments. If you have any questions in the interim, please do not hesitate to contact us.

Sincerely,

D. Keith Bell

Rose Albrizio

cc: NAIC staff
Interested parties

Ref #2022-04

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

Issue: ASU 2021-10, Government Assistance

Check (applicable entity):

	P/C	Life	Health
Modification of Existing SSAP	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>
New Issue or SSAP	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Interpretation	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>

Description of Issue: In November 2021, the Financial Accounting Standards Board (FASB) issued *Accounting Standards Update (ASU) 2021-10, Government Assistance, Disclosures by Business Entities about Government Assistance* to increase financial statement transparency regarding certain types of government assistance by increasing the disclosure of such information in the notes to the financial statements.

The new disclosure aims to increase transparency by enhancing the identification of 1) the types of assistance received, 2) an entity's accounting for said assistance, and 3) the effects of the assistance in an entity's financial statements. The disclosures will contain information about the nature of the transactions, which includes a general description of the transaction and identification of the form (cash or other) in which the assistance was received. In terms of the effects on the financial statement, disclosure will include identification of the specific line items in both the balance sheet and income statement and a description of the extent to which they have been impacted by any government assistance. In addition, an entity will be required to disclose information about any significant terms of the transaction with a government entity, with items including durations of such agreements and any provisions for potential recapture.

ASU 2021-10 defines "government assistance," in a comprehensive manner to capture most types of assistance and includes examples of tax credits, cash grants or grants of other assets. The scope of this ASU is narrow as it does not apply to not-for-profit entities or benefit plans. Further narrowing in scope, the new disclosure requirements in this ASU only apply to transactions that are accounted for by analogizing either a grant or contribution model. As such, these enhanced disclosures do not apply to government transactions that are accounted for in accordance with other codification topics, such as classifying the transactions as debt in ASC 470, income taxes in ASC 740, or as revenue from contracts with customers in ASC 606.

With the specificity of these additional disclosures only applying in certain circumstances (only applicable in cases where the government assistance is not accounted for in accordance with other accounting standards – i.e., revenue in the normal course of business or debt), NAIC staff believe the occurrence of such items requiring disclosure per ASU 2021-10 will likely be relatively infrequent.

NAIC staff also note that consistent with ASU 2021-10, had the assistance been accounted for in a differing manner (e.g., as debt per *SSAP No. 15—Debt and Holding Company Obligations*), that the required identification and disclosures for the applicable SSAP would apply. As a final note, it is anticipated that for most entities who qualified for and received Paycheck Protection Program (PPP) loans, as authorized by the CARES Act, that the additional disclosures in this ASU still would not apply. It is believed that most insurance reporting entities accounted for PPP transactions as liabilities per SSAP No. 15. [For reference, in accordance with SSAP No. 15, debt may only be derecognized if the reporting entity was legally released from the liability (SSAP No. 15, paragraph 11), at which time the extinguishment of debt was reported as a capital gain (SSAP No. 15, paragraph 25).]

Existing Authoritative Literature:

NAIC Staff Note – as mentioned above, NAIC staff believe that as these additional disclosures are not applicable for transactions that are in scope of other accounting standards, and only apply when the transaction is accounted for by analogy using the grant or contribution model, the prevalence of such items will be infrequent. As such, the most appropriate location for these items is reflected in SSAP No. 24.

SSAP No. 24—Discontinued Operations and Unusual or Infrequent Items

Unusual or Infrequently Occurring Items

9. A material event or transaction that an entity considers to be of an unusual nature or of a type that indicates infrequency of occurrence or both shall be reported consistently with the reporting entity's reporting of continuing operations (i.e., no separate line item presentation in the balance sheet or statement of operations). Such items shall not be charged directly to surplus unless specifically addressed elsewhere within the *Accounting Practices and Procedures Manual*.

- a. "Unusual Nature" shall be defined as the underlying event or transaction that should possess a high degree of abnormality and be of a type clearly unrelated to, or only incidentally related to, the ordinary and typical activities of the entity, taking into account the environment in which the entity operates.
- b. "Infrequency of Occurrence" is defined as the underlying event or transaction that would not reasonably be expected to recur in the foreseeable future, taking into account the environment in which the entity operates.

Disclosures [Unusual/Infrequent Items]

16. The nature and financial effects of each unusual or infrequent event or transaction shall be disclosed in the notes to the financial statements. Gains or losses of a similar nature that are not individually material shall be aggregated. This disclosure shall include the line items which have been affected by the event or transaction considered to be unusual and/or infrequent.

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): None

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

Convergence with International Financial Reporting Standards (IFRS): NA

Staff Recommendation: NAIC staff recommends that the Working Group move this item to the active listing, categorized as a SAP clarification, and expose revisions to *SSAP No. 24—Discontinued Operations and Unusual or Infrequent Items*, incorporating certain disclosures from ASU 2021-10. The proposed additions will supplement existing disclosures to require that if the unusual or infrequent item is as the result of government assistance, the transaction will require identification as well as a description of the terms and provisions of the assistance received.

NAIC staff recommend incorporating the new disclosures in ASU 2020-10, modified only to require the supplemental disclosures for all entity types (as SAP disclosures do not differentiate between entity type – i.e., not-for-profit vs. other). As a final note, existing disclosures for unusual/infrequent items (captured in financial

statement note #21) already contains the requirement to identify the specific line items which have been affected by the events or transactions considered to be unusual and/or infrequent - thus that specific portion of ASU 2021-10 is not included in the proposed additions below.

Proposed Revisions to SSAP No. 24

Disclosures [Unusual/Infrequent Items]

16. The nature, including a general description of the transactions, and financial effects of each unusual or infrequent event or transaction shall be disclosed in the notes to the financial statements. Gains or losses of a similar nature that are not individually material shall be aggregated. This disclosure shall include the line items which have been affected by the event or transaction considered to be unusual and/or infrequent. If the unusual or infrequent item is as the result of government assistance (as defined in ASU 2021-10, Government Assistance, Disclosures by Business Entities about Government Assistance) disclosure shall additionally include the form in which the assistance has been received (for example, cash or other assets), and information regarding significant terms and conditions of the transaction, with items including, to the extent applicable, the duration or period of the agreement, and commitments made by the reporting entity, provisions for recapture, or other contingencies.

Relevant Literature

24. This statement adopts ASU 2021-10, Government Assistance: Disclosure by Business Entities about Government Assistance, with modification to require disclosure by all entity types.

Staff Review Completed by: Jim Pinegar - NAIC Staff, January 2022

Recommendation:

NAIC staff recommends that the Working Group move this item to the active listing, categorized as a SAP clarification, and expose revisions to *SSAP No. 24—Discontinued Operations and Unusual or Infrequent Items*, incorporating certain disclosures from ASU 2021-10. The proposed additions will supplement existing disclosures to require that if the unusual or infrequent item is as the result of government assistance, the transaction will require identification as well as a description of the terms and provisions of the assistance received.

Status:

On April 4, 2022, the Statutory Accounting Principles (E) Working Group moved this agenda item to the active listing, categorized as a SAP clarification, and exposed revisions to *SSAP No. 24—Discontinued Operations and Unusual or Infrequent Items*, as illustrated above, which incorporate certain disclosures from ASU 2021-10 to supplement existing disclosures regarding unusual or infrequent items.

On August 10, 2022, the Statutory Accounting Principles (E) Working Group adopted, as final, the exposed revisions, as illustrated above, to *SSAP No. 24—Discontinued Operations and Unusual or Infrequent Items*. The revisions incorporate certain disclosures, adopted with modification from ASU 2021-10, to supplement existing disclosures regarding unusual or infrequent items.

https://naiconline.sharepoint.com/sites/NAICSupportStaffHub/Member Meetings/E CMTE/APPTF/2022SummerNM/1_SAPWG/Minutes/Att One-D_22-04_ASU 2021-10.docx

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

Issue: ASU 2021-09, Leases (Topic 842), Discount Rate for Lessees That Are Not Public Business Entities

Check (applicable entity):

	P/C	Life	Health
Modification of Existing SSAP	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>
New Issue or SSAP	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Interpretation	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>

Description of Issue: In November 2021, the Financial Accounting Standards Board (FASB) issued *Accounting Standard Update (ASU) 2021-09, Leases (Topic 842), Discount Rate for Lessees That Are Not Public Business Entities*. This ASU was issued as part of FASB's post-implementation review to address issues that have been found during the implementation of the new lease guidance from *ASU 2016-02, Leases (Topic 842)*. Topic 842 generally requires the capitalization of leases, which is calculated by discounting the lease payments utilizing the implicit rate in the lease, or if not determinable, the lessee's incremental borrowing rate. However, the standard also provides nonpublic entities with a practical expedient, permitting the use of a risk-free rate (e.g., U.S. Treasury Rate) for the capitalization calculation. As the risk-free rate is generally lower than anyone's incremental borrowing rate, stakeholders expressed concerns that the calculation of present value (utilizing the practical expedient) often results in recognition of lease liabilities and right-of-use assets that are greater than those recognized by their public counterparts. To alleviate this concern, the guidance in ASU 2021-09 broadens the practical expedient so nonpublic lessees may make the risk-free rate election by class of underlying asset, rather than at the entity-wide level – thus the entity more able to apply the practical expedient when beneficial. An entity that makes the risk-free rate election is required to disclose which asset classes it has elected to apply a risk-free rate. The guidance provided in this ASU is specific to the financing lease treatment under U.S. GAAP, and since *SSAP No. 22R—Leases* requires nearly all leases to be treated as operating leases for statutory accounting, adoption of this guidance would be unnecessary.

Existing Authoritative Literature:

The ASUs related to Topic 842 have previously been rejected in *SSAP No. 22R—Leases*.

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): None

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

Convergence with International Financial Reporting Standards (IFRS): ASC Topic 842 was the result of a joint project between FASB and the International Accounting Standards Board.

Recommendation: NAIC staff recommends the Working Group move this agenda item to the active listing, categorized as a SAP clarification and expose revisions to reject ASU 2021-05 in *SSAP No. 22R—Leases*. Under statutory accounting almost all leases are classified as operating leases, thus this U.S. GAAP guidance is not necessary. Proposed Revision to *SSAP No. 22R* (Relevant Literature section – paragraph 52):

- j. *ASU 2021-09, Leases (Topic 842), Discount Rate for Lessees That Are Not Public Business Entities (Rejected in its entirety.)*

Staff Review Completed by: Jake Stultz, NAIC Staff – January 2022

Ref #2022-05

Status:

On April 4, 2022, the Statutory Accounting Principles (E) Working Group moved this item to the active listing, categorized as a SAP clarification, and exposed revisions, as illustrated above, to reject ASU 2021-09 in *SSAP No. 22R—Leases*.

On August 10, 2022, the Statutory Accounting Principles (E) Working Group adopted, as final, the exposed revisions, as illustrated above, to reject ASU 2021-09 in *SSAP No. 22R—Leases*.

https://naiconline.sharepoint.com/sites/NAICSupportStaffHub/Member Meetings/E CMTE/APPTF/2022SummerNM/1_SAPWG/Minutes/Att One-E_22-05_ASU 2021-09.docx

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

Issue: ASU 2021-07, Compensation – Stock Compensation

Check (applicable entity):

	P/C	Life	Health
Modification of Existing SSAP	<input checked="" type="checkbox"/>	<input type="checkbox"/>	<input checked="" type="checkbox"/>
New Issue or SSAP	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Interpretation	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>

Description of Issue: In October 2021, the Financial Accounting Standards Board (FASB) issued *Accounting Standards Update (ASU) 2021-07, Compensation – Stock Compensation (Topic 718), Determining the Current Price of an Underlying Share for Equity-Classified Share-Based Awards* to offer nonpublic companies a practical expedient to one of the several inputs necessary for option-priced modeling. When equity share options or similar instruments are granted in a share-based payment transaction, the fair value (which is used to determine expense recognition at inception and during any subsequent award modification) is estimated using an option-pricing model valuation technique.

In terms of option-priced models, the Black-Scholes-Merton model is considered to be one of the most widely used as it has less complexity than other pricing models. However, despite its reduced complexity, it (and various other pricing models) requires numerous inputs which typically include exercise price, expected dividend rate, risk-free interest rate, expected term, expected share price volatility, and current share price. For public entities, the determination of these values is generally readily available, however for nonpublic entities, many of these inputs are not easily determinable.

Of these inputs, private company stakeholders have indicated that three of these inputs (exercise price, expected dividend rate, and risk-free interest rate) are easy to obtain. However, stakeholders indicated that the remaining three inputs (expected share price volatility, expected term, and current share price) can be costly and difficult to estimate. Topic 718 already provides nonpublic entities with practical expedients for expected share price volatility and expected term. However, prior to ASU 2021-07, a practical expedient was not available for estimating the current price input. The current price input is often considered the most costly and complex input to determine and audit for nonpublic entities, primarily because an active market for those entities' shares does not exist and therefore a readily determinable market price is not available.

ASU 2021-07 provides a practical expedient for nonpublic entities to determine the current price by utilizing a “reasonable application of a reasonable valuation method.” The practical expedient describes several characteristics of a reasonable valuation method and will include 1) consideration of the value of all tangible and intangible assets, 2) the present value of future anticipated cash flows, 3) the market value of similar entities, 4) recent arm’s-length transactions involving the sale or transfer of stock/equity interests, and 5) other relevant factors that affect the valuation or have a material economic effect on the entity. The calculation of share price must be timely in it cannot be more than 12 months stale, and all available information after the date of calculation that may materially affect the valuation of the entity must be considered for any value updates.

One final note - this ASU provides a practical expedient (not an accounting alternative) to one of the inputs used for nonpublic companies in their option-pricing modeling. Also, as mentioned previously, this is the third such practical expedient permitted in Topic 718, of which the previous two (expected share price volatility and expected

term) have previously been adopted and are currently permissible for use in SSAP No. 104R—*Share-Based Payments* (further detailed in the “Existing Authoritative Literature” section).

Existing Authoritative Literature: ASU 2021-07 offers a third practical expedient for the inputs utilized in option-pricing models. As previously mentioned, the prior two practical expedients are permissible in SSAP No. 104R and are included herein for reference:

Practical Expedient Regarding Volatility: Topic 718 (paragraph 718-10-30-20) recognizes nonpublic entities may not be able to reasonably estimate the fair value as it is not practicable to estimate share volatility, a component of the fair value calculation. Adoption of this first practical expedient to address this circumstance occurred through the Working Group's adoption of *FAS 123R, Share-Based Payment*. The applicable paragraph in SSAP No. 104R has been included with relevant guidance bolded.

52. **A reporting entity may not be able to reasonably estimate the fair value of its equity share options, nonemployee awards and similar instruments because it is not practicable for the reporting entity to estimate the expected volatility of its share price. In that situation, the entity shall account for its equity share options, nonemployee awards and similar instruments based on a value calculated using the historical volatility of an appropriate industry sector index instead of the expected volatility of the entity's share price (the calculated value).** A reporting entity's use of calculated value shall be consistent between employee share-based payment transactions and nonemployee share-based payment transactions. Throughout the remainder of this statement, provisions that apply to accounting for share options, nonemployee awards and similar instruments at fair value also apply to calculated value.

Practical Expedient Regarding Expected Term: Topic 718 (paragraph 718-10-30-20A) recognizes nonpublic entities may not be able to reasonably account for the expected term of a share-based payment. Adoption of a second practical expedient to address this circumstance occurred through the Working Group's adoption, with modification, of *ASU 2016-09, Improvements to Employee Share-Based Payment Accounting*. The applicable paragraphs from SSAP No. 104R have been included below:

53. For an award that meets the conditions in paragraph 54, a reporting entity may make an entity-wide accounting policy election to estimate the expected term using the following practical expedient:

- a. If vesting is only dependent upon a service condition, a reporting entity shall estimate the expected term as the midpoint between the employee's requisite service period or the nonemployee's vesting period and the contractual term of the award.
- b. If vesting is dependent upon satisfying a performance condition, an entity first would determine whether the performance condition is probable of being achieved.
 - i. If the reporting entity concludes that the performance condition is probable of being achieved, the entity shall estimate the expected term as the midpoint between the employee's requisite service period or the nonemployee's vesting period and the contractual term.
 - ii. If the reporting entity concludes that the performance condition is not probable of being achieved, the reporting entity shall estimate the expected term as either:
 - (a) The contractual term if the service period is implied (that is, the requisite service period or the nonemployee's vesting period is not explicitly stated but inferred based on the achievement of the performance condition at some undetermined point in the future).

- (b) The midpoint between the employee's requisite service period or the nonemployee's vesting period and the contractual term if the requisite service period is stated explicitly.

54. A reporting entity that elects to apply the practical expedient in paragraph 53 shall apply the practical expedient to a share option or similar award that has all of the following characteristics:

- a. The share option or similar award is granted at the money.
- b. The grantee has only a limited time to exercise the award (typically 30-90 days) if the grantee no longer provides goods or terminates service after vesting.
- c. The grantee can only exercise the award. The grantee cannot sell or hedge the award.
- d. The award does not include a market condition.

A reporting entity that elects to apply the practical expedient in paragraph 53 may always elect to use the contractual term as the expected term when estimating the fair value of a nonemployee award as described in paragraph 42. However, a reporting entity must apply the practical expedient in paragraph 53 for all nonemployee awards that have all the characteristics listed in this paragraph if that reporting entity does not elect to use the contractual term as the expected term and that reporting entity elects the accounting policy election to apply the practical expedient in paragraph 53.

ASU 2021-07 also supplements existing disclosure requiring that if this new practical expedient is utilized, its use shall be disclosed. NAIC staff have determined that additional disclosures in SSAP No. 104R are likely not necessary as existing SAP disclosures reference the disclosures in FASB Codification 718-10-50-2 as required – which is the location for FASB's new disclosure regarding use of this practical expedient.

Disclosures

113. An entity with one or more share-based payment arrangements shall disclose information that enables users of the financial statements to understand all of the following:

- a. The nature and terms of such arrangements that existed during the period and the potential effects of those arrangements on shareholders;
- b. The effect of compensation costs arising from share-based payment arrangements on the income statement;
- c. The method of estimating the fair value of the goods or services received, or the fair value of the equity instruments granted (or offered to grant), during the period; and
- d. The cash flow effects resulting from share-based payment arrangements.

114. The disclosures in paragraph 113 are for annual audited statutory financial statements only. **This statement adopts FASB Codification 718-10-50-2 for the minimum disclosure information needed to achieve the objective in paragraph 113 of this statement, noting that a reporting entity may need to disclose additional information to achieve the objectives.**

As final reference, SSAP No. 104R has predominantly adopted, with modification from U.S. GAAP guidance regarding share-based payment guidance, as detailed below.

126. This statement adopts with modification the U.S. GAAP guidance for share-based payment transactions reflected in FASB *Accounting Standards Codification (ASC) Topic 718, Compensation – Stock*

Compensation, as modified by the ASUs listed in paragraphs 126.a through 126.e, excluding the guidance in ASC Subtopic 718-40, *Employee Stock Ownership Plans* (ESOPs). Statutory accounting guidance for ESOPs is addressed in SSAP No. 12—*Employee Stock Ownership Plans*. This adoption with modification includes the related implementation guidance reflected within the FASB Codification Topic 718 not reflected within this standard. The U.S. GAAP guidance adopted with modification reflects the adoption with modification of the following ASUs:

- a. *ASU 2018-07, Improvements to Nonemployee Share-Based Payment Accounting.* The revisions from ASU 2018-07 expand the scope of ASC 718 to include share-based payment transactions for acquiring goods and services from nonemployees. With ASU 2018-17, ASC 505-50, *Equity – Equity Payments to Nonemployees* was superseded.
 - b. *ASU 2017-09, Scope of Modification Accounting*
 - c. *ASU 2016-09, Improvements to Employee Share-Based Payment Accounting*
 - d. *ASU 2014-12, Accounting for Share-Based Payments When the Terms of an Award Provide That a Performance Target Could Be Achieved after the Requisite Service Period*
 - e. *ASU 2010-13, Effect of Denominating the Exercise Price of a Share-Based Payment Award in the Current of the Market in Which the Underlying Equity Security Trades*
127. The statutory accounting guidance for share-based payments is intended to be consistent with U.S. GAAP. Adopted modifications to U.S. GAAP guidance are as follows:
- a. GAAP references to “public and nonpublic” guidance have been eliminated. However, entities that report share-payment transactions under U.S. GAAP as “public” entities shall not report different amounts between U.S. GAAP and SAP. (For example, if a reporting entity reports “fair value” under U.S. GAAP, that entity shall not utilize a “calculated or intrinsic” amount under statutory accounting).
 - b. Prepaid assets are nonadmitted.
 - c. GAAP references are revised to reference applicable statutory accounting guidance.
 - d. GAAP reporting line items (either explicitly provided in the statement or adopted by reference – such as the GAAP implementation guidance) shall be replaced to reference applicable statutory annual statement line items. (For example, GAAP references to “other comprehensive income” shall be reflected within “Surplus - Unassigned Funds”).
 - e. GAAP guidance to calculate earnings per share is not applicable to statutory accounting and has not been included within the statement.
 - f. GAAP effective date and transition, and transition disclosures have not been incorporated. Reporting entities shall follow the effective date and transition elements provided within this statement.
 - g. Inclusion of guidance specific to statutory for consolidated/holding company plans.
128. The adoption with modification of FASB Codification Topic 718 detailed in paragraph 126 of this statement reflects adoption with modification of the following pre-codification GAAP standards:
- a. *FAS 123R, Share-Based Payment* (FAS 123R);

Ref #2022-06

- b. *FAS 150, Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity* (FAS 150) – (Adopted only to the extent referenced in FAS 123R for classifying instruments as equity or liability for application in this statement. Adopted guidance is reflected in Exhibit A);
- c. *FASB Staff Position FAS 123(R)-1: Classification and Measurement of Freestanding Financial Instruments Originally issued in Exchange for Employee Services under FASB Statement No. 123(R)* (FAS 123R-1);
- d. *FASB Staff Position (FSP) FAS 123(R)-2: Practical Accommodation to the Application of Grant Date as Defined in FASB Statement No. 123(R)* (FSP FAS 123R-2);
- e. *FASB Staff Position (FSP) FAS123(R)-4: Classification of Options and Similar Instruments Issued as Employee Compensation That Allow for Cash Settlement upon the Occurrence of a Contingent Event* (FSP FAS 123R-4);
- f. *FASB Staff Position (FSP) FAS 123(R)-5: Amendment of FASB Staff Position FAS 123R-1* (FSP FAS 123R-5);
- g. *FASB Staff Position (FSP) FAS 123(R)-6: Technical Corrections of FASB Statement No. 123(R)* (FSP FAS 123R-6);
- h. *FASB Emerging Issues Task Force 97-14: Accounting for Deferred Compensation Arrangements Where Amounts Earned Are Held in a Rabbi Trust and Invested* (EITF 97-14);
- i. *FASB Emerging Issues Task Force 00-16: Recognition and Measurement of Employer Payroll Taxes on Employee Stock-Based Compensation* (EITF 00-16);
- j. *FASB Technical Bulletin 97-01, Accounting under Statement 123 for Certain Employee Stock Purchase Plans with a Look-Back Option* (TB 97-01)

129. The adoption with modification of FASB Codification Topic 718 in this statement reflects rejection of the following pre-codification GAAP standards:

- a. *FASB Staff Position (FSP) FAS 123(R)-3: Transition Election Related to Accounting for the Tax Effects of Share-Based Payment Awards* (FSP FAS 123R-3); and
- b. *FASB Staff Position (FSP) EITF 03-6-1; Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities* (FSP EITF 03-6-1).

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): None

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

Convergence with International Financial Reporting Standards (IFRS): N/A

NAIC staff recommends that the Working Group move this item to the active listing, categorized as a SAP clarification, and expose revisions to SSAP No. 104R—Share-Based Payments to incorporate the practical expedient for the current price input, a required component for the option-pricing models – models in which are utilized in the determination of fair value for share-based payments. Integration of this third practical expedient is consistent with previous decisions by the Working Group to adopt the prior two practical expedients

regarding option-pricing modeling input permitted by FASB. The language proposed by NAIC staff directs that the practical expedient is only available when a reporting entity is not able to reasonable estimate the current fair value. While this language is technically broader than what was adopted by FASB (as ASU 2021-07 directly references non-public companies), the proposed language is consistent with prior Working Group adoptions and by default, should not be utilized by public entities – as they would be able to reasonable estimate fair value, which is likely the publicly traded share price.

Proposed Revisions to SSAP No. 104R

52. A reporting entity may not be able to reasonably estimate the fair value of its equity share options, nonemployee awards and similar instruments because it is not practicable for the reporting entity to estimate the expected volatility of its share price. In that situation, the entity shall account for its equity share options, nonemployee awards and similar instruments based on a value calculated using the historical volatility of an appropriate industry sector index instead of the expected volatility of the entity's share price (the calculated value). A reporting entity's use of calculated value shall be consistent between employee share-based payment transactions and nonemployee share-based payment transactions. Throughout the remainder of this statement, provisions that apply to accounting for share options, nonemployee awards and similar instruments at fair value also apply to calculated value.

53. For an award that meets the conditions in paragraph 54, a reporting entity may make an entity-wide accounting policy election to estimate the expected term using the following practical expedient:

- a. If vesting is only dependent upon a service condition, a reporting entity shall estimate the expected term as the midpoint between the employee's requisite service period or the nonemployee's vesting period and the contractual term of the award.
- b. If vesting is dependent upon satisfying a performance condition, an entity first would determine whether the performance condition is probable of being achieved.
 - i. If the reporting entity concludes that the performance condition is probable of being achieved, the entity shall estimate the expected term as the midpoint between the employee's requisite service period or the nonemployee's vesting period and the contractual term.
 - ii. If the reporting entity concludes that the performance condition is not probable of being achieved, the reporting entity shall estimate the expected term as either:
 - (a) The contractual term if the service period is implied (that is, the requisite service period or the nonemployee's vesting period is not explicitly stated but inferred based on the achievement of the performance condition at some undetermined point in the future).
 - (b) The midpoint between the employee's requisite service period or the nonemployee's vesting period and the contractual term if the requisite service period is stated explicitly.

54. A reporting entity that elects to apply the practical expedient in paragraph 53 shall apply the practical expedient to a share option or similar award that has all of the following characteristics:

- a. The share option or similar award is granted at the money.
- b. The grantee has only a limited time to exercise the award (typically 30-90 days) if the grantee no longer provides goods or terminates service after vesting.

- c. The grantee can only exercise the award. The grantee cannot sell or hedge the award.
- d. The award does not include a market condition.

A reporting entity that elects to apply the practical expedient in paragraph 53 may always elect to use the contractual term as the expected term when estimating the fair value of a nonemployee award as described in paragraph 42. However, a reporting entity must apply the practical expedient in paragraph 53 for all nonemployee awards that have all the characteristics listed in this paragraph if that reporting entity does not elect to use the contractual term as the expected term and that reporting entity elects the accounting policy election to apply the practical expedient in paragraph 53.

55. If a reporting entity is not able to reasonably estimate the current share price (fair value), as a practical expedient, a reporting entity may use a value determined by the reasonable application of a reasonable valuation method as the current price of its underlying share for purposes of determining the fair value of an award that is classified as equity at grant date or upon a modification. The determination of whether a valuation method is reasonable, or whether an application of a valuation method is reasonable, shall be made on the facts and circumstances as of the measurement date. Factors to be considered under a reasonable valuation method include, as applicable:

- a. The value of tangible and intangible assets
- b. The present value of anticipated future cash flows
- c. The market value of stock or equity interests in similar corporations and other entities engaged in trades or businesses substantially similar to those engaged by the entity for which the stock is to be valued, the value of which can be readily determined through nondiscretionary, objective means (such as through trading prices on an established securities market or an amount in an arm's length transaction)
- d. Recent arm's length transactions involving the sale or transfer of stock or equity interest
- e. Other relevant factors such as control premiums or discounts for lack of marketability and whether the valuation method is used for other purposes that have a material economic effect on the entity, its stockholders, or its creditors
- f. The entity's consistent use of a valuation method to determine the value of its stock or assets for other purposes, including for purposes unrelated to compensation of service providers.

Effective Date and Transition

130. This statement was effective January 1, 2013, with interim and annual financial reporting thereafter. Early adoption was permitted for December 31, 2012, financial statements with interim and annual reporting thereafter. At the time of initial adoption of this statement, reporting entities with existing share-based payment instruments that applied the guidance in SSAP No. 13—*Stock Options and Stock Purchase Plans* were to apply the requirements of SSAP No. 104 prospectively to new awards and to awards modified, repurchased or cancelled after the required effective date. Those reporting entities were to continue to account for any portion of awards outstanding at the date of initial application using the statutory accounting principles originally applied to those awards (e.g., SSAP No. 13).

131. Since the initial adoption of SSAP No. 104, subsequent revisions were effective as follows:

- a. ASU 2021-07, Compensation – Stock Compensation, Determining the Current Price of an Underlying Share for Equity-Classified Share-Based Awards. This SAP clarification is effective.

Ref #2022-06

- a.b. ASU 2018-07, *Improvements to Nonemployee Share-Based Payment Accounting*: Nonsubstantive revisions effective January 1, 2020, with early application permitted.
- b.c. ASU 2017-09, *Scope of Modification Accounting*: Nonsubstantive revisions effective January 1, 2018, applicable to modifications that occur on or after the effective date, with early application permitted.
- c.d. ASU 2016-09, *Improvements to Employee Share-Based Payment Accounting*: Nonsubstantive revisions effective December 31, 2017, with early adoption permitted. The adoption included the transition provisions from ASU 2016-19, although not duplicated within this statement.
- d.e. ASU 2014-12, *Accounting for Share-Based Payments When the Terms of an Award Provide That a Performance Target Could Be Achieved after the Requisite Service Period*: Nonsubstantive revisions effective January 1, 2016, with early adoption permitted.
- e.f. ASU 2010-13, *Effect of Denominating the Exercise Price of a Share-Based Payment Award in the Current of the Market in Which the Underlying Equity Security Trades*: Captured in the original adoption of SSAP No. 104, effective January 1, 2013.

Staff Review Completed by: Jim Pinegar—NAIC Staff, February 2022

Status:

On April 4, 2022, the Statutory Accounting Principles (E) Working Group moved this agenda item to the active listing, categorized as a SAP clarification, and exposed revisions to *SSAP No. 104R—Share-Based Payments* to incorporate a practical expedient for the current price input, a required component for option-pricing models which are utilized in the determination of fair value for share-based payments.

On August 10, 2022, the Statutory Accounting Principles (E) Working Group adopted, as final, the exposed revisions, as illustrated above, to *SSAP No. 104R—Share-Based Payments* to incorporate a practical expedient for the current price input, a required component for option-pricing models which are utilized in the determination of fair value for share-based payments.

https://naiconline.sharepoint.com/sites/NAICSupportStaffHub/Member Meetings/E CMTE/APPTF/2022SummerNM/1_SAPWG/Minutes/Att One-F_22-06_ASU 2021-07.docx

Ref #2022-07

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

Issue: ASU 2021-08, Business Combinations

Check (applicable entity):

	P/C	Life	Health
Modification of Existing SSAP	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>
New Issue or SSAP	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Interpretation	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>

Description of Issue: In October 2021, the Financial Accounting Standards Board (FASB) issued *Accounting Standards Update (ASU) 2021-08, Business Combinations, Accounting for Contract Assets and Contract Liabilities from Contracts with Customers* to require acquiring entities to apply Topic 606 (the topic that specifies the accounting for revenue and liabilities resulting from contacts with customers), when valuing and recognizing contract related assets and liabilities in a business combination.

Prior to the issuance of ASU 2021-08, acquirers would generally only recognize such items based on their fair values on the date of acquisition. When assessing liabilities at fair value, acquirers would generally only recognize an acquiree's deferred revenue (i.e., a contract liability), to the extent the acquirer had a legal obligation to perform a service or remit a product. However, to only recognize a contract liability to the extent of a legal obligation is contrary to Topic 606 as it states that performance obligations may (and often) extend beyond legal obligations – with examples including implied promises and customer business practices within the contract with a customer, regardless of whether such promises were legally enforceable.

This ASU noted that the amendments will enhance comparability of the business results from before and after the acquisition (as presumably in most cases, the Topic 606 liability of the acquiree would transfer from the acquiree to the acquirer) and thus continuity of presentation would be retained. It is also important to note that the application of Topic 606 (rather than applying fair value standards) for acquired contract liabilities will generally result in a larger liability being recognized by the acquirer. This is because in cases where a provider receives cash in advance of performing a service or providing a product, in many instances some or all of the advanced funds have been spent prior to the date of acquisition, and thus the acquirer, using fair value measurement techniques, will not designate value to the spent funds. However again, the primary goal of these amendments is to improve comparability by providing consistent recognition and measurement guidance for revenue contracts - regardless of if those contracts were or were not acquired in a business combination.

The statutory accounting guidance for business combinations is found in *SSAP No. 68—Business Combinations and Goodwill* and requires business combinations be reported at cost, which in an arms-length transaction; is presumably fair value. SSAP No. 68 also requires that for entities (other than insurance reporting entities), the acquirer use the acquiree's U.S. GAAP book value for the determination of statutory goodwill. The calculation of statutory goodwill, while beyond the scope of this agenda item, is important to briefly comment on as it adds an additional level of conservatism not recognized by U.S. GAAP – as it requires the recognition of goodwill for the amount of cost in excess of the acquiree's book value (as opposed to fair value under U.S. GAAP).

So, in essence, for statutory accounting, other than the reporting of statutory goodwill, the acquiree's book value of all associated assets (and liabilities) are reported on the acquirer's books. As ASU 2021-08 requires the acquirer to utilize the acquiree's book value, measured via Topic 606, for contract liabilities, the practice (unless the acquiree

has not previously or has incorrectly applied Topic 606) conceptually consistent statutory accounting requirements, requires a measurement method previously rejected by statutory accounting.

Existing Authoritative Literature: As previously mentioned, the statutory guidance for business combinations is contained in SSAP No. 68 - relevant paragraphs, with applicable guidance is included below.

SSAP No. 68

Business Combinations

2. A business combination shall be accounted for as either a statutory purchase or a statutory merger. Business combinations that create a parent-subsidiary relationship shall be accounted for as a statutory purchase. Business combinations where equity of one entity is issued in exchange for the equity of another entity, which is then canceled, and prospectively only one entity exists, shall be accounted for as a statutory merger.

Statutory Purchases of SCA Investments

3. **The statutory purchase method of accounting is defined as accounting for a business combination as the acquisition of one entity by another.** It shall be used for all purchases of SCA entities including partnerships, joint ventures, and limited liability companies. **The acquiring reporting entity shall record its investment at cost. Cost is defined as the sum of: (a) any cash payment, (b) the fair value of other assets distributed, (c) the fair value of any liabilities assumed, and (d) any direct costs of the acquisition.**^(INT 00-28) Contingent consideration issued in a purchase business combination that is embedded in a security or that is in the form of a separate financial instrument shall be recorded by the issuer at fair value at the acquisition date.

4. **For those acquired SCA entities accounted for in accordance with paragraphs 8.b.i., 8.b.ii., 8.b.iii. or 8.b.iv. of SSAP No. 97, and joint venture, partnership or limited liability company entities accounted for in accordance with paragraph 8 of SSAP No. 48, goodwill is defined as the difference between the cost of acquiring the entity and the reporting entity's share of the book value of the acquired entity.** When the cost of the acquired entity is greater than the reporting entity's share of the book value, positive goodwill exists. When the cost of the acquired entity is less than the reporting entity's share of the book value, negative goodwill exists. Goodwill resulting from assumption reinsurance shall be recorded as a separate write-in for other-than-invested assets. All other goodwill shall be reported in the carrying value of the investment.

5. A business combination accounted for under the statutory purchase method and in which the acquired entity is valued in accordance with paragraphs 8.b.ii., 8.b.iii. or, 8.b.iv. of SSAP No. 97 **shall determine the amount of positive goodwill or negative goodwill created by the combination using the reporting entity's share of the GAAP net book value of the acquired entity**, adjusted to a statutory basis of accounting in accordance with paragraph 9 of SSAP No. 97 in the case of acquired entities valued in accordance paragraphs 8.b.ii. or 8.b.iv. of SSAP No. 97. Business combinations accounted for under the statutory purchase method and in which the acquired entity is valued in accordance with, paragraph 8.b.i. of SSAP No. 97 shall determine the amount of positive or negative goodwill created by the business combination using the insurer's share of the statutory book value of the acquired entity.

6. For those acquired SCA entities accounted for in accordance with paragraph 8.b.i. of SSAP No. 97 under the statutory purchase method, the historical bases of the acquired entity shall continue to be used in preparing its statutory financial statements. Therefore, pushdown accounting is not permitted.

As mentioned above, utilizing an acquiree's book value is likely consistent with current practice, however, all previous Topic 606 guidance has been rejected for statutory accounting as insurance contracts are explicitly excluded from its scope. The rejections are noted within the body of statutory guidance in *SSAP No. 47—Uninsured Plans*.

SSAP No. 47

Relevant Literature

15. This statement rejects ASU 2014-09, *Revenue from Contracts with Customers*; ASU 2015-14, *Revenue From Contracts With Customers*; ASU 2016-08, *Revenue From Contracts with Customers: Principal versus Agent Considerations (Reporting Revenue Gross versus Net)*; ASU 2016-10, *Revenue from Contracts with Customers: Identifying Performance Obligations and Licensing*; ASU 2016-12, *Revenue from Contracts with Customers: Narrow-Scope Improvements and Practical Expedients*; ASU 2016-20, *Technical Corrections and Improvements to Topic 606, Revenue from Contracts with Customers*; ASU 2018-18, *Collaborative Arrangements (Topic 808), Clarifying the Interaction between Topic 808 and Topic 606*, and ASU 2021-02, *Franchisors—Revenue from Contracts with Customers*.

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): As previously mentioned, all ASUs related to ASC Topic 606 have been rejected by the Working Group.

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

Convergence with International Financial Reporting Standards (IFRS): ASC Topic 606 and IFRS 15 are the result of the joint project between the FASB and IASB to improve financial reporting by creating common revenue recognition guidance.

Staff Recommendation: NAIC staff recommends that the Working Group move this item to the active listing, categorized as SAP clarifications to:

- 1) **Expose revisions to *SSAP No. 47—Uninsured Plans* to reject ASU 2021-08 for statutory accounting.** This recommendation is consistent with how the prior ASUs related to Topic 606 have been treated.
- 2) **Expose revisions to *SSAP No. 68—Business Combinations and Goodwill* to reject the ASU 2021-08 for statutory accounting, while noting that rejection does not impact the determination of U.S. GAAP book value in an acquired entity.** NAIC staff note that as all prior Topic 606 guidance has been rejected for statutory accounting, the explicit rejection of this ASU should not be construed to mean that the U.S. GAAP net book value (which is utilized for the determination of statutory goodwill) will need to be modified by the guidance required in this ASU. The intent is to not modify any U.S. GAAP requirements for the determination of U.S. GAAP net book value within this standard.

Proposed Revisions to SSAP No. 47

Relevant Literature

15. This statement rejects ASU 2014-09, *Revenue from Contracts with Customers*; ASU 2015-14, *Revenue From Contracts With Customers*; ASU 2016-08, *Revenue From Contracts with Customers: Principal versus*

Ref #2022-07

Agent Considerations (Reporting Revenue Gross versus Net); ASU 2016-10, Revenue from Contracts with Customers: Identifying Performance Obligations and Licensing; ASU 2016-12, Revenue from Contracts with Customers: Narrow-Scope Improvements and Practical Expedients; ASU 2016-20, Technical Corrections and Improvements to Topic 606, Revenue from Contracts with Customers; ASU 2018-18, Collaborative Arrangements (Topic 808), Clarifying the Interaction between Topic 808 and Topic 606, and ASU 2021-02, Franchisors—Revenue from Contracts with Customers, and ASU 2021-08, Business Combinations, Accounting for Contract Asset and Contract Liabilities from Contracts with Customers.

Proposed Revisions to SSAP No. 68

Relevant Literature

22. This statement rejects *ASU 2021-08, Business Combinations, Accounting for Contract Asset and Contract Liabilities from Contracts with Customers, however the rejection of which shall not modify the U.S. GAAP accounting standards as required within this standard*, ASU 2019-06, *Intangibles—Goodwill and Other Business Combinations, and Non-for-Profit Entities*, ASU 2017-04, *Simplifying the Test for Goodwill Impairment*, ASU 2016-03, *Intangibles—Goodwill and Other, Business Combinations, Consolidation, Derivatives and Hedging*; ASU 2014-02, *Accounting for Goodwill (a consensus of the Private Company Council)*, ASU 2012-02, *Testing Indefinite-Lived Intangible Assets for Impairment*, ASU 2011-08, *Testing Goodwill for Impairment* and ASU 2010-28, *When to Perform Step 2 of the Goodwill Impairment Test for Reporting Units with Zero or Negative Carrying Amounts*; *Accounting Principles Board Opinion No. 16, Business Combinations; FASB Statement No. 38, Accounting for Preacquisition Contingencies of Purchased Enterprises, an amendment of APB Opinion No. 16; Accounting Principles Board Opinion No. 17, Intangible Assets; FASB Statement No. 79, Elimination of Certain Disclosures for Business Combinations by Nonpublic Enterprises; FASB Statement No. 141, Business Combinations; and FASB Statement No. 142, Goodwill and Other Intangible Assets The following related interpretative pronouncements are also rejected:*

[NAIC Staff Note, the remainder of this paragraph has been omitted for brevity.]

Staff Review Completed by: Jim Pinegar - NAIC Staff, February 2022

Status:

On April 4, 2022, the Statutory Accounting Principles (E) Working Group moved this agenda item to the active listing, categorized as a SAP clarification, and exposed revisions to *SSAP No. 47—Uninsured Plans* and *SSAP No. 68—Business Combinations and Goodwill* to reject ASU 2021-08 for statutory accounting. In addition, the proposed revisions to SSAP No. 68 include notations that the rejection of ASU 2021-08 does not impact the determination of U.S. GAAP book value in an acquired entity. The proposed revisions are illustrated above, under the recommended action.

On August 10, 2022, the Statutory Accounting Principles (E) Working Group adopted, as final, the exposed revisions, as illustrated above, to *SSAP No. 47—Uninsured Plans* and *SSAP No. 68—Business Combinations and Goodwill* to reject ASU 2021-08 for statutory accounting. In addition, the revisions to SSAP No. 68 include notations that the rejection of ASU 2021-08 does not impact the determination of U.S. GAAP book value of an acquired entity.

https://naiconline.sharepoint.com/sites/NAICSupportStaffHub/Member Meetings/E CMTE/APPTF/2022SummerNM/1_SAPWG/Minutes/Att One-G_22-07_ASU 2021-08.docx

**Statutory 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	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>
New Issue or SSAP	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Interpretation	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>

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.

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. 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

Ref # 2021-20

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 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.

SAP Assessment: 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 than 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.

Items to Consider: 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.

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- 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.)

Fair Value Hedges of Interest Rate Risk in Which the Hedged Item Can be Settled Before Scheduled Maturity:

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.

SAP Assessment: 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.

Items to Consider: 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.

Expansion of Excluded Derivative Components from Assessment of Hedge Effectiveness

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.

SAP Assessment: 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.)

Items to Consider: 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.

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- **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*.

On August 10, 2022, the Statutory Accounting Principles (E) Working Group took the following actions:

1. Adopted as final, the exposed revisions:
 - 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.
 - Revisions to SSAP No. 86 to incorporate measurement methods for excluded components.
2. Adopted as final revisions, illustrated below, which detail the January 1, 2023 effective date, with early adoption permitted, and relevant U.S. GAAP references.
3. Directed a blanks proposal to incorporate Schedule DB reporting fields and templates to capture the new disclosures for excluded components detailed in paragraph 41g of the exposed revisions.
4. Directed an Issue Paper to detail the derivative revisions from this agenda item and other statutory derivative revisions resulting from ASU 2017-12 and other recent U.S. GAAP issuances.

SSAP No. 86 Revisions

Relevant Literature

64. This statement adopts the framework established by FAS 133, *FASB Statement No. 137, Accounting for Derivative Instruments and Hedging Activities—Deferral of the Effective Date of FASB Statement No. 133, An amendment of FASB Statement No. 133* (FAS 137) and *FASB Statement No. 138, Accounting for Certain Derivative Instruments and Certain Hedging Activities, An amendment of FASB Statement No. 133* (FAS 138), for fair value and cash flow hedges, including its technical guidance to the extent such guidance is consistent with the statutory accounting approach to derivatives utilized in this statement. This statement adopts the provisions of FAS 133 and 138 related to foreign currency hedges. With the exception of guidance specific to foreign currency hedges and amendments specific to refining the hedging of interest rate risk (under FAS 138, the risk of changes in the benchmark interest rate would be a hedged risk), this statement rejects FAS No. 137 and 138 as well as the various related Emerging Issues Task Force interpretations. This statement adopts paragraphs 4 and 25 of *FASB Statement No. 149: Amendment of Statement 133 on Derivative Instruments and Hedging Activities* (FAS 149) regarding the definition of an underlying and guidance for assessing hedge effectiveness. (The adoption from FAS 149 on the assessment of hedge effectiveness is impacted by the adoption with modification of guidance from ASU 2017-12 as detailed in paragraph 65b, with the guidance from ASU 2017-12 superseding the prior adoption to the extent applicable.) All other paragraphs in FAS 149 are rejected as not applicable for statutory accounting. This statement adopts FSP FAS 133-1 and FIN 45-5: *Disclosures about Credit Derivatives and Certain Guarantees, An Amendment of FASB Statement No. 133 and FASB Interpretation No.45 and Clarification of the Effective Date of FASB Statement No. 161* (FSP FAS 133-1 and FIN 45-4) and requires disclosures by sellers of credit derivatives. This statement rejects *FSP FIN 39-1, Amendments of FASB Interpretation No. 39, and ASU 2014-03, Derivatives and Hedging – Accounting for Certain Receive-Variable, Pay-Fixed Interest Rate Swaps – Simplified Hedge Accounting Approach*.

65. This statement adopts, with modification, certain revisions to ASC 815-20 included in ASU 2017-12. Remaining provisions of ASU 2017-12 will be subsequently assessed for statutory accounting and shall not be considered adopted for statutory accounting until that assessment is complete.

- a. [Revisions effective January 1, 2019 with early adoption permitted. This adoption is](#) are limited to specific provisions, and related transition guidance, pertaining to the documentation and assessment of hedge effectiveness and only includes: 1) provisions allowing more time to perform the initial quantitative hedge effectiveness assessment; 2) provisions allowing subsequent assessments of hedge effectiveness to be performed qualitatively if certain conditions are met; and 3) revisions regarding use of the critical terms and short-cut methods for assessing hedge effectiveness.
- b. [Revisions effective January 1, 2023, with early adoption permitted, are limited to the criteria for initial and subsequent hedge effectiveness detailed in the FASB Accounting Standards Codification \(ASC\) paragraphs 815-20-25-72 through 815-20-35-20, as modified through the issuance of ASU 2017-12. This adoption reflects statutory modifications to specify that the accounting and reporting of hedging instruments, including excluded components of the instruments, shall follow statutory specific guidance detailed in the statement. The intent of this guidance is to clarify that the determination of whether a hedging instrument qualifies as an effective hedge shall converge with U.S. GAAP, but that the measurement method shall continue to follow statutory specific provisions. The adoption of the referenced ASC paragraphs only extends to revisions incorporated through ASU 2017-12; therefore, any subsequent U.S. GAAP edits would require statutory accounting consideration before considered adopted.](#)
The remaining provisions of ASU 2017-12 will be subsequently assessed for statutory accounting and shall not be considered adopted for statutory accounting until that assessment is complete.

Effective Date and Transition

74.73 This statement is effective for derivative transaction entered into or modified on or after January 1, 2003. A modification is any revision or change in contractual terms of the derivative. SSAP No. 31 applies to derivative transaction prior to January 1, 2003. Alternatively, an insurer may choose to apply this statement to all derivatives to which the insurer is a party as of January 1, 2003. In either case, the insurer is to disclose the transition approach that is being used.

- a. Revisions adopted to paragraph 64 to reject FSP FIN 39-1 is effective January 1, 2013, for companies that have previously reported a position in the balance sheet that was net of counterparty agreements. (Companies that have previously reported derivative instruments and/or related collateral gross shall not be impacted by these revisions.)
- b. Revisions adopted in paragraph 16 clarify the reporting for amounts received/paid to adjust variation margin until the derivative contract has ended and are effective January 1, 2018, on a prospective basis, for reporting entities that have previously considered these amounts to reflect settlement or realized gains/losses. (Companies that have previously reported variation margin changes in line with the revisions shall not be impacted by these revisions.)
- c. Revisions to incorporate limited provisions from ASU 2017-12 pertaining to the documentation of hedge effectiveness (detailed in paragraph 65) are effective January 1, 2019, with early adoption permitted for year-end 2018. However, if the reporting entity is a U.S. GAAP filer, the reporting entity may only elect early adoption if the entity has also elected early adoption of ASU 2017-12 for year-end 2018.
- d. Revisions adopted April 2019 to explicitly include structured notes in scope of this statement are effective December 31, 2019. Revisions adopted July 2020 to define “derivative premium,” require gross reporting of derivatives without the impact of financing premiums and require separate recognition of premiums payable and premiums receivable, are effective January 1, 2021.
- e. [Revisions adopted August 2022 that adopt with modification the criteria for initial and subsequent hedge effectiveness detailed in the FASB ASC paragraphs 815-20-25-72 through 815-20-35-20, as modified through the issuance of ASU 2017-12 and that incorporate statutory accounting revisions for the accounting and reporting of excluded components are effective January 1, 2023, with early adoption permitted. These revisions shall be applied prospectively for all new and existing hedges. Entities shall detail the adoption of this guidance as a change in accounting principle pursuant to SSAP No. 3—Accounting Changes and Corrections of Errors.](#)

https://naiconline.sharepoint.com/sites/NAICSupportStaffHub/Member Meetings/E CMTE/APPTF/2022SummerNM/1_SAPWG/Minutes/Att One-H_21-20_ASU 2017-12.docx

Note: On August 10, 2022, the Statutory Accounting Principles (E) Working Group adopted a new Exhibit A as detailed within this document (This is new guidance and any tracked changes within show changes from U.S. GAAP. That tracking will not be shown in SSAP No. 86.)

SSAP No. 86—Derivatives
Assessment of Hedge Effectiveness

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Review of U.S. derivative guidance and the application to SAP is complex with many facets. This initial document considers consistency in the determination of hedge effectiveness between U.S. GAAP and SAP. The second element pertaining to the accounting and reporting of hedging instruments, including excluded components, will be considered separately, as that guidance has been historically different.

1) Assessment of Hedge Effectiveness – Consistency with U.S. GAAP

NAIC staff agree that the assessment of hedge effectiveness for derivatives should be consistent between U.S. GAAP and SAP. This would ensure that transactions identified to be highly effective hedges under U.S. GAAP would also be identified as highly effective hedges under statutory accounting. If a hedging instrument results with offsetting changes (or other permitted aspects) to a hedged item pursuant to the guidelines under U.S. GAAP to qualify as a highly effective hedge, the same assessment as a highly effective hedge should occur under SAP.

NAIC staff highlight that the current guidance in SSAP No. 86 in Exhibit A – Discussion of Hedge Effectiveness and Exhibit B – Assessment of Hedging Effectiveness have not been significantly updated since the original issuance of FAS 133, *Accounting for Derivative Instruments and Hedging Activities* and SSAP No. 86. Exhibit A continues to reference guidance issued by the Derivatives Implementation Group (DIG) in E7 and E8, which were not considered official FASB positions, although these DIG provisions (and other clarifications) been incorporated into the FASB Codification as authoritative. NAIC staff highlight that the list of components permitted to be excluded from the assessment of hedge effectiveness captured in the FASB Codification (815-20-25-82) differs from the statutory accounting guidance in SSAP No. 86, Exhibit B. The statutory accounting guidance in Exhibit B reflects original guidance from FAS 133, paragraph 63, but the statutory accounting guidance has not been updated to reflect provisions from the DIG E19 incorporated into the FASB Codification or the revisions from ASU 2017-12 that pertain to cross-currency basis spread.

To ensure consistency with U.S. GAAP in the assessment of hedge effectiveness, **NAIC staff recommend that the Working Group consider adoption, with modification, of U.S. GAAP guidance pertaining to the criteria for initial and subsequent hedge effectiveness detailed in the FASB Accounting Standards Codification (ASC) paragraphs 815-20-25-72 through 815-20-35-20, as modified through the issuance of ASU 2017-12. Although the U.S. GAAP guidance for the assessment and determination of hedge effectiveness is proposed to be adopted, this action recommends statutory modifications to specify that the accounting and reporting of hedging instruments, including excluded components of the instruments, shall follow statutory specific guidance detailed in SSAP No. 86. The intent of this guidance is to clarify that the determination of whether a hedging instrument qualifies as an effective hedge shall converge with U.S. GAAP, but that the measurement method shall continue to follow statutory specific provisions. The proposed adoption only extends to revisions incorporated through ASU 2017-12, as such, any subsequent U.S. GAAP edits would continue to require statutory accounting consideration before they were considered adopted.**

Exposure and request for comments - Excerpts of the U.S. GAAP guidance proposed to be adopted are recommended to replace the existing guidance in Exhibit A and Exhibit B of SSAP No. 86. However, these excerpts do not reflect the full U.S. GAAP guidance referenced. This reduction of quoted guidance is simply

Note: On August 10, 2022, the Statutory Accounting Principles (E) Working Group adopted a new Exhibit A as detailed within this document (This is new guidance and any tracked changes within show changes from U.S. GAAP. That tracking will not be shown in SSAP No. 86.)

**SSAP No. 86—Derivatives
Assessment of Hedge Effectiveness**

Ref #2021-20

to manage the extent of detail captured in SSAP No. 86. With exposure of the proposed excerpts and adoption language, the Working Group requests comments on whether certain paragraphs should be removed as unnecessary in the Exhibit and whether other guidance from the referenced U.S. GAAP would be beneficial to be incorporated. (NAIC staff note that the U.S. GAAP themes previously captured within Exhibit A and B have been retained – with updated ASC language.) Unless noted with tracked changes, the cited paragraphs are proposed to be incorporated directly from U.S. GAAP. (The tracked changes most commonly update GAAP references or paraphrase topics captured in GAAP references.)

Proposed New Exhibit A Which Would Replace The Existing Exhibit A and Exhibit B

EXHIBIT A – DISCUSSION OF HEDGE EFFECTIVENESS

The guidance within this exhibit reflects the adoption, with modification, of *FASB Accounting Standards Codification (ASC) 815-20-25-72 through 815-20-35-20*, as revised through the issuance of *ASU 2017-12: Derivatives and Hedging: Targeted Improvements to Accounting for Hedging Activities* (ASU 2017-12) (issued on August 28, 2017). This adoption captures the U.S. GAAP guidance for the assessment and determination of hedge effectiveness, with modification to require the accounting and reporting of hedging instruments, including excluded components of hedging instruments to follow specific statutory accounting guidance in SSAP No. 86. The intent of this guidance is to clarify that the determination of whether a hedging instrument and derivative transaction qualifies as an effective hedge shall converge with U.S. GAAP, but that the measurement and reporting of effective hedge transactions shall follow statutory specific provisions. The adoption only extends to revisions incorporated to the FASB ASC through ASU 2017-12, therefore any subsequent U.S. GAAP edits to the ASC would require statutory accounting adoption before application. The guidance within this Exhibit reflects excerpts from the U.S. GAAP ASC, but do not reflect the full U.S. GAAP guidance referenced in the adopted language. The exclusion of cited guidance is to manage the extent of detail included within SSAP No. 86. Excerpts not duplicated within from the cited U.S. GAAP guidance are considered adopted unless subject to the specific accounting and reporting statutory exclusion. This Exhibit intends to supplement the guidance in SSAP No. 86 on hedge effectiveness. In any event in which this Exhibit could be interpreted as conflicting with the SSAP No. 86 guidance, the guidance in the body of SSAP No. 86 shall be followed.

(Staff Note: Tracked changes show proposed revisions to the U.S. GAAP guidance.)

Hedge Effectiveness Criteria Applicable to Both Fair Value Hedges and Cash Flow Hedges

1. This guidance addresses hedge effectiveness criteria applicable to both fair value hedges and cash flow hedges. (815-20-25-74)
2. To qualify for hedge accounting, the hedging relationship, both at inception of the hedge and on an ongoing basis, shall be expected to be highly effective in achieving either of the following: (815-20-25-75)
 - a. Offsetting changes in fair value attributable to the hedged risk during the period that the hedge is designated (if a fair value hedge)

Note: On August 10, 2022, the Statutory Accounting Principles (E) Working Group adopted a new Exhibit A as detailed within this document (This is new guidance and any tracked changes within show changes from U.S. GAAP. That tracking will not be shown in SSAP No. 86.)

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- b. Offsetting cash flows attributable to the hedged risk during the term of the hedge (if a cash flow hedge), unless the hedging instrument is used to modify the contractually specified interest receipts or payments associated with a recognized financial asset liability from one variable rate to another variable rate. ~~except as indicated in paragraph 815-20-25-50~~
3. If the hedging instrument (such as an at-the-money option contract) provides only one-sided offset of the hedged risk, either of the following conditions shall be met: (815-20-25-76)
 - a. The increases (or decreases) in the fair value of the hedging instrument are expected to be highly effective in offsetting the decreases (or increases) in the fair value of the hedged item (if a fair value hedge).
 - b. The cash inflows (outflows) from the hedging instrument are expected to be highly effective in offsetting the corresponding change in the cash outflows or inflows of the hedged transaction (if a cash flow hedge).
4. There would be a mismatch between the change in fair value or cash flows of the hedging instrument and the change in fair value or cash flows of the hedged item or hedged transaction in any of the following circumstances, among others: (815-20-25-77)
 - a. A difference between the basis of the hedging instrument and the hedged item or hedged transaction, to the extent that those bases do not move in tandem
 - b. Differences in critical terms of the hedging instrument and hedged item or hedged transaction, such as differences in any of the following:
 - i. Notional amounts
 - ii. Maturities
 - iii. Quantity
 - iv. Location (not applicable for hedging relationships in which the variability in cash flows attributable to changes in a contractually specified component is designated as the hedged risk)
 - v. Delivery Dates
5. An entity shall consider hedge effectiveness in two different ways—in prospective considerations and in retrospective evaluations: (815-20-25-79)
 - a. Prospective considerations. The entity's expectation that the relationship will be highly effective over future periods in achieving offsetting changes in fair value or cash flows, which is forward looking, must be assessed on a quantitative basis at hedge inception unless

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one of the exceptions detailed in ASU 2017-12, paragraph 815-20-25-3(b)(2)(iv)(01)¹ is met. Prospective assessments shall be subsequently performed whenever financial statements or earnings are reported and at least every three months. The entity shall elect at hedge inception ~~in accordance with paragraph 815-20-25-3(b)(2)(iv)(03)~~ whether to perform subsequent retrospective and prospective hedge effectiveness assessments on a quantitative or qualitative basis. ~~See paragraphs 815-20-35-2A through 35-2F for additional guidance on qualitative assessments of hedge effectiveness.~~ A quantitative assessment can be based on regression or other statistical analysis of past changes in fair values or cash flows as well as on other relevant information. The quantitative prospective assessment of hedge effectiveness shall consider all reasonably possible changes in fair value (if a fair value hedge) or in fair value or cash flows (if a cash flow hedge) of the derivative instrument and the hedged items for the period used to assess whether the requirement for expectation of highly effective offset is satisfied. The quantitative prospective assessment may not be limited only to the likely or expected changes in fair value (if a fair value hedge) or in fair value or cash flows (if a cash flow hedge) of the derivative instrument or the hedged items. Generally, the process of formulating an expectation regarding the effectiveness of a proposed hedging relationship involves a probability-weighted analysis of the possible changes in fair value (if a fair value hedge) or in fair value or cash flows (if a cash flow hedge) of the derivative instrument and the hedged items for the hedge period. Therefore, a probable future change in fair value will be more heavily weighted than a reasonably possible future change. ~~That calculation technique is consistent with the definition of the term expected cash flow in FASB Concepts Statement No. 7, Using Cash Flow Information and Present Value in Accounting Measurements.~~

- b. Retrospective evaluations. An assessment of effectiveness may be performed on a quantitative or qualitative basis on the basis of the entity's election at hedge inception ~~in accordance with paragraph 815-20-25-3(b)(2)(iv)(03)~~. That assessment shall be performed whenever financial statements or earnings are reported, and at least every three months. ~~See paragraphs 815-20-35-2 through 35-4 for further guidance.~~ At inception of the hedge, an entity electing a dollar-offset approach to perform retrospective evaluations on a quantitative basis may choose either a period-by-period approach or a cumulative approach in designating how effectiveness of a fair value hedge or of a cash flow hedge will be assessed retrospectively under that approach, depending on the nature of the hedge ~~initially documented in accordance with paragraph 815-20-25-3. For example, an entity may decide that the cumulative approach is generally preferred, yet may wish to use the period-by-period approach in certain circumstances.~~ ~~See paragraphs 815-20-35-5 through 35-6 for further guidance.~~

Skiping 815-20-25-79A

6. All assessments of effectiveness shall be consistent with the originally documented risk management strategy for that particular hedging relationship. An entity shall use the quantitative

¹ Reference to this ASU 2017-12 guidance is consistent with the guidance in SSAP No. 86, paragraph 42, footnote 5.

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effectiveness assessment method defined at hedge inception consistently for the periods that the entity either elects or is required to assess hedge effectiveness on a quantitative basis. (815-20-25-80)

7. This Subtopic guidance does not specify a single method for assessing whether a hedge is expected to be highly effective. The method of assessing effectiveness shall be reasonable. The appropriateness of a given method of assessing hedge effectiveness depends on the nature of the risk being hedged and the type of hedging instrument used. Ordinarily, an entity shall assess effectiveness for similar hedges in a similar manner, including whether a component of the gain or loss on a derivative instrument is excluded in assessing effectiveness for similar hedges. Use of different methods for similar hedges shall be justified. The mechanics of isolating the change in time value of an option discussed beginning in paragraph 13 815-20-25-98 also shall be applied consistently. (815-20-25-81)

8. In defining how hedge effectiveness will be assessed, an entity shall specify whether it will include in that assessment all of the gain or loss on a hedging instrument. An entity may exclude all or a part of the hedging instrument's time value from the assessment of hedge effectiveness, as follows: (815-20-25-82)

- a. If the effectiveness of a hedge with an option is assessed based on changes in the option's intrinsic value, the change in the time value of the option would be excluded from the assessment of hedge effectiveness.
- b. If the effectiveness of a hedge with an option is assessed based on changes in the option's minimum value, that is, its intrinsic value plus the effect of discounting, the change in the volatility value of the contract shall be excluded from the assessment of hedge effectiveness.
- c. An entity may exclude any of the following components of the change in an option's time value from the assessment of hedge effectiveness:
 - i. The portion of the change in time value attributable to the passage of time (theta)
 - ii. The portion of the change in time value attributable to changes due to volatility (vega)
 - iii. The portion of the change in time value attributable to changes due to interest rates (rho).
- d. If the effectiveness of a hedge with a forward contract or futures contract is assessed based on changes in fair value attributable to changes in spot prices, the change in the fair value of the contract related to the changes in the difference between the spot price and the forward or futures price shall be excluded from the assessment of hedge effectiveness.
- e. An entity may exclude the portion of the change in fair value of a currency swap attributable to a cross-currency basis spread.

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9. No other components of a gain or loss on the designated hedging instrument shall be excluded from the assessment of hedge effectiveness nor shall an entity exclude any aspect of a change in an option's value from the assessment of hedge effectiveness that is not one of the permissible components of the change in an option's time value. For example, an entity shall not exclude from the assessment of hedge effectiveness the portion of the change in time value attributable to changes in other market variables (that is, other than rho and vega). (815-20-25-83)

Note – The following ASC Paragraphs 815-20-25-83A and 83B would not be considered adopted under the proposed language as they address measurement and recognition. SAP measurement and recognition guidance will be captured in the body of the SSAP or Appendix C.

For fair value and cash flow hedges, the initial value of the component excluded from the assessment of effectiveness shall be recognized in earnings using a systematic and rational method over the life of the hedging instrument. Any difference between the change in fair value of the excluded component and amounts recognized in earnings under that systematic and rational method shall be recognized in other comprehensive income. Example 31 beginning in paragraph 815-20-55-235 illustrates this approach for a cash flow hedge in which the hedging instrument is an option and the entire time value is excluded from the assessment of effectiveness. (815-20-25-83A)

For fair value and cash flow hedges, an entity alternatively may elect to record changes in the fair value of the excluded component currently in earnings. This election shall be applied consistently to similar hedges in accordance with paragraph 815-20-25-81 and shall be disclosed in accordance with paragraph 815-10-50-4EEEE. (815-20-25-83B)

10. If the critical terms of the hedging instrument and of the hedged item or hedged forecasted transaction are the same, the entity could conclude that changes in fair value or cash flows attributable to the risk being hedged are expected to completely offset at inception and on an ongoing basis. For example, an entity may assume that a hedge of a forecasted purchase of a commodity with a forward contract will be perfectly effective if all of the following criteria are met:

- a. The forward contract is for purchase of the same quantity of the same commodity at the same time and location as the hedged forecasted purchase. Location differences do not need to be considered if an entity designates the variability in cash flows attributable to changes in a contractually specified component as the hedged risk and the requirements in paragraphs 815-20-25-22A through 25-22B of the FASB Codification are met. (815-20-25-84)
- b. The fair value of the forward contract at inception is zero.
- c. Either of the following criteria is met:
 - i. The change in the discount or premium on the forward contract is excluded from the assessment of effectiveness pursuant to paragraphs 7-9 815-20-25-81 through 25-83.

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- ii. The change in expected cash flows on the forecasted transaction is based on the forward price for the commodity.
11. In a cash flow hedge of a group of forecasted transactions in accordance with paragraph 28a of the SSAP guidance~~815-20-25-15(a)(2)~~, an entity may assume that the timing in which the hedged transactions are expected to occur and the maturity date of the hedging instrument match in accordance with paragraph 10a~~815-20-25-84(a)~~ if those forecasted transactions occur and the derivative matures within the same 31-day period or fiscal month. (815-20-25-84A)
12. If all of the criteria in paragraphs 10-11~~815-20-25-84 through 25-84A~~ are met, an entity shall still perform and document an assessment of hedge effectiveness at the inception of the hedging relationship and, ~~as discussed beginning in paragraph 815-20-35-9~~, on an ongoing basis throughout the hedge period. No quantitative effectiveness assessment is required at hedge inception if the criteria in paragraphs 10-11~~815-20-25-84 through 25-84A~~ are met (see paragraph 815-20-25-3(b)(2)(iv)(01)). (815-20-25-85)

Skipped paragraphs 815-20-25-86 to 815-20-25-97

Computing Changes in an Option's Time Value

13. In computing the changes in an option's time value that would be excluded from the assessment of hedge effectiveness, an entity shall use a technique that appropriately isolates those aspects of the change in time value. Generally, to allocate the total change in an option's time value to its different aspects—the passage of time and the market variables—the change in time value attributable to the first aspect to be isolated is determined by holding all other aspects constant as of the beginning of the period. Each remaining aspect of the change in time value is then determined in turn in a specified order based on the ending values of the previously isolated aspects. (815-20-25-98)
14. Based on that general methodology, if only one aspect of the change in time value is excluded from the assessment of hedge effectiveness (for example, theta), that aspect shall be the first aspect for which the change in time value is computed and would be determined by holding all other parameters constant for the period used for assessing hedge effectiveness. However, if more than one aspect of the change in time value is excluded from the assessment of hedge effectiveness (for example, theta and vega), an entity shall determine the amount of that change in time value by isolating each of those two aspects in turn in a prespecified order (one first, the other second). The second aspect to be isolated would be based on the ending value of the first isolated aspect and the beginning values of the remaining aspects. The portion of the change in time value that is included in the assessment of effectiveness shall be determined by deducting from the total change in time value the portion of the change in time value attributable to excluded components. (815-20-25-99)

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Skipped paragraphs 815-20-25-100 and 815-20-25-101

Assuming Perfect Hedge Effectiveness in a Hedge with an Interest Rate Swap

15. The conditions for the shortcut method do not determine which hedging relationships qualify for hedge accounting; rather, those conditions determine which hedging relationships qualify for a shortcut version of hedge accounting that assumes perfect hedge effectiveness. If all of the applicable conditions in the list in paragraph 17 815-20-25-104 are met, an entity may assume perfect effectiveness in a hedging relationship of interest rate risk involving a recognized interest-bearing asset or liability (or a firm commitment arising on the trade [pricing] date to purchase or issue an interest-bearing asset or liability) and an interest rate swap (or a compound hedging instrument composed of an interest rate swap and a mirror-image call or put option as discussed in paragraph 17e 815-20-25-104[e]) provided that, in the case of a firm commitment, the trade date of the asset or liability differs from its settlement date due to generally established conventions in the marketplace in which the transaction is executed. The shortcut method's application shall be limited to hedging relationships that meet each and every applicable condition. That is, all the conditions applicable to fair value hedges shall be met to apply the shortcut method to a fair value hedge, and all the conditions applicable to cash flow hedges shall be met to apply the shortcut method to a cash flow hedge. A hedging relationship cannot qualify for application of the shortcut method based on an assumption of perfect effectiveness justified by applying other criteria. The verb *match* is used in the specified conditions in the list to mean *be exactly the same or correspond exactly.* (815-20-25-102)

16. Implicit in the conditions for the shortcut method is the requirement that a basis exist for concluding on an ongoing basis that the hedging relationship is expected to be highly effective in achieving offsetting changes in fair values or cash flows. In applying the shortcut method, an entity shall consider the likelihood of the counterparty's compliance with the contractual terms of the hedging derivative that require the counterparty to make payments to the entity. (815-20-25-103)

17. All of the following conditions apply to both fair value hedges and cash flow hedges: (815-20-25-104)

- a. The notional amount of the interest rate swap matches the principal amount of the interest-bearing asset or liability being hedged.
- b. If the hedging instrument is solely an interest rate swap, the fair value of that interest rate swap at the inception of the hedging relationship must be zero, with one exception. The fair value of the swap may be other than zero at the inception of the hedging relationship only if the swap was entered into at the relationship's inception, the transaction price of the swap was zero in the entity's principal market (or most advantageous market), and the difference between transaction price and fair value is attributable solely to differing prices within the bid-ask spread between the entry transaction and a hypothetical exit transaction. The guidance in the preceding sentence is applicable only to transactions considered *at market* (that is, transaction price is zero exclusive of commissions and other transaction costs, as discussed in paragraph 820-10-35-9B). If the hedging instrument is solely an interest rate swap that at the inception of the hedging relationship has a positive or negative

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fair value, but does not meet the one exception specified in this paragraph, the shortcut method shall not be used even if all the other conditions are met.

- c. If the hedging instrument is a compound derivative composed of an interest rate swap and mirror-image call or put option as discussed in (e), the premium for the mirror-image call or put option shall be paid or received in the same manner as the premium on the call or put option embedded in the hedged item based on the following:
 - i. If the implicit premium for the call or put option embedded in the hedged item is being paid principally over the life of the hedged item (through an adjustment of the interest rate), the fair value of the hedging instrument at the inception of the hedging relationship shall be zero (except as discussed previously in (b) regarding differing prices due to the existence of a bid-ask spread).
 - ii. If the implicit premium for the call or put option embedded in the hedged item was principally paid at inception-acquisition (through an original issue discount or premium), the fair value of the hedging instrument at the inception of the hedging relationship shall be equal to the fair value of the mirror-image call or put option.
- d. The formula for computing net settlements under the interest rate swap is the same for each net settlement. That is, both of the following conditions are met:
 - i. The fixed rate is the same throughout the term.
 - ii. The variable rate is based on the same index and includes the same constant adjustment or no adjustment. The existence of a stub period and stub rate is not a violation of the criterion in (d) that would preclude application of the shortcut method if the stub rate is the variable rate that corresponds to the length of the stub period.
- e. The interest-bearing asset or liability is not prepayable, that is, able to be settled by either party before its scheduled maturity, or the assumed maturity date if the hedged item is measured as a partial-term hedge of interest rate risk in which the assumed maturity of the hedged items occur on the date in which the last hedged cash flow is due and payable, ~~in accordance with paragraph 815-25-35-13B~~, with the following qualifications:
 - i. This criterion does not apply to an interest-bearing asset or liability that is prepayable solely due to an embedded call option (put option) if the hedging instrument is a compound derivative composed of an interest rate swap and a mirror-image call option (put option).
 - ii. The call option embedded in the interest rate swap is considered a mirror image of the call option embedded in the hedged item if all of the following conditions are met:

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- (a.) The terms of the two call options match exactly, including all of the following:
- (1.) Maturities
 - (2.) Strike price (that is, the actual amount for which the debt instrument could be called) and there is no termination payment equal to the deferred debt issuance costs that remain unamortized on the date the debt is called
 - (3.) Related notional amounts
 - (4.) Timing and frequency of payments
 - (5.) Dates on which the instruments may be called.
- (b.) The entity is the writer of one call option and the holder (purchaser) of the other call option.
- f. Any other terms in the interest-bearing financial instruments or interest rate swaps meet both of the following conditions:
- i. The terms are typical of those instruments.
 - ii. The terms do not invalidate the assumption of perfect effectiveness.
18. All of the following incremental conditions apply to fair value hedges only: (815-20-25-105)
- a. The expiration date of the interest rate swap matches the maturity date of the interest-bearing asset or liability or the assumed maturity date if the hedged item is measured as a partial-term hedge of interest rate risk in which the assumed maturity of the hedged items occur on the date in which the last hedged cash flow is due and payable in accordance with paragraph 815-25-35-13B.
 - b. There is no floor or cap on the variable interest rate of the interest rate swap.
 - c. The interval between repricings of the variable interest rate in the interest rate swap is frequent enough to justify an assumption that the variable payment or receipt is at a market rate (generally three to six months or less).
 - d. For fair value hedges of a proportion of the principal amount of the interest-bearing asset or liability, the notional amount of the interest rate swap designated as the hedging instrument (see (a) in paragraph 815-20-25-104) matches the portion of the asset or liability being hedged.

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- e. For fair value hedges of portfolios (or proportions thereof) of similar interest-bearing assets or liabilities, both of the following criteria are met:
 - i. The notional amount of the interest rate swap designated as the hedging instrument matches the aggregate notional amount of the hedged item (whether it is all or a proportion of the total portfolio).
 - ii. The remaining criteria for the shortcut method are met with respect to the interest rate swap and the individual assets or liabilities in the portfolio.
 - f. The index on which the variable leg of the interest rate swap is based matches the benchmark interest rate designated as the interest rate risk being hedged for that hedging relationship.
19. All of the following incremental conditions apply to cash flow hedges only: (815-20-25-106)
- a. All interest receipts or payments on the variable-rate asset or liability during the term of the interest rate swap are designated as hedged.
 - b. No interest payments beyond the term of the interest rate swap are designated as hedged.
 - c. Either of the following conditions is met:
 - i. There is no floor or cap on the variable interest rate of the interest rate swap.
 - ii. The variable-rate asset or liability has a floor or cap and the interest rate swap has a floor or cap on the variable interest rate that is comparable to the floor or cap on the variable-rate asset or liability. For purposes of this paragraph, comparable does not necessarily mean equal. For example, if an interest rate swap's variable rate is based on LIBOR and an asset's variable rate is LIBOR plus 2 percent, a 10 percent cap on the interest rate swap would be comparable to a 12 percent cap on the asset.
 - d. The repricing dates of the variable-rate asset or liability and the hedging instrument must occur on the same dates and be calculated the same way (that is, both shall be either prospective or retrospective). If the repricing dates of the hedged item occur on the same dates as the repricing dates of the hedging instrument but the repricing calculation for the hedged item is prospective whereas the repricing calculation for the hedging instrument is retrospective, those repricing dates do not match.
 - e. For cash flow hedges of the interest payments on only a portion of the principal amount of the interest-bearing asset or liability, the notional amount of the interest rate swap designated as the hedging instrument (~~see paragraph 815-20-25-104(a)~~) matches the

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principal amount of the portion of the asset or liability on which the hedged interest payments are based.

- f. For a cash flow hedge in which the hedged forecasted transaction is a group of individual transactions (as permitted by paragraph 28a of the SSAP guidance ~~paragraph 815-20-25-15(a)~~), if both of the following criteria are met:
 - i. The notional amount of the interest rate swap designated as the hedging instrument (~~see paragraph (a)~~) matches the notional amount of the aggregate group of hedged transactions.
 - ii. The remaining criteria for the shortcut method are met with respect to the interest rate swap and the individual transactions that make up the group. For example, the interest rate repricing dates for the variable-rate assets or liabilities whose interest payments are included in the group of forecasted transactions shall match (that is, be exactly the same as) the reset dates for the interest rate swap.
- g. The index on which the variable leg of the interest rate swap is based matches the contractually specified interest rate designated as the interest rate being hedged for that hedging relationship.

20. The shortcut method may be applied to a hedging relationship that involves the use of an interest rate swap-in-arrears provided all of the applicable conditions are met. (815-20-25-107)

21. Any discount or premium in the hedged debt's carrying amount (including any related deferred issuance costs) is irrelevant to and has no direct impact on the determination of whether an interest rate swap contains a mirror-image call option under paragraph 17e.i.(e). Typically, the call price is greater than the par or face amount of the debt instrument. The carrying amount of the debt is economically unrelated to the amount the issuer would be required to pay to exercise the call embedded in the debt. (815-20-25-108)

22. The fixed interest rate on a hedged item need not exactly match the fixed interest rate on an interest rate swap designated as a fair value hedge. Nor does the variable interest rate on an interest-bearing asset or liability need to be the same as the variable interest rate on an interest rate swap designated as a cash flow hedge. An interest rate swap's fair value comes from its net settlements. The fixed and variable interest rates on an interest rate swap can be changed without affecting the net settlement if both are changed by the same amount. That is, an interest rate swap with a payment based on LIBOR and a receipt based on a fixed rate of 5 percent has the same net settlements and fair value as an interest rate swap with a payment based on LIBOR plus 1 percent and a receipt based on a fixed rate of 6 percent. (815-20-25-109)

23. Comparable credit risk at inception is not a condition for assuming perfect effectiveness even though actually achieving perfect offset would require that the same discount rate be used to determine the fair value of the swap and of the hedged item or hedged transaction. To justify using the same discount rate, the credit risk related to both parties to the swap as well as to the debtor on the hedged interest-bearing asset (in a fair value hedge) or the variable-rate asset on which the interest payments are hedged (in a cash flow

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hedge) would have to be the same. However, because that complication is caused by the interaction of interest rate risk and credit risk, which are not easily separable, comparable creditworthiness is not considered a necessary condition for assuming perfect effectiveness in a hedge of interest rate risk. (815-20-25-111)

Skipped paragraphs 815-20-25-112 through 815-20-25-143

Hedge Effectiveness – After Designation

24. If a fair value hedge or cash flow hedge initially qualifies for hedge accounting, the entity would continue to assess whether the hedge meets the effectiveness test on either a quantitative basis (using either a dollar-offset test or a statistical method such as regression analysis) or a qualitative basis. ~~See paragraphs 815-20-35-2A through 35-2F for additional guidance on qualitative assessments of effectiveness.~~ If the hedge fails the effectiveness test at any time (that is, if the entity does not expect the hedge to be highly effective at achieving offsetting changes in fair values or cash flows), the hedge ceases to qualify for hedge accounting. At least quarterly, the hedging entity shall determine whether the hedging relationship has been highly effective in having achieved offsetting changes in fair value or cash flows through the date of the periodic assessment.) (815-20-35-2)

Effectiveness Assessment on a Qualitative Basis

25. An entity may qualitatively assess hedge effectiveness if both of the following criteria are met: (815-20-35-2A)

- a. An entity performs an initial quantitative test of hedge effectiveness on a prospective basis (that is, it is not assuming that the hedging relationship is perfectly effective at hedge inception ~~as described in paragraph 815-20-25-3(b)(2)(iv)(01)(A) through (H)~~), and the results of that quantitative test demonstrate highly effective offset.
- b. At hedge inception, an entity can reasonably support an expectation of high effectiveness on a qualitative basis in subsequent periods.

26. An entity may elect to qualitatively assess hedge effectiveness in accordance with ~~paragraph 25 815-20-35-2A~~ on a hedge-by-hedge basis. If an entity makes this qualitative assessment election, only the quantitative method specified in an entity's initial hedge documentation must comply with ~~paragraph 7815-20-25-81~~. (815-20-35-2B)

27. When an entity performs qualitative assessments of hedge effectiveness, it shall verify and document whenever financial statements or earnings are reported and at least every three months that the facts and circumstances related to the hedging relationship have not changed such that it can assert qualitatively that the hedging relationship was and continues to be highly effective. While not all-inclusive, the following is a list of indicators that may, individually or in the aggregate, allow an entity to continue to assert qualitatively that the hedging relationship is highly effective: (815-20-35-2C)

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- a. An assessment of the factors that enabled the entity to reasonably support an expectation of high effectiveness on a qualitative basis has not changed such that the entity can continue to assert qualitatively that the hedging relationship was and continues to be highly effective. ~~This shall include an assessment of the guidance in paragraph 815-20-25-100 when applicable.~~
- b. There have been no adverse developments regarding the risk of counterparty default.

28. If an entity elects to assess hedge effectiveness on a qualitative basis and then facts and circumstances change such that the entity no longer can assert qualitatively that the hedging relationship was and continues to be highly effective in achieving offsetting changes in fair values or cash flows, the entity shall assess effectiveness of that hedging relationship on a quantitative basis in subsequent periods. In addition, an entity may perform a quantitative assessment of hedge effectiveness in any reporting period to validate whether qualitative assessments of hedge effectiveness remain appropriate. In both cases, the entity shall apply the quantitative method that it identified in its initial hedge documentation ~~in accordance with paragraph (b)(2)(iv)(03)~~. (815-20-35-2D)

29. When an entity determines that facts and circumstances have changed and it no longer can assert qualitatively that the hedging relationship was and continues to be highly effective, the entity shall begin performing subsequent quantitative assessments of hedge effectiveness as of the period that the facts and circumstances changed. If there is no identifiable event that led to the change in the facts and circumstances of the hedging relationship, the entity may begin performing quantitative assessments of effectiveness in the current period. (815-20-35-2E)

30. After performing a quantitative assessment of hedge effectiveness for one or more reporting periods as discussed in paragraphs ~~28-29~~~~815-20-35-2D through 35-2E~~, an entity may revert to qualitative assessments of hedge effectiveness if it can reasonably support an expectation of high effectiveness on a qualitative basis for subsequent periods. ~~See paragraphs 815-20-55-79G through 55-79N for implementation guidance on factors to consider when determining whether qualitative assessments of effectiveness can be performed after hedge inception.~~ (815-20-35-2F)

Quantitative Hedge Effectiveness Assessments After Hedge Designation

31. Quantitative assessments can be based on regression or other statistical analysis of past changes in fair values or cash flows as well as on other relevant information. (815-20-35-2G)

32. If an entity elects at the inception of a hedging relationship to use the same regression analysis approach for both prospective considerations and retrospective evaluations of assessing effectiveness, then during the term of that hedging relationship both of the following conditions shall be met: (815-20-35-3)

- a. Those regression analysis calculations shall generally incorporate the same number of data points.
- b. That entity must periodically update its regression analysis (or other statistical analysis).

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33. Electing to use a regression or other statistical analysis approach instead of a dollar-offset approach to perform retrospective evaluations of assessing hedge effectiveness may affect whether an entity can apply hedge accounting for the current assessment period. (815-20-35-4)

34. In periodically (that is, at least quarterly) assessing retrospectively the effectiveness of a fair value hedge (or a cash flow hedge) in having achieved offsetting changes in fair values (or cash flows) under a dollar-offset approach, an entity shall use either a period-by-period approach or a cumulative approach on individual fair value hedges (or cash flow hedges): (815-20-35-5)

- a. Period-by-period approach. The period-by-period approach involves comparing the changes in the hedging instrument's fair values (or cash flows) that have occurred during the period being assessed to the changes in the hedged item's fair value (or hedged transaction's cash flows) attributable to the risk hedged that have occurred during the same period. If an entity elects to base its comparison of changes in fair value (or cash flows) on a period-by-period approach, the period cannot exceed three months. Fair value (or cash flow) patterns of the hedging instrument or the hedged item (or hedged transaction) in periods before the period being assessed are not relevant.
- b. Cumulative approach. The cumulative approach involves comparing the cumulative changes (to date from inception of the hedge) in the hedging instrument's fair values (or cash flows) to the cumulative changes in the hedged item's fair value (or hedged transaction's cash flows) attributable to the risk hedged.

35. If an entity elects at inception of a hedging relationship to base its comparison of changes in fair value (or cash flows) on a cumulative approach, then that entity must abide by the results of that methodology as long as that hedging relationship remains designated. Electing to utilize a period-by-period approach instead of a cumulative approach (or vice versa) to perform retrospective evaluations of assessing hedge effectiveness under the dollar-offset method may affect whether an entity can apply hedge accounting for the current assessment period. (815-20-35-6)

Assessing Effectiveness Based on Whether the Critical Terms of the Hedging Instrument and the Hedged Items Match

36. If, at inception, the critical terms of the hedging instrument and the hedged forecasted transaction are the same (see paragraphs ~~10-11 815-20-25-84 through 25-84A~~), the entity can conclude that changes in cash flows attributable to the risk being hedged are expected to be completely offset by the hedging derivative. Therefore, subsequent assessments can be performed by verifying and documenting whether the critical terms of the hedging instrument and the forecasted transaction have changed during the period in review. (815-20-35-9)

37. Because the assessment of hedge effectiveness in a cash flow hedge involves assessing the likelihood of the counterparty's compliance with the contractual terms of the derivative instrument designated as the hedging instrument, the entity must also assess whether there have been adverse

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developments regarding the risk of counterparty default, particularly if the entity planned to obtain its cash flows by liquidating the derivative instrument at its fair value. (815-20-35-10)

38. If there are no such changes in the critical terms or adverse developments regarding counterparty default, the entity may conclude that the hedging relationship is perfectly effective. In that case, the change in fair value of the derivative instrument can be viewed as a proxy for the present value of the change in cash flows attributable to the risk being hedged. (815-20-35-11)

39. However, the entity must assess whether the hedging relationship is expected to continue to be highly effective using a quantitative assessment method (either a dollar-offset test or a statistical method such as regression analysis) if any of the following conditions exist: (815-20-35-12)

- a. The critical terms of the hedging instrument or the hedged forecasted transaction have changed.
- b. There have been adverse developments regarding the risk of counterparty default.

Possibility of Default by the Counterparty to Hedging Derivative

40. For an entity to conclude on an ongoing basis that the hedging relationship is expected to be highly effective in achieving offsetting changes in cash flows, the entity shall not ignore whether it will collect the payments it would be owed under the contractual provisions of the derivative instrument. In complying with the requirements of paragraph ~~2b815-20-25-75(b)~~, the entity shall assess the possibility of whether the counterparty to the derivative instrument will default by failing to make any contractually required payments to the entity as scheduled in the derivative instrument. In making that assessment, the entity shall also consider the effect of any related collateralization or financial guarantees. The entity shall be aware of the counterparty's creditworthiness (and changes therein) in determining the fair value of the derivative instrument. Although a change in the counterparty's creditworthiness would not necessarily indicate that the counterparty would default on its obligations, such a change shall warrant further evaluation. (815-20-35-14)

41. If the likelihood that the counterparty will not default ceases to be probable, an entity would be unable to conclude that the hedging relationship in a cash flow hedge is expected to be highly effective in achieving offsetting cash flows. (815-20-35-15)

42. In contrast, a change in the creditworthiness of the derivative instrument's counterparty in a fair value hedge would have an immediate effect because that change in creditworthiness would affect the change in the derivative instrument's fair value, which would immediately affect both of the following: (815-20-35-16)

- a. The assessment of whether the relationship qualifies for hedge accounting
- b. The amount of mismatch between the change in the fair value of the hedging instrument and the hedged item attributable to the hedged risk recognized in earnings under fair value hedge accounting.

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43. Paragraph 16815-20-25-103 states that, in applying the shortcut method, an entity shall consider the likelihood of the counterparty's compliance with the contractual terms of the hedging derivative that require the counterparty to make payments to the entity. That paragraph explains that implicit in the criteria for the shortcut method is the requirement that a basis exist for concluding on an ongoing basis that the hedging relationship is expected to be highly effective in achieving offsetting changes in fair values or cash flows. (815-20-35-18)

Change in Hedge Effectiveness Method When Hedge Effectiveness is Assessed on a Quantitative Basis

44. If the entity identifies an improved method of assessing hedge effectiveness in accordance with the guidance in paragraph 6815-20-25-80 and wants to apply that method prospectively, it shall do both of the following: (815-20-35-19)

- a. Discontinue the existing hedging relationship
- b. Designate the relationship anew using the improved method.

45. The new method of assessing hedge effectiveness shall be applied prospectively and shall also be applied to similar hedges unless the use of a different method for similar hedges is justified. A change in the method of assessing hedge effectiveness by an entity shall not be considered a change in accounting principle as defined in Topic 250SSAP No. 3—Accounting Changes and Corrections of Errors. (815-20-35-20)

U.S. GAAP ASC Excerpts Proposed to be Excluded from Exhibit A

This information is included to illustrate the guidance within the adopted ASC references that are not proposed to be captured in Exhibit A. The guidance within these paragraphs would be considered part of the statutory adoption unless they include specific accounting and reporting guidance. Comments are requested on whether any of the following paragraphs should be explicitly captured in Exhibit A.

Skip 815-20-25-79A

815-20-25-79A See paragraphs 815-20-25-139 through 25-142 about the timing of hedge effectiveness assessments required by paragraph 815-20-25-79 for a private company that is not a financial institution or a not-for-profit entity (except for a not-for-profit entity that has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market).

Skipped paragraphs 815-20-25-86 through 815-20-25-97

815-20-25-86 The remainder of this guidance on hedge effectiveness criteria applicable to both fair value hedges and cash flow hedges is organized as follows:

- a. Hedge effectiveness when the hedging instrument is an option or combination of options
- b. Hedge effectiveness when hedged exposure is more limited than hedging instrument

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- c. Hedge effectiveness during designated hedge period
- d. Assuming perfect effectiveness in a hedge with an interest rate swap (the shortcut method).

Hedge Effectiveness When the Hedging Instrument Is an Option or Combination of Options

815-20-25-87 The hedge effectiveness criteria applicable to options and combinations of options are organized as follows:

- a. Determining whether a combination of options is net written
- b. Hedge effectiveness of written options
- c. Hedge effectiveness of options in general.

Determining Whether a Combination of Options Is Net Written

815-20-25-88 This guidance addresses how an entity shall determine whether a combination of options is considered a net written option subject to the requirements of paragraph 815-20-25-94. A combination of options (for example, an interest rate collar) entered into contemporaneously shall be considered a written option if either at inception or over the life of the contracts a net premium is received in cash or as a favorable rate or other term. Furthermore, a derivative instrument that results from combining a written option and any other non-option derivative instrument shall be considered a written option. The determination of whether a combination of options is considered a net written option depends in part on whether strike prices and notional amounts of the options remain constant.

Strike Prices and Notional Amounts Remain Constant

815-20-25-89 For a combination of options in which the strike price and the notional amount in both the written option component and the purchased option component remain constant over the life of the respective component, that combination of options would be considered a net purchased option or a zero cost collar (that is, the combination shall not be considered a net written option subject to the requirements of paragraph 815-20-25-94) provided all of the following conditions are met:

- a. No net premium is received.
- b. The components of the combination of options are based on the same underlying.
- c. The components of the combination of options have the same maturity date.
- d. The notional amount of the written option component is not greater than the notional amount of the purchased option component.

815-20-25-90 If the combination of options does not meet all of those conditions, it shall be subject to the test in paragraph 815-20-25-94. For example, a combination of options having different underlying indexes, such as a collar containing a written floor based on three-month U.S. Treasury rates and a purchased cap

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based on three-month London Interbank Offered Rate (LIBOR), shall not be considered a net purchased option or a zero cost collar even though those rates may be highly correlated.

Strike Prices and Notional Amounts Do Not Remain Constant

815-20-25-91 If either the written option component or the purchased option component for a combination of options has either strike prices or notional amounts that do not remain constant over the life of the respective component, the assessment to determine whether that combination of options can be considered not to be a written option under paragraph 815-20-25-88 shall be evaluated with respect to each date that either the strike prices or the notional amounts change within the contractual term from inception to maturity.

815-20-25-92 Even though that assessment is made on the date that a combination of options is designated as a hedging instrument (to determine the applicability of paragraph 815-20-25-94), it shall consider the receipt of a net premium (in cash or as a favorable rate or other term) from that combination of options at each point in time that either the strike prices or the notional amounts change, such as either of the following circumstances:

- a. If strike prices fluctuate over the life of a combination of options and no net premium is received at inception, a net premium will typically be received as a favorable term in one or more reporting periods within the contractual term from inception to maturity.
- b. If notional amounts fluctuate over the life of a combination of options and no net premium is received at inception, a net premium or a favorable term will typically be received in one or more periods within the contractual term from inception to maturity.

815-20-25-93 In addition, a combination of options in which either the written option component or the purchased option component has either strike prices or notional amounts that do not remain constant over the life of the respective component shall satisfy all of the conditions in paragraph 815-20-25-89 to be considered not to be a written option (that is, to be considered to be a net purchased option or zero cost collar) under paragraph 815-20-25-88. For example, if the notional amount of the written option component is greater than the notional amount of the purchased option component at any date that the notional amount changes within the contractual term from inception to maturity, the combination of options shall be considered to be a written option under paragraph 815-20-25-88 and, thus, subject to the criteria in the following paragraph.

Hedge Effectiveness of Written Options

815-20-25-94 If a written option is designated as hedging a recognized asset or liability or an unrecognized firm commitment (if a fair value hedge) or the variability in cash flows for a recognized asset or liability or an unrecognized firm commitment (if a cash flow hedge), the combination of the hedged item and the written option provides either of the following:

- a. At least as much potential for gains as a result of a favorable change in the fair value of the combined instruments (that is, the written option and the hedged item, such as an embedded

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purchased option) as exposure to losses from an unfavorable change in their combined fair value (if a fair value hedge)

- b. At least as much potential for favorable cash flows as exposure to unfavorable cash flows (if a cash flow hedge).

815-20-25-95 The written-option test in the preceding paragraph shall be applied only at inception of the hedging relationship and is met if all possible percentage favorable changes in the underlying (from zero percent to 100 percent) would provide either of the following:

- a. At least as much gain as the loss that would be incurred from an unfavorable change in the underlying of the same percentage (if a fair value hedge)
- b. At least as much favorable cash flows as the unfavorable cash flows that would be incurred from an unfavorable change in the underlying of the same percentage (if a cash flow hedge).

815-20-25-96 The time value of a written option (or net written option) may be excluded from the written-option test if, in defining how hedge effectiveness will be assessed, the entity specifies that it will base that assessment on only changes in the option's intrinsic value. In that circumstance, the change in the time value of the options would be excluded from the assessment of hedge effectiveness in accordance with paragraph 815-20-25-82(a).

815-20-25-97 When applying the written-option test to determine whether there is symmetry of the gain and loss potential of the combined hedged position for all possible percentage changes in the underlying, an entity is permitted to measure the change in the intrinsic value of the written option (or net written option) combined with the change in fair value of the hedged item.

Skipped paragraphs 815-20-25-100 and 815-20-25-101

Hedge Effectiveness When Hedged Exposure Is More Limited Than Hedging Instrument

815-20-25-100 An entity may designate as the hedging instrument in a fair value hedge or cash flow hedge a derivative instrument that does not have a limited exposure comparable to the limited exposure of the hedged item to the risk being hedged. However, to make that designation, in accordance with paragraph 815-20-25-75, the entity shall establish that the hedging relationship is expected to be highly effective in achieving offsetting changes in fair value or cash flows attributable to the hedged risk during the period that the hedge is designated. See paragraph 815-20-25-79(a) for additional guidance on prospective considerations of hedge effectiveness in this circumstance.

Hedge Effectiveness during Designated Hedge Period

815-20-25-101 It is inappropriate under this Subtopic for an entity to designate a derivative instrument as the hedging instrument if the entity expects that the derivative instrument will not be highly effective in achieving offsetting changes in fair value or cash flows attributable to the hedged risk during the period

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that the hedge is designated, unless the entity has documented undertaking a dynamic hedging strategy in which it has committed itself to an ongoing repositioning strategy for its hedging relationship.

Skipped paragraphs 815-20-25-112 through 815-20-25-143

>>> Application of Prepayable Criterion

815-20-25-112 An interest-bearing asset or liability shall be considered prepayable under the provisions of paragraph 815-20-25-104(e) if one party to the contract has the right to cause the payment of principal before the scheduled payment dates unless either of the following conditions is met:

- a. The debtor has the right to cause settlement of the entire contract before its stated maturity at an amount that is always greater than the then fair value of the contract absent that right.
- b. The creditor has the right to cause settlement of the entire contract before its stated maturity at an amount that is always less than the then fair value of the contract absent that right.

815-20-25-113 However, none of the following shall be considered a prepayment provision:

a. Any term, clause, or other provision in a debt instrument that gives the debtor or creditor the right to cause prepayment of the debt contingent upon the occurrence of a specific event related to the debtor's credit deterioration or other change in the debtor's credit risk, such as any of the following:

1. The debtor's failure to make timely payment, thus making it delinquent
2. The debtor's failure to meet specific covenant ratios
3. The debtor's disposition of specific significant assets (such as a factory)
4. A declaration of cross-default
5. A restructuring by the debtor.

b. Any term, clause, or other provision in a debt instrument that gives the debtor or creditor the right to cause prepayment of the debt contingent upon the occurrence of a specific event that meets all of the following conditions:

1. It is not probable at the time of debt issuance.
2. It is unrelated to changes in benchmark interest rates, contractually specified interest rates, or any other market variable.
3. It is related either to the debtor's or creditor's death or to regulatory actions, legislative actions, or other similar events that are beyond the control of the debtor or creditor.

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c. Contingent acceleration clauses that permit the debtor to accelerate the maturity of an outstanding note only upon the occurrence of a specified event that meets all of the following conditions:

1. It is not probable at the time of debt issuance.
2. It is unrelated to changes in benchmark interest rates, contractually specified interest rates, or any other market variable.
3. It is related to regulatory actions, legislative actions, or other similar events that are beyond the control of the debtor or creditor.

815-20-25-114 Furthermore, a right to cause a contract to be prepaid at its then fair value would not cause the interest-bearing asset or liability to be considered prepayable because that right would have a fair value of zero at all times and essentially would provide only liquidity to the holder.

815-20-25-115 Application of this guidance to specific debt instruments is illustrated in paragraph 815-20-55-75.

Application of the Shortcut Method to a Portfolio of Hedged Items

815-20-25-116 Portfolio hedging cannot be used to circumvent the application of the shortcut method criteria beginning in paragraph 815-20-25-102 to a fair value hedge of an individual interest-bearing asset or liability. A portfolio of interest-bearing assets or interest-bearing liabilities cannot qualify for the shortcut method if it contains an interest-bearing asset or liability that individually cannot qualify for the shortcut method.

815-20-25-117 The fair value hedge requirements of paragraph 815-20-25-12(b)(1) ensure that the individual items in a portfolio share the same risk exposure and have fair value changes attributable to the hedged risk that are expected to respond in a generally proportionate manner to the overall fair value changes of the entire portfolio. That requirement restricts the types of portfolios that can qualify for portfolio hedging; however, it also permits the existence of a mismatch between the change in the fair value of the individual hedged items and the change in the fair value of the hedged portfolio attributable to the hedged risk in portfolios that do qualify. As a result, the assumption of perfect effectiveness required for the shortcut method generally is inappropriate for portfolio hedges of similar assets or liabilities that are not also nearly identical (except for their notional amounts). Application of the shortcut method to portfolios that meet the requirements of paragraph 815-20-25-12(b)(1) is appropriate only if the assets or liabilities in the portfolio meet the same stringent criteria in paragraphs 815-20-25-104(e), 815-20-25-104(g), and 815-20-25-105(a) as required for hedges of individual assets and liabilities.

Application of Whether the Shortcut Method Was Not or No Longer Is Appropriate

815-20-25-117A In the period in which an entity determines that use of the shortcut method was not or no longer is appropriate, the entity may use a quantitative method to assess hedge effectiveness and

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measure hedge results without dedesignating the hedging relationship if both of the following criteria are met:

- a. The entity documented at hedge inception in accordance with paragraph 815-20-25-3(b)(2)(iv)(04) which quantitative method it would use to assess hedge effectiveness and measure hedge results if the shortcut method was not or no longer is appropriate during the life of the hedging relationship.
- b. The hedging relationship was highly effective on a prospective and retrospective basis in achieving offsetting changes in fair value or cash flows attributable to the hedged risk for the periods in which the shortcut method criteria were not met.

815-20-25-117B If the criterion in paragraph 815-20-25-117A(a) is not met, the hedging relationship shall be considered invalid in the period in which the criteria for the shortcut method were not met and in all subsequent periods. If the criterion in paragraph 815-20-25-117A(a) is met, the hedging relationship shall be considered invalid in all periods in which the criterion in paragraph 815-20-25-117A(b) is not met.

815-20-25-117C If an entity cannot identify the date on which the shortcut criteria ceased to be met, the entity shall perform the quantitative assessment of effectiveness documented at hedge inception for all periods since hedge inception.

815-20-25-117D The terms of the hedged item and hedging instrument used to assess effectiveness, in accordance with paragraph 815-20-25-117A(b), shall be those existing as of the date that the shortcut criteria ceased to be met. For cash flow hedges, if the hypothetical derivative method is used as a proxy for the hedged item, the value of the hypothetical derivative shall be set to zero as of hedge inception.

Hedge Effectiveness Criterion Applicable to Fair Value Hedges Only—Effectiveness Horizon

815-20-25-118 In documenting its risk management strategy for a fair value hedge, an entity may specify an intent to consider the possible changes (that is, not limited to the likely or expected changes) in value of the hedging derivative instrument and the hedged item only over a shorter period than the derivative instrument's remaining life in formulating its expectation that the hedging relationship will be highly effective in achieving offsetting changes in fair value for the risk being hedged. The entity does not need to contemplate the offsetting effect for the entire term of the hedging instrument.

Consideration of Prepayment Risk Using the Last-of-Layer Method

815-20-25-118A In a fair value hedge of interest rate risk designated under the last-of-layer method in accordance with paragraph 815-20-25-12A, an entity may exclude prepayment risk when measuring the change in fair value of the hedged item attributable to interest rate risk.

Hedge Effectiveness Criteria Applicable to Cash Flow Hedges Only

815-20-25-119 The hedge effectiveness criteria applicable to cash flow hedges only are organized as follows:

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- a. Consideration of the time value of money
- b. Consideration of counterparty credit risk
- c. Additional considerations for options in cash flow hedges
- d. Assuming perfect hedge effectiveness in a cash flow hedge of a variable-rate borrowing with a receive-variable, pay-fixed interest rate swap recorded under the simplified hedge accounting approach.

Consideration of the Time Value of Money

815-20-25-120 In assessing the effectiveness of a cash flow hedge, an entity generally shall consider the time value of money, especially if the hedging instrument involves periodic cash settlements.

815-20-25-121 An example of a situation in which an entity likely would reflect the time value of money is a tailing strategy with futures contracts. When using a tailing strategy, an entity adjusts the size or contract amount of futures contracts used in a hedge so that earnings (or expense) from reinvestment (or funding) of daily settlement gains (or losses) on the futures do not distort the results of the hedge. To assess offset of expected cash flows when a tailing strategy has been used, an entity could reflect the time value of money, perhaps by comparing the present value of the hedged forecasted cash flow with the results of the hedging instrument.

Consideration of Counterparty Credit Risk

815-20-25-122 For a cash flow hedge, an entity shall consider the likelihood of the counterparty's compliance with the contractual terms of the hedging derivative instrument that require the counterparty to make payments to the entity. Paragraph 815-20-35-14 states that, for an entity to conclude on an ongoing basis that a cash flow hedging relationship is expected to be highly effective in achieving offsetting changes in cash flows, the entity shall not ignore whether it will collect the payments it would be owed under the contractual provisions of the derivative instrument. See paragraphs 815-20-35-14 through 35-18 for further guidance.

Additional Considerations for Options in Cash Flow Hedges

815-20-25-123 When an entity has documented that the effectiveness of a cash flow hedge will be assessed based on changes in the hedging option's intrinsic value pursuant to paragraph 815-20-25-82(a), that assessment (and the related cash flow hedge accounting) shall be performed for all changes in intrinsic value—that is, for all periods of time when the option has an intrinsic value, such as when the underlying is above the strike price of the call option.

815-20-25-124 When a purchased option is designated as a hedging instrument in a cash flow hedge, an entity shall not define only limited parameters for the risk exposure designated as being hedged that would include the time value component of that option. An entity cannot arbitrarily exclude some portion of an option's intrinsic value from the hedge effectiveness assessment simply through an articulation of the risk

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exposure definition. It is inappropriate to assert that only limited risk exposures are being hedged (for example, exposures related only to currency-exchange-rate changes above \$1.65 per pound sterling as illustrated in Example 26 [see paragraph 815-20-55-205]).

815-20-25-125 If an option is designated as the hedging instrument in a cash flow hedge, an entity may assess hedge effectiveness based on a measure of the difference, as of the end of the period used for assessing hedge effectiveness, between the strike price and forward price of the underlying, undiscounted. Although assessment of cash flow hedge effectiveness with respect to an option designated as the hedging instrument in a cash flow hedge shall be performed by comparing the changes in present value of the expected future cash flows of the forecasted transaction to the change in fair value of the derivative instrument (aside from any excluded component under paragraph 815-20-25-82), that measure of changes in the expected future cash flows of the forecasted transaction based on forward rates, undiscounted, is not prohibited. With respect to an option designated as the hedging instrument in a cash flow hedge, assessing hedge effectiveness based on a similar measure with respect to the hedging instrument eliminates any difference that the effect of discounting may have on the hedging instrument and the hedged transaction. Pursuant to paragraph 815-20-25-3(b)(2)(iv), entities shall document the measure of intrinsic value that will be used in the assessment of hedge effectiveness. As discussed in paragraph 815-20-25-80, that measure must be used consistently for each period following designation of the hedging relationship.

Assessing Hedge Effectiveness Based on an Option's Terminal Value

815-20-25-126 The guidance in paragraph 815-20-25-129 addresses a cash flow hedge that meets all of the following conditions:

- a. The hedging instrument is a purchased option or a combination of only options that comprise either a net purchased option or a zero-cost collar.
- b. The exposure being hedged is the variability in expected future cash flows attributed to a particular rate or price beyond (or within) a specified level (or levels).
- c. The assessment of effectiveness is documented as being based on total changes in the option's cash flows (that is, the assessment will include the hedging instrument's entire change in fair value, not just changes in intrinsic value).

815-20-25-127 This guidance has no effect on the accounting for fair value hedging relationships. In addition, in determining the accounting for seemingly similar cash flow hedging relationships, it would be inappropriate to analogize to this guidance.

815-20-25-128 For a hedging relationship that meets all of the conditions in paragraph 815-20-25-126, an entity may focus on the hedging instrument's terminal value (that is, its expected future pay-off amount at its maturity date) in determining whether the hedging relationship is expected to be highly effective in achieving offsetting cash flows attributable to the hedged risk during the term of the hedge. An entity's focus on the hedging instrument's terminal value is not an impediment to the entity's subsequently deciding to redesignate that cash flow hedge before the occurrence of the hedged transaction. If the hedging instrument is a purchased cap consisting of a series of purchased caplets that are each hedging an individual

Note: On August 10, 2022, the Statutory Accounting Principles (E) Working Group adopted a new Exhibit A as detailed within this document (This is new guidance and any tracked changes within show changes from U.S. GAAP. That tracking will not be shown in SSAP No. 86.)

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hedged transaction in a series of hedged transactions (such as caplets hedging a series of hedged interest payments at different monthly or quarterly dates), the entity may focus on the terminal value of each caplet (that is, the expected future pay-off amount at the maturity date of each caplet) in determining whether each of those hedging relationships is expected to be highly effective in achieving offsetting cash flows. The guidance in this paragraph applies to a purchased option regardless of whether at the inception of the cash flow hedging relationship it is at the money, in the money, or out of the money.

815-20-25-129 A hedging relationship that meets all of the conditions in paragraph 815-20-25-126 may be considered to be perfectly effective if all of the following conditions are met:

- a. The critical terms of the hedging instrument (such as its notional amount, underlying, maturity date, and so forth) completely match the related terms of the hedged forecasted transaction (such as the notional amount, the variable that determines the variability in cash flows, the expected date of the hedged transaction, and so forth).
- b. The strike price (or prices) of the hedging option (or combination of options) matches the specified level (or levels) beyond (or within) which the entity's exposure is being hedged.
- c. The hedging instrument's inflows (outflows) at its maturity date completely offset the change in the hedged transaction's cash flows for the risk being hedged.
- d. The hedging instrument can be exercised only on a single date—its contractual maturity date.

The condition in (d) is consistent with the entity's focus on the hedging instrument's terminal value. If the holder of the option chooses to pay for the ability to exercise the option at dates before the maturity date (for example, by acquiring an American-style option), the hedging relationship would not be perfectly effective.

815-20-25-129A In a hedge of a group of forecasted transactions in accordance with paragraph 815-20-25-15(a)(2), an entity may assume that the timing in which the hedged transactions are expected to occur and the maturity date of the hedging instrument match in accordance with paragraph 815-20-25-129(a) if those forecasted transactions occur and the derivative matures within the same 31-day period or fiscal month.

Hedge Effectiveness of a Net-Purchased Combination of Options

815-20-25-130 The guidance in the following paragraph addresses a cash flow hedging relationship that meets both of the following conditions:

- a. A combination of options (deemed to be a net purchased option) is designated as the hedging instrument.
- b. The effectiveness of the hedge is assessed based only on changes in intrinsic value of the hedging instrument (the combination of options).

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815-20-25-131 The assessment of effectiveness of a cash flow hedging relationship meeting the conditions in the preceding paragraph may be based only on changes in the underlying that cause a change in the intrinsic value of the hedging instrument (the combination of options). Thus, the assessment can exclude ranges of changes in the underlying for which there is no change in the hedging instrument's intrinsic value.

Hedge Accounting Provisions Applicable to Certain Private Companies

Assuming Perfect Hedge Effectiveness in a Cash Flow Hedge of a Variable-Rate Borrowing with a Receive-Variable, Pay-Fixed Interest Rate Swap Recorded under the Simplified Hedge Accounting Approach

815-20-25-133 Paragraphs 815-10-35-1A through 35-1C, 815-10-50-3, 815-20-25-3A, 815-20-25-119, 815-20-25-134 through 25-138, 815-20-55-79A through 55-79B, 825-10-50-3, and 825-10-50-8 provide guidance for an entity electing the simplified hedge accounting approach. See paragraph 815-10-65-6 for transition guidance on applying the simplified hedge accounting approach.

815-20-25-134 The conditions for the simplified hedge accounting approach determine which cash flow hedging relationships qualify for a simplified version of hedge accounting. If all of the conditions in paragraphs 815-20-25-135 and 815-20-25-137 are met, an entity may assume perfect effectiveness in a cash flow hedging relationship involving a variable-rate borrowing and a receive-variable, pay-fixed interest rate swap.

815-20-25-135 Provided all of the conditions in paragraph 815-20-25-137 are met, the simplified hedge accounting approach may be applied by a **private company** except for a financial institution as described in paragraph 942-320-50-1. An entity may elect the simplified hedge accounting approach for any receive-variable, pay-fixed interest rate swap, provided that all of the conditions for applying the simplified hedge accounting approach specified in paragraph 815-20-25-137 are met. Implementation guidance on the conditions set forth in paragraph 815-20-25-137 is provided in paragraphs 815-20-55-79A through 55-79B.

815-20-25-136 In applying the simplified hedge accounting approach, the documentation required by paragraph 815-20-25-3 to qualify for hedge accounting must be completed by the date on which the first annual **financial statements are available to be issued** after hedge inception rather than concurrently at hedge inception.

815-20-25-137 An eligible entity under paragraph 815-20-25-135 must meet all of the following conditions to apply the simplified hedge accounting approach to a cash flow hedge of a variable-rate borrowing with a receive-variable, pay-fixed interest rate swap:

- a. Both the variable rate on the swap and the borrowing are based on the same index and reset period (for example, both the swap and borrowing are based on one-month London Interbank Offered Rate [LIBOR] or both the swap and borrowing are based on three-month LIBOR).
- b. The terms of the swap are typical (in other words, the swap is what is generally considered to be a “plain-vanilla” swap), and there is no floor or cap on the variable interest rate of the swap unless the borrowing has a comparable floor or cap.

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- c. The repricing and settlement dates for the swap and the borrowing match or differ by no more than a few days.
- d. The swap's fair value at inception (that is, at the time the derivative was executed to hedge the interest rate risk of the borrowing) is at or near zero.
- e. The notional amount of the swap matches the principal amount of the borrowing being hedged. In complying with this condition, the amount of the borrowing being hedged may be less than the total principal amount of the borrowing.
- f. All interest payments occurring on the borrowing during the term of the swap (or the effective term of the swap underlying the forward starting swap) are designated as hedged whether in total or in proportion to the principal amount of the borrowing being hedged.

815-20-25-138 A cash flow hedge established through the use of a forward starting receive-variable, pay-fixed interest rate swap may be permitted in applying the simplified hedge accounting approach only if the occurrence of forecasted interest payments to be swapped is probable. When forecasted interest payments are no longer probable of occurring, a cash flow hedging relationship will no longer qualify for the simplified hedge accounting approach and the General Subsections of this Topic shall apply at the date of change and on a prospective basis.

Timing of Hedge Documentation for Certain Private Companies If Simplified Hedge Accounting Approach Is Not Applied

Concurrent Hedge Documentation

815-20-25-139 Concurrent with hedge inception, a **private company** that is not a financial institution as described in paragraph 942-320-50-1 shall document the following:

- a. The hedging relationship in accordance with paragraph 815-20-25-3(b)(1)
- b. The hedging instrument in accordance with paragraph 815-20-25-3(b)(2)(i)
- c. The hedged item in accordance with paragraph 815-20-25-3(b)(2)(ii), including (if applicable) firm commitments or the analysis supporting a last-of-layer designation in paragraph 815-20-25-3(c), or forecasted transactions in paragraph 815-20-25-3(d)
- d. The nature of the risk being hedged in accordance with paragraph 815-20-25-3(b)(2)(iii).

815-20-25-140 A private company that is not a financial institution is not required to perform or document the following items concurrent with hedge inception but rather is required to perform or document them within the time periods discussed in paragraph 815-20-25-142:

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- a. The method of assessing hedge effectiveness at inception and on an ongoing basis in accordance with paragraph 815-20-25-3(b)(2)(iv) and (vi)
- b. Initial hedge effectiveness assessments in accordance with paragraph 815-20-25-3(b)(2)(iv)(01) through (04).

815-20-25-141 Example 1A beginning in paragraph 815-20-55-80A illustrates hedge documentation when the critical terms of the hedging instrument and hedged forecasted transaction match. Although that Example illustrates the documentation of the method of assessing hedge effectiveness, private companies that are not financial institutions may complete hedge documentation requirements in accordance with paragraphs 815-20-25-139 through 25-140.

Hedge Effectiveness Assessments

815-20-25-142 For a private company that is not a financial institution, the performance and documentation of the items listed in paragraph 815-20-25-140, as well as required subsequent quarterly hedge effectiveness assessments, may be completed before the date on which the next interim (if applicable) or annual financial statements are available to be issued. Even though the completion of the initial and ongoing assessments of effectiveness may be deferred to the date on which financial statements are available to be issued the assessments shall be completed using information applicable as of hedge inception and each subsequent quarterly assessment date when completing this documentation on a deferred basis. Therefore, the assessment should be performed to determine whether the hedge was highly effective at achieving offsetting changes in fair values or cash flows at inception and in each subsequent quarterly assessment period up to the reporting date.

Hedge Accounting Provisions Applicable to Certain Not-for-Profit Entities

815-20-25-143 Not-for-profit entities (except for not-for-profit entities that have issued, or are a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market) may apply the guidance on the timing of hedge documentation and hedge effectiveness assessments in paragraphs 815-20-25-139 through 25-142. Specifically, those entities shall document the items listed in paragraph 815-20-25-139 concurrent with hedge inception, but they may perform and document the items listed in paragraph 815-20-25-140 and perform the required subsequent quarterly hedge effectiveness assessments in accordance with paragraph 815-20-25-142 within the time periods discussed in paragraph 815-20-25-142.

https://naiconline.sharepoint.com/sites/NAICSupportStaffHub/Member Meetings/E CMTE/APPTF/2022SummerNM/1_SAPWG/Minutes/Attachment One-I_21-20_SSAP86_Exhibit A.docx

Note: On August 10, 2022, the Statutory Accounting Principles (E) Working Group adopted the proposed revisions shown as tracked changes to SSAP No. 86 within this document.

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Review of U.S. derivative guidance and the application to SAP is complex with many facets. This document is the second of two initial documents and focuses on the accounting and reporting of hedging instruments, including excluded components.

2) Measurement of Excluded Components In Hedging Instruments

Existing guidance in SSAP No. 86, paragraph 40, Exhibit B – Assessment of Hedging Effectiveness, and Exhibit C – Specific Hedge Accounting Procedures for Derivatives address components permitted to be excluded when determining hedge effectiveness and/or the measurement of excluded components. Key elements to note with regards to the existing guidance:

- Components permitted for exclusion in Exhibit B were adopted from U.S. GAAP (FAS 133, paragraph 63) at the time of initial SSAP adoption. Although these have not been updated since original issuance, NAIC staff is proposing (in the Hedge Effectiveness review document) to continue the adoption of U.S. GAAP in determining hedge effectiveness. This will ensure that hedging instruments identified as effective hedges under U.S. GAAP will be considered effective hedges under statutory accounting principles.
- The guidance in paragraph 40 and Exhibit B appears to adopt U.S. GAAP with the treatment of accounting for excluded components at fair value, with changes in fair value recognized as unrealized gains or losses.
- The existing guidance adopted from U.S. GAAP (in paragraph 40 and Exhibit B) is contradictory to guidance in SSAP No. 86, paragraph 23 and Exhibit C. Pursuant to paragraph 23, entities should not bifurcate the effectiveness of derivatives and a derivative instrument is either classified as an effective hedge or an ineffective hedge. If classified as an effective hedge, then the measurement method of the hedged item is used for the hedging instrument (e.g., amortized cost). This guidance does not seemingly permit reporting entities to report part of a hedging instrument at amortized cost, with excluded components reported at fair value. (However, NAIC staff believes this may in fact occur in practice under the provisions of paragraph 40 and Exhibit B.)
- Furthermore, the guidance in Exhibit C for foreign currency swaps and forwards identifies that premiums / discounts shall be amortized into income over the life of the contract. This treatment is different than the fair value / change in unrealized recognition for excluded component detailed in paragraph 40 and Exhibit B. (This guidance has been part of Exhibit C since the original adoption of the SSAP and reflects a difference from U.S. GAAP.)

Interested parties have identified that the SAP treatment of excluded components related to foreign currency transactions are hindering the ability to engage in those transactions and have requested consideration to 1) clarify the inconsistent guidance in SSAP No. 86, and 2) consider SAP specific measurement methods for excluded components to prevent surplus volatility from derivative transactions.

As background information, the classification of derivatives as highly effective is ultimately an income-statement matching tool. Although all derivatives are reported at fair value under U.S. GAAP, if effective

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hedges, then changes in fair value are allocated to either net income or other comprehensive income (OCI) in a manner that matches and predominantly offsets the fluctuations from the hedged item. (For example, under U.S. GAAP, a fair value hedge requires both the hedging instrument and the hedged item to be reported at fair value, so fluctuations on one offset by the other.) Under SAP, as the hedged items are not commonly reported at fair value, the guidance in SSAP No. 86 permits the derivative to reflect a measurement method that is more akin to the hedged item. (So, if hedging a bond at amortized cost, the hedging instrument would also be reported at amortized cost. This prevents fair value fluctuations from the highly effective hedge from causing ‘noise’ in the financial statements throughout the hedge duration.)

Interested parties have communicated that requiring excluded components for foreign currency hedges to be recognized at fair value, with changes in fair value recognized as unrealized gains / losses, the financial statements show volatility that is not reflective of the underlying hedging transaction:

- For foreign currency forward contracts that have a premium / discount (e.g., forward point – difference between the forward contract rate and the spot rate at derivative execution), the amount required is set at origination. Although the change in spot rate over the hedge term could result with a fair value change of the forward point / premium, this change in fair value does not impact the required amount that was set at derivative execution. (Under Exhibit C, the existing guidance would require amortization of the premium, but this is conflicting with paragraph 40 and Exhibit B.) Regardless of if the derivative is terminated early or is identified as ineffective, there is no change to the amount required from the forward point determined at derivative execution. (**As such, requiring recognition at fair value, and the change of fair value, does not result with a presentation of the amount owed by the reporting entity.**)
- For a foreign currency swap with a cross-currency basis spread, the fair value changes are captured as part of the foreign currency periodic interest accruals. (A forward contract does not have periodic interest accruals, which is why the premium / forward point is proposed to be amortized under the prior example). Furthermore, regardless of if the derivative transaction continues to be effective, at the time of derivative maturity, the cross-currency basis spread is zero. The only time a reporting entity would be obligated to provide payment for a cross-currency basis spread is if the currency swap is terminated prior to maturity. Interested parties have noted that this is unlikely for the following reasons:
 - Most foreign bond exposures come through private investments that are generally more difficult to sell, providing a disincentive to selling the bond exposure.
 - The investment was originally acquired as the risk profile of the foreign bond was attractive to the reporting entity over the term of the investment. So, unless the bond issuer is having significant credit deterioration, it is unlikely an insurer will sell the bond.
 - In the event the foreign bond is terminated early, the derivative would also be terminated early. This will result in both items being removed from the balance sheet, and the offsetting economics would be recognized together in the same period. (So, in this situation, even if a cross-currency basis spread is obligated, it would be offset by the foreign currency impact of the bond.)

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- Industry representatives have identified that it would be even more unlikely for the derivative to be sold while retaining the foreign bond, however, if that was to occur, then the existing guidance for derivative termination would occur.

After considering the scenarios and industry comments for foreign currency excluded components, NAIC staff agrees that requiring these foreign currency excluded components to be reported at fair value, with changes in fair value recognized as unrealized gains / losses throughout the derivative term, results with financial statement impacts that are not reflective of the derivative transactions. Ultimately, the fair value recognition of these components creates surplus volatility / noise, that is not reflective of the intent, nor the final outcome of the derivative instrument. NAIC staff highlights that the key exception to this conclusion would be for scenarios in which a reporting entity was to elect to terminate a derivative in advance of the maturity date. Although existing guidance requires recognition at fair value with the impact in net income (realized gain/loss) at the time of such termination, NAIC staff believes it would be more appropriate to require recognition at fair value at the time that an entity has decided to terminate a hedging instrument prior to its maturity date. This would be consistent with other statutory accounting guidance that requires recognition at fair value (other than amortized cost) at the time such decisions are made. NAIC staff believe this would be appropriate in situations in which both the hedging instrument and hedged item would be terminated together and situations in which the hedging instrument is terminated while the hedged item continues to be held.

Although the prior discussion, and current industry comments, were focused on foreign currency excluded components, NAIC staff highlights that U.S. GAAP permits other elements to be excluded from the assessment of hedge effectiveness. These include the following:

- a. If the effectiveness of a hedge with an option is assessed based on changes in the option's intrinsic value, the change in the time value of the option would be excluded from the assessment of hedge effectiveness.
- b. If the effectiveness of a hedge with an option is assessed based on changes in the option's minimum value, that is, its intrinsic value plus the effect of discounting, the change in the volatility value of the contract shall be excluded from the assessment of hedge effectiveness.
- c. An entity may exclude any of the following components of the change in an option's time value from the assessment of hedge effectiveness:
 - i. The portion of the change in time value attributable to the passage of time (theta)
 - ii. The portion of the change in time value attributable to changes due to volatility (vega)
 - iii. The portion of the change in time value attributable to changes due to interest rates (rho).

Even if specific guidance is established for the foreign currency forward point and the cross-currency basis spread, statutory accounting guidance would still need clarification on the accounting and reporting for the other excluded components. If these excluded components are reported at fair value, with changes in unrealized gain/loss, NAIC staff highlights that the guidance should be clear in SSAP No. 86 and in the Schedule DB reporting instructions. Based on preliminary information, it seems current reporting for

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effective hedges is likely inconsistent for hedging instruments that have excluded components. NAIC staff has the impression that the following two options may currently be occurring:

- BACV reflects amortized cost. This would be consistent with SSAP No. 86, paragraph 23, but would be contrary to paragraph 40 and Exhibit B. (This would mean that the excluded components are not being recognized in the statutory financial statements.)
- BACV reflects a combination of amortized cost and fair value for the excluded components. This would be consistent with SSAP No. 86, paragraph 40 and Exhibit B, but would present an odd representation in Schedule DB as a derivative reported as an effective hedge would have an unrealized gain/loss, and the amount shown as an unrealized gain or loss would only be a specific portion of the change in fair value and could not be calculated from the information reported.

Unless subsequent information and discussion supports a different approach for the non-foreign currency excluded components detailed above, NAIC staff agrees that reporting these components at fair value, with fair value changes recognized through unrealized gains/losses is appropriate. In order to facilitate this recognition, NAIC staff recommends clarifications to SSAP No. 86 to specify the commingled reporting of BACV for effective hedges with excluded components, as well as revisions to Schedule DB to capture information on excluded components in new electronic-only columns. NAIC staff also recommends a new disclosure that captures information on all excluded components by classification type.

Proposed SSAP Revisions To Incorporate / Clarify Guidance for Excluded Components

Derivatives Used in Hedging Transactions

22. 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)¹.

23. Entities shall not bifurcate the effectiveness of derivatives. A derivative instrument is either classified as an effective hedge or an ineffective hedge. Entities must account for the derivative using fair value accounting if it is deemed to be ineffective or becomes ineffective. Derivative instruments classified as effective with excluded components in determining hedge effectiveness pursuant to Exhibit A, paragraph 8, shall account for the derivative and excluded components pursuant to the guidance in paragraph 40. Entities may redesignate a derivative in a hedging relationship even though the derivative was used in a previous hedging relationship that proved to be ineffective. A change in the counterparty

¹ Pursuant to paragraph 19, the gross reported value of a derivative and the determination of unrealized gains or losses shall exclude the impact of financing premiums. Premiums payable or receivable from the acquisition or writing of a derivative shall not be reflected in the gross reporting of derivatives or in determining the fair value change in a derivative.

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to a derivative instrument that has been designated as the hedging instrument in an existing hedging relationship would not, in and of itself, be considered a termination of the derivative instrument. An entity shall prospectively discontinue hedge accounting for an existing hedge if any one of the following occurs:

- a. Any criterion in paragraphs 26-38 is no longer met;
- b. The derivative expires or is sold, terminated, or exercised (the effect is recorded as realized gains or losses or, for effective hedges of firm commitments or forecasted transactions, in a manner that is consistent with the hedged transaction – see paragraph 24);
- c. The entity removes the designation of the hedge; or
- d. The derivative is deemed to be impaired in accordance with paragraph 18. A permanent decline in a counterparty's credit quality/rating is one example of impairment required by paragraph 18, for derivatives used in hedging transactions.

Hedge Effectiveness

39. The measurement of hedge effectiveness for a particular hedging relationship shall be consistent with the entity's risk management strategy and the method of assessing hedge effectiveness that was documented at the inception of the hedging relationship, as discussed in paragraph 41.

40. The gain or loss on a derivative designated as a hedge and assessed to be effective is reported consistently with the hedged item. (Therefore, if the hedged item is reported at amortized cost, and the hedging instrument is consistent with that measurement method, fluctuations in fair value would not be recognized as unrealized gains or losses for either the hedging item or hedging instrument.) If an entity's defined risk management strategy for a particular hedging relationship excludes a specific component of the gain or loss, or related cash flows, on the hedging derivative from the assessment of hedge effectiveness (as discussed in Exhibit BA, paragraph 8), specific accounting treatment shall be followed for the that excluded component: of the gain or loss shall be recognized as an unrealized gain or loss. For example, if the effectiveness of a hedge with an option contract is assessed based on changes in the option's intrinsic value, the changes in the option's time value would be recognized in unrealized gains or losses. Time value is equal to the fair value of the option less its intrinsic value.

- a. -If the excluded component pertains to the difference between a foreign currency spot price and the forward or future price (e.g., a forward spot rate), then this premium / discount shall be amortized into income over the life of the contract or hedged program. (This guidance addresses the excluded component in Exhibit A, paragraph 8d.)
- b. If the excluded component pertains to a foreign currency swap cross-currency basis spread, the impact of fair value changes shall be reflected as a component of the foreign currency swap's periodic interest accrual. (This guidance addresses the excluded component in Exhibit A, paragraph 8e.)
- c. For all other excluded components, the excluded component shall be measured and reported at fair value, with changes in fair value recognized as unrealized gains or losses. (This guidance shall be applied to excluded components detailed in Exhibit A, paragraphs 8a-8c.)

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41. Hedging instruments with excluded components shall be identified in the financial statement investment schedule (Schedule DB) and shall be disclosed pursuant to paragraph 41g.

Proposed New Disclosure Paragraph (This is proposed as a new subparagraph 41g with reordering of subsequent paragraphs.)

g. For hedging instruments with excluded components for determining hedge effectiveness:

- i. In the investment schedule, identify hedging instruments with excluded components, and report the current fair value of the excluded component, the fair value of the excluded component that is reflected in the reported BACV for the hedging instrument (this item would not be applicable for foreign-currency forwards and currency swaps where the forward points or cross-currency basis, respectively, are the excluded component), and the change in fair value reported as an unrealized gains/loss. (Note – These items will be proposed in electronic columns to Schedule DB.)
- ii. In the notes to the financial statements, provide information on the aggregate excluded components by category: Time Value, Intrinsic Value, Forward Points and Cross Currency Basis Spread. The aggregate amounts reported should include the following (as applicable): current fair value, recognized unrealized gain/loss, the fair value reflected in BACV, and for the excluded forward points (e.g., forward spot rates), the aggregate amount owed at maturity, along with current year and remaining amortization. (Note – These items will be captured in a blanks proposal / template.)

Proposed Edits to Exhibit C – Foreign Currency Swaps and Forwards

Note: Only Specific Excerpts Included

Specific hedge accounting procedures for derivative instruments are outlined below.

1. Call and Put Options, Warrants, Caps, and Floors:
 - a. Accounting at Date of Acquisition (purchase) or Issuance (written): The premium paid or received for purchasing or writing a call option, put option, warrant, cap or floor shall either be (i) recorded as an asset (purchase) or liability (written) on the Derivative line on the Assets (or) Liabilities pages or (ii) combined with the hedged item(s) individually or in the aggregate;
 - b. Statement Value:
 - i. Open derivatives hedging items recorded at amortized cost:
 - (a) Options, warrants, caps, and floors purchased or written shall be valued at amortized cost in a manner consistent with the hedged item. (Components of a hedging instrument excluded from the determination of hedge effectiveness shall be recognized at fair value, with changes in fair value recognized as unrealized gains/losses throughout the duration of the hedging instrument. These components are not captured within the guidance for effective hedges detailed within this section.)

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- (b) The amortization period and methods used shall result in a constant effective yield over the life of the hedged item or program. (For floating rate hedged items, the estimated effective yield shall be based on the current rate so the changes in yields attributable to changes in interest rates will be recognized in the period of change). Specific treatment includes:
- (1) Holdings in derivatives purchased or written within a year of maturity or expiry need not be amortized;
 - (2) For hedges of forecasted transactions or firm commitments, the derivative may be recorded at cost until the hedged transaction occurs or it is determined that the hedge was not effective (see (d) in this section 1.b.i.);
 - (3) For other derivatives, the amortization period is usually from date of acquisition (issuance) of the derivative to maturity of the hedged item or program.
- (c) For hedges where the cost of the derivative is combined with the hedged item, the statement value is zero. The fair value of the derivative and hedged item shall be determined and reported separately, either individually or in the aggregate;
- (d) For hedges of forecasted transactions or firm commitments, the derivative shall be recorded at cost until (1) the hedged transaction occurs or (2) it is determined that the hedge was not effective (when the derivative is valued in accordance with (e) in this section);
- (e) If during the life of the derivative it or a designated portion of the derivative is no longer effective as a hedge, valuation at amortized cost ceases and the derivative or the designated portion of the derivative shall be valued at its current fair value with gains and losses recognized in unrealized gains or unrealized losses to the extent it ceased to be an effective hedge.
- d. Gain/Loss on Termination of an option, warrant, cap or floor accounted for under hedge accounting (includes closing, exercise, maturity, and expiry):
- i. Exercise of an Option: The remaining book value of the derivative shall become an adjustment to the cost or proceeds of the hedged item(s) received or disposed of individually or in aggregate;
 - ii. Sale, maturity, expiry, or other closing transaction of a derivative which is an effective hedge—Any gain or loss on the transaction, except for excluded components, will adjust the basis (or proceeds) of the hedged item(s) individually or in aggregate. Alternatively, if the item being hedged is subject to IMR, the gain or loss on the terminated hedging derivative may be realized and shall be subject to IMR upon termination. For hedging instruments with excluded components in determining hedge effectiveness, the unrealized gain/loss from the change in fair value of the excluded component shall be realized upon the closing transaction.

Note: On August 10, 2022, the Statutory Accounting Principles (E) Working Group adopted the revisions noted herein.

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This gain/loss shall not be used to adjust the basis or proceeds of the hedged item.

- iii. Gain/loss on termination of derivatives will be recognized currently in net income (realized gain/loss) to the extent they ceased to be effective hedges.
- iv. Upon the redesignation of a derivative from a currently effective hedging relationship:
 - (a) with an item(s) carried at amortized cost to another effective hedging relationship with an item(s) carried at amortized cost, the derivative shall continue to be recorded at amortized cost and no gain or loss on the derivative shall be recognized.
 - (b) with an item(s) carried at amortized cost or fair value to an effective relationship with an item(s) carried at fair value, the accounting for the derivative shall be consistent with (ii) above.
 - (c) with an item(s) carried at fair value to an effective relationship with an item(s) carried at amortized cost, the accounting for the derivative shall be consistent with (ii) above.

2. Swaps, Collars, and Forwards (see also discussion in Introduction above):

- a. Accounting at Date of Opening Position:
 - i. Any premium paid or received at date of opening shall either be (a) recorded on the Derivative line on the Assets (or) Liabilities pages or (b) combined with the hedged item(s), individually or in the aggregate;
- b. Statement Value:
 - i. Open derivatives hedging items recorded at amortized cost:
 - (a) Swaps, collars, and forwards shall be valued at amortized cost in a manner consistent with hedged item. (Components of a hedging instrument excluded from the determination of hedge effectiveness not addressed in 2.b.iii shall be recognized at fair value, with changes in fair value of the excluded component recognized as unrealized gains/losses throughout the duration of the hedging instrument. These components are not captured within the guidance for effective hedges detailed within this section.)
 - (b) The amortization period and methods used shall result in a constant effective yield over the life of the hedged item or program. (For floating rate hedged items the estimated effective yield shall be based on the current rate so the changes in yields attributable to changes in interest rates will be recognized in the period of change.) Specific treatment includes:

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(1) Holdings in derivatives purchased or written within a year of maturity or expiry need not be amortized;

(2) For hedges of forecasted transactions or firm commitments, the derivative shall be recorded at cost until (a) the hedged transaction occurs or (b) it is determined that the hedge was not effective (see (5) in this section 2.b.i.);

(3) For other derivatives the amortization period is usually from date of acquisition (issuance) of the derivative to maturity of the hedged item or program;

(4) For hedges where the cost of the derivative is combined with the hedged item, the statement value is zero. The fair value of the derivative and hedged item shall be determined and reported separately, either individually or in the aggregate;

(5) If during the life of the derivative it or a designated portion of the derivative is no longer effective as a hedge, valuation at amortized cost ceases and the derivative or a designated portion of the derivative shall be valued at its current fair value with gains and losses recorded in unrealized gains or unrealized losses to the extent that it ceased to be an effective hedge. Upon redesignation into an effective hedging relationship, the derivative's mark to fair value through unrealized gain or loss shall be reversed.

ii. Open derivatives hedging items recorded at fair value (where gains and losses on the hedged item are recognized as adjustments to unassigned funds (surplus)):

(a) Swaps, collars, or forwards shall be valued at current fair value with changes in fair value recognized currently consistent with the hedged item; this will result in unrealized gain/loss treatment with adjustment to unassigned funds (surplus);

(b) For hedges where the derivative is combined with the hedged item, the fair value of the derivative and hedge item shall be determined and reported separately, either individually or in the aggregate. The cost (book value) basis used to figure gain/loss on the derivative is zero.

iii. Open foreign currency swap and forward contracts hedging foreign currency exposure on items denominated in a foreign currency and translated into U.S. dollars where fair value accounting is not being used:

(a) ~~The foreign exchange premium (discount) on the currency contract shall be amortized into income over the life of the contract or hedge program.~~ The foreign exchange premium (discount) is defined as the foreign currency (notional) amount to be received (paid) times the net of the forward rate minus the spot rate at the time the contract was opened. For forward contracts, an excluded component representing a foreign

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exchange premium (discount) (forward points) on the currency contract shall be amortized into income over the life of the contract or hedge program. Amortization is not required if the contract was entered into within a year of maturity. For foreign currency swaps, an excluded component representing a cross-currency basis spread, is recognized into income through the foreign currency swap's periodic interest accruals.

Amortization is not required if the contract was entered into within a year of maturity;

- (b) A foreign currency translation adjustment shall be reflected as an unrealized gain/loss (unassigned funds (surplus) adjustment) using the same procedures as done to translate the hedged item;
- (c) The unrealized gain/loss for the period equals the foreign currency (notional) amount to be received (paid) times the net of the current spot rate minus the prior period end spot rate;
- (d) The statement value of the derivative equals the amortized cost plus:
 1. For forward contracts, the amortized (premium) discount plus the cumulative unrealized gain/(loss) on the contract.
 2. For foreign currency swaps, Tthe cumulative unrealized gain/(loss) on the contract. The cross-currency basis spread is recorded through the Investment Income Due and Accrued or Other Liabilities, as a component of the foreign currency swap's periodic interest accrual.
- (e) Recognition of unrealized gains/losses and amortization of foreign exchange premium/discount on derivatives hedging forecasted transactions or firm commitments shall be deferred until the hedged transaction occurs. These deferred gains/losses will adjust the basis or proceeds of the hedged transaction when it occurs;
- (f) For hedges where the cost of the foreign currency contract is combined with the hedged item, the statement value on Schedule DB is zero. The fair value of the derivative and hedged item shall be determined and reported separately, either individually or in the aggregate;
- (g) If during the life of the currency contract it or a designated portion of the currency contract is not effective as a hedge, The derivative shall be recorded at fair value and valuation at amortized cost shall cease. To the extent it ceased to be an effective hedge, a cumulative unrealized gain/loss (surplus adjustment) will shall be recognized equal to the difference between the carrying value of the derivative on the balance sheet and the fair value of the derivative if either of the following occur:

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1. During the life of the currency contract it or a designated portion of the currency contract is not effective as a hedge.
2. The entity decides to terminate the derivative in advance of scheduled maturity.

~~notional amount or designated notional amount times the difference between the forward rate available for the remaining maturity of the contract (i.e., the forward rate as of the balance sheet date) and the forward rate at the time it ceased to be an effective hedge.~~

- iv. Open derivatives hedging items recorded at fair value, where gains and losses on the hedged item are recognized currently in earnings: swaps, collars and forwards shall be valued at current fair value with changes in fair value recognized currently in earnings together with the gains and losses on the hedged item.
 - (a) If during the life of the derivative it or a designated portion of the derivative is no longer effective as a hedge, recognition of changes in fair value through earnings ceases. The derivative shall continue to be valued at its current fair value, but thereafter gains or losses shall be recognized in unrealized gains or unrealized losses to the extent it ceased to be an effective hedge.
- c. Cash Flows and Income:
 - i. Where the cost of the derivative is not combined with the hedged item:
 - (a) Amortization of premium paid or received on derivatives is an adjustment to net investment income or another appropriate caption within operating income consistent with the reporting of the hedged item;
 - (b) 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.
 - ii. Where the cost of the derivative is combined with the hedged item, the cash flows and income of the derivative on Schedule DB is zero. All related amortization and cash flow accounting shall be reported with the hedged item instead of with the derivative.
- d. Gain/Loss on Termination of a swap, collar or forward accounted for under hedge accounting (includes closing, exercise, maturity, and expiry):
 - i. Exercise—The remaining book value of the derivative shall become an adjustment to the cost or proceeds of the hedged item(s) received or disposed of individually or in aggregate;
 - ii. Sale, maturity, expiry, or other closing transaction of a derivative which is an effective hedge—Any gain or loss on the transaction, except for excluded components, will adjust the basis (or proceeds) of the hedged item(s) individually or in aggregate. Alternatively, if the item being hedged is subject to IMR, the gain

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or loss on the terminated hedging derivative may be realized and shall be subject to IMR upon termination.¹⁷

- iii. Gain/loss on termination of derivatives will be recognized currently in net income (realized gain/loss) to the extent they ceased to be effective hedges.
- iv. Upon the redesignation of a derivative from a currently effective hedging relationship-
 - (a) with an item(s) carried at amortized cost to another effective hedging relationship with an item(s) carried at amortized cost, the derivative shall continue to be recorded at amortized cost and no gain or loss on the derivative shall be recognized.
 - (b) with an item(s) carried at amortized cost or fair value to an effective relationship with an item(s) carried at fair value, the accounting for the derivative shall be consistent with (ii) above.
 - (c) with an item(s) carried at fair value to an effective relationship with an item(s) carried at amortized cost, the accounting for the derivative shall be consistent with (ii) above.

https://naiconline.sharepoint.com/sites/NAICSupportStaffHub/Member Meetings/E CMTE/APPTF/2022SummerNM/1_SAPWG/Minutes/Attachment One-J_21-20_SSAP86.docx

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

Issue: SSAP No. 48 – Alternative Valuation of Minority Ownership Interests

Check (applicable entity):

	P/C	Life	Health
Modification of Existing SSAP	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>
New Issue or SSAP	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Interpretation	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>

Description of Issue: SSAP No. 48—*Joint Ventures, Partnerships and Limited Liability Companies* establishes the statutory accounting principles for investments in joint ventures, partnerships, or limited liability companies (herein collectively referred to as SSAP No. 48 investments). This agenda item is presented to review the alternative valuation methods permitted in limited circumstances where the investee has a minor ownership interest (less than 10%) or lacks control as discussed in paragraphs 15 and 16 (see Authoritative Literature), and where audited U.S. GAAP basis financial statements are not available.

In general, SSAP No. 48 requires a financial statement audit for admission of investments with a more than minor ownership interest or where control is present. If an investee owns greater than 10% measured at the holding company level, or can exercise control, the SSAP No. 48 investment is to be reported using the equity method as defined in SSAP No. 97—*Investments in Subsidiary, Controlled and Affiliated Entities*, which effectively directs the valuation based on the nature of the operations (e.g., requiring statutory accounting for insurance operations or U.S. GAAP accounting for other various entities). Embedded in SSAP No. 97, the proxy for SSAP No. 48 investments in which the investor owns greater than 10% or can exercise control, is the requirement for a statutory or a U.S. GAAP financial statement audit. (The requirement for audited financial statements in these instances is not proposed to be the subject of discussion.)

If insurer has less than 10% ownership (minor ownership interest) or lacks control the preference is to use audited U.S. GAAP financial statements. However, when audited U.S. GAAP financial statements are not available, paragraph 9 provides the following three alternatives, which includes: 1) investee's audited foreign GAAP with an audited U.S. GAAP reconciliation footnote, 2) audited IFRS financial statements, or 3) audited U.S. tax equity financial statements. The permissible exceptions for when audited U.S. GAAP basis financials are not available are detailed in paragraph 9 below:

9. **If audited U.S. GAAP basis financial statements of the investee are not available, joint ventures, partnerships, and limited liability companies in which the entity has a minor ownership interest (i.e., less than 10%) or lacks control as stipulated in paragraphs 15 and 16 may be recorded based on either of the valuation methodologies allowed under paragraphs 9.a. or 9.b.** If either one of the valuation methodologies allowed under paragraphs 9.a. or 9.b. is used to value the investment, documentation must be maintained regarding the reason that audited U.S. GAAP basis financial statements could not be provided.

- a. Non U.S. joint ventures, partnerships, and limited liability companies in which the entity has a minor ownership interest of less than 10% and for which audited U.S. GAAP basis financial statements of the investee are not available, may be recorded based on:
 - i the U.S. GAAP basis equity as set forth in the audited footnote reconciliation of the investee's equity and income to U.S. GAAP within the investee's audited foreign GAAP prepared financial statements or,

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- ii the IFRS basis equity as set forth in the investee's audited IFRS financial statements prepared in compliance, both annually and quarterly, with IFRS as issued by the International Accounting Standards Board (IASB).
- b. **If audited U.S. GAAP basis financial statements of the investee are not available, joint ventures, partnerships, and limited liability companies in which the entity has a minor ownership interest of less than 10%, measured at the holding company level, may be recorded based on the underlying audited U.S. tax basis equity.** For investments recorded based on the underlying audited U.S. tax basis equity, the reporting entity shall review investments held by the joint venture, partnership or limited liability company in accordance with the impairment guidance in paragraphs 18 and 19. The reporting entity must first attempt to obtain audited U.S. GAAP basis financial statements and, if such financial statements are unavailable, must maintain documentation regarding the reason that audited U.S. GAAP basis financial statements could not be provided.

NAIC staff believe the intent of the U.S. GAAP audit exceptions provided in paragraph 9 was meant to accommodate limited situations where an insurer has a minor ownership interest and or lacks control and therefore, they are unable to require or entice the entity to acquire a U.S. GAAP audit. NAIC staff note this distinction, as SSAP No. 48, paragraph 9 currently permits that if an insurer owns less than 10% **or** lacks control, they are permitted the exceptions which still require audits if audited U.S. GAAP basis financial statements are unavailable. It is important to note that technically SSAP No. 48, paragraph 16 could permit a significant ownership percentage and as long as an insurer has rebutted control of the investment, they would be permitted to use the paragraph 9 exceptions, that is if the insurer could articulate why audited U.S. GAAP basis financial statements were not available.

This agenda item has been drafted to propose two alternative clarifications to SSAP No. 48. The first option presented is to propose deletion of the U.S. GAAP audit exception provided in SSAP No. 48, paragraph 9.b as this exception does not appear to be utilized by insurers. The second option presented is to retain the U.S. GAAP audit exception in paragraph 9.b but clarify that the U.S. tax basis audit is to reside at the investee level – that is the investee must have an audit in order for this valuation be permitted for admission of the investment. This clarification would eliminate any ambiguity regarding the level at which the audit is required.

Existing Authoritative Literature: While a significant portion of the potentially impacted paragraphs have been included above, all relevant SSAP No. 48 guidance is included below, with pertinent items bolded for emphasis.

SCOPE OF STATEMENT

1. **This statement establishes statutory accounting principles for investments in any joint ventures, partnerships, and limited liability companies, including investments** in certified capital companies (CAPCO) per *INT 06-02: Accounting and Reporting for Investments in a Certified Capital Company (CAPCO)*, whether or not it is considered to be controlled by or affiliated with the reporting entity. Single real estate property investments that are wholly-owned by an LLC that is directly and wholly-owned by the reporting entity, and that meet the criteria established in *SSAP No. 40R—Real Estate Investments*, are excluded from this statement. This statement does not address the accounting for investments in partnerships and limited liability companies that invest in Low-Income Housing Tax Credit Properties as discussed in *SSAP No. 93—Low-Income Housing Tax Credit Property Investments*. However, investments in certain state Low-Income Housing Tax Credit Property Investments that do not fall within the scope of SSAP No. 93 are covered by the requirements of this statement.

SUMMARY CONCLUSION

2. **Investments in joint ventures shall include investments in corporate joint ventures and unincorporated joint ventures** (also referred to as undivided interests in ventures). A corporate joint venture is defined as a corporation owned and operated by a small group (the joint venturers) as a separate and specific business or project for the mutual benefit of the members of the group. A corporate joint venture usually provides an arrangement under which each joint venturer may participate, directly or indirectly, in the overall management of the joint venture. Joint venturers thus have an interest or relationship other than as passive investors. An unincorporated joint venture is similar in its purpose but is not incorporated.
3. **Investments in partnerships shall include investments in general partnership interests and limited partnership interests.** A general partnership is defined as an association in which each partner has unlimited liability. Each partner assumes joint and several liability for all partnership debts. A limited partnership shall be defined as a partnership having two classes of partners: (a) general partners who manage the partnership, subject to the partnership agreement, and have personal liability for the general obligations of the partnership and (b) limited partners who are passive investors and have no personal liability beyond their investment.
4. A limited liability company is defined as a business organization which is a hybrid of a corporation and partnership whereby the owners have limited liability like a corporation and profits may pass through to the owners for tax purposes like a partnership if certain criteria are met. The owner's personal liability is limited to his own acts and the owners can fully participate in the management of the business with no adverse impact on their limited liability.
5. Investments in the ventures defined in paragraphs 2-4 meet the definition of assets as defined in **SSAP No. 4—Assets and Nonadmitted Assets** and are admitted assets to the extent they conform to the requirements of this statement. Investments in joint ventures, partnerships, and limited liability companies shall be reported in Other Invested Assets in the financial statements.
6. **Investments in these ventures, except for joint ventures, partnerships and limited liability companies with a minor ownership interest, shall be reported using an equity method as defined in SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities, paragraphs 8.b.i. through 8.b.iv.** (The equity method calculation may result with a negative valuation of the investment; therefore, the SSAP No. 97 equity method calculation shall occur regardless of whether the investment is supported by an audit and the reporting entity will nonadmit the investment.) A reporting entity whose shares of losses in a SSAP No. 48 entity exceeds its investment in the SSAP No. 48 entity shall disclose the information required by SSAP No. 97, paragraph 35.a.
7. Investments reported using an equity method from SSAP No. 97, paragraph 8.b.ii. through 8.b.iv. may have fiscal year ends, not calendar year ends. To recognize a change to the reporting year-end of an equity method investee, including changes in, or the elimination of, previously existing differences (lag period) due to the reporting entity's ability to obtain financial results from a reporting period that is more consistent with, or the same as, that of the reporting entity's, the guidance included in *FASB Emerging Issues Task Force No. 06-9: Reporting a Change in (or the elimination of) a Previously Existing Difference Between the Fiscal Year-End of a Parent Company and That of a Consolidated Entity or Between the Reporting Period of an Investor and That of an Equity Method Investee* that defines such reporting period changes as a change in accounting principle in accordance with **SSAP No. 3—Accounting Changes and Corrections of Errors** shall be followed.
8. **Joint ventures, partnerships and limited liability companies in which the entity has a minor ownership interest (i.e., less than 10%) or lacks control as stipulated in paragraphs 15 and 16, shall be recorded based on the underlying audited U.S. GAAP equity of the investee.** The investment shall be nonadmitted if the audited financial statements include substantial doubt about the entity's ability to

continue as a going concern. Additionally, the investment shall be nonadmitted on the basis/contents of the audit opinion as detailed in paragraph 21 of SSAP No. 97.

9. If audited U.S. GAAP basis financial statements of the investee are not available, joint ventures, partnerships, and limited liability companies in which the entity has a minor ownership interest (i.e., less than 10%) or lacks control as stipulated in paragraphs 15 and 16 may be recorded based on either of the valuation methodologies allowed under paragraphs 9.a. or 9.b. If either one of the valuation methodologies allowed under paragraphs 9.a. or 9.b. is used to value the investment, documentation must be maintained regarding the reason that audited U.S. GAAP basis financial statements could not be provided.

- a. Non U.S. joint ventures, partnerships, and limited liability companies in which the entity has a minor ownership interest of less than 10% and for which audited U.S. GAAP basis financial statements of the investee are not available, may be recorded based on:**
 - i the U.S. GAAP basis equity as set forth in the audited footnote reconciliation of the investee's equity and income to U.S. GAAP within the investee's audited foreign GAAP prepared financial statements or,**
 - ii the IFRS basis equity as set forth in the investee's audited IFRS financial statements prepared in compliance, both annually and quarterly, with IFRS as issued by the International Accounting Standards Board (IASB).**
- b. If audited U.S. GAAP basis financial statements of the investee are not available, joint ventures, partnerships, and limited liability companies in which the entity has a minor ownership interest of less than 10%, measured at the holding company level, may be recorded based on the underlying audited U.S. tax basis equity. For investments recorded based on the underlying audited U.S. tax basis equity, the reporting entity shall review investments held by the joint venture, partnership or limited liability company in accordance with the impairment guidance in paragraphs 18 and 19. The reporting entity must first attempt to obtain audited U.S. GAAP basis financial statements and, if such financial statements are unavailable, must maintain documentation regarding the reason that audited U.S. GAAP basis financial statements could not be provided.**

10. The amount to be recorded shall be defined as the initial investment in an investee at cost (as defined in paragraph 3 of SSAP No. 68—*Business Combinations and Goodwill*) plus subsequent capital contributions to the investee. The carrying amount of the investment shall be adjusted for the amortization of the basis difference (difference between the cost and the underlying GAAP equity), as well as to recognize the reporting entity's share of: (i) the audited U.S. GAAP basis earnings or losses of the investee after the date of acquisition, adjusted for any distributions received, or (ii) if audited U.S. GAAP basis financial statements of the investee are not available, the earnings or losses of the investee after the date of acquisition, adjusted for any distributions received, based on either one of the valuation methodologies allowed under paragraphs 9.a. or 9.b. A reporting entity's share of adjustments, excluding changes in capital contributions to the investee, that are recorded directly to the investee's stockholders' equity shall also be recorded as adjustments to the carrying value of the investment with an offsetting amount recorded to unrealized capital gains and losses on investments.

11. Entities may recognize their investment in joint ventures, partnerships, and limited liability companies in which the entity has a minor ownership interest based on an unaudited basis for investment determination (i.e., foreign GAAP, IFRS, or tax basis as allowed under paragraph 9) if annual audited information is not complete as of the annual statement filing deadline. The recorded investment shall be adjusted for annual audit adjustments, if any, as soon as annual audited information is available. If financial statements of an investee are not sufficiently timely for the reporting entity to apply an

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equity method to the investee's current results of operations, the reporting entity shall record its share of the earnings or losses of an investee from the most recent available financial statements. A lag in reporting shall be consistent from period to period.

15. Control is defined as the possession, directly or indirectly, of the power to direct or cause the direction of the management and policies of the investee, whether through the (a) ownership of voting securities, (b) by contract other than a commercial contract for goods or nonmanagement services, (c) by common management, or (d) otherwise. Control shall be presumed to exist if a reporting entity and its affiliates directly or indirectly, own, control, hold with the power to vote, or hold proxies representing 10% or more of the voting interests of the entity.

16. Control as defined in paragraph 15 shall be measured at the holding company level. For example, if one member of an affiliated group has a 5% interest in an entity and a second member of the group has an 8% interest in the same entity, the total interest is 13% and therefore each member of the affiliated group shall be presumed to have control. This presumption will stand until rebutted by an evaluation of all the facts and circumstances relating to the investment based on the criteria in *FASB Interpretation No. 35, Criteria for Applying the Equity Method of Accounting for Investments in Common Stock, an Interpretation of APB Opinion No. 18*. The corollary is required to demonstrate control when a reporting entity owns less than 10% of the voting interests of an investee. The insurer shall maintain documents substantiating its determination for review by the domiciliary commissioner. Examples of situations where the presumption of control may be in doubt include the following:

- a. Any limited partner investment in a Limited Partnership, unless the limited partner is affiliated with the general partner.
- b. An entity where the insurer owns less than 50% of an entity and there is an unaffiliated individual or group of investors who own a controlling interest.
- c. An entity where the insurer has given up participation rights as a shareholder to the investee.

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):

In May 2008, in agenda item 2007-34R: SSAP 48, the Working Group adopted revisions in SSAP No. 48 permitting the use of an audited U.S. tax basis equity valuation method in cases where the insurer is a minor interest or lacks control and audited U.S. GAAP financial statements of the investee were not available.

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

Convergence with International Financial Reporting Standards (IFRS): N/A

Staff Recommendation: NAIC staff recommends that the Working Group move this item to the active listing, categorized as a SAP clarification, and expose two possible options for the U.S. GAAP audit exception in *SSAP No. 48—Joint Ventures, Partnerships and Limited Liability Companies*. Option #1 proposes to delete the audited U.S. tax basis equity as a permissible valuation method as this method does not appear to be utilized by insurers. Option #2 proposes to retain the audited U.S. tax basis equity valuation method but clarifies that the audit must reside at the investee level.

Option 1: Delete the valuation method permitted in SSAP No. 48, paragraph 9b.

9. If audited U.S. GAAP basis financial statements of the investee are not available, joint ventures, partnerships, and limited liability companies in which the entity has a minor ownership interest (i.e., less than 10%) or lacks control as stipulated in paragraphs 15 and 16 may be recorded based on either of the valuation methodologies allowed under paragraphs 9.a. or 9.b. If either one of the valuation methodologies allowed under paragraphs 9.a. or 9.b. is used to value the investment, documentation must be maintained regarding the reason that audited U.S. GAAP basis financial statements could not be provided.

- a. Non U.S. joint ventures, partnerships, and limited liability companies in which the entity has a minor ownership interest of less than 10% and for which audited U.S. GAAP basis financial statements of the investee are not available, may be recorded based on:
 - i the U.S. GAAP basis equity as set forth in the audited footnote reconciliation of the investee's equity and income to U.S. GAAP within the investee's audited foreign GAAP prepared financial statements or,
 - ii the IFRS basis equity as set forth in the investee's audited IFRS financial statements prepared in compliance, both annually and quarterly, with IFRS as issued by the International Accounting Standards Board (IASB).
- b. ~~If audited U.S. GAAP basis financial statements of the investee are not available, joint ventures, partnerships, and limited liability companies in which the entity has a minor ownership interest of less than 10%, measured at the holding company level, may be recorded based on the underlying audited U.S. tax basis equity. For investments recorded based on the underlying audited U.S. tax basis equity, the reporting entity shall review investments held by the joint venture, partnership or limited liability company in accordance with the impairment guidance in paragraphs 18 and 19. The reporting entity must first attempt to obtain audited U.S. GAAP basis financial statements and, if such financial statements are unavailable, must maintain documentation regarding the reason that audited U.S. GAAP basis financial statements could not be provided.~~

Option 2: Retain the alternative valuation method but clarify that the required U.S. tax basis equity audit is to reside at the investee level.

9. If audited U.S. GAAP basis financial statements of the investee are not available, joint ventures, partnerships, and limited liability companies in which the entity has a minor ownership interest (i.e., less than 10%) or lacks control as stipulated in paragraphs 15 and 16 may be recorded based on either of the valuation methodologies allowed under paragraphs 9.a. or 9.b. If either one of the valuation methodologies allowed under paragraphs 9.a. or 9.b. is used to value the investment, documentation must be maintained regarding the reason that audited U.S. GAAP basis financial statements could not be provided.

- a. Non U.S. joint ventures, partnerships, and limited liability companies in which the entity has a minor ownership interest of less than 10% and for which audited U.S. GAAP basis financial statements of the investee are not available, may be recorded based on:
 - i the U.S. GAAP basis equity as set forth in the audited footnote reconciliation of the investee's equity and income to U.S. GAAP within the investee's audited foreign GAAP prepared financial statements or,
 - ii the IFRS basis equity as set forth in the investee's audited IFRS financial statements prepared in compliance, both annually and quarterly, with IFRS as issued by the International Accounting Standards Board (IASB).

- b. If audited U.S. GAAP basis financial statements of the investee are not available, joint ventures, partnerships, and limited liability companies in which the entity has a minor ownership interest of less than 10%, measured at the holding company level, may be recorded based on the underlying audited U.S. tax basis equity. [The U.S. tax basis equity audit shall occur at the investee level.](#) For investments recorded based on the underlying audited U.S. tax basis equity, the reporting entity shall review investments held by the joint venture, partnership or limited liability company in accordance with the impairment guidance in paragraphs 18 and 19. The reporting entity must first attempt to obtain audited U.S. GAAP basis financial statements and, if such financial statements are unavailable, must maintain documentation regarding the reason that audited U.S. GAAP basis financial statements could not be provided.

Staff Review Completed by: Jim Pinegar– NAIC Staff, February 2022

Status:

On April 4, 2022, the Statutory Accounting Principles (E) Working Group moved this agenda item to the active listing, categorized as a SAP clarification, and exposed two possible options for the U.S. GAAP audit exception in *SSAP No. 48—Joint Ventures, Partnerships and Limited Liability Companies*. The options are described below while the revisions are illustrated above in the recommended action.

Option #1 proposes to delete the audited U.S. tax basis equity as a permissible valuation method as this method does not appear to be utilized by insurers.

Option #2 proposes to retain the audited U.S. tax basis equity valuation method but clarifies that the audit must reside at the investee level.

On August 10, 2022, the Statutory Accounting Principles (E) Working Group adopted, as final, the exposed revisions detailed in option #2, as illustrated below, to *SSAP No. 48—Joint Ventures, Partnerships and Limited Liability Companies*. These revisions clarify that the audit of an entity utilizing the U.S. tax basis equity valuation exception shall occur at the investee level.

Adopted revisions to SSAP No. 48:

9. If audited U.S. GAAP basis financial statements of the investee are not available, joint ventures, partnerships, and limited liability companies in which the entity has a minor ownership interest (i.e., less than 10%) or lacks control as stipulated in paragraphs 15 and 16 may be recorded based on either of the valuation methodologies allowed under paragraphs 9.a. or 9.b. If either one of the valuation methodologies allowed under paragraphs 9.a. or 9.b. is used to value the investment, documentation must be maintained regarding the reason that audited U.S. GAAP basis financial statements could not be provided.

- a. Non U.S. joint ventures, partnerships, and limited liability companies in which the entity has a minor ownership interest of less than 10% and for which audited U.S. GAAP basis financial statements of the investee are not available, may be recorded based on:
- i the U.S. GAAP basis equity as set forth in the audited footnote reconciliation of the investee's equity and income to U.S. GAAP within the investee's audited foreign GAAP prepared financial statements or,
 - ii the IFRS basis equity as set forth in the investee's audited IFRS financial statements prepared in compliance, both annually and quarterly, with IFRS as issued by the International Accounting Standards Board (IASB).

Ref #2022-02

- b. If audited U.S. GAAP basis financial statements of the investee are not available, joint ventures, partnerships, and limited liability companies in which the entity has a minor ownership interest of less than 10%, measured at the holding company level, may be recorded based on the underlying audited U.S. tax basis equity. [The U.S. tax basis equity audit shall occur at the investee level.](#) For investments recorded based on the underlying audited U.S. tax basis equity, the reporting entity shall review investments held by the joint venture, partnership or limited liability company in accordance with the impairment guidance in paragraphs 18 and 19. The reporting entity must first attempt to obtain audited U.S. GAAP basis financial statements and, if such financial statements are unavailable, must maintain documentation regarding the reason that audited U.S. GAAP basis financial statements could not be provided.

https://naiconline.sharepoint.com/sites/NAICSupportStaffHub/Member Meetings/E CMTE/APPTF/2022SummerNM/1_SAPWG/Minutes/Att One-K_22-02_SSAP48.docx

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

Issue: Conceptual Framework – Updates

Check (applicable entity):

	P/C	Life	Health
Modification of Existing SSAP	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>
New Issue or SSAP	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Interpretation	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>

Description of Issue: In December 2021, the Financial Accounting Standards Board (FASB) issued two new chapters of its conceptual framework. The conceptual framework is a body of interrelated objectives and fundamentals that provides the FASB with a foundation for setting standards and concepts to consider when it resolves questions or develops/modifies accounting and reporting guidance.

It is important to note that the Statements of Financial Accounting Concepts are not authoritative and do not establish new or change existing U.S. GAAP. Per the FASB chair, these concepts are “a tool for the Board to use in setting standards that improve the understandability of information entities provide to existing and potential investors, lenders, donors, and other resource providers.”

This agenda item reviews and summarizes each of the two newly issued concept chapters and reviews their potential impact on statutory accounting. Again, while the conceptual framework statements are not authoritative, they are the guiding principles for standard setting and these new updates have superseded chapters currently referenced in the *Accounting Practices and Procedures Manual* (AP&P Manual). In addition, and most notably, in the case of one of these chapters, FASB changed certain key fundamental definitions, specifically the definition of an asset and a liability, which have historically been mirrored by statutory accounting.

Update 1:

FASB Concepts Statement No. 8, *Conceptual Framework for Financial Reporting—Chapter 4, Elements of Financial Statements* introduced updated definitions of certain key elements used in financial reporting – the definition of an asset and liability. The chapter states that assets and liabilities have conceptual and definitional primacy because assets and liabilities (and changes in those elements) are foundational to all the other items reported in the financial statements. To correctly identify and represent an asset or liability is the beginning basis for all financial reporting and due to their importance, updates to both financial statement elements have been adopted. A summary of each, comparing the historical and current definitions, is provided below:

Changes regarding the definition of an ASSET:

- **Historical definition:** a probable future economic benefit obtained or controlled by a particular entity as a result of past transactions or events.
- **Historical Characteristics: Three essential characteristics:**
 1. it embodies a probable future benefit that involves a capacity, singly or in combination with other assets, to contribute directly or indirectly to future net cash inflows,
 2. a particular enterprise can obtain the benefit and control others' access to it, and
 3. the transaction or other event giving rise to the enterprise's right to or control of the benefit has already occurred.

➤ **New Definition:** a present right of an entity to an economic benefit.

➤ **Current Characteristics: Two essential characteristics:**

1. it is a present right, and
2. the right is to an economic benefit.

The combination of these two characteristics allows an entity to obtain the economic benefit and control others' access to the benefit. A present right of an entity to an economic benefit entitles the entity to the economic benefit and the ability to restrict others' access to the benefit to which the entity is entitled. For clarity, an "economic benefit" represents services or other items of economic value and generally result in net cash inflows to the entity.

Commentary regarding definitional changes:

The current definition of an asset no longer includes the term *probable* or the phrases *future economic benefit* and *past transactions or events*. The FASB concluded that the term *probable* has historically been misunderstood as implying that a future benefit must be probable to a certain threshold before the definition of an asset was met. Thus, if the probability of a future benefit was low, an asset could not be recognized. FASB also struck the phrase *future economic benefit* as this phrase often was interpreted that the asset must represent a certain future economic benefit (such as eventual cash inflows), however with this update, FASB clarified that the asset represents the rights to the benefit, not the actual benefit itself – nor the probability of realization.

Finally, FASB struck the phrase as the result of *past transactions or events*. It was concluded that if the asset represents a *present right*, by default, the right must have occurred as the result of a past transaction or event and thus this phraseology was deemed redundant and unnecessary.

Changes regarding the definition of a LIABILITY:

○ **Historical definition:** are [certain or] probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events.

○ **Historical Characteristics: Three essential characteristics:**

1. it embodies a present duty or responsibility to one or more other entities that entails settlement by probable future transfer or use of assets at a specified or determinable date, on occurrence of a specified event, or on demand,
2. the duty or responsibility obligates a particular enterprise, leaving it little or no discretion to avoid the future sacrifice, and
3. the transaction or other event obligating the enterprise has already happened.

➤ **New Definition:** a present obligation of an entity to transfer an economic benefit.

➤ **Current Characteristics: Two essential characteristics:**

1. it is a present obligation, and
2. the obligation requires an entity to transfer or otherwise provide economic benefit to others. (For the purposes of this characteristic, *transfer* is typically used to describe obligations to pay cash or convey assets, while the term *provide* is used to describe obligations to provide services or stand by to do so).

Commentary regarding definitional changes:

The current definition of a liability no longer includes the term *probable* or the phrase *in the future as a result of past transactions or events*. The FASB concluded that the term *probable* has historically been understood as implying that a future obligation must meet a probability to a certain threshold before the definition of a liability was met. Thus, if the probability of a future transfer of an asset (or the requirement to provide a service) was low, a liability would likely not be recognized. In removing the term *probable* (and replacing it with “present obligation”), FASB concluded that in almost all situations, the presence of an obligation will be apparent. It stated that most present obligations are legally enforceable, including obligations arising from binding contracts, agreements, statutes, or other legal or contractual means. Chapter 4 also discusses the prevalence of certain business risks and how to assess if they result in the recognition of a liability. It concluded that while certain businesses pose risk of future events occurring that will cause them to transfer an economic benefit (an asset), the risk itself does not represent a present obligation because exposure to a potential negative consequence does not constitute a present obligation.

However, FASB also stated situations lacking clear legal or contractual evidence of a present obligation may pose particular challenges that may make it difficult to discern whether a present obligation exists. In these settings, the FASB stated that constructive obligations or other noncontractual obligations are created by circumstance rather than by explicit agreement. In the absence of an explicit agreement, sufficient information to distinguish a present obligation is likely only available at the specific standards level. Thus, the FASB concluded that the specific facts and circumstances at the standards level (or in the case of statutory accounting, at the SAP level) must be utilized to determine whether the entity has created a constructive obligation and must recognize a liability.

FASB also struck the phrase as the result of *past transactions or events*. It was concluded that if the liability represents a *present right*, by default, the right must have occurred as the result of a past transaction or event and thus this phraseology was deemed redundant and unnecessary.

Update 2:

FASB Concepts Statement No. 8, *Conceptual Framework for Financial Reporting—Chapter 7, Presentation* identifies factors that the FASB will consider when deciding **how** items should be displayed on the financial statements. Chapter 7 describes the information to be included in the financial statements and how appropriate presentation can contribute to the objective of financial reporting – to communicate financial information about an entity that is useful to existing and potential investors, lenders, and other creditors in making decisions about providing resources (goods and services) to the entity. These decisions typically involve buying or selling of goods/services or holding equity and debt instruments as well as providing or settling loans or other forms of credit. This chapter articulates that the financial statements meet a “general purpose” and should not be considered to meet all purposes for possible users – and thus a common set of conceptual standards is appropriate.

Chapter 7 also describes the importance of financial statement notes, or supplementary information so that financial statement users are provided with a more complete picture of an entity’s accounting policy or any particular unique circumstance or event. In terms of general reporting, the conceptual statement relays that a distinction between nonhomogeneous items should be depicted in the financial statements with different reporting line items and subtotals and that the information should be provided based on recognition and measurement standards. In essence, reporting should be sufficiently aggregated, but not aggregated to a level in which the information is too consolidated for general use and understanding. Once reported, then any significant accounting policy or circumstance would further be defined with accompanying notes.

The chapter broadly states that to meet the objectives of financial reporting, line items should be distinct based on the information being provided – as the information should distinguish between various types of transactions/events and should assist users in their estimates in the amounts and timing of future cash flows or the entity’s ability to

provide other economic value. The financial statements should depict the results of different types of transactions, including changes in events or other circumstances that may vary the frequency or predictability of performance based on many items, including changes in economic conditions.

In summary, while Chapter 7 does supersede sections of *Statement of Financial Accounting Concept 5*, it did not result in fundamental changes to the principal concepts of financial reporting. The chapter articulates the need for complete financial reporting, describes the interconnectedness of a ‘complete set of financial statements’ and relays the importance of these documents as the information in the financial statements is the primary (and typically the sole) source for analyzing current and potential future performance of an organization and its ability to meet its long-term financial objectives. At a high level, the chapter discusses what information should broadly be categorized as revenues, expenses, gains, and losses and to the extent equity is impacted by operations as well as changes in owners’ equity through investments or distributions.

In terms of the impact to statutory accounting, the updated concepts in this chapter are not expected to modify current guidance, other than to update references to superseded accounting concepts.

Existing Authoritative Literature:

NAIC Staff Note – the Preamble contains reference to certain concept statements in footnotes 2 and 4 and have been bolded below for ease of identification. It is important to note that while these footnotes currently reference superseded conceptual statements, the conceptual statements noted do not represent adopted guidance - they are noted as reference for overarching guiding principles regarding financial reporting.

Preamble

IV. Statutory Accounting Principles Statement of Concepts

25. This document states the fundamental concepts on which statutory financial accounting and reporting standards are based. These concepts provide a framework to guide the National Association of Insurance Commissioners (NAIC) in the continued development and maintenance of statutory accounting principles (“SAP” or “statutory basis”) and, as such, these concepts and principles constitute an accounting basis for the preparation and issuance of statutory financial statements by insurance companies in the absence of state statutes and/or regulations.

26. The NAIC and state insurance departments are primarily concerned with statutory accounting principles that differ from GAAP reflective of the varying objectives of regulation. Recodification of areas where SAP and GAAP are parallel is an inefficient use of limited resources.

27. SAP utilizes the framework established by GAAP. **FN2** This document integrates that framework with objectives exclusive to statutory accounting. The NAIC’s guidance on SAP is comprehensive for those principles that differ from GAAP based on the concepts of statutory accounting outlined herein. Those GAAP pronouncements that are not applicable to insurance companies will not be adopted by the NAIC. For those principles that do not differ from GAAP, the NAIC must specifically adopt those GAAP Pronouncements to be included in statutory accounting. GAAP Pronouncements do not become part of SAP until and unless adopted by the NAIC.

28. The body of statutory accounting principles is prescribed in the statutory hierarchy of accounting guidance. This hierarchy provides the framework for judging the presentation of statutory financial statements in conformance with statutory accounting principles.

29. Statutory requirements vary from state to state. While it is desirable to minimize these variations, to the extent that they exist it is the objective of NAIC statutory accounting principles to provide the standard against which the exceptions will be measured and disclosed if material.

FN 2 - The GAAP framework applicable to insurance accounting is set forth in *Statements of Financial Accounting Concepts One, Two, Five, and Six*. These documents, promulgated by the Financial Accounting Standards Board, set forth the objectives and concepts which are used in developing accounting and reporting standards.

V. Statutory Hierarchy

42. The following Hierarchy is not intended to preempt state legislative and regulatory authority.

Level 1

SSAPs, including U.S. GAAP reference material to the extent adopted by the NAIC from the FASB Accounting Standards Codification (FASB Codification or GAAP guidance)

Level 2

Consensus positions of the Emerging Accounting Issues (E) Working Group as adopted by the NAIC (INTs adopted before 2016)

Interpretations of existing SSAPs as adopted by the Statutory Accounting Principles (E) Working Group (INTs adopted in 2016 or beyond)

Level 3

NAIC Annual Statement Instructions

Purposes and Procedures Manual of the NAIC Investment Analysis Office

Level 4

Statutory Accounting Principles Preamble and Statement of Concepts FN4

Level 5

Sources of nonauthoritative GAAP accounting guidance and literature, including: (a) practices that are widely recognized and prevalent either generally or in the industry, (b) FASB Concept Statements, (c) AICPA guidance not included in FASB Codification, (d) International Financial Reporting Standards, (e) Pronouncements of professional associations or regulatory agencies, (f) Technical Information Service Inquiries and Replies included in the AICPA Technical Practice Aids, and (g) Accounting textbooks, handbooks and articles

43. If the accounting treatment of a transaction or event is not specified by the SSAPs, preparers, regulators and auditors of statutory financial statements should consider whether the accounting treatment is specified by another source of established statutory accounting principles. If an established statutory accounting principle from one or more sources in Level 2 or 3 is relevant to the circumstances, the preparer, regulator or auditor should apply such principle. If there is a conflict between statutory accounting principles from one or more sources in Level 2 or 3, the preparer, regulator or auditor should follow the treatment specified by the source in the higher level—that is, follow Level 2 treatment over Level 3. Revisions to guidance in accordance with additions or revisions to the NAIC statutory hierarchy should be accounted for as a change in accounting principle in accordance with SSAP No. 3—*Accounting Changes and Corrections of Errors*.

44. Because of developments such as new legislation or the evolution of a new type of business transaction, there sometimes are no established statutory accounting principles for reporting a specific transaction or event. In those instances, it might be possible to report the event or transaction on the basis of its substance by selecting a statutory accounting principle that appears appropriate when applied in a manner similar to the application of an established statutory principle to an analogous transaction or event. In the absence of a SSAP or another source of established statutory accounting principles, the preparer, regulator or auditor of statutory financial statements may consider other accounting literature, depending on its relevance in the circumstances. Other accounting literature includes the Statutory Accounting Principles Statement of Concepts and GAAP reference material and accounting literature identified in Level 5. The appropriateness of other accounting literature depends on its relevance to the particular circumstances, the specificity of the guidance, and the general recognition of the issuer or author as an authority. For example, the Statutory Accounting Principles Statement of Concepts would be more authoritative than any other sources of accounting literature. Similarly, FASB Concepts Statements would normally be more influential than other sources of nonauthoritative GAAP pronouncements.

FN 4 - The Statutory Accounting Principles Statement of Concepts incorporates by reference FASB Concepts Statements One, Two, Five and Six to the extent they do not conflict with the concepts outlined in the statement. However, for purposes of applying this hierarchy the FASB Concepts Statements shall be included in Level 5 and only those concepts unique to statutory accounting as stated in the statement are included in Level 4.

SSAP No. 4—Assets and Nonadmitted Assets

NAIC Staff Note – this SAP contains the definition of the financial statement element of an **Asset**. Relevant items have been bolded below for ease of identification.

2. For purposes of statutory accounting, **an asset shall be defined as: probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events**. An asset has three essential characteristics: (a) it embodies a probable future benefit that involves a capacity, singly or in combination with other assets, to contribute directly or indirectly to future net cash inflows, (b) a particular entity can obtain the benefit and control others' access to it, and (c) **the transaction or other event giving rise to the entity's right to or control of the benefit has already occurred**. These assets shall then be evaluated to determine whether they are admitted. The criteria used is outlined in paragraph 3.

3. As stated in the Statement of Concepts, "The ability to meet policyholder obligations is predicated on the existence of readily marketable assets available when both current and future obligations are due. Assets having economic value other than those which can be used to fulfill policyholder obligations, or those assets which are unavailable due to encumbrances or other third-party interests should not be recognized on the balance sheet," and are, therefore, considered nonadmitted. For purposes of statutory accounting principles, a nonadmitted asset shall be defined as an asset meeting the criteria in paragraph 2, which is accorded limited or no value in statutory reporting, and is one which is:

- a. Specifically identified within the *Accounting Practices and Procedures Manual* as a nonadmitted asset; or
- b. Not specifically identified as an admitted asset within the *Accounting Practices and Procedures Manual*.

If an asset meets one of these criteria, the asset shall be reported as a nonadmitted asset and charged against surplus unless otherwise specifically addressed within the *Accounting Practices and Procedures Manual*. The asset shall be depreciated or amortized against net income as the estimated economic benefit expires. In accordance with the reporting entity's written capitalization policy, amounts less than a predefined threshold of furniture, fixtures, equipment, or supplies, shall be expensed when purchased.

4. Transactions which do not give rise to assets as defined in paragraph 2 shall be charged to operations in the period the transactions occur. Those transactions which result in amounts which may meet the definition of assets, but are specifically identified within the *Accounting Practices and Procedures Manual* as not giving rise to assets (e.g., policy acquisition costs), shall also be charged to operations in the period the transactions occur.

5. The reporting entity shall maintain a capitalization policy containing the predefined thresholds for each asset class to be made available for the department(s) of insurance.

FN1 - FASB Statement of Financial Accounting Concepts No. 6, Elements of Financial Statements, states: Probable is used with its usual general meaning, rather than in a specific accounting or technical sense (such as that in *FASB Statement No. 5, Accounting for Contingencies*, paragraph 3), and refers to that which can reasonably be expected or believed on the basis of available evidence or logic but is neither certain nor proved.

FN2 - If assets of an insurance entity are pledged or otherwise restricted by the action of a related party, the assets are not under the exclusive control of the insurance entity and are not available to satisfy policyholder obligations due to these encumbrances or other third-party interests. Thus, pursuant to paragraph 2(c), such assets shall not be recognized as an admitted asset on the balance sheet. Additional guidance for assets pledged as collateral is included in INT 01-31.

SSAP No. 5—Liabilities, Contingencies and Impairments of Assets

NAIC Staff Note – this SAP contains the definition of the financial statement element of a **Liability**. Relevant items have been bolded below for ease of identification.

2. **A liability is defined as certain or probable FN1 future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or to provide services to other entities in the future as a result of a past transaction(s) or event(s).**

3. **A liability has three essential characteristics:** (a) it embodies a present duty or responsibility to one or more other entities that entails settlement by probable FN1 future transfer or use of assets at a specified or determinable date, on occurrence of a specified event, or on demand, (b) the duty or responsibility obligates a particular entity, leaving it little or no discretion to avoid the future sacrifice, and (c) the transaction or other event obligating the entity has already happened. This includes, but is not limited to, liabilities arising from policyholder obligations (e.g., policyholder benefits, reported claims and reserves for incurred but not reported claims). Liabilities shall be recorded on a reporting entity's financial statements when incurred.

4. Estimates (e.g., loss reserves) are required in financial statements for many ongoing and recurring activities of a reporting entity. The mere fact that an estimate is involved does not of itself constitute a loss contingency. For example, estimates of losses utilizing appropriate actuarial methodologies meet the definition of liabilities as outlined above and are not loss contingencies.

FN1 - FASB Statement of Financial Accounting Concepts No. 6, Elements of Financial Statements, states: Probable is used with its usual general meaning, rather than in a specific accounting or technical sense (such as that in *FASB Statement 5, Accounting for Contingencies*, paragraph 3), and refers to that which can reasonably be expected or believed on the basis of available evidence or logic but is neither certain nor proved.

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): None

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

Convergence with International Financial Reporting Standards (IFRS): While slightly different, the updated FASB asset & liability definitions do closer align with IFRS definitions. While IFRS retains the phrase “as a result of past events,” it also explicitly retains the term “control,” which is now implicit with the FASB updates. The elimination of the explicit term “control” was a deliberate action of the FASB as they noted that the notion of control has been historically misunderstood (control is to the right that gives rise to the economic benefit rather than to the economic benefits themselves). For reference *IFRS Chapter 4 – The Elements of Financial Statements*, defines an **asset** as a present economic resource controlled by the entity as a result of past events; with the economic resource representing a right that has the potential to produce economic benefits. Additionally, the chapter defines a **liability** as a present obligation of an entity to transfer an economic resource as a result of past events.

Staff Recommendation: NAIC staff recommends that the Working Group move this item to the active listing, categorized as a SAP clarification, and expose revisions to the Preamble, SSAP No. 4—*Assets and Nonadmitted Assets* and SSAP No. 5R—*Liabilities, Contingencies and Impairment of Assets*, as illustrated below and in the issue papers, to incorporate updates from *Chapter 4, Elements of Financial Statements* and *Chapter 7, Presentation* of the FASB’s Conceptual Framework for Financial Reporting.

Proposed edits to the Preamble: proposed modifications reflect updates for superseded FASB Financial Accounting Concepts.

IV. Statutory Accounting Principles Statement of Concepts

25. This document states the fundamental concepts on which statutory financial accounting and reporting standards are based. These concepts provide a framework to guide the National Association of Insurance Commissioners (NAIC) in the continued development and maintenance of statutory accounting principles (“SAP” or “statutory basis”) and, as such, these concepts and principles constitute an accounting basis for the preparation and issuance of statutory financial statements by insurance companies in the absence of state statutes and/or regulations.

26. The NAIC and state insurance departments are primarily concerned with statutory accounting principles that differ from GAAP reflective of the varying objectives of regulation. Recodification of areas where SAP and GAAP are parallel is an inefficient use of limited resources.

27. SAP utilizes the framework established by GAAP. **FN2** This document integrates that framework with objectives exclusive to statutory accounting. The NAIC’s guidance on SAP is comprehensive for those principles that differ from GAAP based on the concepts of statutory accounting outlined herein. Those GAAP pronouncements that are not applicable to insurance companies will not be adopted by the NAIC. For those principles that do not differ from GAAP, the NAIC must specifically adopt those GAAP Pronouncements to be included in statutory accounting. GAAP Pronouncements do not become part of SAP until and unless adopted by the NAIC.

28. The body of statutory accounting principles is prescribed in the statutory hierarchy of accounting guidance. This hierarchy provides the framework for judging the presentation of statutory financial statements in conformance with statutory accounting principles.

29. Statutory requirements vary from state to state. While it is desirable to minimize these variations, to the extent that they exist it is the objective of NAIC statutory accounting principles to provide the standard against which the exceptions will be measured and disclosed if material.

FN 2 - The GAAP framework applicable to insurance accounting is set forth in *Statements of Financial Accounting Concepts* ~~One, Two, Five, and Six~~^{Eight}. These documents, promulgated by the Financial Accounting Standards Board, set forth the objectives and concepts which are used in developing accounting and reporting standards.

V. Statutory Hierarchy

42. The following Hierarchy is not intended to preempt state legislative and regulatory authority.

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Statutory Accounting Principles Preamble and Statement of Concepts FN4

Level 5

Sources of nonauthoritative GAAP accounting guidance and literature, including: (a) practices that are widely recognized and prevalent either generally or in the industry, (b) FASB Concept Statements, (c) AICPA guidance not included in FASB Codification, (d) International Financial Reporting Standards, (e) Pronouncements of professional associations or regulatory agencies, (f) Technical Information Service Inquiries and Replies included in the AICPA Technical Practice Aids, and (g) Accounting textbooks, handbooks and articles

FN 4 - The Statutory Accounting Principles Statement of Concepts incorporates by reference FASB Concepts Statements ~~One, Two, Five and Six~~^{Eight} to the extent they do not conflict with the concepts outlined in the statement. However, for purposes of applying this hierarchy the FASB Concepts Statements shall be included in Level 5 and only those concepts unique to statutory accounting as stated in the statement are included in Level 4.

Proposed edits SSAP No. 4—Assets and Nonadmitted Assets: proposed modifications reflect an updated definition of the term Asset – to match the newly issued definition in FASB Statement of Financial Accounting Concepts No. 8

2. For purposes of statutory accounting, an asset shall be defined as: ~~a present right of an entity to an economic benefit, probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events.~~ An asset has ~~two~~^{three} essential characteristics: (a) it ~~is a present right~~^{embodies a probable future benefit that involves a capacity, singly or in combination with other assets,}

~~to contribute directly or indirectly to future net cash inflows, and (b) the right is to an economic benefit, a particular entity can obtain the benefit and control others' access to it FN1 FN2, and (c) the transaction or other event giving rise to the entity's right to or control of the benefit has already occurred.~~ These assets shall then be evaluated to determine whether they are admitted. The criteria used is outlined in paragraph 3.

3. As stated in the Statement of Concepts, "The ability to meet policyholder obligations is predicated on the existence of readily marketable assets available when both current and future obligations are due. Assets having economic value other than those which can be used to fulfill policyholder obligations, or those assets which are unavailable due to encumbrances or other third-party interests should not be recognized on the balance sheet," and are, therefore, considered nonadmitted. For purposes of statutory accounting principles, a nonadmitted asset shall be defined as an asset meeting the criteria in paragraph 2, which is accorded limited or no value in statutory reporting, and is one which is:

- a. Specifically identified within the *Accounting Practices and Procedures Manual* as a nonadmitted asset; or
- b. Not specifically identified as an admitted asset within the *Accounting Practices and Procedures Manual*.

If an asset meets one of these criteria, the asset shall be reported as a nonadmitted asset and charged against surplus unless otherwise specifically addressed within the *Accounting Practices and Procedures Manual*. The asset shall be depreciated or amortized against net income as the estimated economic benefit expires. In accordance with the reporting entity's written capitalization policy, amounts less than a predefined threshold of furniture, fixtures, equipment, or supplies, shall be expensed when purchased.

4. Transactions which do not give rise to assets as defined in paragraph 2 shall be charged to operations in the period the transactions occur. Those transactions which result in amounts which may meet the definition of assets, but are specifically identified within the *Accounting Practices and Procedures Manual* as not giving rise to assets (e.g., policy acquisition costs), shall also be charged to operations in the period the transactions occur.

5. The reporting entity shall maintain a capitalization policy containing the predefined thresholds for each asset class to be made available for the department(s) of insurance.

FN1 - FASB Statement of Financial Accounting Concepts No. 86, Elements of Financial Statements, states that the combination of these two characteristics allows an entity to obtain the economic benefit and control others' access to the benefit. A present right of an entity to an economic benefit entitles the entity to the economic benefit and the ability to restrict others' access to the benefit to which the entity is entitled. Probable is used with its usual general meaning, rather than in a specific accounting or technical sense (such as that in *FASB Statement No. 5, Accounting for Contingencies*, paragraph 3), and refers to that which can reasonably be expected or believed on the basis of available evidence or logic but is neither certain nor proved.

FN2 - If assets of an insurance entity are pledged or otherwise restricted by the action of a related party, the assets are not under the exclusive control of the insurance entity and are not available to satisfy policyholder obligations due to these encumbrances or other third-party interests. Thus, pursuant to paragraph 2(c), such assets shall not be recognized as an admitted asset on the balance sheet. Additional guidance for assets pledged as collateral is included in INT 01-31.

Relevant Literature

9. This statement incorporates the definition of an asset from FASB Statement of Financial Accounting Concepts No. 8, Chapter 4, Elements of Financial Statements, paragraphs E16-E18~~25-33~~.

References

Relevant Issue Papers

Issue Paper No. 4—Definition of Assets and Nonadmitted Assets

Issue Paper No. 119—Capitalization Policy, An Amendment to SSAP Nos. 4, 19, 29, 73, 79 and 82

Issue Paper No. 16X -Updates to the Definition of an Asset

SSAP No. 5—Liabilities, Contingencies and Impairments of Assets: proposed modifications reflect an updated definition of the term **Liability** – to match the newly issued definition in FASB Statement of Financial Accounting Concepts No. 8

2. A liability is defined as ~~a present obligation of an entity to transfer an economic benefit, certain or probable FN1 future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or to provide services to other entities in the future as a result of a past transaction(s) or event(s)~~.

3. A liability has ~~three two~~ essential characteristics: (a) it ~~is a present obligation embodies a present duty or responsibility to one or more other entities that entails settlement by probable FN1 future transfer or use of assets at a specified or determinable date, on occurrence of a specified event, or on demand, and~~ (b) the ~~obligation requires an entity to transfer or otherwise provide economic benefit to others duty or responsibility obligates a particular entity, leaving it little or no discretion to avoid the future sacrifice, and~~ (c) ~~the transaction or other event obligating the entity has already happened.~~ This includes, but is not limited to, liabilities arising from policyholder obligations (e.g., policyholder benefits, reported claims and reserves for incurred but not reported claims). Liabilities shall be recorded on a reporting entity's financial statements when incurred.

4. Estimates (e.g., loss reserves) are required in financial statements for many ongoing and recurring activities of a reporting entity. The mere fact that an estimate is involved does not of itself constitute a loss contingency. For example, estimates of losses utilizing appropriate actuarial methodologies meet the definition of liabilities as outlined above and are not loss contingencies.

~~FN1—FASB Statement of Financial Accounting Concepts No. 6, Elements of Financial Statements, states: Probable is used with its usual general meaning, rather than in a specific accounting or technical sense (such as that in FASB Statement 5, Accounting for Contingencies, paragraph 3), and refers to that which can reasonably be expected or believed on the basis of available evidence or logic but is neither certain nor proved.~~

Relevant Literature

39. This statement adopts FASB Statement No. 5, Accounting for Contingencies (FAS 5), FASB Statement 114, Accounting by Creditors for Impairment of a Loan only as it amends in part FAS 5~~and paragraphs 35 and 36 of FASB Statement of Financial Accounting Concepts No. 6, Elements of Financial Statements~~. FASB Interpretation No. 14, Reasonable Estimation of the Amount of a Loss, An Interpretation of FASB Statement No. 5 (FIN No. 14) is adopted with the modification to accrue the loss

amount as the midpoint of the range rather than the minimum as discussed in paragraph 3 of FIN No. 14. This statement adopts with modification ASU 2013-04, *Obligations Resulting from Joint and Several Liability Arrangements for Which the Total Amount of the Obligation is Fixed at the Reporting Date* with the same statutory modification adopted for FIN 14. This statement incorporates the definition of a liability from FASB Statement of Financial Accounting Concepts No. 8, Chapter 4, Elements of Financial Statements, paragraphs E37 and E38.

References

Relevant Issue Papers

Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets

Issue Paper No. 20—Gain Contingencies

Issue Paper No. 135—Guarantor’s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others

[Issue Paper No. 16X – Updates to the Definition of a Liability](#)

Recommendation:

NAIC staff recommends that the Working Group move this item to the active listing, categorized as a SAP clarification, and expose revisions to the Preamble, SSAP No. 4—Assets and Nonadmitted Assets and SSAP No. 5R—Liabilities, Contingencies and Impairment of Assets, as illustrated in the agenda item and in the draft issue papers, to incorporate updates from Chapter 4, Elements of Financial Statements and Chapter 7, Presentation of the FASB’s Conceptual Framework for Financial Reporting.

Staff Review Completed by: Jim Pinegar—NAIC Staff, January – 2022

Status:

On April 4, 2022, the Statutory Accounting Principles (E) Working Group moved this agenda item to the active listing, categorized as a SAP clarification, and exposed revisions to the Preamble, SSAP No. 4—Assets and Nonadmitted Assets and SSAP No. 5R—Liabilities, Contingencies and Impairment of Assets to incorporate 1) updates from FASB Concepts Statement No. 8, *Conceptual Framework for Financial Reporting—Chapter 7, Presentation* which identifies factors to consider when deciding how items should be displayed on the financial statements, and 2) Concepts Statement No. 8, *Conceptual Framework for Financial Reporting—Chapter 4, Elements of Financial Statements*, which updates the definitions of an asset and a liability. The Working Group also exposed two draft issue papers for historical documentation of these SAP clarifications.

On August 10, 2022, the Statutory Accounting Principles (E) Working Group adopted, as final, the exposed revisions, as illustrated above, to the Preamble and SSAP No. 4—Assets and Nonadmitted Assets. The revisions incorporate updates from FASB Concepts Statement No. 8, *Conceptual Framework for Financial Reporting—Chapter 7, Presentation*, which identifies factors to consider when deciding how items should be displayed on the financial statements, and Concepts Statement No. 8, *Conceptual Framework for Financial Reporting—Chapter 4, Elements of Financial Statements*, which updates the definition of an asset. In addition, the Working Group adopted *Issue Paper No. 166—Updates to the Definition of an Asset*, which documents the revisions to SSAP No. 4.

Additionally, on August 10, 2022, the Working Group re-exposed the proposed revisions and draft issue paper related to the definition change of a liability in SSAP No. 5R—Liabilities, Contingencies and Impairment of Assets.

Attachment One-L
Accounting Practices and Procedures (E) Task Force
8/11/22

Ref #2022-01

This exposure intends to provide additional time for industry to review the changes in accordance with statutory accounting statements. These revisions are also shown above under the SSAP No. 5R heading.

https://naiconline.sharepoint.com/sites/NAICSupportStaffHub/Member Meetings/E CMTE/APPTF/2022SummerNM/1_SAPWG/Minutes/Att One-L_22-01_Preamble_SSAP4.docx

Statutory Issue Paper No. 166

Updates to the Definition of an Asset

STATUS

Finalized – August 10, 2022

Original and Current Authoritative Guidance: SSAP No. 4

Type of Issue:

Common Area

SUMMARY OF ISSUE

1. This issue paper documents the SAP clarification revisions to *SSAP No. 4—Assets and Nonadmitted Assets*. The intent of the revisions is to align current statutory accounting guidance, specifically the definition of an “asset,” with the term utilized by the Financial Accounting Standards Board (FASB).

SUMMARY CONCLUSION

2. The statutory accounting principle clarifications to SSAP No. 4 (illustrated in Exhibit A), reflect that for the purposes of statutory accounting, an asset shall be defined as: a present right of an entity to an economic benefit. An asset has two essential characteristics: (1) it is a present right, and (2) the right is to an economic benefit. The combination of these two characteristics allows an entity to obtain the economic benefit and control others’ access to the benefit. A present right of an entity to an economic benefit entitles the entity to the economic benefit and the ability to restrict others’ access to the benefit to which the entity is entitled. For clarity, an “economic benefit” represents services or other items of economic value and generally result in net cash inflows to the entity. Pursuant to current guidance, assets are then evaluated, as outlined in paragraph 3 below, to determine whether they are admitted for statutory accounting purposes.

3. Assets having economic value other than those which can be used to fulfill policyholder obligations, or those assets which are unavailable due to encumbrances or other third-party interests should not be recognized on the balance sheet, and are, therefore, considered nonadmitted. For purposes of statutory accounting principles, a nonadmitted asset shall be defined as an asset meeting the criteria in paragraph 2, which is accorded limited or no value in statutory reporting, and is one which is:

- a. Specifically identified within the *Accounting Practices and Procedures Manual* as a nonadmitted asset; or
- b. Not specifically identified as an admitted asset within the *Accounting Practices and Procedures Manual*.

If an asset meets one of these criteria, the asset shall be reported as a nonadmitted asset and charged against surplus unless otherwise specifically addressed within the *Accounting Practices and Procedures Manual*. The asset shall be depreciated or amortized against net income as the estimated economic benefit expires. In accordance with the reporting entity’s written capitalization policy, amounts less than a predefined threshold of furniture, fixtures, equipment, or supplies, shall be expensed when purchased.

4. Transactions which do not give rise to assets as defined in paragraph 2 shall be charged to operations in the period the transactions occur. Those transactions which result in amounts which may meet the definition of assets but are specifically identified within the *Accounting Practices and Procedures*

Manual as not giving rise to assets (e.g., policy acquisition costs), shall also be charged to operations in the period the transactions occur.

5. The reporting entity shall maintain a capitalization policy containing the predefined thresholds for each asset class to be made available for the department(s) of insurance.

DISCUSSION

6. In December 2021, FASB issued *Concepts Statement No. 8, Conceptual Framework for Financial Reporting—Chapter 4, Elements of Financial Statements*, which introduced updated definitions of certain key elements used in financial reporting – most notably updating the fundamental definition of an asset. Through the FASB’s adoption of Concept Statement No. 8, the original Concept Statement No. 6 has been superseded. As statutory accounting currently reflects FASB’s historical definition, this issue paper is to review the prior concept definition (currently utilized by statutory accounting) and compare it to FASB’s updated concept definition and assess whether the revised concept definition shall be reflected in statutory accounting.

7. FASB concept statements do not reflect authoritative U.S. GAAP guidance. Rather concept statements are intended to set forth objectives and fundamental concepts that will be the basis for development of financial accounting and reporting guidance. The term “asset” is not captured or defined in the FASB Accounting Standards Codification (which is the source of authoritative U.S. GAAP.) Furthermore, although the concept statement is intended to be used as a guide in establishing authoritative U.S. GAAP, the FASB is not restricted to the concepts when developing guidance, and the FASB may issue U.S. GAAP which may be inconsistent with the objectives and fundamental concepts set forth in Concept Statements. A change in a FASB Concept Statement does not 1) require a change in existing U.S. GAAP, 2) amend, modify or interpret the Accounting Standards Codification, or 3) justify either changing existing generally accepted accounting and reporting practices or interpreting the Accounting Standards Codification based on personal interpretations of the objectives and concepts in the concepts statement.

8. Under the prior FASB concept statement, which was reflected in SSAP No. 4, an asset was defined as a probable future economic benefit obtained or controlled by a particular entity as a result of past transactions or events. In addition, the historical definition possessed three essential characteristics in that (1) it embodies a probable future benefit that involves a capacity, singly or in combination with other assets, to contribute directly or indirectly to future net cash inflows, (2) a particular enterprise can obtain the benefit and control others' access to it, and (3) the transaction or other event giving rise to the enterprise's right to or control of the benefit has already occurred.

9. Pursuant to the prior concept statement, and as incorporated in SSAP No. 4, *probable*, as referenced both in the definition and essential characters, was used in a usual general meaning, rather than in a specific accounting or technical sense and referred to which can reasonably be expected or believed on the basis of available evidence or logic but is neither certain nor proved.

10. With the new FASB conceptual framework chapter, an asset is now defined as a present right of an entity to an economic benefit. In addition, the current definition only has two essential characteristics in that the asset is (1) a present right, and (2) the right is to an economic benefit. The combination of these two characteristics allows an entity to obtain the economic benefit and control others' access to the benefit. A present right of an entity to an economic benefit entitles the entity to the economic benefit and the ability to restrict others' access to the benefit to which the entity is entitled. For clarity, an “economic benefit” represents services or other items of economic value to the asset holder and generally result in net cash inflows to the entity.

11. The updated asset definition from Concept Statement No. 8 no longer includes the term *probable* or the phrases *future economic benefit* and *as a result of past transactions or events*. The FASB concluded that the term *probable* has historically been misunderstood as implying that a future benefit must be probable to a certain threshold before the definition of an asset was met. Thus, if the probability of a future benefit was low, an asset could not be recognized. The FASB also struck the phrase *future economic benefit* as this phrase often was interpreted that the asset must represent a certain future economic benefit (such as eventual cash inflows), however with this action, the FASB clarified that the asset represents the rights to the benefit, not the actual benefit itself – nor the probability of realization. Finally, FASB struck the phrase *as the result of past transactions or events*. It was concluded that if the asset represents a *present right*, by default, the right must have occurred as the result of a past transaction or event and thus this phraseology was deemed redundant and unnecessary.

12. To meet the definition of an asset, the right must be a “present right,” that is the right must exist at the financial statement date, not a right that is expected to occur in the future. The existence of a present right at the financial statement date means that the right and therefore the reasons why that asset was obtained, must have arisen from a past transaction or event. A right entitles its holder to have or obtain something, or act in a certain manner. Rights can be obtained in various ways and are often obtained through legal ownership. Legal ownership gives the owner access to the economic benefits, including the ability to possess, use, and enjoy the right. However, legally enforceable rights to economic benefits can also be obtained without legal ownership of the underlying property. This occurs in cases where the underlying benefit itself, as is the example in the right of use or rights to specified cashflows in contract provisions, are possessed by an entity other than the legal title holder. One important aspect of the change in definition is the removal of the term “control.” The FASB clarified that while the term control has been removed, the notion of control has been maintained in the updated definition. In the prior definition, control was a required element and thus without control, an asset was not recognized. However, control often refers to the ability to direct, manage, or have power over something. The FASB stated that in many instances, constituents misunderstood the notion of control by 1) believing it represented a probable future economic benefit, or 2) failing to properly identify what was specifically controlled. An example provided was a trade receivable – the definition of control might be misapplied to mean the successful collection; however, the correct application should refer to the rights of collection – not the successful collection itself. Citing this as an example, the FASB concluded that while the notion of control was an important aspect, the explicit term did not sufficiently add to the definition – thus the term “control” was removed.

13. When reviewing the substance of the revisions, the FASB concluded that the updated definition resulted in a clearer and more precise definition and it did not fundamentally change the historical concept of an asset, nor should the revisions result in any material changes in instrument reclassification (e.g., items now being classified as an asset when previously they were not considered assets). For statutory accounting purposes, the updated definition should be viewed similarly, that is it does not change fundamental concepts, change current practices, or introduce a new, original or a modified accounting principle. The revisions to the definition of an asset clarify the definitional language and do not modify the original intent of SSAP No. 4 and thus the changes are deemed to be a statutory accounting principle clarification.

14. One concept articulated in SSAP No. 4, and one that is not proposed for revision, is the concept of nonadmitted assets. As revisions are not proposed to this concept, further discussion is not included in this issue paper.

Actions of the Statutory Accounting Principles (E) Working Group

15. During the Spring 2022 National Meeting, the Working Group exposed this issue paper for public comment.

16. During the Summer 2022 National Meeting, the Working Group adopted the exposed revisions to SSAP No. 4 and affirmed the SAP clarification classification of these revisions.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

17. Relevant excerpts of SSAP No. 4, paragraphs 2-5 regarding the definition of an asset and a nonadmitted asset (nonadmitted asset as it is referenced in definition of an asset paragraph) utilized by statutory accounting is:

2. For purposes of statutory accounting, an asset shall be defined as: probable¹ future economic benefits obtained or controlled by a particular entity as a result of past transactions or events. An asset has three essential characteristics: (a) it embodies a probable future benefit that involves a capacity, singly or in combination with other assets, to contribute directly or indirectly to future net cash inflows, (b) a particular entity can obtain the benefit and control others' access to it², and (c) the transaction or other event giving rise to the entity's right to or control of the benefit has already occurred. These assets shall then be evaluated to determine whether they are admitted. The criteria used is outlined in paragraph 3.

3. As stated in the Statement of Concepts, "The ability to meet policyholder obligations is predicated on the existence of readily marketable assets available when both current and future obligations are due. Assets having economic value other than those which can be used to fulfill policyholder obligations, or those assets which are unavailable due to encumbrances or other third-party interests should not be recognized on the balance sheet," and are, therefore, considered nonadmitted. For purposes of statutory accounting principles, a nonadmitted asset shall be defined as an asset meeting the criteria in paragraph 2, which is accorded limited or no value in statutory reporting, and is one which is:

- a. Specifically identified within the *Accounting Practices and Procedures Manual* as a nonadmitted asset; or
- b. Not specifically identified as an admitted asset within the *Accounting Practices and Procedures Manual*.

If an asset meets one of these criteria, the asset shall be reported as a nonadmitted asset and charged against surplus unless otherwise specifically addressed within the *Accounting Practices and Procedures Manual*. The asset shall be depreciated or amortized against net income as the estimated economic benefit expires. In accordance with the reporting entity's written capitalization policy, amounts less than a predefined threshold of furniture, fixtures, equipment, or supplies, shall be expensed when purchased.

4. Transactions which do not give rise to assets as defined in paragraph 2 shall be charged to operations in the period the transactions occur. Those transactions which result in amounts

¹ FASB Statement of Financial Accounting Concepts No. 6, *Elements of Financial Statements*, states:

Probable is used with its usual general meaning, rather than in a specific accounting or technical sense (such as that in FASB Statement No. 5, *Accounting for Contingencies*, paragraph 3), and refers to that which can reasonably be expected or believed on the basis of available evidence or logic but is neither certain nor proved.

² If assets of an insurance entity are pledged or otherwise restricted by the action of a related party, the assets are not under the exclusive control of the insurance entity and are not available to satisfy policyholder obligations due to these encumbrances or other third-party interests. Thus, pursuant to paragraph 2(c), such assets shall not be recognized as an admitted asset on the balance sheet. Additional guidance for assets pledged as collateral is included in INT 01-31.

which may meet the definition of assets, but are specifically identified within the *Accounting Practices and Procedures Manual* as not giving rise to assets (e.g., policy acquisition costs), shall also be charged to operations in the period the transactions occur.

5. The reporting entity shall maintain a capitalization policy containing the predefined thresholds for each asset class to be made available for the department(s) of insurance.

Generally Accepted Accounting Principles

18. Relevant paragraphs from *Concepts Statement No. 8, Conceptual Framework for Financial Reporting—Chapter 4, Elements of Financial Statements* have been included below:

Assets

E16. An asset is a present right of an entity to an economic benefit.

Characteristics of Assets

E17. An asset has the following two essential characteristics: a. It is a present right. b. The right is to an economic benefit.

The combination of those two characteristics allows an entity to obtain the economic benefit and control others' access to the benefit. A present right of an entity to an economic benefit entitles the entity to the economic benefit and the ability to restrict others' access to the benefit to which the entity is entitled.

E19. Essential to the definition of an asset is a right to an "economic benefit"—the capacity to provide services or benefits to the entities that use them. Generally, in a business entity, that economic benefit eventually results in potential net cash inflows to the entity. In a not-for-profit entity, that economic benefit is used to provide desired or needed goods or services to beneficiaries or other constituents, which may or may not directly result in net cash inflows to the entity. Some not-for-profit entities rely significantly on contributions or donations of cash to supplement selling prices or to replace cash or other assets used in providing goods and services. The relationship between the economic benefit of an entity's assets and net cash inflows to that entity can be indirect in both business entities and not-for-profit entities.

E22. A right entitles its holder to have or obtain something or to act in a certain manner. Rights can be obtained in various ways. Often, rights are obtained by legal ownership, for example, owning a building. Legal ownership gives the owner access to economic benefits, including the ability to possess, use, and enjoy the right; to sell, donate, or exchange the right; or to exploit the right's value by, for example, pledging it as a security for borrowing.

E23. Legally enforceable rights to economic benefits can be obtained without legal ownership of the underlying benefit itself as is the case, for example, when property is leased or intellectual property is licensed or when an entity has the rights to specified certain cash flows, as in the case of a contract providing rights only to interest flows from a specified debt instrument. Other legally enforceable rights that give rise to assets include the right to require other parties to make payments or render services and the right to use a patent or a trademark. Legally enforceable rights include, among other rights, contractual rights (for example, rights from options held).

E31. Another essential characteristic of an asset is that the right of an entity must be to an economic benefit. An asset of an entity might be represented by rights to a particular property (such as the right to possess, use, and enjoy a parcel of land) or by rights to some or all the economic benefits derived from the property.

19. One of the most notable changes to the definitional change was the explicit removal of the term *control*, however the notion of control was retained. *Chapter 4, Elements of Financial Statements* included commentary regarding the FASB's rationale of the change.

BC4.17. The definition of an asset in Concepts Statement 6 associated assets with a particular entity by inclusion of the term control. Control often refers to the ability to direct, manage, or have power over something to obtain or access benefits or to increase, maintain, or protect those benefits. Control goes beyond legal rights and includes the ability to obtain and control the benefit in other ways, including restricting, or otherwise prohibiting, the access of others to the economic benefit of the asset.

BC4.18. In applying the definition of an asset in Concepts Statement 6, however, many constituents misunderstood the notion of control. Some improperly viewed control of a probable future economic benefit in the same manner as described in business combinations or consolidation accounting. Additionally, in applying the term control, some failed to properly identify that which was controlled under the asset definition. For example, in the instance of trade receivables, the definition could be misunderstood to indicate that what is controlled is the successful collection of the receivable in the future. When applied appropriately, however, the definition in Concepts Statement 6 would conclude that the present right to collection is what is controlled. Similarly, if an entity has an option to acquire an asset, the present right of that entity is to the option itself, not the underlying asset that the option provides the right to acquire. Thus, control references the existing right that has the ability to generate economic benefits, or potential economic benefits, and to restrict others' access to those benefits.

BC4.19. While the Board concluded that the notion of control was an important aspect of the asset definition, it was not clear to the Board whether the explicit term control added anything significant to the definition of an asset. Those considerations are addressed by including the term present right in the definition in this chapter. If an entity has a present right to an economic benefit, that would seem to be sufficient to establish the fact that the asset is an asset of that entity.³⁷ Indeed, if an entity has exclusive rights, it presumably can deny or regulate access to that benefit by others, thereby implying control.

BC4.22. The Board redeliberated the issue and decided that the term control should not be used in the definition of an asset for the following reasons:

- a. It eliminates redundancy. If an entity has a present right, that would seem to be sufficient to establish the fact that the asset is an asset of that entity. In fact, the Board used the phrase of the entity in the definition of an asset to clarify that point. Indeed, if an entity has exclusive rights, it presumably can deny or regulate access to that benefit by others.
- b. It eliminates misunderstanding of the term. The term control has two issues in the existing definition of an asset. First, many have a different definition of the term control. Second, many associate the term control with whether one has control of the economic benefit. The Board notes that what is controlled is the existing right that gives rise to economic benefits, or potential economic benefits, rather than the economic benefits themselves. The Board's reasoning for removing the term control is the same as removing other terms, such as future and probable, from the definition of an asset.
- c. It avoids confusion with the IASB's Conceptual Framework use and meaning of the term. The IASB defines an asset as "a present economic resource controlled by the entity as a result of past events." In the basis for conclusions to the IASB's Conceptual Framework's discussion on control, footnote 19 references both IFRS 10, Consolidated Financial Statements, and IFRS 15, Revenue from Contracts with Customers. The Board is concerned about the references to IFRS 10 and

IFRS 15 because those standards refer to control of an economic benefit, not control of the right. The Board notes that convergence with the IASB's asset definition on this point is not critical because it could perpetuate the misunderstanding discussed above.

20. Other changes regarding the definition of an asset included removal of the term *probable* and the phrases *future economic benefit* and *past transactions of events*. Rationale for these changes were documented in *Chapter 4, Elements of Financial Statements* commentary as follows:

BC4.11. The definitions of both an asset and a liability in Concepts Statement 6 include the term probable and the phrases future economic benefit and past transactions or events. The term probable in the definitions in Concepts Statement 6 has been misunderstood as implying that a future economic benefit or a future sacrifice of economic benefit must be probable to a certain threshold before the definition of an asset or a liability is met. In other words, if the probability of future economic benefit is low, the asset definition is not met under that interpretation. A similar interpretation could be made for liabilities. The footnotes to the Concepts Statement 6 definition of assets and liabilities also were not helpful in clarifying the application of the term probable as used in the definitions of assets and liabilities. Accordingly, the Board decided to eliminate that term from the definitions of both assets and liabilities.

BC4.12. The term future in the definitions in Concepts Statement 6 focused on identifying a future flow of economic benefits to demonstrate that an asset exists or identifying a future transfer of economic benefits to demonstrate that a liability exists. The definitions in Concepts Statement 6 were often misunderstood as meaning that the asset (liability) is the ultimate future inflow (outflow). For example, in the instance of trade receivables, the definition in Concepts Statement 6 could be misunderstood to indicate that the asset is the successful collection of the receivable in the future. When applied appropriately, however, the definition would conclude that the asset is the present right to collection. Similar misunderstandings occurred in applying the liability definition. As a result, the Board concluded that a focus on the term present would appropriately shift the focus from identifying a future occurrence. Therefore, the Board decided to include the term present right to demonstrate that an asset exists and emphasize the term present obligation to demonstrate that a liability exists.

BC4.13. The definitions of assets and liabilities in Concepts Statement 6 both include the phrase past transactions or events. The Board concluded that if an entity has a present right or a present obligation, one can reasonably assume that it was obtained from some past transaction or event. Therefore, that phrase is considered redundant and has been eliminated from the definitions.

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy

Generally Accepted Accounting Principles

- FASB Statement of Financial Accounting Concepts No. 8, Conceptual Framework for Financial Reporting – Chapter 4, Elements of Financial Statements

Effective Date

21. As issue papers are not authoritative and are not represented in the Statutory Hierarchy (see Section V of the Preamble), the consideration and adoption of this issue paper will not have any impact on the SAP clarifications adopted to SSAP No. 4 by the Working Group on August 10, 2022.

Ref # 2022-01

EXHIBIT A – SAP Clarification Revisions to SSAP No. 4—Assets and Nonadmitted Assets

Statement of Statutory Accounting Principles No. 4

Assets and Nonadmitted Assets

SCOPE OF STATEMENT

1. This statement establishes the definition of an “asset” for use in statutory accounting and establishes the criteria for consistent treatment of nonadmitted assets.

SUMMARY CONCLUSION

2. For purposes of statutory accounting, an asset shall be defined as: a present right of an entity to an economic benefit³ ~~probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events~~. An asset has ~~three~~ ~~two~~ essential characteristics: (a) it ~~is a present right~~ embodies a probable future benefit that involves a capacity, singly or in combination with other assets, to contribute directly or indirectly to future net cash inflows, and (b) ~~the right is to an economic benefit, a particular entity can obtain the benefit and control others' access to it⁴⁵, and (c) the transaction or other event giving rise to the entity's right to or control of the benefit has already occurred~~. These assets shall then be evaluated to determine whether they are admitted. The criteria used is outlined in paragraph 3.

3. As stated in the Statement of Concepts, "The ability to meet policyholder obligations is predicated on the existence of readily marketable assets available when both current and future obligations are due. Assets having economic value other than those which can be used to fulfill policyholder obligations, or those assets which are unavailable due to encumbrances or other third-party interests should not be recognized on the balance sheet," and are, therefore, considered nonadmitted. For purposes of statutory accounting principles, a nonadmitted asset shall be defined as an asset meeting the criteria in paragraph 2, which is accorded limited or no value in statutory reporting, and is one which is:

- a. Specifically identified within the *Accounting Practices and Procedures Manual* as a nonadmitted asset; or
- b. Not specifically identified as an admitted asset within the *Accounting Practices and Procedures Manual*.

³ *FASB Statement of Financial Accounting Concepts No. 6, Elements of Financial Statements*, states:

~~Probable is used with its usual general meaning, rather than in a specific accounting or technical sense (such as that in FASB Statement No. 5, Accounting for Contingencies, paragraph 3), and refers to that which can reasonably be expected or believed on the basis of available evidence or logic but is neither certain nor proved.~~

⁴ *FASB Statement of Financial Accounting Concepts No. 8, Elements of Financial Statements*, states that the combination of these two characteristics allows an entity to obtain the economic benefit and control others' access to the benefit. A present right of an entity to an economic benefit entitles the entity to the economic benefits and the ability to restrict other's access to the benefit to which the entity is entitled.

⁵ If assets of an insurance entity are pledged or otherwise restricted by the action of a related party, the assets are not under the exclusive control of the insurance entity and are not available to satisfy policyholder obligations due to these encumbrances or other third-party interests. Thus, pursuant to paragraph 2(c), such assets shall not be recognized as an admitted asset on the balance sheet. Additional guidance for assets pledged as collateral is included in INT 01-31.

If an asset meets one of these criteria, the asset shall be reported as a nonadmitted asset and charged against surplus unless otherwise specifically addressed within the *Accounting Practices and Procedures Manual*. The asset shall be depreciated or amortized against net income as the estimated economic benefit expires. In accordance with the reporting entity's written capitalization policy, amounts less than a predefined threshold of furniture, fixtures, equipment, or supplies, shall be expensed when purchased.

4. Transactions which do not give rise to assets as defined in paragraph 2 shall be charged to operations in the period the transactions occur. Those transactions which result in amounts which may meet the definition of assets, but are specifically identified within the *Accounting Practices and Procedures Manual* as not giving rise to assets (e.g., policy acquisition costs), shall also be charged to operations in the period the transactions occur.
5. The reporting entity shall maintain a capitalization policy containing the predefined thresholds for each asset class to be made available for the department(s) of insurance.

Assets Pledged as Collateral or Otherwise Restricted

6. Assets that are pledged to others as collateral or otherwise restricted (not under the exclusive control of the insurer, subject to a put option contract, etc.) shall be identified in the investment schedules pursuant to the codes in the annual statement instructions, disclosed in accordance with SSAP No. 1—*Accounting Policies, Risks & Uncertainties, and Other Disclosures*, reported in the general interrogatories, and included in any other statutory schedules or disclosure requirements requesting information for assets pledged as collateral or otherwise restricted. Restricted assets should be reviewed to determine admitted or nonadmitted assets status in the statutory financial statements per the terms of their respective SSAPs. Asset restrictions may be a factor in determining the admissibility of an asset under a respective SSAP⁶. However, determining that a restricted asset is an admitted asset does not eliminate the statutory requirements to document and identify the asset as one that is pledged as collateral or otherwise restricted.

7. Assets pledged as collateral are one example of assets that are not under the exclusive control of the insurer, and are therefore restricted, even if the assets are admitted under statutory accounting guidelines (e.g., the asset is substitutable and/or other related SSAP conditions are met). As such, the asset shall be coded as pledged in the investment schedules pursuant to the annual statement instructions, disclosed in accordance with SSAP No. 1, reported in the general interrogatories, and included in any other statutory schedules or disclosure requirements requesting information for assets pledged as collateral or otherwise restricted.

Disclosure

8. The financial statements shall disclose if the written capitalization policy and the resultant predefined thresholds changed from the prior period and the reason(s) for such change.

Relevant Literature

9. This statement incorporates the definition of an asset from ~~adopts~~-FASB Statement of Financial Accounting Concepts No. 86, Chapter 4. Elements of Financial Statements, paragraphs E16-E18~~25-33~~.

Effective Date and Transition

10. This statement is effective for years beginning January 1, 2001. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with SSAP No.

⁶ An example of such a situation is detailed in footnote 2 pertaining to assets restricted by the action of a related party. This is only a single example and each restricted asset would need to be reviewed to ensure it qualifies as an admitted asset.

Ref # 2022-01

3—*Accounting Changes and Corrections of Errors.* Guidance reflected in paragraphs 3, 5 and 8, incorporated from SSAP No. 87, was originally effective for years beginning on and after January 1, 2004. The guidance in footnote 2 to paragraph 2 was originally contained within *INT 01-03: Assets Pledged as Collateral or Restricted for the Benefit of a Related Party* and was effective June 11, 2001.

REFERENCES

Relevant Issue Papers

- *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets*
- *Issue Paper No. 119—Capitalization Policy, An Amendment to SSAP Nos. 4, 19, 29, 73, 79 and 82*
- [*Issue Paper No. 166—Updates to the Definition of an Asset*](#)

https://naiconline.sharepoint.com/sites/NAICSupportStaffHub/Member_Meetings/E_CMTE/APPTF/2022SummerNM/1_SAPWG/Minutes/Attachment%20One-M_22-01A_IP166.docx

MEMORANDUM

TO: Dale Bruggeman (MO), Chair, Statutory Accounting Principles (E) Working Group
Kevin Clark, (IA), Vice Chair, Statutory Accounting Principles (E) Working Group

FROM: Mike Boerner (TX), Chair, Life Actuarial (A) Task Force,
Craig Chupp (VA), Vice Chair, Life Actuarial (A) Task Force

DATE: July 27, 2022

RE: Life Actuarial (A) Task Force Coordination with the Statutory Accounting Principles (E) Working Group
Summer 2022

The Statutory Accounting Principles (E) Working Group charges requires the Working Group to *coordinate with the Life Actuarial (A) Task Force on changes to the AP&P Manual related to the Valuation Manual VM-A, Requirements, and VM-C, Actuarial Guidelines, as well as other Valuation Manual requirements. This process will include the receipt of periodic reports on changes to the Valuation Manual on items that require coordination.* To facilitate the coordination, the Task Force will provide to the Working Group a memorandum of Valuation Manual amendments, actuarial guidelines and valuation related NAIC model revisions prior to each NAIC National Meeting. This memorandum provides the Working Group updates to the publications since the 2021 NAIC Summer Meeting.

Valuation Manual – Attachment A to this memo includes a detailed listing of the amendments made to the Valuation Manual since the 2021 NAIC Summer Meeting. The amendments were adopted by the Life Insurance and Annuities (A) Committee on July 20, 2022. The amendments will be considered for adoption by the Executive (EX) Committee and Plenary at the 2022 NAIC Summer Meeting.

Actuarial Guidelines – Since the 2021 NAIC Summer Meeting the Task Force has created or revised the actuarial guidelines created listed below:

Actuarial Guideline XXV – Calculation of Minimum Reserves and Minimum Nonforfeiture Values for Policies with Guaranteed Increasing Death Benefits Based on an Index
Life Insurance and Annuities (A) Committee adoption – Dec. 15, 2021
Executive (EX) Committee and Plenary adoption – Dec. 16, 2021

Actuarial Guideline LIII – Application of the Valuation Manual for Testing the Adequacy of Life Reserves
Life Insurance and Annuities (A) Committee adoption - July 20, 2022
Executive (EX) Committee and Plenary consideration at the 2022 NAIC Summer Meeting.

NAIC Models – The Task Force has not created or revised any models since the 2021 NAIC Summer Meeting

LATF VM Amendment	Valuation Manual Reference	Valuation Manual Amendment Proposal Descriptions	LATF Adoption Date
2020-12	VM-01, VM-20, VM-21, VM-31	Create consistency between CDHS determination in VM-20 and VM-21. Revise hedge modeling to only require CDHS if modeling future hedging reduces the reserves under VM-20 or TAR under VM-21.	6/9/22
2021-11	VM-21, section 12 and various others	Add a section for other assumptions requirement in VM-21 which covers general guidance and requirements for assumptions, and expense assumptions.	2/3/22
2021-12	VM-21 Section 6.B.3.a, VM-21 Section 6.B.6.a, VM-21 Section 6.B.6.b, VM-21 Section 6.C.4, VM-21 Section 6.C.10, VM-21 Section 6.C.11	Correct CSMP reference and clarify requirements for VA contracts with no minimum guaranteed benefits in Additional Standard Projection Amount in VM-21 Section 6.C. These three prescribed assumptions are Partial Withdrawal, Account Value Depletion, and Other Voluntary Contract Termination.	11/18/21
2021-13	VM-20 Sect. 9.C.6.e, VM-20 Sect. 9.C.7, VM-31 Sect. 3.D.3.o.	It has been observed that adding the prescribed mortality margins for some Life/LTC combination products cause modeled reserves to decrease rather than increase.	11/4/21
2022-01	VM-20 Section 8.C.18	Clarifying the Valuation Manual treatment of the pre-reinsurance ceded reserve and the reserve credit for retrocessions	3/10/22
2022-02	VM-31	Revise language and add an explicit cross-reference to the VM-21 section since it has further details on how to demonstrate compliance	3/31/22
2022-03	VM-20, VM-21, VM-31	General cleanup, including updating cross-references, better consistency between VM-20 and VM-21, where reasonable, and making clarifying edits.	3/31/22
2022-04	VM-20 Section 9.F.8, App 2.F, App 2.G	LIBOR transition to the Secured Overnight Financing Rate (SOFR) - Updated VM-20 prescribed swap spreads guidance to facilitate the LIBOR transition to SOFR.	6/30/22
2022-05	VM-51 App 1, App 4	Add dividend plan code & Covid-19 indicator; change field identifier; correct Appendix 1 reference.	5/12/22

https://naiconline.sharepoint.com/sites/naicsupportstaffhub/member%20meetings/e%20cmte/apptf/2022summernm/1_sapwg/minutes/att%20one-n_latf-sapcoordination%20memo%20summer%202022.docx



NATIONAL ASSOCIATION OF
INSURANCE COMMISSIONERS

Attachment One-O
Accounting Practices and Procedures (E) Task Force
8/11/22

To: Dale Bruggeman, Statutory Accounting Principles (E) Working Group Chair,
Kevin Clark, Statutory Accounting Principles (E) Working Group Co-Vice Chair, and
Carrie Mears, Statutory Accounting Principles (E) Working Group Co-Vice Chair

From: Marlene Caride, Commissioner, Financial Stability (E) Task Force Chair and
Justin Schrader, Macroprudential (E) Working Group Chair

CC: NAIC Support Staff: Julie Gann/Robin Marcotte/Jim Pinegar/Jake Stultz/Jason Farr

Date: July 21, 2022

Re: Referral from the Plan for the List of MWG Considerations

The NAIC Macroprudential (E) Working Group (MWG) of the Financial Stability (E) Task Force (FSTF) was charged with coordinating the various NAIC activities related to private equity (PE) owned insurers. As an initial step, the MWG developed a list of 13 regulatory considerations. These considerations are frequently referenced as private equity (PE) concerns, but the Working Group developed the list with an activities-based frame of mind, recognizing that any ownership type and/or corporate structure could participate in these activities, including but not limited to PE owned insurers. The MWG members discussed detailed elements of the considerations and potential regulatory work, including explicit reference to the 2013 guidance added to the NAIC Financial Analysis Handbook for Form A reviews when a private equity owner was involved, and interested parties added useful comments to these during an exposure period. The MWG and FSTF adopted a final plan for addressing each of the 13 considerations, including many referrals to other NAIC committee groups.

The Financial Condition E Committee adopted this plan with no changes made during its virtual meeting on July 21, 2022. NAIC staff support drafted this referral letter to accomplish the actions captured in the adopted plan. It is unlikely any further modifications will occur to the adopted plan when it is considered for adoption by the full Plenary, but it is a possibility. Please begin work to address these referrals, recognizing the adoption by Plenary is still outstanding. Each MWG consideration referred to your group is listed below. The summarized notes from the MWG regulator-only discussions follow the consideration in blue font and any interested party comments are also provided in purple font. Please consider these discussion points and comments in addition to your own discussion ideas when developing proposals to address the MWG consideration.

NAIC staff support for the MWG will follow the work your group performs and summarize your activities for reporting up to the FSTF. If you have any questions or need further direction, please contact Todd Sells (tsells@naic.org).

MWG Consideration Items Referred:

12. The trend of life insurers in pension risk transfer (PRT) business and supporting such business with the more complex investments outlined above. (Enhanced reporting in 2021 Separate

Washington, DC 444 North Capitol Street NW, Suite 700, Washington, DC 20001-1509

p | 202 471 3990

Kansas City 1100 Walnut Street, Suite 1500, Kansas City, MO 64106-2197

p | 816 842 3600

New York One New York Plaza, Suite 4210, New York, NY 10004

p | 212 398 9000

Accounts blank will specifically identify assets backing PRT liabilities.) Considerations have also been raised regarding the RBC treatment of PRT business.

- a. **LATF has exposed an Actuarial Guideline** to achieve a primary goal of ensuring claims-paying ability even if the complex assets (often private equity-related) did not perform as the company expects, and a secondary goal to require stress testing and best practices related to valuation of non-publicly traded assets (note – LATF's considerations are not limited to PRT). Comment period for the 2nd exposure draft ends on May 2.

Regulator discussion results:

- Regulators focused on the need to have disclosures on the risks to the General Account from the Separate Account PRT business – for guarantees but also reporting/tracking when the Separate Account is not able to support its own liabilities. Regulators noted the need to address the differences between buy in PRT transactions and buy out.
- Regulators are comfortable LATF is addressing the reserve considerations. *To address the disclosure considerations, regulators support sending a referral to the Statutory Accounting Principles (E) Working Group since regulators suggested it be an item in the Notes to Financial Statements.* (Regulators noted it might help to discuss such disclosure concepts with LATF's Valuation Manual 22 (A) Working Group.)
 - While the exposed AG is not limited to PRT, and general disclosures may be helpful, regulators recognized additional and/or more specific disclosures may be needed for PRT business.

(Consideration 3 has been referred to the Risk-Focused Surveillance (E) Working Group. A copy follows since the Statutory Accounting Principles (E) Working Group (SAPWG) is referenced in the regulator discussion.)

3. The material terms of the IMA and whether they are arm's length or include conflicts of interest –including the amount and types of investment management fees paid by the insurer, the termination provisions (how difficult or costly it would be for the insurer to terminate the IMA) and the degree of discretion or control of the investment manager over investment guidelines, allocation, and decisions.

Regulator discussion results:

- Refer this item to the NAIC Risk-Focused Surveillance (E) Working Group. Regulators recognized similar dynamics to the first two considerations, but this Working Group was selected because it is already currently focused on a project involving affiliated agreements and Form D filings. Items discussed:
 - o Consider training and examples, such as unique termination clauses and use of sub-advisors with the potential for additive fees, and strategies to address these.
 - This included addressing pushback on obtaining sub-advisor agreements as Form D disclosures and some optional disclosures for the Form A.
 - o Given the increasing prevalence of bespoke agreements, does it make sense to tie this work in to the work of the NAIC Valuation of Securities (E) Task Force and/or the NAIC Securities Valuation Office? If yes, how best to do so?
 - o Surplus Notes and appropriate interest rates given their special regulatory treatment, including whether floating rates are appropriate; *follow any Statutory Accounting Principles (E) Working Group projects related to this topic and provide comments needed.*

Risk & Regulatory Consulting (RRC) Comment: "With respect to an Investment Management Agreement, RRC encourages an approach that includes a thorough review of the IMA to ensure it is fair and reasonable to the insurer. In addition to the specific items noted for consideration:

- ♣ Are there detailed and reasonable investment guidelines?
- ♣ Is there sufficient expertise at the insurer and on the insurer's Board to properly assess the performance and compliance of the investment manager?
- ♣ Is the investment manager registered as such under the Investment Advisers Act of 1940, and recognizes the standard of care as a fiduciary?

AIC Comments on "Conflict of Interest, Fees, and Termination" (3 individual comments):

Conflict of Interest

As a general matter, the terms of a contractual agreement should not be viewed as giving rise to a conflict of interest when the agreement is negotiated on an arm's length basis. Notwithstanding the foregoing, current law provides an established process to address potential conflicts (for example, requirements to appoint independent directors and traditional corporate law processes to ensure fairness and, under certain circumstances, review of transactions by regulators pursuant to Form D filings). Accordingly, investments sourced and allocated by alternative asset managers on behalf of insurance company clients should not, absent other factors, be viewed as presenting a potential conflict of interest, particularly where insurers retain full control over asset allocation (for example, insurers retain control over the asset classes in which they invest, as well as the amounts and periods of time over which such asset exposure is achieved).

Fees

Importantly, as an initial consideration, any fees paid to investment managers cannot be considered in isolation, rather they should be considered on a "net" basis - i.e., on the basis of total return (after fees are taken into account). Sophisticated institutional investors (including insurers) have a successful history of investing in a range of strategies despite certain investment products generally having higher fees than other available investment opportunities. On a net basis, private equity has consistently outperformed more traditional asset classes such as publicly traded stocks and public mutual funds⁸. Net-of-fees private debt funds have also consistently outperformed bond and equity market benchmarks.⁹ Insurers continue to recognize the value of investment opportunities that outperform when considered on a net basis.¹⁰ This approach has enabled the consistent delivery of industry leading investment results, which ultimately leads to a high level of financial strength.

Termination

Asset managers often dedicate extensive resources at the outset of a new arrangement in support of managing an insurer's general account assets (e.g., dedicating or reassigning existing personnel, hiring new employees, investing in information technology systems, expanding office space, further enhancing compliance and regulatory processes). As such, and because, in our experience, insurers have the right to terminate their investment management agreements (e.g., upon 30 days' notice), the desire for external asset managers to seek contractual protections (subject to arms' length negotiations) should an insurer decide to terminate the arrangement earlier than was originally anticipated by the parties is entirely appropriate.

(Similarly, Considerations 7, 8 and 9 are included because of reference to SAPWG work related to these considerations and the MWG regulators' decision to forward an RRC comment to the SAPWG due to its work related to these three considerations.)

7. The lack of identification of related party-originated investments (including structured securities). This may create potential conflicts of interests and excessive and/or hidden fees in the portfolio structure, as assets created and managed by affiliates may include fees at different levels of the value chain. For example, a CLO which is managed or structured by a related party.

- a. An agenda item and blanks proposal are being re-exposed by SAPWG. Desire for 2022 year-end reporting to include disclosures identifying related-party issuance/acquisition.

Regulator discussion results:

- Regulators are comfortable the SAPWG's work is sufficient as a first step since it involves code disclosures to identify various related party issues. They also recognize that existing and/or referred work at the Risk-Focused Surveillance (E) Working Group may address some items in this consideration. Once regulators work with these SAPWG disclosures and other regulatory enhancement, further regulatory guidance may be considered as needed.)

8. Though the blanks include affiliated investment disclosures, it is not easy to identify underlying affiliated investments and/or collateral within structured security investments. Additionally, transactions may be excluded from affiliated reporting due to nuanced technicalities. Regulatory disclosures may be required to identify underlying related party investments and/or collateral within structured security investments. This would include, for example, loans in a CLO issued by a corporation owned by a related party.

- a. An agenda item and blanks proposal are being re-exposed by SAPWG. The concept being used for investment schedule disclosures is the use of code indicators to identify the role of the related party in the investment, e.g., a code to identify direct credit exposure as well as codes for relationships in securitizations or similar investments.

Regulator discussion results:

- Like the previous consideration, regulators are looking forward to using these code disclosures to help target areas for further review. However, specific to CLO/structured security considerations, regulators support a referral to the Examination Oversight (E) Task Force. Specific items discussed include:
 - o Since investors in CLOs obtain monthly collateral reports, regulators should consider asking for such reports when concerns exist regarding a company's potential exposure to affiliated entities within their CLO holdings.
 - o Regulators would like to have more information regarding the underlying portfolio companies affiliated with a CLO manager to help quantify potential exposure between affiliates and related parties.
 - o Regulators request NAIC staff to consider their ability to provide tools and/or reports to help regulators target CLOs/structured securities to consider more closely.

RRC Comments on "collateralized loan obligations (CLOs) as a source of concern and therefore a focus for additional disclosure. "While there has been a continuing level of concern about CLOs in general, RRC encourages the working group to take a broader view as well. As a general matter, investments in

CLOs are at least subject to disclosure and conflicts of interest standards under various securities laws and regulations. On the other hand, there are other potentially problematic investments that do not benefit from that regulatory oversight.

- ♣ Private funds – Some of the issues noted with respect to concerns about overlapping interests in CLOs may also be prevalent in various kinds of funds, especially privately placed funds that are reported on Schedule BA. Such investment vehicles may have significant areas that have the potential for a conflict of interest that would not be captured by securities laws. Such investment vehicles may also include substantial management fees for management of the fund.
 - ♣ Collateral Loans – The U.S. insurance industry's reported exposure to Collateral Loans that are reported on Schedule BA has grown substantially in the last ten years. In addition to the same potential conflicts, it may be appropriate to revisit valuation and reporting guidance.
9. Broader considerations exist around asset manager affiliates (not just PE owners) and disclaimers of affiliation avoiding current affiliate investment disclosures. A new Schedule Y, Pt 3, has been adopted and is in effect for year-end 2021. This schedule will identify all entities with greater than 10% ownership - regardless of any disclaimer of affiliation - and whether there is a disclaimer of control/disclaimer of affiliation. It will also identify the ultimate controlling party.
- a. Additionally, SAPWG is developing a proposal to revamp Schedule D reporting, with primary concepts to use principles to determine what reflects a qualifying bond and to identify different types of investments more clearly. For example, D1 may include issuer credits and traditional ABS, while a sub-schedule of D1 could be used for additional disclosures for equity-based issues, balloon payment issues, etc. This is a much longer-term project, 2024 or beyond.

Regulator discussion results:

- Regulators recognize the new Schedule Y, Part 3, will give them more insights for owners of greater than 10%, but it does not provide insights for owners of less than 10%. However, regulators also recognize that existing and/or referral work of the Risk-Focused Surveillance (E) Working Group may help with some of this dynamic. Additionally, since the SAPWG 2022 code project and its longer-term Schedule D revamp project will help provide further disclosures that will assist with this consideration, regulators are comfortable waiting to see if further regulatory guidance is needed after using the resulting disclosures and other enhancements from these projects.
 - Specific to owners of less than 10%, regulators discussed the April 19, 2022, Insurance Circular Letter No. 5 (2022) sent by the New York Department of Financial Services to all New York domiciled insurers and other interested parties. This letter highlights that avoiding the levels deemed presumption of control, e.g., greater than 10% ownership, does not create a safe harbor from a control determination and the related regulatory requirements. The circular letter was distributed to all MWG members and interested regulators.

For Considerations 7, 8, and 9 above, the following RRC comment was directed to the SAPWG for its work related to these considerations:

RRC Comments on "collateralized loan obligations (CLOs) as a source of concern and therefore a focus for additional disclosure. "While there has been a continuing level of concern about CLOs in general, RRC encourages the working group to take a broader view as well. As a general matter, investments in CLOs are at least subject to disclosure and conflicts of interest standards under various securities laws

and regulations. On the other hand, there are other potentially problematic investments that do not benefit from that regulatory oversight.

- ♣ Private funds - Some of the issues noted with respect to concerns about overlapping interests in CLOs may also be prevalent in various kinds of funds, especially privately placed funds that are reported on Schedule BA. Such investment vehicles may have significant areas that have the potential for a conflict of interest that would not be captured by securities laws. Such investment vehicles may also include substantial management fees for management of the fund.
- ♣ Collateral Loans - The U.S. insurance industry's reported exposure to Collateral Loans that are reported on Schedule BA has grown substantially in the last ten years. In addition to the same potential conflicts, it may be appropriate to revisit valuation and reporting guidance.

(For Consideration 10, referrals were made to the Examination Oversight (E) Task Force and the RBC Investment Risk and Evaluation (E) Working Group. A copy is included below due to a reference to SAPWG's Schedule D revamp project.)

10. The material increases in privately structured securities (both by affiliated and non-affiliated asset managers), which introduce other sources of risk or increase traditional credit risk, such as complexity risk and illiquidity risk, and involve a lack of transparency. (The NAIC Capital Markets Bureau continues to monitor this and issue regular reports, but much of the work is complex and time-intensive with a lot of manual research required. The NAIC Securities Valuation Office will begin receiving private rating rationale reports in 2022; these will offer some transparency into these private securities.)
 - a. LATF's exposed AG includes disclosure requirements for these risks as well as how the insurer is modeling the risks.
 - b. SVO staff have proposed to VOSTF a blanks proposal to add market data fields (e.g., market yields) for private securities. If VOSTF approves, a referral will be made to the Blanks WG.

Regulator discussion results:

- Regulators focused on the need to assess whether the risks of these investments are adequately included in insurers' results and whether the insurer has the appropriate governance and controls for these investments. Regulators discussed the potential need for analysis and examination guidance on these qualifications.
- To assist regulators in identifying concerns in these investments, regulators expressed support for the VOSTF proposal to obtain market yields to allow a comparison with the NAIC Designation. Once such data is available, regulators ask NAIC staff to develop a tool or report to automate this type of initial screening. *Also, regulators again recognized the SAPWG Schedule D revamp work will help in identifying other items for initial screening.*
- The regulators discussed LATF's exposed AG, noting the Actuarial Memorandum disclosures that would be required for these privately structured securities along with the actuarial review work, and recognizing how those would be useful for analysts and examiners when reviewing these investments. Additionally, the Valuation and Analysis (E) Working Group would be able to serve as a resource for some of these insights for states without in house actuaries.
- As a result of the above discussions, regulators agreed to a referral to the Examination Oversight (E) Task Force to address the disclosures that will be available from LATF's exposed AG. *They agreed to wait for any further work or referral until they have an opportunity to work with the results of the VOSTF proposal and the SAPWG Schedule D revamp project.*

- Since reserves are not intended to capture tail risk, refer this item to the NAIC RBC Investment Risk and Evaluation (E) Working Group and monitor the Working Group's progress. (Regulators adopted this recommendation from the RRC comment letter.)

RRC Comments on "privately structured securities which introduce other sources of risk or increase traditional credit risk, such as complexity risk and illiquidity risk, and involve a lack of transparency."

- ❖ While the lack of available public data does present a significant issue and does mean there is in theory a lower degree of liquidity, we caution at being overly concerned about the private nature of such transactions.
 - Any highly structured transaction is going to lack liquidity.
 - The NAIC had at one time a disclosure for Structured Notes. This allowed regulators to see when that represented an excessive risk. We encourage the reinstitution of that disclosure.
- ❖ A potential consideration related to complex asset structures would be to incorporate this risk factor into the criteria for additional liquidity risk analysis outlined in the NAIC 2021 Liquidity Stress Test Framework (Framework). Considering the amount of effort spent on developing the Framework, it may be helpful to leverage its requirements for situations in which significant complex securities are used to back insurer liabilities.

AIC Comment on "Privately Structured Securities" (the comment and its 6 bullets follow) - *Regulators asked the AIC to follow the work of the NAIC Examination Oversight (E) Task Force and the NAIC Valuation of Securities (E) Task Force and provide comments on specific recommendations if needed.*

Insurers are increasingly seeking the services of alternative asset managers with significant asset origination capabilities and private credit expertise to manage a portion of their assets, which provide a number of benefits to the insurer and their policyholders. Those benefits include:

- ❖ A natural alignment between the long-dated insurance liabilities and the long-term investment approach taken by alternative asset managers, including in the private credit space;
- ❖ Alternative asset managers have the ability to source, underwrite and execute private credit transactions that require skill sets, experience, and scale that many insurance companies do not possess in-house;
- ❖ Private equity and private credit firms also provide an opportunity for smaller and midsized insurers to access these asset classes, which historically have been the primary purview of large insurers that have the scale to afford in-house asset management functions that can originate these assets, making the industry more competitive to the ultimate benefit of policyholders;
- ❖ Engaging asset managers with differentiated capabilities can be more cost efficient than making significant investments in an internal asset management function. By availing themselves of these advantages, insurers can benefit from cost-effective sourcing and origination capabilities in attractive asset classes, resulting in enhanced long-term adequacy margins for policyholders, increased spread/earnings, and more competitive product pricing that inures to the benefit of policyholders;
- ❖ Asset-backed security default rates are substantially similar to corporate investment grade debt default rates while CLO default rates are substantially lower than corporate default rates; and
- ❖ The focus on private investments is belied by the fact that institutions with higher allocations to private investments have outperformed (with less volatility) those with less.