Date: 3/7/2023

2023 Spring National Meeting
Louisville, Kentucky

Statutory Accounting Principles (E) Working Group
Wednesday, March 22, 2023
10:00 a.m. – 12:00 p.m. (ET)

OVERVIEW AGENDA

HEARING AGENDA

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1. SAPWG Hearing – Adoption of Minutes—Dale Bruggeman (OH)
2. SAPWG Hearing – Review and Adoption of Non-Contested Positions
   —Dale Bruggeman (OH)
   • Ref #2017-33: Issue Paper No. 16X—Derivatives and Hedging
   • Ref #2022-15: SSAP No. 25 – Affiliate Reporting Clarification
   • Ref #2022-16: ASU 2022-03: Fair Value Measurement of Equity Securities Subject to Contractual Sale Restrictions
   • Ref #2022-18: ASU 2022-04, Disclosure of Supplier Finance Program Obligations
3. SAPWG Hearing – Review of Comments on Exposed Items—Dale Bruggeman (OH)
   • Ref #2019-21: Principles-Based Bond Definition
   • Ref #2022-01: Conceptual Framework - Updates
   • Ref #2022-11: Collateral for Loans
   • Ref #2022-12: Review of INT 03-02: Modifications to an Existing Intercompany Pooling Arrangement
   • Ref #2022-14: New Market Tax Credits
   • Ref #2022-17: Interest Income Disclosure Update
   • Ref #2022-19: Negative IMR

Comment Letters
OVERVIEW AGENDA

MEETING AGENDA

4. SAPWG Meeting – Maintenance Agenda – Pending List—Dale Bruggeman (OH)
   - Ref #2023-01: Review Annual Statement Instructions for Accounting Guidance  1  A
   - Ref #2023-02: SSAP No. 43R – CLO Financial Modeling  2  B
   - Ref #2023-03: New C-2 Mortality Risk Note  2  C
   - Ref #2023-04: Corporate Alternative Minimum Tax Guidance  3  D
   - Ref #2023-05: ASU 2022-06, Reference Rate Reform (Topic 848), Deferral of the Sunset Date of Topic 848  3  E, F
   - Ref #2023-06: Additional Updates on ASU 2021-10, Government Assistance  4  G
   - Ref #2023-07: ASU 2019-08, Codification Improvements to Topic 718 and Topic 606  5  H
   - Ref #2023-08: ASU 2019-07, Codification Updates to SEC Sections  6  I
   - Ref #2023-09: ASU 2020-09, Codification Updates to SEC Sections  6  J
   - Ref #2023-10: ASU 2022-05, Transition for Sold Contracts  7  K
   - Ref #2023-11EP: Editorial  7  L

5. SAPWG Meeting – Any Other Matters Brought Before the Working Group—Dale Bruggeman (OH)
   - Receive & Discuss Valuation of Securities (E) Task Force Referral  8  M-O
   - 2023 NAIC Accounting Practices and Procedures Manual  8  P, Q
   - American Academy of Actuaries Request  9  R
   - Update on International Activity – IAIS Accounting and Auditing Working Group (AAWG)  9  None
   - Review of U.S. GAAP Exposures  9  S

- Comment Deadline for Ref #2023-03 & #2023-11EP – Friday, May 5
- Comment Deadline for all other items – Friday, June 9
Hearing Agenda

Statutory Accounting Principles (E) Working Group
Hearing Agenda
March 22, 2023
10:00 a.m. – 12:00 p.m. (ET)

ROLL CALL

Dale Bruggeman, Chair
Ohio
Judy Weaver
Michigan

Kevin Clark, Vice Chair
Iowa
Doug Bartlett
New Hampshire

Sheila Travis
Alabama
Bob Kasinow
New York

Kim Hudson
California
Diana Sherman/Matt Milford
Pennsylvania

William Arfanis/Michael Estabrook
Connecticut
Jamie Walker
Texas

Rylynn Brown
Delaware
Doug Stolte/David Smith
Virginia

Cindy Andersen
Illinois
Amy Malm/Elena Vetrina
Wisconsin

Melissa Gibson/Stewart Guerin
Louisiana

NAIC Support Staff: Julie Gann, Robin Marcotte, Jake Stultz, Jason Farr, Wil Oden

Note: This meeting will be recorded for subsequent use.

REVIEW AND ADOPTION OF MINUTES

1. Fall National Meeting (Attachment 1)

The Statutory Accounting Principles (E) Working Group met in regulator-to-regulator sessions on January 17, 20 and February 22. These regulator sessions were pursuant to the NAIC Open Meetings Policy paragraph 3 (discussion of specific companies, entities or individuals) and paragraph 6 (consultations with NAIC staff related to NAIC technical guidance of the Accounting Practices and Procedures Manual). No actions were taken during these meetings as the discussion previewed the Spring National Meeting agendas and discussed other items with NAIC staff pursuant to the NAIC open meeting policy.

REVIEW AND ADOPTION of NON-CONTESTED POSITIONS

The Working Group may individually discuss the following items, or may consider adoption in a single motion:

1. Ref #2017-33: Issue Paper No. 16X—Derivatives and Hedging
2. Ref #2022-15: SSAP No. 25 – Affiliate Reporting Clarification
3. Ref #2022-16: ASU 2022-03: Fair Value Measurement of Equity Securities Subject to Contractual Sale Restrictions
Summary:
During the 2022 Fall National Meeting, the Working Group exposed a draft Issue Paper No. 16X—Derivatives and Hedging to detail revisions previously adopted from ASU 2017-12, Derivatives and Hedging and ASU 2022-01, Fair Value Hedging – Portfolio Layer Method. This issue paper details, as tracked changes, the revisions adopted in the following agenda items:

- Ref #2018-30: This agenda item incorporated revisions, effective January 1, 2019, with early application permitted, limited to specific provisions, and related transition guidance, pertaining to the documentation and assessment of hedge effectiveness: 1) provisions allowing more time to perform the initial qualitative 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 method for assessing hedge effectiveness.

- Ref #2021-20: This agenda item resulted with both the new Exhibit A that adopts with modification U.S. GAAP guidance in determining hedge effectiveness and the revisions to SSAP No. 86 to incorporate measurement method guidance for excluded components. These revisions were adopted with a January 1, 2023, effective date, with early adoption permitted.

- Ref #2022-09: The revisions incorporate the U.S. GAAP portfolio layer method and the partial-term hedging method, with modifications to limit application of the partial-term hedging method to recognized assets. These revisions were adopted with a January 1, 2023, effective date, with early adoption permitted.

Interested Parties’ Comments:
Interested parties have no comments on this item.

Recommendation:
NAIC staff recommends that the Working Group adopt the exposed Issue Paper No. 16X—Derivatives and Hedging to detail the historical actions resulting in new SAP concepts within SSAP No. 86—Derivatives. (As the statutory accounting guidance has already been adopted, the issue paper adoption is for historical documentation and does not change authoritative guidance.)

Summary:
During the 2022 Fall National Meeting, the Working Group exposed SAP clarifications to SSAP No. 25—Affiliates and Other Related Parties to clarify that any invested asset held by a reporting entity which is issued by an affiliated entity, or which includes the obligations of an affiliated entity is an affiliated investment.

Interested Parties’ Comments:
Interested parties have no comments on this item.
Recommendation:
NAIC staff recommends that the Working Group adopt the exposed SAP clarification to SSAP No. 25.

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<tr>
<td>2022-16</td>
<td>ASU 2022-03, Fair Value Measurement of Restricted Securities</td>
<td>4 – Agenda Item</td>
<td>No Comment</td>
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Summary:
During the 2022 Fall National Meeting the Working Group exposed SAP clarification revisions to SSAP No. 100R—Fair Value to adopt ASU 2022-03, Fair Value Measurement of Equity Securities Subject to Contractual Sale Restrictions with modification to be consistent with statutory language in the respective statutory accounting statements. As detailed within the agenda item, the exposure does not incorporate the new proposed GAAP disclosures on sales restrictions, but identifies those items restricted as to sale would be captured as restricted assets per SSAP No. 1 and subject to admittance considerations under SSAP No. 4.

Interested Parties’ Comments:
Interested parties have no comments on this item.

Recommendation:
NAIC staff recommends that the Working Group adopt the exposed SAP clarifications to SSAP No. 100R, which adopts ASU 2022-03, Fair Value Measurement of Equity Securities Subject to Contractual Sales Restrictions with modification regarding SAP terminology and modification to exclude the sales restrictions disclosures in the ASU.

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<td>ASU 2022-04, Disclosure of Supplier Finance Program Obligations</td>
<td>5 – Agenda Item</td>
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Summary:
During the 2022 Fall National Meeting, the Working Group exposed SAP clarifications to SSAP No. 105R—Working Capital Finance Investments to reject ASU 2022-04, Disclosure of Supplier Finance Program Obligations for statutory accounting as the disclosures are for borrowers in these programs and as such, are not relevant for insurance preparers that may invest in these programs.

Interested Parties’ Comments:
Interested parties have no comments on this item.

Recommendation:
NAIC staff recommends that the Working Group adopt the exposed SAP clarifications to SSAP No. 105R—Working Capital Finance Investments to reject ASU 2022-04, Disclosure of Supplier Finance Program Obligations for statutory accounting.
REVIEW of COMMENTS on EXPOSED ITEMS

The following items received comments during the exposure period that are open for discussion.

1. Ref #2019-21: Principles-Based Bond Definition
2. Ref #2022-01: Conceptual Framework - Updates
3. Ref #2022-11: Collateral for Loans
4. Ref #2022-12: Review of INT 03-02: Modifications to an Existing Intercompany Pooling Arrangement
5. Ref #2022-14: New Market Tax Credits
6. Ref #2022-17: Interest Income Disclosure Update
7. Ref #2022-19: Negative IMR

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Summary:
In November 2022 and at the 2022 Fall National Meeting, the Working Group exposed revisions to SSAP No. 26R—Bonds, SSAP No. 43R—Asset-Backed Securities, as well as revisions to other SSAPs as necessary to update for the principles-based bond project. These revisions also included edits to SSAP No. 2R—Cash, Cash Equivalents, Drafts and Short-Term Investments to restrict asset-backed securities from being captured in scope and SSAP No. 21R—Other Admitted Assets to provide guidance for debt securities that do not qualify as bonds. In addition to the SSAP revisions, an updated issue paper detailing the discussions and revisions as well as proposed reporting changes were also exposed.

Interested Parties’ Comments:
The interested parties submitted a separate comment letter dated February 10, 2023, on the proposed SSAP revisions. The interested parties also identified that they have not provided comments on the reporting exposure as they believe comments can be optimized once the reporting changes are exposed by the Blanks (E) Working Group.

The letter indicates that interested parties continue to support the development of high-quality bond standards and believe they are headed in the right direction. It also notes that Staff has tackled this project with appropriate rigor and their collaboration with interested parties has been greatly appreciated. The letter identifies that interested parties stand ready to continue to assist as this project gets nearer the finish line.

Rather than including the full scope of the interested parties’ comments on the bond revisions, they are summarized as follows:

- SSAP No. 26R, Paragraph 6d – Interested parties agree with the exclusions detailed in this paragraph but suggest modifications from “credit-rating related” to “credit-quality related” to encompass the broader range of adjustments that align interests of debtholders and issuing entities (e.g., debt to EBITDA ratio, interest coverage ratio, debt service coverage ratio, etc.). Such bonds are prevalent in insurer portfolios.
  - *NAIC staff note - Revisions have been reflected for this comment.*

- SSAP No. 26R, Paragraph 6d – Interested parties believe this paragraph would inappropriately capture certain bonds with an interest coupon rate linked to sustainability goals. For example, the debt may have coupon interest equal to either a fixed or floating rate (e.g., SOFR) that is adjusted based on one or more sustainability goals or variables. Interested parties therefore suggest either a special exclusion for these type
of debt instruments such as “SLB-linked bonds with de minimis interest rate adjustments” or “SLB-linked bonds with interest rate adjustments with the potential to adjust the total return from interest by no more than 10%”. Quite possibly, it may be more appropriate for such a “de minimis” exclusion to be applied to other non-debt variables more broadly so there is not an abrupt cliff effect for non-schedule D reporting due to the potentially punitive risk-based capital treatment, for de minimis non-debt variables in general.

- **NAIC staff note - Revisions have been reflected for this comment.**

**SSAP No. 26R, Paragraph 6di** – Interested parties have proposed edits to ensure that Replication Synthetic Assets (RSATs) continue to meet the replication accounting requirements regardless of changes to the definition of a Schedule D bond. They also request additional discussion with staff on revisions to SSAP No. 86 that currently addresses the accounting for replication transactions as changes may be needed to coincide with the effective date of the principles-based bond definition.

- **NAIC staff note - Revisions have been reflected for this comment.**

**SSAP No. 26R, Paragraph 10** – Interested parties noted an inconsistency with the treatment of residual tranches in the proposed SSAP No. 26R and SSAP No. 43R, with reference to SSAP No. 21R as the source of the guidance. As residual guidance is not captured in SSAP No. 21R, they have proposed revisions to include the reporting treatment on Schedule BA within SSAP No. 26R.

- **NAIC staff note - Revisions have been reflected for this comment. These revisions propose to capture information on residuals in SSAP No. 21R.**

**SSAP No. 26R, Paragraphs 43-46 (and corresponding paragraphs in SSAP No. 43R)** – Interested parties have proposed minor editorial edits to the transition guidance to reflect what they believe was the intent. They have also requested revisions to clarify that the revised bond categories from the annual statement shall be applied prospectively beginning with the first year of adoption and not result with a restatement of the prior year’s reporting.

- **NAIC staff note - Revisions have been reflected for this comment.**

**SSAP No. 26R, Example 2** – Interested parties have proposed two editorial changes to provide a nuanced technical clarification and a more formal conclusion within the example rationale.

- **NAIC staff note - Revisions have been reflected for this comment.**

**SSAP No. 21R, Paragraph 22 (Debt Securities That Do Not Qualify as Bonds)** – Interested parties have provided general comments on the categories when for when a debt instrument does not meet the principle-based bond definition as laid out in SSAP No. 26R as well as the accounting and measurement basis. They have identified that they would like to think through the guidance with staff to determine if further refinement is necessary especially if the intent of these categories is to feed risk-based capital factors where additional refinement may be necessary.

- **NAIC staff note – Limited revisions have been proposed, but further discussion with interested parties is recommended.**

**SSAP No. 21R, Paragraph 22 (Debt Securities That Do Not Qualify as Bonds)** – Interested parties have provided comments on the guidance that limits admittance of debt securities, when the source of repayment is derived through rights to underlying collateral, to the extent that they are secured by admitted invested assets. These comments have identified that they understand the rationale for the guidance, as the resulting security is very similar to a collateral loan, but they have noted that it is a meaningful penalty and would like more time to discuss with staff. These comments have noted that it is conceivable that a securitization with a residual tranche could be reported as an admitted asset, whereas a more-senior debt tranche would be a nonadmitted asset.

- **NAIC staff note – Limited revisions have been proposed, but further discussion with interested parties is recommended.**
**Recommendation:**
NAIC staff appreciates the comments from interested parties and interim discussions which have continued to discuss key comments and potential revisions. For the Spring National Meeting, it is recommended that the Working Group expose updated documents to detail the statutory accounting guidance. Revisions have been proposed to reflect a majority of the interested parties’ comments, and a summary of revisions is detailed within the documents. With exposure, it is requested that interim discussions continue to occur with interested parties. Updated documents proposed for exposure:

- SSAP No. 26R—Bonds
- SSAP No. 43R—Asset-Backed Securities
- SSAP No. 21R—Other Admitted Assets
- Other SSAP Revisions – (This document only includes proposed changes to SSAP No. 86 for RSATs.)

In addition to the documents proposing SSAP revisions, NAIC staff has drafted a proposal to revise the reporting lines on Schedule BA to encompass the debt securities that do not qualify as bonds, as well as to consolidate existing reporting lines. NAIC staff recommends that this document also be exposed for initial comment. This document only proposes the changes to schedule BA. Once comments are considered, subsequent revisions to incorporate the changes through other schedules as appropriate (such as AVR) would be drafted.

NAIC staff notes that revisions to the issue paper will be presented to the Working Group for subsequent consideration. Also, on March 7, 2023, the Blanks (E) Working Group exposed blanks proposals to detail the bond reporting changes, as well investment schedule changes identified from the bond project.

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**Summary:**

FASB has updated the definition of an ASSET to be defined as a present right of an entity to an economic benefit. The asset definition possesses two essential characteristics in that 1) an asset is a present right and 2), the right is to an economic benefit. On August 10, 2022, the Statutory Accounting Principles (E) Working Group adopted, the previously exposed revisions, to the Preamble and SSAP No. 4—Assets and Nonadmitted Assets and Issue Paper No. 166—Updates to the Definition of an Asset.

FASB has updated the definition of a LIABILITY to be defined as a present obligation of an entity to transfer an economic benefit. The liability definition possesses two essential characteristics in that 1) the liability 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.)
There are some existing GAAP and SAP standards which provide liability guidance which do not meet the existing or proposed revised definitions of a liability for GAAP or SAP. Because SAP treats the definitions of an asset and a liability as authoritative, updating these definitions requires careful consideration. Statutory accounting variations from the definition of a liability are typically topic specific items which are often for purposes of conservatism or implementing other regulatory objectives. Examples of existing SAP variations from the definition of a liability are:

- **SSAP No. 7—Asset Valuation Reserves and Interest Maintenance Reserves** – AVR and IMR establish liabilities for regulatory objectives.
- **SSAP No. 62R—Property and Casualty Reinsurance** – contains the provision for reinsurance liability guidance which results in a liability that is a regulatory valuation allowance for overdue and slow paying reinsurance and also enforces Credit for Reinsurance (Model No. 785) collateral requirements.
- **SSAP No. 92—Post Retirement Benefits Other than Pensions**, provides liability recognition, which adopts several GAAP standards with modifications.

**Interested Parties’ Comments:**
Interested parties are currently reviewing the additional materials provided by NAIC staff and will comment at a later date.

**Recommendation:**
NAIC staff recommends exposure of additional clarifications regarding: deferring to SSAP guidance which provides topic specific variations from the definition of a liability in SSAP No. 5R and the related Issue Paper No. 16X—Updates to the Definition of a Liability as illustrated under “Proposed Revisions” below.

These clarifications are recommended because of the authoritative treatment that statutory accounting provides to the definition of an asset and a liability in SSAP No. 4 and SSAP No. 5R. For GAAP, the FASB Conceptual statements definitions are not authoritative, but rather are concepts to consider when developing and applying guidance. The FASB basis for conclusions noted that some existing authoritative FASB literature regarding liabilities is inconsistent with the updates to Concepts Statement No. 8. Therefore, a modification regarding topic specific liabilities guidance is recommended.

Lastly, because of previous comments on this agenda item from interested parties, NAIC staff have prepared a new agenda item in meeting which proposes a project to ensure that accounting guidance from annual statement instructions are incorporated into the SSAPs - See agenda item 2023-01)

- **Proposed revisions – Topic Specific Footnote** - This language is proposed for incorporation as a footnote to the liability definition in SSAP No. 5R and its related and Issue Paper No. 16X—Updates to the Definition of a Liability.

  **New Footnote:**
  The guidance in this statement regarding the definition of a liability is applicable unless another authoritative statement of statutory accounting principles provides more topic specific contradictory guidance. In such cases the topic specific guidance shall apply.

- **Proposed revisions to SSAP No. 5R—Liabilities, Contingencies and Impairment of Assets and Issue Paper No. 16X—Updates to the Definition of a Liability** (New language shaded):

**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 with modification reflected in this Statement regarding topic specific guidance.

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<td>Collateral for Loans</td>
<td>13 – Agenda Item</td>
<td>Comments Received</td>
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**Summary:**
During the 2022 Fall National Meeting, the Working Group re-exposed revisions to SSAP No. 21R to clarify that invested assets pledged as collateral for admitted collateral loans must qualify as admitted invested assets.

**Interested Parties’ Comments:**
The impact of the new exposed language can be interpreted to affect requirements for collateral loans which are backed by investments in joint ventures, partnerships, and LLCs. As commented during the 2022 NAIC National Fall Meeting, we believe that audits of joint ventures, partnerships, and LLCs, while required under SSAP No. 97 and SSAP No. 48 for those assets held directly, are not necessarily suited for the task of assessing sufficiency of collateral, because an audit does not validate fair value of the investment, which is a core standard of collateral guidance, and audits may be unreasonably costly for this narrow purpose.

Interested parties noted that regulators indicated concern over arrangements in which the collateral asset or the collateral loan itself may be related to or affiliated with the reporting entity. We believe that this concern is more directly addressed in recent industry exposures and adoptions over related party reporting; a collateral loan involving a related party is required to be labeled as such in annual statement filings. A collateral loan which is backed by a related joint venture, partnership, or LLC, is expected to be disclosed as such under existing SSAP No. 25 guidance. It is our view that in cases where an audit is not performed, allowing an unrelated third party to perform a fair value assessment would address objectivity concerns for this narrow purpose, noting that primary guidance over related party transactions is addressed elsewhere outside of SSAP No. 21R.

Interested parties propose that the following footnote be included in SSAP No. 21R which would effectively permit companies with these investments to obtain a third-party valuation assessment in place of an audit, where the third-party assessment would satisfy both the admitted asset requirement as well as the fair value sufficiency requirement applicable to collateral assets.

**Footnote:**
Because an audit, which is required for certain investments in joint ventures, partnerships, and LLCs to be admitted assets, does not necessarily provide assurance over the fair value of such an investment which is collateral for a loan, companies are permitted to obtain a fair value assessment provided by an unrelated third party in place of an audit, in order for a collateral asset which is a joint venture, partnership, or LLC to qualify as an admitted asset under this standard.

**Recommendation:**
NAIC staff recommends revisions to SSAP No. 21R be re-exposed with the shaded revisions illustrated under proposed revisions below.
The regulators which originated the request for this agenda item believe it is imperative to uphold the existing requirement to maintain audit requirements if joint venture, partnerships, limited liability companies or investments that would qualify as subsidiary controlled or affiliated entities (SCA) if the collateral was directly held as these investments must qualify as admitted investments under SSAP No. 48 and SSAP No. 97 to qualify as collateral for loans. In their view, allowing fair value without an audit would lower the collateral requirement standard and allow potential arbitrage within RBC and admissibility of assets by using a collateral loan as the conduit. Additionally, they note concerns that a level 3 fair value without a deep active secondary market is subject to varying expert opinions and is difficult to take regulatory action on.

NAIC staff recommends continuing to require the use of audits of collateral where indicated for admissibility and to revise the standard to note that a fair value comparison is required unless the collateral would be considered a SSAP No. 48 or a SSAP No. 97 investment, in which case the comparison is to audited net equity value. We note that audited equity value reflects the value that would likely be the day 2 value reported in the event the collateral was used to make the debt holder whole for these assets. (At initial recognition, the reporting entity would report the investment at fair value, but with the guidance in SSAP No. 48/97, the reporting entity would then subsequently report the investment at net audited equity value.)

Proposed revisions to SSAP No. 21 – Revised—Other Admitted Assets (new wording shown tracked and shaded)

Collateral Loans

4. Collateral loans are unconditional obligations for the payment of money secured by the pledge of a qualifying investment and meet the definition of assets as defined in SSAP No. 4, and are admitted assets to the extent they conform to the requirements of this statement. The outstanding principal balance on the loan and any related accrued interest shall be recorded as an admitted asset subject to the following limitations:

   a. Loan Impairment—Determination as to the impairment of a collateral loan shall be based on current information and events. When it is considered probable that any portion of amounts due under the contractual terms of the loan will not be collected the loan is considered impaired. The impairment shall be measured based on the fair value of the collateral less estimated costs to obtain and sell the collateral. The difference between the net value of the collateral and the recorded asset shall be written off in accordance with SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets;

   b. Nonadmitted Asset—In accordance with SSAP No. 20—Nonadmitted Assets, collateral loans secured by assets that do not qualify as investments which would otherwise be admitted shall be nonadmitted. Further, any amount of the loan outstanding which is in excess of the permitted relationship of fair value of the pledged investment to the collateral loan shall be treated as a nonadmitted asset. For qualifying investments which are pledged as collateral that would be in the scope of SSAP No. 48 or SSAP No. 97 if held directly by the reporting entity, such as joint ventures, partnerships and limited liability companies and investments that would qualify as SCAs if held directly, the proportionate audited equity valuation shall be used for the comparison for the adequacy of pledged collateral. If the collateral loan exceeds the audited equity valuation of these pledged investments, then the excess shall be nonadmitted.

Footnote 1: For purposes of determining a collateral loan in scope of this statement, a collateral loan does not include investments captured in scope of other statements. For example, SSAP No. 26R—Bonds includes securities (as defined in that statement) representing a creditor relationship whereby there is a fixed schedule for one or more future payments. Investments captured in SSAP No. 26R that are also secured with collateral shall continue to be captured within scope of SSAP No. 26R.

Footnote 2: A qualifying investment defined as those assets listed in Section 3 of Appendix A-001—Investments of Reporting Entities which would if held by the insurer qualify for admittance. For example, if the collateral would not qualify for admittance under SSAP No. 4 due to encumbrances or other third-
party interests, then it does not meet the definition of "qualifying" and the collateral loan, or any portion thereof which is not adequately collateralized, is not permitted to be admitted. In the cases where the collateral is an equity/unit investment in a joint venture, partnership, limited liability company, and or SCA is pledged as collateral in a collateral loan, audited financial statements on a consistent annual basis are always required in accordance with SSAP No. 48 and or SSAP No. 97.

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**Summary:**
During the 2022 Fall National Meeting, the Working Group re-exposed the intent to nullify INT 03-02. With this re-exposure, the Working Group requested industry to provide comments on specific instances in which the interpretation was being applied and specific staff identified items noted in the agenda.

**Interested Parties’ Comments:**
Staff provided the following comments regarding some of the key points from industry. Interested parties’ response to each comment is provided in italics below following each comment:

1. In the current interest rate environment, the fair value of many bonds is below book value. For example, a bond with an amortized cost of $100 with a fair value of $85. The way INT 03-02 is written a bond with a fair value of 85 could be used to settle an intercompany reinsurance pooling obligation of $100. If the reporting entity paid with cash, they would be required to pay $100. The actual cash value of obligations when they are extinguished is a relevant measure of the transaction.

   If a bond was transferred at market value in order to settle the $100 pooling obligation as proposed by NAIC staff in the example above, a bond with a fair value of $100 would have to be used to settle the obligation. In the event that the bond was in an unrealized loss position at the time of the transfer, a realized loss would be recognized on the transferring entity’s books and the combined pool’s books. To avoid this situation, a legal entity could use cash to settle the obligation, but the use of such cash may not be the most efficient use of the transferring entity’s resources.

   If the bond was transferred at FV as proposed by NAIC staff but the bond was in an unrealized gain position, a more significant issue would arise. Realized gains would be recorded in the financial statements of the transferring entity, thus resulting in an initial gain in surplus at the legal entity level of reporting as part of the intercompany pooling modification and requiring the intercompany pooling reinsurance to be accounted for as retroactive reinsurance.

   There are extreme anomalies with transferring bonds at market value, as illustrated above.

2. Using book value for measurement of payments between affiliates can result in either unrecognized [gains or losses] of in effect dividend or losses. SSAP No. 25 requires such transfers of assets between affiliates to use fair value. If a subsidiary can pay the parent with assets that have a lower fair value than book value (ex, owes $100 but pays with a bond of 85), this has a similar effect as an unrecognized capital contribution to the subsidiary. SSAP No. 72 requires a capital contribution to be valued using fair value.

   The hypothetical capital contribution noted by NAIC staff is mitigated by the fact that, in actual practice, the transferring company would likely have two options if it did not transfer the bond:
• The company could sell the bond, recognize a realized loss, and reinvest in a higher interest-bearing bond which would offset the realized loss over time.

• The company could hold the bond until maturity, at which point it is redeemed at the $100 par value.

We also note that modifications to intercompany pooling arrangements are subject to prior regulatory review and approval, and if the example noted by NAIC staff were part of a planned intercompany pooling transaction, the regulator could address it before granting approval to the intercompany pooling modification.

3. Staff agrees that at the ultimate parent level such transfer of assets (in accordance with SSAP No. 25 guidance) may be noneconomic in that the parent continues to hold an interest in the same assets. Therefore, at the parent level, such transfers of assets may result in the deferral of gains. Staff believes that losses would not be deferred at the ultimate parent level.

The issue noted by interested parties is not that the bond transaction may be economic at the subsidiary level but non-economic at the parent level. Rather, the interested parties letter notes that the transfer of reserves in an intercompany pooling modification is a non-economic transfer, and INT-03-02 treats the transfer of bonds consistently (i.e., non-economic) with the transfer of the liabilities.

4. Staff notes that while it may be more expedient to pay intercompany reinsurance pooling transactions with assets, the valuation used should be similar to if the obligation was extinguished with cash. Therefore, an entity can still choose to pay with assets, they just need to be valued consistently with SSAP No. 25 guidance.

This comment seems to imply that staff disagrees with the views of the Statutory Accounting Principles Working Group, which deliberated this issue in 2003 and decided that the appropriate guidance is SSAP No. 62 and not SSAP No. 25.

5. SSAP No. 62R, paragraph 36d provides an exception to retroactive reinsurance accounting guidance which allows for prospective accounting treatment for intercompany reinsurance among 100% owned affiliated provided there is no gain to the ceding entity. If there is a gain to the ceding entity, there is guidance in SSAP No. 62R, paragraph 37 which requires a more punitive method of accounting than either prospective or retroactive reinsurance accounting. Therefore, NAIC staff comment is that the statutory accounting objective is to provide different treatment for retroactive reinsurance contracts if there is a gain to the ceding entity. This is another reason that the guidance in INT 03-02 is problematic. The object is to correctly measure the effects of the contract, which drives the accounting. The objective is not to obscure whether there is a gain to the ceding entity, which can happen in the event that the assets used in payment are not measured correctly.

INT 03-02 avoids the gain in surplus issue by requiring that the transfer of bonds be at book value. This avoids inconsistent accounting of intercompany pooling modifications between prospective reinsurance accounting and retrospective reinsurance accounting. INT 03-02 provides consistent accounting for all such modification transactions.

Interested parties believe that INT 03-02 was not meant to address whether assets used as payments in an intercompany pooling modification are measured correctly, but rather the INT was meant to address which accounting is appropriate given the facts and circumstances of the transaction. We still believe that INT 03-02 provides a reasonable approach with respect to accounting for intercompany pooling modifications and provides consistency in reporting across companies.
6. Interested parties noted that modifications to intercompany pooling arrangements are typically effective retroactive to the beginning of the year. Staff notes that the payment value when the transaction is settled should be equivalent to the cash value of what is owed on the date of extinguishment of the liability.

This view raises the question of whether the “fair value” of the reserves need to be considered. That would be unprecedented and not consistent with any statutory accounting guidance.

7. Many of the interested parties’ comments regarding GAAP use of book value are more relevant to consolidated basis accounting which is not consistent with the legal entity basis of statutory accounting.

Interested parties respectfully disagree. The interested parties comment letter references the example of accounting for mergers, which is not the same as consolidation accounting.

8. Interested parties’ comments noted that there is a difference in treatment for intercompany pooling participants who are not 100% owned by a common parent. NAIC staff notes that retroactive pooling agreement changes with participants that are not 100% under common control do not meet the exception to retroactive accounting provided in SSAP No. 62R, paragraph 36d. NAIC staff notes that SSAP No. 62R, paragraph 37 provides guidance for retroactive reinsurance agreements among affiliates where there is a gain to the ceding entity.

This comment appears to conflate the issue of being under the control of a common parent versus under 100% common control of a group. The interested parties comment letter was distinguishing between intercompany pool entities which have a common parent versus intercompany pool entities which do not have a common parent. All of the intercompany pool entities are under 100% common control, but not necessarily under the same common parent.

As an example, there may be downstream insurance subsidiaries of two top-tier insurance entities. The downstream insurance subsidiaries do not have common parents but are under 100% common control of the group.

We believe that nullification of the existing INT will likely result in inconsistent interpretation of the guidance by both companies and regulators and will result in inconsistent accounting treatment.

Recommendation:
NAIC Staff continues to recommend nullification of the INT 03-02, as it is inconsistent with SSAP No. 25 guidance regarding economic and non-economic transactions between related parties. The guidance in INT 03-02 can result with in essence, unrecognized gains (dividends) or losses through the use of statutory book valuation when using assets (bonds) to make payments to affiliates for modifications to existing intercompany reinsurance pooling agreements. Treatment of transfers of assets between affiliates should be consistent for all intercompany transactions and there is not a compelling need to be different when valuing assets for intercompany reinsurance transactions. NAIC staff requests Working Group direction on effective date for nullification and suggests December 31, 2022.

INT 03-02, for intercompany reinsurance transactions, takes an approach that either SSAP No. 25 or SSAP No. 62R applies, however but multiple Working Group discussions have noted that SSAP No. 25 provides the overarching guidance that is relevant in evaluating all related party transactions. INT 03-02, paragraph 8 indicates that the statutory accounting intention is to avoid surplus gains for the ceding entity as a result of implementing a modification to an intercompany pooling arrangement. However, the guidance in SSAP No, 62R, paragraph 37 uses a more punitive method of accounting if there is a gain in surplus to the ceding entity as a result of the intercompany reinsurance transaction. Therefore, NAIC staff would characterize the SSAP No. 62R guidance as imposing an accounting penalty if there is a gain, rather than seeking to avoid recognizing such a gain. The INT also characterizes SSAP No. 25 as being for isolated transactions, which is inconsistent with discussions of the Working Group on the applicability of SSAP No. 25.
Summary:
During the 2022 Fall National Meeting, the Working Group exposed a discussion document to expand current statutory accounting guidance in SSAP No. 93—Low-Income Housing Tax Credit Property Investments to capture all tax equity investments that provide federal business tax credit and state premium tax credits if they meet specified criteria.

Interested Parties’ Comments:
Interested parties agree with having uniformity in accounting and reporting for equity investments for which the return is earned primarily through tax credits. Interested parties agree that the proportional amortization method is an appropriate method to use for any type of investment (debt or equity) where the return is primarily earned through tax credits. We are providing responses to the questions exposed in the Discussion Paper in this document. There are two key takeaways from our responses summarized as follows:

1. Interested parties ask the Working Group to consider allowing for the reporting of both the amortization of the investments and the use of the tax credits themselves in the same income statement line similar to what is required under U.S. GAAP.

2. Interested parties have concerns regarding tax credit investments that are issued in debt form and requiring those investments to be reported on Schedule BA instead of Schedule D. Interested parties believe that tax credit investments issued in debt form are better suited for Schedule D reporting.

NOTE: In addition to these two comments, interested parties have provided responses to the questions detailed in the discussion document. These responses are detailed in the comment letter but have not been duplicated within this hearing agenda.

Recommendation:
NAIC staff recommends that the Working Group direct NAIC staff to proceed with drafting revised statutory accounting guidance and a related issue paper to expand the guidance in SSAP No. 93 for tax credits, as well as to draft revisions to SSAP No. 94—Transferable and Non-Transferable State Tax Credits for future Working Group discussion. NAIC staff proposes to consider the feedback from interested parties on the discussion document as well as the revised FASB guidance, which is expected to be issued in the near future, in updating the proposed revised statutory accounting guidance for subsequent exposure consideration.

With regards to the two key takeaways from interested parties, NAIC staff notes the following:

1. **Income Statement Reporting:** Regarding the interested parties’ request to capture amortization and tax credits in the same income statement line similar to U.S. GAAP as a component of income tax expense (or benefit). It is noted that the current SAP reporting which amortizes the investment as the investment tax credits are proportionately used and recognizes tax credits used as a reduction in the related tax expense category was an intentional Working Group decision when the guidance was originally adopted, but this divergence from U.S. GAAP will be detailed and presented to the Working Group so the Working Group can choose whether to alter their prior conclusion.
2. **Bond Classification**: The interested parties’ comments have noted concerns with tax credit investments issued in debt form being reported on Schedule BA and not Schedule D-1. From initial regulator feedback received, tax credit investments shall not be reported as bonds and shall be reported on Schedule BA. NAIC staff requests Working Group comments on this assessment.

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**Summary:**
During the 2022 Fall National Meeting, the Working Group exposed SAP clarifications to SSAP No. 34—Investment Income Due and Accrued to add additional disclosures and to data-capture the disclosures.

**Interested Parties’ Comments:**
Interested parties propose that the exposed changes which are an outgrowth of the Bond project should share the same effective date. This will also allow companies to make the system changes needed to provide this information.

Interested parties also suggest the following editorial revisions to the disclosures contained in SSAP No. 34 for clarification and to be consistent with the proposed Blanks changes:

7. The following disclosures shall be made for investment income due and accrued in the financial statements. (SSAP No. 37 captures disclosures for mortgage loans on nonaccrual status pursuant to paragraph 6.)

   a. The bases by category of investment income for excluding (nonadmitting) any investment income due and accrued;

   b. Disclose total amount excluded;

   c. Disclose the gross, nonadmitted and admitted amounts for interest income due and accrued.

   d. Disclose aggregate deferred interest and cumulative amounts of paid-in-kind (PIK) interest included in the current principal balance.

   e. Disclose cumulative amounts of paid-in-kind (PIK) interest included in the current principal balance.

**Recommendation:**
NAIC staff recommends that the Working Group adopt the exposed revisions to SSAP No. 34—Investment Income Due and Accrued, with the minor revisions that were suggested by the Interested Parties’ comment and illustrated above, effective for year-end 2023. NAIC staff will work staff from the Blanks (E) Working Group to create an agenda item to incorporate the changes into the annual statement blanks. NAIC staff recognizes that this item was identified from bond project discussions, but this new disclose is not contingent on the bond proposal and is pertinent to existing investments held.
Summary:
During the 2022 Fall National Meeting, the Working Group exposed the agenda item as a new SAP Concept with a request for comments by industry on potential guardrails and details on unique considerations. The Working Group directed NAIC staff to coordinate with the Life Actuarial (A) Task Force and requested regulator-only sessions with industry to receive company specific information.

American Council of Life Insurers (ACLI) Comments:
The American Council of Life Insurers (ACLI) appreciates the opportunity to provide comments on the above referenced exposure as well as the thoughtful and timely attention this important topic is receiving from SAPWG and LATF. The ACLI stands ready to continue working with the NAIC to create sufficient, yet practical, safeguards to ensure that the most appropriate treatment of Interest Maintenance Reserve (IMR) can be applied, and a company’s surplus and financial strength are properly reflected, while not disincentivizing prudent investment and risk management in the best interest of all.

A rising interest rate environment from historically low rates is generally favorable to the financial health of the life insurance industry. However, ACLI is concerned that without a change to the current treatment of negative IMR, the environment will give the inappropriate perception of decreased financial strength through lower surplus and risk-based capital ratios. This problem will only be exacerbated if interest rates remain at or near their current levels or increase further; therefore, it is imperative that we work together toward developing an industry-wide solution for implementation by year-end 2023.

Upon the sale of and subsequent reinvestment in a fixed income instrument, the reflection in surplus of either a gain or loss is not reflective of the true economics, as there is no change to solvency, liquidity, or claims paying ability because the difference between the reported amortized cost value and fair value is equal to the IMR. This letter addresses our assessment of the suitability of the five potential guardrails proposed at the SAPWG fall national meeting and raises two additional proposals for consideration.

Background
While this letter will focus on potential additional safeguards, as suggested at the SAPWG fall national meeting, this is a complex topic and we want to summarize, review, and expand on relevant background information largely included in our previous letter dated October 31, 2022.

The NAIC’s statutory accounting framework is largely an “amortized cost framework” in that fixed income investments are generally reported at amortized cost and long-term insurance liabilities are generally reported with locked and conservative assumptions.

We strongly support the NAIC framework, as it facilitates the issuance of long-term insurance products in the US market by not overly focusing on current market fluctuations. This is unlike many market valuation regimes where over-reliance or misapplication of current market conditions often distorts the financial solvency of insurance companies and can lead and has led to the decrease or elimination of such long-term product issuances in those regimes.
However, an amortized cost framework could also potentially distort the financial solvency of insurance companies through the misrepresentation of surplus. The IMR was developed as a safeguard to ensure surplus is properly reflected within the NAIC’s framework.

Specifically, in a declining interest rate environment, an insurance company could sell its fixed income investment portfolio, recognize gains, increase surplus and show increased financial strength. This increase in surplus would largely be illusory as the increased surplus would be offset by a lower yielding investment portfolio.

IMR requires deferrals of those gains from surplus, and the gains are amortized through income over the remaining life of the bonds sold to:

- Ensure accurate representation of a company’s reported surplus by eliminating the potential for overstatement of surplus, and
- Keep the relationship of anticipated investment yield consistent with that needed to support the liabilities.

But without IMR, a rising interest rate environment could result in similarly misleading surplus (in this case an illusory lack of surplus) because a company would be investing in higher yielding bonds.

When IMR was developed, it was anticipated that the IMR would work consistently for both net realized gains and losses; however, the allowance of a net negative IMR was not initially adopted upon implementation in 1992. It was expected that the issue would be addressed in subsequent years and remained on the SAPWG agenda at least until 2005 but was never addressed in any substantive way. This was largely because of a lack of urgency due to the decades-long declining interest rate environment where IMR was largely positive for life insurance companies.

This issue had been referred to SAPWG from the AVR/IMR working group which believed the basic rationale for the IMR would conclude that neither a maximum nor minimum is appropriate. It was fully expected that the IMR, whether negative or positive, would be included in asset adequacy testing and addressed by the actuarial opinion.

We are very appreciative that SAPWG and LATF are looking to substantively revisit the negative IMR issue as anticipated during its original development. The current interest rate environment has changed circumstances in a meaningful way. While rising interest rates from historically low levels are beneficial to insurance companies, the recent rapid rise of interest rates has increased the urgency to address the negative IMR issue to avoid the misrepresentation of capital positions of insurance companies.

The current interest rate environment or a further rise in interest rates would only exacerbate the urgency as losses from bond sales could result in a significantly inappropriate portrayal of surplus that would be inconsistent with the rationale for which IMR was initially developed. In this case, insurers would show a significant illusory lack of surplus because they would be investing in higher yielding bonds.

IMR is an important construct that effectively adjusts liabilities so that the balance sheet liabilities net of IMR remain on the same basis as the reported balance sheet assets, limiting artificial volatility within surplus. As discussed above, negative IMR, from an asset-liability perspective, represents either high future income from reinvestments or future reserve releases that will be available to pay claims from an asset liability perspective.

Although the status quo use of permitted practices may grant relief for specific companies, it may lead to an unlevel playing field. Consequently, the ACLI wants to emphasize the importance of developing a uniform national standard for consistently ensuring the appropriate theoretical and practical treatment of IMR (e.g., symmetrical treatment of both gains and losses).

The ACLI would like to work with the NAIC to fulfill the original intent of IMR that ensures surplus and financial strength are properly reflected and do not disincentivize prudent investment and risk management. At the same time, we want to work with regulators to ensure IMR cannot somehow be circumvented in a rising interest rate environment, whether intentionally or inadvertently, to misrepresent financial strength.
Common Interest to not Disincentivize Prudent Behavior

We want to reiterate the importance of not disincentivizing prudent portfolio and asset liability management.

In addition to prudent portfolio management and managing credit/investment risk exposure, insurance companies manage duration. These prudent risk management processes all require on-going transactions that impact the IMR, such as whether it is sales and reinvestment in fixed income investments, which we discussed in our previous letter dated October 31, 2022, or use of derivatives to achieve the same appropriate end. We would note that bond sales may trigger derivative terminations that offset in IMR; however, derivatives settlements can impact IMR without an offset impact from a bond sale.

Hedging strategies are used to address product risks like contract guarantees, disintermediation, and reinvestment risks as part of prudent risk management practices utilized by life insurance companies. These hedging strategies may involve interest rate swaps, caps, floors, swaptions, interest rate futures, among others, that also may generate IMR gains and losses.

For example, negative IMR can be generated by hedging strategies utilized for pension risk transfers. Once the contract is executed, insurers will enter hedging contracts to ensure interest rate certainty while awaiting cash and assets in-kind and/or the right investment opportunities to meet the long-term goals for the accounts. As the hedges are unwound to meet pricing and investment targets, immediate losses and negative IMR may be generated as interest rates rise, but the losses are ultimately offset over time with higher fixed instrument yields.

Further, many life insurance and annuity products have significant long term reinvestment risk, where premiums are received for many decades before benefit payments may be made. Companies may use interest rate futures, swaps, or bond forwards, to reduce reinvestment risk by locking in interest rates at which the future premiums will be invested. When interest rates rise, these hedging transactions may settle, roll-over, or be terminated, leading to expected IMR losses but are ultimately offset by future higher reinvestment yields. Without these hedging transactions, returns might not be equivalent to policyowner obligations, exposing the company to significant interest rate risk.

Similarly, life insurance companies may utilize stochastic asset liability modeling to establish asset duration targets that may include setting different asset duration targets by product if appropriate, through an asset segmentation plan. This considers scenarios where interest rates increase rapidly (where there is potential for disintermediation risk) and very low interest rates (considering product guarantees). Such analysis is refreshed on a regular basis to update the duration target based on the liability in force characteristics and the economic environment. Portfolio asset duration is managed to the target on an ongoing basis and requires asset sales/purchases or use of derivatives that affect IMR. These are but several distinct examples of the types of prudent risk management practices utilized by life insurance companies.

A rising interest rate environment is generally favorable to the financial health of the life insurance industry. Without a change to the treatment of negative IMR, a rising interest rate environment will give the inappropriate perception of decreased financial strength through lower surplus and risk-based capital ratios, which is both counterintuitive and not reflective of the economics. It may create undesirable incentives for companies to deviate from prudent investment/risk management to avoid creating negative IMR.

It essentially creates two equally objectionable alternatives for insurers and their policyowners.

- Applying the current statutory guidance will improperly reflect financial strength through understating surplus,
- Insurers could take steps to manage their current capital position by limiting trading of fixed income investments and/or usage of derivatives, which would diminish significant economic value or worse, create a mismatch between assets and liabilities and prevent the ability to fulfil long-term contract obligations.
Insurers may avoid hedging or trading to ensure future reinvestment risks are mitigated, by being incentivized to overly focus on managing misrepresented short-term financial position by effectively keeping asset duration shorter than their liabilities and taking on interest rate risk.

We do not believe this is in the best interest of insurance companies or their policyowners and believe it is a common interest we share with regulators. Consequently, developing a national standard for allowing negative IMR with appropriate safeguards should be a common goal for all.

Existing Safeguards
As noted above, IMR itself is a safeguard for the NAIC’s amortized cost framework that accomplishes two main objectives:

- Addresses the risk of misrepresentation of surplus, and
- Keeps the relationship of anticipated investment yield consistent with that needed to support the liabilities.

Excess Withdrawal Safeguard

An Excess Withdrawal safeguard is already embedded in the IMR framework for the situations in which asset sales are “forced”, either due to reputational or disintermediation events, and the liability that the assets supported no longer exists. At such a point, deferring gains and losses to IMR ceases.

While we believe this safeguard was primarily developed to address troubled companies or potential disintermediation in a rising interest rate environment, we understand regulators may want to re-assess the safeguard’s robustness. The ACLI supports such a re-assessment and looks forward to working with the NAIC.

Asset Adequacy Testing (AAT)

AAT is an additional safeguard that helps protect against further unintended consequences when IMR goes negative. Reflecting all admitted negative IMR in AAT would replace assets that generate investment income in AAT, where the starting point is statutory assets are equal to statutory liabilities. Unless the remaining assets can earn a sufficient yield due to reinvestment, there will be negative impacts to the results, which could lead to additional asset adequacy reserves and hence a reduction in statutory surplus. AAT provides a framework to ensure that there are sufficient margins to support claims alongside a negative IMR asset that eventually amortizes to zero, hence ensuring adequate reserves and proper representation of surplus. A simplified example of how AAT works with negative IMR in different reinvestment scenarios is included in Appendix I of this letter.

While we believe that AAT provides a robust safeguard that prevents a misuse of allowable negative IMR, we understand the NAIC wants to contemplate additional safeguards, as AAT may not be applied uniformly across states and practitioners and is only shared with regulators annually.

Additional Potential Safeguards
At the SAPWG fall national meeting the following five potential safeguards were discussed:

1) Ensure there is reinvestment in fixed income securities (see below),
2) Enhancement to asset adequacy testing (see below),
3) Shorten the amortization period for negative IMR (see Appendix II),
4) Limit negative IMR as a percentage of surplus, assets, etc. (see Appendix II), or
5) Restrict surplus via the special surplus funds (see Appendix II).

ACLI proposes two additional possibilities:

1) Limit based on the risk-based capital framework (see below), or
2) Create an “Opt-in Framework” with structured governance (see below).

The remainder of this letter outlines a broad framework of the aforementioned additional safeguards that we believe are responsive to regulators’ specific concerns. Redundant or more arbitrary potential safeguards are further discussed in Appendix II attached to this letter.

Ensure there is reinvestment in fixed income securities

IMR theory assumes sales of fixed income investments are reinvested in new fixed income investments. When doing so, the reinvestment is done in the current interest rate environment, and the difference in earnings arising from the reinvestment is roughly equal in magnitude, but opposite in direction, to the gain or loss realized on the old investment.

In a rising interest rate environment, a sale essentially transforms the loss to negative IMR. There is essentially no difference in balance sheet economics pre- and post-trade, related to liquidity or claims paying ability, as the difference between the reported amortized cost value, and fair value, upon sale, is equal to the negative IMR.

While AAT would arguably address any deficit in reinvestment as illustrated in our example in Appendix I, ACLI is open to supporting additional demonstrations of reinvestment in fixed income investment. This could be done, for example, by generally requiring the sum of the proceeds from the sale and maturity of bonds (line 12.1) and mortgage loans (line 12.3) are less than the sum of the cost of bonds acquired bonds (line 13.1) and mortgage loans (line 13.3) from the cash flow statement ultimately submitted to regulators in the annual statement.

Such a requirement would provide the following benefits:

1) It is objective, easily verifiable, and ultimately rolls up into the audited financial statements,
2) It eliminates the issue surrounding the “fungibility of cash” – that is “proving” reinvestment of each sale, which would be difficult and potentially inappropriate, if on a macro basis there was a major shift to equities for example, and
3) It demonstrates on a macro basis significant reinvestment is occurring.

We note that even if there were a significant shift to equities, in theory, this should be captured by AAT with equity investments being appropriately stressed, but it would also significantly reduce risk-based capital ratios which would provide significant dis-incentivization for this to occur.

Lastly, such a metric could be coupled with the “Opt-in Approach” proposed below, that would provide additional structure by requiring documentation and controls on prudent strategies for investment management, asset liability management or hedging deemed appropriate and against which future transactions could subsequently be verified as appropriate by the company’s domiciliary regulator.

Enhancement to Asset Adequacy Testing

We propose that negative IMR should only be allowed if it is included in AAT. This would replace assets that generate investment income in AAT when starting with statutory assets equal to statutory liabilities. Unless the remaining assets can earn a higher yield through reinvestment at higher rates, there will be negative impacts to the results, which could lead to additional asset adequacy reserves and a reduction in statutory surplus.

Fixed income investments that sit in surplus or non-product portfolios could be sold generating IMR. Therefore, we recommend the allowance of negative IMR only if it is included in AAT. This would further prevent any potential balance sheet manipulation, whether intentional or unintentional, through shifting assets with losses to non-insurance portfolios and admitting losses on assets that are not offset by matched liabilities. This concept could also be coupled with the “Opt-in Approach” proposed below.
Limit based on the risk-based capital framework

One potential safeguard that was not mentioned by SAPWG at the fall national meeting is to allow negative IMR only if a company’s risk-based capital threshold showed that they were financially strong. This would have the following benefits:

1) Address regulator concerns on allowing negative IMR if a company was or was nearing being financially troubled,

2) Would not be arbitrary and would be based on an objective and verifiable threshold that would be available to regulators, potentially quarterly, and provide early warning to any concerns they may have in this regard, and

3) Would essentially achieve the same ends as shortening the amortization period, restricting capital, or creating an arbitrary limit.

We are willing to work with the NAIC to think through an appropriate threshold as well as what would occur if that threshold was subsequently crossed so there would not be inappropriate cliff effects.

This concept could also be coupled with the “Opt-in Approach” proposed below.

Create an “Opt-in Framework” with Structured Governance

An “Opt-in Framework,” similar to the framework included within SSAP No. 108 – Derivative Hedging Variable Annuity Guarantees (SSAP No. 108), could be developed.

SSAP No. 108 recognizes the prudency of hedging guarantees embedded within variable annuity contracts while also recognizing the non-economic volatility created (and therefore inappropriate under/overstatement of surplus). It also recognized that this volatility was created because derivatives used in a dynamic hedging approach were required to be reported at fair market value, as they would not meet the strict hedge accounting requirements, while the liabilities did not require marking to market of the hedged guarantees.

To not disincentivize this prudent dynamic hedging, SSAP No. 108 requires additional structure and governance to avoid misrepresentation. The allowance of negative IMR has similar parallels.

Key provisions of SSAP No. 108 that could be considered for a framework for negative IMR allowability include:

- Explicit approval of a company’s domiciliary regulator prior to implementation,
- A clearly defined portfolio and asset liability management strategy (with documentation; analogous to SSAP No. 108 but tailored more appropriately for portfolio and asset liability management strategies),
- Actuarial certification of the asset liability management strategy, and
- Certification by a financial officer of the company (CFO, treasurer, CIO, or designated person with authority over the actual portfolio and asset liability management strategies).

This framework provides sufficient tools that allow for timely and appropriate regulatory review; additional tools could be specifically tailored for IMR.

In the context of a negative IMR, the approach could be tailored to incorporate documentation and controls of prudent strategies for investment management, asset liability management, and hedging strategies deemed appropriate and against which future transactions could subsequently be verified as necessary by the company’s domiciliary regulator.
Achieving the “opt-in” in the context of negative IMR could require satisfying these documentation requirements, in addition to incorporating and complying with a combination of one or more of the other potential safeguards mentioned above. This package of requirements and safeguards would constitute a national standard for allowing negative IMR that can be consistently applied across all companies.

In the current interest rate environment, and with additional interest rate increases potentially on the horizon, the disallowance of negative IMR has become a serious and pressing issue for industry as we seek to execute prudent portfolio and risk management strategies that align with our economic realities. The ACLI looks forward to working with the NAIC to expedite a reasonable, permanent solution that fulfils the original intent of IMR and work on the appropriate additional safeguards that may be needed for year-end 2023 implementation. Lastly, ACLI recalls a specific question raised by regulators at the NAIC’s fall national meeting. We would like to understand this question and/or concern more fully and discuss with regulators or NAIC staff.

Recommendation:
NAIC staff recommends that the Working Group provide feedback and direction for future consideration.

The comment letters are included in Attachment 20 (42 pages).

Draft: 1/4/23

Statutory Accounting Principles (E) Working Group
Tampa, Florida
December 13, 2022

The Statutory Accounting Principles (E) Working Group of the Accounting Practices and Procedures (E) Task Force met in Tampa, FL, Dec. 13, 2022. The following Working Group members participated: Dale Bruggeman, Chair (OH); Kevin Clark, Vice Chair (IA); Sheila Travis and Todrick Burks (AL); Kim Hudson and Ted Chang (CA); William Arfanis and Jack Broccoli (CT); Rylynn Brown (DE); Cindy Andersen (IL); Melissa Gibson (LA); Judy Weaver (MI); Pat Gosselin (NH); Bob Kasinow (NY); Melissa Greiner, Matt Milford, and Diana Sherman (PA); Jamie Walker (TX); Doug Stolte and Greg Chew (VA); and Amy Malm (WI). Also participating was: David Wolf (NJ).

1. Adopted its Nov. 16, Oct. 24, Oct. 6, and Summer National Meeting Minutes

The Working Group met Nov. 16 and Oct. 24. During its Nov. 16 meeting, the Working Group exposed revisions to agenda item 2019-21: Proposed Bond Definition. The exposure included updated drafts of Statement of Statutory Accounting Principle (SSAP) No. 26R—Bonds and SSAP No. 43R—Loan-Backed and Securities. The revised drafts also include proposed transition guidance, which includes identification of the Jan. 1, 2025, effective date. The exposure included a document that details “Other SSAP Revisions” that proposes revisions to various SSAPs, including SSAP No. 2R—Cash, Cash Equivalents, Drafts and Short-Term Investments to exclude asset-backed securities (ABS) from short-term/cash equivalent classification and SSAP No. 21R—Other Admitted Assets to establish guidance for debt securities that do not qualify as bonds. The comment deadline for these exposures is Feb. 10, 2023. The Working Group also exposed revisions to Interpretation (INT) 22-02: Third Quarter 2022 through First Quarter 2023 Reporting of the Inflation Reduction Act – Corporate Alternative Minimum Tax, to extend the INT through year-end 2022 and the first quarter of 2023 with an additional disclosure regarding applicable entities, for a public comment period ending Dec. 1, 2022. The Working Group noted that the amended INT 22-02 would be automatically nullified on June 15, 2023.

During its Oct. 24 meeting, the Working Group adopted INT 22-02 for third-quarter 2022 reporting with edits to paragraph 13b recommended by interested parties. The edits are more explicit on whether a reporting entity is expected to pay in 2023 and that the corporate alternative minimum tax (CAMT) is calculated based on multiple reporting entities if a reporting entity files a consolidated tax return.

Additionally, the Working Group conducted an e-vote that concluded Oct. 6 to expose INT 22-02 and INT 22-03: Inflation Reduction Act – Corporate Alternative Minimum Tax. These interpretations are in response to the federal Inflation Reduction Act, which is effective for tax years 2023 and after. The federal Inflation Reduction Act includes the concept of CAMT, and under the existing statutory accounting guidance, an entity must consider the impact of the tax change in the statutory valuation allowance and the admissibility of deferred tax assets in the period of enactment. The proposed INTs provide exceptions to statutory accounting based on whether reasonable estimates can be made.

The Working Group also met Dec. 8 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 Fall National Meeting agenda.
Walker made a motion, seconded by Malm, to adopt the Working Group’s Nov. 16 (Attachment One-A), Oct. 24 (Attachment One-B), Oct. 6 (Attachment One-C), and Summer National Meeting (see NAIC Proceedings – Summer 2022, Accounting Practices and Procedures (E) Task Force) minutes. The motion passed unanimously.

2. **Adopted Non-Contested Positions**

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

Malm made a motion, seconded by Arfanis, to adopt the revisions detailed below as non-contested statutory accounting revisions. The motion passed unanimously.

a. **Agenda Item 2022-09**

Bruggeman directed the Working Group to agenda item 2022-09: ASU 2022-01, Fair Value Hedging – Portfolio Layer Method (Attachment One-E). Julie Gann (NAIC) stated that this is the third agenda item addressing derivatives coming from Accounting Standards Update (ASU) 2017-12, Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities and stated that this agenda item also reviews ASU 2022-01, Fair Value Hedging – Portfolio Layer Method. She stated that this guidance adopts U.S. generally accepted accounting principles (GAAP) for the portfolio layer method and incorporates revisions for partial term hedges with the intent to converge with GAAP to the extent possible, so if something is an effective hedge under GAAP, it would be an effective hedge under statutory accounting. Gann stated that there is a deviation for partial term hedges because the statutory accounting guidance is limited to financial asset hedges only, which mirrors the provisions for the portfolio layer method. She stated that the revisions reflect new statutory accounting principles (SAP) concepts detailed in SSAP No. 86—Derivatives and are effective Jan. 1, 2023, with early application permitted. Gann stated that this concludes the review of ASU 2017-12 and that anything that comes after this would be addressed in a new agenda item. She stated that there is an issue paper proposed for exposure which will be discussed the meeting portion of the agenda that documents the revisions from the derivative review from ASU 2017-12 for historical purposes.

b. **Agenda Item 2022-10**

Bruggeman directed the Working Group to agenda item 2022-10: ASU 2022-02: Troubled Debt Restructurings and Vintage Disclosures (Attachment One-F). Gann stated that this agenda item reviews ASU 2022-02: Troubled Debt Restructurings and Vintage Disclosures and revises the relevant literature section of SSAP No. 36—Troubled Debt Restructuring. She stated that although previously GAAP guidance was adopted related to troubled debt restructuring, the new GAAP guidance is being rejected for this topic as it was revised in line with their current expected credit loss (CECL) standard. Since CECL has not been adopted for statutory accounting, the SAP clarification revisions retain the guidance in SSAP No. 36 and identify the rejection of U.S. GAAP.

c. **Agenda Item 2022-13**

Bruggeman directed the Working Group to agenda item 2022-13: Related Parties – Footnote Updates (Attachment One-G). Jake Stultz (NAIC) stated that this agenda item was exposed at the Summer National Meeting to incorporate SAP clarification language to exempt foreign open-ended investment funds, governed and authorized in accordance with regulations established by applicable foreign jurisdictions, from look-through provisions in SSAP No. 25—Affiliated and Other Related Parties unless the reporting entity has the ability to control the foreign fund.
3. **Reviewed Comments on Exposed Items – Minimal Discussion**

   a. **Agenda Item 2021-25**

Bruggeman directed the Working Group to agenda item 2021-25: Leasehold Improvements after Lease Termination. Stultz stated that this agenda item was most recently exposed at the Summer National Meeting and that it contains edits to clarify that amortization of leasehold improvements will immediately end when the lease is terminated and will require that any remaining unamortized leasehold improvement balance be immediately expensed. This includes scenarios where the lease terminates naturally or when the lessee purchases the property. Stultz stated that the agenda item includes a specific exclusion in SSAP No. 73—Health Care Delivery Assets and Leasehold Improvements in Health Care Facilities that allows leasehold improvements necessary for the functionality of specific health care delivery assets to be excluded, in some cases, from the purchase cost of the real estate.

Stultz stated that the final issue with this agenda item related to leasehold improvements where the lessee purchases real estate that they had been previously leasing. He stated that the guidance that is being proposed would clarify that in this situation, leasehold improvements should be expensed, just like any other lease termination. He noted that the industry position is that the value of the leasehold improvements is essentially being excluded from the purchase price of the real estate, when in practice it is unlikely that a professional real estate company would not work to get any value that they can out of the sale of the property, as they are obligated to their investors to do so. He noted that if the industry recommendation were followed, after the purchase, the real estate would be at its market value on the books, plus the remaining unamortized balance of leasehold improvements, thereby overstating fixed assets by the remaining balance of the leasehold improvements.

Stultz stated that interested parties provided a detailed comment letter that is included in the meeting materials. He stated that the comment letter included a minor revision suggesting an update to SSAP No. 19—Furniture, Fixtures, Equipment and Leasehold Improvements, paragraph 9. Stultz stated that NAIC staff recommend adoption of this agenda item, with the minor revisions to SSAP No. 19, paragraph 9.

Malm made a motion, seconded by Weaver, to adopt the exposed SAP clarification, which clarifies that amortization of leasehold improvements will immediately end when the lease is terminated and will require that any remaining unamortized leasehold improvement balance be immediately expensed in SSAP No. 19 and SSAP No. 73, with the additional revisions to SSAP No. 19, paragraph 9 suggested by interested parties (Attachment One-H). The motion passed unanimously.

   b. **INT 22-02**

Bruggeman directed the Working Group to INT 22-02: Third Quarter 2022 through First Quarter 2023 Reporting of the Inflation Reduction Act – Corporate Alternative Minimum Tax. Robin Marcotte (NAIC) stated that the Working Group exposed revisions to this agenda item on Nov. 16, and that it was originally issued to only cover the third quarter of 2022, but it has been extended through the first-quarter 2023 financial statements. She stated that the guidance in INT 22-02 provides statutory exceptions to the impacts of the CAMT, as reasonable estimates cannot be made. She stated that the extension includes disclosures previously included in INT 22-02, with a new disclosure to identify whether the reporting entity or the controlled group of corporations for which the reporting entity is a member has determined that they expect to be required to perform calculations to determine if they will owe the CAMT. Marcotte stated that this expands a subsequent event exception to include events identified through Dec. 31, 2022. She stated that INT 22-02 has a nullification date of June 15, 2023. She stated that interested parties support adoption of INT 22-02, indicating that many entities will not have information they
need until the second quarter of 2023. Marcotte stated that NAIC staff recommend adoption of the revisions as exposed to INT 22-02.

Rosemarie Albrizio (Equitable), representing interested parties, stated that interested parties support adoption of the amended interpretation to allow additional time for additional guidance to be provided by the U.S. Department of the Treasury (Treasury Department). She stated that adoption of this amended interpretation would also allow time to determine allocation from the consolidated tax to the reporting entities and to determine the impact on tax-sharing arrangements.

Weaver made a motion, seconded by Clark, to adopt the exposed revisions to INT 22-02 (Attachment One-I). The motion passed unanimously.

4. Reviewed Comments on Exposed Items

   a. Agenda Item 2022-01

Bruggeman directed the Working Group to agenda item 2022-01: Conceptual Framework – Updates for Liabilities. Marcotte stated that the Financial Accounting Standards Board (FASB) updated 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 FASB also updated 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. She stated that at the Summer National Meeting, the Working Group adopted changes to the preamble, updates to the definition of an asset in SSAP No. 4—Assets and Nonadmitted Assets and Issue Paper No. 166—Updates to the Definition of an Asset. The Working Group also re-exposed revisions to the definition of a liability in a draft issue paper.

She stated that FASB treats the asset and liability definitions in the same manner as statutory accounting treats the Statement of Concepts when developing guidance. So, the updates do not change FASB authoritative literature. By contrast, statutory accounting has treated SSAP No. 4 and SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets, which incorporated these FASB definitions, as authoritative statements. Marcotte stated that FASB noted that some existing authoritative FASB literature, particularly for liabilities, is inconsistent with the definition changes in the Concepts Statement No. 8. Marcotte stated that interested parties suggested that an additional footnote be added to both the definition of an asset and a liability due to the different treatment between GAAP and SAP on these definitions. She stated that NAIC staff recommend that the Working Group re-expose, with some footnote language proposed by NAIC staff, or just re-expose to allow additional work on a footnote to point to topic-specific guidance in other SSAPs when there is a conflict with SSAP No. 5R.

Bruggeman stated that there are items where the guidance is in the NAIC Annual Statement Instructions and not in the SSAPs. He stated that he understands industry’s concern with the possibility of having conflicting guidance.

Albrizio stated that the issue is that the annual statement instructions have accounting guidance, so the wording should be carefully considered. Additional time would be helpful to work with NAIC staff. Bruggeman stated that the recommendation is to continue the exposure to allow time to collaborate with interested parties to adjust the language. Hudson stated support for giving additional time to consider this issue.

Weaver made a motion, seconded by Clark, to re-expose in order to allow for additional time for all parties to discuss the issue. The motion passed unanimously.
b. Agenda Item 2022-11

Bruggeman directed the Working Group to agenda item 2022-11: Collateral for Loans. Marcotte stated that the Working Group exposed revisions to SSAP No. 21R at the Summer National Meeting to clarify that invested assets pledged as collateral for admitted collateral loans must qualify as admitted invested assets. She stated that this agenda item was drafted to address an inconsistency regarding the collateral loan guidance in SSAP No. 20—Nonadmitted Assets and SSAP 21R, as both identify the need for adequate collateral that qualifies as an invested asset. She stated that SSAP No. 20 was more explicit than the guidance in SSAP No. 21R. Marcotte stated that interested parties provided comments recommending the inclusion of a footnote indicating that SSAP No. 48—Joint Ventures, Partnerships and Limited Liability Companies investments would not need to be audited if provided as support for a collateral loan to be admitted. If the loan defaulted and the reporting entity takes possession of the collateral, an audit would be required for the investment to be admitted pursuant to SSAP No. 48. She stated that NAIC staff recommend the Working Group discuss the exposed revisions to SSAP No. 21R, as well as the footnote provided by interested parties. She stated that some state insurance regulators have expressed that an audit is required. Other state insurance regulators have noted a heightened concern with loans secured by related parties. Marcotte stated that NAIC staff defer to the Working Group on the action to take at this meeting. The Working Group could adopt as exposed, consider re-exposure, or expose with a proposed footnote.

Bruggeman stated that there needs to be more discussion and expressed support for a re-exposure. Hudson stated support for more consideration on this agenda item and a re-exposure.

Andrew Morse (Global Atlantic Financial Group), representing interested parties, stated that various companies have landed on generally the same accounting treatment and that the comment letter was meant to ask the Working Group’s consideration about whether this treatment could become the official prescribed guidance going forward. He stated that, currently, SSAP No. 21R has two criteria for collateral. First, it must be an investment. Second, the fair value of the collateral must be sufficient to support the collateral loan. He stated that companies have built accounting controls and processes around ensuring that collateral is an investment and that fair value is sufficient. Morse stated that missing in that framework is that there is no concept of an audit for the collateral asset. He stated that per SSAP No. 48 and SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities, an audit is required if held directly, but an audit does not necessarily include a fair value confirmation of the pledged LLC investment, which is the foundation of the SSAP No. 21R guidance. Companies recognize that if they were eventually to take possession of the collateral directly, at that point they would need to obtain an audit. He stated that various companies have applied this same rationale and have been operating under this framework up until now. Morse stated that the Working Group’s exposure redefines the first collateral requirement to be not just an investment, but an admitted invested asset, which means an audit would need to be performed of the collateral asset. He stated that is not the current practice that companies have been performing and interested parties have concerns since an audit does not validate fair value. As such, this adds additional costs and processes to reporting entities when completing the evaluation process. He stated it may cause confusion because an audit would determine an audited GAAP book value, which will not be used to evaluate the sufficiency of the collateral. He stated that interested parties believe that cases of default are rare, and they are not aware of any cases where collateral assets of this type have been taken on directly, perhaps due to the creditworthiness of the loan borrowers. He stated that their expectation is that there is only a remote likelihood that collateral assets would be owned outright. He stated that if further verification is needed, a fair value assessment would be better suited for the task. Morse stated that companies want to avoid performing duplicative and costly audits on these assets.

Bruggeman inquired how interested parties would recognize fair value for assets supporting related party collateral loans and whether they would have an independent party assess fair value.
Morse stated that they currently follow SSAP No. 100R—Fair Value, where there are a number of different steps taken to determine fair value, but that these would likely be classified as level 2 or level 3 fair values. He stated that interested parties have had discussions and that instead of requiring an audit, it would be better to either have an audit or a third-party assessment of the fair value. He stated that this would save companies from having to perform two processes.

In response to Clark’s request for further clarification of the interested parties’ proposal, Morse stated that various companies looked to SSAP No. 21R first and adopted policies around the guidance. With that experience, they believe that it is a sound approach given their opinion that a GAAP audit is not useful for this topic.

Clark made a motion, seconded by Walker, to re-expose the proposed revisions to allow for further discussion. The motion passed unanimously.

c. Agenda Item 2022-12

Bruggeman directed the Working Group to agenda item 2022-12: Review of INT 03-02: Modifications to an Existing Intercompany Pooling Arrangement. Marcotte stated that at the Summer National Meeting, the Working Group exposed the intent to nullify INT 03-02 as it is inconsistent with SSAP No. 25 guidance regarding economic and noneconomic transactions between related parties. She stated that the guidance in INT 03-02 can result in unrecognized gains or losses through the use of statutory book value when using assets, such as bonds, to make payments to affiliates for modifications to existing intercompany reinsurance pooling agreements. Marcotte stated that NAIC staff continue to recommend nullification of INT 03-02 and not have long-term differences between SSAPs and INTs. She stated that NAIC staff recommend the Working Group re-expose the intent to nullify INT 03-02 to allow for further discussion.

Marcotte stated that with the exposure, the Working Group should request comments on the effective date and identified key points for consideration during the exposure in response to some of the interested parties’ comments received. Key points identified included that: 1) in the current interest rate environment, the fair value of many bonds is below book value; 2) SSAP No. 25 requires such transfers of assets between affiliates to use fair value and that using book value for the measurement of payments between affiliates can result in either unrecognized, or in effect, dividends or losses; 3) at the ultimate parent level, such transfer of assets (in accordance with SSAP No. 25 guidance) may be noneconomic in that the parent continues to hold an interest in the same assets; 4) while an entity can still choose to pay with assets, the transfer should be valued consistently with SSAP No. 25 guidance; 5) many of the interested parties’ comments regarding GAAP’s use of book value are more relevant to consolidated basis accounting, which is not consistent with the legal entity basis of statutory accounting; 6) addressing comments regarding valuation and timing of settlement compared to the effective date of the contract; 7) identifying if there is a need for differences in treatment for intercompany pooling participants that are not 100% owned by the same ultimate controlling entity; and 8) comments on SSAP No. 62R—Property and Casualty Reinsurance paragraphs 36d and 37 provide different treatment, noting that the regulatory objective is not to avoid gain but to properly account for intercompany retroactive contracts that include gains.

Brendan Bridgeland (Center for Insurance Research—CIR) questioned whether INT 03-02 is going to be replaced by a different INT to address pooling changes. He stated that he is aware of where changes in pooling agreements have affected consumers of particular companies.

Bruggeman stated that there is no intention to replace the INT. He stated that SSAP No. 25 is applicable for this topic. Bruggeman stated that there are footnotes and disclosures in place that address this issue.
Weaver made a motion, seconded by Gosselin, to re-expose the intent to nullify INT 03-02 and that gathering additional comments on key areas identified would also be included in the exposure. The motion passed unanimously.

5. Considered Maintenance Agenda – Pending Listing – Exposures


a. Agenda Item 2022-14

Bruggeman directed the Working Group to agenda item 2022-14: ASU 2022-14: New Market Tax Credits. Gann stated that although the agenda item focuses on new market tax credits, as detailed in the recommendation, it is proposed that the topic go beyond named investment structures. She stated that the materials include a discussion document that proposes to expand SSAP No. 93—Low-Income Housing Tax Credit Property Investments to encompass all tax entity investments that meet certain criteria. She stated that there are four broad types that provide tax credits under federal IRS law: 1) new market tax credits; 2) low-income housing tax credits; 3) the rehabilitation tax credit; and 4) the investment tax credit, which focuses on solar and energy. Gann stated that the discussion document follows the theme of SSAP No. 93 and would require the proportional amortization method. She stated it has some revisions to nonadmittance and assessing impairment because the benefit for insurance companies is the tax benefits and if those tax benefits are not going to be obtained or cannot be used, then that would warrant either impairment or nonadmittance depending on the situation. She stated that proposed U.S. GAAP guidance was used in developing the document, and adjustments will need to be considered once the final U.S. GAAP guidance is issued. Gann stated that a recently exposed GAAP project on this topic is also being monitored. She stated that NAIC staff are recommending exposure of both the agenda item and the discussion document. Gann stated that there will also need to be blanks and RBC changes as current guidance is specific to low-income housing tax credits, but those proposals would be developed subsequently. She also stated that a review of SSAP No. 94R—Transferable and Non-Transferable State Tax Credits will be upcoming.

b. Agenda Item 2022-15

Bruggeman directed the Working Group to agenda item 2022-15: Affiliate Reporting Clarification. Stultz stated that this agenda item resulted from work on previous agenda item 2021-21: Related Party Reporting. He stated that during the discussions, there was a question of when an investment is considered an affiliated investment and, therefore, reported on the parent, subsidiary, and affiliates reporting lines in the investment schedules. Stultz stated that NAIC staff recommend the Working Group expose the agenda item, including revisions to SSAP No. 25, to clarify that any invested asset held by a reporting entity, which is issued by an affiliated entity, or which included obligations of an affiliated entity, is an affiliated investment. He stated that NAIC staff are also recommending the Working Group direct the Blanks (E) Working Group to modify the annual statement instructions as described in the attached materials.

c. Agenda Item 2022-16

Bruggeman directed the Working Group to agenda item 2022-16: ASU 2022-03, Fair Value Measurement of Restricted Securities. Stultz stated this agenda item was created to clarify GAAP when measuring the fair value of equity securities subject to contractual sale restrictions that prohibit the sale of the equity security. Stultz stated this agenda item provides updated guidance for two specific scenarios: 1) where the restriction is based on the entity holding the equity security; and 2) where the restriction is a characteristic of the equity security. Stultz
stated that NAIC staff recommend the Working Group expose revisions to SSAP No. 100R to adopt ASU 2022-03, with modifications to be consistent with statutory language in the respective statutory accounting statements. He also noted that the GAAP disclosures were not proposed to be adopted.

d. **Agenda Item 2022-17**

Bruggeman directed the Working Group to agenda item 2022-17: Interest Income Disclosure Update. Stultz stated that this agenda item resulted from comments related to the principles-based bond project. This agenda item proposed capturing the gross, nonadmitted and admitted amounts for interest income due and accrued, and also that a data element included in the bond proposal project be updated to reflect the cumulative amount of paid-in-kind (PIK) interest included in the current principal balance. Stultz stated that NAIC staff recommend the Working Group expose revisions to *SSAP No. 34—Investment Income Due and Accrued* to add additional disclosures to data capture the proposed items.

e. **Agenda Item 2022-18**

Bruggeman directed the Working Group to agenda item 2022-18: ASU 2022-04, Disclosure of Supplier Finance Program Obligations. Marcotte stated that the amendments in this ASU apply to all entities that use supplier finance programs. The amendments require that a buyer in a supplier finance program disclose sufficient information about the program to allow a user of the financial statements to understand the program’s nature, activity during the period, changes from period to period, and potential magnitude. She stated that these disclosures were developed as buyers who use these programs are getting a form of financing, but the amounts owed to the financial intermediaries may have been reported differently. The issue requires annual disclosures of qualitative and quantitative information about supplier finance programs. She stated that NAIC staff recommend the Working Group expose revisions in *SSAP No. 105R—Working Capital Finance Investments* to reject ASU 2022-04. This is because the insurers would not be the buyers as described in the ASU for supplier finance programs.

d. **Agenda Item 2022-19**

Bruggeman directed the Working Group to agenda item 2022-19: SSAP No. 7 – IMR. Gann stated that this agenda item details the background of interest maintenance reserve (IMR), current accounting guidance, and the recent discussion of the Life Actuarial (A) Task Force. It also includes broad financial results from 2021 and interim 2022 financial statements. She stated that when IMR goes negative, companies report a zero on the liability page and then are required to report a nonadmitted asset as an aggregate write-in on the asset page. In order to identify the information on companies with a net negative IMR as of the third quarter of 2022, NAIC staff did a manual review of the financial statements to identify the disallowed IMR. She stated that 60 companies were found to have negative IMR totaling $1 billion. Gann stated that the American Council of Life Insurers (ACLI) comment letter received indicated that the rising interest rates are favorable to the financial health of the insurance industry and policyholders, and negative IMR that is disallowed could affect rating agency reviews. Gann stated that NAIC staff do not have a recommendation on the agenda item and intend the drafted agenda item to facilitate discussion.

Michael Reis (Northwestern Mutual), representing interested parties, stated that IMR is a safeguard for statutory accounting. He stated that when IMR was developed, it was theoretically intended to have no minimums or maximums for positive or negative IMR. He stated that when IMR was adopted, it was only adopted for the net positive realized capital gains (net of realized capital losses) and that if there were net negative capital losses, the amount was disallowed (nonadmitted). He attributed this due to a prolonged period of declining interest rates. Reis stated industry’s belief that addressing negative IMR is an urgent issue.
Bruggeman stated that the challenge within statutory accounting, under the concept of conservatism, is that recognizing the deferred capital loss as an asset is troubling because these amounts cannot be used to pay policyholder claims. He requested additional discussion, with industry-proposed viable guardrails to protect surplus and policyholders. As initial suggestions, he identified: requiring bond reinvestment; recording special surplus to limit dividends; restricting the amount of negative IMR to a percentage of surplus, bonds, invested assets, or total assets; implementing shorter time frames for when negative IMR would be amortized; and adding asset adequacy testing adjustments (potential haircutting when in net negative IMR).

Malm stated that the Working Group needs feedback from industry on specific situations, with actuaries in attendance, so all parties are in alignment going forward. Walker stated that a joint presentation with the Life Actuarial (A) Task Force could be helpful. Chang stated that it is important to look at the motivation of why a company is selling a bond. Weaver stated that the Working Group should discuss this issue with actuaries and should distribute to state insurance regulators a list of potential guardrails. Wolf stated that permitted practices for 2022 would have to be determined and finalized no later than the filing of the annual statement.

Malm made a motion, seconded by Walker, to expose agenda item 2022-19 with a request for comments by industry on potential guardrails and details on unique considerations. The Working Group directed NAIC staff to coordinate with the Life Actuarial (A) Task Force and request regulator-only sessions with industry to receive specific company information. The motion passed unanimously.

6. **Considered Maintenance Agenda – Active Listing**

   a. **Agenda Item 2017-33**

   Bruggeman directed the Working Group to agenda item 2017-33: ASU 2017-12 – Derivatives and Hedging. Gann stated that this agenda item is an issue paper, containing all of the adoptions for GAAP derivative guidance, of all the previously adopted agenda items for historical documentation.

   Clark made a motion, seconded by Malm, to expose the draft issue paper. The motion passed unanimously.

   b. **Agenda Item 2019-12**

   Bruggeman directed the Working Group to agenda item 2019-12: Proposed Bond Definition. Gann stated that the issue paper has been updated to include discussions and revisions from its Nov. 16 meeting. She stated that there are three documents for reporting changes. Two of them were previously exposed and have been modified to reflect industry comments related to the general instructions for Schedule D, as well as the new annual statement instructions for Schedule D, Part 1, Section 1 and Schedule D, Part 1, Section 2. Gann stated that there is a new document, referred to as Other Reporting Changes, which summarizes all reporting schedules and instructions that refer to bonds with recommendations to reflect changes under the bond project. She stated that most are minor edits, although some schedules will have significant revisions, including the summary investment schedule, summary by country, and Schedule D, Part 1A. Gann stated that the recommended exposure period will have a Feb. 10, 2023, exposure deadline.

   Clark made a motion, seconded by Stolte, to expose the documents and the agenda item. The motion passed unanimously.
7. **Discussed Other Matters**

   a. **Update on the Macroprudential Referral**

   Marcotte stated that the Working Group received a referral from the Macroprudential (E) Working Group at the Summer National Meeting. She stated that the status update memorandum detailed that several items had already been addressed and some are still in progress (Attachment One-J). She noted that the Working Group will continue to respond to issues and that a status update has also been forwarded to the Macroprudential (E) Working Group.

   b. **Review of U.S. GAAP Exposures**

   Stultz identified four items with disclosure deadlines from December 2022 to February 2023 that will be reviewed by NAIC staff in the normal process (Attachment One-K).

   Mike Monahan (ACLI) stated that the FASB indicated a final ASU, addressing insurance companies that sold business, will be available in Dec. 2022.

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

Statutory Issue Paper No. 16X

Derivatives and Hedging

STATUS
Exposure Draft – December 13, 2022

Original SSAP: SSAP No. 86;
Current Authoritative Guidance: SSAP No. 86

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Statutory accounting guidance for derivatives is in SSAP No. 86—Derivatives. Although SSAP No. 86 indicates “adoption of the framework” of specific U.S. GAAP guidance, the accounting and reporting guidance for derivatives, particularly with regards to the four U.S. GAAP derivative cornerstones, is distinctly different between SSAP No. 86 and FAS 133/ASC 815. For example, under U.S. GAAP, assessment effectiveness under U.S. GAAP is largely an income statement management tool (to offset variations consistently through net income or other comprehensive income – OCI), but as SAP uses an amortized cost measurement method for a number of hedged items, the criteria for hedge effectiveness and the measurement approach for derivatives must be adjusted accordingly.

2. In August 2017, the FASB issued ASU 2017-12, Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities to improve the financial reporting of hedging relationships to better portray the economic results of an entity’s risk management activities in its financial statements. In addition, the amendments incorporated certain targeted improvements to simplify the application of the hedge accounting guidance in current U.S. GAAP. ASU 2017-12 included a new concept for a ‘last of layer’ approach to make portfolio fair value hedge accounting more accessible for specific assets. With the issuance of the last-of-layer guidance, a number of questions were received. After considering those questions, ASU 2022-01 Fair Value Hedging – Portfolio Layer Method was issued. This ASU expanded the original guidance and provided additional specifications and guidance.

3. The Statutory Accounting Principles (E) Working Group has considered several revisions to SSAP No. 86 in response to the review of ASU 2017-12 and ASU 2022-01. This issue paper has been drafted to detail the revisions incorporated into statutory accounting. These revisions, except for those initially adopted in 2018, are considered new SAP concepts.

DISCUSSION

Topic 1: Hedge Documentation and Initial Assessment Efficiencies (Agenda Item 2018-30)

4. The overall intent of ASU 2017-12 was to reduce cost and complexity of applying hedge accounting by simplifying the way assessments of hedge effectiveness may be performed. It was noted that the efficiencies gained from the revisions in the ASU for U.S. GAAP filers would be lost if corresponding provisions were not considered for statutory accounting. Pursuant to a July 9, 2018, interested parties’ comment letter, three elements were requested to be considered by the Statutory Accounting Principles (E) Working Group in a nonsubstantive (SAP clarification) proposal. Interested parties noted that these elements will reduce the costs associated with hedge accounting, while neither changing the underlying accounting, nor creating any additional regulatory risks or concerns:
a. Allow companies to perform subsequent assessments of hedge effectiveness qualitatively if certain conditions are met.

b. Allow companies more time to perform the quantitative hedge effectiveness assessment.

c. Clarify that companies may apply the “critical terms match” method for a group of forecaster transactions if the transactions occur and the derivatives mature within the same 31-day period or fiscal month, and the other requirements for applying the critical match method are satisfied.

5. On August 4, 2018, the Working Group exposed revisions to incorporate hedge documentation and assessment efficiencies from ASU 2017-12. This item was exposed with a shortened comment period to allow for potential revisions and re-exposure if needed, to permit adoption and application prior to year-end 2018. On November 15, 2018, the Working Group adopted the exposed revisions as final. The revisions were adopted with an effective date of January 1, 2019, with early adoption permitted for year-end 2018. U.S. GAAP filers could only early adopt if they had also early adopted ASU 2017-12.

6. Additionally, in ASU 2017-12, in response to comments requesting a more flexible approach to hedging interest rate risk, the FASB decided to amend the guidance for hedging interest rate risk of financial instruments for both fair value and cash flow hedges. With the revisions, the FASB decided to redefine the term interest rate risk and eliminate the benchmark interest rate concept for variable-rate financial instruments. With the changes, the FASB incorporated the SIFMA rate in the list of eligible rates for fixed income instruments and noted that the FASB will add to the list of eligible benchmark rates as necessary. The revisions adopted to SSAP No. 86 are detailed in Exhibit A.

7. With the inclusion of revisions, certain elements from the U.S.GAAP guidance were not duplicated within statutory accounting. The elements were considered part of the prior adoption of the “FAS 133 / technical guidance” originally reflected in SSAP No. 86:

a. Exceptions from the initial prospective quantitative assessment were not captured in the statutory guidance as they were not necessarily new under ASU 2017-12. The following overview details when an initial prospective quantitative assessment would not be required:

   i. In a cash flow or fair value hedge, the entity applies the short-cut method.

   ii. In a cash flow or fair value hedge, the entity determines that the critical terms of the hedging instrument and the hedged item match.

   iii. In a cash flow hedge, the hedging instrument is an option and it meets specific criteria detailed in the U.S. GAAP guidance

   iv. In a cash flow hedge, a private company that is not a financial institution applies the simplified hedge accounting approach.

   v. In a cash flow hedge, the entity assesses hedge effectiveness under the change in variable cash flows method permitted under U.S. GAAP, with all noted conditions being met.

   vi. In a cash flow hedge, the entity assesses hedge effectiveness under the hypothetical derivative method permitted under U.S. GAAP and all the critical terms of the hypothetical derivative and the hedging instrument are the same.
vii. In a net investment hedge, the entity assesses hedge effectiveness using a method based on changes in spot exchange rates, and the conditions noted under U.S. GAAP are met.

viii. In a net investment hedge, the entity assesses hedge effectiveness using a method based on changes in forward exchange rates and the noted condition under U.S. GAAP are met.

b. The short-cut method and critical terms match method are current method permitted under U.S. GAAP retained under ASU 2017-12. Under these methods, an entity may qualitatively assume, in very limited circumstances, that

8. Ultimately, the revisions incorporated in 2018, effective January 1, 2019, with early application permitted, from ASU 2017-12 were limited to specific provisions, and related transition guidance, pertaining to the documentation and assessment of hedge effectiveness: 1) provisions allowing more time to perform the initial qualitative 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 method for assessing hedge effectiveness. With the adoption of the limited provisions, it was identified that the remaining provisions of ASU 2017-12 would be subsequently assessed for statutory accounting and shall not be considered adopted for statutory accounting until that assessment is completed, with a conclusion to adopt the U.S. GAAP guidance.

9. The revisions adopted in November 2018 included revisions to both SSAP No. 86 as well as Exhibit B – Assessment of Hedging Effectiveness. The subsequent revisions adopted in 2022 eliminated Exhibit B as well as incorporated new guidance through the SSAP. Ultimately, the final adopted guidance, as reflected in the AP&P Manual, is the authoritative guidance.

**Topic 2: Hedge Effectiveness and Measurement Methods for Excluded Components (Ref #2021-20)**

10. In December 2011, consideration began on revisions to facilitate effective hedge assessments consistently between statutory accounting and U.S. GAAP. The Working Group exposed a concept agenda item to solicit comments and directed NAIC staff to work with regulators and industry in developing revisions for consistent hedge effectiveness assessments and with the treatment of excluded components.

11. After working with industry, on April 4, 2022, the Working Group exposed two documents for public comment. The first document proposed revisions in the form of a new exhibit A to SSAP No. 86, which would replace both Exhibit A and Exhibit B. This new exhibit A would adopt with modification U.S. Guidance in determining hedge effectiveness. The second document proposed revised guidance to SSAP No. 86 to update the permitted excluded components to mirror U.S. GAAP but establish statutory-specific measurement methods for the excluded components.

12. The new Exhibit A intends to reflect the position that the assessment of hedge effectiveness for derivatives should be consistent between U.S. GAAP and SAP. In order words, transactions identified to be highly effective hedges under U.S. would be identified as highly effective hedged 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.

13. The Exhibit A would adopt, with modification 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, statutory modifications are captured 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 adopt from U.S. GAAP only extends to revisions incorporated through ASU 2017-12, as such, any subsequent U.S. GAAP edits would require statutory accounting consideration before they were considered adopted.

14. In addition to new Exhibit A to SSAP No. 86, the Working Group also exposed proposed revisions to SSAP No. 86, paragraphs 23, 40-41 and Exhibit C, to expand the list of permitted excluded components in assessing derivative effectiveness to match U.S. GAAP and to establish statutory specific measurement requirements for each type of excluded component.

15. The prior SSAP No. 86 guidance reflected the list of permitted excluded components originally adopted from U.S. GAAP. Since the original inclusion in SSAP No. 86, and within ASU 2017-12, U.S. GAAP had expanded the list, and it was noted that the statutory accounting treatment of excluded components related to foreign currency transactions were hindering the ability to engage in those transactions. It was also identified that current measurement guidance within the SSAP was conflicting between the guidance and specific hedge procedures detailed in Exhibit C. Through the discussions with industry, it was identified that different measurement or recognition provisions should be considered to properly reflect the type of excluded component with the financial statements, with specific guidance included in SSAP No. 86 accordingly:

   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 8.d.)

   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 8.e.)

   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 8.a. through 8.c.)

16. On August 10, 2022, after the exposure timeframe, in which interested party comments were received supporting the proposed revisions, the Working Group adopted the exposed revisions. This adoption resulted with both the new Exhibit A that adopts with modification U.S. GAAP guidance in determining hedge effectiveness and the revisions to SSAP No. 86 to incorporate measurement method guidance for excluded components. These revisions were adopted with a January 1, 2023, effective date, with early adoption permitted. With the action to adopt, the Working Group directed a blanks proposal to incorporate Schedule DB reporting fields and templates to capture the new disclosures for excluded components. These disclosure and investment schedule changes will be in effect for year-end 2023. Companies that early adopt the revisions are directly to complete the required disclosures in a narrative format for year-end 2022.

**Topic 3: Portfolio Layer Method and Partial Term Hedging (Ref #2022-09)**
17. In August 2022, considerations began to expand statutory accounting guidance to incorporate the portfolio layer method detailed in ASU 2022-01, Fair Value Hedging – Portfolio Layer Method. The guidance in ASU 2022-01 reflects an expansion of the last-of-layer method detailed in ASU 2017-12.

18. Under the last-of-layer approach captured in ASU 2017-12, for a closed portfolio of prepayable financial assets or one or more beneficial interests secured by a portfolio of prepayable financial instruments, entities were allowed to hedge a stated amount of the asset or assets in the closed portfolio that is anticipated to be outstanding for the designated hedged period. If the requirements for the last-of-layer method were met, prepayment risk is not incorporated into the measurement of the hedged item. With the application of this guidance, a number of questions were received. After considering those questions, FASB issued ASU 2022-01, Fair Value Hedging – Portfolio Layer Method, which expanded the guidance and provided additional specifications for application. Ultimately, for a closed portfolio of financial assets or one of more beneficial interests secured by a portfolio of financial instruments, an entity may designate as the hedged item or items a hedged layer or layers if the following criteria is met:

   a. As part of the initial hedge documentation, an analysis is completed and documented to support the entity’s expectation that the hedged item or items (that is, the hedged layer or layers in aggregate) is anticipated to be outstanding for the designated hedge period. That analysis shall incorporate the entity’s current expectations of prepayments, defaults, and other factors affecting the timing and amount of cash flows associated with the closed portfolio.

   b. For purposes of its analysis, the entity assumes that as prepayments, defaults, and other factors affecting the timing and amount of cash flows occur, they first will be applied to the portion of the closed portfolio that is not hedged.

   c. The entity applies the partial-term hedging guidance to the assets or beneficial interests used to support the entity’s expectation. An asset that matures on a hedged layer’s assumed maturity date meets this requirement.

19. Similar to concepts supporting the adoption of prior U.S. GAAP revisions, there is a general assessment that determination of effective hedges shall be consistent between statutory accounting and U.S. GAAP. As such, new SAP concepts revisions to reflect the portfolio layer method in establishing effective hedge dynamics was proposed to be consistent with U.S. GAAP. With the U.S. GAAP guidance limiting the application of this guidance to hedges of recognized financial assets, a consistent scope threshold was established for statutory accounting.

20. The review of the portfolio layer method identified that U.S. GAAP prevents basis adjustments directly to assets hedged in a portfolio and it was considered on whether statutory revisions would be necessary to address similar basis adjustment revisions under statutory accounting. However, after further assessments, it was identified that the fair value measurement method under U.S. GAAP, which results in ongoing basis adjustments from changes in fair value over the derivative term, would not be a prominent issue under statutory accounting, which predominantly uses an amortized cost approach for effective hedges. With the use of amortized cost, basis adjustments do not occur until hedge termination or at designation of the hedge, therefore this was identified as not a key statutory accounting impact.

21. In addition to considering guidance for the portfolio layer method, representatives from interested parties proposed to also capture concepts for partial term hedges from ASU 2017-12. (As detailed in the FASB criteria above in paragraph 18 for portfolio layer method hedges, application of a the partial-term hedging guidance is used to support the entity’s expectation.) Prior review of partial term hedge concepts noted concern as how interim adjustments to hedged items, particularly for hedged liabilities, would be
reflected in the financial statements. With the statutory accounting guidance to reflect derivative gains or losses as basis adjustments on the hedge item, if a hedge to a recognized liability resulted in a reduction to the presentation of the liability, this could misrepresent the financial statements as the liability itself had not been reduced. In considering these concerns and recognizing that a broader project would likely be needed to address these basis adjustments, representatives from industry recommended incorporated the U.S. GAAP guidance for partial term hedges, with a statutory modification to limit the application to hedges of recognized assets.

22. Although the proposal to limit partial term hedges to recognized assets is a modification from the overarching concept to mirror hedge effectiveness assessments between U.S. GAAP and SAP, it was identified as an approach that would be consistent with the U.S. GAAP scope application for the portfolio layer method and would reflect how industry currently uses partial term hedge transactions. As such, although the modification created a U.S. GAAP and SAP difference, the modification satisfies the current need for statutory guidance and prevents significant concerns on how the guidance could impact the presentation of liabilities. With this discussion, it was identified that subsequent consideration of the limitation to recognized assets could occur, with potential expansion to hedges of recognized liabilities as part of a broader discussion on how derivative gains and losses are recognized as basis adjustments.

23. The proposed revisions exposed to incorporate the portfolio layer method and the partial-term hedging method are summarized as follows:

a. Revisions to SSAP No. 86, predominantly in paragraph 26.d., 26.f., and 26.g., to detail the ability to hedge recognized assets under the portfolio layer method and partial-term hedge. Also, revisions to paragraph 62 for a new disclosure for portfolio layer derivatives that no longer qualify for hedge accounting and the circumstances that led to the breach, as well as guidance in paragraphs 65.c. and 74.f. to detail relevant U.S. GAAP literature and the effective date.

b. Revisions to SSAP No. 86 – Exhibit, Exhibit A – Assessment of Hedge Effectiveness, to add a new section on the assessment of portfolio layer method for hedge effectiveness. (Note – This exhibit was the new exhibit adopted in agenda item 2021-20 which replaced the prior Exhibit A and Exhibit B within SSAP No. 86.)

c. Revisions to SSAP No. 86 – Exhibit C, paragraph 2.d., for which a portfolio layer method is discontinued to detail how the basis adjustment shall be allocated to the remaining individual assets in the closed portfolio. (Note – With the adoption of agenda item 2021-20, this Exhibit was renamed as Exhibit B.)

24. The proposed revisions reflect adoption of U.S. GAAP for the criteria for the portfolio layer method detailed in ASU 2022-01, criteria to only consider how changes in the benchmark interest rate affect the decision to settle the hedged item before its scheduled maturity date in ASC 815-20-25-6B, adding option in calculating the change in the hedged item’s fair value attributed to changes in the benchmark interest rate based on the benchmark rate components of the contractual cash flows detailed in FASB ASC 815-25-35-13, and the partial-term hedging method detailed in FASB ASC 815-25-35-13B. The adoption of the partial term hedging method reflects statutory modifications that limits its use only when the hedged item is a recognized asset. This is different than U.S. GAAP, which permits the partial term method for hedged liabilities. The statutory limitation is established to prevent interim basis adjustments to hedged liabilities that could present a reduction of reported liabilities on the financial statements when the actual liability has not been reduced. Reconsideration of this statutory limitation may occur after a broader project to consider how derivative basis adjustments to hedged liabilities shall be reflected in the financial statements.
25. On December 13, 2022, the Working Group adopted the exposed revisions. This adoption resulted with the revisions identified in paragraph 23 above. These revisions were adopted with a January 1, 2023 effective date, with early adoption permitted. The revisions shall be applied prospectively to qualifying new hedges.

Exhibit 1 – Revisions adopted to SSAP No. 86 on November 15, 2018 (Agenda Item 2018-30)

38. At inception of the hedge, documentation must include:
   a. A formal documentation of the hedging relationship and the entity’s risk management objective and strategy for undertaking the hedge, including identification of the hedging instrument, the hedged item, the nature of the risk being hedged, and how the hedging instrument’s effectiveness in offsetting the exposure to changes in the hedged item’s fair value or variability in cash flows attributable to the hedged risk will be assessed, including whether an entity will perform subsequent effectiveness assessments on a qualitative basis (per paragraph 42) and how it intends to carry out that qualitative assessment. There must be a reasonable basis for how the entity plans to assess the hedging instrument’s effectiveness;
   
   b. An entity’s defined risk management strategy for a particular hedging relationship may exclude certain components of a specific hedging derivative’s change in fair value, such as time value, from the assessment of hedge effectiveness, as discussed in paragraph 37 and Exhibit B;
   
   c. Signature of approval, for each instrument, by person(s) authorized, either by the entity’s board of directors or a committee authorized by the board, to approve such transactions; and
   
   d. A description of the reporting entity’s methodology used to verify that opening transactions do not exceed limitations promulgated by the state of domicile.

39. At inception, if an entity is required to perform an initial prospective assessment of hedge effectiveness on a quantitative basis (using information applicable as of the date of hedge inception\(FN\)), the assessment is considered to be performed concurrently at hedge inception if it completed by the earliest of the following: (815-20-25-3)

   a. The first quarterly hedge effectiveness assessment date.
   
   b. The date that financial statements that include the hedged transaction are available to be issued.
   
   c. The date that the hedging instrument and hedged item no longer qualify for hedge accounting.
   
   d. The date of expiration, sale, termination or exercise of the hedging instrument.
   
   e. The date of redesignation of the hedging relationship.
   
   f. For a cash flow hedge of a forecasted transaction, the date that the forecasted transaction occurs.

New Footnote – Entities are required to perform an initial prospective assessment unless qualifying for an exception in accordance with ASU 2017-12, paragraph 815-20-25-3.
40. For all derivatives terminated, expired, or exercised during the year:
   a. Signature of approval, for each instrument, by person(s) authorized, either by the entity's board of directors or a committee authorized by the board, to approve such transactions;
   b. A description, for each instrument, of the nature of the transaction, including:
      i. The date of the transaction;
      ii. A complete and accurate description of the specific derivative, including description of the underlying securities, currencies, rates, indices, commodities, derivatives, or other financial market instruments;
      iii. Number of contracts or notional amount;
      iv. Date of maturity, expiry or settlement;
      v. Strike price, rate or index (termination price for futures contracts);
      vi. Counterparty, or exchange on which the transaction was traded; and
      vii. Consideration paid or received, if any, on termination.
   c. Description of the reporting entity's methodology to verify that derivatives were effective hedges; and
   d. Identification of any derivatives that ceased to be effective as hedges.

41. For derivatives open at quarter-end:
   a. A description of the methodology used to verify the continued effectiveness of hedges, and whether the entity is using qualitative assessments pursuant to paragraph 42FN;
   b. An identification of any derivatives that have ceased to be effective as hedges;
   c. A description of the reporting entity's methodology to determine fair values of derivatives;
   d. Copy of Master Agreements, if any, where indicated on Schedule DB Part D.

New Footnote: For purposes of this requirement, this statement adopts the guidance for effectiveness assessment after initial designation reflected in ASU 2017-12, including the concepts and restrictions for use of the short-cut method and the critical terms match method.

42. An entity may subsequently qualitatively assess hedge effectiveness, on a hedge-by-hedge basis, if both the conditions in paragraphs 42.a. and 42.b. were initially met. When an entity performs subsequent 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. An entity may perform a quantitative assessment in any reporting period to validate whether qualitative assessments remain appropriate. When facts and circumstances change such that an entity no longer can assert qualitatively that the hedging relationship continue to be highly effective, then the entity shall begin performing quantitative assessments. (815-20-35-2A, 2C and 2D abbreviated)
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) 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.

RELEVANT LITERATURE

6059. 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. 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.

61. This statement adopts certain revisions to ASC 815-20 included in ASU 2017-12. This adoption is 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. 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.

6260. This statement adopts with modification revisions to ASC 815 as reflected within ASU 2016-05, Effect of Derivative Contract Novations on Existing Hedge Accounting Relationships. This guidance is modified to require prospective application, as such it is only applicable to future counterparty changes in derivative instruments, and this guidance cannot be used to adjust derivative transactions previously terminated. This statement adopts revisions to ASC 815-20-25-15 as reflected within ASU 2010-08, Technical Corrections to Various Topics. This statement adopts revisions to ASC 815-10-50-4K as reflected within ASU 2010-11, Derivatives and Hedging (Topic 815), Scope Exception Related to Embedded Credit Derivatives, but rejects all other GAAP revisions from ASU 2010-11 and ASU 2014-16, Derivatives and Hedging, Determining Whether the Host Contract in a Hybrid Financial Instrument Issued in the Form of a Share is More Akin to Debt or to Equity and ASU 2016-06, Derivatives and Hedging, Contingent Put and Call Options in Debt Instruments. These GAAP revisions are rejected as embedded derivatives are not separated from the host contract and recognized as derivatives under SSAP No. 86. Revisions are also incorporated to SSAP No. 86 to require disclosures on embedded credit derivatives that expose the holder of a financial instrument to the possibility of being required to make future payments. This disclosure is a modification to the GAAP disclosures specific to statutory accounting as embedded credit derivatives are
not separately recognized under statutory accounting. It should be noted that the conclusions reached in this statement are not intended to usurp the rules and regulations put forth by states in their respective investment laws. The contents of this statement are intended to provide accounting guidance on the use of derivatives as allowed by an insurer’s state of domicile. It is not intended to imply that insurers may use derivatives or cash instruments that the insurer’s state of domicile does not allow under the state’s insurance regulatory requirements, e.g., in replication transactions.

6364. This statement adopts revisions to ASC 815-20 as reflected within ASU 2013-10, Derivatives and Hedging, Inclusion of the Fed Funds Effective Swap Rate (or Overnight Index Swap Rate) as a benchmark interest rate for Hedge Accounting Purposes. These revisions define a benchmark interest rate, clarify what can be used in the U.S. for a benchmark interest rate, and eliminate the prior restriction on using different benchmark rates for similar hedges.

Effective Date and Transition

6765. 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. Revisions adopted to paragraph 59 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.) Revisions adopted in paragraph 15 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.) Revisions to incorporate limited provisions from ASU 2017-12 pertaining to the documentation of hedge effectiveness (detailed in paragraph 61) 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.

SSAP NO. 86 - EXHIBIT B – ASSESSMENT OF HEDGING EFFECTIVENESS

The following is based on paragraphs 62-70 of FAS 133 to offer additional guidance on assessing hedging effectiveness. The intent of such is to remain consistent with FAS 133U.S. GAAP with respect to assessing hedge effectiveness, including guidance in ASU 2017-12 that outlines when an entity may perform subsequent assessments of hedge effectiveness qualitatively.

1. This statement requires that an entity define at the time it designates a hedging relationship the method it will use to assess the hedge’s effectiveness in achieving offsetting changes in fair value or offsetting cash flows attributable to the risk being hedged. It also requires that an entity use that defined method consistently throughout the hedge period to assess at inception of the hedge and on an ongoing basis whether it expects the hedging relationship to be highly effective in achieving offset. If the entity identifies an improved method and wants to apply that method prospectively, it must discontinue the existing hedging relationship and designate the relationship anew using the improved method. Although this statement suggests a method for assessing whether a hedge is expected to be highly effective or measuring hedge ineffectiveness, the appropriateness of a given method of assessing hedge effectiveness can depend on the nature of the risk being hedged and the type of hedging instrument used. Ordinarily, however, an entity should assess effectiveness for similar hedges in a similar manner; use of different methods for similar hedges should be justified.

2. In defining how hedge effectiveness will be assessed, an entity must specify whether it will include in that assessment all of the gain or loss on a hedging instrument. As discussed in paragraph 33, this
statement permits (but does not require) an entity to exclude all or a part of the hedging instrument’s time value from the assessment of hedge effectiveness, as follows:

a. If the effectiveness of a hedge with an option contract is assessed based on changes in the option’s intrinsic value, the change in the time value of the contract would be excluded from the assessment of hedge effectiveness.

b. If the effectiveness of a hedge with an option contract 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 would be excluded from the assessment of hedge effectiveness.

c. If the effectiveness of a hedge with a forward 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 would be excluded from the assessment of hedge effectiveness.

In each circumstance above, changes in the excluded component would be included in unrealized gains or losses. As noted in paragraph 1 of this Exhibit, the effectiveness of similar hedges generally should be assessed similarly; that includes whether a component of the gain or loss on a derivative is excluded in assessing effectiveness. No other components of a gain or loss on the designated hedging instrument may be excluded from the assessment of hedge effectiveness.

3. In assessing the effectiveness of a cash flow hedge, an entity generally will need to consider the time value of money if significant in the circumstances. Considering the effect of the time value of money is especially important if the hedging instrument involves periodic cash settlements. 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.

4. Whether a hedging relationship qualifies as highly effective sometimes will be easy to assess. If the critical terms of the hedging instrument and of the entire hedged item or liability (as opposed to selected cash flows) 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 highly perfectly effective if:

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.

b. The fair value of the forward contract at inception is zero.

c. Either the change in the discount or premium on the forward contract is excluded from the assessment of effectiveness and included directly in unrealized gains and losses pursuant to paragraph 22.B. or the change in expected cash flows on the forecasted transaction is based on the forward price for the commodity.

5. In a cash flow hedge of a group of forecasted transactions, 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 if those forecasted transactions occur and the derivative matures within the same 31-day period or fiscal month. (815-20-25-84A)
However, assessing hedge effectiveness can be more complex. For example, hedge effectiveness would be reduced by the following circumstances, among others:

a. A difference between the basis of the hedging instrument and the hedged item or hedged transaction (such as a Deutsche mark-based hedging instrument and Dutch guilder-based hedged item), 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 notional amounts, maturities, quantity, location, or delivery dates.

Hedge effectiveness also would be reduced if part of the change in the fair value of a derivative is attributable to a change in the counterparty’s creditworthiness.

A hedge that meets the effectiveness test specified in paragraphs 19.b. and 20.b. (that is, both at inception and on an ongoing basis, the entity expects the hedge to be highly effective at achieving offsetting changes in fair values or cash flows) also must meet the other hedge accounting criteria to qualify for hedge accounting. If the hedge initially qualifies for hedge accounting, the entity would continue to assess whether the hedge meets the effectiveness test. 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. The discussions of measuring hedge effectiveness in the examples in the remainder of this Exhibit assume that the hedge satisfied all of the criteria for hedge accounting at inception.

Exhibit 2 – Revisions adopted to SSAP No. 86 on August 10, 2021 (Agenda Item 2021-20)

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).

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 to a derivative

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.
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 8.d.)

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 8.e.)

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 8.a.-8.c.

41. Hedging instruments with excluded components shall be identified in the financial statement investment schedule (Schedule DB) and shall be disclosed pursuant to paragraph 41.g.

Proposed New Disclosure Paragraph (This is proposed as a new paragraph 41.g. 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.)

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 65.b., 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 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

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.
With the adoption of the new Exhibit A as detailed in the subsequent section, Exhibit C will be renamed Exhibit B. Due to the details of Exhibit A (including the FASB ASC paragraphs not duplicated in the SSAP), the following Exhibit B section is included before the new Exhibit A in this issue paper for ease of readability.

EXHIBIT C-B – SPECIFIC HEDGE ACCOUNTING PROCEDURES FOR DERIVATIVES

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.);
         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. 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:

(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 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, the 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.

The cumulative unrealized gain/loss equals the foreign currency (notional) amount to be received (paid) times the net of the current spot rate minus the spot rate at the time the contract was opened;

(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 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:

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.

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 or loss on the terminated hedging derivative may be realized and shall be subject to IMR upon termination.2

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.

The following new Exhibit A replaces both Exhibit A and Exhibit B within the existing SSAP No. 86. This is new guidance within SSAP No. 86, and the tracked changes shown in the section below reflect the modifications from U.S. GAAP. References to the FASB ASC are included in this issue paper for historical reference and will not be duplicated within the SSAP.

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.
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)
   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 one of the exceptions detailed in ASU 2017-12, paragraph 815-20-25-3(b)(2)(iv)(01)2 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.

(ASC paragraph 815-20-25-79A not included in Exhibit A.)

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 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)

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

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 are not adopted within SSAP No. 86 as they address measurement and recognition. Measurement and recognition guidance shall follow the provisions detailed in SSAP No. 86.
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 815-10-50-4EEE. (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 7-9815-20-25-81 through 25-83.

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 28.a. of the SSAP guidance815-20-25-15(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 10.a. 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)
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)

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 17.e. 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 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 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 prepaid, 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:

   (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.

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 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 28.a. 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 17.e.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 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)

(ASC paragraphs 815-20-25-112 through 815-20-25-143 not included in Exhibit A.)

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)(v)(1)(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 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 815-20-25-81. (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)

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).

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 10-11815-20-25-84 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 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 2.1.2.815-20-25-75(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.

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 if 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)
This information is included to illustrate the guidance within the adopted ASC references that are not captured in Exhibit A. The guidance within these paragraphs is considered part of the statutory adoption unless they include specific accounting and reporting guidance.

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).

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
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 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 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.

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 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.
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.

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 measure hedge results without redesignating 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:

   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 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 designate 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 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).

**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


**815-20-25-134** 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.

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:

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.

Exhibit 3 – Revisions adopted to SSAP No. 86 on December 12, 2022 (Agenda Item 2022-09)

Fair Value Hedges (Note – Paragraphs 26.a. through 26.e. are not affected and are omitted for brevity.)

26. Fair value hedges qualify for hedge accounting if all of the following criteria are met:

   d. The hedged item is specifically identified as either all, or a specific portion, or the partial term of a recognized asset, or all or a specific portion of, or a recognized liability or of an unrecognized firm commitment. The hedged item is a single asset or liability (or a specific portion or partial term thereof) or is a portfolio of similar assets or a portfolio of similar liabilities (or a specific portion thereof) or a closed portfolio of assets (pursuant to paragraph 26.f. and Exhibit A, paragraph 46) where assumed layer or layers is anticipated to be outstanding (or a specific portion thereof)3. For a partial term hedge of one or more consecutive selected contractual cash flows where the hedged item begins when the first hedge cash flow begins to accrue and ends at the end of the designation hedge period.

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3 For clarity, partial-term hedges and portfolio hedges addressed in paragraph 26.f. are limited to the situations in which the hedged item(s) is a recognized asset or a closed portfolio of financial assets. These hedging accounting methods are not permitted to hedge liabilities.
the assumed maturity of the hedged item occurs at the end of the designated hedge period;  
(ASC 815-25-35-13B Partial Term Hedging.)

e. If similar assets or similar liabilities are aggregated and hedged as a portfolio, the individual 
assets or individual liabilities must share the risk exposure for which they are designated 
as being hedged. The change in fair value attributable to the hedged risk for each individual 
item in a hedged portfolio must be expected to respond in a generally proportionate manner 
to the overall change in fair value of the aggregate portfolio attributable to the hedged risk; and

f. For a closed portfolio of financial assets or one or more beneficial interests secured by a 
portfolio of financial instruments, an entity may designate as the hedged item or items a 
hedged layer or layers (this designation is referred to throughout as the “portfolio layer 
method” (detailed in Exhibit A).  
(ASC 815-20-25-12A Portfolio Layer Method)

t.g. If the hedged item is a financial asset or liability, a recognized loan servicing right, or a 
nonfinancial firm commitment with financial components, the designated risk being hedged 
is:

i. The risk of changes in the overall fair value of the entire hedged item;

ii. The risk of changes in its fair value attributable to changes in benchmark interest 
rate;

iii. The risk of changes in its fair value attributable to changes in the related foreign 
currency exchange rates; or

iv. The risk of changes in its fair value attributable to both changes in the obligor’s 
creditworthiness and changes in the spread over the benchmark interest rate with 
respect to the related financial asset’s or liability’s credit sector at inception of the 
hedge (referred to as credit risk).

If the risk designated as being hedged is not the risk in paragraph 26.f.i., two or more of 
the other risks (benchmark interest rate risk, foreign currency exchange risk, and credit 
risk) may simultaneously be designated as being hedged.

The benchmark interest rate being hedged in a hedge of interest rate risk must be 
specifically identified as part of the designation and documentation at the inception of the 
hedging relationship. In calculating the change in the hedged item’s fair value attributable 
to changes in the benchmark interest rate, the estimated coupon cash flows used in 
calculating fair value shall must be based on either all of the full contractual cash flows of 
the entire hedged item or the benchmark rate component of the contractual coupon cash 
flows of the hedged item determined at hedge inception. An entity may designate a fair 
value hedge of interest rate risk in which the hedged item is a prepayment instrument. The 
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 change in the benchmark interest rate affect an obligor’s decision to call a debt 
instrument when it has the right to do so.) The entity need not consider other factors that 
would affect this decision (for example, credit risk) when assessing hedge effectiveness. 
(ASU 815-25-35-13 & 815-20-25-6B) Excluding some of the hedged item’s contractual cash 
flows (for example, the portion of the interest coupon in excess of the benchmark interest 
rate) from the calculation is not permitted. 

4 The first sentence of paragraph 26.d. that specifically permits the hedged item to be identified as either all or a specific portion of a 
recognized asset or liability or of an unrecognized firm commitment is not affected by the provisions in this subparagraph.

4 An entity may not simply designate prepayment
risk as the risk being hedged for a financial asset. However, it can designate the option component of a prepayable instrument as the hedged item in a fair value hedge of the entity’s exposure to changes in the fair value of that “prepayment” option, perhaps thereby achieving the objective of its desire to hedge prepayment risk. The effect of an embedded derivative of the same risk class must be considered in designating a hedge of an individual risk. For example, the effect of an embedded prepayment option must be considered in designating a hedge of benchmark interest rate risk.

Disclosure Requirements

62. Reporting entities shall disclose the following for all derivative contracts used:

   a. General disclosures:

      vii. The net gain or loss recognized in unrealized gains or losses during the period resulting from derivatives that no longer qualify for hedge accounting. For portfolio layer method hedges, disclose circumstances that led to the breach. (ASC 815-10-50-5C.)

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 65.b., 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, 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.

c. Revisions effective January 1, 2022, with early adoption permitted, are limited to the criteria for the portfolio layer method detailed in ASU 2022-01, criteria to only consider how changes in the benchmark interest rate affect the decision to settle the hedged item before its scheduled maturity date in 815-20-25-6B, adding option in calculating the change in the hedged item’s fair value attributed to changes in the benchmark interest rate based on the benchmark rate components of the contractual cash flows detailed in FASB ASC 815-25-35-13, and the partial-term hedging method detailed in FASB ASC 815-25-35-13B. The adoption of the partial term hedging method reflects statutory modifications that limits its use only when the hedged item is a recognized asset. This is different than U.S. GAAP, which permits the partial term method for hedged liabilities. The statutory limitation is established to prevent interim basis adjustments to hedged liabilities that could present a reduction of reported liabilities on the financial statements when the actual liability has not been reduced. Reconsideration of this statutory limitation may occur after a broader project to consider how derivative basis adjustments to hedged liabilities shall be reflected in the financial statements.

Effective Date and Transition

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.

f. Revisions adopted December 12, 2022 that adopt U.S. GAAP guidance for the portfolio layer method, U.S. GAAP guidance to only consider how changes in the benchmark interest rate affect the decision to settle the hedged item before its scheduled maturity, U.S. GAAP guidance adding option in calculating the change in the hedged item’s fair value attributed to changes in the benchmark interest rate based on the benchmark rate component of the contractual coupon cash flows, that and adopt with modification U.S. GAAP guidance for partial term hedging are effective January 1, 2023, with early adoption permitted. These revisions shall be applied prospectively to qualifying new hedges.

Edits to New Exhibit A – Discussion of Hedge Effectiveness

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

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 at the end of the designated hedge period, 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:

18. All of the following incremental conditions apply to fair value hedges only: (815-20-25-105 & 815-25-35-13B)

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 ends at the end of the designated hedge period occur on the date in which the last hedged cash flow is due and payable in accordance with paragraph 815-25-35-13B.

Portfolio Layer Method (New paragraphs at the end of Exhibit A.)
46. For a closed portfolio of financial assets or one or more beneficial interests secured by a portfolio of financial instruments, an entity may designate as the hedged item or items a hedged layer or layers (this designation is referred to throughout as the “portfolio layer method.”) (ASU 815-20-25-12A)

   a. As part of the initial hedge documentation, an analysis is completed and documented to support the entity’s expectation that the hedged item or items (that is, the hedged layer or layers in aggregate) is anticipated to be outstanding for the designated hedge period. That analysis shall incorporate the entity’s current expectations of prepayments, defaults, and other factors affecting the timing and amount of cash flows associated with the closed portfolio.

   b. For purposes of its analysis in paragraph 46.a., the entity assumes that as prepayments, defaults, and other factors affecting the timing and amount of cash flows occur, they first will be applied to the portion of the closed portfolio that is not hedged; and

   c. The entity applies the partial-term hedging guidance to the assets or beneficial interest used to support the entity’s expectation in paragraph 46.a. An asset that matures on a hedged layer’s assumed maturity date meets this requirement.

47. After a closed portfolio is established in accordance with paragraph 46, and entity may designate new hedging relationships associated with the closed portfolio without redesignating any existing hedging relationships associated with the closed portfolio if the criteria of paragraph 46 are met for those newly designated hedging relationships. (ASU 815-20-25-12B)

48. For the portfolio layer method if both of the following conditions exist, the quantitative test described for similar assets (shared risk exposure) may be performed qualitatively on a hedge-by-hedge basis and only at hedge inception:

   a. The hedged item is a hedged layer in a portfolio layer hedge and designated in accordance with paragraph 26.f. of SSAP No. 86.

   b. An entity measures the change in fair value of the hedged item based on the benchmark rate component of the contractual coupon cash flows.

   Using the benchmark rate component of the contractual coupon cash flows when all assets have the same assumed maturity date and prepayment risk does not affect the measurement of the hedged item results in all hedged items having the same benchmark rate component coupon cash flows. (ASU 815-20-55-14A)

49. For one or more hedging relationships designated under the portfolio layer method, an entity shall discontinue (or partially discontinue) hedge accounting in the following circumstances: (ASU 815-25-40-8)

   a. If the entity cannot support on a subsequent testing date that the hedged layer or layers are anticipated to be outstanding for the designated hedge (that is, a breach is anticipated), it shall discontinue (or partially discontinue) hedge accounting for one or more hedging relationships for the portion of the hedged item that is no longer anticipated to be outstanding for the designated hedge period.

   b. If on a subsequent testing date the outstanding amount of the closed portfolio of financial assets or one or more beneficial interests is less than the hedged layer or layers (that is, a breach has occurred), the entity shall discontinue (or partially discontinue) hedge
accounting for one or more hedging relationships for the portion of the hedged item that is no longer outstanding.

50. In the event of either an anticipated breach (as described in paragraph 49.a.) or a breach that has occurred (as described in paragraph 49.b.) for portfolio layer method, if multiple hedged layers are associated with a closed portfolio, an entity shall determine which hedge or hedges to discontinue (or partially discontinue) in accordance with an accounting policy election. That accounting policy election shall specify a systematic and rational approach to determining which hedge or hedges to discontinue (or partially discontinue). An entity shall establish its accounting policy no later than when it first anticipates a breach or when a breach has occurred (whichever comes first). After an entity establishes its accounting policy, it shall consistently apply its accounting policy to all portfolio layer method breaches (anticipated and occurred). *(ASU 815-25-40-8A)*

U.S. GAAP references not pulled into Exhibit will also be updated as follows:

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

*815-20-25-118A* In a fair value hedge of interest rate risk designated under the portfoliolo layer 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.

**Edits to Exhibit C-B – Specific Hedge Accounting Procedures for Derivatives**

2. Swaps, Collars, and Forwards (see also discussion in Introduction above):

   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. If a portfolio layer method hedging relationship is discontinued (or partially discontinued) in a voluntary redesignation or in anticipation of a breach, the basis adjustment associated with the redesignated amount as of the discontinuation date shall be allocated to the remaining individual assets in the closed portfolio that supported the redesignated hedged layer using a systematic and rational method. 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. *(ASU 815-25-40-9)*

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

Issue: SSAP No. 25 – Affiliate Reporting Clarification

Check (applicable entity):

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Description of Issue:
At its May 24, 2022, meeting, the Statutory Accounting Principles (E) Working Group adopted agenda item 2021-21: Related Party Reporting, which included revisions 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. During the discussion on the call, it was suggested that there needs to be a clarification of when an investment is considered to be and affiliated investment and reported on the affiliated line in the investment schedules. When agenda item 2021-21 was adopted, it included a recommendation that NAIC staff look to further clarify when investments should be classified as affiliated in the reporting schedules. This agenda item intends to clarify that an investment held from an affiliate is considered an affiliated investment.

Existing Authoritative Literature:
The Insurance Holding Company System Regulatory Act (Model #440) establishes the laws for holding company structures. The Act also establishes the concept of an affiliate in Section 1A, and this definition is used for statutory accounting purposes.

A. “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.

SSAP No. 25—Affiliates and Other Related Parties establishes statutory accounting principles for affiliates and related parties. This definition is the language that is used to help define when an investment is affiliated or nonaffiliated for reporting in the various investment schedules.

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.

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.
On May 24, 2022, the Working Group adopted revisions to SSAP No. 25 and *SSAP No. 43R—Loan-Backed and Structured Securities*, 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, and included a new disclosure that was adopted by the Blanks (E) Working Group in proposal 2021-22BWG, which adds a new electronic-only column for the investment schedules and the related instructions which describes the nature of any related party relationship that exists related to the investment.

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

**Convergence with International Financial Reporting Standards (IFRS):** None

**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. 25 to clarify that any invested asset held by a reporting entity which is issued by an affiliated entity, or which includes the obligations of an affiliated entity is an affiliated investment. Staff also recommend that Working Group direct the Blanks (E) Working Group to modify the Annual Statement Instructions as illustrated below.

**Proposed edits to SSAP No. 25:**

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. **Any invested asset held by a reporting entity which is issued by an affiliated entity, or which includes the obligations of an affiliated entity is an affiliated investment.**

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

This will be included in the Investment Schedules General Instructions in several places covering several different types of investment, and this revision is proposed to be included in each place under the header “Parent, Subsidiaries and Affiliates.”

**Parent, Subsidiaries and Affiliates:**

Defined by *SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities*. **Any invested asset held by a reporting entity which is issued by an affiliated entity, or which includes the obligations of an affiliated entity is an affiliated investment.**

**Staff Review Completed by:** Jake Stultz—NAIC Staff, November 2022

**Status:**
On December 13, 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. 25 to clarify that any invested asset held by a reporting entity which is issued by an affiliated entity, or which includes the obligations of an affiliated entity is an affiliated investment.

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

Issue: ASU 2022-03, *Fair Value Measurement of Equity Securities Subject to Contractual Sale Restrictions*

Check (applicable entity):

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Description of Issue:
In June 2022, the Financial Accounting Standards Board (FASB) issued *ASU 2022-03, Fair Value Measurement of Equity Securities Subject to Contractual Sale Restrictions* to 1) clarify the guidance in Topic 820, Fair Value Measurement, when measuring the fair value of an equity security subject to contractual restrictions that prohibit the sale of an equity security, 2) amend a related illustrative example, and 3) add a new disclosure of the fair value of equity securities subject to contractual sale restrictions, nature and remaining duration of the restrictions, and circumstances that could cause a lapse in the restrictions, in accordance with Topic 820.

These amendments do not change the principles of fair value measurement. They provide clarity in situations involving equity securities that have restrictions related to the sale of the asset. This ASU provides updated guidance for two specific scenarios, one where the restriction is based on the entity holding the equity security and one where the restriction is a characteristic of the equity security.

- First, it clarifies situations where an equity security cannot be sold on the measurement date because of a contractual sale restriction where the entity is not allowed to sell an asset. An example of this would be lock-up periods, where the assets cannot be sold for a set period but can be readily priced based on a public security exchange.

- Second, it provides guidance for situations where the restriction is based on characteristics of the asset that limits if it can be sold in regular markets. An example would be an equity security issued through a private placement and not SEC registered and are legally restricted from being sold on a national securities exchange or an over-the-counter market. These assets would be available to be sold on an existing market (not on the public exchange) but would have a fair value based on the market price of the similar unrestricted equity security adjusted to reflect the effect of the restriction.

Guidance for restricted assets is in *SSAP No. 4—Assets and Nonadmitted Assets*, and additional guidance specific to securities in ASU 2022-03 are included in *SSAP No. 30R—Unaffiliated Common Stock*, *SSAP No. 32R—Preferred Stock*, and *SSAP No. 48—Joint Ventures, Partnerships and Limited Liability Companies*. Under these SSAPs, restricted securities are generally considered to be admitted assets to the extent that they can be used to cover policyholder obligations.

**Existing Authoritative Literature:**
The primary guidance for fair value is in *SSAP No. 100R—Fair Value*, *SSAP No. 30R—Unaffiliated Common Stock* and *SSAP No. 32R—Preferred Stock*, include some guidance on restricted investments involving common and preferred stock, but neither goes into detail on the specific guidance discussed in ASU 2022-03. Additionally, *SSAP No. 1—Accounting Policies, Risks & Uncertainties, and Other Disclosures* and *SSAP No. 4—Assets and Nonadmitted Assets* include references to restricted assets, primarily related to disclosures.

**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):
None

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. 100R—Fair Value to adopt ASU 2022-03, Fair Value Measurement of Equity Securities Subject to Contractual Sale Restrictions with modification to be consistent with statutory language in the respective statutory accounting statements. Proposed revisions are illustrated below.

Proposed edits to SSAP No. 100R:

**Equity Securities Subject to Contractual Sale Restrictions**

15. An equity security that an entity cannot sell on the measurement date because of a contractual sale restriction shall be measured at fair value on the basis of the price in the principal (or most advantageous) market\(^\text{FN}\). A contractual sale restriction does not change the market in which that equity security would be sold. A discount applied to the price of an equity security because of a contractual sale restriction is not a characteristic of the equity security. A contractual sale restriction is a characteristic of the reporting entity holding the equity security rather than a characteristic of the asset and, therefore, is not considered in measuring the fair value of an equity security. A contractual sale restriction prohibiting the sale of an equity security is a characteristic of the reporting entity holding the equity security and shall not be separately recognized as its own unit of account.

16. The effect on a fair value measurement arising from a restriction on the sale or use of an asset by a reporting entity will differ depending on whether the restriction would be taken into account by market participants when pricing the asset. When the restriction is a characteristic of the asset, the restriction is a characteristic of the asset and should be considered in measuring the fair value of the asset. For example, an equity security issued through a private placement is not registered and is legally restricted from being sold on a national securities exchange or an over-the-counter market until the shares are registered or the conditions necessary for an exemption from registration have been satisfied. A market participant would sell the private placement equity securities in a different market than the market used for registered equity securities on the measurement date. Because that restriction would be a characteristic of the equity security, a market participant would consider the inability to resell the security on a national securities exchange or an over-the-counter market when pricing the equity security; therefore, the reporting entity that holds the Class A shares acquired through a private placement transaction would consider that restriction a characteristic of the asset, and the reporting entity should measure the fair value of the equity security on the basis of the market price of the similar unrestricted equity security adjusted to reflect the effect of the restriction\(^\text{FN}\).

\[^\text{FN}\]—Refer to SSAP No. 4—Assets and Nonadmitted Assets for admissibility guidance for restricted equity securities.

60. For equity securities that are subject to contractual sales, disclose the fair value of equity securities subject to contractual sale restrictions.

65. This standard adopts ASU 2022-03, Fair Value Measurement of Equity Securities Subject to Contractual Sale Restrictions, with modification to be consistent with statutory language in the respective statutory accounting statements.

**Staff Review Completed by:** Jake Stultz– NAIC Staff, November 2022
Status:
On December 13, 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. 100R to adopt ASU 2022-03, *Fair Value Measurement of Equity Securities Subject to Contractual Sale Restrictions* with modification to be consistent with statutory language in the respective statutory accounting statements, as illustrated above. Note that this agenda item does not recommend incorporating the new proposed GAAP disclosures on sales restrictions, but identifies that items restricted as to sale would be captured as restricted assets per SSAP No. 1 and subject to admittance considerations under SSAP No. 4.

Issue: ASU 2022-04, Disclosure of Supplier Finance Program Obligations

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Description of Issue:
In September 2022, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update 2022-04, Liabilities—Supplier Finance Programs (Subtopic 405-50) Disclosure of Supplier Finance Program Obligations. The Board issued ASU 2022-04 to enhance the transparency of supplier finance programs. ASU 2022-04 is effective for fiscal years beginning after December 15, 2022.

The amendments in ASU 2022-04 apply to all entities that use supplier finance programs in connection with the purchase of goods and services (described as buyer parties). Supplier finance programs, which also may be referred to as reverse factoring, payables finance, or structured payables arrangements, allow a buyer to offer its suppliers the option to access payment in advance of an invoice due date through a third-party finance provider or intermediary on the basis of invoices that the buyer has confirmed as valid.

Typically, a buyer in a program (1) enters into an agreement with a finance provider or an intermediary to establish the program, (2) purchases goods and services from suppliers with a promise to pay at a later date, and (3) notifies the finance provider or intermediary of the supplier invoices that it has confirmed as valid. Suppliers may then request early payment from the finance provider or intermediary for those confirmed invoices. Suppliers generally agree to accept an amount less than owed to receive payment from the intermediary timelier than the invoice due date. The full amount owed by the buyer is then paid to the intermediary, resulting in a spread income to the financing intermediary.

The ASU amendments require that a buyer in a supplier finance program disclose sufficient information about the program to allow a user of financial statements to understand the program’s nature, activity during the period, changes from period to period, and potential magnitude. These disclosures were supported as buyers who utilize these programs are getting a form of financing, but the amounts owed to the financial intermediaries have been reported differently, with some entities reporting as trade payables and others reporting as debt. As such, users of the financial statements do not have clear information on the use of these financing structures. ASU 2202-04 requires the buyer to make the following annual disclosures of qualitative and quantitative information about its supplier finance programs:

1. The key terms of the program, including a description of the payment terms (including payment timing and basis for its determination) and assets pledged as security or other forms of guarantees provided for the committed payment to the finance provider or intermediary

2. For the obligations that the buyer has confirmed as valid to the finance provider or intermediary:
   a. The amount outstanding that remains unpaid by the buyer as of the end of the annual period (the outstanding confirmed amount)
   b. A description of where those obligations are presented in the balance sheet
c. A rollforward of those obligations during the annual period, including the amount of obligations confirmed and the amount of obligations subsequently paid.

In each interim reporting period, the buyer should disclose the amount of obligations outstanding that the buyer has confirmed as valid to the finance provider or intermediary as of the end of the interim period.

SSAP No. 105R—Working Capital Finance Investments addresses programs similar to some of the ones described in ASU 2022-04, however it addresses such programs from the perspective of evaluating investments in such programs for admissibility for the investor in such programs. That is, the insurers tend to act as a finance provider or an investor in the supplier chain finance program, not the “buyer.” Insurers are not typically “buyers” in such programs as they are described in ASU 2022-04. The guidance in SSAP No. 105R would describe the “buyer” in the ASU 2022-04 as an obligor of the working capital finance program. Therefore, since the disclosures in ASU 2022-04 are for buyers/obligors of supplier finance programs, not for providers of liquidity – the investors, the disclosures do not seem relevant to require of the investors in such programs for statutory accounting.

Note that if an insurer were to sell its premium receivables, existing guidance in SSAP No. 42—Sale of Premium Receivables and SSAP No. 103R—Transfers and Servicing of Financial Assets and Extinguishment of Liabilities provide guidance which distinguishes sales from financing transactions. Therefore, the new GAAP disclosures in ASU 2022-04 are not recommended for incorporation into statutory accounting.

Existing Authoritative Literature:
SSAP No. 105R—Working Capital Finance Investments

1. This statement establishes statutory accounting principles for working capital finance investments held by reporting entities. This statement amends SSAP No. 20—Nonadmitted Assets (SSAP No. 20) to allow working capital finance investments as admitted assets to the extent they conform to the requirements of this statement.

Activity to Date (issues previously addressed by the Working Group, Emerging Accounting Issues (E) Working Group, SEC, FASB, other State Departments of Insurance or other NAIC groups):
The Working Group most recently updated SSAP No. 105R with substantive revisions which were effective June 30, 2020. Revisions to SSAP No. 105R were from agenda item 2019-25: Working Capital Finance Notes which also resulted in Issue Paper No. 163—Working Capital Finance Investment Updates. In agenda item 2019-25 the Working Group reviewed ten industry requests and incorporated 7 out of 10 revisions to SSAP No. 105R.

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

Convergence with International Financial Reporting Standards (IFRS): None

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. 105R to reject ASU 2022-04 as illustrated below. As insurance reporting entities are not the buyers (obligors) of supplier chain finance programs, the disclosures in ASU 2022-04 are not relevant. Reporting entities that invest in working capital finance programs are the providers of capital (investors) not the buyers (obligors) of such programs. Revisions to SSAP No. 105R:

33. ASU 2022-04, Disclosure of Supplier Finance Program Obligations is rejected.

Staff Review Completed by: Robin Marcotte– NAIC Staff, November 2022
Status:
On December 13, 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. 105R to reject ASU 2022-04 for statutory accounting as the disclosures are not relevant for insurance entity preparers.

Summary of Revisions:

1. All changes exposed in November 2022 have been accepted with new edits shown as tracked. (This has been done for readability and to highlight changes from the prior exposure.)

2. Paragraph 4d: New scope exclusion paragraph to exclude securities that do not qualify as bonds pursuant to the principles-based bond definition, including first loss positions that lack contractual payments or substantive credit enhancement. This edit was driven from industry comments as it was recognized that guidance for first loss positions was still in SSAP No. 26R. Edits have been proposed to be explicit with the accounting guidance (see paragraph 10b) as well as incorporate guidance into SSAP No. 21R.

3. Paragraph 4e: New scope exclusion to clarify that replication (synthetic asset) transactions are addressed in SSAP No. 86 and are not impacted by the principles-based bond definition. This edit was also driven from industry comments but is reflected within the scope language rather than with the structured note language in paragraph 6d.i.

4. Paragraph 6d: Revisions revise the reference to “credit rating related” to “credit-quality related.” This change was recommended by industry to encompass the broader range of adjustments that align interests of debtholders and issuing entities (e.g., debt to EBITDA ratio, interest coverage ratio, debt service coverage ratio, etc.) Industry noted that these bonds are very prevalent.

5. Paragraph 6d: Revisions include an exception for nominal interest rate adjustments. A new footnote defines the exception as adjustments that are too small to be taken into consideration when assessing an investment’s substance as a bond. The footnote includes an example application, and clarifies that any adjustments that cause an investment to meet the definition of a structured note would not be considered nominal.

6. Paragraph 10b: Incorporate accounting and reporting guidance for first loss positions as recommended by industry. The guidance also retains the pointer to SSAP No. 21R. Industry noted that the guidance was not included in SSAP No. 21R so to provide direction for Schedule BA in SSAP No. 26R. Although the guidance will be captured in SSAP No. 21R, NAIC staff supports the explicit guidance in SSAP No. 26R for ease of reference.

7. Paragraph 44: Revisions to clarify that investment assessments are required as of origination and to permit current or acquisition information in determining whether investments qualify at the time of transition. This edit is also in line with industry comments.

8. Paragraph 47: Included guidance to clarify that the transition guidance shall be applied prospectively beginning with the first year of adoption (Jan. 1, 2025). For disclosures that provide comparative information, reporting entities shall not restate the prior year’s information in the 2025 disclosure. This edit is also in line with industry comments.

9. Example 2 (Page 23-24): Revisions to incorporate the industry’s editorial suggestions and to clarify in the example that the reporting entity determined that the debtholder was in a fundamentally different position than if the real estate was owned directly.
SCOPE OF STATEMENT

1. The principles-based definition of a bond within this statement shall be utilized to identify whether security structures should be reported as bonds. Investments that qualify within the principles-based definition as an issuer credit obligation shall follow the accounting guidance within this statement. Investments that qualify within the principles-based definition as an asset-backed security (ABS) shall follow the accounting guidance in SSAP No. 43R—Asset-Backed Securities.

2. In addition to security investments that qualify under the principles-based definition as issuer credit obligations, certain specific instruments are also captured in scope of this statement:
   a. Certificates of deposit that have a fixed schedule of payments and a maturity date in excess of one year from the date of acquisition;
   b. Bank loans that are obligations of operating entities issued directly by a reporting entity or acquired through a participation, syndication or assignment;
   c. Debt instruments in a certified capital company (CAPCO) (INT 06-02)
   d. Exchange Traded Funds (ETFs) that qualify for bond treatment as identified in the Purposes and Procedures Manual of the NAIC Investment Analysis Office and included in the ‘SVO-Identified Bond ETF List’ published on the SVO’s webpage. (These instruments are referred to as SVO-Identified Bond ETFs.)
   e. Mortgage loans in scope of SSAP No. 37—Mortgage Loans that qualify under an SVO structural assessment and are identified as SVO-Identified Credit Tenant Loans.

3. Securities that qualify as issuer credit obligations with a maturity date of one year or less from date of acquisition that qualify as cash equivalents or short-term investments shall follow the accounting requirements of this statement. These investments are also captured in SSAP No. 2R—Cash, Cash

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1 Bank Loan – Fixed-income instruments, representing indebtedness of a borrower, made by a financial institution. Bank loans can be issued directly by a reporting entity or acquired through an assignment, participation or syndication:

- **Assignment** – A bank loan assignment is defined as a fixed-income instrument in which there is the sale and transfer of the rights and obligations of a lender (as assignor) under an existing loan agreement to a new lender (and as assignee) pursuant to an Assignment and Acceptance Agreement (or similar agreement) which effects a novation under contract law, so the new lender becomes the direct creditor of and is in contractual privity with the borrower having the sole right to enforce rights under the loan agreement.

- **Participation** – A bank loan participation is defined as a fixed-income investment in which a single lender makes a large loan to a borrower and subsequently transfers (sells) undivided interests in the loan to other entities. Transfers by the originating lender may take the legal form of either assignments or participations. The transfers are usually on a nonrecourse basis, and the originating lender continues to service the loan. The participating entity may or may not have the right to sell or transfer its participation during the term of the loan, depending on the terms of the participation agreement. Loan Participations can be made on a pari-passu basis (where each participant shares equally) or a senior subordinated basis (senior lenders get paid first and the subordinated participant gets paid if there are sufficient funds left to make a payment).

- **Syndication** – A bank loan syndication is defined as a fixed-income investment in which several lenders share in lending to a single borrower. Each lender loans a specific amount to the borrower and has the right to repayment from the borrower. Separate debt instruments exist between the debtor and the individual creditors participating in the syndication. Each lender in a syndication shall account for the amounts it is owed by the borrower. Repayments by the borrower may be made to a lead lender that then distributes the collections to the other lenders of the syndicate. In those circumstances, the lead lender is simply functioning as a servicer and shall not recognize the aggregate loan as an asset. A loan syndication arrangement may result in multiple loans to the same borrower by different lenders. Each of those loans is considered a separate instrument.
4. This statement excludes:

   a. Mortgage loans and other real estate lending activities made in the ordinary course of business. These investments are addressed in SSAP No. 37—Mortgage Loans and SSAP No. 39—Reverse Mortgages.

   b. Investments that qualify within the principles-based definition as an ABS. These investments shall follow the guidance in SSAP No. 43R—Asset-Backed Securities.

   c. Securities that provide varying principal or interest based on underlying equity appreciation or depreciation, an equity-based derivative, real estate or other non-debt variable, as described in paragraph 10.

   d. Securities that do not qualify as bonds pursuant to the principles-based bond definition, including first loss positions that lack contractual payments or substantive credit enhancement. These investments shall follow the appropriate guidance in SSAP No. 21R—Other Admitted Assets.

   e.e. Replication (synthetic asset) transactions addressed in SSAP No. 86—Derivatives. The admissibility, classification and measurement of a replication (synthetic asset) transactions are not preemptively determined by the principles-based bond definition and should be evaluated in accordance with the guidance on replication (synthetic asset) transactions within SSAP No. 86.

   d.f. Investments that are captured specifically within other SSAPs. For example, reporting entity acquired structured settlements are captured in scope of SSAP No. 21R—Other Admitted Assets, held surplus notes are captured in scope of SSAP No. 41R—Surplus Notes and working capital finance investments are captured in scope of SSAP No. 105—Working Capital Finance Investments. Investments captured in scope of other SSAPs are subject to the measurement and admissance provisions of those SSAPs. Furthermore, investments that have specific reporting lines on dedicated schedules (such as with both surplus notes and WCFI) shall be reported on their dedicated lines.

SUMMARY CONCLUSION

Principal-Based Bond Definition

5. A bond shall be defined as any security representing a creditor relationship, whereby there is a fixed schedule for one or more future payments, and which qualifies as either an issuer credit obligation or an asset-backed security as described in this statement.

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2 This statement adopts the GAAP definition of a security as it is used in FASB Accounting Standards Codification Topics 320 and 860. Evaluation of an investment under this definition should consider the substance of the instrument rather than solely its legal form.

Security: A share, participation, or other interest in property or in an entity of the issuer or an obligation of the issuer that has all of the following characteristics:

   a. It is either represented by an instrument issued in bearer or registered form or, if not represented by an instrument, is registered in books maintained to record transfers by or on behalf of the issuer.

   b. It is of a type commonly dealt in on securities exchanges or markets or, when represented by an instrument, is commonly recognized in any area in which it is issued or dealt in as a medium for investment.

   c. It is either one of a class or series or by its terms is divisible into a class or series of shares, participations, interests or obligations.
6. Determining whether a security represents a creditor relationship should consider its substance, rather than solely the legal form of the instrument. The analysis of whether a security represents a creditor relationship should consider all other investments the reporting entity owns in the investee as well as any other contractual arrangements. A security that in substance possesses equity-like characteristics or represents an ownership interest in the issuer does not represent a creditor relationship. While not intended to be all-inclusive, paragraphs 6a-6d discuss specific elements that may introduce equity-like characteristics:

a. Determining whether a debt instrument represents a creditor relationship in substance when the source of cash flows for repayment is derived from underlying equity interests inherently requires significant judgment and analysis. Unlike a debt instrument collateralized by assets with contractual cash flows, debt instruments collateralized by equity interests are dependent on cash flow distributions that are not contractually required to be made and are not controlled by the issuer of the debt. As a result, there is a rebuttable presumption that a debt instrument collateralized by equity interests does not represent a creditor relationship in substance. Notwithstanding this rebuttable presumption, it is possible for such a debt instrument to represent a creditor relationship if the characteristics of the underlying equity interests lend themselves to the production of predictable cash flows and the underlying equity risks have been sufficiently redistributed through the capital structure of the issuer. Factors to consider in making this determination include but are not limited to:

i. Number and diversification of the underlying equity interests
ii. Characteristics of the underlying equity interests (vintage, asset-types, etc.)
iii. Liquidity facilities
iv. Overcollateralization
v. Waiting period for distributions/paydowns to begin
vi. Capitalization of interest
vii. Covenants (e.g., loan-to-value trigger provisions)
viii. Reliance on ongoing sponsor commitments

b. While reliance of the debt instrument on sale of underlying equity interests or refinancing at maturity does not preclude the rebuttable presumption from being overcome, it does require that the other characteristics mitigate the inherent reliance on equity valuation risk to support the transformation of underlying equity risk to bond risk. As reliance on sale or refinancing increases, the more compelling the other factors needed to overcome the rebuttable presumption become.

c. Analysis of whether the rebuttable presumption for underlying equity interests is overcome shall be conducted and documented by a reporting entity at the time such an investment is acquired. The level of documentation and analysis required will vary based on the characteristics of the individual debt instrument, as well as the level of third-party and/or non-insurance company market validation to which the issuance has been subjected. For example, a debt instrument collateralized by fewer, less diversified equity interests would require more extensive and persuasive documented analysis than one collateralized by a larger diversified portfolio of equity interests. Likewise, a debt instrument that has been successfully marketed to unrelated and/or non-insurance company investors, may provide enhanced market validation of the structure compared to one held only by related party and/or insurance company investors where capital relief may be the primary motivation for the securitization.

d. In order for a debt instrument to represent a creditor relationship in accordance with Paragraph 6, it must have pre-determined principal and interest payments (whether fixed
interest or variable interest) with contractual amounts that do not vary based on the appreciation or depreciation (i.e., performance) of any underlying collateral value or other non-debt variable. For example, an issued security that has varying principal and interest payments based on the appreciation of referenced equity, real estate or other non-debt variable is precluded from bond treatment. This exclusion is not intended to restrict variables that are commonly related to debt instruments such as, but not limited to, plain-vanilla3 inflation or benchmark interest rate adjustments (such as with U.S. TIPS or SOFR-linked coupons, respectively), scheduled interest rate step-ups, or credit-quality-related interest rate adjustments. This exclusion is also not intended to encompass nominal interest rate adjustments4. For clarification purposes, all returns from a debt instrument in excess of principal 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 referenced non-debt variables. Examples of securities excluded from the bond definition under this guidance:

i. Structured Notes, which are securities that otherwise meet the definition of a bond, but for which the contractual amount of the instrument to be paid at maturity (or the original investment) is at risk for other than the failure of the borrower to pay the principal amount due, are excluded from the bond definition. These investments, although in the form of a debt instrument, incorporate the risk of an underlying variable in the terms of the agreement, and the issuer obligation to return the full principal is contingent on the performance of the underlying variable. These investments are addressed in SSAP No. 86—Derivatives. Mortgage-referenced securities issued by a government sponsored enterprise are explicit inclusions in scope of SSAP No. 43. Foreign-denominated bonds subject to variation as a result of foreign currency fluctuations are not structured notes.

ii. Principal-protected securities, as defined in the Purposes and Procedures Manual of the NAIC Investment Analysis Office are excluded from the bond definition as they have a performance component whose payments originate from, or are determined by, non-fixed income securities. These investments shall follow the guidance for non-bond securities in SSAP No. 21—Other Admitted Assets.

7. An issuer credit obligation is a bond, for which the general creditworthiness of an operating entity or entities through direct or indirect recourse, is the primary5 source of repayment. Operating entity or entities includes holding companies with operating entity subsidiaries where the holding company has the

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3 Inflation or benchmark interest rate adjustment mechanisms are considered plain-vanilla if based on widely recognized measures of inflation or interest rate benchmarks and excludes those that involve either leverage (such as a multiplier) or an inverse adjustment relationship.

4 Nominal interest rate adjustments are those that are too small to be taken into consideration when assessing the investment’s substance as a bond. Nominal adjustments are not typically influential factors in an investors’ evaluation of investment return and are often included to incentivize certain behavior of the issuer. An example would include sustainability-linked bonds where failure to achieve performance metrics could cause interest rate adjustments. In general, interest rate adjustments that adjust the total return from interest by more than 10% (e.g., >0.4% for a 4% yielding bond), would not be considered nominal. Further, any such adjustments that cause an investment to meet the definition of a structured note would not be considered nominal.

5 “Primary” refers to the first in order of repayment source, not to a majority of the sources of repayment. For example, an issuer obligation may have secondary recourse to collateral upon default of the operating entity but would otherwise be expected to be fully repaid with cash flows of the operating entity. This differs from an asset-backed security for which the primary source of repayment is from cash flows of the collateral.
ability to access the operating subsidiaries’ cash flows through its ownership rights. An operating entity may be any sort of business entity, not-for-profit organization, governmental unit, or other provider of goods or services, but not a natural person or “ABS Issuer” (as defined in paragraph 8). Examples of issuer credit obligations include, but are not limited to:

a. U.S. Treasury securities, including U.S. Treasury Inflation-Indexed Securities;

b. U.S. government agency securities;

c. Municipal securities issued by the municipality or supported by cash flows generated by a municipally-owned asset or entity that provides goods or services (e.g., airport, toll roads, etc.);

d. Corporate bonds issued by operating entities, including Yankee bonds and zero-coupon bonds;

e. Corporate bonds, issued by holding companies that own operating entities;

f. Project finance bonds issued by operating entities;

g. 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 principal 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.

h. Bonds issued by real estate investment trusts (REITs) or similar property trusts;

i. Bonds issued by business development corporations, closed-end funds, or similar operating entities, in each case registered under the 1940 Act.

j. Convertible bonds issued by operating entities, including mandatory convertible bonds as defined in paragraph 20.b.

8. An asset backed security is a bond issued by an entity (an “ABS Issuer”) created for the primary purpose of raising debt capital backed by financial assets or cash generating non-financial assets owned by the ABS Issuer, for which the primary source of repayment is derived from the cash flows associated

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6 The underlying collateral supporting an asset-backed security shall meet the definition of an asset by the ABS Issuer. Certain forms of collateral, such as rights to future cash flows, may not be recognized as assets by the selling entity but may be recognized as assets when sold to an ABS Issuer. These assets are permitted as the collateral supporting an asset-backed security, although they may not represent an asset that can be liquidated to provide payment toward the issued debt obligations (i.e., if the future cash flows do not materialize). The limited ability to liquidate the underlying collateral supporting an asset-backed security does not impact the structural determination of whether an issued security meets the definition of an asset-backed security but may impact the recoverability of the investment, as well as the consideration of whether there is sufficient credit enhancement.

7 SSAP No. 103R—Transfers and Servicing of Financial Assets and Extinguishments of Liabilities defines a financial asset as cash, evidence of an ownership interest in an entity, or a contract that conveys to one entity a right (a) to receive cash or another financial instrument from a second entity or (b) to exchange other financial instruments on potentially favorable terms with the second entity. As a point of clarity, for the purposes of this standard, financial assets do not include assets for which the realization of the benefits conveyed by the above rights depends on the completion of a performance obligation (e.g., leases, mortgage servicing rights, royalty rights, etc.). These assets represent non-financial assets, or a means through which non-financial assets produce cash flows, until the performance obligation has been satisfied.
with the underlying defined collateral rather than the cash flows of an operating entity. In most instances, the ABS Issuer is not expected to continue functioning beyond the final maturity of the debt initially raised by the ABS Issuer. Also, many ABS Issuers are in the form of a trust or special purpose vehicle (“SPV”), although the presence or lack of a trust or SPV is not a definitive criterion for determining that a security meets the definition of an asset-backed security. The provisions in paragraphs 9-10 detail the two defining characteristics that must be present for a security to meet the definition of an asset-backed security.

9. The assets owned by the ABS Issuer are either financial assets or cash-generating non-financial assets. Cash-generating non-financial assets are defined as assets that are expected to generate a meaningful level of cash flows toward repayment of the bond through use, licensing, leasing, servicing or management fees, or other similar cash flow generation. For the avoidance of doubt, there must be a meaningful level of cash flows to service the debt, other than through the sale or refinancing of the underlying assets held by the ABS Issuer. Reliance on cash flows from the sale or refinancing of cash generating non-financial assets does not preclude a security from being classified as an asset-backed security so long as the conditions in this paragraph are met.

a. **Meaningful Level of Cash Flows:** Determining what constitutes a “meaningful” level of cash flows generated to service the debt from sources other than the sale or refinancing of the underlying collateral pursuant to paragraph 9 is specific to each transaction, determined at origination, and shall consider the following factors:

i. The price volatility in the principal market for the underlying collateral;

ii. The liquidity in the principal market for the underlying collateral;

iii. The diversification characteristics of the underlying collateral (i.e., types of collateral, geographic location(s), source(s) of cash flows within the structure, etc.);

iv. The overcollateralization of the underlying collateral relative to the debt obligation; and

v. The variability of cash flows, from sources other than sale or refinancing, expected to be generated from the underlying collateral.

The factors for price variability and the variability of cash flows are directly related to the “meaningful” requirement. That is, as price volatility or variability of cash flows increase, the required percentage of cash flows generated to service the debt from sources other than the sale or refinancing of the underlying collateral must also increase. The factors for liquidity, diversification and overcollateralization are inversely related to the “meaningful” concept. That is, as liquidity, diversification or overcollateralization increase, the required percentage of cash flows generated to service the debt from sources other than the sale or refinancing of the underlying collateral may decrease.

b. As a practical expedient to determining whether a cash generating non-financial asset is expected to produce meaningful cash flows, a reporting entity may consider an asset for which less than 50% of the original principal relies on sale or refinancing to meet the meaningful criteria. In applying this practical expedient, only contractual cash flows of the non-financial assets may be considered. This practical expedient should not be construed to mean that assets cannot meet the meaningful criteria if they rely on sale or refinancing to service greater than 50% of the original principal or if they rely on cash flows that are not contracted at origination. Rather, such instances would require a complete analysis of

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8 Dedicated cash flows from an operating entity can form the underlying defined collateral in an asset-backed security. This dynamic, perhaps noted in a whole-business securitization, still reflects an asset-backed security and is not an issuer credit obligation.
the considerations described within the meaningful level of cash flows definition in paragraph 9.

10. The holder of a debt instrument issued by an ABS Issuer is in a different economic position than if the holder owned the ABS Issuer’s assets directly. The holder of the debt instrument is in a different economic position if such debt instrument benefits from substantive credit enhancement through guarantees (or other similar forms of recourse), subordination and/or overcollateralization.

a. **Substantive Credit Enhancement:** The intent of the criteria requiring the holder to be in a different economic position is to distinguish qualifying bonds from instruments with equity-like characteristics or where the substance of the transaction is more closely aligned with that of the underlying collateral. To qualify as an ABS 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. This is inherent in the context of an issuer credit obligation in scope of SSAP No. 26R as the owners of the equity in the operating entity are the first to absorb any variability in performance of the operating entity. The same concept applies to asset-backed securities. If substantive credit enhancement did not exist, the substance of the debt instrument being evaluated would be more closely aligned with that of the underlying collateral than that of a bond. Credit enhancement that is merely nominal or lacks economic substance does not put a holder in a different economic position. The substantive credit enhancement required to be in a different economic position is specific to each transaction; determined at origination; and refers to the level of credit enhancement a market participant (i.e., knowledgeable investor transacting at arm’s length) would conclude is substantive.

b. The first loss position may be issued as part of a securitization in the form of a debt or equity interest, or it may be retained by the sponsor and not issued as part of the securitization. If the first loss position (or a more senior position(s), if the first loss position(s) lacks contractual payments along with a substantive credit enhancement) is issued as part of the securitization, and does not have contractual principal and interest payments along with substantive credit enhancement and is held by a reporting entity, the investment(s) does not qualify for reporting as a bond and shall be reported on Schedule BA: Other Long-Term Invested Assets at the lower of amortized cost or fair value consistent with the treatment for residuals. (These items are further addressed in should be reported as a non-bond security pursuant to SSAP No. 21R—Other Admitted Assets.)

11. Whether an issuer of debt represents an operating entity or ABS Issuer is unambiguous in most instances, but certain instances may be less clear. For example, an entity may operate a single asset such as a toll road or power generation facility (e.g., project finance) which serves to collateralize a debt issuance, and the cash flows produced by the operation of the assets are pledged to service the debt. In many such instances, the entity is structured as a bankruptcy-remote entity that is separate from the municipality or project sponsor. Such entities have characteristics of operating entities as the operation of the asset constitutes a stand-alone business. They also have many common characteristics of ABS Issuers as they are formed for the purpose of raising debt capital backed by the cash flows from collateral held by a bankruptcy-remote entity. When viewed more holistically, these issuing entities are typically being used to facilitate the financing of an operating component of a project sponsor or municipality. The use of a bankruptcy-remote entity facilitates the efficient raising of debt to finance the operating project, but the primary purpose is to finance an operating project. Therefore, structures in which the issuing entity represents a stand-alone business producing its own operating revenues and expenses, where the primary purpose is to finance an operating project, shall be considered operating entities despite certain characteristics they may share with ABS Issuers.
12. The definition of a creditor relationship, per paragraph 6, does not include equity/fund investments (such as mutual funds or exchanged-traded funds), or securities that possess equity-like characteristics or that represent an ownership interests in the issuer. However, as identified in paragraph 2, exchange traded funds (ETFs), which qualify for bond treatment, as identified in Part Three of the Purposes and Procedures Manual of the NAIC Investment Analysis Office and included in the ‘SVO-Identified Bond ETF List’ published on the SVO’s webpage are provided special statutory accounting treatment and are included within the scope of this statement. These investments shall follow the guidance within this statement, as if they were issuer credit obligations, unless different treatment is specifically identified in paragraphs 32-38.

13. Investments within the scope of this statement issued by a related party, or acquired through a related party transaction, are also subject to the provisions, admittance assessments and disclosure requirements of SSAP No. 25—Affiliates and Other Related Parties.

14. Investments within the scope of this statement 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.

Accounting and Reporting Guidance for Investments that Qualify as Issuer Credit Obligations

Acquisitions, Disposals and Changes in Unrealized Gains and Losses

15. A bond acquisition or disposal shall be recorded on the trade date (not the settlement date) except for the acquisition of private placement bonds which shall be recorded on the funding date. At acquisition, bonds shall be reported at their cost, including brokerage and other related fees. The reported cost of a bond received as a property dividend or capital contribution shall be the initial recognized value. SSAP No. 25 shall be used to determine whether a transfer is economic or noneconomic for initial recognition.

16. For reporting entities required to maintain an interest maintenance reserve (IMR), the accounting for realized capital gains and losses on sales of bonds shall be in accordance with SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve. For reporting entities required to maintain an asset valuation reserve (AVR), the accounting for unrealized gains and losses shall be in accordance with SSAP No. 7.

17. For reporting entities not required to maintain an IMR, realized gains and losses on sales of bonds shall be reported as net realized capital gains or losses in the statement of income. For reporting entities not required to maintain an AVR, unrealized gains and losses shall be recorded as a direct credit or charge to unassigned funds (surplus).

Amortized Cost

18. Amortization of bond premium or discount shall be calculated using the scientific (constant yield) interest method taking into consideration specified interest and principal provisions over the life of the bond. Bonds containing call provisions (where the issue can be called away from the reporting entity at the issuer’s discretion), except “make-whole” call provisions, shall be amortized to the call or maturity value/date which produces the lowest asset value (yield-to-worst). Although the concept for yield-to-worst shall be followed for all callable bonds, make-whole call provisions, which allow the bond to be callable at any time, shall not be considered in determining the timeframe for amortizing bond premium or

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9 For all references to “bond” investments beginning in paragraph 15, this term intends to refer to investments that are permitted accounting and reporting treatment within scope of this standard.

10 For perpetual bonds with an effective call option, any applicable premium shall be amortized utilizing the yield-to-worst method.
discount unless information is known by the reporting entity indicating that the issuer is expected to invoke the make-whole call provision.

Application of Yield-to-Worst

19. For callable bonds\textsuperscript{11}, the first call date after the lockout period (or the date of acquisition if no lockout period exists) shall be used as the “effective date of maturity.” Depending on the characteristics of the callable bonds, the yield-to-worst concept in paragraph 18 shall be applied as follows:

a. For callable bonds with a lockout period, premium in excess of the next call price\textsuperscript{12} (subsequent to acquisition\textsuperscript{13} and lockout period) shall be amortized proportionally over the length of the lockout period. After each lockout period (if more than one), remaining premium shall be amortized to the call or maturity value/date which produces the lowest asset value.

b. For callable bonds without a lockout period, the book adjusted carrying value (at the time of acquisition) of the callable bonds shall equal the lesser of the next call price (subsequent to acquisition) or cost. Remaining premium shall then be amortized to the call or maturity value/date which produces the lowest asset value.

c. For callable bonds that do not have a stated call price, all premiums over par shall be immediately expensed. For callable bonds with a call price at par in advance of the maturity date, all premiums shall be amortized to the call date.

Balance Sheet Amount

20. Bonds shall be valued and reported in accordance with this statement, the \textit{Purposes and Procedures Manual of the NAIC Investment Analysis Office}, and the designation assigned in the NAIC \textit{Valuations of Securities} product prepared by the NAIC Securities Valuation Office (SVO).

a. Bonds, except for mandatory convertible bonds: For reporting entities that maintain an asset valuation reserve (AVR), the bonds shall be reported at amortized cost, except for those with an NAIC designation of 6, which shall be reported at the lower of amortized cost or fair value. For reporting entities that do not maintain an AVR, bonds that are designated highest-quality and high-quality (NAIC designations 1 and 2, respectively) shall be reported at amortized cost; all other bonds (NAIC designations 3 to 6) shall be reported at the lower of amortized cost or fair value. For perpetual bonds which do not possess or no longer possess an effective call option, the bond shall be reported at fair value regardless of NAIC designation.

b. Mandatory convertible bonds: Mandatory convertible bonds are subject to special reporting instructions and are not assigned NAIC designations or unit prices by the SVO. The balance sheet amount for mandatory convertible bonds shall be reported at the lower of amortized cost or fair value during the period prior to conversion. This reporting method is not impacted by NAIC designation or information received from credit rating providers.

\textsuperscript{11} Callable bonds within the scope of paragraph 19 excludes bonds with make-whole call provisions unless information is known by the reporting entity indicating that the issuer is expected to invoke the make-whole call provision. Exhibit D includes illustrations for the amortization of callable bonds.

\textsuperscript{12} Reference to the “next call price” indicates that the reporting entity shall continuously review the call dates/prices to ensure that the amortization (and resulting BACV) follows the yield-to-worst concept throughout the time the reporting entity holds the bond.

\textsuperscript{13} The reporting entity shall only consider call dates/prices that occur after the reporting entity acquires the bond. If all of the call dates had expired prior to the reporting entity acquiring the bond, the reporting entity would consider the bond continuously callable without a lockout period.
CRPs). Upon conversion, these securities will be subject to the accounting guidance of the statement that reflects their revised characteristics. (For example, if converted to common stock, the security will be in scope of SSAP No. 30R—Unaffiliated Common Stock, if converted to preferred stock, the security will be in scope of SSAP No. 32R—Preferred Stocks.)

21. The premium paid on a zero coupon convertible bond that produces a negative yield as a result of the value of a warrant exceeding the bond discount shall be written off immediately so that a negative yield is not produced. The full amount of the premium should be recorded as amortization within investment income on the date of purchase.

Impairment

22. An other-than-temporary impairment shall be considered to have occurred if it is probable that the reporting entity will be unable to collect all amounts due according to the contractual terms of a debt security in effect at the date of acquisition.\(^\text{14}\) A decline in fair value which is other-than-temporary includes situations where a reporting entity has made a decision to sell a security prior to its maturity at an amount below its carrying value. If it is determined that a decline in the fair value of a bond is other-than-temporary, an impairment loss shall be recognized as a realized loss equal to the entire difference between the bond’s carrying value and its fair value at the balance sheet date of the reporting period for which the assessment is made. The measurement of the impairment loss shall not include partial recoveries of fair value subsequent to the balance sheet date. For reporting entities required to maintain an AVR/IMR, the accounting for the entire amount of the realized capital loss shall be in accordance with SSAP No. 7. The other-than-temporary impairment loss shall be recorded entirely to either AVR or IMR (and not bifurcated between credit and non-credit components) in accordance with the annual statement instructions.

23. In periods subsequent to the recognition of an other-than-temporary impairment loss for a bond, the reporting entity shall account for the other-than-temporarily impaired security as if the security had been purchased on the measurement date of the other-than-temporary impairment. The fair value of the bond on the measurement date shall become the new cost basis of the bond and the new cost basis shall not be adjusted for subsequent recoveries in fair value. The discount or reduced premium recorded for the security, based on the new cost basis, shall be amortized over the remaining life of the security in the prospective manner based on the amount and timing of future estimated cash flows. The security shall continue to be subject to impairment analysis for each subsequent reporting period. Future declines in fair value which are determined to be other-than-temporary shall be recorded as realized losses.

Income

24. Interest income for any period consists of interest collected during the period, the change in the due and accrued interest between the beginning and end of the period as well as reductions for premium amortization and interest paid on acquisition of bonds, and the addition of discount accrual. In accordance with SSAP No. 34—Investment Income Due and Accrued, investment income shall be reduced for amounts which have been determined to be uncollectible. Contingent interest may be accrued if the applicable provisions of the underlying contract and the prerequisite conditions have been met.

25. A bond may provide for a prepayment penalty or acceleration fee in the event the bond is liquidated prior to its scheduled termination date. Such fees shall be reported as investment income when received.

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\(^{14}\) If a bond has been modified from original acquisition, the guidance in SSAP No. 36—Troubled Debt Restructuring and paragraph 22 of SSAP No. 103R—Transfers and Servicing of Financial Assets and Extinguishments of Liabilities shall be followed, as applicable. After modification of original terms, future assessments to determine other-than-temporary impairment shall be based on the modified contractual terms of the debt instrument.
26. The amount of prepayment penalty and/or acceleration fees to be reported as investment income or loss shall be calculated as follows:

   a. For called or tendered bonds in which the total proceeds (consideration) received exceeds par:

      i. The amount of investment income reported is equal to the consideration received less the par value of the investment; and

      ii. Any difference between the book adjusted carrying value (BACV) and the par value at the time of disposal shall be reported as realized capital gains and losses, subject to the authoritative literature in SSAP No. 7.

   b. For called or tendered bonds in which the consideration received is less than par\textsuperscript{15}:

      i. To the extent an entity has in place a process to identify explicit prepayment penalty or acceleration fees, these should be reported as investment income. (An entity shall consistently apply their process. Once a process is in place, an entity is required to maintain a process to identify prepayment penalties for called bonds in which consideration received is less than par.)

      ii. After determining any explicit prepayment penalty or acceleration fees, the reporting entity shall calculate the resulting realized gain as the difference between the remaining consideration and the BACV, which shall be reported as realized capital gain, subject to the authoritative literature in SSAP No. 7.

**Origination Fees**

27. Origination fees represent fees charged to the borrower in connection with the process of originating or restructuring a transaction such as the private placement of bonds. The fees include, but are not limited to, points, management, arrangement, placement, application, underwriting and other fees pursuant to such a transaction. Origination fees shall not be recorded until received in cash. Origination fees intended to compensate the reporting entity for interest rate risks (e.g., points) shall be amortized into income over the term of the bond consistent with paragraph 18 of this statement. Other origination fees shall be recorded as income upon receipt.

**Origination, Acquisition and Commitment Costs**

28. Costs related to origination when paid in the form of brokerage and other related fees shall be capitalized as part of the cost of the bond, consistent with paragraph 15 of this statement. All other costs, including internal costs or costs paid to an affiliated entity related to origination, purchase or commitment to purchase bonds shall be charged to expense when incurred.

**Commitment Fees**

29. Commitment fees are fees paid to the reporting entity that obligate the reporting entity to make available funds for future borrowing under a specified condition. A fee paid to the reporting entity to obtain a commitment to make funds available at some time in the future, generally, is refundable only if the bond

\textsuperscript{15} This guidance applies to situations in which consideration received is less than par but greater than the book adjusted carrying value (BACV). Pursuant to the yield-to-worst concept, bonds shall be amortized to the call or maturity date that produces the lowest asset value. In the event a bond has not been amortized to the lowest value prior to the call, or in cases of an accepted tender bond offer (BACV is greater than the consideration received), the entire difference between consideration received and the BACV shall be reported to investment income.
is issued. If the bond is not issued, then the fees shall be recorded as investment income by the reporting entity when the commitment expires.

30. A fee paid to the reporting entity to obtain a commitment to be able to borrow funds at a specified rate and with specified terms quoted in the commitment agreement, generally, is not refundable unless the commitment is refused by the reporting entity. This type of fee shall be deferred, and amortization shall depend on whether or not the commitment is exercised. If the commitment is exercised, then the fee shall be amortized in accordance with paragraph 18 of this statement over the life of the bond as an adjustment to the investment income on the bond. If the commitment expires unexercised, the commitment fee shall be recognized in income on the commitment expiration date.

Exchanges and Conversions

31. If a bond is exchanged or converted into other securities (including conversions of mandatory convertible securities addressed in paragraph 20.b.), the fair value of the bond surrendered at the date of the exchange or conversion shall become the cost basis for the new securities with any gain or loss realized at the time of the exchange or conversion. However, if the fair value of the securities received in an exchange or conversion is more clearly evident than the fair value of the bond surrendered, then it shall become the cost basis for the new securities.

SVO-Identified Bond Exchange-Traded Funds

32. SVO-identified bond exchange-traded fund (ETF) investments, as discussed in paragraph 2, are captured within the scope of this statement for accounting and reporting purposes only. The inclusion of these investments within this statement is not intended to contradict state law regarding the classification of these investments and does not intend to provide exceptions to state investment limitations involving types of financial instruments (e.g., equity/fund interests), or with regards to concentration risk (e.g., issuer).

33. SVO-identified bond ETF investments shall be initially reported at cost, including brokerage and other related fees. Subsequently, SVO-identified bond ETF investments shall be reported at fair value, with changes in fair value recorded as unrealized gains or losses) unless the reporting entity has elected use of a documented systematic approach to amortize or accrete the investment in a manner that represents the expected cash flows from the underlying bond holdings. This special measurement approach is referred to as the “systematic value” measurement method and shall only be used for the SVO-identified bond ETF investments within the scope of this statement.

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16 With the inclusion of these SVO-identified investments as bonds, specific guidelines are detailed in the annual statement instructions for reporting purposes.

17 For these investments, net asset value (NAV) is allowed as a practical expedient to fair value.

18 The election to use systematic value is not a permitted or prescribed practice as it is an accounting provision allowed within this SSAP. Similarly, this election does not override state statutes, and if a state does not permit reporting entities the election to use systematic value as the measurement method, this is also not considered a permitted or prescribed practice. SVO-identified investments reported at fair value (NAV) or systematic value, if in accordance with the provisions of this standard, are considered in line with SSAP No. 26R and do not require permitted or prescribed disclosures under SSAP No. 1—Accounting Policies, Risks & Uncertainties and Other Disclosures.
34. Use of the systematic value for SVO-identified bond ETF investments is limited as follows:
   
   a. Systematic value is only permitted to be designated as the measurement method for AVR filers acquiring qualifying investments that have an NAIC designation of 1 to 5, and for non-AVR filers acquiring qualifying investments with an NAIC designation of 1 or 2. SVO-identified investments that have an NAIC designation of 6 for AVR filers or 3-6 for non AVR filers shall be measured at fair value.
   
   b. Designated use of a systematic value is an irrevocable election per qualifying investment (by CUSIP) at the time investment is originally acquired\(^{19}\). Investments owned prior to being identified by the SVO as a qualifying SSAP No. 26R investment are permitted to be subsequently designated to the systematic value measurement method. This designation shall be applied as a change in accounting principle pursuant to SSAP No. 3—Accounting Changes and Corrections of Errors, which requires the reporting entity to recognize a cumulative effect to adjust capital and surplus as if the systematic value measurement method had been applied retroactively for all prior periods in which the investment was held. The election to use systematic value for investments shall be made before the year-end reporting of the investment in the year in which the SVO first identifies the investment as a qualifying SSAP No. 26R investment.
   
   c. Once designated for a particular investment, the systematic value measurement method must be retained as long as the qualifying investment is held by the reporting entity and the investment remains within the scope of this statement with an allowable NAIC designation per paragraph 34.a. Upon a full sale/disposal of an SVO-identified investment (elimination of the entire CUSIP investment), after 90 days the reporting entity can reacquire the SVO-identified investment and designate a different measurement method. If the reporting entity was to reacquire the same investment within 90 days after it was sold/disposed, the reporting entity must utilize the measurement method previously designated for the investment. Subsequent/additional purchases of the same SVO-identified investment (same CUSIP) already held by a reporting entity must follow the election previously made by the reporting entity. If an investment no longer qualifies for a systematic value measurement because the NAIC designation has declined, then the security must be subsequently reported at the lower of “systematic value” or fair value. If the security has been removed from the SVO-identified listings, and is no longer in scope of this statement, then the security shall be measured and reported in accordance with the applicable SSAP.
   
   d. Determination of the designated systematic value must follow the established\(^ {20}\) approach, which is consistently applied for all SVO-identified bond ETF investments designated for a systematic value. In all situations, an approach that continuously reflects “original” or “historical cost” is not an acceptable measurement method. The designated approach shall result with systematic amortization or accretion of the equity/fund investment in a manner that represents the expected cash flows from the underlying bond holdings.

35. Income distributions received from SVO-identified bond ETF investments (cash or shares) shall be reported as interest income in the period in which it is earned. For those SVO-identified bond ETF investments where the systematic value method is applied, interest income shall be recognized based on the book yield applied to the carrying value each period, similar to bonds.

\(^{19}\) This guidance requires investments purchased in lots to follow the measurement method established at the time the investment was first acquired.

\(^{20}\) Exhibit B details the established systematic value approach.
36. For reporting entities required to hold an IMR and AVR reserve, realized and unrealized gains and losses for the SVO-identified bond ETF investments shall be consistent with bonds within the scope of this standard. With this guidance, recognition of gains/losses (and corresponding AVR/IMR impacts) will be based on the ETF, and not activity that occurs within the ETF (e.g., such as changes in the underlying bonds held within the ETF). Also consistent with the guidance for bonds, recognized losses from other-than-temporary impairments shall be recorded entirely to either AVR or IMR (and not bifurcated between credit and non-credit components) in accordance with the annual statement instructions.

37. SVO-identified bond ETF investments reported at systematic value shall recognize other-than-temporary impairments in accordance with the following guidance:

   a. A decision to sell an SVO-identified bond ETF investment that has a fair value less than systematic value results in an other-than-temporary impairment that shall be recognized.

   b. In situations in which an SVO-identified bond ETF investment has a fair value that is less than systematic value, the reporting entity must assess for other-than-temporary impairment. For these investments, a key determinant, along with other impairment indicators in INT 06-07: Definition of Phrase “Other Than Temporary,” shall be whether the net present value of the projected cash flows for the underlying bonds in the SVO-identified investment have materially[^21] declined from the prior reporting period (most recent issued financial statements) or from the date of acquisition. In calculating the net present value of the projected cash flows for each reporting period, entities shall discount cash flows using a constant purchase yield, which is the initial book yield at acquisition. Consistent with INT 06-07, a predefined threshold to determine whether the decline in projected cash flows (e.g., percentage change) shall result in an other than temporary impairment has not been set, as exclusive reliance on such thresholds removes the ability of management to apply its judgement.

   c. Upon identification of an SVO-identified investment as OTTI, the reporting entity shall recognize a realized loss equal to the difference between systematic value and the current fair value. (Although the determination of OTTI is likely based on projected cash flows, the realized loss recognized for the OTTI is based on the difference between systematic value and fair value.) The fair value of the SVO-identified investment on the date of the OTTI shall become the new cost basis of the investment.

   d. Subsequent to recognition of an OTTI, the SVO-identified bond ETF investment is required to be reported at the lower of the then-current period systematic value or fair value. As the underlying bonds can be replaced within an ETF, it is possible for a subsequent period systematic value and fair value to recover above the fair value that existed at the time an OTTI was recognized. As such, the requirement for subsequent reporting at the lower of systematic value or fair value is intended to be a current period assessment. For example, in reporting periods after an OTTI, the systematic value for an SVO-identified investment may exceed the fair value at the time of the OTTI, but in no event shall the reported systematic value exceed the then-current period fair value. If current calculated systematic value is lower than the current fair value, systematic value is required.

38. Impairment guidance for SVO-identified bond ETF investments reported at fair value is consistent with impairment guidance for investments captured under SSAP No. 30R. Pursuant to this guidance, realized losses are required to be recognized when a decline in fair value is considered to be other-than-temporary.

[^21]: The net present value of cash flows will decline in a declining interest rate environment. Reporting entities shall use judgment when assessing whether the decline in cash flows is related to a decline in interest rates or the result of a non-interest related decline, and determine whether the decline represents an OTTI pursuant to INT 06-07.
temporary. Subsequent fluctuations in fair value shall be recorded as unrealized gains or losses. Future declines in fair value which are determined to be other-than-temporary shall be recorded as realized losses. A decision to sell an impaired security results with an other-than-temporary impairment that shall be recognized.

Disclosures

39. The financial statements shall include the following disclosures:

a. Fair value in accordance with SSAP No. 100R—Fair Value;

b. Concentrations of credit risk in accordance with SSAP No. 27—Off-Balance-Sheet and Credit Risk Disclosures;

c. The basis at which the bonds, mandatory convertible securities, and SVO-identified bond ETF investments identified in paragraph 2, are stated;

d. Amortization method for bonds and mandatory convertible securities, and if elected by the reporting entity, the approach for determining the systematic value for SVO-identified securities per paragraph 33. If utilizing systematic value measurement method approach for SVO-identified investments, the reporting entity must include the following information:

i. Whether the reporting entity consistently utilizes the same measurement method for all SVO-identified investments\(^{22}\) (e.g., fair value or systematic value). If different measurement methods are used\(^ {23}\), information on why the reporting entity has elected to use fair value for some SVO-identified investments and systematic value for others.

ii. Whether SVO-identified investments are being reported at a different measurement method from what was used in an earlier current-year interim and/or in a prior annual statement. (For example, if reported at systematic value prior to the sale, and then reacquired and reported at fair value.) This disclosure is required in all interim reporting periods and in the year-end financial statements for the year in which an SVO-identified investment has been reacquired and reported using a different measurement method from what was previously used for the investment. (This disclosure is required regardless of the length of time between the sale/reacquisition of the investments, but is only required in the year in which the investment is reacquired.)

iii. Identification of securities still held that no longer qualify for the systematic value method. This should separately identify those securities that are still within the scope of SSAP No. 26R and those that are being reported under a different SSAP.

e. For each balance sheet presented, the book/adjusted carrying values, fair values, excess of book/carrying value over fair value or fair value over book/adjusted carrying values for each pertinent bond or assets in scope of this statement.

\(^{22}\) As identified in paragraph 34.d., a consistent approach must be followed for all investments designated to use the systematic value method. As such, this disclosure is limited to situations in which a reporting entity uses both fair value and systematic value for reported SVO-identified investments.

\(^{23}\) The guidance in this statement allows different measurement methods by qualifying investment (CUSIP), but it is anticipated that companies will generally utilize a consistent approach for all qualifying investments.

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f. For the most recent balance sheet, the book/adjusted carrying values and the fair values of bonds and assets in scope of this statement, reported in statutory Annual Statement Schedule D – Part 1A due:
   i. In one year or less (including items without a maturity date which are payable on demand and in good standing);
   ii. After one year through five years;
   iii. After five years through ten years;
   iv. After ten years (including items without a maturity date which are either not payable on demand or not in good standing).

g. For each period for which results of operations are presented, the proceeds from sales of bonds and assets in scope of this Statement and gross realized gains and gross realized losses on such sales.

h. For each balance sheet presented, all items in scope of this Statement in an unrealized loss position for which other-than-temporary declines in value have not been recognized:
   i. The aggregate amount of unrealized losses (that is, the amount by which cost or amortized cost exceeds fair value) and
   ii. The aggregate related fair value of bonds with unrealized losses.

i. The disclosures in paragraphs 39.h.i. and 39.h.ii. should be segregated by items that have been in a continuous unrealized loss position for less than 12 months and those that have been in a continuous unrealized loss position for 12 months or longer using fair values determined in accordance with SSAP No. 100R.

j. As of the most recent balance sheet date presented, additional information should be included describing the general categories of information that the investor considered in reaching the conclusion that the impairments are not other-than-temporary.

k. When it is not practicable to estimate fair value in accordance with SSAP No. 100R, the investor should disclose the following additional information, if applicable, as of each date for which a statement of financial position is presented in its annual financial statements:
   i. The aggregate carrying value of the investments not evaluated for impairment, and
   ii. The circumstances that may have a significant adverse effect on the fair value.

l. For securities sold, redeemed or otherwise disposed as a result of a call or tender offer feature (including make-whole call provisions), disclose the number of CUSIPs sold, disposed or otherwise redeemed and the aggregate amount of investment income generated as a result of a prepayment penalty and/or acceleration fee.

40. Refer to the Preamble for further discussion regarding disclosure requirements. The disclosures in paragraphs 39.b., 39.e., 39.f., 39.g., 39.h., 39.i., 39.j. and 39.k. shall be included in the annual audited statutory financial reports only.
Relevant Literature

41. This statement adopts AICPA Statement of Position 90-11, Disclosure of Certain Information by Financial Institutions About Debt Securities Held as Assets, and AICPA Practice Bulletin No. 4, Accounting for Foreign Debt/Equity Swaps. This statement also adopts FASB Staff Position 115-1/124-1, The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments, paragraph 16, with modification to be consistent with statutory language in the respective statutory accounting statements. This statement adopts the GAAP definition of “security” as it is used in FASB Codification Topic 320 and 860. This statement refers to the definition of “financial assets” captured in SSAP No. 103R adopted from U.S. GAAP. As noted in footnote 7, for purposes of this statement, and in applying the principles-based bond definition, financial assets do not include assets that depend on the completion of a performance obligation. When there is a performance obligation, the asset represents non-financial assets, or a means through which non-financial assets produce cash flows, until the performance obligation has been satisfied.

42. This statement rejects the GAAP guidance for debt securities, which is contained in ASU 2020-08, Codification Improvements to Subtopic 310-20, Receivables – Nonrefundable Fees and Other Costs, ASU 2018-03, Recognition and Measurement of Financial Assets and Financial Liabilities, ASU 2017-08, Premium Amortization on Purchased Callable Debt Securities, ASU 2016-01, Financial Instruments – Overall, FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities, FASB Statement No. 91, Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases, FASB Emerging Issues Task Force No. 89-18, Diversitues of Certain Investment Securities to an Unregulated Commonly Controlled Entity under FIRREA, and FASB Emerging Issues Task Force No. 96-10, Impact of Certain Transactions on Held-to-Maturity Classifications Under FASB Statement No. 115.

Effective Date and Transition

43. Revisions to SSAP No. 26R to incorporate the principle-based bond concepts are effective January 1, 2025. These revisions incorporate principle concepts on what should be reported as a long-term bond. Securities that qualify as issuer credit obligations within the principle concepts are captured within scope of SSAP No. 26R. Securities that qualify as asset-backed securities within the principle concepts are captured within scope of SSAP No. 43R. Securities that do not qualify as issuer credit obligations or ABS, unless specifically permitted in scope of these statements, are not permitted to be reported as a bond.

44. At the time of transition, reporting entities shall make their best efforts to assess investments to determine whether they qualify within the bond definition for reporting on Schedule D-1. The bond definition requires assessments at the time of acquisition (as of the origination date), and it is recognized that reporting entities may not have the means to complete historical assessments for securities held at the time of transition. For these instances, if information is not readily available for reporting entities to assess a security as of the date at acquisition, reporting entities may utilize current or acquisition information in concluding that a security qualifies for reporting as a bond as either an issuer obligation or asset-backed security.

45. Investments that were reported as a bond on Schedule D-1: Long-Term Bonds as of December 31, 2024 that do not qualify under the principle-based bond concepts shall be reported as a disposal from that schedule, with a reacquisition on the appropriate reporting schedule as of January 1, 2025. These investments shall be accounted for in accordance with the resulting SSAP that addresses the specific investment structure. For securities that are reported at the lower of amortized cost or fair value under the new applicable guidance, this could result with an unrealized loss in the measurement of the investment at the time of the reclassification. Although the adoption of this guidance is considered a change in accounting principle under SSAP No. 3, the following transition guidance shall be applied on January 1, 2025, to ensure consistency in reporting and to allow investment schedules to roll appropriately.
a. Securities reclassified from Schedule D-1 as they no longer qualify under the bond definition shall be reported as a disposal from Schedule D-1 at amortized cost. Although no proceeds are received, amortized cost at the time of disposal shall be reported as consideration on Schedule D-4.

i. For securities held at amortized cost at the time of disposal, book adjusted carrying value and amortized cost shall agree, preventing gain or loss recognition at the time of reclassification.

ii. For securities held at fair value under the lower of amortized cost or fair value measurement method, previously reported unrealized losses shall be reversed on Jan. 1, 2025, prior to disposal, resulting with a reported value that mirrors amortized cost at the time of disposal. This action prevents realized loss recognition at time of reclassification.

b. Securities reclassified from Schedule D-1 shall be recognized on the subsequent schedule (e.g., Schedule BA) with an actual cost that agrees to the disposal value (amortized cost). Immediately subsequent to recognition on the resulting schedule, the securities shall be reported in accordance with the measurement method prescribed by the applicable SSAP:

i. For securities previously reported at fair value on Schedule D-1 (under a lower of amortized cost or fair value measurement method), the reporting entity will recognize an unrealized loss to match the previously reported book adjusted carrying value. Subsequently, the security will continue to reflect a lower of amortized cost or fair value measurement method.

ii. For securities previously reported at amortized cost on Schedule D-1, if the subsequent statement requires a lower of amortized cost or fair value measurement method, then the reporting entity shall recognize an unrealized loss to the extent fair value is less than amortized cost.

iii. After application of paragraph 45b.i and 45b.ii all securities shall reflect either the same reported value as of December 31, 2024 (amortized cost or fair value) or a lower reported value (if the security is subject to the lower of amortized cost or fair value measurement method). There should be no instances that result with a security having a greater reported value than what was presented on December 31, 2024. Subsequent to transition, securities reported at fair value may incur unrealized gains or losses due to fair value fluctuations, but should never have unrealized gains that result with a book adjusted carrying value that exceeds amortized cost.

46. With this transition guidance, changes in measurement for securities reclassified under the bond definition will be reported as a change in unrealized capital gains (losses) in the first quarter 2025 financial statements (unless sold in the interim with a realized gain or loss) and not as a change in accounting principle. To enable regulators the ability to identify the impact of securities reclassified under the bond definition, the following disclosure for the 2025 first quarter financial statement is required:


b. Aggregate book adjusted carrying value after transition for all securities reclassified off Schedule D-1 that resulted with a change in measurement basis. (This shall be a subset of
paragraph 46a and captures the securities that moved from an amortized cost to a fair value measurement method under the lower of amortized cost or fair value approach.)

c. Aggregate surplus impact for securities reclassified off Schedule D-1. This shall include the difference between book adjusted carrying value as of December 31, 2024 and book adjusted carrying value after transition for those securities that moved from an amortized cost to a fair value measurement method under the lower of amortized cost or fair value approach.

47. For clarification purposes, the transition guidance shall be applied prospectively beginning with the first year of adoption (Jan. 1, 2025). For disclosures that provide comparative information, reporting entities shall not restate the prior year’s information in the 2025 disclosure.

Historical Adoption and Revisions of SSAP No. 26R:

47.48. For historical reference, the original adoption, and subsequent revisions to SSAP No. 26R prior to the adoption of the principles-based bond definition are detailed below:

a. SSAP No. 26R was originally effective for years beginning January 1, 2001.

b. Guidance for the accounting of securities subsequent to other than temporary impairments was originally effective for reporting periods beginning on January 1, 2009, with early adoption permitted. This guidance was incorporated from SSAP No. 99—Accounting for Securities Subsequent to an Other-Than-Temporary Impairment in 2010. The original impairment guidance included in this standard, and the substantive revisions reflected in SSAP No. 99 are retained for historical purposes in Issue Paper No. 131.

c. Guidance pertaining to the accounting for zero-coupon convertible bonds was originally effective December 8, 2002 and was subsequently incorporated into this statement from INT 02-05: Accounting for Zero Coupon Convertible Bonds.

d. Guidance adopted in December 2013 clarifying the ‘yield-to-worst’ concept for bonds with make-whole call provisions was initially effective January 1, 2014, unless the company had previously been following the guidance. (Companies that have previously been following the original intent, as clarified in the revisions, were not impacted by these changes.)

e. The guidance on the calculation of investment income for prepayment penalties and/or acceleration fees was effective January 1, 2017, on a prospective basis and was required for interim and annual reporting periods thereafter, with early application permitted.

f. In April 2017, revisions were incorporated in accordance with the investment classification project. These revisions are detailed in Issue Paper No. 156 and were effective December 31, 2017. These revisions clarified the scope of the bond definition as well as incorporated new guidance for SVO-Identified Bond ETFs identified in scope of this statement. Retained transition / application guidance is captured as follows:

i. For situations in which there is an interval of time between when a company purchases an investment and when the investment is designated as an SVO-identified investment eligible for systematic value, the book yield should be calculated by equating the book/adjusted carrying value at that time to the portfolio’s aggregate cash flows (ACF). For these situations, the ETF shall be reported as a disposed security on the prior reporting schedule and reported as an acquisition.
ii. In accordance with the systematic value methodology, at the next reporting period date, the reporting entity shall amortize or accrete the carrying value by the difference between the effective interest using the initial book yield, and the distributions received, and shall recalculate the new effective book yield using the new carrying value and ACF as of the last day of the reporting period.

iii. As the necessary historical ACF data is not available for calculating the initial book yield at acquisition for the net present value constant purchase yield (NPV-CPY) method for impairment recognition, reporting entities shall use recently published yield-to-maturity (YTM) as their constant purchase yield to be applied for NPV-CPY impairment recognition.

iv. If the investment no longer qualifies as an SVO-Identified Bond ETF in scope of statement, this change shall be reflected prospectively from the effective date. Investments previously included this statement, that will move within the scope of another SSAP and reporting schedule shall be shown as dispositions on and shown as an acquisition on the schedule for which it will be subsequently reported.

b. The guidance to explicitly exclude securities for which the contract amount of the instrument to be paid at maturity (or the original investment) is at risk for other than failure of the borrower to pay the contractual amount due, were effective December 31, 2019.

c. Revisions to clarify existing guidance that all prepayment penalty and acceleration fees for when a bond is liquidated prior to its scheduled maturity date, including those from tendered bonds, shall follow the guidance in SSAP No. 26R was effective January 1, 2021. Reporting entities that have historically applied this guidance shall not change historical practices, but the effective date of January 1, 2021, with early application permitted, was allowed for reporting entities to make systems changes to capture tendered bonds in scope of this guidance.

REFERENCES

Other

• Purposes and Procedures Manual of the NAIC Investment Analysis Office

• NAIC Valuation of Securities product prepared by the Securities Valuation Office

Relevant Issue Papers

• Issue Paper No. 26—Bonds, Excluding Loan-Backed and Structured Securities

• Issue Paper No. 131—Accounting for Certain Securities Subsequent to an Other-Than-Temporary Impairment

• Issue Paper No. 156—Bonds

• Issue Paper No. XX—Principles-Based Bond Definition
EXHIBIT A - EXAMPLES OF ANALYSIS FOR ASSET-BACKED SECURITIES

1. As detailed in paragraphs 9-10, the holder of an asset-backed securities is 1) required to be in a different economic position than if the holder owned the ABS Issuer’s assets directly, and 2) if the assets owned by the ABS Issuer are cash generating non-financial assets, then the assets are expected to generate a meaningful level of cash flows towards repayment of the bond through use, licensing, leasing servicing or management fees, or other similar cash flow generation. (This guidance requires a meaningful level of cash flows to service the debt other than through the sale or refinancing of the assets.) This appendix details example analysis for these meaningful cash flow and substantive credit enhancements.

2. **Example 1:** A reporting entity invests in debt instruments issued from a SPV sponsored by the Government National Mortgage Association (GNMA), the Federal National Mortgage Association (FNMA) and the Federal Home Loan Mortgage Corporation (Freddie Mac) (collectively, “Agency or Agencies”). These debt instruments pass through principal and interest payments received from underlying mortgage loans held by the SPV to the debtholders proportionally, with principal and interest guaranteed by the Agencies. While there is prepayment and extension risk associated with the repayment of the underlying mortgage loans, the credit risk associated with the mortgage loans is assumed by the Agencies. Although the reporting entity participates on a proportional basis in the cash flows from the underlying mortgage loans held by the SPV, the reporting entity is in a different economic position than if it owned the underlying mortgage loans directly because the credit risk has been redistributed and assumed by the Agencies. This is a substantive credit enhancement because a market participant (i.e., a knowledgeable investor transacting at arm’s length) would conclude the Agency guarantee is expected to absorb all losses before the debt instrument being evaluated. Therefore, the holder of the debt instrument is in a substantively different economic position than if the holder owned the ABS Issuer’s unguaranteed assets directly, in accordance with the requirements in paragraph 10. When guarantees do not cover 100% of principal and interest as the Agency guarantees do in this example, it is still appropriate to determine if the guarantee is substantive in accordance with the requirements in paragraph 10, to determine if the holder is in a substantively different economic position that if the holder held the ABS Issuer’s assets directly.

3. **Example 1 Rationale:** Although the reporting entity participates on a proportional basis in the cash flows from the underlying mortgage loans held by the SPV, the reporting entity is in a different economic position than if it owned the underlying mortgage loans directly because the credit risk has been redistributed and assumed by the Agencies. This is a substantive credit enhancement because a market participant (i.e., a knowledgeable investor transacting at arm’s length) would conclude the Agency guarantee is expected to absorb all losses before the debt instrument being evaluated. Therefore, the holder of the debt instrument is in a substantively different economic position than if the holder owned the ABS Issuer’s unguaranteed assets directly, in accordance with the requirements in paragraph 10. When guarantees do not cover 100% of principal and interest as the Agency guarantees do in this example, it is still appropriate to determine if the guarantee is substantive in accordance with the requirements in paragraph 10, to determine if the holder is in a substantively different economic position that if the holder held the ABS Issuer’s assets directly.

4. **Example 2:** A reporting entity invested in a debt instrument issued by a SPV. Payments under the instrument are secured by a note, a legal assignment from the borrower of a lease for real property and an assignment of the lease payments from an operating entity tenant. Additional security is provided by a mortgage on the leased property (the “underlying collateral”). The leased property is owned by the borrower under the note -- the SPV does not have any ownership interest in the underlying collateral, though it has legal recourse to it through the mortgage. The tenant makes contractually-fixed payments over the life of the lease to the borrower, who has assigned both the lease and the lease payments to the SPV as security for the debt. While the debt is outstanding, the lease, the lease payments, and the mortgage all serve as security for the debtholders. Should a default occur, the debtholders can foreclose on and liquidate the real property as well as submit an unsecured lease claim in the lessee’s bankruptcy for any/all or a portion of the defaulted lease payments. The loan-to-value (as a percentage of property value) at origination is 100%.

5. The existing lease payments are sufficient to cover all interest payments and all scheduled debt amortization payments over the life of the debt instrument. However, at debt maturity, there is a balloon payment due, totaling 50% of the original outstanding debt principal amount. The corresponding lease has no balloon payment due at lease maturity, so the SPV will either need to refinance the debt or sell the underlying collateral to service the final debt balloon payment. The property has a high probability of appreciating in value over the term, however ignoring any potential for appreciation, the 50% loan-to-value at maturity is the expected figure at the end of the debt term based solely on scheduled amortization payments. The real property is expected to be subject to some market value volatility and periods of lower
liquidity at certain points in time but has a predictable value range and ready market over a longer period of time, such that the property could be liquidated over a reasonable period of time, if necessary.

6. **Example 2 Rationale:** The reporting entity determined that the debtholder was in a fundamentally different position than if the real estate was owned directly. The lease is a cash generating non-financial asset which is expected to generate a meaningful level of cash flows for the repayment of the bonds which covers all interest payments and 50% of the principal payments. The level of reliance on the collateral value for sale or refinancing is just over the cutoff for using the practical expedient (<50%), so a full analysis is required. In reaching its determination, the reporting entity considered the predictable nature of the cash flows, which are contractually fixed for the life of the debt instrument, as well as the ability of the underlying collateral value to provide for the balloon payment through sale or refinancing in light of its characteristics. While the real property may have some market value volatility and periods of lower liquidity at points in time, the cash flows produced by the lease were concluded to reduce the loan balance to a level (50% loan-to-value) that would be able to be recovered by sale or refinancing at the maturity of the loan.

7. The reporting entity also determined that the structure provides substantive credit enhancement in the form of overcollateralization to conclude that investors are in a different economic position than holding the real property directly, in accordance with the requirements in paragraph 10. In reaching this conclusion, the reporting entity noted that although the debt instrument starts with a 100% loan-to-value (not including the value of the contractually required lease payments), contractual fixed payments from the lease provide additional security such that the reporting entity is in a different economic position than owning the property directly. Lease cash flows are sufficient to cover the payment of all interest and 50% of the outstanding principal over the term of the lease. In the context of the predictable nature of the cash flows and collateral value range over time, the reporting entity concluded that a market participant (i.e., knowledgeable investor transacting at arm’s length) would consider this level of overcollateralization to put the investor in a substantively different economic position than owning the underlying property directly.

8. For the purposes of determining whether there is substantive overcollateralization, it is appropriate to consider any expected economic depreciation, if it is reasonably expected, but it is not appropriate to consider any expected economic appreciation. Note that a debt instrument with a loan-to-value that is expected to decrease over time is not necessarily deemed to have substantive overcollateralization.

9. **Example 3:** A reporting entity invested in a debt instrument with the same characteristics as described in Example 2, except that the existing lease at the time of origination has a contractual term that is shorter than that of the debt instrument. It is expected with a high degree of probability that the lease will be renewed, and a substantial leasing market exists to replace the lessee should they not renew. However, in the unlikely circumstance that the property cannot be re-leased, there would not be enough cash flows to service the scheduled principal and interest payments, and the property would have to be liquidated to pay off the debt upon default.

10. **Example 3 Rationale:** All details of Example 3, including the expected collateral cash flows, are consistent with those in Example 2, except that the cash flows in Example 2 are contractually fixed for the duration of the debt while the cash flows in Example 3 are subject to re-leasing risk. Notwithstanding the involvement of re-leasing risk, the reporting entity concluded that the ability to re-lease the property was highly predictable and supported the conclusion that the underlying collateral was expected to produce meaningful cash flows to service the debt.

11. This distinction is to highlight that the expected cash flows of a cash-generating non-financial asset may or may not be contractually fixed for the term of the bond. Certain securitized cash flow streams may not by their nature lend themselves to long-term contracts (e.g., single-family home rentals), but may nevertheless lend themselves to the production of predictable cash flows. While the non-contractual nature of the cash flows is an important consideration in determining whether a non-financial asset is expected to produce meaningful cash flows to service the debt, it does not, in and of itself, preclude a reporting entity from concluding that the assets are expected to produce meaningful cash flows.
12. **Example 4**: A reporting entity invested in a debt instrument issued by a SPV that owns equipment which is leased to an equipment operator. The equipment operator makes lease payments to the SPV, which are passed through to service the SPV’s debt obligation. While the debt is outstanding, the equipment and lease are held in trust and pledged as collateral for the debtholders. Should a default occur, the debtholders can foreclose on and liquidate the equipment as well as submit an unsecured lease claim in the lessee’s bankruptcy for any defaulted lease payments. The loan-to-value at origination is 70%.

13. The existing lease payments are sufficient to cover all interest payments and all scheduled debt amortization payments over the life of the debt instrument. However, at maturity, there is a balloon payment due, totaling 80% of the original outstanding principal amount. The corresponding lease has no balloon payment due at lease maturity, so the SPV will either need to refinance the debt or sell the underlying equipment to service the final debt balloon payment. The loan-to-value at maturity is expected to increase to 95% considering the scheduled principal amortization payments net of the expected economic depreciation in the equipment value over the term of the debt. The equipment is expected to be subject to some market value volatility and periods of lower liquidity at certain points in time, but has a predictable value range and ready market over a longer period of time, such that the equipment could be liquidated over a reasonable period of time, if necessary.

14. **Example 4 Rationale**: The equipment is a cash generating non-financial asset which is not expected to generate a meaningful level of cash flows for the repayment of the bonds via the existing lease that covers all interest payments and 20% of principal payments. In reaching this determination, the reporting entity considered that, while the cash flows being produced are predictable, the ability to recover the principal of the debt investment is almost entirely reliant on the equipment retaining sufficient value to sell or refinance to satisfy the debt.

15. The reporting entity also determined that the structure lacks substantive credit enhancement to conclude that investors are in a different economic position than holding the equipment directly, in accordance with the requirements are in paragraph 10. In reaching this conclusion, the reporting entity noted that the debt starts with a 70% loan-to-value, but the overcollateralization is expected to deteriorate over the term of the debt as the equipment economically depreciates more quickly than the debt amortizes. This results in a high loan-to-value (i.e., 95%) at maturity, relative to the market value volatility of the underlying collateral. Despite the predictable nature of the cash flows, the reporting entity concluded that the debt instrument lacked a substantive level of overcollateralization to conclude that the investor is in a different economic position than owning the underlying equipment directly. It was determined that the level of overcollateralization, as determined by a market participant (i.e., a knowledgeable investor transacting at arm’s length), is nominal. Therefore, the reporting entity concluded that it was in a substantively similar position as if it owned the equipment directly.

16. For the purposes of determining whether there is substantive overcollateralization, it is appropriate to consider any expected economic depreciation, if it is reasonably expected, but it is not appropriate to factor in any expected economic appreciation. Note that a debt instrument with a loan-to-value that is expected to increase over time is not necessarily deemed to have nominal overcollateralization.
**EXHIBIT B – SYSTEMATIC VALUE CALCULATION**

The established systematic value method is considered an “aggregated cash flow” (ACF) method in which the cash flow streams from the individual bond holdings are aggregated into a single cash flow stream. These cash flows are scaled such that, when equated with the market price at which the ETF was purchased or sold, an internal rate of return is calculated, representing the investor’s initial book yield for the ETF. Although the initial book yield is utilized to determine the current period effective yield, and the resulting adjustments to the ETF’s reported (systematic) value, the book yield is recalculated at least quarterly in order to adjust the investor’s book yield to reflect current cash flow projections of the current bond holdings within the ETF.

The following calculation shall be followed by reporting entities electing systematic value:

| NAV: | $115.07 (Official end-of-day NAV found on ETF provider website) |
| Maturity: | 12/8/2027 |
| Par Value: | 2,500 # shares purchased |
| Distribution: | $0.34 Found on provider website |
| Net Amortization/Accretion: | $0.06 (Monthly Effective Interest) – (Distribution) |
| Prior Month Ending Book Value: | $115.35 |
| NPV Constant Yield Method: | $117.10 = XNPV (Initial Book Yield, CASHFLOW column, CASHFLOW_DATE column) / 1000000 |
| Initial Book Yield: | 4.15% |
| Book (Systematic) Value: | $115.41 = (Prior Period Ending Book Value) + (Net “amortization/ accretion”) |
| Expense Ratio: | 0.1500% |
| Recalculated Effective Book Yield: | 4.1639% |

1. Download cash flows file from ETF provider website.

2. Insert a row in between the column headings and the cash flow data.

3. Filter for “Call Type” is WORST. (Click “Data” at the top of Excel sheet, then click “Filter” and click the new dropdown box in the “Call Type” cell and select only “WORST”).

4. Enter the date of the cash flow data file underneath cash flow date.

5. Under the column “CASHFLOW” enter the following formula in Excel: =(-Ending Book Value)\*1000000

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<th>ASOF_DATE</th>
<th>CALL_TYPE</th>
<th>CASHFLOW_DATE</th>
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<th>PRINCIPAL</th>
<th>CASHFLOW</th>
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<td>218,010.937</td>
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All formulas on the left are at a per share level (excepting “Par Value” which represents the number of shares purchased for this lot).

The resulting values calculated on the left are aggregated to reflect the total number of shares held on the previous tabs reflecting how one might populate the reporting schedule with these values.

Additionally, the cash flows in the data file are based on 1 million shares. This was done in order to make the cash flows easier to observe and work with (i.e., at a single share level, cash flows would be at fractional dollar levels). Therefore, in order to calculate the yield, investors must multiply the price of the ETF by 1 million shares and then use that value as a cash outflow against the positive cash inflows from the bond portfolio in order to calculate the IRR.
EXHIBIT C – AMORTIZATION TREATMENT FOR CALLABLE BONDS

Example 1: Call Price Less Than BACV Throughout the Life of the Bond

12/31/2008 – Issuance of Bond. Par = 100/10-Year Bond (Matures 12/31/2018)
01/01/2009 – Call Date/Call Price 107
01/01/2012 – Scheduled Call Date Subsequent to Reporting Entity Acquisition. Call Price 104
01/01/2014 – Scheduled Call Date Subsequent to Reporting Entity Acquisition. Call Price 103
01/01/2016 – Scheduled Call Date Subsequent to Reporting Entity Acquisition. Call Price 102

General Note for Examples: The reporting entity purchased the bond at a premium (cost was greater than par). The 1/1/2009 call date and price is ignored as it occurred prior to the reporting entity acquiring the bond. The bolded numbers represent the lowest asset value at each reporting period. The bond is amortized to the lowest asset value, which in this scenario is amortizing to the call dates and prices. (The standard amortization to the maturity date is shown as it should be compared to the amortization to the call date/price to verify that the BACV at any given reporting date reflects the lowest asset value.)

<table>
<thead>
<tr>
<th>Date</th>
<th>Action</th>
<th>Cost</th>
<th>Call Price</th>
<th>BACV (Under Call Date/Price)</th>
<th>Amortization to the Lowest Value</th>
<th>BACV Under Standard Amortization</th>
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</thead>
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<tr>
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<td>106</td>
<td>106</td>
<td>106</td>
<td></td>
<td>106</td>
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<tr>
<td>12/31/2011</td>
<td>Lockout Period</td>
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<td>104</td>
<td>2</td>
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<td></td>
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<td>01/01/2016</td>
<td>Call Date Exercised</td>
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</table>

**Standard Amortization**
This table shows the amortization with a purchase date of 12/15/2010 at $106 through the maturity date of 12/31/2018.

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<th>Amortization</th>
<th>BACV (Under Standard Amortization)</th>
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<td>105.25</td>
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<tr>
<td>12/31/2011</td>
<td>.75</td>
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<td>12/31/2012</td>
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<td>.75</td>
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<tr>
<td>12/31/2016</td>
<td>.75</td>
<td>100.75</td>
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<td>12/31/2017</td>
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<table>
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<th>Consideration</th>
<th>Par Value</th>
<th>BACV at Disposal Date</th>
<th>Realized Gain/Loss*</th>
</tr>
</thead>
<tbody>
<tr>
<td>01/01/2016</td>
<td>Call Exercised</td>
<td>102</td>
<td>100</td>
<td>102</td>
</tr>
</tbody>
</table>

* Per paragraph 26, the entity would recognize a $(2) loss (BACV less par), and investment income of $2 (consideration less par).
Example 2: Call Price Could be Greater Than BACV

12/31/2008 – Issuance of Bond. Par = 100/10-Year Bond (Matures 12/31/2018)
01/01/2009 – Call Date/Call Price 107
12/15/2010 – Reporting Entity Acquires Bond. Cost = 104
01/01/2012 – Scheduled Call Date Subsequent to Reporting Entity Acquisition. Call Price 106
01/01/2014 – Scheduled Call Date Subsequent to Reporting Entity Acquisition. Call Price 103
01/01/2016 – Scheduled Call Date Subsequent to Reporting Entity Acquisition. Call Price 102

The bolded numbers represent the lowest asset value:

<table>
<thead>
<tr>
<th>Date</th>
<th>Action</th>
<th>Cost</th>
<th>Call Price</th>
<th>BACV (Under Call Date / Price)</th>
<th>Amortization To the Lowest Asset Value</th>
<th>BACV Under Standard Amortization</th>
</tr>
</thead>
<tbody>
<tr>
<td>12/15/2010</td>
<td>Acquired</td>
<td>104</td>
<td>104</td>
<td>104</td>
<td>104</td>
<td></td>
</tr>
<tr>
<td>12/31/2011</td>
<td>Lockout Period</td>
<td></td>
<td>106</td>
<td>104</td>
<td>0.5</td>
<td>103.50</td>
</tr>
<tr>
<td>01/01/2012</td>
<td>Call Date</td>
<td>106</td>
<td>104</td>
<td>103.5</td>
<td>0.5</td>
<td>103.50</td>
</tr>
<tr>
<td>12/31/2012</td>
<td>Year-End Reporting</td>
<td></td>
<td>106</td>
<td>103.5</td>
<td>0.5</td>
<td>103.50</td>
</tr>
<tr>
<td>12/31/2013</td>
<td>Year-End Reporting</td>
<td></td>
<td>106</td>
<td>103</td>
<td>0.5</td>
<td>102.50</td>
</tr>
<tr>
<td>01/01/2014</td>
<td>Call Date</td>
<td>106</td>
<td>106</td>
<td>102</td>
<td>0.5</td>
<td>101.50</td>
</tr>
<tr>
<td>12/31/2015</td>
<td>Year-End Reporting</td>
<td></td>
<td>106</td>
<td>101.5</td>
<td>0.5</td>
<td>100.50</td>
</tr>
<tr>
<td>01/01/2016</td>
<td>Call Date Exercised</td>
<td>106</td>
<td>106</td>
<td>101.5</td>
<td>0.5</td>
<td>100.50</td>
</tr>
</tbody>
</table>

Standard Amortization

This table shows the amortization with a purchase date of 12/15/2010 at $104 through the maturity date of 12/31/2018.

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Amortization</td>
<td>0.50</td>
<td>0.50</td>
<td>0.50</td>
<td>0.50</td>
<td>0.50</td>
<td>0.50</td>
<td>0.50</td>
<td>0.50</td>
<td>0.50</td>
</tr>
<tr>
<td>BACV</td>
<td>103.50</td>
<td>103.50</td>
<td>103.50</td>
<td>103.50</td>
<td>103.50</td>
<td>103.50</td>
<td>103.50</td>
<td>103.50</td>
<td>103.50</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Consideration</th>
<th>Par Value</th>
<th>BACV at Disposal Date</th>
<th>Realized Gain/Loss*</th>
</tr>
</thead>
<tbody>
<tr>
<td>01/01/2016 Call Exercised</td>
<td>102</td>
<td>100</td>
<td>101.50</td>
</tr>
</tbody>
</table>

* Per paragraph 26, the entity would recognize a $(1.50) loss (BACV less par), and investment income of $2 (consideration less par).
Example 3: Call Price Could be Greater Than BACV

12/31/2008 – Issuance of Bond. Par = 100/10-Year Bond (Matures 12/31/2018)
01/01/2009 – Call Date/Call Price 107
12/15/2010 – Reporting Entity Acquires Bond. Cost = 104
01/01/2012 – Scheduled Call Date Subsequent to Reporting Entity Acquisition. Call Price 106
01/01/2014 – Scheduled Call Date Subsequent to Reporting Entity Acquisition. Call Price 102
01/01/2016 – Scheduled Call Date Subsequent to Reporting Entity Acquisition. Call Price 101

Note – This illustration shows that the evaluation of whether standard amortization (to the maturity date) or the call date price may change over the time. The bolded numbers represent the lowest asset value:

<table>
<thead>
<tr>
<th>Date</th>
<th>Action</th>
<th>Cost</th>
<th>Call Price</th>
<th>BACV (Under Call Date / Price)</th>
<th>Amortization To the Lowest Asset Value</th>
<th>BACV Under Standard Amortization</th>
</tr>
</thead>
<tbody>
<tr>
<td>12/15/2010</td>
<td>Acquired</td>
<td>104</td>
<td>104</td>
<td></td>
<td></td>
<td>104</td>
</tr>
<tr>
<td>12/31/2011</td>
<td>Lockout Period</td>
<td></td>
<td>106</td>
<td>104</td>
<td>0.5</td>
<td>103.50</td>
</tr>
<tr>
<td>01/01/2012</td>
<td>Call Date</td>
<td></td>
<td>106</td>
<td>104</td>
<td></td>
<td>103.50</td>
</tr>
<tr>
<td>12/31/2012</td>
<td>Year-End Reporting</td>
<td></td>
<td>106</td>
<td>104</td>
<td>0.5</td>
<td>103</td>
</tr>
<tr>
<td>12/31/2013</td>
<td>Year-End Reporting</td>
<td></td>
<td>102</td>
<td>104</td>
<td>1</td>
<td>102.50</td>
</tr>
<tr>
<td>01/01/2014</td>
<td>Call Date</td>
<td></td>
<td>102</td>
<td>104</td>
<td></td>
<td>102.50</td>
</tr>
<tr>
<td>12/31/2014</td>
<td>Year-End Reporting</td>
<td></td>
<td>101.5</td>
<td>104</td>
<td>0.5</td>
<td>102</td>
</tr>
<tr>
<td>12/31/2015</td>
<td>Year-End Reporting</td>
<td></td>
<td>101</td>
<td>104</td>
<td>0.5</td>
<td>101.50</td>
</tr>
<tr>
<td>01/01/2016</td>
<td>Call Date Exercised</td>
<td></td>
<td>101</td>
<td>104</td>
<td></td>
<td>101</td>
</tr>
</tbody>
</table>

**Standard Amortization**

This table shows the amortization with a purchase date of 12/15/2010 at $104 through the maturity date of 12/31/2018.

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Amortization</td>
<td>0.50</td>
<td>0.50</td>
<td>0.50</td>
<td>0.50</td>
<td>0.50</td>
<td>0.50</td>
<td>0.50</td>
<td>0.50</td>
<td>0.50</td>
</tr>
<tr>
<td>BACV</td>
<td>103.50</td>
<td>103</td>
<td>102.50</td>
<td>102</td>
<td>101.50</td>
<td>101</td>
<td>100.50</td>
<td>100</td>
<td>100</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Consideration</th>
<th>Par Value</th>
<th>BACV at Disposal Date</th>
<th>Realized Gain/Loss*</th>
</tr>
</thead>
<tbody>
<tr>
<td>01/01/2016</td>
<td>101</td>
<td>100</td>
<td>101</td>
</tr>
</tbody>
</table>

* Per paragraph 26, the entity would recognize a $(1) loss (BACV less par), and investment income of $1 (consideration less par).
Example 4: Continuously Callable Bond – Callable at Par After Initial Lockout Period

12/31/2008 – Issuance of Bond. Par = 100/10-Year Bond (Matures 12/31/2018)
01/01/2009 – Call Date / Call Price 107 – Continuously Callable Thereafter at Par
12/15/2010 – Reporting Entity Acquires Bond. Cost = 104

The bolded numbers represent the lowest asset value:

<table>
<thead>
<tr>
<th>Date</th>
<th>Action</th>
<th>Cost</th>
<th>Call Price</th>
<th>BACV (Under Call Date/Price)</th>
<th>Amortization To the Lowest Asset Value</th>
<th>BACV Under Standard Amortization</th>
</tr>
</thead>
<tbody>
<tr>
<td>12/15/2010</td>
<td>Acquired</td>
<td>104</td>
<td>100</td>
<td>100</td>
<td>4</td>
<td>104</td>
</tr>
<tr>
<td>12/31/2010</td>
<td>Year-End Reporting</td>
<td>100</td>
<td>100</td>
<td></td>
<td></td>
<td>103.50</td>
</tr>
<tr>
<td>12/31/2011</td>
<td>Year-End Reporting</td>
<td>100</td>
<td>100</td>
<td></td>
<td></td>
<td>103</td>
</tr>
<tr>
<td>12/31/2012</td>
<td>Year-End Reporting</td>
<td>100</td>
<td>100</td>
<td></td>
<td></td>
<td>103</td>
</tr>
<tr>
<td>12/31/2013</td>
<td>Year-End Reporting</td>
<td>100</td>
<td>100</td>
<td></td>
<td></td>
<td>102.50</td>
</tr>
<tr>
<td>12/31/2014</td>
<td>Year-End Reporting</td>
<td>100</td>
<td>100</td>
<td></td>
<td></td>
<td>102</td>
</tr>
<tr>
<td>12/31/2015</td>
<td>Year-End Reporting</td>
<td>100</td>
<td>100</td>
<td></td>
<td></td>
<td>101.50</td>
</tr>
<tr>
<td>01/01/2016</td>
<td>Year-End Reporting</td>
<td>100</td>
<td>100</td>
<td></td>
<td></td>
<td>101.50</td>
</tr>
</tbody>
</table>

**Standard Amortization**

This table shows the amortization with a purchase date of 12/15/2010 at $104 through the maturity date of 12/31/2018.

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Amortization</td>
<td>0.50</td>
<td>0.50</td>
<td>0.50</td>
<td>0.50</td>
<td>0.50</td>
<td>0.50</td>
<td>0.50</td>
<td>0.50</td>
</tr>
<tr>
<td>BACV</td>
<td>103.50</td>
<td>103</td>
<td>102.50</td>
<td>102</td>
<td>101.50</td>
<td>101</td>
<td>100.50</td>
<td>100</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Consideration</th>
<th>Par Value</th>
<th>BACV at Disposal Date</th>
<th>Realized Gain/Loss*</th>
</tr>
</thead>
<tbody>
<tr>
<td>01/01/2016 Call Exercised</td>
<td>100</td>
<td>100</td>
<td>0</td>
</tr>
</tbody>
</table>

* Since the call price is par and could occur immediately after acquisition, the premium is immediately expensed. When the bond is called, there is no gain or loss as the consideration received equals the BACV.
Example 5: Determination of Prepayment Penalty When Call Price is Less Than Par

<table>
<thead>
<tr>
<th>Call Price Less than Par</th>
<th>Entity 1</th>
<th>Entity 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Par</td>
<td>100</td>
<td>Par</td>
</tr>
<tr>
<td>BACV</td>
<td>24</td>
<td>BACV</td>
</tr>
<tr>
<td>Consideration</td>
<td>26</td>
<td>Consideration</td>
</tr>
<tr>
<td>Explicit fee</td>
<td>1</td>
<td>Explicit fee</td>
</tr>
<tr>
<td>Remaining consideration</td>
<td>25</td>
<td>Remaining consideration</td>
</tr>
<tr>
<td>Gain</td>
<td>2</td>
<td>Gain</td>
</tr>
<tr>
<td>Income*</td>
<td>0</td>
<td>Income**</td>
</tr>
</tbody>
</table>

*Entity 1 does not have in place a process to identify explicit prepayment penalty or acceleration fees.

**Entity 2 has in place a process to identify explicit prepayment penalty or acceleration fees.

Proposed Revisions to SSAP No. 43R

Summary of Revisions:

1. All changes exposed in November 2022 have been accepted with new edits shown as tracked. (This has been done for readability and to highlight changes from the prior exposure.)

2. Paragraph 4c: Revisions to exclude residual tranches, interests and first loss positions from the scope of SSAP No. 43R and to identify that they are captured in SSAP No. 21R. (The guidance for these to be on Schedule BA is still included in paragraph 11c, but this revision is intended to be clear that these items do not qualify for reporting as bonds.)

3. Paragraph 11c (and footnote 4): Revisions to remove reference to residual tranches and interests being captured in scope of SSAP No. 43R and to point to the accounting and admittance requirements of SSAP No. 21R.

4. Paragraph 48: Revisions to clarify that investment assessments are required as of origination and to permit current or acquisition information in determining whether investments qualify at the time of transition. This edit is also in line with industry comments.

5. Paragraph 51: Included guidance to clarify that the transition guidance shall be applied prospectively beginning with the first year of adoption (Jan. 1, 2025). For disclosures that provide comparative information, reporting entities shall not restate the prior year’s information in the 2025 disclosure. This edit is also in line with industry comments.
Statement of Statutory Accounting Principles No. 43 - Revised

Asset-Backed Securities

SCOPE OF STATEMENT

1. This statement establishes statutory accounting principles for each security investment that qualifies as an asset-backed security (ABS) under the principles-based bond definition detailed in SSAP No. 26R—Bonds. Each security shall be individually assessed under the bond definition to determine applicability as an asset-backed security and reported separately regardless of whether the security was issued in combination or as a unit with other investments. Items captured in scope of this statement are collectively referred to as asset-backed securities.

2. In addition to security investments that qualify under the principles-based definition as an asset-backed security, certain specific investments are also captured in scope of this statement:

   a. Mortgage Referenced Securities that do not meet the definition of an asset-backed security. In order to qualify as a mortgage-referenced security, the security must be issued by a government sponsored enterprise or by a special purpose trust in a transaction sponsored by a government sponsored enterprise in the form of a “credit risk transfer.” In these situations, 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 within this standard apply to mortgage-referenced securities. (P5)

   b. Freddie-Mac When Issued K-Deal (WI Trust) Certificates fully guaranteed by Freddie Mac are included in scope of this statement from original acquisition, and not initially reported as a derivative forward contract. (INT 22-01)

3. Securities captured in scope of this statement are not permitted to be reported as cash equivalents or short-term investments in scope of SSAP No. 2R—Cash, Cash Equivalents, Drafts and Short-Term Investments even if acquired within one year or less from the maturity date. Investments captured in scope of SSAP No. 2R are intended to reflect situations in which limited risk remains, either from changes in credit-quality or interest rates, due the short-duration until maturity. As ultimate cash flows from asset-backed securities may have other risks beyond default risk or interest rate risk (such as performance factors, balloon payments, collateral quality) reporting as a cash equivalent or short-term investment is not permitted to prevent inappropriate assumptions of the investment’s remaining potential risk.

4. This statement excludes:

   a. Securities captured in scope of SSAP No. 26R—Bonds.

---

1 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.
b. Mortgage loans in scope of SSAP No. 37—Mortgage Loans that qualify under an SVO structural assessment as SVO-Identified Credit Tenant Loans. These investments are excluded as these are captured as issuer credit obligations under SSAP No. 26R.

c. Securities that do not qualify as Asset-Backed Securities per the bond definition in SSAP No. 26R—Bonds. This exclusion includes residual or interests, as well as first loss positions, that do not have contractual payments or substantive credit enhancement. Debt securities that do not qualify and residual interests shall follow guidance in SSAP No. 21R—Other Admitted Assets.

SUMMARY CONCLUSION

Principles-Based Bond Definition - Asset-Backed Security

5. 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—Affiliates and Other Related Parties. 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. Asset-backed 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 an asset-backed security may be acquired from a non-related issuer, if the assets held in trust predominantly 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. An asset-backed 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 asset-backed 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.

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2 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.
Initial Reporting Value and Recognition of Origination and Commitment Fees & Costs

6. Items in scope of this statement shall initially be reported at cost, including brokerage and related fees, unless otherwise detailed in paragraph 8. Acquisitions and dispositions shall be recorded on the trade date, not the settlement date, except for the acquisition of private placement asset-backed securities which shall be recorded on the funding date. For securities where all information is not known as of the trade date (e.g., actual payment factors and specific pools), a reporting entity shall make its best estimate based on known facts. (P8)

7. For assets that qualify in scope of this statement that result from a securitization or transfer of assets by the reporting entity captured in SSAP No. 103R, the guidance in that SSAP determines the initial reporting value:

   a. For asset-backed securities resulting from transfers of participating interests that qualify as a sale, the participating interests in financial assets that continue to be held by the reporting entity transferor shall be measured and reported at the date of transfer by allocating the previous carrying amount between the participating interests transferred and sold, and the participating interests that are not transferred and continue to be held by the reporting entity, based on their relative fair values.

   b. For asset-backed securities resulting from transfers of an entire financial asset or group of entire financial assets that qualify as a sale, assets obtained, including beneficial interests, shall be initially recognized at fair value.

   c. For asset-backed securities resulting from the transfer of assets that do not qualify as sales, the reporting entity transferor shall continue to report the transferred financial assets with no change in measurement.

8. Costs related to origination when paid in the form of brokerage and other related fees shall be capitalized as part of the cost of the asset-backed security. All other costs, including internal costs or costs paid to an affiliated entity related to origination, purchase, or commitment to purchase asset-backed securities, shall be charged to expense when incurred. (P44)

9. Origination fees represent fees charged to the borrower (paid to the reporting entity) in connection with the process of originating or restructuring a transaction. The fees include, but are not limited to, points, management, arrangement, placement, application, underwriting, and other fees pursuant to such a transaction. Origination fees shall not be recorded until received in cash. Origination fees intended to compensate the reporting entity for interest rate risks (e.g., points), shall be amortized into income over the term of the asset-backed security consistent with paragraph 12 of this statement. Other origination fees shall be recorded as income upon receipt. (P43)

10. Commitment fees are fees paid to the reporting entity that obligate the reporting entity to make available funds for future borrowing under a specified condition:

    a. A fee paid to the reporting entity to obtain a commitment to make funds available at some time in the future is generally refundable only if the asset-backed security is issued. If the security is not issued, then the fees shall be recorded as investment income by the reporting entity when the commitment expires. (P45)

    b. A fee paid to the reporting entity to obtain a commitment to borrow funds at a specified rate and with specified terms quoted in the commitment agreement is generally not refundable unless the commitment is refused by the reporting entity. This type of fee shall be deferred, and amortization shall depend on whether or not the commitment is exercised. If the commitment
is exercised, then the fee shall be amortized in accordance with paragraph 12 of this statement over the life of the asset-backed security as an adjustment to the investment income on the security. If the commitment expires unexercised, the commitment fee shall be recognized in income on the commitment expiration date. (P46)

Subsequent Carrying Value Method, Amortization, Accruals and Prepayment Penalties

11. After initial recognition, the carrying value shall be determined in accordance with the reported NAIC designation. The determination of NAIC designations shall be in accordance with the requirements detailed in the Purposes and Procedures Manual of the NAIC Investment Analysis Office (P&P Manual)³:

a. For reporting entities that maintain an Asset Valuation Reserve (AVR), asset-backed securities, excluding residual tranches or interests, shall be reported at amortized cost, except for those with an NAIC designation of 6, which shall be reported at the lower of amortized cost or fair value.

b. For reporting entities that do not maintain an AVR, asset-backed securities designated highest-quality and high-quality (NAIC designations 1 and 2, respectively), excluding residual tranches or interests, shall be reported at amortized cost; loan-backed and structured securities that are designated medium quality, low quality, lowest quality and in or near default (NAIC designations 3 to 6, respectively) shall be reported at the lower of amortized cost or fair value.

c. For residual tranches or interests⁴ captured in scope of this statement, all reporting entities shall report the item on Schedule BA: Other Long-Term Invested Assets at the lower of amortized cost or fair value. Changes in the reported value from the prior period shall be recorded as unrealized gains or losses. For reporting entities that maintain an AVR, the accounting for unrealized gains and losses shall be in accordance with SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve. These items are captured in SSAP No. 21R—Other Admitted Assets and subject to admittance restrictions detailed in that statement.

12. Amortization of premium or discount shall be calculated using the scientific (constant yield) interest method and shall be recorded as an adjustment to investment income.⁵ The interest method results in a constant effective yield equal to the prevailing rate at the time of purchase or at the time of subsequent adjustments to book value. The amortization period shall reflect estimates of the period over which repayment of principal of the asset-backed securities is expected to occur, not the stated maturity period. (P9)

13. Interest shall be accrued using the effective-yield method using the redemption prices and redemption dates used for amortizing premiums and discounts. Interest income consists of interest collected during the period, the change in the due and accrued interest between the beginning and end of the period as well as reductions for premium amortization and interest paid on acquisition of asset-backed securities,

³ Paragraphs 39-40 provide guidance on the NAIC financial modeling approach applicable to certain securities in determining NAIC designations.

⁴ Reference to “residual tranches or interests” intends to capture securitization tranches and beneficial interests as well as other structures captured in scope of this statement that reflect loss layers without any contractual payments, whether principal or interest, or both. Payments to holders of these investments occur after contractual interest and principal payments have been made to other tranches or interests and are based on the remaining available funds. Although payments to holders can occur throughout an investment’s duration (and not just at maturity), such instances still reflect the residual amount permitted to be distributed after other holders have received contractual interest and principal payments.
and the addition of discount accrual. Contingent interest may be accrued if the applicable provisions of the underlying contract and the prerequisite conditions have been met. (P10)

14. An asset-backed security may provide for a prepayment penalty or acceleration fee in the event the investment is liquidated prior to its scheduled termination date. These fees shall be reported as investment income when received. (P12)

15. The amount of prepayment penalty and/or acceleration fees to be reported as investment income shall be calculated as follows: (P13)

a. The amount of investment income reported is equal to the total proceeds (consideration) received less the par value of the investment; and

b. Any difference between the book adjusted carrying value (BACV) and the par value at the time of disposal shall be reported as realized capital gains and losses subject to the authoritative literature in SSAP No. 7.

Assessment of Cash Flows and Impact of Prepayments

16. Prepayments can be a significant variable element in the cash flows received from asset-backed securities because they may affect the yield and determine the expected maturity against which the yield is evaluated. For example, with a mortgage-backed security, falling interest rates generate faster prepayment of the mortgages underlying the security, shortening its duration. This causes the reporting entity to reinvest assets sooner than expected at potentially less advantageous rates. This is called prepayment risk. Extension risk is created when rising interest rates slow repayment and can significantly lengthen the duration of the security. In addition to interest rate risk, other factors can influence the cash flows generated from an asset-backed security. These factors include, but are not limited to, defaults of the underlying payors as well as performance requirements that must occur before cash flows can be generated from the underlying assets (such as with leases or royalty rights). If the underlying assets are delinquent or otherwise not generating expected cash flows, such items should be reflected in the cash flow analysis through diminishing security cash flows. Updated cash flow assessments shall continue to occur even if the underlying assets have not been liquidated and regardless of whether an other-than-temporary loss has been recognized. (P14)

17. Changes in currently estimated cash flows, including the effect of prepayment assumptions, on all asset-backed securities shall be reviewed periodically, at least quarterly. The prepayment rates of the underlying assets shall be used to determine prepayment assumptions. Prepayment assumptions shall be applied consistently across portfolios to all asset-backed securities backed by similar collateral (similar with respect to coupon, issuer, and age of collateral). Reporting entities shall use consistent assumptions across portfolios for similar collateral within controlled affiliated groups. Since each reporting entity may have a unique method for determining the prepayment assumptions, it is impractical to set standard assumptions for the industry. Relevant sources and rationale used to determine each prepayment assumption shall be documented by the reporting entity. (P15)

18. Asset-backed securities shall be revalued using the currently estimated cash flows, including new prepayment assumptions. Reporting entities may utilize the prospective adjustment method for all asset-backed securities, or they may elect to utilize the retrospective adjustment methodology to specific asset-backed securities that are reported with NAIC designations that are of high credit quality at the time of acquisition by the reporting entity. That is, the reporting entity shall determine if it will apply the

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5 Under U.S. GAAP, application of the retrospective method for beneficial interests in securitized financial assets, which would generally encompass most asset-backed securities defined within SSAP 43R, is limited to “high quality” investments. This has been interpreted to be investments with AA or better ratings.
retrospective or prospective method at the time of acquisition depending on the NAIC designation at that
time and can only apply retrospective (as a policy election) to securities that of high credit. Subsequently,
if an investment is downgraded below high credit qualify, the reporting entity may continue to apply the
retrospective method unless the security is other-then-temporarily impaired. (P16)

19. The prospective approach recognizes, through the recalculation of the effective yield to be applied
to future periods, the effects of all cash flows whose amounts differ from those estimated earlier and the
effects and changes in projected cash flows. Under the prospective method, the recalculated effective yield
will equate the amortized cost of the investment to the present value of the anticipated future cash flows.
The recalculated yield is then used to accrue income on the investment balance for subsequent accounting
periods. There are no accounting changes in the current period unless the security is determined to be other
than temporarily impaired. (P17)

20. The retrospective methodology changes both the yield and the amortized cost so that expected
future cash flows produce a return on the investment equal to the return now expected over the life of the
investment as measured from the date of acquisition. Under the retrospective method, the recalculated
effective yield will equate the present value of the actual and anticipated cash flows with the original cost
of the investment. The current amortized cost basis for the asset-backed security is then increased or
decreased to the amount that would have resulted had the revised yield been applied since inception, and
investment income is correspondingly decreased or increased. (P18)

Accretable Yield and Changes to Effective Yield for Application of Prospective Method

21. At initial acquisition of an asset-backed security, the reporting entity shall determine the accretable
yield. The accretable yield is the excess of cash flows expected to be collected over the reporting entity’s
initial investment in the asset-backed security. The accretable yield shall be recognized as interest income
on an effective-yield basis over the life of the asset-backed security. The nonaccretable difference is the
contractually required payments in excess of the cash flows expected to be collected. The nonaccretable
difference shall not be recognized as an adjustment to yield, a loss accrual or a valuation allowance for
credit risk. For transactions initially captured in SSAP No. 103R resulting from a reporting entity’s transfer
of assets, all cash flows estimated at the transaction date are defined as the holder’s estimate of the amount
and timing of estimated future principal and interest cash flows used in determining the purchase price or
the holder’s fair value for purposes of determining a gain or loss under SSAP No. 103R. (P20 – In Part)

(FASB Glossary / ASC 325-40-35-1 & 3) (Note – Modified to be applicable to all ABS and not just those
with known credit deterioration.)

22. After the transaction date, cash flows expected to be collected are defined as the holder’s estimate
of the amount and timing of the estimated principal and interest cash flows based on the holder’s best
estimate of current considerations and reasonable and supportable forecasts. Expected cash flows are re-
evaluated each quarter to determine if there has been a favorable (or an adverse) change in cash flows versus
the previous estimate.

23. If upon evaluation there is a favorable (or an adverse) change in cash flows expected to be collected
from the cash flows previously projected, the reporting entity shall recalculate the amount of accretable
yield for the asset-backed security on the date of evaluation as the excess of cash flows expected to be
collected over the asset-backed security’s current amortized cost. The amortized cost is equal to the initial
investment minus cash received to date, minus write-offs of the amortized cost basis (e.g., recognized other
than temporary impairments) plus the yield accreted to date. If the security is in an impaired state (meaning,

6 An asset-backed security may be acquired at a discount because of a change in credit quality or rate or both. When a security is
acquired at a discount that relates, at least in part, to the security’s credit quality, the effective interest rate is the discount rate that
equates the present value of the investor’s estimate of the security’s future cash flows with the purchase price of the security.
fair value is less than amortized cost, regardless if an unrealized loss has been recognized because the security is reported at amortized cost) and there is an adverse change in cash flows expected to be collected, an other-than-temporary impairment shall be considered to have occurred as described in paragraph 30 and requires recognition of a realized loss pursuant to paragraph 35. However, an adverse change in cash flows due solely to changes in the interest rate of a “plain-vanilla”, variable-rate asset-backed security generally shall not result in the recognition of an other-than-temporary impairment (a plain-vanilla, variable-rate asset-backed investment does not include those variable-rate investments with interest rate reset formulas that involve either leverage or an inverse floater). (ASC 325-40-35-4, 4A and 4B)

24. A favorable (or an adverse) change in cash flows expected to be collected is considered in the context of both timing and amount of the cash flows expected to be collected. Based on cash flows expected to be collected, interest income may be recognized on an asset-backed security even if the net investment in the asset-backed security is accreted to an amount greater than the amount at which the asset-backed security could be settled if prepaid immediately in its entirety. The adjustment shall be accounted for prospectively as a change in estimate in conformity with SSAP No. 3, with the amount of periodic accretion adjusted over the remaining life of the asset-backed security.

25. Determining whether there has been a favorable (or an adverse) change in cash flows expected to be collected involves comparing the present value of the remaining cash flows expected to be collected at the initial transaction date (or at the last date previously revised) against the present value of the cash flows expected to be collected at the current financial reporting date. Both the current and previous sets of cash flows shall be discounted at a rate equal to the current yield used to accrete the asset-backed security. (ASC 325-40-35-5 & 6.)

Recognition of Realized and Unrealized Gains and Losses and Impairment Guidance

26. Asset-backed securities required to be reported at the lower of amortized cost or fair value shall report changes from the prior reporting period as unrealized gains or losses unless an other-than-temporary impairment has occurred. For reporting entities required to maintain an AVR, the accounting for unrealized gains and losses shall be reported through the AVR. For reporting entities not required to maintain an AVR, unrealized gains and losses shall be recorded as a direct credit or charge to unassigned funds (surplus). (P29)

27. Assessment of an other-than-temporary impairment is required for all asset-backed securities when fair value is less than the amortized cost basis. The amortized cost basis includes adjustments made to the cost of an investment for accretion, amortization, collection of cash, and previous other-than-temporary impairments recognized as a realized loss. Reporting a security at the lower of amortized cost or fair value is not a substitute for other-than-temporary impairment recognition. For securities reported at fair value where an other-than-temporary impairment has been determined, the loss recognized reflects the realization of unrealized losses previously recorded from fluctuations in fair value. (The extent to which unrealized losses are realized depends on whether the other-than-temporary impairment is considered a full impairment or a bifurcated impairment pursuant to paragraphs 34 and 35.) After the recognition of an other-than-temporary impairment, securities reported at the lower of amortized cost or fair value shall continue to report unrealized gains and losses from fluctuations in fair value. (P31 & 30)

28. If an entity intends to sell the asset-backed security (that is, it has decided to sell the security), an other-than-temporary impairment shall be considered to have occurred. (P32)
29. If an entity does not intend to sell the asset-backed security, the entity shall assess whether it has the intent and ability\(^7\) to retain the investment in the security for a period of time sufficient to recover the amortized cost basis. If the entity does not have the intent and ability to retain the investment for the time sufficient to recover the amortized cost basis, an other-than-temporary impairment shall be considered to have occurred. (P33)

30. If the entity does not expect to recover the entire amortized cost basis of the security, the entity would be unable to assert that it will recover its amortized cost basis even if it does not intend to sell the security and the entity has the intent and ability to hold. (This includes situations in which an entity has an adverse change in cash flows expected to be collected for a security that is an impaired position (meaning, fair value is less than amortized cost, regardless of if an unrealized loss has been recognized.) In such situations, an other-than-temporary impairment shall be considered to have occurred. (For mortgage-referenced securities, an OTTI is considered to have occurred when there has been a delinquency or other credit event in the referenced pool of mortgages such that the entity does not expect to recover the entire amortized cost basis of the security.) In assessing whether the entire amortized cost basis of the security will be recovered, an entity shall compare the present value of cash flows expected to be collected from the security with the amortized cost basis of the security. If present value of cash flows expected to be collected is less than the amortized cost basis of the security, the entire amortized cost basis of the security will not be recovered, and an other-than-temporary impairment shall be considered to have occurred. A decrease in the present value of cashflows expected to be collected on an asset-backed security that results from an increase or decrease in expected prepayments on the underlying assets shall be considered in the estimate of the present value of cashflows expected to be collected. (P34)

31. In determining whether an other-than-temporary impairment has occurred, an entity shall calculate the present value of cash flows expected to be collected based on an estimate of the expected future cash flows of the impaired asset-backed security, discounted at the security’s effective interest rate. For securities in which there was no nonaccretable yield and for which there has been no changes to estimated cash flows since acquisition, the effective interest rate is the rate of return implicit in the security (that is, the contractual interest rate adjusted for any net deferred fees or costs, premium, or discount existing at the origination or acquisition of the security).\(^8\) For all other securities, the effective interest rate is the rate implicit immediately prior to the recognition of the other-than-temporary impairment. (Meaning, the effective interest rate as adjusted to reflect the last revised assessment of expected cash flows.) (P35)

32. It is inappropriate to automatically conclude that a security is not other-than-temporarily impaired because all of the scheduled payments to date have been received. However, it also is inappropriate to automatically conclude that every decline in fair value represents an other-than-temporary impairment. Further analysis and judgment are required to assess whether a decline in fair value indicates that it is probable that the holder will not collect all of the contractual or estimated cash flows from the security. In addition, the length of time and extent to which the fair value has been less than cost can indicate a decline is other than temporary. The longer and/or the more severe the decline in fair value, the more persuasive the evidence that is needed to overcome the premise that it is probable that the holder will not collect all of the contractual or estimated cash flows from the issuer of the security. (P41, ASC 325-40-35-10A)

33. In making its other-than-temporary impairment assessment, the holder shall consider all available information relevant to the collectibility of the security, including information about past events, current conditions, and reasonable and supportable forecasts, when developing the estimate of future cash flows. Such information generally shall include the remaining payment terms of the security, prepayment speeds,

\(^7\) This assessment shall be considered a high standard due to the accounting measurement method established for the securities within the scope of this statement (amortized cost).

\(^8\) See Footnote 1.
the financial condition of the issuer(s), expected defaults, and the value of any underlying collateral. To achieve that objective, the holder shall consider, for example, industry analyst reports and forecasts, sector credit ratings, and other market data that are relevant to the collectibility of the security. The holder also shall consider how other credit enhancements affect the expected performance of the security, including consideration of the current financial condition of the guarantor of a security (if the guarantee is not a separate contract) and/or whether any subordinated interests are capable of absorbing estimated losses on the loans underlying the security. The remaining payment terms of the security could be significantly different from the payment terms in prior periods (such as for some securities backed by “nontraditional loans”). Thus, the holder shall consider whether a security backed by currently performing loans will continue to perform when required payments increase in the future (including “balloon” payments). The holder also shall consider how the value of any collateral would affect the expected performance of the security. If the fair value of the collateral has declined, the holder needs to assess the effect of that decline on the ability of the holder to collect the balloon payment. (P42)

34. When an other-than-temporary impairment has occurred because the entity intends to sell the security or has assessed that they do not have the intent and ability to retain the investments in the security for a period of time sufficient to recover the amortized cost basis, the amount of the other-than-temporary impairment recognized in earnings as a realized loss shall equal the entire difference between the investment’s amortized cost basis and its fair value at the balance sheet date (full impairment). For asset-backed securities held at lower of amortized cost or fair value, upon recognition of an other-than-temporary impairment, all unrealized losses would be considered realized and the current fair value becomes the new cost basis. (P36)

35. When an other-than-temporary impairment has occurred because the entity does not expect to recover the entire amortized cost basis of the security even if the entity has no intent to sell and the entity has the intent and ability to hold, the amount of the other-than-temporary impairment recognized as a realized loss shall equal the difference between the investment’s amortized cost basis and the present value of cash flows expected to be collected, discounted at the security’s effective interest rate in accordance with paragraph 31 (bifurcated impairment). For asset-backed securities held at lower of cost or fair value, unrealized losses would be realized for the non-interest related decline. Hence, unrealized losses could continue to be reflected for these securities based on the difference between the current fair value and the present value of cash flows expected to be collected. (After recognizing an OTTI in these situations, the present value of cash flows expected to be collected becomes the new cost basis of the security.) (P37)

36. For reporting entities required to maintain an AVR or IMR, all unrealized gains and losses shall be reported through the AVR. For realized gains and losses, an analysis is required on whether the realized loss reflects an interest or non-interest related decline. The analysis required is the same regardless whether a realized loss results from an impairment write-down or whether there was a gain or loss upon sale. Guidance on specific scenarios resulting in realized gains and losses are as follows (P38):

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9 A nontraditional loan may have features such as (a) terms that permit principal payment deferral or payments smaller than interest accruals (negative amortization), (b) a high loan-to-value ratio, (c) multiple loans on the same collateral that when combined result in a high loan-to-value ratio, (d) option adjustable-rate mortgages (option ARMs) or similar products that may expose the borrower to future increases in repayments in excess of increases that result solely from increases in the market interest rate (for example, once negative amortization results in the loan reaching a maximum principal accrual limit), (e) an initial interest rate that is below the market interest rate for the initial period of the loan term and that may increase significantly when that period ends, and (f) interest-only loans that should be considered in developing an estimate of future cash flows.

10 Pursuant to INT 06-07, the term interest-related includes a declining value due to both increases in the risk free interest rate and general credit spread widening. Credit spreads can widen or contract for a variety of reasons, including supply/demand imbalances in the marketplace or the perceived higher/lower risk of an entire sector. If the declining value is caused, in whole or in part, due to credit spreads widening, but not due to fundamental credit problems of the issuer, the change in credit spreads is deemed to be interest-related.
a. Unrealized Gains and Losses – Record all unrealized gains and losses through AVR. At the time an unrealized gain or loss is realized, allocation between AVR or IMR will depend on the analysis and bifurcation between interest or non-interest related declines. Unrealized gains or losses that are realized shall be reversed from AVR before the recognition of the realized gain or loss within AVR and IMR.

b. Other-Than-Temporary Impairment – Non-interest related other-than-temporary impairment losses shall be recorded through the AVR and interest-related OTTI losses shall be recorded through the IMR. If the reporting entity wrote the security down to fair value due to the intent to sell or because the entity does not have the intent and ability to retain the investment for a period of time sufficient to recover the amortized cost basis, the entity shall bifurcate the realized loss between non-interest related (AVR) and interest related (IMR). The analysis for bifurcating impairment losses between AVR and IMR shall be completed as of the date when the other-than-temporary impairment is determined. Entities that recognized an OTTI based on the difference between amortized cost and the present value of expected cash flows shall recognize the full realized loss through AVR.

c. Security Sold at a Loss Without Prior OTTI – An entity shall bifurcate the loss into AVR and IMR portions depending on interest and non-interest related declines in accordance with the analysis performed as of the date of sale.

d. Security Sold at a Loss With Prior OTTI – An entity shall bifurcate the current realized loss into AVR and IMR portions depending on interest and non-interest related declines in accordance with the analysis performed as of the date of sale. An entity shall not adjust previous allocations to AVR and IMR that resulted from previous recognition of other-than-temporary impairments.

e. Security Sold at a Gain With Prior OTTI – An entity shall bifurcate the gain into AVR and IMR portions depending on interest and non-interest factors in accordance with the analysis performed as of the date of sale. The bifurcation between AVR and IMR that occurs as of the date of sale may be different from the AVR and IMR allocation that occurred at the time of previous other-than-temporary impairments. An entity shall not adjust previous allocations to AVR and IMR that resulted from previous recognition of other-than-temporary impairments.

f. Security Sold at a Gain Without Prior OTTI – An entity shall bifurcate the gain into AVR and IMR portions depending on interest and non-interest factors in accordance with the analysis performed as of the date of sale.

37. This statement does not permit reversals of recognized other-than-temporary impairments based on subsequent recoveries of fair value. If there are subsequent changes to the cash flows expected to be collected, the prospective adjustment method shall be used to adjust the effective yield in future periods to reflect those changes. (P39)

38. In periods subsequent to the recognition of an other than temporary impairment loss for an asset-backed security, the reporting entity shall account for the other-than-temporarily impaired security as if the security had been purchased on the measurement date of the other-than-temporary impairment at an amortized cost basis equal to the previous amortized cost basis less the other-than-temporary impairment recognized as a realized loss. The difference between the new amortized cost basis and the cash flows expected to be collected shall be accreted as interest income. A reporting entity shall continue to estimate the present value of cash flows expected to be collected over the life of the asset-backed security. (P40)
Designation Guidance

39. For RMBS/CMBS securities within the scope of this statement, the initial NAIC designation used to determine the carrying value method and the final NAIC designation for reporting purposes is determined using a multi-step process or the NAIC designation assigned by the NAIC Securities Valuation Office. The P&P Manual provides detailed guidance. A general description of the processes is as follows:

a. Financial Modeling: Pursuant to the P&P Manual, the NAIC identifies select securities where financial modeling must be used to determine the NAIC designation. For a modeled legacy security, meaning one which closed prior to January 1, 2013, the NAIC designation is based on financial modeling incorporating the insurers’ carrying value. For a modeled non-legacy security, meaning one which closed after December 31, 2012, the NAIC designation and NAIC designation category assigned by the NAIC Securities Valuation Office must be used. For those legacy securities that are financially modeled, the insurer must use NAIC CUSIP specific modeled breakpoints provided by the modelers in determining initial and final designation for these identified securities. As specified in the P&P Manual, a modeled legacy security RMBS or CMBS tranche that has no expected loss, as compiled and published by the NAIC Securities Valuation Office, under any of the selected modeling scenarios would be assigned an NAIC 1 designation and NAIC 1.A designation category regardless of the insurer’s book/adjusted carrying value. The three-step process for modeled legacy securities is as follows:

i. Step 1: Determine Initial Designation – The current amortized cost (divided by remaining par amount) of an asset-backed security is compared to the modeled breakpoint values assigned to each NAIC designation and NAIC designation category for each CUSIP to establish the initial NAIC designation.

ii. Step 2: Determine Carrying Value Method – The carrying value method, either the amortized cost method or the lower of amortized cost or fair value method, is then determined as described in paragraph 11 based upon the initial NAIC designation from Step 1.

iii. Step 3: Determine Final Designation – The final NAIC designation is determined by comparing the carrying value (divided by remaining par amount) of a security (based on paragraph 39.a.ii.) to the NAIC CUSIP specific modeled breakpoint values assigned to the NAIC designation and NAIC designation category for each CUSIP or is mapped to an NAIC designation category, according to the instructions in the P&P Manual. This final NAIC designation shall be applicable for statutory accounting and reporting purposes and the NAIC designation category will be used for investment schedule reporting and establishing RBC and AVR charges. The final NAIC designation is not used for establishing the appropriate carrying value method in Step 2 (paragraph 39.a.ii.).

b. All Other Asset-Backed Securities: For securities not subject to paragraph 39.a. (financial modeling) follow the established designation procedures according to the appropriate section of the P&P Manual. The NAIC designation shall be applicable for statutory accounting and reporting purposes (including determining the carrying value method and establishing the AVR charges). The carrying value method is established as described in paragraph 11.

40. For securities that will be financially modeled under paragraph 39, the guidance in this paragraph shall be applied in determining the reporting method for such securities acquired in the current year for quarterly financial statements. Securities reported as of the prior-year end shall continue to be reported...
under the prior-year end methodology for the current-year quarterly financial statements. For year-end reporting, securities shall be reported in accordance with paragraph 39, regardless of the quarterly methodology used. (P28)

- Reporting entities that acquired the entire financial modeling database for the prior-year end are required to follow the financial modeling methodology (paragraph 39.a.) for all securities acquired in the subsequent year that were included in the financial modeling data acquired for the prior year-end.

- Reporting entities that acquired identical securities (identical CUSIP) to those held and financially modeled for the prior year-end are required to follow the prior year-end financial modeling methodology (paragraph 39.a.) for these securities acquired subsequent to year-end.

- Reporting entities that do not acquire the prior-year financial modeling information for current-year acquired individual CUSIPS, and are not captured within paragraphs 39.a. or 39.b., are required to follow the analytical procedures for non-financially modeled securities (paragraph 39.b. as appropriate). Reporting entities that do acquire the individual CUSIP information from the prior-year financial modeling database shall use that information for interim reporting.

- Reporting entities that acquire securities not previously modeled at the prior year-end are required to follow the analytical procedures for non-financially modeled securities (paragraph 39.b. as appropriate).

**Giantization/Megatization of FHLMC or FNMA Mortgage-Backed Securities**

41. Giantization/megatization of mortgage-backed securities is defined as existing pools of FHLMC or FNMA mortgage-backed securities (MBS) with like coupon and prefix which are repooled together by the issuing agency creating a new larger security. The new Fannie Mae “Mega” or Freddie Mac “Giant” is a guaranteed MBS pass-through representing an undivided interest in the underlying pools of loans. (P47)

42. Repooled FHLMC and FNMA securities meet the definition of substantially the same as defined in SSAP No. 103R—Transfers and Servicing of Financial Assets and Extinguishments of Liabilities. The transaction shall not be considered a sale/purchase and no gain or loss shall be recognized. To properly document the repooling, the transaction shall be reported through Schedule D of the annual statement as a disposition and an acquisition. (P48)

43. Transaction fees charged by the issuing agencies shall be capitalized and amortized over the life of the repooled security. (P49)

**Disclosures**

44. In addition to the disclosures required for invested assets in general, the following disclosures regarding asset-backed securities shall be made in the financial statements. Regardless of the allowances within paragraph 63 of the Preamble, the disclosures in paragraph 44.f., 44.g. and 44.h. of this statement are required in separate, distinct notes to the financial statements:

- Fair values in accordance with SSAP No. 100R—Fair Value.
- Concentrations of credit risk in accordance with SSAP No. 27;
- Basis at which the asset-backed securities are stated;
d. The adjustment methodology used for each type of security (prospective or retrospective);

e. Descriptions of sources used to determine prepayment assumptions.

f. All securities within the scope of this statement with a recognized other-than-temporary impairment, disclosed in the aggregate, classified on the basis for the other-than-temporary impairment: (1) intent to sell, (2) inability or lack of intent to retain the investment in the security for a period of time sufficient to recover the amortized cost basis, or (3) present value of cash flows expected to be collected is less than the amortized cost basis of the security.

g. For each security with an other-than-temporary impairment, recognized in the current reporting period by the reporting entity, as the present value of cash flows expected to be collected is less than the amortized cost basis of the securities:

i. The amortized cost basis, prior to any current-period other-than-temporary impairment.

ii. The other-than-temporary impairment recognized in earnings as a realized loss.

iii. The fair value of the security.

iv. The amortized cost basis after the current-period other-than-temporary impairment.

h. All impaired securities (fair value is less than cost or amortized cost) for which an other-than-temporary impairment has not been recognized in earnings as a realized loss (including securities with a recognized other-than-temporary impairment for non-interest related declines when a non-recognized interest related impairment remains):

i. The aggregate amount of unrealized losses (that is, the amount by which cost or amortized cost exceeds fair value) and

ii. The aggregate related fair value of securities with unrealized losses.

i. The disclosures in (i) and (ii) above should be segregated by those securities that have been in a continuous unrealized loss position for less than 12 months and those that have been in a continuous unrealized loss position for 12 months or longer using fair values determined in accordance with SSAP No. 100R.

j. Additional information should be included describing the general categories of information that the investor considered in reaching the conclusion that the impairments are not other-than-temporary.

k. When it is not practicable to estimate fair value, the investor should disclose the following additional information, if applicable:

i. The aggregate carrying value of the investments not evaluated for impairment, and

ii. The circumstances that may have a significant adverse effect on the fair value.

l. For securities sold, redeemed or otherwise disposed as a result of a callable feature (including make whole call provisions), disclose the number of CUSIPs sold, disposed or
otherwise redeemed and the aggregate amount of investment income generated as a result of a prepayment penalty and/or acceleration fee.

45. Refer to the Preamble for further discussion regarding disclosure requirements. All disclosures within this statement, except disclosures included in paragraphs 44.b., 44.k. and 44.m., shall be included within the interim and annual statutory financial statements. Disclosure requirements in paragraphs 44.b., 44.k. and 44.m. are required in the annual audited statutory financial statements only.

Relevant Literature

46. This statement reflects specific statutory accounting guidance for assets that qualify as asset-backed securities under the statutory accounting principles-based bond definition. The classification of investments as ‘bonds’ for statutory accounting and reporting purposes differs from the U.S. GAAP determination of a “debt instrument” and this statement reflects statutory specific measurement and impairment guidance for investments captured in scope. This statement does incorporate limited U.S. GAAP concepts, particularly with the determination of accretable yield and consideration of changes in expected cash flows using the retrospective or prospective method. However, due to the statutory accounting specifications on scope, measurement method and impairment, no U.S. GAAP standards are considered adopted within this statement. Concepts that converge with U.S. GAAP are limited to the extent they are detailed in this statement.

Note – With adoption, U.S. GAAP standards previously adopted in SSAP No. 43R will be identified as rejected for statutory accounting. With the issuance of this standard, all relevant literature guidance will be removed. This information can be detailed in the issue paper for historical tracking purposes.

Effective Date and Transition

47. This statement is effective for years beginning January 1, 2025. The revisions to this statement, and SSAP No. 26R—Bonds, incorporate principal concepts on what should be reported as a long-term bond. Securities that qualify as issuer credit obligations within the principal concepts are captured within scope of SSAP No. 26R. Securities that qualify as asset-backed securities within the principal concepts are captured within scope of SSAP No. 43R. Securities that do not qualify as issuer credit obligations or ABS, unless specifically permitted in scope of these statements, are not permitted to be reported as a bond.

48. At the time of transition, reporting entities shall make their best efforts to assess investments to determine whether they qualify within the bond definition for reporting as issuer credit obligations on Schedule D-1:1 or asset-backed securities on Schedule D-1-2. The bond definition requires assessments at the time of acquisition (as of the origination date), and it is recognized that reporting entities may not have the means to complete historical assessments for securities held at the time of transition. For these instances, if information is not readily available for reporting entities to assess a security as of the date at acquisition, reporting entities may utilize current or acquisition information in concluding that a security qualifies for reporting as a bond as either an issuer obligation or asset-backed security.

49. Investments that were reported as a bond on Schedule D-1: Long-Term Bonds as of December 31, 2024 that do not qualify under the principle-based bond concepts shall be reported as a disposal from that schedule, with a reacquisition on the appropriate reporting schedule as of January 1, 2025. These investments shall be accounted for in accordance with the resulting SSAP that addresses the specific investment structure. For securities that are reported at the lower of amortized cost or fair value under the new applicable guidance, this could result with an unrealized loss in the measurement of the investment at the time of the reclassification. Although the adoption of this guidance is considered a change in accounting
principle under SSAP No. 3, the following transition guidance shall be applied on January 1, 2025, to ensure consistency in reporting and to allow investment schedules to roll appropriately:

a. Securities reclassified from Schedule D-1 as they no longer qualify under the bond definition shall be reported as a disposal from Schedule D-1 at amortized cost. Although no proceeds are received, amortized cost at the time of disposal shall be reported as consideration on Schedule D-4.

i. For securities held at amortized cost at the time of disposal, book adjusted carrying value and amortized cost shall agree, preventing gain or loss recognition at the time of reclassification.

ii. For securities held at fair value under the lower of amortized cost or fair value measurement method, previously reported unrealized losses shall be reversed on Jan. 1, 2025, prior to disposal, resulting with a reported value that mirrors amortized cost at the time of disposal. This action prevents realized loss recognition at time of reclassification.

b. Securities reclassified from Schedule D-1 shall be recognized on the subsequent schedule (e.g., Schedule BA) with an actual cost that agrees to the disposal value (amortized cost). Immediately subsequent to recognition on the resulting schedule, the securities shall be reported in accordance with the measurement method prescribed by the applicable SSAP:

i. For securities previously reported at fair value on Schedule D-1 (under a lower of amortized cost or fair value measurement method), the reporting entity will recognize an unrealized loss to match the previously reported book adjusted carrying value. Subsequently, the security will continue to reflect a lower of amortized cost or fair value measurement method.

ii. For securities previously reported at amortized cost on Schedule D-1, if the subsequent statement requires a lower of amortized cost or fair value measurement method, then the reporting entity shall recognize an unrealized loss to the extent fair value is less than amortized cost.

iii. After application of paragraph 49b.i and 49b.ii all securities shall reflect either the same reported value as of December 31, 2024 (amortized cost or fair value) or a lower reported value (if the security is subject to the lower of amortized cost or fair value measurement method). There should be no instances that result with a security having a greater reported value than what was presented on December 31, 2024. Subsequent to transition, securities reported at fair value may incur unrealized gains or losses due to fair value fluctuations, but should never have unrealized gains that result with a book adjusted carrying value that exceeds amortized cost.

50. With this transition guidance, changes in measurement for securities reclassified under the bond definition will be reported as a change in unrealized capital gains (losses) in the first quarter 2025 financial statements (unless sold in the interim with a realized gain or loss) and not as a change in accounting principle. To enable regulators the ability to identify the impact of securities reclassified under the bond definition, the following disclosure for the 2025 first quarter financial statement is required:

b. Aggregate book adjusted carrying value after transition for all securities reclassified off Schedule D-1 that resulted with a change in measurement basis. (This shall be a subset of paragraph 50a and captures the securities that moved from an amortized cost to a fair value measurement method under the lower of amortized cost or fair value approach.)

c. Aggregate surplus impact for securities reclassified off Schedule D-1. This shall include the difference between book adjusted carrying value as of December 31, 2024 and book adjusted carrying value after transition for those securities that moved from an amortized cost to a fair value measurement method under the lower of amortized cost or fair value approach.

51. Asset-backed securities that were previously reported as short-term (Schedule DA) or as a cash equivalent (Schedule E2) shall be reclassified to be reported on Schedule D-1-2 on Jan. 1, 2025. Similar to the process detailed in paragraph 49, the securities shall be removed from DA and E2 at amortized cost, with reversal of any unrealized loss prior to the reclassification. The amortized cost shall be reported as ‘consideration received on disposals’ on Schedule DA – Verification Between Years or Schedule E-2 – Verification Between Years, as applicable based on the prior reporting location. The security shall be recognized as an ABS acquired on Schedule D-3 at amortized cost. Immediately after initial recognition, if the security was required to be held at fair value, under the lower of amortized cost or fair value measurement method, the reporting entity shall recognize an unrealized loss.

51.52. For clarification purposes, the transition guidance shall be applied prospectively beginning with the first year of adoption (Jan. 1, 2025). For disclosures that provide comparative information, reporting entities shall not restate the prior year’s information in the 2025 disclosure.

REFERENCES

Other

- *Purposes and Procedures Manual of the NAIC Investment Analysis Office*
- NAIC Valuation of Securities product prepared by the Securities Valuation Office

Relevant Issue Papers

- *Issue Paper No. XX—Principles Based Bond Definition*
EXHIBIT A – QUESTION AND ANSWER IMPLEMENTATION GUIDE

This exhibit addresses common questions regarding the valuation and impairment guidance detailed in SSAP No. 43R.

Index to Questions

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Questions 8-10 are specific to securities subject to the financial modeling process. (This process is limited to qualifying RMBS/CMBS securities reviewed by the NAIC Structured Securities Group.) The guidance in questions 8-10 shall not be inferred to other securities in scope of SSAP No. 43R.

| 8   | Do ABS purchased in different lots result in a different NAIC designation for the same CUSIP? Can reporting entities use a weighted average method determined on a legal entity basis? |
| 9   | The NAIC Designation process for ABS may incorporate loss expectations that differ from the reporting entity’s expectations related to OTTI conclusions. Should the reporting entities be required to incorporate recovery values obtained from data provided by the service provider used for the NAIC Designation process for impairment analysis as required by SSAP No. 43R? |
Questions 8-10 are specific to securities subject to the financial modeling process. (This process is limited to qualifying RMBS/CMBS securities reviewed by the NAIC Structured Securities Group.) The guidance in questions 8-10 shall not be inferred to other securities in scope of SSAP No. 43R.

1. **Question** - Are reporting entities permitted to establish an accounting policy to write down a SSAP No. 43R other-than-temporarily impaired security, for which a “non-interest” related decline exists, to fair-value regardless of whether the reporting entity intends to sell, or has the intent and ability to hold?

   1.1 Pursuant to the guidance in SSAP No. 43R, optionality is not permitted. As such, an accounting policy that differs from SSAP No. 43R would be considered a departure from statutory accounting principles as prescribed by the NAIC Accounting Practices and Procedures Manual.

2. **Question** – Can a reporting entity avoid completing a cash-flow assessment or testing for a specific other-than-temporarily impaired security when the entity believes there is a clear cash-flow shortage (i.e., non-interest related impairment) and elect to recognize a full impairment for the SSAP No. 43R security (no impairment bifurcation), with fair value becoming the new amortized cost basis, and recognition of the full other-than-temporary impairment as a realized loss?

   2.1 Under the basis of SSAP No. 43R, an entity is not permitted to elect a write-down to fair value in lieu of assessing cash flows and bifurcating “interest” and “non-interest” impairment components. As noted in paragraph 30, if the entity does not have the intent to sell, and has the intent and ability to hold, but does not expect to recover the entire amortized cost basis of the security, the entity shall compare the present value of cash flows expected to be collected with the amortized cost basis of the security. If present value of cash flows expected to be collected is less than the amortized cost basis of the security, the entire amortized cost basis of the security will not be recovered (a non-interest decline exists) and an other-than-temporary impairment shall be considered to have occurred. Pursuant to paragraph 34, when an other-than-temporary impairment has occurred because the entity does not expect to recover the entire amortized cost basis of the security even if the entity has no intent to sell and the entity has the intent and ability to hold, the amount of the other-than-temporary impairment recognized as a realized loss shall equal the difference between the investment’s amortized cost basis and the present value of cash flows expected to be collected, discounted at the asset-backed security’s effective interest rate.

   2.2 If the entity does not want to assess cash flows of an impaired security (fair value is less than amortized cost), the entity can designate the security as one the entity intends to sell, or one that the entity does not have the intent and ability to hold, providing it is reflective of the true intent and assessment of the ability of the entity. Once an impaired security has this designation, pursuant to paragraphs 28 or 29, an other-than-temporary impairment shall be considered to have occurred. As detailed in paragraph 34, the amount of the other-than-temporary impairment recognized in earnings as a realized loss shall equal the entire difference between the investment’s amortized cost basis and its fair value at the balance sheet date.
2.3 As addressed in question 3 of this Question and Answer Guide, reporting entities are not permitted to change assertions regarding their intent to sell or their lack of intent and ability to hold. Once the security has been identified as one the entity intends to sell, or as a security that the entity does not have the intent and ability to hold, that assertion shall not change as long as the entity continues to hold the security.

3. **Question** - Can reporting entities change their “intend to sell” or “unable to hold” assertions and recover previously recognized other-than-temporary impairments?

3.1 No, a reporting entity is not permitted to change assertions and reverse previously recognized SSAP No. 43R other-than-temporary impairments. Although an entity may elect to hold a security due to a favorable change in the security’s fair value, once the security has been identified as one the entity intends to sell, or as a security that the entity does not have the intent and ability to hold for purposes of initially recognizing an other-than-temporary impairment, that assertion shall not change as long as the entity continues to hold the security.

3.2 Reporting entities that have recognized an other-than-temporary impairment on a SSAP No. 43R security in a manner corresponding with an assertion on the intent to sell or the lack of the intent and ability to hold, for which a subsequent other-than-temporary impairment has been identified, shall recognize a realized loss for the difference between the current amortized cost (reflecting the previously recognized SSAP No. 43R other-than-temporary impairment) and the fair value at the balance sheet date of the subsequent impairment. Thus, bifurcation of impairment between interest and non-interest related declines is not permitted for securities in which an other-than-temporary impairment was previously recognized on the basis that the reporting entity had the intent to sell, or lacked the intent and ability to hold, regardless if the entity has subsequently decided to hold the security.

3.3 Reporting entities shall reclassify a security as one for which there is an intent to sell, or for which there is not an intent or ability to hold, regardless if a bifurcated other-than-temporary impairment had previously been recognized, as soon as the entity realizes that they can no longer support a previous assertion to hold the security. In making such reclassifications, if the security is impaired, the difference between the amortized cost (reflecting the initial non-interest other-than-temporary impairment recognized) and fair value at the balance sheet date of the reclassification shall be recognized as a realized loss, with fair value reflecting the new amortized cost basis. Once such a reclassification occurs, and the security is classified as one for which there is an intent to sell, or for which there is not an intent and ability to hold, the security must continue to carry that assertion until it is no longer held by the reporting entity.

4. **Question** – How do the regulators intend the phrase “intent and ability to hold” as used within SSAP No. 43R to be interpreted?

4.1 SSAP No. 43R paragraph 29 states in part “…the entity shall assess whether it has the intent and ability to retain the investment in the security for a period of time sufficient to recover the amortized cost basis. If the entity does not have the intent and ability to retain the investment for the time sufficient to recover the amortized cost basis, an other-than-temporary impairment shall be considered to have occurred.”

4.2 The intent of this language within SSAP No. 43R is focused on ensuring that, as of the balance sheet date, after considering the entity’s own cash or working capital requirements and contractual or regulatory obligations and all known facts and circumstances related to
the impaired security, the entity does not have the intention of selling the impaired security and has the current intent and ability to hold the security to recovery. Due to impairment bifurcation provisions provided within SSAP No. 43R, and the amortized cost measurement method generally permitted for asset-backed securities, the assessment of “intent and ability” is intended to be a high standard. Despite the intent of paragraph 29, it is identified that information not known to the entity may become known in subsequent periods and/or facts and circumstances related to an individual holding or group of holdings may change thereby influencing the entity’s subsequent determination of intent and ability with respect to a security or securities.

4.3 If a reporting entity asserts that it has the intent and ability to hold a security, or group of securities, until recovery of the amortized cost, but sells or otherwise disposes the security or securities prior to such recovery, the reporting entity shall be prepared to justify this departure from their original assertion to examiners and auditors. SSAP No. 43R purposely does not identify specific circumstances in which a change in assertion would be justifiable, but requires judgment from management, examiners and auditors on whether future assertions warrant closer review.

4.4 Delaying recognition of other-than-temporary impairments is a cause of serious concern by the regulators, and entities that habitually delay such recognition through false assertions on the “intent and ability to hold” may face increased scrutiny and regulatory action by their domiciliary state. It is imperative that a reporting entity recognize the full other-than-temporary impairment as soon as the entity realizes that they will no longer be able to hold the security until recovery of the amortized cost basis. Greater scrutiny shall be placed on securities sold or otherwise disposed shortly after a financial statement reporting date if such securities had been excluded from the full other-than-temporary impairment recognition on the basis of the reporting entity’s intent and ability to hold.

4.5 As noted in paragraph 3.3 of this question and answer guide, once a security is classified as one for which there is an intent to sell, or for which there is not an intent and ability to hold, the security must continue to carry that assertion until the security is no longer held by the reporting entity.

5. **Question** – How do contractual prepayments affect the determination of credit losses?

5.1 **Paragraph 30** of SSAP No. 43R states that "A decrease in cash flows expected to be collected on asset-backed security that results from an increase in prepayments on the underlying assets shall be considered in the estimate of present value of cash flows expected to be collected.” Paragraph 18 states that "Asset-backed securities shall be revalued using the currently estimated cash flows, including new prepayment assumptions. Reporting entities may utilize the prospective adjustment method for all asset-backed securities that are reported with NAIC designations that are of high credit at the of acquisition by the reporting entity.”
6. **Question** – Are the disclosure requirements within paragraphs 44.f. and 44.g. of SSAP No. 43R required to be completed for the current reporting quarter only, or as a year-to-date cumulative disclosure?

6.1 The disclosures should reflect the year-to-date other-than-temporary impairments. The “fair value” reported within the disclosure is intended to reflect the fair value at the date of the other-than-temporary impairment and shall not be updated due to the fluctuations identified at subsequent reporting dates. If a security has more than one other-than-temporary impairment identified during a fiscal reporting year, the security shall be included on the disclosure listing separately for each identified other-than-temporary impairment. Notation shall be included on the disclosure identifying the other-than-temporary impairments that were recognized for each respective reporting period.

7. **Question** – If an impairment loss is recognized based on the "present value of projected cash flows" in one period is the entity required to get new cash flows every reporting period subsequent or just in the periods where there has been a significant change in the actual cash flows from projected cash flows?

7.1 The guidance in paragraph 38 of SSAP No. 43R indicates that a reporting entity shall continue to estimate the present value of cash flows expected to be collected over the life of the asset-backed security. This guidance is explicit that the reporting entity shall continue to estimate the present value of cash flows expected to be collected over the life of the loan-backed or structured security.

7.2 As provided in paragraph 2.2 of this Q&A, if the entity does not want to assess cash flows of an impaired security (fair value is less than amortized cost), the entity can designate the security as one the entity intends to sell, or one that the entity does not have the intent and ability to hold, providing it is reflective of the true intent and assessment of the ability of the entity. Reporting entities subject to the requirements of AVR and IMR should allocate the impairment loss between AVR and IMR accordingly.

8. **Question** – Do ABS purchased in different lots result in a different NAIC designation for the same CUSIP? Can reporting entities use a weighted average method determined on a legal entity basis?

8.1 Under the financial modeling process (applicable to qualifying RMBS/CMBS reviewed by the NAIC Structured Securities Group), the amortized cost of the security impacts the “final” NAIC designation used for reporting and RBC purposes. As such, securities subject to the financial modeling process acquired in different lots can result in a different NAIC designation for the same CUSIP. In accordance with the current instructions for calculating AVR and IMR, reporting entities are required to keep track of the different lots separately, which means reporting the different designations. For reporting purposes, if a SSAP No. 43R security (by CUSIP) has different NAIC designations by lot, the reporting entity shall either 1) report the aggregate investment with the lowest applicable NAIC designation or 2) report the investment separately by purchase lot on the investment schedule. If reporting separately, the investment may be aggregated by NAIC designation. (For example, all acquisitions of the identical CUSIP resulting with an NAIC 1 designation may be aggregated, and all acquisitions of the identical CUSIP resulting with an NAIC 3 designation may be aggregated.)

9. **Question** – The NAIC Designation process for ABS subject to the financial modeling process may incorporate loss expectations that differ from the reporting entity’s expectations related to OTTI conclusions. Should the reporting entities be required to incorporate recovery values obtained from data provided by the service provider used for the NAIC Designation process for impairment analysis as required by SSAP No. 43R?
9.1 In accordance with INT 06-07: Definition of Phrase “Other Than Temporary,” reporting entities are expected to “consider all available evidence” at their disposal, including the information that can be derived from the NAIC designation.

10. Question - For companies that have separate accounts, can the NAIC designation be assigned based upon the total legal entity or whether it needs to be calculated separately for the general account and the total separate account?

10.1 The financial modeling process for qualifying RMBS/CMBS securities is required for applicable securities held in either the general or separate account.

SSAP No. 21R—Other Admitted Assets

Debt Securities That Do Not Qualify as Bonds

20. The guidance within paragraphs 20-28 of this statement shall apply for any security, as defined in SSAP No. 26R, whereby there is a fixed schedule for one or more future payments (referred to herein as debt securities), but for which the security does not qualify for bond reporting under SSAP No. 26R as an issuer credit obligation or an asset backed security. Investments in scope of this guidance are limited to:

a. Debt securities for which the investment does not reflect a creditor relationship in substance.
b. Debt securities that do not qualify for bond reporting due to a lack of substantive credit enhancement.
c. Debt securities that do not qualify for bond reporting due solely to a lack of meaningful cash flows.

21. Debt securities as described in this statement meet the definition of assets as defined in SSAP 4, and are admitted assets to the extent they conform to the requirements of this statement. The guidance in these paragraphs shall not be inferred to other securities or investment structures that are not otherwise addressed in statutory accounting, nor shall it be applied to any investments that are captured within other statutory accounting guidance.

22. Debt securities in scope for which the source of repayment is derived through rights to underlying collateral, qualify as admitted assets only to the extent they are secured by admitted invested assets. Any amounts in excess of the fair value of the underlying admitted invested assets shall be nonadmitted.

23. Debt securities that do not qualify for bond reporting due solely to a lack of meaningful cash flows shall be reported on Schedule BA: Other Long-Term Invested Assets using the same accounting and measurement basis described in SSAP 43R—Asset-Backed Securities, including using a carrying value method determined by NAIC designation. Reporting entities that are reporting an amortized cost measurement shall obtain an NAIC designation in accordance with the parameters of the Purposes and Procedures Manual of the NAIC Investment Analysis Office and report the designation on Schedule BA.

23. All other debt securities in scope of this statement shall be initially reported at acquisition at cost, including brokerage and other related fees on Schedule BA: Other Long-Term Invested Assets. These securities are permitted as admitted assets.

24. Debt securities captured in scope shall be reported at the lower of amortized cost or fair value. Changes in measurement to reflect a lower value or to reflect changes in fair value shall be recorded as unrealized gains or losses.

24.25. Debt securities that do not qualify as bonds captured in scope of this statement shall follow the guidance in SSAP No. 43R—Asset-Backed Securities for calculating amortized cost, for determining and recognizing other-than-temporary impairments and for allocating unrealized and realized gains and losses between the asset valuation reserve (AVR) and interest maintenance reserve (IMR).

25.26. Investment income shall be recorded, with assessments for collectability and nonadmittance completed and recognized, pursuant to SSAP No. 34—Investment Income Due and Accrued.

26.27. Securities captured within this section shall be included in all invested asset disclosures, along with the following disclosures:
a. Fair values in accordance with SSAP No. 100R—Fair Value.

b. Concentrations of credit risk in accordance with SSAP No. 27;

c. Basis at which the securities are stated;

d. The adjustment methodology used for each type of security (prospective or retrospective);

e. Descriptions of sources used to determine prepayment assumptions.

f. All securities within the scope of this statement with a recognized other-than-temporary impairment, disclosed in the aggregate, classified on the basis for the other-than-temporary impairment: (1) intent to sell, (2) inability or lack of intent to retain the investment in the security for a period of time sufficient to recover the amortized cost basis, or (3) present value of cash flows expected to be collected is less than the amortized cost basis of the security.

g. For each security with an other-than-temporary impairment, recognized in the current reporting period by the reporting entity, as the present value of cash flows expected to be collected is less than the amortized cost basis of the securities:

i. The amortized cost basis, prior to any current-period other-than-temporary impairment.

ii. The other-than-temporary impairment recognized in earnings as a realized loss.

iii. The fair value of the security.

iv. The amortized cost basis after the current-period other-than-temporary impairment.

h. All impaired securities (fair value is less than cost or amortized cost) for which an other-than-temporary impairment has not been recognized in earnings as a realized loss (including securities with a recognized other-than-temporary impairment for non-interest related declines when a non-recognized interest related impairment remains):

v. The aggregate amount of unrealized losses (that is, the amount by which cost or amortized cost exceeds fair value) and

vi. The aggregate related fair value of securities with unrealized losses.

i. The disclosures in (i) and (ii) above should be segregated by those securities that have been in a continuous unrealized loss position for less than 12 months and those that have been in a continuous unrealized loss position for 12 months or longer using fair values determined in accordance with SSAP No. 100R.

j. When it is not practicable to estimate fair value, the investor should disclose the following additional information, if applicable:

i. The aggregate carrying value of the investments not evaluated for impairment, and
ii. The circumstances that may have a significant adverse effect on the fair value.

k. For securities sold, redeemed or otherwise disposed as a result of a callable feature (including make whole call provisions), disclose the number of CUSIPs sold, disposed or otherwise redeemed and the aggregate amount of investment income generated as a result of a prepayment penalty and/or acceleration fee.

Residual Tranches or Interests / Loss Positions

28. Residual tranches or interests from securitization tranches, beneficial interests and loss positions that lack contractual payments along with substantive credit enhancements as defined in SSAP No. 26R—Bonds and SSAP No. 43R—Asset-Backed Securities (which are collectively referred to as residuals), do not qualify for bond reporting and are required to be reported on Schedule BA: Other Long-Term Invested Assets.

29. Residuals are permitted to be admitted if debt securities from the same securitization qualify, or would qualify, as admitted assets. For example, if a debt security from a securitization does not qualify as a bond, and the source of repayment is derived through rights to the underlying collateral, the debt security is only permitted to be admitted if the underlying assets qualify as admitted assets. If the debt security from a securitization is nonadmitted, then any residual interests or loss positions held from the same securitization also do not qualify as admitted assets and would be reported as nonadmitted assets.

30. Residuals shall be initially reported at cost, or allocated cost (using proportional fair values) if acquired along with debt tranches from the securitization. Subsequent to initial acquisition, residuals shall be reported at the lower of amortized cost or fair value, with changes in fair value (or from amortized cost to fair value) reported as unrealized gains or losses.

31. Residuals shall be assessed for other-than-temporary impairment (OTTI) on an ongoing basis. An OTTI shall be considered to have occurred if it is probable that the reporting entity will not receive cash flows distributed to the residual tranche to cover the reported amortized cost basis. Upon identification of a probable OTTI, the reporting entity shall recognize a realized loss equal to the remaining amortized cost basis. Subsequent to the recognition of an OTTI, the residual shall be reported with a zero book adjusted carrying value. Any subsequent cash flows received attributed to the residual tranche shall be reported as interest income.

Exposure Question: Industry is requested to provide information on how residual tranches have been amortized and how they have been assessed for OTTI as there are no contractual principal or interest payments.
Bond Definition - Proposed Revisions to other SSAPs

SSAP Reference Revisions
Spring 2023 Exposure – Only Changes to SSAP No. 86 (shaded)
SSAP No. 21R Moved to Separate Document

1. **SSAP No. 2R—Cash, Cash Equivalents, Drafts and Short-Term Investments**
   - SSAP No. 26R: Update reference in paragraph 18. No revisions needed to paragraph 7 or 15.
   - SSSAP No. 43R: Adjusted title references in paragraphs 7 and 15.

2. **SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve**
   - SSAP No. 43R: Adjusted reference in paragraph 3.

3. **SSAP No. 15—Debt and Holding Company Obligations**
   - SSAP No. 26R: No revisions needed to paragraph 13.

4. **SSAP No. 21—Other Admitted Assets**
   - SSAP No. 26R: Update footnote 1 and clarified guidance for GICs in paragraphs 14-17.
   - SSAP No. 43R: Adjusted reference in paragraph 6 to asset backed securities that qualify.

5. **SSAP No. 36—Troubled Debt Restructuring**
   - SSAP No. 26R: No revisions needed to paragraph 29.

6. **SSAP No. 43R—Asset-Backed Securities**
   - SSAP No. 26R: Update disclosure reference that link to SSAP No. 26R, paragraph 51m

7. **SSAP No. 86—Derivatives**
   - SSAP No. 26R and SSAP No. 43R: Updated the guidance for structured notes in paragraph 5.g.
     *Note: This footnote updated per February 10, 2023, industry comments. See shading within*

8. **SSAP No. 95—Nonmonetary Transactions**
   - SSAP No. 26R: No revisions needed to paragraph 6.
   - SSAP No. 43R: Adjusted the citation to SSAP No. 43R in paragraph 6.

9. **SSAP No. 100R—Fair Value**
   - SSAP No. 26R: No revisions needed to Footnote 3.
10. **SSAP No. 103R—Transfers and Servicing of Financial Assets and Extinguishments of Liabilities**

SSAP No. 43R: Revisions remove the direct pointer of beneficial interests as in scope of SSAP No. 43R and incorporate guidance for reporting under the applicable SSAP in paragraphs 2, 11 and 18.

11. **INT 01-25: Accounting for U.S. Treasury Inflation-Indexed Securities**

SSAP No. 26: No revisions needed.

12. **06-02: Accounting and Reporting for Investments in a Certified Capital Company (CAPCO)**

SSAP No. 26: Update paragraph reference in paragraph 5.a.

13. **06-07: Definition of Phrase “Other Than Temporary”**

SSAP No. 26: No revisions needed.

SSAP No. 43R: Updated reference in list of applicable SSAPs.

14. **INT 07-01: Application of the Scientific (Constant Yield) Method in Situations of Reverse Amortization**

SSAP No. 26R: Remove quoted guidance.

SSAP No. 43R: Updated reference in list of applicable SSAPs and remove quoted guidance.

15. **INT 19-02: Freddie Mac Single Security Initiative**

SSAP No. 26R: No revisions needed.

SSAP No. 43R: Updated reference in list of applicable SSAPs and in paragraph 1.

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

SSAP No. 43R: Updated reference in list of applicable SSAPs and in paragraph 1.

**Summary of SAP Guidance Revisions**

17. **SSAP No. 2R—Cash, Cash Equivalents, Drafts and Short-Term Investments**

Revisions preclude asset backed securities that are in scope of SSAP No. 43R from being reported as cash equivalents or short-term investments. The revisions also identify items captured on Schedule BA as non-bond securities. (These revisions also add reference to working capital finance investments, but that is not new guidance, but was not explicitly stated in SSAP No. 2R.)
Summary of SAP Reference Revisions:

**SSAP No. 2R—Cash, Cash Equivalents, Drafts and Short-Term Investments**

7. Regardless of maturity date, related party or affiliated investments that would be in scope of SSAP No. 26R—Bonds, SSAP No. 43R—Loan-Backed and Structured Asset-Backed Securities, or that would be reported as “Other Invested Assets” shall be reported as long-term investments if any of the following conditions apply, unless the reporting entity has re-underwritten the investment, maintained appropriate re-underwriting documentation, and each participating party had the ability to independently review the terms and can terminate the transaction prior to renewal.

a. The reporting entity does not reasonably expect the investment to terminate on the maturity date. This provision includes investments that are expected to be renewed (or rolled) with a maturity date that ends subsequent to the initial 90-day timeframe.

b. The investment was previously reported as a cash equivalent investment and the initial maturity timeframe has passed. If an investment is reported as a cash equivalent and it is unexpectedly renewed/rolled, the reporting entity is not permitted to continue to report the held security as a cash equivalent, regardless of the updated maturity date, and shall report the security as a long-term investment. An investment is only permitted to be reported as a cash equivalent for one quarter reporting period. Meaning, if an investment was reported as a cash equivalent in the first quarter, it is not permitted to be reported as a cash equivalent in the second quarter.

c. The reporting entity reacquired the investment (or a substantially similar investment) within one year after the original security matured or was terminated. These reacquired securities shall be reported as long-term investments. (These securities are also not permitted to be reported as short-term investments, regardless of the maturity date of the reacquired investment.)

Footnote 1: Cash equivalents subject to the provisions of paragraph 7 are not permitted to be subsequently reported as short-term investments, even if the updated/reacquired maturity date is within one year. These investments shall be reported as long-term investments. To avoid changes in reporting schedules, reporting entities are permitted to report securities as long-term investments at initial acquisition, regardless of the initial maturity date.

15. Regardless of maturity date, related party or affiliated investments in scope of SSAP No. 26R—Bonds, SSAP No. 43R—Loan-Backed and Structured Asset-Backed Securities, or that would be reported as “Other Invested Assets” shall be reported as long-term investments if any of the following conditions apply, unless the reporting entity has re-underwritten the investment, maintained appropriate re-underwriting documentation, and each participating party had the ability to independently review the terms and can terminate the transaction prior to renewal.

a. The reporting entity does not reasonably expect the investment to terminate on the maturity date. This provision includes investments that are expected to be renewed (or rolled) with a maturity date that ends subsequent to the initial “less than one year” timeframe.

b. The investment was previously reported as a short-term investment and the initial maturity timeframe has passed. If an investment is reported as a short-term investment and it is unexpectedly renewed/rolled, the reporting entity is not permitted to continue to report the held security as a short-term investment (or as a cash equivalent) regardless of the updated maturity date and shall report the security as a long-term investment. An investment is only permitted to be reported as a short-term investment for one annual reporting period. Meaning, if an investment was reported as a short-term investment as of December 31, 2018, it is not permitted to be reported as short-term investment as of December 31, 2019.
c. The reporting entity reacquired the investment (or a substantially similar investment) within one year after the original security matured or was terminated. These reacquired securities shall be reported as long-term investments. (These securities are also not permitted to be reported as cash equivalent investments regardless of the maturity date of the reacquired investment.)

Footnote 2: Reverse repurchase transactions are excluded from these provisions if admitted in accordance with collateral requirements pursuant to SSAP No. 103R—Transfers and Servicing of Financial Assets and Extinguishments of Liabilities.

Footnote 3: Short-term investments subject to the provisions of paragraph 15 are not permitted to be subsequently reported as cash equivalents, even if the updated/reacquired maturity date is within 90 days. These investments shall be reported as long-term investments. To avoid changes in reporting schedules, reporting entities are permitted to report securities as long-term investments at initial acquisition, regardless of the initial maturity date.

Disclosures

18. The following disclosures shall be made for short-term investments in the financial statements:

   a. Fair values in accordance with SSAP No. 100R—Fair Value;

   b. Concentrations of credit risk in accordance with SSAP No. 27—Off-Balance-Sheet and Credit Risk Disclosures;

   c. Basis at which the short-term investments are stated.

   d. The items in the scope of this statement are also subject to the annual audited disclosures in SSAP No. 26R—Bonds, paragraph 39.f30.f.

   e. Identification of cash equivalents (excluding money market mutual funds as detailed in paragraph 8) and short-term investments (or substantially similar investments), which remain on the same reporting schedule for more than one consecutive reporting period. This disclosure is satisfied by use of a designated code in the investment schedules of the statutory financial statements.

SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve

3. The IMR and AVR shall be calculated and reported as determined per guidance in the SSAP for the specific type of investment (e.g., SSAP No. 43R for loan-backed and structured asset-backed securities), or if not specifically stated in the respective SSAP, in accordance with the NAIC Annual Statement Instructions for Life and Accident and Health Insurance Companies.

SSAP No. 15—Debt and Holding Company Obligations - (No Changes)

13. Convertible debt securities and convertible preferred stock with beneficial conversion features are to be valued according to the appropriate statutory accounting statement; SSAP No. 26R—Bonds or SSAP No. 32R—Preferred Stock.
Collateral Loans

4. Collateral loans are unconditional obligations for the payment of money secured by the pledge of an investment and meet the definition of assets as defined in SSAP No. 4, and are admitted assets to the extent they conform to the requirements of this statement. The outstanding principal balance on the loan and any related accrued interest shall be recorded as an admitted asset subject to the following limitations:

Footnote 1: For purposes of determining a collateral loan in scope of this statement, a collateral loan does not include investments captured in scope of other statements. For example, SSAP No. 26R—Bonds includes securities that qualify as issuer creditor obligations and SSAP No. 43—Asset-Backed Securities includes securities that qualify as asset backed securities under the bond definition, (as defined in that statement) representing a creditor relationship whereby there is a fixed schedule for one or more future payments. Investments captured in SSAP No. 26R or SSAP No. 43R that are also secured with collateral shall continue to be captured within scope of SSAP No. 26R or those statements.

Footnote 2: Investment defined as those assets listed in Section 3 of Appendix A-001—Investments of Reporting Entities.

6. A reporting entity that acquires (directly or indirectly) structured settlement payment rights through a factoring company, excluding securitizations that qualify as asset-backed securities captured in scope of SSAP No. 43R, shall report the acquisition as follows:

   a. Period-certain (non-life contingent) structured settlement income streams shall be reported as other long-term invested assets, and are admitted assets if the rights to the future payments from a structured settlement have been legally acquired in accordance with all state and federal requirements. If the structured settlement has not met all legal requirements, including the court-approved transfer from the original recipient, then the reporting entity shall recognize the appropriate excise tax obligation and the structured settlement shall be nonadmitted.

   b. Life-contingent structured settlement income streams shall be reported as other long-term invested assets on Schedule BA and shall be nonadmitted. (Nonadmittance is required regardless if the right to future payments has been legally transferred.)

Footnote 3: This guidance is specific to acquired structured settlement income streams (legal right to receive future payments from a structured settlement) and does not capture accounting and reporting guidance for the acquisition of any insurance product (e.g., life settlement, annuities, etc.).

Footnote 4: Reporting entities that hold qualifying structured settlement payment rights shall report the security on Schedule BA either as an “any other class of asset” or as a “fixed or variable interest rate investment with underlying characteristics of other fixed income instruments” if the structured settlement payment right qualifies for reporting within that reporting line (e.g., NAIC designation).

Guaranteed Investment Contracts

14. Guaranteed Investment Contracts (GICs) purchased for investment purposes meet the definition of assets as defined in SSAP No. 4, and are admitted assets to the extent they conform to the requirements of this statement. This includes an investment in a GIC payment stream which can be created when an intermediary purchases individual GICs, pools them, and sells the rights to the payment stream.

   15. GICs acquired in a security structure that qualify under the bond definition as an issuer obligation or asset backed security shall follow the accounting guidance within SSAP No. 26R or SSAP No. 43R as applicable.
15.16. Purchases of GIC investments that do not meet the definition of a security, but for which all contractual rights and ownership of the GIC result in an investment similar to a corporate bond, shall be reported at amortized cost and accounted for in accordance with the guidance in SSAP No. 26R—Bonds included on Schedule BA: Other Long-Term Invested Assets. If, in accordance with SSAP No. 5R, it is probable that the carrying value of a GIC is not fully recoverable the investment shall be considered impaired. Accordingly, the cost basis of the investment shall be written down to the undiscounted estimated cash flows and the amount of the write down shall be accounted for as a realized loss. The new cost basis shall not be changed for subsequent recoveries in fair value.

16. An investment in a GIC payment stream is created when an intermediary purchases individual GICs, pools them, and sells the rights to the payment stream. These investments shall be reported as other long-term invested assets and shall be carried at amortized cost.

17. If, in accordance with SSAP No. 5R, it is probable that the carrying value of a GIC is not fully recoverable the investment shall be considered impaired. Accordingly, the cost basis of the investment shall be written down to the undiscounted estimated cash flows and the amount of the write down shall be accounted for as a capital loss. The new cost basis shall not be changed for subsequent recoveries in fair value.

SSAP No. 36—Troubled Debt Restructuring (No Changes)

29. Although FASB Statement No. 91, Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases (FAS 91) was rejected in SSAP No. 26R—Bonds, this statement is consistent with paragraph 14 of FAS No. 91.

SSAP No. 43R—Asset-Backed Securities

Disclosures

51. In addition to the disclosures required for invested assets in general, the following disclosures regarding loan-backed and structured securities shall be made in the financial statements. Regardless of the allowances within paragraph 63 of the Preamble, the disclosures in paragraph 51.f., 51.g. and 51.h. of this statement are required in separate, distinct notes to the financial statements:

m. The items in the scope of this statement are also subject to the annual audited disclosures in SSAP No. 26R—Bonds, paragraphs 39.e, 39.f, 39.g, and 39.h.

SSAP No. 86—Derivatives

5. Derivative instruments include, but are not limited to; options, warrants used in a hedging transaction and not attached to another financial instrument, caps, floors, collars, swaps, forwards, futures, structured notes with risk of principal/original investment loss based on the terms of the agreement (in addition to default risk), and any other agreements or instruments substantially similar thereto or any series or combination thereof.

g. “Structured Notes” in scope of this statement are instruments defined in SSAP No. 26R—Bonds (often in the form of debt instruments), in scope of this statement are instruments in which the amount of principal repayment or return of original investment is contingent on an underlying variable/interest rate where the terms of the agreement make it possible that the reporting entity could lose all or a portion of its original investment amount (for other than failure of the issuer to pay the contractual amounts due). Structured notes that are mortgage-referenced securities issued by a government sponsored enterprise in the
form of credit-risk transfers where an issue security is tied to a referenced pool are mortgages are captured in SSAP No. 43R—Loan-Backed and Structured Securities.

Footnote 5 - The “structured notes” captured within scope of this statement is specific to instruments in which the terms of the agreement make it possible that the reporting entity could lose all or a portion of its original investment amount (for other than failure of the issuer to pay the contractual amounts due). These instruments incorporate both the credit risk of the issuer, as well as the risk of an underlying variable/interest (such as the performance of an equity index or the performance of an unrelated security). Securities that are labeled “principal-protected notes” are captured within scope of this statement if the “principal protection” involves only a portion of the principal and/or if the principal protection requires the reporting entity to meet qualifying conditions in order to be safeguarded from the risk of loss from the underlying linked variable. Securities that may have changing positive interest rates in response to a linked underlying variable or the passage of time, or that have the potential for increased principal repayments in response to a linked variable (such as U.S. Treasury Inflation-Indexed Securities) that do not incorporate risk of original investment/principal loss (outside of default risk) are not captured as structured notes in scope of this statement. A replication (synthetic asset) transaction addressed within this standard may reproduce the investment characteristics of an otherwise permissible investment that would not meet the principles-based bond definition (e.g., is distinct from a “structured note” as defined here); the admissibility, classification and measurement of a replication (synthetic asset) transaction are not preemptively determined by the principles-based bond definition, and should be evaluated in accordance with the guidance on replication (synthetic asset) transactions within this standard.

SSAP No. 95—Nonmonetary Transactions

6. Fair value of assets received or transferred in a nonreciprocal transfer shall be measured based on statutory accounting principles for the type of asset transferred. Accordingly, the value shall be determined in accordance with SSAP No. 26R—Bonds, SSAP No. 30R—Unaffiliated Common Stock, SSAP No. 32R—Preferred Stock, SSAP No. 37—Mortgage Loans, SSAP No. 39—Reverse Mortgages, SSAP No. 40R—Real Estate Investments, SSAP No. 43R—Loan-Backed and Structured Asset-Backed Securities, SSAP No. 90—Impairment or Disposal of Real Estate Investments or other applicable statements. The guidance provided in SSAP No. 25 shall be followed in accounting for nonreciprocal transactions with affiliates and other related parties as defined in that statement.

SSAP No. 100—Fair Value (No Changes)

48. For each class of assets and liabilities measured and reported at fair value or NAV in the statement of financial position after initial recognition. The reporting entity shall determine appropriate classes of assets and liabilities in accordance with the annual statement instructions.

Footnote 3: The term “reported” is intended to reflect the measurement basis for which the asset or liability is classified within its underlying SSAP. For example, a bond with an NAIC designation of 2 is considered an amortized cost measurement and is not included within this disclosure even if the amortized cost and fair value measurement are the same. An example of when such a situation may occur includes a bond that is written down as other-than-temporarily impaired as of the date of financial position. The amortized cost of the bond after the recognition of the other-than-temporary impairment may agree to fair value, but under SSAP No. 26R this security is considered to still be reported at amortized cost.

SSAP No. 103R—Transfers and Servicing of Financial Assets and Extinguishments of Liabilities

2. This statement focuses on the issues of accounting for transfers and servicing of financial assets and extinguishments of liabilities. This statement establishes statutory accounting principles for transfers and servicing of financial assets, including asset securitizations and securitizations of policy acquisition costs, extinguishments of liabilities, repurchase agreements, repurchase financing and reverse repurchase agreements, including dollar repurchase and dollar reverse repurchase agreements that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts). This statement discusses generalized situations. Facts and circumstances and specific contracts need to be considered carefully in applying this statement. Securitizations of nonfinancial assets are outside the scope of this statement. Transfers of financial assets that are in substance real estate shall be accounted
for in accordance with SSAP No. 40R—Real Estate Investments. Additionally, retained beneficial interests from the sale of loan-backed or structured asset-backed securities are to be accounted for in accordance with the statutory accounting statement that is applicable to the investment retained with SSAP No. 43R—Loan-Backed and Structured Securities, Revised. If the retained security does not qualify for reporting as a bond under the bond definition detailed in SSAP No. 26R, it shall be reported as a debt security that does not qualify as a bond in scope of SSAP No. 21R—Other Admitted Assets.

11. Upon completion of a transfer of an entire financial asset or a group of entire financial assets that satisfies the conditions to be accounted for as a sale (see paragraph 8), the transferor (seller) shall:

a. Derecognize the transferred financial assets;

b. Recognize and initially measure at fair value servicing assets, servicing liabilities, and any other assets obtained (including a transferor’s beneficial interest in the transferred financial assets) and liabilities incurred\(^1\) in the sale (paragraphs 60 and 62-66).

c. For reporting entities required to maintain an Interest Maintenance Reserve (IMR), the accounting for realized and unrealized capital gains and losses shall be determined per the guidance in the SSAP for the specific type of investment (e.g., SSAP No. 43R for loan-backed and structured securities), or if not specifically stated in the related SSAP, in accordance with SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve. For reporting entities not required to maintain an IMR, realized capital gains and losses shall be reported as net realized capital gains or losses in the statement of income, and unrealized capital gains and losses shall be reported as net unrealized gains and losses in unassigned funds (surplus).

The transferee shall recognize all assets obtained and any liabilities incurred, and initially measure them at fair value.

Footnote 1: Some assets that might be obtained and liabilities that might be incurred include cash, put or call options that are held or written (for example, guarantee or recourse obligations), forward commitments (for example, commitments to deliver additional receivables during the revolving periods of some securitizations) and swaps (for example, provisions that convert interest rates from fixed to variable).

Financial Assets Subject to Prepayment

18. Financial assets, except for instruments that are within the scope of SSAP No. 86—Derivatives, that can contractually be prepaid or otherwise settled in such a way that the holder would not recover substantially all of its recorded investment shall be assessed in accordance with the bond definition captured in SSAP No. 26R—Bonds to determine appropriate accounting and reporting. Securities that do not qualify for bond reporting shall be captured as debt securities that do not qualify as bonds in scope of SSAP No. 21R—Other Admitted Assets, subsequently measured in accordance with the statutory accounting statement that is applicable to the financial asset, subsequently measured like investments in debt securities and loan-backed and structured securities in accordance with SSAP No. 43R. Examples of such financial assets include, but are not limited to, interest-only strips, other beneficial interests, loans, or other receivables.

INT 01-25: Accounting for U.S. Treasury Inflation-Indexed Securities

- No Change – Applies to SSAP No. 26R.

INT 06-02: Accounting and Reporting for Investments in a Certified Capital Company (CAPCO)
5. For Issue 1, the Working Group came to a consensus that reporting entities should account and report for investments in CAPCO’s consistent with the agreement structure within the guidance provided below:

h. Investment in a debt instrument of a CAPCO shall be reported as a bond in accordance with the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* and the designation assigned in the *NAIC Valuations of Securities* product prepared by the NAIC Securities Valuation Office (Valuations of Securities manual) as stated in SSAP No. 26R, paragraph 2014.

i. Investment in an equity interest of a CAPCO shall be reported as common stock and reported at fair value as stated in SSAP No. 30R, paragraph 8.

j. Investment in preferred stock interest of a CAPCO shall be reported as preferred stock in accordance with the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* and the designation assigned in the *NAIC Valuations of Securities* product prepared by the NAIC Securities Valuation Office (Valuations of Securities manual) as stated in SSAP No. 32R, paragraphs 19-22.

k. Investment in a Joint Venture, Partnership and Limited Liability Company (LLC) shall be reported in accordance with SSAP No. 48, paragraphs 5-6. The reported value of the investment shall be decreased in proportion to the premium tax credits utilized.

l. The tax credits shall be recognized as a reduction of the tax liabilities as they are utilized. Tax credits received are not to be included in investment income.

**INT 06-07: Definition of Phrase “Other Than Temporary”**

- Update interpreted SSAP list to reference to SSAP No. 43R—Asset Backed Securities

**INT 07-01: Application of the Scientific (Constant) Yield Method in Situations of Reverse Amortizations**

1. SSAP No. 26R and SSAP No. 43R both reference the use of the scientific or constant yield method of amortization of a premium or a discount. *SSAP No. 26R—Bonds* provides the following (bolding added for emphasis):

   **Amortized Cost**

   9. Amortization of bond premium or discount shall be calculated using the scientific (constant yield) interest method taking into consideration specified interest and principal provisions over the life of the bond. Bonds containing call provisions (where the issue can be called away from the reporting entity at the issuer’s discretion) shall be amortized to the call or maturity value/date which produces the lowest asset value (yield to worst).

   *SSAP No. 43R—Loan-Backed and Structured Securities* provides the following (bolding added for emphasis):

   **Amortization**

   8. Amortization of premium or discount shall be calculated using the scientific (constant yield) interest method and shall be recorded as an adjustment to investment income. The interest method results in a constant effective yield equal to the prevailing rate at the time of purchase or at the time of subsequent adjustments to book value. The amortization period shall
reflect estimates of the period over which repayment of principal of the loan-backed securities is expected to occur, not the stated maturity period.

**Collection of All Contractual Cashflows is Probable**

12. The following guidance applies to loan-backed and structured securities for which it is probable that the investor will be able to collect all contractually required payments receivable. (Paragraphs 17-19 provide guidance for securities in which collection of all contractual cash flows is not probable and paragraphs 20-24 provide guidance for beneficial interests.) Prepayments are a significant variable element in the cash flow of loan-backed securities because they affect the yield and determine the expected maturity against which the yield is evaluated. Falling interest rates generate faster prepayment of the mortgages underlying the security, shortening its duration. This causes the reporting entity to reinvest assets sooner than expected at potentially less advantageous rates. This is called prepayment risk. Extension risk is created by rising interest rates which slow repayment and can significantly lengthen the duration of the security. Differences in cash flows can also result from other changes in the cash flows from the underlying assets. If assets are delinquent or otherwise not generating cash flow, which should be reflected in the cash flow analysis through diminishing security cash flows, even if assets have not been liquidated and gains/losses have not been booked.

13. Changes in currently estimated cash flows, including the effect of prepayment assumptions, on loan-backed securities shall be reviewed periodically, at least quarterly. The prepayment rates of the underlying loans shall be used to determine prepayment assumptions. Prepayment assumptions shall be applied consistently across portfolios to all securities backed by similar collateral (similar with respect to coupon, issuer, and age of collateral). Reporting entities shall use consistent assumptions across portfolios for similar collateral within controlled affiliated groups. Since each reporting entity may have a unique method for determining the prepayment assumptions, it is impractical to set standard assumptions for the industry. Relevant sources and rationale used to determine each prepayment assumption shall be documented by the reporting entity.

14. Loan-backed securities shall be revalued using the currently estimated cash flows, including new prepayment assumptions, using either the prospective or retrospective adjustment methodologies, consistently applied by type of securities. However, if at any time during the holding period, the reporting entity determines it is no longer probable that they will collect all contractual cashflows, the reporting entity shall apply the accounting requirements in paragraphs 17-19.

15. The prospective approach recognizes, through the recalculation of the effective yield, the effects of all cash flows whose amounts differ from those estimated earlier and the effects and changes in projected cash flows. Under the prospective method, the recalculated effective yield will equate the carrying amount of the investment to the present value of the anticipated future cash flows. The recalculated yield is then used to accrue income on the investment balance for subsequent accounting periods. There are no accounting changes in the current period unless the security is determined to be other than temporarily impaired.

16. The retrospective methodology changes both the yield and the asset balance so that expected future cash flows produce a return on the investment equal to the return now expected over the life of the investment as measured from the date of acquisition. Under the retrospective method, the recalculated effective yield will equate the present value of the actual and anticipated cash flows with the original cost of the investment. The current balance is then increased or decreased to the amount that would have resulted had the revised yield been applied since inception, and investment income is correspondingly decreased or increased.

2. **This interpretation** identifies three situations where, using a constant yield methodology for determining amortization or accretion, changes in amortized value move in the opposite direction of what is expected. That is, if a security is purchased at a premium, the constant yield methodology will, in certain cases, cause the amortized value to move to a discount during the life of the...
security. Conversely, if the security were purchased at a discount, the constant yield methodology will, in certain cases, cause the amortized value to move to a premium during the life of the security.

**INT 19-02: Freddie Mac Single Security Initiative**

- Update interpreted SSAP list to reference to *SSAP No. 43R—Asset Backed Securities*

  1. This interpretation has been issued to provide a limited-scope exception to the exchange and conversion guidance in *SSAP No. 26R—Bonds* as well as prescribe guidance in *SSAP No. 43R—Asset-Backed Loan-Backed and Structured Securities* (SSAP No. 43R) for instruments converted in accordance with the Freddie Mac Single Security Initiative. Under this initiative, reporting entities will be permitted to exchange “45-day securities” for “55-day securities” without any material change to the securities, or to the loans that back the securities. (With the exchange, there would be a 10-day delay in payment cycle.)

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

- Update interpreted SSAP list to reference to *SSAP No. 43R—Asset Backed Securities*

  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 Asset-Backed Securities* or as a forward contract in scope of *SSAP No. 86—Derivatives.*
Summary of SAP Guidance Revisions:

**SSAP No. 2R—Cash, Cash Equivalents, Drafts and Short-Term Investments**

**Cash Equivalents**

6. Cash equivalents are short-term, highly liquid investments that are both (a) readily convertible to known amounts of cash, and (b) so near their maturity that they present insignificant risk of changes in value because of changes in interest rates. Only investments with original maturities\(^1\) of three months or less can qualify under this definition, with the exception of money market mutual funds, as detailed in paragraph 8, and cash pooling, as detailed in paragraph 9. Regardless of maturity date, the following investments are not permitted to be reported as cash equivalents and shall be reported on the investment schedule that corresponds to the SSAP for which the investment is applicable:

a. Asset-backed securities captured in scope of SSAP No. 43R.

b. All debt securities that do not qualify as bonds which are in scope of SSAP No. 21R.

c. Derivative instruments in scope of SSAP No. 86 or SSAP No. 108 shall not be reported as cash equivalents and shall be reported as derivatives on Schedule DB.

d. Working capital finance investments in scope of SSAP No. 105R.

- Securities with terms that are reset at predefined dates (e.g., an auction-rate security that has a long-term maturity and an interest rate that is regularly reset through a Dutch auction) or have other features an investor may believe results in a different term than the related contractual maturity shall be accounted for based on the contractual maturity at the date of acquisition, except where other specific rules within the statutory accounting framework currently exist.

**Short-Term Investments**

14. Short-term investments are investments that do not qualify as cash equivalents with remaining maturities (or repurchase dates under reverse repurchase agreements) of one year or less at the time of acquisition. Short-term investments can include, but are not limited to bonds, commercial paper, reverse repurchase agreements, and collateral and mortgage loans which meet the noted criteria. Short-term investments shall not include investments specifically classified as cash equivalents as defined in this statement, certificates of deposit, or derivatives. Regardless of maturity date, the following investments are not permitted to be reported as cash equivalents and shall be reported on the investment schedule that corresponds to the SSAP for which the investment is applicable:

a. Asset-backed securities captured in scope of SSAP No. 43R.

b. All debt securities that do not qualify as bonds which are in scope of SSAP No. 21R.

c. Derivative instruments in scope of SSAP No. 86 or SSAP No. 108 shall not be reported as short-term investments and shall be reported as derivatives on Schedule DB.

d. Working capital finance investments in scope of SSAP No. 105R.

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\(^1\) Original maturity means original maturity to the entity holding the investment. For example, both a three-month U.S. Treasury bill and a three-year Treasury note purchased three months from maturity qualify as cash equivalents. However, a Treasury note purchased three years ago does not become a cash equivalent when its remaining maturity is three months.
This document proposes annual statement reporting line and descriptions for suggested reporting lines for investments reported as other invested assets on Schedule BA. The main focus is to categorize debt securities that do not qualify as bonds under SSAP No. 26—Bonds or SSAP No. 43R—Asset-Backed Securities and are captured in scope of SSAP No. 21—Other Invested Assets. As detailed within, other revisions have also been proposed to update the schedule.

Comments are requested on all aspects of this document— including whether reporting lines should be added or deleted as well as the suggested instructions to clarify what should be captured in each location.

SCHEDULE BA – PARTS 1, 2 AND 3

OTHER LONG-TERM INVESTED ASSETS – GENERAL INSTRUCTIONS

Include only those classes of invested assets not clearly or normally includable in any other invested asset schedule, or that have been specifically identified for reporting on Schedule BA: Other Invested Assets. Such assets should include any assets previously written off for book purposes, but which still have a market or investment value. Give a detailed description of each investment and the underlying security. If an asset is to be recorded in Schedule BA that is normally reported in one of the other invested asset schedules, make full disclosure in the Name or Description column of the reason for recording such an asset in Schedule BA.

For accounting guidance related to foreign currency transactions and translations, refer to SSAP No. 23—Foreign Currency Transactions and Translations.

If a reporting entity has any detail lines reported for any of the following required groups, categories, or subcategories, it shall report the subtotal amount of the corresponding group, category, or subcategory, with the specified subtotal line number appearing in the same manner and location as the pre-printed total or grand total line and number:

<table>
<thead>
<tr>
<th>Group or Category</th>
<th>Line Number</th>
</tr>
</thead>
<tbody>
<tr>
<td>Debt Securities That Do Not Qualify as Bonds</td>
<td></td>
</tr>
<tr>
<td>Debt Securities That Do Not Reflect a Creditor Relationship in Substance</td>
<td></td>
</tr>
<tr>
<td>NAIC Designation Assigned by the Securities Valuation Office (SVO)</td>
<td></td>
</tr>
<tr>
<td>Unaffiliated</td>
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<tr>
<td>Affiliated</td>
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<td>NAIC Designation Not Assigned by the Securities Valuation Office (SVO)</td>
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<td>Affiliated</td>
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<tr>
<td>Debt Securities That Lack Substantive Credit Enhancement</td>
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<td>NAIC Designation Assigned by the Securities Valuation Office (SVO)</td>
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Joint Venture (Including Non-Registered Private Funds), Partnership or Limited Liability Company Interests with Underlying Assets Having the Characteristics of:

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<td>Non-Guaranteed Federal Low Income Housing Tax Credit</td>
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<td>Guaranteed State Low Income Housing Tax Credit</td>
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<td>Non-Guaranteed State Low Income Housing Tax Credit</td>
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<td>All Other Low Income Housing Tax Credit</td>
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<td>Working Capital Finance Investment</td>
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<td>Residual Tranches or Interests with Underlying Assets Having Characteristics of:</td>
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<td>Fixed Income Instruments</td>
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The following listing is intended to give examples of investments to be included in each category; however, the list should not be considered all-inclusive, and it should not be implied that any invested asset currently being reported in Schedules A, B or D is to be reclassified to Schedule BA:

**Oil and Gas Production**

Include: Offshore oil and gas leases.

**Transportation Equipment**

Include: Aircraft owned under leveraged lease agreements.

Motor Vehicle Trust Certificates.

**Mineral Rights**

Include: Investments in extractive materials.

Timber Deeds.

**Debt Securities That Do Not Qualify as Bonds**

Include: Debt securities captured in SSAP No. 21—Other Admitted Assets. This is specific to securities, as that term is defined in SSAP No. 26—Bonds, whereby there is a fixed schedule for one or more future payments (referred to as debt securities), but for which the security does not qualify for bond reporting under SSAP No. 26 as an issuer credit obligation or an asset-backed security.

Investments that have been assigned an NAIC designation by the Securities Valuation Office (SVO) pursuant to the policies in the Purposes and Procedures Manual of the NAIC Investment Analysis Office shall be reported on Lines 0799999 and 0899999.

Investments that have not been assigned an NAIC designation by the Securities Valuation Office (SVO) pursuant to the policies in the Purposes and Procedures Manual of the NAIC Investment Analysis Office for this category. Designations received from an SEC NRSRO are permitted to be reported but are not required. Report these investments on Lines 0999999, 1099999, 1199999, 1299999, 1399999 and 1499999.

Exclude: Any investment that does not qualify as a security. This term is defined in SSAP No. 26R.

Any investment that is not captured as a debt security that does not qualify as a bond pursuant to SSAP No. 21R—Other Admitted Assets.

**Non-Registered Private Funds with Underlying Assets Having Characteristics of a Bond, Mortgage Loan or Other Fixed Income Instrument**

Include: Fixed income instruments that are not corporate or governmental unit obligations (Schedule D) or secured by real property (Schedule B).

Any investments deemed by the reporting entity to possess the underlying characteristics of a bond or other fixed income instrument that has been assigned an NAIC designation by the Securities Valuation Office (SVO) pursuant to the policies in the Purposes and Procedures Manual of the NAIC Investment Analysis Office for this category. Report these investments on Lines 0799999 and 0899999.

Any investments deemed by the reporting entity to possess the underlying characteristics of a bond or other fixed income investment that has not been assigned an NAIC designation by the Securities Valuation Office (SVO) pursuant to the policies in the Purposes and Procedures Manual of the NAIC Investment Analysis Office...
Joint Ventures (Including Non-Registered Private Funds), Partnership or Limited Liability Company Interests with Underlying Assets Having the Characteristics:

**Fixed Income Instruments**

Include: Joint venture (including non-registered private funds), partnership or limited liability company investments that are engaged in bond or preferred stock fixed income strategies, Leveraged Buy-out Fund, A fund investing in the “Z” strip of Collateralized Mortgage Obligations.

Investments on the NAIC List of Schedule BA Non-Registered Private Funds with Underlying Assets Having Characteristics of Bonds or Preferred Stock Any investments deemed by the reporting entity to possess the underlying characteristics of fixed income instruments that has been assigned an NAIC designation by the Securities Valuation Office (SVO) pursuant to the policies in the Purposes and Procedures Manual of the NAIC Investment Analysis Office for this category. Report these investments on Lines 1599999 and 1699999.

Any investments deemed by the reporting entity to possess the underlying characteristics of fixed income instruments that have not been assigned an NAIC designation by the Securities Valuation Office (SVO) pursuant to the policies in the Purposes and Procedures Manual of the NAIC Investment Analysis Office for this category. Designations received from an SEC NRSRO are permitted to be reported but are not required. Report these investments on Lines 1799999 and 1899999.

**Common Stocks**

Include: Venture Capital Funds or other underlying equity investments.

**Real Estate**

Include: Real estate development interest. Reporting should be consistent with the detailed property analysis appropriate for the corresponding risk-based capital factor for this investment category. If the requisite details are not available for reporting, report under “Other” subcategory.

**Mortgage Loans**

Include: Mortgage obligations. Reporting should be consistent with the detailed property analysis appropriate for the corresponding risk-based capital factor for this investment category. If the requisite details are not available for reporting, report under “Other” subcategory.

**Other**

Include: Limited partnership interests in oil and gas production. Forest product partnerships.

Investments within the Joint Venture and Partnership Interests category that do not qualify for inclusion in the “Fixed Income Instruments,” “Common Stocks,” “Real Estate” or “Mortgage Loans” subcategories. Reporting should be consistent with the corresponding risk-based capital factor for this investment category (i.e., Other Long-Term Assets).
Surplus Debentures, etc.

Include: That portion of any subordinated indebtedness, surplus debenture, surplus note, debenture note, premium income note, bond, or other contingent evidence of indebtedness that is reported in the surplus of the issuer.

Collateral Loans

Include: Refer to SSAP No. 21R—Other Admitted Assets for a definition of collateral loans. Loans that are backed by any form of collateral, regardless of if the collateral is sufficient to fully cover the loan, shall be captured in this category. Guidance in SSAP No. 21R shall be followed to determine nonadmittance.

In the description column, the name of the actual borrower and state if the borrower is a parent, subsidiary, affiliate, officer or director. Also include the type of collateral held.

Non-collateral Loans

Include: For purposes of this section, non-collateral loans are considered the unpaid portion of loans previously made to another organization or individual in which the reporting entity has a right to receive money for the loan, but for which the reporting entity has not obtained collateral to secure the loan.

Non-collateral loans shall not include those instruments that meet the definition of a bond, per SSAP No. 26R—Bonds, a mortgage loan per SSAP No. 37—Mortgage Loans, loan backed or structured asset-backed securities per SSAP No. 43R—Loan-Backed and Structured Securities, or a policy or contract loan per SSAP No. 49—Policy Loans.

In the description column, provide the name of the actual borrower. For affiliated entities, state if the borrower is a parent, subsidiary, affiliate, officer or director. Refer to SSAP No. 20—Nonadmitted Assets and SSAP No. 25—Affiliates and Other Related Parties for accounting guidance.

Capital Notes

Include: The portion of any capital note that is reported on the line for capital notes of the issuing insurance reporting entity.
Low Income Housing Tax Credit

Note: These instructions will be updated in accordance with the SAPWG tax credit agenda item.

Include: All Low Income Housing Tax Credit Investments (LIHTC or affordable housing) that are in the form of a Limited Partnership or a Limited Liability Company including those investments that have the following risk mitigation factors:

A. Guaranteed Low Income Housing Tax Credit Investments. There must be an all-inclusive guarantee from a CRP-rated entity that guarantees the yield on the investment.

B. Non-guaranteed Low Income Housing Tax Credit Investments.
   I. A level of leverage below 50%. For a LIHTC Fund, the level of leverage is measured at the fund level.
   II. There is a Tax Credit Guarantee Agreement from General Partner or managing member. This agreement requires the General Partner or managing member to reimburse investors for any shortfalls in tax credits due to errors of compliance, for the life of the partnership. For a LIHTC Fund, a Tax Credit Guarantee is required from the developers of the lower tier LIHTC properties to the upper tier partnership and all other LIHTC investments.
   III. There are sufficient operating reserves, capital replacement reserves and/or operating deficit guarantees present to mitigate foreseeable foreclosure risk at the time of the investment.

Non-qualifying LIHTCs should be reported in the “All Other” category

Working Capital Finance Investment

Include: Investments in an interest in a Confirmed Supplier Receivables (CSR) under a Working Capital Finance Program (WCFP) that is designated by the SVO as meeting the criteria specified in the Purposes and Procedures Manual of the NAIC Investment Analysis Office for an NAIC “1” or “2.”

Working Capital Finance Program (WCFP)

Open account program under which an Investor may purchase interests, or evidence thereof, in commercial non-insurance receivables. A WFCP is created for the benefit of a commercial investment grade obligor and its suppliers of goods or services and facilitated by a financial intermediary.

Confirmed Supplier Receivables (CSR)

A first priority perfected security interest claim or right to payment of a monetary obligation from the Obligor arising from the sale of goods or services from the Supplier to the Obligor the payment of which the Obligor has confirmed by representing and warranting that it will not protest, delay, or deny, nor offer nor assert any defenses against, payment to the supplier or any party taking claim or right to payment from the supplier.

Residual Tranches or Interests with Underlying Assets Having Characteristics of:

Investment in Residual Tranches or Interests should be assigned to the subcategory with the highest underlying asset concentration. There shouldn’t be any bifurcation of the underlying assets among the subcategories.

Include: Residual tranches or interests captures securitization tranches and beneficial interests as well as other structures captured in scope of SSAP No. 43R – Loan-Backed and Structured Securities, that reflect loss layers without any contractual payments, whether interest or principal, or both. Payments to holders of these investments occur after contractual interest and principal payments have been made to other tranches or interests and are based on the remaining available funds. See SSAP No. 43R for accounting guidance.

Fixed Income Instruments

Include: Investments with underlying collateral which, if held individually, would be reported on Schedule D – Part 1 – Long-Term Bonds

Common Stocks

Include: Investments with underlying collateral which, if held individually, would be reported on Schedule D – Part 2 – Section 2 – Common Stocks

Preferred Stocks

Include: Investments with underlying collateral which, if held individually, would be reported on Schedule D – Part 2 – Section 1 – Preferred Stocks

Real Estate

Include: Investments with underlying collateral which, if held individually, would be reported on Schedule A – Real Estate Owned

Mortgage Loans

Include: Investments with underlying collateral which, if held individually, would be reported on Schedule B – Mortgage Loans

Other

Include: Items that do not qualify for inclusion in the above subcategories.

Any Other Class of Assets

Include: Investments that do not fit into one of the other categories. An example of items that may be included are reverse mortgages.

All structured settlement income streams acquired as investments where the reporting entity acquires the legal right to receive payments. (Valuation and admittance provisions are detailed in SSAP No. 21R—Other Admitted Assets.)

This category shall also include oil and gas leases, aircraft owned under leveraged lease arrangements, investments in extractive materials and timber deeds that are not owned within a partnership, LLC or joint venture structure.
Issue: Conceptual Framework – Updates

Check (applicable entity):

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<th>Modification of Existing SSAP</th>
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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:**

<table>
<thead>
<tr>
<th>Preamble</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>IV. Statutory Accounting Principles Statement of Concepts</strong></td>
</tr>
<tr>
<td>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.</td>
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| 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. |

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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
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


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 Impairment 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 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 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.

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.

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)

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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

FN 4 - The Statutory Accounting Principles Statement of Concepts incorporates by reference *FASB Concepts Statements* One, Two, Five and SixEight 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 twothree 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 adopts FASB Statement of Financial
Accounting Concepts No. 86, Chapter 4, Elements of Financial Statements, paragraphs E16-E1825-33.

**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. 166—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 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 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. 166—Updates to the Definition of an Asset

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; Robin Marcotte, NAIC Staff, December – 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. 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.

On December 13, 2022, the Working Group re-exposed the proposed revisions and draft Issue Paper No. 16X—Updates to the Definition of a Liability related to the definition change of a liability in SSAP No. 5R—Liabilities, Contingencies and Impairment of Assets. This exposure intends to provide additional time for industry to review the changes in accordance with statutory accounting statements. NAIC staff were directed to collaborate with interested parties on proposed clarifying language.

Statutory Issue Paper No. 16X

Updates to the Definition of a Liability

STATUS
Exposure Draft – December 13, 2022 (re-exposure)

Original and Current Authoritative Guidance: SSAP No. 5R

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. This issue paper documents the SAP clarification revisions to SSAP No. 5R—Liabilities, Contingencies and Impairment of Assets. The intent of the revisions is to align current statutory accounting guidance, specifically the definition of a “liability,” with the term utilized by the Financial Accounting Standards Board (FASB).

SUMMARY CONCLUSION

2. The statutory accounting principle clarifications to SSAP No. 5R (illustrated in Exhibit A), reflect that for the purposes of statutory accounting, a liability shall be defined as: a present obligation of an entity to transfer an economic benefit. A liability has 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 these characteristics, 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. 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.

3. 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. (The definition and recognition requirements of loss contingencies under SSAP No. 5R are not proposed to be revised and will continue as statutory accounting guidance.)

DISCUSSION

4. 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 a liability. 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.

5. 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 “liability” 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.

6. Under the prior FASB concept statement, which was reflected in SSAP No. 5R, a liability was defined as a probable future sacrifice 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 past transactions or events. In addition, the historical definition possessed three essential characteristics in that (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 entity, leaving it little or no discretion to avoid the future sacrifice, and (3) the transaction or other event obligating the entity has already happened.

7. Pursuant to the prior concept statement, and as incorporated in SSAP No. 5R, 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.

8. With the new FASB conceptual framework chapter, a liability is now defined as a present obligation of an entity to transfer an economic benefit. In addition, the current definition has two essential characteristics in that the liability is (1) a present obligation, and (2) the obligation requires an entity to transfer or otherwise provide economic benefits to others.

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.

11. The FASB also struck the phrase as the result of past transactions or events. With this action, the FASB clarified that if the liability represents a present obligation, by default, the obligation must have occurred as the result of a past transaction or event and thus this phraseology was deemed redundant and unnecessary.
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.

14. The remaining concepts and guidance articulated in SSAP No. 5R (e.g., contingencies, impairments, guarantees, etc.) were not proposed for revision and thus are not further discussed in this issue paper.

Actions of the Statutory Accounting Principles (E) Working Group

15. During the Spring 2022 National Meeting, the Working Group is exposed this issue paper for public comment.

16. During the Summer 2022 National Meeting, the Working Group is re-exposed this issue paper for public comment.

17. At the Fall 2022 National Meeting, the Working Group re-exposed this issue paper related to the definition change of a liability in SSAP No. 5R—Liabilities, Contingencies and Impairment of Assets. This exposure intends to provide additional time for industry to review the changes in accordance with statutory accounting statements. NAIC staff were directed to collaborate with interested parties on proposed clarifying language.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

18. Relevant excerpts of SSAP No. 5R, paragraphs 2-3 regarding the definition of a liability accounting are as follows:

2. A liability is defined as certain or probable 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).

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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 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.
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 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.

**Generally Accepted Accounting Principles**

17. Relevant paragraphs from *Concepts Statement No. 8, Conceptual Framework for Financial Reporting—Chapter 4, Elements of Financial Statements* have been included below:

**Liabilities**

E37. A liability is a present obligation of an entity to transfer an economic benefit

**Characteristics of Liabilities**

E38. A liability has the following two essential characteristics: a. It is a present obligation. b. The obligation requires an entity to transfer or otherwise provide economic benefits to others.

E39. Liabilities commonly have features that help identify them. For example, many liabilities require the obligated entity to pay cash to one or more identified other entities. Liabilities may not require an entity to pay cash but may require the entity to convey other assets, provide services, or transfer other economic benefits or to be ready to do so. Liabilities are based on a foundation of legal rights and duties.

E40. Entities routinely incur liabilities in exchange transactions to acquire the funds, goods, and services they need to operate. For example, borrowing cash (acquiring funds) obligates an entity to repay the amount borrowed, acquiring assets on credit obligates an entity to pay for the assets, and selling products with a warranty or guarantee obligates an entity to either pay cash or repair or replace any products that prove defective. Often, obligations incurred in exchange transactions are contractual based on written or oral agreements to pay cash or to provide goods or services to specified or determinable entities on demand at specified or determinable dates or on the occurrence of specified events.

**Present obligation**

E41. A liability requires that an entity be obligated to perform or act in a certain manner. In most cases it is apparent that liabilities are legally enforceable. Legally enforceable obligations include those arising from binding contracts, agreements, rules, statutes, or other requirements that would be upheld by a judicial system or government. Judicial systems vary in type and form, and the term judicial systems includes any such system that would enforce laws, statutes, and regulations. In the context most relevant to financial reporting, an obligation is any condition that binds an entity to some performance or action. In a financial reporting context, something is binding on an entity if it requires performance. Performance is what the entity is required to do to satisfy the obligation.

E42. Many obligations that qualify as liabilities stem from contracts and other agreements that are enforceable by courts or from governmental actions that have the force of law. Agreements, contracts, or statutory requirements often will specify or imply how an obligation was incurred and...
when and how the obligation is to be settled. For example, borrowing and lease agreements specify
the amount of charges and the dates when the payments are due. The absence of a specified
maturity date or event to require settlement may cast doubt that an obligation exists.

E43. Liabilities necessarily involve other parties, society, or law. The identity of the other party or
recipient need not be known to the obligated entity before the time of settlement. An obligation of
an entity to itself cannot be a liability. For example, in the absence of external requirements an
entity is not obligated to repair the roof of its building or maintain its plant and equipment. Although
those actions may be wise business moves, the entity may forgo or defer such activities because
there is no present obligation to perform the activity.

E44. Certain obligations require nonreciprocal transfers from an entity to one or more other entities.
Such obligations include taxes imposed by governments, donations pledged to charitable entities,
and cash dividends declared but not yet paid.

E45. To have a liability, an entity must have a present obligation, that is, the obligation exists at the
financial statement date. The settlement date of the liability may occur in the future, but the
obligation must be present at the financial statement date. Transactions or other events or
circumstances expected to occur in the future do not in and of themselves give rise to obligations
today.

E46. An intention to purchase an item, for example, an asset, does not in and of itself create a
liability. However, a contractual obligation that requires an entity to pay more than the fair value of
the asset at the transaction date may create a liability before the asset is received, reflecting what
the entity might have to pay to undo the unfavorable contract.

E47. Business risks result from the conduct of an entity’s business activities. A business risk is not
a present obligation, though at some point in the future an event may occur that creates a present
obligation. Some businesses have the potential of carrying out activities and creating present
obligations as a result of those activities. However, no present obligation exists even if it is virtually
certain that an obligating event will occur, though at present no such event has occurred. The
essence of distinguishing business risks from liabilities is determining the point in time when an
entity has a present obligation.

E48. Some business risks result from an entity’s transactions, for example, selling goods in
overseas markets might expose an entity to the risk of future cash flow fluctuations because of
changes in foreign exchange rates. Other business risks result from an entity’s operating
environment, for example, operating in a highly specialized industry might expose an entity to the
risk that it will be unable to attract sufficient skilled staff to sustain its operating activities. Those
risks are not liabilities.

E49. To be presently obligated, an entity must be bound, either legally or in some other way, to
perform or act in a certain way. Most liabilities are legally enforceable, including those arising from
contracts, agreements, rules, and statutes. An entity also can become obligated by other means
that would be expected to be upheld by a judicial process. However, the existence of a present
obligation may be less clear in those circumstances.

E50. Some liabilities rest on constructive obligations, including some that arise in exchange
transactions. A constructive obligation is created, inferred, or construed from the facts in a particular
situation rather than contracted by agreement with another entity or imposed by government. An
entity may become constructively obligated through customary business practice. In the normal
course of business, an entity conducting certain activities may not create a clear contractual
obligation but may nonetheless cause the entity to become presently obligated. For example,
policies and practices for sales returns and those for warranties in the absence of a contract may
create a present obligation because the pattern of behavior may create an enforceable claim for
performance that would be upheld in the ultimate conclusion of a judiciary process.
E51. An entity's past behavior also may give rise to a present obligation. Repeated engagement in a certain behavior may obligate the entity to perform or act in a certain way on the basis of that pattern of behavior. For example, the entity may create a constructive obligation to employees for vacation pay or year-end bonuses by paying them every year even though it is not contractually bound to do so and has not announced a policy to do so.

18. The most notable changes regarding the definition of a liability included removal of the term *probable* and the phrase *as a result of past transactions or 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.

19. The other significant change to the definition of a liability included changing *future sacrifices* to a *present obligation*. Rationale for these changes were documented in *Chapter 4, Elements of Financial Statements* commentary as follows:

**BC4.25.** The term present obligation is included in the definition of a liability, both in this chapter and in Concepts Statement 6. Because the application of the liability definition under Concepts Statement 6 did not give sufficient emphasis to the term present obligation, the definition in this chapter more appropriately emphasizes that term. Assessing whether a present obligation exists is the primary criterion in the definition of a liability in this chapter. The primacy of the term present obligation is made more evident through the removal of many of the problematic terms in the definition of a liability in Concepts Statement 6, as discussed in paragraphs BC4.11–BC4.13.

**BC4.26.** Almost always, the existence of a present obligation will be apparent. Most present obligations are legally enforceable, including obligations arising from binding contracts, agreements, statutes, or other legal or contractual means. However, situations lacking clear legal or contractual evidence of a present obligation pose particular challenges that may make it difficult to discern whether a present obligation exists.
Determining when a present obligation exists has caused confusion with the existence of business risks. Business risks result from the nature of the business and where, when, and how an entity conducts its business. While certain businesses pose risks of future events occurring that will cause a transfer of economic benefits, the Board decided that the risks themselves are not present obligations because exposure to a potential negative consequence does not constitute a present obligation. Rather than viewing all business risks as liabilities, the Board decided that an entity has a present obligation only after an event occurs that demonstrates that the inherent business risk has created a present obligation. Thus, distinguishing when a business risk makes an entity presently obligated requires analysis of the facts and circumstances at the standards level.

Determining the existence of a present obligation is particularly challenging in evaluating constructive obligations. Interpreting constructive obligations too narrowly will tend to exclude significant actual obligations of an entity, while interpreting them too broadly will effectively nullify the definition by including items that lack an essential characteristic of liabilities.

Given that constructive obligations and other noncontractual obligations are created by circumstance rather than explicit agreement, it can be unclear whether a present obligation exists. 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 Board decided that specific facts and circumstances at the standards level must be assessed to determine whether an entity has created a constructive obligation.

RELEVANT LITERATURE

Statutory Accounting
  - Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy

Generally Accepted Accounting Principles

Effective Date

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. 5R by the Working Group on TBD.
EXHIBIT A – SAP Clarification Revisions to SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets

Statement of Statutory Accounting Principles No. 5 - Revised

Liabilities, Contingencies and Impairments of Assets

SCOPE OF STATEMENT

1. This statement defines and establishes statutory accounting principles for liabilities, contingencies and impairments of assets.

SUMMARY CONCLUSION

Liabilities

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 probableFN1 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 required an entity to transfer or otherwise provide economic benefit to othersduty 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

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

Issue: Collateral for Loans

Check (applicable entity):

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Description of Issue:

This agenda item has been drafted to address an inconsistency regarding the collateral loan guidance in SSAP No. 20—Nonadmitted Assets and SSAP No. 21—Other Admitted Assets (See excerpts in Authoritative Literature). These two statements contain guidance about unsecured and secured loans which is complementary.

SSAP No. 20 details the nonadmitted assets status of unsecured loans and loans secured by assets which do not qualify as investments. SSAP No. 20 also references write off and impairment guidance in SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets for impaired and uncollectible loans. SSAP No. 20 provides that improperly collateralized loans include loans that do not have underlying assets that would otherwise qualify as admitted assets and stated that such loans are nonadmitted assets because the collateral would be of questionable economic value if needed to fulfill policyholder obligations. SSAP No. 20 includes similar nonadmission guidance regarding loans on personal security, cash advances to officers or agents and for travel advances.

SSAP No. 21 details the requirements for collateral loans which can qualify to be admitted assets. It provides that the collateral loan must be secured by the pledge of an investment. A footnote further describes that investment collateral would be of a type that would be in Section 3 of Appendix A-001—Investments of Reporting Entities. SSAP No. 21 also references the nonadmission guidance in SSAP No. 20 for collateral loans secured by assets that do not qualify as investments. The referenced guidance in SSAP No. 20 notes that the underlying assets must qualify as admitted assets.

Both SSAP No. 20 and SSAP No. 21 identify the need for adequate collateral that qualifies as an invested asset. SSAP No. 20 is explicit that the investment asset collateral must qualify as an admitted asset. Recent discussions with state regulators have highlighted that although SSAP No. 21 references the guidance in SSAP No. 20, that it would be beneficial to also note the need for the collateral to qualify as an admitted invested asset. This agenda item recommends a clarification to SSAP No. 21 that the acceptable invested asset collateral, for collateral loans must qualify as admissible invested assets.

Existing Authoritative Literature:

SSAP No. 20—Nonadmitted Assets (Bolding added for emphasis):

4. Consistent with paragraph 2, the following assets shall be nonadmitted:
   a. Deposits in Suspended Depositories—Amounts on deposit with suspended depositories may not be fully recoverable. Any amounts not reasonably expected to be recovered shall be written off in accordance with SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets. Amounts in excess of that written off shall be nonadmitted as they are not available to satisfy obligations to policyholders;
b. **Bills Receivable Not for Premium and Loans Unsecured or Secured by Assets That Do Not Qualify As Investments**—In accordance with SSAP No. 5R, amounts determined to be uncollectible or otherwise impaired shall be written off. Amounts in excess of that written off are not considered to be properly collateralized as there are no underlying assets which would otherwise be admitted assets. Such amounts shall be nonadmitted as they may be of questionable economic value if needed to fulfill policyholder obligations. Receivables arising from working capital finance programs designated by the Securities Valuation Office are subject to the guidance in SSAP No. 105R—Working Capital Finance Investments;

c. **Loans on Personal Security, Cash Advances To, Or In The Hands Of, Officers Or Agents And Travel Advances**—In accordance with SSAP No. 5R, amounts determined to be uncollectible or otherwise impaired shall be written off. Amounts in excess of that written off typically are unsecured and as such have no underlying assets which would otherwise be admitted assets. Such amounts shall be nonadmitted as they may be of questionable economic value if needed to fulfill policyholder obligations. Some of these items may also be considered prepaid expenses which, per SSAP No. 29—Prepaid Expenses, are nonadmitted;

d. **All “Non-Bankable” Checks**—Examples of “non-bankable” checks are NSF (non-sufficient funds) checks, post-dated checks, or checks for which payment has been stopped. Although these checks may still maintain probable future benefits (and thus meet the definition of assets), at the date on which they are non-bankable they are not available for policyholder obligations and shall be nonadmitted until the uncertainty related to the probable future benefit is resolved and the checks are converted to available funds;

e. **Trade Names And Other Intangible Assets**—These assets, by their nature, are not readily marketable and available to satisfy policyholder obligations and shall be nonadmitted;

f. **Automobiles, Airplanes and Other Vehicles**—Automobiles, airplanes and other vehicles meet the definition of assets established in SSAP No. 4. However, they are not readily available to satisfy policyholder obligations and as a result the undepreciated portion shall be nonadmitted. The accounting for these assets shall be consistent with the accounting for equipment provided in SSAP No. 19—Furniture, Fixtures, Equipment and Leasehold Improvements or for commercial airplane leveraged leases, refer to the guidance in SSAP No. 22R–Leases;

g. **Company’s Stock as Collateral for Loan**—When a reporting entity lends money and accepts its own stock as collateral for the loan, it shall report the amount of the loan receivable and any related accrued interest on the loan as a nonadmitted asset. The asset is nonadmitted as the collateral could not be used to satisfy the obligation in the event of default.

**Footnote 1:** Defensible intangible assets are defined as an intangible asset acquired in a business combination or an asset acquisition that an entity does not intend to actively use but does intend to prevent others from using. These may also be referred to as a "locked-up asset" because while the asset is not being actively used, it is likely contributing to an increase in the value of other assets owned by the entity. These assets are not readily available to satisfy policyholder obligations and shall be nonadmitted.
SSAP No. 21 – Revised—Other Admitted Assets (Bolding added for emphasis)

Collateral Loans

4. Collateral loans are unconditional obligations\(^1\) for the payment of money secured by the pledge of an investment\(^2\) and meet the definition of assets as defined in SSAP No. 4, and are admitted assets to the extent they conform to the requirements of this statement. The outstanding principal balance on the loan and any related accrued interest shall be recorded as an admitted asset subject to the following limitations:

   a. Loan Impairment—Determination as to the impairment of a collateral loan shall be based on current information and events. When it is considered probable that any portion of amounts due under the contractual terms of the loan will not be collected the loan is considered impaired. The impairment shall be measured based on the fair value of the collateral less estimated costs to obtain and sell the collateral. The difference between the net value of the collateral and the recorded asset shall be written off in accordance with SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets;

   b. Nonadmitted Asset—In accordance with SSAP No. 20—Nonadmitted Assets, collateral loans secured by assets that do not qualify as investments shall be nonadmitted. Further, any amount of the loan outstanding which is in excess of the permitted relationship of fair value of the pledged investment to the collateral loan shall be treated as a nonadmitted asset.

Footnote 1: For purposes of determining a collateral loan in scope of this statement, a collateral loan does not include investments captured in scope of other statements. For example, SSAP No. 26R—Bonds includes securities (as defined in that statement) representing a creditor relationship whereby there is a fixed schedule for one or more future payments. Investments captured in SSAP No. 26R that are also secured with collateral shall continue to be captured within scope of SSAP No. 26R.

Footnote 2: Investment defined as those assets listed in Section 3 of Appendix A-001—Investments of Reporting Entities.

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


Staff Review Completed by: Robin Marcotte – NAIC Staff – July 2022

Staff Recommendation: NAIC staff recommends that the Working Group move this item to the active listing, categorized as a SAP clarification, and expose the revisions to SSAP No. 21, illustrated below, which clarify that the invested assets pledged as collateral for admitted collateral loans must qualify as admitted invested assets.
Proposed revisions to 

**SSAP No. 21 – Revised—Other Admitted Assets**

**Collateral Loans**

4. Collateral loans are unconditional obligations¹ for the payment of money secured by the pledge of a qualifying investment² and meet the definition of assets as defined in SSAP No. 4, and are admitted assets to the extent they conform to the requirements of this statement. The outstanding principal balance on the loan and any related accrued interest shall be recorded as an admitted asset subject to the following limitations:

   a. Loan Impairment—Determination as to the impairment of a collateral loan shall be based on current information and events. When it is considered probable that any portion of amounts due under the contractual terms of the loan will not be collected the loan is considered impaired. The impairment shall be measured based on the fair value of the collateral less estimated costs to obtain and sell the collateral. The difference between the net value of the collateral and the recorded asset shall be written off in accordance with SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets;

   b. Nonadmitted Asset—In accordance with SSAP No. 20—Nonadmitted Assets, collateral loans secured by assets that do not qualify as investments which would otherwise be admitted shall be nonadmitted. Further, any amount of the loan outstanding which is in excess of the permitted relationship of fair value of the pledged investment to the collateral loan shall be treated as a nonadmitted asset.

**Footnote 1:** For purposes of determining a collateral loan in scope of this statement, a collateral loan does not include investments captured in scope of other statements. For example, SSAP No. 26R—Bonds includes securities (as defined in that statement) representing a creditor relationship whereby there is a fixed schedule for one or more future payments. Investments captured in SSAP No. 26R that are also secured with collateral shall continue to be captured within scope of SSAP No. 26R.

**Footnote 2:** A qualifying investment defined as those assets listed in Section 3 of Appendix A-001—Investments of Reporting Entities which would, if held by the insurer, qualify for admittance. For example, if the collateral would not qualify for admittance under SSAP No. 4 due to encumbrances or other third-party interests, then it does not meet the definition of "qualifying" and the collateral loan, or any portion thereof which is not adequately collateralized, is not permitted to be admitted.

**Status:**

On August 10, 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. 21R to clarify that invested assets pledged as collateral for admitted collateral loans must qualify as admitted invested assets.

On December 13, 2022, the Working Group re-exposed revisions to SSAP No. 21R to clarify that invested assets pledged as collateral for admitted collateral loans must qualify as admitted invested assets.
Issue: Review of INT 03-02: Modification to an Existing Intercompany Pooling Arrangement

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Description of Issue:
This agenda item provides a review of Interpretation (INT) 03-02: Modification to an Existing Intercompany Pooling Arrangement, because of conflicts between INT 03-02 and SSAP No. 25—Affiliates and Other Related Parties. This agenda item was prompted by the recent focus of Statutory Accounting Principles (E) Working Group on related party transactions, recent queries to NAIC about how broadly to apply the guidance in INT 03-02 and the review of the SSAP No. 62R, paragraph INT 03-02 addresses the valuation of bonds in instances when bonds are used instead of cash for the payment among affiliates for amounts due on modifications to existing intercompany reinsurance pooling contracts. The discrepancy between the INT 03-02 and SSAP No. 25 has been identified through recent discussions evaluating related party transactions. Key excerpts of INT 03-02 are in the Authoritative Literature section below.

The primary accounting question that is a concern for this agenda item is INT 03-02, paragraph 11b which asks, “What is the appropriate valuation basis to be used for assets and liabilities that are transferred among affiliates in conjunction with the execution of a new reinsurance agreement(s) that serves to substantively modify an existing intercompany pooling arrangement?” The response provided in INT 03-02, paragraph 13 is, “The appropriate valuation basis to be used for assets and liabilities that are transferred among affiliates in conjunction with the execution of a new reinsurance agreement(s) that serves to substantively modify an existing intercompany pooling arrangement is statutory book value for assets and statutory value for liabilities. Book value is defined in the glossary of the Accounting Practices and Procedure Manual.”

INT 03-02 lists that it is an interpretation of the following three reinsurance statements: SSAP No. 61R—Life, Deposit-Type and Accident and Health Reinsurance, SSAP No. 62R—Property and Casualty Reinsurance and SSAP No. 63—Underwriting Pools. SSAP No. 25—Affiliates and Other Related Parties is not listed as an interpreted statement. However, as described below, the consensus in INT 03-02, paragraph 13 is not consistent with the guidance in SSAP No. 25 regarding economic transactions between related parties.

The result of the consensus in INT 03-02, paragraph 13 allows assets used in affiliated payments for reinsurance contracts, which modify existing intercompany reinsurance pooling agreements, to be transferred using statutory book value. Note that in most cases, this means that bonds which are likely the primary assets that would be used, would typically have a statutory book value that reflects amortized cost. The valuation of assets using statutory book value on transfer to an affiliate, can result in substantial differences from the cash equivalent (fair value) for the payment due. For example, bonds reported at amortized cost book value could have a corresponding fair value that is materially higher or lower. This difference in valuation can result in an unacknowledged dividend or with the passing on of an investment loss.

SSAP No. 25 describes economic transactions and non-economic transactions (See Authoritative Literature). Economic transactions are defined as arm’s-length transactions which results in the transfer of the risks and rewards of ownership and represents a consummated act thereof, i.e., “permanence.” SSAP No. 25, paragraph 18 indicates that economic transactions between related parties shall be recorded at fair value at the date of the transaction and also notes that to the extent that the related parties are affiliates under common control, the controlling reporting
entity shall defer the effects of such transactions that result in gains or increases in surplus until such time that the asset is sold outside the group.

It is quite possible, by using transfers at book value instead of fair value, to design a transaction with a very significant economic effect. The following example illustrates the concern with the results of the guidance in INT 03-02. For this example, $100 million is due on an existing intercompany reinsurance pooling agreement. INT 03-02 would allow bonds to be settled using statutory book value which may not be reflective of the fair value equivalent of a cash settlement.

<table>
<thead>
<tr>
<th>Asset used to settle</th>
<th>Book Value (millions) measurement for settlement</th>
<th>Fair Value (millions)</th>
<th>Result</th>
<th>Consistent with SSAP No. 25 for an economic transaction?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$100</td>
<td>$100</td>
<td>No difference in basis</td>
<td>Yes</td>
</tr>
<tr>
<td>Bonds</td>
<td>$100</td>
<td>$85</td>
<td>$15 difference in fair value means the paid party received an amount less than what is actually owed. This approach could allow reporting entities to transfer impaired assets to affiliates in lieu of assessing OTTI.</td>
<td>No</td>
</tr>
<tr>
<td>Bonds</td>
<td>$100</td>
<td>$110</td>
<td>$10 difference in fair value means the paid party has received an asset greater than what was owed. This dynamic could result in an unrecognized gain or dividend.</td>
<td>No</td>
</tr>
</tbody>
</table>

The INT 03-02 direction to use statutory book value for the transfer of bonds between affiliated entities in most instances would conflict with the primary guidance on affiliated transactions contained in SSAP No. 25—Affiliates and Other Related Parties. For example, economic transactions between related parties are valued using fair value. (There are more nuances in SSAP No. 25 when payments have the possibility of being economic for one entity and noneconomic for an upper-level parent). NAIC staff recommends that the treatment of transfers of assets between affiliates should be consistent for all intercompany transactions and there is not a compelling need to be different if assets are transferred instead of cash for intercompany reinsurance.

Under INT 03-02, for intercompany reinsurance transactions, takes an approach that either SSAP No. 25 or SSAP No. 62R may apply, but multiple Working Group discussions have noted that SSAP No. 25 provides the overarching guidance that is relevant in evaluating all related party transactions. INT 03-02, paragraph 8 indicates that the statutory accounting intention is to avoid surplus gains for the ceding entity as a result of implementing a modification to an intercompany pooling arrangement. However, the guidance in SSAP No. 62R, paragraph 37 uses a more punitive method of accounting if there is a gain in surplus to the ceding entity as a result of the intercompany reinsurance transaction. Therefore, NAIC staff would characterize the SSAP No. 62R guidance as imposing an accounting penalty if there is a gain, rather than seeking to avoid recognizing such a gain. The INT also characterizes SSAP No. 25 as being for isolated transactions, which is inconsistent with discussions of the Working Group on the applicability of SSAP No. 25.

SSAP No. 62R, paragraph 36d (see Authoritative Literature) includes an exception to retroactive reinsurance accounting which allows prospective accounting treatment for intercompany reinsurance agreements and any amendments thereto, among companies 100% owned by a common parent or ultimate controlling person provided there is no gain in surplus as a result of the transaction. Paragraph 37 provides that if there is a gain to the ceding entity that a more restrictive method of accounting is required which is less beneficial to the financial statements. Whereas the INT tries to argue that statutory intent is to avoid surplus gain, NAIC staff would note that the goal is not to avoid gain as a result of the reinsurance transaction, but to impose a different accounting if there is a gain.
NAIC staff would characterize evaluating reinsurance agreements for SSAP No. 62R, paragraph 36d or paragraph 37 as using the cash flows or corresponding equivalent fair value (cash equivalent) of the amounts payable or receivable in the reinsurance transactions to determine if there is a gain or loss to the ceding entity. The reinsurance cash flows evaluated should be the same as if the bond was sold for fair value and resulting cash equivalent obligation was paid. The fact that the bond sold has a gain or loss is not part of the reinsurance contract evaluation, the reinsurance contract that is an economic transaction evaluation is based on the cash equivalent value of the assets transferred less the liabilities transferred. The evaluation of gain or loss on the intercompany reinsurance transaction should give the same answer if either cash or assets were transferred.

**Existing Authoritative Literature:**

03-02: *Modification to an Existing Intercompany Pooling Arrangement* is attached in full. The following excerpts are from INT 03-02:

8. Therefore, based on the foregoing guidance and background, the statutory accounting intent is to avoid surplus gains for the ceding entity as a result of implementing a modification to an intercompany pooling arrangement. On that basis, such a modification does not represent an economic transaction to the insurance group or to the impacted companies. As such, the transfer of both the assets and the liabilities valued at statutory book value ensures that there is no impact to surplus as a result of implementing a modification to an existing pooling arrangement.

11. The accounting issues are:

   a. What is the relevant guidance for modifications to intercompany pooling arrangements?

   b. What is the appropriate valuation basis to be used for assets and liabilities that are transferred among affiliates in conjunction with the execution of a new reinsurance agreement(s) that serves to substantially modify an existing intercompany pooling arrangement?

The Working Group reached a consensus as follows:

12. SSAP No. 62R provides accounting for property and casualty reinsurance agreements including specific guidance on intercompany pooling agreements. SSAP No. 62R provides two methods of accounting for changes in intercompany pooling agreements, depending on whether or not the pooling results in a gain in surplus.

13. The appropriate valuation basis to be used for assets and liabilities that are transferred among affiliates in conjunction with the execution of a new reinsurance agreement(s) that serves to substantially modify an existing intercompany pooling arrangement is statutory book value for assets and statutory value for liabilities. Book value is defined in the glossary of the *Accounting Practices and Procedure Manual*.

**SSAP No. 25—Affiliates and Other Related Parties**

**Transactions Involving the Exchange of Assets or Liabilities**

14. An arm’s-length transaction is defined as a transaction in which willing parties, each being reasonably aware of all relevant facts and neither under compulsion to buy, sell, or loan, would be willing to participate. A transaction between related parties involving the exchange of assets or liabilities shall be designated as either an economic transaction or non-economic transaction. An economic transaction is defined as an arm’s-length transaction which results in the transfer of the risks and rewards of ownership and represents a consummated act thereof, i.e., “permanence.” The appearance of permanence is also an important criterion in assessing the economic substance of a transaction. In order for a transaction to have economic substance and thus warrant revenue (loss) recognition, it must appear unlikely to be reversed. If subsequent events or transactions reverse the effect of an earlier transaction prior to the issuance of the financial statements, the reversal shall be considered in determining whether economic substance existed.
in the case of the original transaction. Subsequent events are addressed in SSAP No. 9—Subsequent Events. An economic transaction must represent a bonafide business purpose demonstrable in measurable terms. A transaction which results in the mere inflation of surplus without any other demonstrable and measurable betterment is not an economic transaction. The statutory accounting shall follow the substance, not the form of the transaction.

15. In determining whether there has been a transfer of the risks and rewards of ownership in the transfer of assets or liabilities between related parties, the following—and any other relevant facts and circumstances related to the transaction—shall be considered:

a. Whether the seller has a continuing involvement in the transaction or in the financial interest transferred, such as through the exercise of managerial authority to a degree usually associated with ownership;

b. Whether there is an absence of significant financial investment by the buyer in the financial interest transferred, as evidenced, for example, by a token down payment or by a concurrent loan to the buyer;

c. Whether repayment of debt that constitutes the principal consideration in the transaction is dependent on the generation of sufficient funds from the asset transferred;

d. Whether limitations or restrictions exist on the buyer’s use of the financial interest transferred or on the profits arising from it;

e. Whether there is retention of effective control of the financial interest by the seller.

16. A transaction between related parties may meet the criteria for treatment as an economic transaction at one level of financial reporting, but may not meet such criteria at another level of financial reporting. An example of such a transaction is a reporting entity purchasing securities at fair value from an affiliated reporting entity that carried the securities at amortized cost. This transaction meets the criteria of an economic transaction at this level of financial reporting, and therefore, the selling reporting entity would record a gain and the acquiring reporting entity would record the securities at their cost (fair value on the transaction date). At the common parent level of reporting, this transaction has resulted in the mere inflation of surplus, and therefore, is a non-economic transaction. The parent reporting entity shall defer the net effects of any gain or increase in surplus resulting from such transactions by recording a deferred gain and an unrealized loss. The deferred gain shall not be recognized by the parent reporting entity unless and until arms-length transaction(s) with independent third parties give rise to appropriate recognition of the gain.

17. A non-economic transaction is defined as any transaction that does not meet the criteria of an economic transaction. Similar to the situation described in paragraph 16, transfers of assets from a parent reporting entity to a subsidiary, controlled or affiliated entity shall be treated as non-economic transactions at the parent reporting level because the parent has continuing indirect involvement in the assets.

18. When accounting for a specific transaction, reporting entities shall use the following valuation methods:

a. Economic transactions between related parties shall be recorded at fair value at the date of the transaction. To the extent that the related parties are affiliates under common control, the controlling reporting entity shall defer the effects of such transactions that result in gains or increases in surplus (see paragraph 16);

b. Non-economic transactions between reporting entities, which meet the definition of related parties above, shall be recorded at the lower of existing book values or fair values at the date of the transaction;

c. Non-economic transactions between a reporting entity and an entity that has no significant ongoing operations other than to hold assets that are primarily for the direct or indirect benefit or use of the reporting entity or its affiliates, shall be recorded at the fair value at
the date of the transaction; however, to the extent that the transaction results in a gain, that
gain shall be deferred until such time as permanence can be verified;

d. Transactions which are designed to avoid statutory accounting practices shall be reported
as if the reporting entity continued to own the assets or to be obligated for a liability directly
instead of through a subsidiary.

Examples of transactions deemed to be non-economic include security swaps of similar issues between or
among affiliated companies, and swaps of dissimilar issues accompanied by exchanges of liabilities
between or among affiliates.

Transactions Involving Services

19. Transactions involving services between related parties can take a variety of different forms. One
of the significant factors as to whether these transactions will be deemed to be arm’s length is the amount
charged for such services. In general, amounts charged for services are based either on current market
rates or on allocations of costs. Determining market rates for services is difficult because the circumstances
surrounding each transaction are unique. Unlike transactions involving the exchange of assets and liabilities
between related parties, transactions for services create income on one party’s books and expense on the
second party’s books, and therefore, do not lend themselves to the mere inflation of surplus. These
arrangements are generally subject to regulatory approval.

20. Transactions involving services provided between related parties shall be recorded at the amount
charged1. Regulatory scrutiny of related party transactions where amounts charged for services do not meet
the fair and reasonable standard established by Appendix A-440, may result in (a) amounts charged being
recharacterized as dividends or capital contributions, (b) transactions being reversed, (c) receivable
balances being nonadmitted, or (d) other regulatory action. Expenses that result from cost allocations shall
be allocated subject to the same fair and reasonable standards, and the books and records of each party
shall disclose clearly and accurately the precise nature and details of the transaction. See SSAP No 70—
Allocation of Expenses for additional discussion regarding the allocation of expenses.

SSAP No. 62R—Property and Casualty Reinsurance provides the following (bolding added for emphasis):

36. The accounting principles for retroactive reinsurance agreements in paragraph 34 shall not apply
to the following types of agreements (which shall be accounted for as prospective reinsurance agreements
unless otherwise provided in this statement):

   a. Structured settlement annuities for individual claims purchased to implement settlements
      of policy obligations;

   b. Novations, (i.e., (i) transactions in which the original direct insurer’s obligations are
      completely extinguished, resulting in no further exposure to loss arising on the business
      novated or (ii) transactions in which the original assuming entity’s obligations are
      completely extinguished) resulting in no further exposure to loss arising on the business
      novated, provided that (1) the parties to the transaction are not affiliates (or if affiliates, that
      the transaction has the prior approval of the domiciliary regulators of the parties) and (2)
      the accounting for the original reinsurance agreement will not be altered from retroactive
      to prospective;

1 The amount charged shall be reviewed when there are any modifications or waivers subsequent to the establishment of the contract terms.
If waivers or modifications to amounts charged occur, the related party transaction shall be reassessed to determine whether the contract
continues to reflect fair and reasonable standards. If the transaction was with a parent or other stockholder and the charge for services has
been fully waived, then the guidance in SSAP No. 72 for recognition as contributed capital (forgiveness of reporting entity obligation) or as
a dividend (forgiveness of amount owed to the reporting entity) shall apply.
c. The termination of, or reduction in participation in, reinsurance treaties entered into in the ordinary course of business;

d. Intercompany reinsurance agreements, and any amendments thereto, among companies 100% owned by a common parent or ultimate controlling person provided there is no gain in surplus as a result of the transaction; or

e. Reinsurance/retrocession agreements that meet the criteria of property/casualty run-off agreements described in paragraphs 102-105.

37. Retroactive reinsurance agreements resulting in surplus gain to the ceding entity (with or without risk transfer) entered into between affiliates or between insurers under common control (as those terms are defined in Appendix A-440) shall be reported as follows:

a. The consideration paid by the ceding entity shall be recorded as a deposit and reported as a nonadmitted asset; and

b. No deduction shall be made from loss and loss adjustment expense reserves on the ceding entity’s balance sheet, schedules, and exhibits.

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):

INT 03-02 was exposed in March of 2003 and adopted in June 2003. The interpretation was not subsequently amended. The final vote on this consensus had three members opposed. The March 2003 exposure received six different comment letters to the Emerging Accounting Issues (E) Working Group from: 1) Ohio (EAIWG member); 2) New Hampshire (EAIWG member); 3) Interested parties, 4) Liberty Mutual and 5) PriceWaterhouseCoopers (one of the very few letters ever submitted directly by the firm.) and 6) CNA. Five out of the six commenters noted concerns that the proposed guidance (which was ultimately adopted) would conflict with SSAP No. 25 guidance regarding economic transactions. While the interested parties comment letter was more neutral, the verbal comments provided supported the use of SSAP No. 25.

Several commenters recommended not adopting the guidance regarding the use of book value and instead following SSAP No. 25 guidance for economic and non-economic transactions. The commenters noted that SSAP No. 25 directs the use of fair value when such transactions meet the definition of an economic transactions and that tax regulations would provide a result similar to SSAP No. 25. Multiple comments noted concerns similar to those highlighted in the illustration above. Commenters also noted that intercompany pooling reinsurance transactions are economic transactions. They noted that when assets (such as bonds valued at amortized cost) are transferred, if the assets have a different fair value than book value, that difference should be recognized since the transferor no longer controls the assets. Commenters also noted that treatment for reinsurance transactions for asset transfers should not be different than the treatment for other intercompany transactions.

CNA comments were supportive of adopting the exposed consensus, the comment letter provided illustrations and noted that intercompany reinsurance agreements were subject to regulatory approval. The comments tried to illustrate concerns possibly having premature gain / surplus recognition. .

The June 2003 minutes Emerging Accounting Issues (E) Working Group discussion on the INT 03-02 are excerpted below.

The working group was referred to INT 03-02: Modification to an existing intercompany pooling arrangement (Attachment D). Written comments were received from Ohio, New Hampshire and interested parties. Ohio and New Hampshire believe that the transfer of assets and liabilities in an intercompany pooling arrangement constitute an economic transaction and the accounting guidance in SSAP No. 25—Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties (SSAP No. 25), should be followed. As such, the assets should be transferred at fair value and the ceding entity should record a realized gain or loss. Keith Bell (Travelers) spoke on behalf of interested parties. Interested parties
commented that if the transaction was considered to be an economic transaction, SSAP No. 25 should be followed. If the modification of an intercompany pooling arrangement is considered a noneconomic transaction, the guidance in SSAP No.62—Property and Casualty Reinsurance (SSAP No. 62) is applied, as such, statutory book value should be used for assets and statutory value should be used for liabilities. Jeff Alton (CNA) presented his comments by summarizing the statements made in his comment letter. Mr. Alton stated that no revenue recognition should occur and suggested using a modified statutory book value for transferring assets and liabilities. Mr. Clark stated that the Statutory Accounting Principles Working Group must address the recommended transfer at modified statutory book value as this recommendation would require substantive adjustments to statutory accounting principles. Shelly Zimmerman (Liberty Mutual) provided comments which supported that intercompany pooling changes should follow the accounting guidance in SSAP No. 25 as these are economic transactions between affiliates. Jean Connelly (PriceWaterhouseCoopers) provided comments that summarize those outlined in the comment letter. Ms. Connelly stated that intercompany pooling arrangements are economic transactions and that INT 03-01 provides a substantive change to SSAP No. 25.

Mr. Johnson then stated that he believes there is a stronger case for non-economic transaction treatment and as such, statutory book value is appropriate for valuation purposes. Additionally, all these transactions are subject to regulatory review under the Insurance Holding Company Act, affording regulators some control over the approval of these transactions. Mr. Fritsch commented that if this guidance is not adopted in the form of a new interpretation, SSAP No. 25 should be followed. Mr. Alton stated that he believes the current guidance in effect for intercompany pooling arrangements exists in SSAP No. 62, paragraph 30d which supports surplus neutrality: hence, the need is for an interpretation of paragraph 30d. Mr. Johnson stated that language clarification in SSAP No.61—Life, Deposit-Type and Accident and Health Reinsurance (SSAP No. 61) and SSAP No. 62 should be addressed as a project of the reinsurance subgroup of the SAPWG. Mr. Johnson made a motion to adopt Interpretation 03-02 with deletion of the first two sentences in paragraph 11. Mr. Stolte seconded the motion. Mr. Johnson requested a roll call vote. There were 9 yeas from Alabama, Connecticut, Florida, Illinois, Louisiana, Michigan, Texas, Pennsylvania and Virginia. There were 3 nays from New York, Ohio, and Wisconsin. Therefore, the working group adopted Interpretation 03-02 by consensus. Mr. Johnson also made a motion to refer to the Reinsurance Subgroup of the SAPWG, review of the current guidance in SSAP No. 61, SSAP No. 62 and SSAP No. 63—Underwriting Pools and Associations Including Intercompany Pools. Mr. Ford seconded the motion. The working group unanimously adopted the referral.

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


Staff Review Completed by: Robin Marcotte – NAIC Staff, July - 2022

Staff Recommendation: NAIC staff recommends that the Working Group move this item to the active listing, categorized as a SAP clarification, and expose the intent to nullify INT 03-02, as it is inconsistent with SSAP No. 25 guidance regarding economic and non-economic transactions between related parties. The guidance in INT 03-02 can result with in essence, unrecognized gains (dividends) or losses through the using the statutory book valuation when using assets (bonds) to make payments to affiliates for modifications to existing intercompany reinsurance pooling agreements. Treatment of transfers of assets between affiliates should be consistent for all intercompany transactions and there is not a compelling need to be different when valuing assets for intercompany reinsurance transactions.

Status:
On August 10, 2022, the Statutory Accounting Principles (E) Working Group moved this agenda item to the active listing, categorized as a SAP clarification, and exposed the intent to nullify INT 03-02.

On December 13, 2022, the Working Group moved this agenda item to the active listing, categorized as a SAP clarification, and re-exposed the intent to nullify INT 03-02. This re-exposure requested industry to provide
comments on specific instances in which the interpretation was being applied. In addition, the following key points were noted for consideration during the exposure in response to some of the comments received.

1. In the current interest rate environment, the fair value of many bonds is below book value. For example, a bond with an amortized cost of 100 with a fair value of 85. The way INT 03-02 is written a bond with a fair value of 85 could be used to settle an intercompany reinsurance pooling obligation of 100. If the reporting entity paid with cash, they would be required to pay $100. The actual cash value of obligations when they are extinguished is a relevant measure of the transaction.

2. Using book value for measurement of payments between affiliates can result in either unrecognized of in effect dividend or losses. SSAP No. 25 requires such transfers of assets between affiliates to use fair value. If a subsidiary can pay the parent with assets that have a lower fair value than book value (ex, owes $100 but pays with a bond of 85), this has a similar effect as an unrecognized capital contribution to the subsidiary. SSAP No. 72 requires a capital contribution to be valued using fair value.

3. At the ultimate parent level such transfer of assets (in accordance with SSAP No. 25 guidance) may be noneconomic in that the parent continues to hold an interest in the same assets. Therefore, at the parent level, such transfers of assets may result in the deferral of gains. Staff believes that losses would not be deferred at the ultimate parent level.

4. While it may be more expedient to pay intercompany reinsurance pooling transactions with assets, the valuation used should be similar to if the obligation was extinguished with cash. Therefore, an entity can still choose to pay with assets, they just need to be valued consistently with SSAP No. 25 guidance.

5. SSAP No. 62R, paragraph 36d provides an exception to retroactive reinsurance accounting guidance which allows for prospective accounting treatment for intercompany reinsurance among 100% owned affiliated provided there is no gain to the ceding entity. If there is again to the ceding entity, there is guidance in SSAP No. 62R, paragraph 37 which requires a more punitive method of accounting than either prospective or retroactive reinsurance accounting. Therefore, NAIC staff comment is that the statutory accounting objective is to provide different treatment for retroactive reinsurance contracts if there is a gain to the ceding entity. This is another reason that the guidance in INT 03-02 is problematic. The object is to correctly measure the effects of the contract, which drives the accounting. The objective is not to obscure whether there is a gain to the ceding entity, which can happen in the event that the assets used in payment are not measured correctly.

6. Interested parties noted that modifications to intercompany pooling arrangements are typically effective retroactive to the beginning of the year. Staff notes that the payment value when the transaction is settled should be equivalent to the cash value of what is owed on the date of extinguishment of the liability.

7. Many of the interested parties’ comments regarding GAAP use of book value are more relevant to consolidated basis accounting which is not consistent with the legal entity basis of statutory accounting.

8. Interested parties’ comments noted that there is a difference in treatment for intercompany pooling participants who are not 100% owned by a common parent. NAIC staff notes that retroactive pooling agreement changes with participants that are not 100% under common control do not meet the exception to retroactive accounting provided in SSAP No. 62R, paragraph 36d. NAIC staff notes that SSAP No. 62R, paragraph 37 provides guidance for retroactive reinsurance agreements among affiliates where there is a gain to the ceding entity. Therefore, the regulatory objective is not to avoid gain but to properly account for intercompany retroactive contracts that include gains.
Interpretation of the Emerging Accounting Issues (E) Working Group

INT 03-02: Modification to an Existing Intercompany Pooling Arrangement

NOTE: The Statutory Accounting Principles (E) Working Group has exposed the intent to nullify this Interpretation.

INT 03-02 Dates Discussed

March 9, 2003; June 22, 2003; August 10, 2022; December 13, 2022

INT 03-02 References

Current:
SSAP No. 61R—Life, Deposit-Type and Accident and Health Reinsurance
SSAP No. 62R—Property and Casualty Reinsurance
SSAP No. 63—Underwriting Pools

INT 03-02 Issue

1. Insurance groups that utilize intercompany pooling arrangements often modify these arrangements from time to time for various business reasons. These business reasons commonly include mergers, acquisitions, dispositions or a restructuring of the group’s legal entity structure. As an insurance group’s business objectives and strategies evolve, it may be necessary for the insurance group’s legal entity structure to similarly evolve in order to address the insurance group’s business needs.

2. SSAP No. 63, paragraphs 5 and 7, defines and describes intercompany pooling as an arrangement among affiliated entities whereby “all of the pooled business is ceded to the lead entity and then retroceded back to the pool participants in accordance with their stipulated shares.” This arrangement is established through “a conventional quota share reinsurance agreement…” Arrangements whereby there is one lead company that retains 100% of the pooled business and all or some of the affiliated companies have a 0% net share of the pool may qualify as intercompany pooling.”

3. Therefore, in order to effectuate a modification to the existing intercompany pooling arrangement, companies must either 1) amend the existing reinsurance agreement, or 2) execute new agreements. The latter scenario may entail executing at least two agreements: a commutation of the existing agreement, and a new quota share agreement(s) that covers both past and future periods.

4. To illustrate, in order to effectuate a relatively simple modification, such as changing pooling participation percentages without changing the pool participants, companies often simply amend the existing pooling agreement. Alternatively, in order to effectuate a more complex modification, such as changing (by adding or removing) the number of pool participants, a company must commute the existing pooling agreement and execute a new quota share agreement(s). In conjunction with executing the appropriate reinsurance agreements, a transfer of assets and liabilities amongst the impacted affiliates is also required in order to implement the new reinsurance agreement(s). At issue is the appropriate valuation basis to be used for assets and liabilities that are transferred pursuant to the new reinsurance agreement(s).

5. Since SSAP No. 63 does not specifically address modifications to intercompany pooling arrangements, insurance groups that modify their intercompany pooling arrangements must refer elsewhere in Statutory Accounting Principles (SAP) for relevant guidance. The obvious guidance for such transactions is SSAP No. 62R since an intercompany pooling arrangement is, by definition, affiliated
reinsurance. There is, however, a minority opinion that SSAP No. 25—Affiliates and Other Related Parties appears to apply due to the affiliated nature of these transactions. Since the guidance and intent of SSAP No. 62R and SSAP No. 25 provide for different valuation bases, this interpretation serves to provide definitive guidance as to which SSAP is relevant for these transactions and, therefore, clarify the appropriate valuation basis to be used for assets and liabilities transferred pursuant to a modification to an intercompany pooling arrangement.

SSAP No. 62R Approach:

6. This approach refers to the guidance and statutory accounting intent from SSAP No. 62R since intercompany pooling arrangements are defined and established through reinsurance. Further, since modifications to intercompany pooling agreements typically involve the transfer of net liabilities incurred since the inception of the existing pooling agreement (i.e., prior to the effective date of the new agreement), the retroactive reinsurance accounting guidance in paragraphs 33-39 of SSAP No. 62R is applicable. Paragraph 33 states that this special accounting treatment is warranted “due to the potential abuses involving the creation of surplus to policyholders and the distortion of underwriting results…” However, paragraph 36.d. specifically applies to intercompany reinsurance arrangements, and amendments to intercompany reinsurance agreements, since the reinsurance agreement is among companies 100% owned by a common parent. This paragraph allows prospective accounting treatment for intercompany reinsurance agreements that do not result in a gain in surplus as a result of the transaction.

7. To provide historical perspective, prior to the adoption (with modification) of FASB Statement No. 113, Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts (FAS 113) as SAP, paragraph 36.d. was added as one of the SAP modifications. The intent of adding paragraph 36.d. was to specifically exclude intercompany reinsurance agreements among entities 100% owned by a common parent from retroactive reinsurance accounting requirements as a result of amending or modifying these agreements, provided there is no surplus gain. The presumption in this intent was that there would be no gains to the ceding entity resulting from implementing amendments or modifications to these types of reinsurance agreements.

8. Therefore, based on the foregoing guidance and background, the statutory accounting intent is to avoid surplus gains for the ceding entity as a result of implementing a modification to an intercompany pooling arrangement. On that basis, such a modification does not represent an economic transaction to the insurance group or to the impacted companies. As such, the transfer of both the assets and the liabilities valued at statutory book value ensures that there is no impact to surplus as a result of implementing a modification to an existing pooling arrangement.

SSAP No. 25 Approach:

9. An approach different from that which refers to reinsurance accounting guidance is to refer to the guidance in SSAP No. 25 since some may view a modification to an intercompany pooling agreement as a related party transaction involving the exchange of assets or liabilities. In this case, paragraphs 14-18 of SSAP No. 25 would appear applicable. This guidance specifies differing valuation bases, depending on whether the transaction is considered an economic or a non-economic transaction. SSAP No. 25, paragraph 14, states that “…The appearance of permanence is also an important criterion is assessing the economic substance of a transaction. In order for a transaction to have economic substance and thus warrant revenue (loss) recognition, it must appear unlikely to be reversed …” Since insurance groups often modify intercompany pooling arrangements, this type of transaction is not permanent, and may be construed as a non-economic transaction. SSAP No. 25, paragraph 18.b., states that “non-economic transactions … shall be recorded at the lower of existing book value or fair value at the date of the transaction.”
10. It appears that this guidance is intended to address matters involving discrete or isolated transfers of assets and/or liabilities between affiliates rather than transfers of assets and liabilities effected in relation to executing reinsurance transactions (the guidance for which is SSAP No. 62R). Additionally, application of this guidance would result in a change to the surplus of the insurance group as a result of implementing a modification to an existing intercompany pooling arrangement. As previously stated, the statutory accounting intent is to avoid surplus gains for the insurance group as a result of implementing a modification to an intercompany pooling arrangement.

11. The accounting issues are:

   a. What is the relevant guidance for modifications to intercompany pooling arrangements?
   
   b. What is the appropriate valuation basis to be used for assets and liabilities that are transferred among affiliates in conjunction with the execution of a new reinsurance agreement(s) that serves to substantively modify an existing intercompany pooling arrangement?

**INT 03-02 Discussion**

The Working Group reached a consensus as follows:

12. SSAP No. 62R provides accounting for property and casualty reinsurance agreements including specific guidance on intercompany pooling agreements. SSAP No. 62R provides two methods of accounting for changes in intercompany pooling agreements, depending on whether or not the pooling results in a gain in surplus.

13. The appropriate valuation basis to be used for assets and liabilities that are transferred among affiliates in conjunction with the execution of a new reinsurance agreement(s) that serves to substantively modify an existing intercompany pooling arrangement is statutory book value for assets and statutory value for liabilities. Book value is defined in the glossary of the *Accounting Practices and Procedure Manual*.

**INT 03-02 Status**

14. No further discussion is planned.
Issue: New Market Tax Credits

Check (applicable entity):

- Modification of Existing SSAP: ☒
- New Issue or SSAP: ☐
- Interpretation: ☐

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**Description of Issue:** The New Market Tax Credits (NMTC) Program was established by Congress in December 2000 and permits individual and corporate taxpayers to receive a non-refundable tax credit against federal income taxes for making equity investments in financial intermediaries known as Community Development Entities (CDEs). CDEs that receive the tax credit allocation authority under the program are domestic corporations or partnerships that provide loans, investments, or financial counseling in low-income urban and rural communities. The tax credit provided to the investors total 39% of the total cost of the investment and is claimed over a seven-year period. The CDEs in turn use the capital raised to make investments in low-income communities. CDEs must apply annually to the CDFI Fund to compete for NMTC allocation authority. The NMTC program is currently subject to expiration but has been extended to Dec. 31, 2025. The NMTC Extension Act of 2021 (introduced February 2021) would make the NMTC program permanent, modify the credit to provide for an inflation adjustment to the limitation amount for the credit after 2021, and allow an offset against the alternative minimum tax for the credit.

The success of the federal NMTC program has led to states adopting their own NMTC legislation. Per one noted article, majority of state NMTC programs follow the federal rules with some modifications that vary from state to state. State modifications have been noted to specifically target smaller business, simplifying the application process, prohibiting the use of real estate business, and capping the amount of tax credits that can be allocated to one project. The economic impact of the state NMTC programs is typically less than the impact of federal NMTC programs because the economic return to investors for state tax credits is generally lower than what they receive for federal credits. Some states require that state tax credits can only be used in conjunction with federal credits. Pairing federal and state programs is beneficial to the qualifying business as they keep more of the investment without an obligation to return as the investors gets more tax credits.

**Overview of Federal Program:**

- Federal government authorizes an annual credit authority for NMTCs (amount of tax credits available).
- The Community Development Fund Institutions (CDFI fund) is a division of the U.S. Treasury responsible for implementing the NMTC program. Since there are limited tax credits each year, the CDFI fund has a competitive application process for the right to grant tax credits to investors and to make qualified NMTC investments.
- The right to grant tax credits is referred to as “NMTC Allocation” and is awarded to Community Development Entities (CDEs) that invest in low-income communities. The CDEs offer the tax credits to cash investors, and then use the cash to make investments (typically loans to a qualifying project – a “Qualifying Active Low-Income Community Business” - QALICB) that further the mission and objectives of the NMTC program.
The program specifies that the investor must provide cash as an equity investment (qualified equity investment – QEI) and it must stay invested in the CDE and the resulting NMTC qualifying project (QALICB) for a period of seven years.

- The restrictions are specific that the investment is an equity investment as stock (other than nonqualified preferred) in an entity that is a corporation for federal tax purposes or any capital interest in an entity that is a partnership for federal tax purposes. (The investor is generally a 99.99% or 100% equity owner.)

- NMTC investments must remain in a qualified business for a seven-year period. Any principal amount repaid during that period must be reinvested by the CDE until the seven-year period expires. Most CDEs and investors avoid the reinvestment requirement and structure interest-only loans that prohibit principal repayment within the seven-year timeframe.

  - The 39% tax credit is provided as 5% of the investment in the first 3 years and then 6% of the investment for the next 4 years.
  
  - For tax purposes, the basis adjustment in the qualified equity investment is reduced by the amount of any new market tax credits on each credit allowance date.
  
  - Programs that cease to qualify are subject to tax credit recapture.

- Investors enter these transactions recognizing that the original investment amount will not be fully returned. Rather, a portion (or perhaps all) of the equity investment will be unpaid without an obligation to return from the borrowing business. NMTC investments with these terms have specific maturing terms / actions. One approach could be that an option (put/call) is held by the investor that gives them the right to sell its equity investment to the borrower for a nominal price.

- The designs are often complex and introduce leverage lenders to maximize tax credits to the equity investor:

  - Equity investor provides $3M to acquire 100% equity interest in an investment fund.
  - Investment fund borrows $7M from a leverage lender.
  - This results with a $10M qualifying NMTC transaction, resulting with the equity investor receiving $3.9M in tax credits over 7 years from an initial $3M investment.
  - The investment fund provides two loans to the qualified low-income business (QALICB). The first loan is for the $7M leverage loan, the second is for the $3M equity investment.
  - Both loans only pay interest for the seven-year period to meet the NMTC terms.
  - At the conclusion of the 7 years, the project sponsor purchases the second loan via a ‘put/call’ agreement, converting the $3M into a permanent subsidiary for the project.
  - The borrower / project sponsor refinances the $7M loan to repay the leverage lender.
  - The ultimate result is that the equity investor received $3.9M over 7 years in tax credits for $3M.

- Example without leverage lender:

  - Investor provides a $10M NMTC Investment
  - Investor receives $3.9M in tax credits over seven years.
  - Investors receives $7.4M of original investment at the end of the seven years.
  - Borrower keeps $2.6M of the original investment to further their low-income qualifying activities.
  - Investor receives a net return of $1.3M. ($10M less $3.9M tax credits less return of 7.4M principal.)
FASB Discussion
The FASB has a current Emerging Issues Task Force project to assess whether the proportional amortization method of accounting, which is used for Low-Income Housing Tax Credits (LIHTC), should be expanded to investments in tax credit structures beyond LIHTC. The proportional amortization method results in the tax credit investment being amortized in proportion to the allocation of tax credits in each period and allows the investment amortization and tax credits to be presented on a net basis within the income tax line item. Currently, investments in other tax credit structures are typically accounted for using the equity method or the cost method. Under the equity and cost methods, investment gains/losses and tax credits are presented on a gross basis on an entity’s income statement. The FASB has received two requests asking that the proportional amortization method be made applicable to New Market Tax Credit Structures as well as other investment structures that are made primarily for the purpose of receiving tax credits and other tax benefits. The FASB added a project to the Emerging Issues Task Force agenda on Sept. 22, 2021. The FASB Task Force reached a consensus-for-exposure on June 16, 2022, that the proportional amortization method can be elected on a tax credit program by tax credit program basis. This proposed ASU was exposed in August 2022, with comments due Oct. 6, 2022. A final ASU is expected later in 2022 or early in 2023.

IRS Provisions – The NMTC is captured as a nonrefundable ‘general business credit’ and is limited to tax liability. If tax liability is not sufficient to take the credit, then the tax credit is subject to carryforward/carryback provisions. Per instructions from the 2021 Instructions for Form 3800 – General Business Credit, general business credits that cannot be used because of a tax liability limit are first carried-back 1 year through an amended return. If there are unused credits after carrying back 1 year, the tax credit can be carried forward to each of the 20 tax years after the year of the credit.

Inflation Reduction Act Provisions – The Inflation Reduction Act was signed by President Biden on Aug. 16, 2022. Although there are several elements within the Act, it includes a 15% corporate minimum tax rate for corporations with at least $1 billion in income and includes numerous investments in climate protection, clean energy production and tax credits aimed at reducing carbon emissions. Although the Act has been signed, several elements are pending further application guidance. From preliminary information, the act allows for general business credits, such as the low-income housing tax credit (LIHTC), new markets tax credit (NMTC), historic tax credit (HTC) and renewable energy tax credits (RETCs) to be taken against the minimum tax. However, further monitoring of application/interpretation guidance that is still forthcoming is required to assess the actual application and impact of tax credits on companies subject to the minimum tax.

Statutory Accounting Considerations:

- Although the design is an equity investment of stock or interest in a corporation or partnership, which would normally be subject to SSAP No. 48—Joint Ventures, Partnerships and Limited Liability Companies, the intent of NMTC investments is for tax credits and not equity returns. As such, this structure is closer to the existing low-income housing tax credits guidance in SSAP No. 93 than the partnership/LLC guidance in SSAP No. 48.

- Although SSAP No. 93—Low Income Housing Tax Credit Property Investments provides guidance for an equity investment, that provides tax credits with a limited (or zero) residual investment value, the guidance in SSAP No. 93 is specific to LIHTC programs.

- It has been identified that there are structures that have been designed to resemble fixed-income notes that do not pay regular cash interest, but rather provide NMTC tax credits as interest returns. These structures are in substance that same as other investments in NMTC, with an underlying equity interest in the CDE that generates tax credits. However, they have been structured with a guarantee for compensatory interest in the form of cash for the amount of the tax credit expected to have been received that year. These structures are also being considered within scope of this agenda item. Such structures have to meet specific criteria to qualify for tax credits under the IRS rules.
Existing Authoritative Literature:

SSAP Authoritative Guidance:

- **SSAP No. 93—Low Income Housing Tax Credit Property Investments**
  This statement establishes accounting principles for investments in federal certain state sponsored Low Income Housing Tax Credit (LIHTC) properties owned through limited liability entities that are flow-through entities for tax purposes. The guidance requires LIHTC investments to be initially recorded at cost and carried at proportional amortized cost unless the investment is identified as impaired. Under the proportional amortization method, amortization of the LLC investment is recognized in the income statement as a component of net investment income/expense and the current tax credit is accounted for as a component of income tax expense:

  - Federal tax credits are recognized in the income statement as an offset to federal taxes in the tax reporting year in which the tax credit is utilized in accordance with SSAP No. 101—Income Taxes.

  - State tax credits shall be recognized in the income statement as an offset to state premium tax or state income tax, whichever is applicable, in the tax-reporting year in which the credit is utilized.

  - Tax benefits received, other than tax credits, shall be accounted for pursuant to SSAP No. 101.

  SSAP No. 93 indicates that immediate recognition of the entire benefit of the tax credit to be received during the term of the investment in a low-income housing project is not appropriate. It also indicates that low-income housing tax credits shall not be recognized in the financial statements before their inclusion in the investor’s tax return.

- **SSAP No. 94R—Transferable and Non-Transferable State Tax Credits**
  This statement establishes accounting principles for investments transferable and non-transferable state tax credits, with an explicit exclusion for LIHTCs (or similar tax credits) captured in scope of SSAP No. 93.

  Guidance for admittance of state tax credits under this statement varies based on whether it is transferable or non-transferable:

  **Transferable** – Per the SSAP, all the following criteria must be met for admittance:

  1) The holder of the transferable state tax credit may sell or otherwise transfer the transferable state tax credit to another entity, which can likewise sell or transfer the credit;

  2) The transferable state tax credit will expire if not used by a predetermined date; and

  3) The transferable state tax credit can be applied against either state income tax or state premium tax.

  **Non-Transferable** – Per the SSAP, all the following criteria must be met for admittance:

  1) Successive holder of a state tax credit must redeem the credit by April 15 of the subsequent year to the entity’s acquisition of the state tax credit and is not permitted to carry-over, carry-back, obtain a refund, sell or assign the credit;

  2) The non-transferable state tax credit will expire if not used by the predetermined date; and

  3) The non-transferable state tax credits can be applied against either state income tax or state premium tax.
Review of Existing Statutory Accounting Guidance for NMTC and Overall Application:

- Existing statutory accounting guidance does not encompass federal NMTC (or other federal tax credits), as SSAP No. 93 is limited to LIHTC and SSAP No. 94 is specific to state tax credits.

- Provisions in SSAP No. 93 do not fully address earned (received) tax credits that carryforward for future use.

- The admittance criteria in SSAP No. 94 are applied to characteristics that perhaps may not be factors that would impact admittance:
  - A tax credit that does not expire would be precluded as an admitted asset under the guidance.
  - A non-transferable tax credit that can be carried-forward, carried-back, able to be refunded or that can be sold or assigned is precluded as an admitted asset under the guidance.

Statutory Accounting Reporting Guidance:

Guaranteed and non-guaranteed federal low-income housing tax credits have separate reporting lines on Schedule BA along with an “all other” low-income housing tax credit line. The guidance is specific that these lines are only for low-income tax credits (or tax credits for affordable housing) that are in the form of a partnership or limited liability company. Non-qualifying LIHTC are to be reported in the “All Other” category. With this current guidance, there is no explicit reporting provision for tax credits that are not captured in LIHTC.

Reporting Lines and Instructions:

Guaranteed Federal Low Income Housing Tax Credit
- Unaffiliated ......................................................................................................................................... 3599999
- Affiliated ............................................................................................................................................. 3699999

Non-Guaranteed Federal Low Income Housing Tax Credit
- Unaffiliated ......................................................................................................................................... 3799999
- Affiliated ............................................................................................................................................. 3899999

Guaranteed State Low Income Housing Tax Credit
- Unaffiliated ......................................................................................................................................... 3999999
- Affiliated ............................................................................................................................................. 4099999

Non-Guaranteed State Low Income Housing Tax Credit
- Unaffiliated ......................................................................................................................................... 4199999
- Affiliated ............................................................................................................................................. 4299999

All Other Low Income Housing Tax Credit
- Unaffiliated ......................................................................................................................................... 4399999
- Affiliated ............................................................................................................................................. 4499999

Low Income Housing Tax Credit

Include: All Low Income Housing Tax Credit Investments (LIHTC or affordable housing) that are in the form of a Limited Partnership or a Limited Liability Company including those investments that have the following risk mitigation factors:

A. Guaranteed Low Income Housing Tax Credit Investments. There must be an all-inclusive guarantee from a CRP-rated entity that guarantees the yield on the investment.

B. Non-guaranteed Low Income Housing Tax Credit Investments.
I. A level of leverage below 50%. For a LIHTC Fund, the level of leverage is measured at the fund level.

II. There is a Tax Credit Guarantee Agreement from General Partner or managing member. This agreement requires the General Partner or managing member to reimburse investors for any shortfalls in tax credits due to errors of compliance, for the life of the partnership. For a LIHTC Fund, a Tax Credit Guarantee is required from the developers of the lower tier LIHTC properties to the upper tier partnership and all other LIHTC investments.

III. There are sufficient operating reserves, capital replacement reserves and/or operating deficit guarantees present to mitigate foreseeable foreclosure risk at the time of the investment.

Non-qualifying LIHTCs should be reported in the “All Other” category.

**Statutory Accounting RBC Impact:**

**Life:** The RBC factor for LIHTC are captured as part of the real estate on LR007:

- (17) Federal Guaranteed LIHTC AVR Equity Component Column 1 Line 75 0.0014
- (18) Federal Non-Guaranteed Low Income Housing Tax Credits AVR Equity Component Column 1 Line 76 0.0260
- (19) State Guaranteed LIHTC AVR Equity Component Column 1 Line 77 0.0014
- (20) State Non-Guaranteed Low Income Housing Tax Credits AVR Equity Component Column 1 Line 78 0.0260
- (21) All Other Low Income Housing Tax Credits AVR Equity Component Column 1 Line 79 0.1500
- (22) Total Schedule BA Real Estate Lines (16) + (17) + (18) + (19) + (20) + (21)

**P/C and Health:** The RBC factors for LIHTC are captured as components of other long-term assets. The reporting lines and factors are the same as they are for life (as shown above).

**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):**

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

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

**Recommendation:**

NAIC staff recommends that the Working Group direct NAIC staff to draft statutory accounting guidance in the form of a new or revised SSAP that expands the current LIHTC guidance for equity investments that general federal business tax credit and state premium tax credits. Although this agenda item is focusing on NMTC, it is recommended that consideration be given to guidance that does not name specific designs, such as NMTC or other specific tax credits, so that it can be applicable for all qualifying tax equity investments. This guidance will consider the proposed FASB guidance as well as admittance and impairment provisions, recognizing that tax credits cannot be used to provide direct payment to policyholders, but rather are utilized to impact a reporting entity’s tax liability. This agenda item also recommends a review of SSAP No. 94—Transferable and Non-Transferable State Tax Credits to ensure the guidance properly reflects items that should be captured in scope and appropriate admittance provisions.

With the proposal of a new or revised SSAP, this agenda item is proposed to be captured as a ‘New SAP Concept’ with a corresponding issue paper. Along with statutory accounting revisions, a resulting blanks
proposal and a potential RBC referral are anticipated to update blanks reporting and RBC references accordingly. As detailed within, all Schedule BA reporting lines and RBC instructions (for both federal and state) only reference Low-Income Housing Tax Credits. The BA instructions also need to be updated as the concept for ‘guaranteed’ provisions from a CRP-rated entity seems to only be applicable to limited NMTC designs, as a guarantee may disqualify an entity from being able to use tax credits under IRS provisions.

**Staff Review Completed by:** Julie Gann - NAIC Staff, September 2022

**Status:**
On December 13, 2022, the Statutory Accounting Principles (E) Working Group moved this agenda item to the active listing, categorized as a new SAP concept, and exposed a discussion document to expand current statutory accounting guidance for low-income housing tax credits to capture all tax equity investments that provide general federal business tax credit and state premium tax credits if they meet specified criteria.

Purpose: This document has been drafted to provide general concepts to consider in developing a revised or new SSAP to address equity investments that provide general business federal tax credits and state tax credits. It is anticipated that the proposed guidance will supersede SSAP No. 93—Low Income Housing Tax Credits Property Investments. Subsequent consideration will also occur to review and revise SSAP No. 94—Transferable and Non-Transferable State Tax Credits.

This document is in the form of potential guidance, with NAIC staff questions. Responses to the questions as well as other information that would be beneficial for such structures would be beneficial during the exposure period. As the guidance would reflect new SAP Concepts, an issue paper will also be developed. As an additional note, concepts from the U.S. GAAP exposure for expanding use for the Proportional Amortization Method have been considered. Final guidance is expected in the fourth quarter 2022 and will be assessed prior to finalizing the statutory accounting guidance.

Proposed Statutory Accounting Guidance and NAIC staff Accounting Questions:

1. This statement establishes statutory accounting principles for qualifying tax equity investments in programs made primarily for the purpose of receiving allowable general business federal tax credits and state tax credits, including state premium tax credit programs.

2. The programs in scope of this statement are not limited to named programs as new tax credit programs may be introduced. Examples of programs for general business federal tax credits include:
   a. Investment tax credits (ITCs)
   b. Historical rehabilitation tax credit (HTC)
   c. Low-income housing tax credit (LIHTC)
   d. New market tax credits (NMTC)

3. Programs that generate general business federal tax credits, corresponding state tax credits or state premium tax credits that meet the following conditions at the time of initial investment are required to be captured in scope of this statement:
   a. Reporting entity is an equity investor in a project that generates tax credits and other tax benefits through limited liability entities that are flow-through entities for tax purposes.
   b. It is probable that the tax credits allocable to the investor will be available.
   c. Reporting entity investor does not have the ability to exercise significant influence over the operating and financial policies of the underlying project.
   d. Substantially all of the projected benefits are from tax credits and other tax benefits, determined on a discounted basis using a discount rate that is consistent with the cash flow assumptions utilized by the reporting entity for the purpose of making a decision to invest in the project.

1 Permitted tax credit structures are subject to changes under federal and state tax law.
e. The reporting entity’s projected yield based solely on the cash flows from the tax credits and other tax benefits is positive.

f. The reporting entity is a limited liability investor in the limited liability entity for both legal and tax purposes, and the investor’s liability is limited to its capital investment.

4. Equity investments that do not meet the conditions in paragraph 3 shall be captured within the statutory accounting statement that addresses the underlying investment structure. This would generally be SSAP No. 48—Joint Ventures, Partnerships and Limited Liability Companies.

Staff Question / Items for Discussion:

1) Paragraph 1 – The scope intends to include programs that provide general business federal tax credits, which are income tax credits, and programs that meet the criteria that provide for state premium tax credits. This would be an extension from the FASB exposure that only permits income tax credits but is in line with comments received by the FASB that insurers receive credits for state premium tax. Comments are requested on the proposed inclusion for programs that meet the criteria in paragraph 3 that generate state premium tax credits.

2) Paragraph 3 – The criteria mirror the concepts included in the proposed FASB guidance. Under U.S. GAAP, the use of the portfolio allocation method is an election, but under SAP, the guidance would be required if the criteria are met. (This would be consistent with the existing guidance in SSAP No. 93 for LIHTC.) Based on the FASB comment letters reviewed, the criteria are expected to be met for most state premium-based tax equity investments. Should other criteria be considered or are there concerns with requiring application if the criteria are met?

SUMMARY CONCLUSION

5. The general structure of investments to qualify for federal tax credits is consistent regardless of the type of tax credit. The reporting entity is required to hold an equity investment, in which they represent a true partner at risk for which equity returns or losses can be generated other than through the tax credits. With the requirement for a ‘true partner’ design, a guarantee of return disqualifies the investor as obtaining a tax credit for federal income tax purposes. A limited exception to this structure can exist for NMTC using a financial institution syndicating a NMTC in which the financial institution guarantees the credits or returns. Although the syndication structure may result with a security structure that resembles a debt instrument, such structures are in substance tax credit investments and shall be captured in scope of this statement regardless of this legal investment structure. Note – Include exclusion in SSAP No. 26R.)

6. The structure for state premium tax credits is similar to federal tax credit programs in which the reporting entity invests in a limited partnership or limited liability company and receives allocated premium tax credits and other tax related benefits. Premium tax credits are non-refundable and may only be utilized up to the amount of premium tax liability each year for the particular state from which the credit was issued.

7. The overall intent with investments in scope of this statement is to obtain a positive rate of return, through tax credits and other tax benefits, prior to disposing the reporting entity’s interest in the project. The liquidation of the investment commonly occurs at the end of the tax credit timeframe through a put agreement, often reflecting a nominal amount, that was established at the time of acquisition. Investors in these tax credit programs recognize that the original investment amount will not be returned.

8. Investments in programs for the primary purpose to generate tax credits benefit reporting entities through a reduction in tax liability. Restrictions in federal tax credit programs may prohibit principal repayment to the reporting entity prior to the conclusion of the stipulated timeframe for the tax credit investment. Further, tax credits are most often not transferable. If the tax credits cannot be used to reduce tax liability, then the investments generally do not provide financial benefits to the reporting entity and likely do not reflect investments that can be liquidated to directly pay policyholder claims.
9. Equity investments in tax credit programs that qualify in scope of this statement meet the definition of an asset as specified in SSAP No. 4—Assets and Nonadmitted Assets and are admissible assets to the extent that they comply with the requirements of this statement.

**Staff Question / Items for Discussion:**

3) Paragraphs 5-8 – The information details IRS provisions to qualify for the tax credit and overall information on the use of tax credits investments. Under the IRS rules, the federal business tax credits are not transferable, as only the entity that has a true equity interest can take the tax credit. Furthermore, the designs are most often established to have provisions to liquidate the equity investment (through a put/call) at the end of the timeframe. Comments are requested on whether other designs are prevalent as well as inclusion of this guidance in the SSAP and/or the Issue Paper.

**Accounting**

10. At initial recognition, investments in scope of this statement shall be recorded at cost. A liability shall also be recognized for delayed equity contributions that are unconditional and legally binding. (ASU 323-740-25-3)

11. Reporting entities shall recognize income tax credits in the period they are allocated to the investor for tax purposes. Unless all tax credits are allocated to the reporting entity at the date of initial investment, immediate recognition of the entire benefit of the tax credits to be received during the term of the investment project that generates tax credits and other tax benefits is not permitted. Tax credits shall not be recognized in the financial statements before the year in which the credit arises. (ASU 323-740-25-5)

12. Subsequent to initial recognition, the investment shall be carried at proportional amortized cost. Under the proportional amortization method, the reporting entity amortizes the initial cost of the investment in proportion to the tax credits and other tax benefits allocated to the investor. The amortization amount shall be calculated as follows:

   a. The initial investment balance less any expected residual value of the investment, multiplied by,

   b. The percentage of actual tax credits and other tax benefits allocated to the reporting entity in the current period divided by the total estimated tax credits and other tax benefits expected to be received by the reporting entity over the life of the investment.

Exhibit A illustrates the application of accounting guidance in two examples that generate tax credit and tax benefits using the proportional amortization method. The first example illustrates the application of a standard project. The second example illustrates the application of the accounting guidance in a project that generates non-tax related benefits in addition to tax credits and other tax benefits using the proportional amortization method. (ASU 323-740-35-2 & 3)

13. The expected residual value of the investment shall be excluded from the proportional amortization calculation. Non-income-tax related benefits received from operations of the limited liability entity shall be included in earnings when realized or realizable. Gains or losses on the sale of the investment, if any, shall be included as a capital gain or loss at the time of the sale. (ASU 3623-740-35-5) Determination of gain or loss will depend on the current reported value (e.g., residual value at the end of the amortization timeframe) to the amount received in exchange for the equity interest.

14. At the end of the amortization timeframe (life of the investment), if the reporting entity retains the equity interest, the investment shall be subsequently captured in scope of SSAP No. 48—Joint Ventures, Partnerships and Limited Liability Companies.
Application of Proportional Amortization Method

15. Under the proportional amortized cost method, the amortization of the investment is recognized in the income statement as an expense component of the net investment income calculation. Tax credits or other tax benefits from the investment shall not be reported as a component of net investment income.

16. Tax credits and other tax benefits shall be reflected as follows:

   a. Federal tax credits shall be recognized in the period that they are allocated to the reporting entity for tax purposes. Federal tax credits that can be utilized in the year allocated shall be reported in the income statement as an offset to federal taxes in accordance with SSAP No. 101—Income Taxes. Federal tax credits that cannot be utilized in the year allocated and are carried forward to a future tax year shall be recognized as a deferred tax asset (DTA), subject to applicable admittance provisions, in accordance with SSAP No. 101. Use of the tax credit in a future period shall be reflected as an offset to federal tax in the tax reporting year in which the tax credit is utilized.

   b. State tax credits shall be recognized in the income statement as an offset to state premium tax or state income tax, whichever is applicable, in the tax-reporting year in which the credit is utilized.

   c. Federal or state tax benefits other than tax credits (e.g., tax benefits from investment depreciation) shall be recognized in the year earned as a component of income tax expense pursuant to SSAP No. 101.

Staff Question / Items for Discussion:

4) Paragraphs 10-14 – This information mirrors guidance from the proposed ASU with SAP clarifications. Comments are requested on whether SAP modifications should be considered.

5) Paragraphs 15-16 - This guidance details the application of the proportional amortization method for statutory accounting. It is more detailed, but generally consistent with SSAP No. 93. The existing SAP guidance was driven from EITF 94-1 and refers to recognition at the time a tax credit can be included in a tax return. However, that guidance is contradictory with the recognition of tax credit carryforwards under both current SAP and U.S. GAAP. The proposed guidance in paragraph 11 reflects the new GAAP guidance for recognition in the year in which the credit arises, and the guidance in paragraph 16 identifies how carryforwards would be considered a DTA.

Admittance Requirements

17. Investments in tax credit programs provide benefit to reporting entities through a reduction in tax liability. Investors in these tax credit program recognize that the original investment amount will not likely be returned, but they will obtain a positive rate of return through tax credits and other tax benefits.

18. Although investments in tax credit programs do not represent investments that can be directly liquidated for policyholder claims, the reduction of tax liability represents a benefit that supports admittance of these investments, but only if the tax credit will be received and can be utilized by the reporting entity. Investments in tax credit programs that will not result with tax credits or that will result with tax credits that cannot be utilized by the reporting entity shall be nonadmitted.

19. To support admittance, a reporting entity shall monitor the tax credit eligibility of a program and obtain a tax opinion on the validity of the credits and the structure of the program. Investments in tax credit programs that are not supported by a tax opinion shall be nonadmitted. If the program is a permitted
syndicated program with a guarantee\(^2\), the opinion must verify that the investment and guarantee has been properly structured under IRS rules and the guarantee does not disqualify the reporting entity from obtaining federal general business tax credits.

20. Once supported by a tax opinion, a reporting entity is required to assess the realization of tax credits against tax liability for both the tax year in which the credit can be initially utilized as well as in accordance with carry-forward periods to determine the extent the investments can be admitted:

a. If a reporting entity does not expect tax liability in the upcoming tax year, investments in tax credit programs intended to reduce the tax liability shall be nonadmitted. In subsequent years, and only after verification of tax liability for which tax credits can be applied, a reporting entity can assess utilization of tax credits to determine admittance under paragraph 20.b.

b. A reporting entity that expects tax liability in the upcoming tax year is permitted to admit investments in tax credit programs to the extent that a reporting entity expects to ultimately utilize the tax credits under permitted IRS or state tax provisions. If projections identify that the tax credits from investments in tax credit programs will exceed what can be utilized under IRS tax provisions (current and other applicable tax periods), the reporting entity shall nonadmit investments as necessary so that investments in scope of this statement (in aggregate) are only admitted to the extent tax credits are expected to be utilized. In making this assessment, the reporting entity is not permitted to assume increased operations (e.g., expanded product sales) beyond actual experience to conclude that additional federal or state tax liability will exist that would allow additional utilization of tax credits.

Staff Question / Items for Discussion:

6) Paragraphs 17-20 – These paragraphs provide explicit SAP provisions for admittance. If the program does not generate tax credits or if the reporting entity cannot use the tax credits, the guidance requires nonadmittance. Consideration was given as to whether admittance should be permitted based on the ability to liquidate the investment, but that is not proposed. As detailed in the scope criteria, substantially all of the projected benefits from the investment should be from tax credits or other tax benefits. From information gathered for the federal tax credit programs, liquidation may be restricted for set periods of time or be contingent on finding a buyer for the equity interest. Although a put/call provision may be in place to revert the equity interest at the end of the life for the investment, such amounts are nominal to the original investment amount. With the guidance, if the tax credits will not be received or cannot be utilized, then the investment shall be nonadmitted. If an entity cannot obtain or utilize tax credits from the investment, and can liquidate the investment, then a reporting entity should consider liquidating the investment to have cash for reinvestment / admittance purposes. Until then, the investment is proposed to be nonadmitted.

Future Contributions and Additional Tax Credits

21. Many tax credit investments require future equity contributions by the investor, that may be contingent on a variety of conditions, such as receiving representations, contract performance, meeting occupancy requirements, etc. A liability shall be recognized for delayed equity contributions that are unconditional and legally binding and a liability shall also be recognized for equity contributions that are contingent upon a future event when that contingent event becomes probable pursuant to the loss contingency guidance in SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets. (ASU 323- 740-25-3)

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\(^2\) In 2022, only NMTC programs could be structured as syndicated programs with guarantees.
22. If the commitment to provide equity contributions does not meet the definition of a loss contingency, the contingent commitment shall be disclosed in the notes to the financial statements with other contingent commitments.

23. Additional contributions made that do not result in additional tax credits for the reporting entity investor shall be immediately expensed as a component of net investment income.

24. In the event a reporting entity obtains additional tax credits after making an additional contribution, the following shall be applied:
   
a. If additional tax credits are allocated without the reporting entity making additional contributions, the additional tax credits shall not be afforded any value in the financial statements. (The reported value of the investment generating tax credits and amortization does not change.) Rather, the tax credit shall be recognized in the period allocated pursuant to paragraph 14.
   
b. If additional funding is directly related to acquisition of additional tax credits, the provisions of this statement shall be followed as if the additional funding were a new tax credit investment.

Staff Question / Items for Discussion:

7) Paragraphs 21-24 – This guidance is generally consistent with SSAP No. 93, except the recognition of a liability for a future contribution follows the loss contingency guidance in SSAP No. 5R. This is consistent with the ‘probable’ threshold reflected under U.S. GAAP.

Impairment

25. Reporting entities with investments in tax credit programs shall complete and document an impairment analysis at each reporting period. For this analysis, the reporting entity shall compare the current book value to the fair value of the investment. (In lieu of fair value, an entity can compare book value to the present value of future tax credits and other tax benefits discounted at a risk-free rate of return.) The investment shall be written-down as an other-than-temporary impairment (INT 06-07) if the book value is higher. This will result in a new cost basis and the amount of the write-down shall be accounted for as a realized loss. The new cost basis shall not be changed for subsequent recoveries in the discounted value.

26. An other-than-temporary impairment shall also be considered to have occurred if a previously received tax credit has been recaptured or if it is probable that future tax credits will not be received as expected. This could occur due to changes in ownership of a project or if the project ceases to operate. If a project no longer qualifies for tax credits, the entire investment, less any residual established at initial recognition, shall be written off as other-than-temporarily impaired. If the reporting entity has a tax credit recapture, the reporting entity shall assess whether future tax credits will qualify for use by the reporting entity. If future credits will not be generated or will be subject to future recapture, then the reporting entity shall write-off the investment as other-than-temporarily impaired so that the resulting investment value only reflects expected qualifying tax credits and other benefits expected to be received.

Staff Question / Items for Discussion:

8) Paragraphs 25- Paragraph 25 is consistent with SSAP No. 93, except it incorporates fair value as the compared value. Current SSAP No. 93 uses the present value calculation, so it is retained as a proxy of fair value. U.S. GAAP uses fair value, and the existing disclosure in SSAP No. 93 also references fair value.

9) Paragraph 26 - This guidance incorporates concepts on whether the structure will continue to produce qualifying tax credits. The guidance specific to LIHTC from SSAP No. 93 is not retained. The guidance
has divided the guidance for nonadmittance to reflect situations that impact a reporting entity’s use of tax credits and OTTI to reflect issues with the actual investment in generating qualified tax credits. Comments are requested on this approach and the principle concepts for OTTI.

Disclosures

27. A reporting entity shall disclose information that enables users of its financial statements to understand the following information about its tax equity investments in projects that generate tax credits and other tax benefits from tax programs captured in scope of this statement: (ASU 323-740-50-1)

   a. The nature of its investments in projects that generate tax credits and other tax benefits.
   b. The effect of the measurement and recognition of its investments in projects that generate tax credits and other tax benefits and the related tax credits on its financial position and results of operations.

28. A reporting entity shall disclose the following information about its tax equity investments in projects that generate tax credits and other tax benefits from a tax credit program in scope of this statement:

   a. The amount of tax credits and other tax benefits recognized during the period.
   b. Disclose the balance of the investments recognized in the statement of financial position for the reporting period(s) presented.
   c. Significant modifications or events that resulted in a change in the nature of the investment or a change in the relationship with the underlying project for investments in scope. (ASU 323-740-50-1A)
   d. An aggregate schedule of tax credits expected to be generated each year for the subsequent 15 years.
   e. Disclose if the underlying property is currently subject to any regulatory reviews and the status of such review. (Example investigations by the housing authority.)

29. Any commitment or contingent commitment (e.g., guarantees or commitments to provide additional capital contributions) including the amount of equity contributions that are contingent commitments related to tax credit investments and the year(s) that contingent commitments are expected to be paid shall be disclosed.

30. The significance of an investment to the reporting entity's financial position and results of operations shall be considered in evaluating the extent of disclosures of the financial position and results of operations of tax credit investments. If in the aggregate tax credit investments exceed 10% of the total admitted assets of the reporting entity the following disclosures shall be made:

   a. (i) The name of each partnership or limited liability entity and percentage of ownership, (ii) the accounting policies of the reporting entity with respect to investments in partnerships and limited liability entities (iii) the difference, if any, between the amount at which the investment is carried and the amount of underlying equity in net assets (i.e., nonadmitted goodwill or other nonadmitted assets) and (iv) the accounting treatment of the difference;
   b. For partnerships, and limited liability entities for which a quoted fair value is available, the aggregate value of each partnership, or limited liability entity investment based on the quoted fair value; and
c. Summarized information as to assets, liabilities and results of operations for partnerships, and limited liability entities, either individually or in groups.

31. A reporting entity that recognizes an impairment loss shall disclose the following in the financial statements that include the period of the impairment write-down:
   a. A description of the impaired assets and the facts and circumstances leading to the impairment; and
   b. The amount of the impairment and how fair value was determined.

32. Disclose the amount and nature of the write-downs or reclassifications made during the year resulting from the forfeiture or ineligibility of tax credits, etc.

33. Refer to the Preamble for further discussion regarding disclosure requirements.

Staff Question / Items for Discussion:

10) Paragraph 27 – Disclosures in 27a-b are from U.S. GAAP.

11) Paragraph 28 - Disclosures in paragraph 28 a-c come from U.S. GAAP. The disclosures in paragraphs 28d-e are based on concepts previously included SSAP No. 93. Comments are requested on whether those disclosures (or other disclosures from SSAP No. 93) should be included. (For 28d, the prior SSAP No. 93 disclosure was for a number of remaining years of unexpired tax credits and the required holding period, but since that is an individual investment disclosure, it has been modified to reflect an aggregate investment disclosure.)

12) Paragraph 30 – This disclosure is in SSAP No. 93 and comments are requested on whether it should be retained.

Relevant Literature

34. This statement adopts with modification ________. The ASU is modified for the following statutory concepts:
   a. This statement is applicable to all federal and state tax credit programs that meet the requirements in paragraph ____. Under the ASU, use of the proportional amortization method is an election and only pertains to income tax. With this statement, the election is rejected and the guidance is expanded for state premium tax credits.
   b. Investments that meet the criteria of this statement are required to use a proportional amortization method as prescribed in this statement. This method requires the tax credits and benefits to be recognized in proportion to the percentage of actual tax credits and other tax benefits allocated to the reporting entity in the current period divided by the total estimated tax credits and other tax benefits expected to be received by the reporting entity over the life of the investment. This statement requires a gross presentation on the financial statements, with amortization in investment income.
   c. Federal tax credits shall be recognized in the income statement as an offset to federal income taxes in the tax reporting year in which the tax credit is utilized in accordance with SSAP No. 101—Income Taxes. State tax credits shall be recognized in the income statement as an offset to state premium tax or state income tax, whichever is applicable, in the tax reporting year in which the credit is utilized.
d. Tax benefits received, other than tax credits, shall be accounted for pursuant to SSAP No. 101. Amortization shall be reported as a component of net investment income.

e. Reporting entities shall follow the guidance in paragraphs 11 and 12 regarding the recognition of contingent commitments from SSAP No. 5R—Liabilities Contingencies and Impairments of Assets to equity contributions.

f. SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities shall be utilized to account for investments that qualify as subsidiary, controlled or affiliated entities.

g. This statement has specific impairment and nonadmittance requirements.

h. For statutory accounting purposes, deferred taxes are not reported as a component of income from continuing operations in the income statement; rather deferred taxes are recognized as a separate component of gains and losses in unassigned funds (surplus).

i. Disclosures should be followed as indicated in the disclosures section in this statement.

**Effective Date and Transition**

35. This statement is effective for reporting periods beginning on or after January 1, 2006. Early adoption is permitted. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with SSAP No. 3. The guidance previously in paragraph 3 of this statement superseded paragraph 1 of SSAP No. 48. In 2011, this guidance was moved to SSAP No. 48—Joint Ventures, Partnerships and Limited Liability Companies and deleted from this statement. The original guidance included in this standard is retained for historical purposes in Issue Paper No. 125. The guidance from ASU 2014-01 is effective for reporting periods beginning on or after January 1, 2015, with early adoption permitted.

**Staff Question / Items for Discussion:**

13) Paragraphs 34 & 35 – The relevant literature section and effective date section will be updated once the final ASU has been released to reflect GAAP adoptions / modifications and a revised SSAP is being considered.

**REFERENCES**

**Relevant Issue Papers**

- Issue Paper No. 125—Accounting for Low-Income Housing Tax Credit Property Investments
EXHIBIT A – APPLICATION OF PROPORTIONAL AMORTIZATION METHOD

Example 1: Application of Proportional Amortization Method for Qualifying Investment

This example is based on paragraph 323-740-55-5 of the Accounting Standards Codification. The amount and timing of amortization in the proportional amortization method is consistent with the statutory modifications; therefore, the table incorporated in this exhibit is based on the proportional amortization table. The statutory income statement requires a gross presentation on the income statement, with proportional amortization of the initial cost of the investment in investment income and the tax credits and benefits included in income tax expense.

Terms:
Date of Investment: January 1, 20X1
Purchase Price of Investment: $100,000

Assumptions:
1. All cash flows (except initial investment) occur at the end of each year.
2. Depreciation expense is computed, for book and tax purposes, using the straight-line method with a 27.5 year life (the same method is used for simplicity).
3. The investor made a $100,000 investment for a 5 percent limited partnership interest in the project at the beginning of the first year of eligibility for the tax credit.
4. The partnership finances the project cost of $4,000,000 with 50 percent equity and 50 percent debt.
5. The annual tax credit allocation (equal to 4 percent of the project's original cost) will be received for a period of 10 years.
6. The investor's tax rate is 40 percent.
7. For simplicity, the project will operate with break-even pretax cash flows including debt service during the first 15 years of operations.
8. The project's taxable loss will be equal to depreciation expense. The cumulative book loss (and thus the cumulative depreciation expense) recognized by the investor is limited to the $100,000 investment.
9. It is assumed that all requirements are met to retain allocable tax credits so there will be no recapture of tax credits.
10. The investor expects that the estimated residual value of the investment will be zero.
### Proportional Amortization Method with Statutory Modifications

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1. End-of-year investment for a 5 percent limited liability interest in the project net of amortization in Column (2).
2. Initial investment of $100,000 x (total tax benefits received during the year in Column (6)/total anticipated tax benefits over the life of the investment of $120,000).
3. Four percent tax credit on $200,000 tax basis of the underlying assets.
4. Depreciation (on $200,000 tax basis of the underlying assets) using the straight-line method over 27.5 years up to the amount of the initial investment of $100,000.
5. Column (4) x 40% tax rate.
6. Column (3) + Column (5).
Example 2: Tax Equity Investments with Non-Income Tax Related Benefits

This example is based on paragraphs 323-740-55-11 through 323-740-55-14 of the Accounting Standards Codification and illustrates a tax equity investment that generates non-income-tax-related benefits in addition to tax credits and other income tax benefits.

The amount and timing of amortization in the proportional amortization method is consistent with the statutory modifications; therefore, the table incorporated in this exhibit is based on the proportional amortization table. The statutory income statement requires a gross presentation on the income statement, with proportional amortization of the initial cost of the investment in investment income and the tax credits and benefits included in income tax expense.

Terms:
Date of Investment: January 1, 20X1
Purchase Price of Investment: $100,000

Assumptions:

1. All cash flows (except initial investment) occur at the end of each year.
2. Depreciation expense is computed, for book and tax purposes, using the straight-line method with a 27.5 year life (the same method is used for simplicity).
3. The investor made a $100,000 investment for a 5 percent limited partnership interest in the project at the beginning of the first year of eligibility for the tax credit.
4. The partnership will receive production tax credits based on the energy the project produces. The credits will be received over a four-year period.
5. The tax equity investor will receive cash proceeds based on 2 percent of the project’s cash generated during the life of the project.
6. The investor's tax rate is 40 percent.
7. All requirements are met to retain allocable income tax credits such that there will be no recapture of income tax credits.
8. The investor expects that the estimated residual value of the investment will be zero.
9. All of the condition are met to require use of the proportional amortization method.
10. After 10 years, the tax equity investor has a right to require that the project sponsor purchase the tax equity investor’s equity interest for a nominal amount. It is assumed that the option will be exercised.
### Proportional Amortization Method with Statutory Modifications

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1. End-of-year investment for a 5 percent limited liability interest in the project net of amortization in Column (2).

2. Initial investment of $100,000 x (total tax benefits received during the year in Column (6)/total anticipated tax benefits over the life of the investment of $113,200).

3. These tax credits have been generated through the production of electricity, which generates production tax credits. The tax equity investor is not receiving renewable energy credits or carbon offsets.

4. Depreciation /other tax losses passed on to the investor.

5. Column (4) x 40% tax rate.

6. Column (3) + Column (5).

7. Non-income-tax-related benefits recognized in current-period pre-tax earnings when received. This represents the cash proceeds received by the tax equity investor based on the cash generated from the project.
Issue: Interest Income Disclosure Update

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Description of Issue:
This agenda item is the result of comments received from interested parties from the Principles-Based Bond Project. In the Oct. 7, 2022, comment letter, which provided comments on the Aug. 10 exposure by the Working Group, interested parties suggested some revisions to further enhance reporting of interest income on Schedule D-I-1 Bonds, and recommended that NAIC staff look further at if this should be added to any of the other reporting schedules where interest income is reported in accordance with SSAP No. 34—Investment Income Due and Accrued.

There were two distinct items noted in the interested parties’ comments that are addressed by this agenda item. First, they suggested data capturing the gross, nonadmitted and admitted amounts for interest income due and accrued. Second, they suggested that a data element that is included in the bond proposal project be changed to reflect the cumulative amount of paid-in-kind (PIK) interest included in the current principal balance.

With this agenda item, the Working Group will sponsor a proposal at the Blanks (E) Working Group to expand disclosures, with data capturing, to include gross, nonadmitted and admitted amounts for interest income due and accrued. The blanks proposal will also include cumulative amounts of paid-in-kind (PIK) interest included in the current principal balances.

Existing Authoritative Literature:
The guidance for disclosure of interest income is included in SSAP No. 34—Investment Income Due and Accrued.

Disclosures

7. The following disclosures shall be made for investment income due and accrued in the financial statements. (SSAP No. 37 captures disclosures for mortgage loans on nonaccrual status pursuant to paragraph 6.)
   a. The bases by category of investment income for excluding (nonadmitting) any investment income due and accrued;
   b. Disclose total amount excluded.

8. Refer to the Preamble for further discussion regarding disclosure requirements.

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 noted above, this agenda item comes from a suggestion from interested parties, which was included in their Oct. 7, 2022, comment letter.

Information or issues (included in Description of Issue) not previously contemplated by the Working Group: None
Convergence with International Financial Reporting Standards (IFRS): None

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. 34—Investment Income Due and Accrued to add additional disclosures to data capture the gross, nonadmitted and admitted amounts for interest income due and to add disclosure of the cumulative amount of paid-in-kind (PIK) interest included in the current principal balance. Adoption of this agenda item will also signify support for a corresponding Blanks (E) Working Group proposal to add these disclosures to Note 7 of the Annual Statement blanks.

Proposed edits to SSAP No. 34:

Disclosures

7. The following disclosures shall be made for investment income due and accrued in the financial statements. (SSAP No. 37 captures disclosures for mortgage loans on nonaccrual status pursuant to paragraph 6.)

   a. The bases by category of investment income for excluding (nonadmitting) any investment income due and accrued;

   b. Disclose total amount excluded;

   c. Disclose the gross, nonadmitted and admitted amounts for interest income due and accrued.

   d. Disclose aggregate deferred interest and cumulative amounts of paid-in-kind (PIK) interest included in the current principal balance.

8. Refer to the Preamble for further discussion regarding disclosure requirements.

Staff Review Completed by: Jake Stultz—NAIC Staff, November 2022

Status:
On December 13, 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. 34, to add additional disclosures, as illustrated above, and to data-capture the disclosures.

Issue: Negative IMR

Check (applicable entity):

- Modification of Existing SSAP [ ]
- New Issue or SSAP [ ]
- Interpretation [ ]

P/C | Life | Health
--- | --- | ---
[ ] | [ ] | [ ]

Description of Issue: This agenda item has been developed to discuss the interest maintenance reserve (IMR) within statutory accounting, specifically the current guidance for the nonadmittance of disallowed negative IMR. Although the statutory accounting guidance has been in place for several years, the rising interest rate environment has created an increased likelihood for reporting entities to move to a negative IMR position. This agenda item intends to provide information on the background of IMR, current accounting guidance, recent discussions of the Life Actuarial (A) Task Force and some broad financial results from year-end 2021 and interim 2022 financial statements. The intent is to provide this information to facilitate Working Group discussion.

The following provides a high-level overview of the use of the terms positive IMR and negative IMR for entities filing the Life, Accident & Health / Fraternal annual statement blank:

- A positive IMR means that the net realized interest related gains which are amortized in the IMR calculation are greater than net realized interest related losses which are being amortized in the IMR calculation. A positive IMR is reported as a statutory liability and amortized to income over time.

- A negative IMR means that net realized interest related losses which are amortized in the IMR calculation are greater than net realized interest related gains which are amortized in the IMR calculation. A disallowed negative IMR is reported as a nonadmitted asset and amortized to income as a loss over time.

As IMR occurs in the general and separate account, there are specific guidelines in determining whether the IMR reflects a net disallowed negative or position in the annual statement instructions. These are on page 5.

A letter from the American Council of Life Insurers (ACLI) dated Oct. 31, 2022, raised concerns with existing statutory accounting requirements on the nonadmittance of disallowed negative IMR noting negative ramifications for insurers. Key summarized positions from this ACLI letter include:

- In general, rising interest rates are favorable to the financial health of the insurance industry and policyholders. However, with negative IMR, there is an inappropriate perception of decreased financial strength through lower surplus and risk-based capital.

- Negative IMR could impact the rating agency view of the industry or incentivize companies to avoid prudent investment transactions that are necessary to avoid mismatches between assets and liabilities. In either scenario, negative IMR encourages short-term non-economic activity that is not in the best long-term interest of a reporting entity’s financial health or its policyholders.

Background of IMR
The IMR was first effective in statutory accounting in 1992 and requires that a realized fixed income gains or losses attributable to changes in interest rates (excluding gains/losses that are credit related) be amortized into income over the remaining term to maturity of the fixed-income investments (and related hedging programs) sold rather than being reflected in income immediately.
Minutes, including adopted materials – in the Blue Book (Life Statement), from the 2002 4th Quarter NAIC Proceedings discussing IMR are provided below. Please note the last section that includes “Future Directions” which identifies recognition of negative IMR as a major area of effort.

Description and other components of IMR from the Blue Book, captured in the 2002 4th Quarter NAIC Proceedings, provides the following definition and other details: (Only key excepts included.)

The Interest Maintenance Reserve (IMR): captures for all types of fixed income investments, all of the realized capital gains and losses which result from changes in the overall level of interest rates as they occur. Once captured, these capital gains or losses are amortized into income over the remaining life (period to maturity) of the investments sold. Realized gains and losses on derivative investments, which alter the interest rate characteristics of assets/liabilities, also are allocated to the IMR and are to be amortized into income over the life of the associated assets/liabilities. Note: certain significant unusual transactions may require immediate recognition of any realized capital gains or losses, as described in a later section. This reserve is not subject to any maximum.

VII. IMR MINIMUMS/MAXIMUMS: A. Minimums: The IMR can be negative for any line of business as long as the aggregate IMR for the Company is not less than zero. Any otherwise negative IMR value is carried over to subsequent years. B. Maximums: There is no maximum of the IMR

VIII. BACKGROUND/PERSPECTIVE: To insure solvency of a company, its assets should be invested so that the company has a very high probability of paying its contractual liabilities when they become due. In order to assess whether a company is able to fulfill its obligations, it must present its liabilities and assets on a financially integrated basis. Since the accounting practices prescribed for the life insurance annual statement are an important element in this discipline, it is imperative that the accounting practices be consistent for assets and liabilities. If they are inconsistent, then the annual statement will not reveal whether assets exceed liabilities; more importantly, neither regulators nor management can determine the risk of insolvency for the company.

The Valuation Actuary’s Opinion includes a statement that the assets backing the liabilities make adequate provision for the company’s liabilities. That is, the Actuary must look beyond the statutory valuation formulas and satisfy himself that the cash flows generated by the assets will probably be sufficient to discharge the liabilities. Prior to the AVR and IMR, there were many circumstances under which the statutory formula valuation methods gave rise to inappropriate results. Some examples were:

- Changes in values due to interest rate swings were recognized inconsistently on the asset and liability sides of the balance sheet. Liabilities are valued using interest rates fixed at issue while some assets may be valued using current interest rates through trading activity.

- When the assets are poorly matched to the liabilities, a significant adverse swing in the interest rates will reduce financial strength and could lead to insolvency even though the balance sheet value of the assets exceeds the balance sheet value of the liabilities. Using long term assets to back demand liabilities is dangerous if there is a significant upswing in interest rates. In addition, individual insurance premiums are received and invested for many years after the issue date on which the reserve interest rate is determined, creating a potential for inadequate yields that is not reflected in standard accounting procedures.

- The potential for future asset losses was not well reflected in the balance sheet or earnings statement.

It is desirable that the valuation of the assets and liabilities be made as consistent as possible to 1) minimize the instances where, in order to render a clean opinion, the actuary must establish extra reserves due to interest rate gains or potential for defaults and 2) increase the likelihood that assets supporting liabilities are sufficient even in the absence of an Actuarial Opinion. The development of an AVR and IMR will correct many of these deficiencies in consistency.
XII. AVR AND IMR BUILT ON AND COMPLEMENT EXISTING VALUATION PRACTICES: The existing framework of asset and liability valuation practices, as augmented by the NAIC Model Standard Valuation Law, played a key role in designing the AVR and IMR, including:

A. Reserve valuation standards should contain a provision for future losses. Although it is well understood that in cash flow testing provision must be made for future asset losses, it may not be as well understood that historically the minimum valuation standards implicitly contained such a provision.

B. Interest assumptions in reserve valuation generally recognize the potential for mismatch. Dynamic valuation rates are lower for ordinary life than for guaranteed investment contracts, for example, because the mismatch is almost inevitable on the former. In addition, it is required in other regulations, and in the NAIC Model Standard Valuation Law, that cash flow testing should be used and may result in the adoption of lower than the dynamic valuation rates if mismatch exists. Hence, with the one exception noted in section (c), there is no need for the IMR reserves to make provision for the risk of mismatch.

C. Asset valuations for fixed interest securities usually reflect the outlook at the time of purchase of an asset. In particular, bond amortization tends to reflect the yields available at time of purchase and the expected cash flow. Liabilities are established at the same time, and the interest rate assumptions on them are those appropriate to the outlook at that time. But if securities are traded, a new amortization schedule is established that may be based on an entirely different yield environment, which may not be consistent with the liabilities that have been established. Using the IMR to absorb trading gains is desirable and appropriate to eliminate this subsequently created mismatch.

D. Equities present special valuation problems. Common stocks are valued at market rather than amortized value; hence they require different treatment. Real estate and similar investments, although usually valued at depreciated value, require special consideration because of the great likelihood of major changes in yield and yield expectation after purchase.

XXII. RESERVE MAXIMUM AND MINIMUM LEVELS: No maximum is placed on the Interest Maintenance Reserve. The aggregate minimum value for the IMR for the Company is zero. The IMR may be negative for any Line of Business as long as the aggregate for all lines equals zero. Provision is made in the accounting rules that if an aggregate negative IMR is developed in the absence of the zero minimum, that negative value is carried over to subsequent years.

The basic rationale for the IMR would conclude that neither a maximum nor a minimum is appropriate. If the liability values are based on the assumption that the assets were purchased at about the same time as the liabilities were established, then there should be no bounds to the reserve which corrects for departures from that assumption; if a company has to set up a large reserve because of trading gains, it is in no worse position than if it had held the original assets. As for negative values of the IMR, the same rationale applies. However, the concept of a negative reserve in the aggregate has not been adopted.

XXVIII. EXCESSIVE WITHDRAWALS:

A. Background: Major book-value withdrawals or increases in policy loans can occur at a time of elevated interest rates. If these withdrawals or increases are far in excess of the withdrawals provided for in the company's reserving and cash flow testing, and if asset sales at this point are, in effect, forced sales to fund liabilities that are no longer on the books, the allocation of a negative amount to the IMR is not correct.

A company may also experience a “run on the bank” due to adverse publicity. This could occur even during a period of low interest rates, and the sale of assets to meet a run would conceivably produce gains. It is appropriate to register the gains immediately.

If the withdrawals were scheduled payments under a GIC, then there is a presumption that any gains or losses that might occur at the time of withdrawal should be added to the IMR since the gains or losses would be spurious if the company has followed a policy of matching its assets to its liabilities.
Note that many of the situations where an upsurge in withdrawal activity generates real losses arise when a company has a severe mismatch between its assets and its liabilities. Such losses can be present even in the absence of any realized gains or losses. The primary protection as to the adequacy of reserves in these circumstances is the requirement for an actuary's opinion.

B. IMR Exclusions: All realized interest-related gains or losses which arise from the sale of investments required to meet “Excess Withdrawal Activity” as defined below will be excluded from the IMR and will be reflected in net income.

STANDARDS FOR ACTUARIAL RESERVES WITH AN IMR AND AN AVR

LXX. IMR RESERVE STANDARD The Interest Maintenance Reserve is a true actuarial reserve, and actuaries should use the assets supporting the Interest Maintenance Reserve when opining that the assets supporting the company’s reserves make adequate provision for the company’s obligations. In the case of a negative IMR, the actuarial opinion should include an explicit statement that the impact of the negative IMR on reserve adequacy has been considered and that the reserves after deduction of the negative IMR still make adequate provision for the liabilities.

LXXI. GENERAL EXPLANATION The IMR is designed to work with minimum statutory reserves based on formulas contained in laws or regulations. Where, for example, the valuation rate is based on the interest rate conditions prevailing in the year of deposit, the assets supporting the liabilities will be consistent with the liability assumptions. Disposal of the assets during a period of declining interest rates will produce interest-related gains, but these gains will be needed to support the liabilities that are still valued at the interest rate levels prevailing at time of deposit. Thus, it is appropriate in the case of positive IMR to treat the IMR as an additional reserve requirement above and beyond formula minimums.

In cash-flow-testing actuaries take future cash flows into account from existing assets. In an example such as described above, existing assets may well have been purchased at rates below those prevailing at the time reserves were established. The positive IMR that has been built up has captured the gains and not allowed them to be available for distribution. The IMR is recognized as part of the reserves available to meet future obligation cash flows.

Thus from either point of view a positive IMR is treated as a true actuarial reserve. The same arguments should apply equally well in the case of a negative IMR, but some concern has been expressed that in this case the net reserves are in effect lower than statutory formulas minimums, and therefore special considerations are required.

FUTURE DIRECTIONS

In late 2002, the interested persons (as its name had become) considered refinements of the AVR/IMR for the next several years, from that vantage point, some of the major areas of effort appear to be as follows:

1. There should be recognition of negative values of the IMR. The group had long recognized that the philosophical basis for the IMR supports negative values of the reserve as well as positive. There is a need to have investment return match the liabilities associated with the investment; and a need to remove the incentive for a company to make investment decisions based on the short-term balance sheet effect; and these needs exist also on the negative side of the IMR.

No doubt there are concerns that a negative reserve of this type could somehow lead to an unsound condition, so there has been appended to this report a discussion entitled “Why Are Negative Values For the IMR Necessary?” It also seems as though there should be additional safeguards in the case of a negative IMR. Rather than put arbitrary limits on the amount of the negative reserve, however, consideration is being given to an actuary’s statement that an asset adequacy analysis has been carried out that demonstrates the soundness of the reserves.

(Staff Note: The NAIC library does not have a record of the report noted in the above paragraph.)
Current Accounting Guidance

The statutory accounting guidance for IMR (and the Asset Valuation Reserve – AVR) is within SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve, but the guidance within that SSAP is very limited. It provides a general description, identifies that IMR/AVR shall be calculated and reported per the guidance in the applicable SSAP, and if not explicit in the SSAP, in accordance with the Annual Statement Instructions. The SSAPs most often simply direct allocation to (or between) IMR and AVR, with the bulk of the guidance within the Annual Statement Instructions.

The guidance in the Annual Statement instructions provides information on the net IMR balance, which takes into consideration both the positive and negative balances in the general and separate accounts. As detailed, disallowed negative IMR is reported so that it is a direct reduction to surplus on the Summary of Operations, page 4, line 41 change in nonadmitted assets:

<table>
<thead>
<tr>
<th>Line 6</th>
<th>Reserve as of December 31, Current Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>Record any positive or allowable negative balance in the liability line captioned “Interest Maintenance Reserve” on Page 3, Line 9.4 of the General Account Statement and Line 3 of the Separate Accounts Statement. A negative IMR balance may be recorded as a negative liability in either the General Account or the Separate Accounts Statement of a company only to the extent that it is covered or offset by a positive IMR liability in the other statement.</td>
<td></td>
</tr>
</tbody>
</table>

If there is any disallowed negative IMR balance in the General Account Statement, include the change in the disallowed portion in Page 4, Line 41 so that the change will be appropriately charged or credited to the Capital and Surplus Account on Page 4. If there is any disallowed negative IMR balance in the Separate Accounts Statement, determine the change in the disallowed portion (prior year less current year disallowed portions), and make a direct charge or credit to the surplus account for the “Change in Disallowed Interest Maintenance Reserve” in the write-in line, in the Surplus Account on Page 4 of the Separate Accounts Statement.

The following information is presented to assist in determining the proper accounting:

<table>
<thead>
<tr>
<th>General Account IMR Balance</th>
<th>Separate Account IMR Balance</th>
<th>Net IMR Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Positive</td>
<td>Positive</td>
<td>Positive (See rule a)</td>
</tr>
<tr>
<td>Negative</td>
<td>Negative</td>
<td>Negative (See rule b)</td>
</tr>
<tr>
<td>Positive</td>
<td>Positive</td>
<td>Positive (See rule c)</td>
</tr>
<tr>
<td>Positive</td>
<td>Negative</td>
<td>Negative (See rule d)</td>
</tr>
<tr>
<td>Negative</td>
<td>Positive</td>
<td>Positive (See rule e)</td>
</tr>
<tr>
<td>Negative</td>
<td>Positive</td>
<td>Negative (See rule f)</td>
</tr>
</tbody>
</table>

Rules:

a. If both balances are positive, then report each as a liability in its respective statement.

b. If both balances are negative, then no portion of the negative balances is allowable as a negative liability in either statement. Report a zero for the IMR liability in each statement and follow the above instructions for handling disallowed negative IMR balances in each statement.

c. If the general account balance is positive, the separate accounts balance is negative and the combined net balance is positive, then all of the negative IMR balance is allowable as a negative liability in the Separate Accounts Statement.
d. If the general account balance is positive, the separate account balance is negative, and the combined net balance is negative, then the negative amount not covered by the positive amount is not allowable. Report only the allowable portion as a negative liability in the Separate Accounts Statement and follow the above instructions for handling the disallowed portion of negative IMR balances in the Separate Accounts Statement.

e. If the general account balance is negative, the separate account balance is positive, and the combined net balance is positive, then all of the negative IMR balance is allowable as a negative liability in the General Account Statement.

f. If the general account balance is negative, the separate account balance is positive, and the combined net balance is negative, then the negative amount not covered by the positive amount is not allowable. Report only the allowable portion as a negative liability in the General Account Statement and follow the above instructions for handling the disallowed portion of negative IMR balances in the General Account Statement.

The Statutory Accounting Statement of Concepts in the Preamble to the AP&P provides the following on Recognition:

**Recognition**

35. The principal focus of solvency measurement is determination of financial condition through analysis of the balance sheet. However, protection of the policyholders can only be maintained through continued monitoring of the financial condition of the insurance enterprise. Operating performance is another indicator of an enterprise’s ability to maintain itself as a going concern. Accordingly, the income statement is a secondary focus of statutory accounting and should not be diminished in importance to the extent contemplated by a liquidation basis of accounting.

36. 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 but rather should be charged against surplus when acquired or when availability otherwise becomes questionable.

37. Liabilities require recognition as they are incurred. Certain statutorily mandated liabilities may also be required to arrive at conservative estimates of liabilities and probable loss contingencies (e.g., interest maintenance reserves, asset valuation reserves, and others).

**Life Actuarial (A) Task Force 2022 Guidance**

The Life Actuarial (A) Task Force considered comments from the ACLI that the inclusion of a negative IMR balance in asset adequacy testing, the disallowance of a negative IMR could result in double counting of losses (i.e., through the disallowance of the balance sheet and the potential AAT-related reserve deficiency). The Task Force identified that VM-20 Section 7.D.7.b notes that “…the company shall use a reasonable approach to allocate any portion of the total company balance that is disallowable under statutory accounting procedures (i.e., when the total company balance is an asset rather than a liability).” Question 22 of the AAA’s Asset Adequacy Practice Note (Attachment 2) states that “…a negative IMR is not an admitted asset in the annual statement. So, some actuaries do not reflect a negative value of IMR in the liabilities used for asset adequacy analysis.” However, Question 22 also notes a 2012 survey data that showed varying practices across companies, including some companies that allocated negative IMR.

On Nov. 17, 2022, in order to assist state regulators in achieving uniform outcomes for year-end 2022, the Task Force exposed guidance until November 30, 2022:

**Recommendation** In order to assist state regulators in achieving uniform outcomes for year-end 2022, we have the following recommendation: the allocation of IMR in VM-20, VM-21, and VM-30 should be
principle-based, “appropriate”, and “reasonable”. Companies are not required to allocate any non-admitted portion of IMR (or PIMR, as applicable) for purposes of VM-20, VM-21, and VM-30, as being consistent with the asset handling for the nonadmitted portion of IMR would be part of a principle-based, reasonable and appropriate allocation. However, if a company was granted a permitted practice to admit negative IMR as an asset, the company should allocate the formerly non-admitted portion of negative IMR, as again a principle-based, reasonable and appropriate IMR allocation would be consistent with the handling of the IMR asset. This recommended guidance is for year-end 2022, to address the current uncertainty and concerns with the “double-counting” of losses. This recommended guidance will help ensure consistency between states and between life insurers in this volatile rate environment. Refinement of this guidance may be considered beyond year-end 2022.

The Oct. 31 ACLI Letter also identified the following references to IMR in the valuation manual and Risk-Based Capital Calculations:

<table>
<thead>
<tr>
<th>Regulation</th>
<th>Use</th>
<th>IMR references</th>
</tr>
</thead>
<tbody>
<tr>
<td>Actuarial Opinion and Memorandum Regulation (VM-30)</td>
<td>Asset adequacy analysis for annual reserve opinion</td>
<td>An appropriate allocation of assets in the amount of the IMR, whether positive or negative, shall be used in any asset adequacy analysis.</td>
</tr>
<tr>
<td>Life principle-based reserves (VM-20)</td>
<td>Calculation of deterministic reserve</td>
<td>Calculate the deterministic reserve equal to the actuarial present value of benefits, expenses, and related amounts less the actuarial present value of premiums and related amounts, less the positive or negative pre-tax IMR balance at the valuation date allocated to the group of one or more policies being modeled.</td>
</tr>
<tr>
<td>Life principle-based reserves (VM-20)</td>
<td>Calculation of stochastic reserve</td>
<td>Add the CTE amount (D) plus any additional amount (E) less the positive or negative pre-tax IMR balance allocated to the group of one or more policies being modeled.</td>
</tr>
<tr>
<td>Variable annuities principle-based reserves (VM-21)</td>
<td>Reserving for variable annuities</td>
<td>The IMR shall be handled consistently with the treatment in the company’s cash-flow testing, and the amounts should be adjusted to a pre-tax basis.</td>
</tr>
<tr>
<td>C3 Phase 1 (Interest rate risk capital)</td>
<td>RBC for fixed annuities and single premium life</td>
<td>IMR assets should be used for C3 modeling.</td>
</tr>
</tbody>
</table>
Assessment of 2020-2022 IMR Balances:

Note – The following amounts reflect the general account IMR Reserve balance. (This is the amount shown as a liability and shows the decrease in the positive IMR reported since 2020.) This detail does not show the disallowed negative IMR reported as an asset and nonadmitted. Also, information on the separate account IMR, which is a factor in determining in disallowed negative IMR, will not be known until the year-end financial statements are filed (March 1, 2023).

<table>
<thead>
<tr>
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<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Aggregate IMR</td>
<td>27,601,001,445</td>
<td>31,859,274,989</td>
<td>37,697,176,149</td>
<td>40,598,068,038</td>
</tr>
<tr>
<td>Change from Prior</td>
<td>(4,258,273,544)</td>
<td>(5,837,901,160)</td>
<td>(2,900,891,889)</td>
<td>5,368,489,312</td>
</tr>
<tr>
<td>% Change</td>
<td>(13.4%)</td>
<td>(21.5%)</td>
<td>(7.1%)</td>
<td>15.2%</td>
</tr>
</tbody>
</table>

Review of GA IMR Reserve Decrease:

- From the first quarter (Q1) to second quarter (Q2), 25 companies had decreases in the IMR reserve balance over $50M totaling $4,717,657,986, representing 80% of the overall change. 13 of these companies had decreases of IMR over $100M, totaling $3,959,569,339, representing 68% of the change. Four of these companies had decreases of IMR over $400M. One of these companies reported a zero IMR liability and reported a disallowed IMR on the asset page of approx. $570M.

- From the first quarter (Q1) to second quarter (Q2), 49 companies increased their prior reported positive IMR by $61,390,564. From the second quarter (Q2) to third quarter (Q3), 56 companies increase their prior reported positive IMR by $60,316,403

- From the second quarter (Q2) to third quarter (Q3), 16 companies had decreases in the IMR reserve balance over $50M totaling $3,161,570,362, representing 74% of the change. 8 of these companies had decreases of IMR over $100M, totaling $2,580,832,015, representing 60% of the change. All of these companies were still in a net positive IMR position.

- For the 30 companies that reflected the largest decline in reported IMR between the first to second quarter and then the second to third quarter, the following key details are noted.
  - From the first (Q1) to second quarter (Q2), the top 30 companies reflected a decrease in $4,923,166,733, which is 84% of the total decrease.
  - From the second (Q2) to third quarter (Q3), the top 30 companies reflected a decrease in $3,642,088,165, which is 85.5% of the total decrease.

- 19 companies were noted as being in the population for both periods. 29 of the 30 companies reported a net positive IMR in the third quarter. One company reported a zero IMR in Q3.

- For the 15 companies that had the largest declines between the first quarter (Q1) to second quarter (Q2), eight of those companies also had the largest declines from second quarter (Q2) to third quarter (Q3).

- A limited number of companies are reporting a negative IMR on the liabilities side. Seven companies reported a net negative IMR balance in the third quarter (Q3) for a total of 11,031,998. One company made up $10.5M of the aggregate balance and this company initially went negative in the second quarter (Q2). Six companies reported a net negative IMR balance for Q2 for a total of $9,815,594. (The other companies with negative IMR were immaterial amounts.) (Under the guidance in the A/S instructions, these companies should stop at zero and report the negative as disallowed nonadmitted asset.)
Review of Disallowed IMR:
Although the assessment of the liability balance shows the decrease in positive IMR, it no longer tracks the decline for companies that go negative, as the reserve balance on the liability page should stop at zero. (This info may be identifiable from the IMR schedule, but not within the quarterly financials from a review of the IMR reported on the liability page.) As such, NAIC staff completed a review of the data to identify the companies that moved to a zero balance (from a prior positive balance) at year-end 2021 or in the 2022 quarters:

Companies that moved from a positive IMR (liability) to a zero balance:
- Initially went to zero in 2022 – Q3: 20 companies
- Initially went to zero in 2022 – Q2: 20 companies
- Initially went to zero in 2022 – Q1: 11 companies
- Initially went to zero YE 2021 – 20 companies (This is a comparison to YE 2020.)

For these 71 companies, NAIC staff has completed a manual review to the 2022 third quarter financial statements to determine if a disallowed IMR was reported as an aggregate write-in on the asset page. For these companies, 60 were identified with a disallowed IMR for a total of $1 Billion as of the third quarter 2022.

Existing Authoritative Literature:

SSAP Authoritative Guidance:
- SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve
- Life Annual Statement Instructions

(Guidance included as part of discussion.)

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):
- Nov. 17, 2022, Discussion by Life Actuarial (A) Task Force as discussed above.

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

Convergence with International Financial Reporting Standards (IFRS): NA

Recommendation:
NAIC staff recommend that the Working Group include this item on their maintenance agenda as a New SAP Concept for discussion to assess the current guidance for disallowed negative IMR. NAIC staff recommend that at the Working Group’s conclusion, documentation of the discussion, and resulting decisions, be captured for historical purposes in an Issue Paper.

Staff Review Completed by: Julie Gann - NAIC Staff, November 2022

Status:
On December 13, 2022, the Statutory Accounting Principles (E) Working Group moved this agenda item to the active listing, categorized as a New SAP Concept and exposed the agenda item with a request for comments by industry on potential guardrails and details on unique considerations. The Working Group directed NAIC staff to coordinate with the Life Actuarial (A) Task Force and request regulator-only sessions with industry to receive specific company information.


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</tr>
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<td>Interested Parties – February 10, 2023</td>
<td></td>
</tr>
<tr>
<td>o Principles-Based Bond Definition</td>
<td></td>
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February 10, 2023

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 with Comments due February 10th

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) on December 13, 2022, with comments due February 10th.

We offer the following comments:

**Principles-Based Bond Definition**

The Working Group exposed changes that include proposed revisions to reflect the bond definition in SSAP No. 26R—Bonds and SSAP No. 43R—Asset Backed Securities. Exposure also includes corresponding revisions to other SSAPs, which includes guidance restricting asset-backed securities (ABS) from SSAP No. 2R and guidance for debt instruments that do not qualify as bonds in SSAP No. 21R.

Interested parties have submitted a separate comment letter on these proposed changes.

**Ref #2019-21: Proposed Bond Definition**

The Working Group also exposed reporting changes for bonds under the principles-based bond project. In addition to a new schedule and granular reporting lines, the exposure includes proposed revisions to other schedules and instructions that reference bond reporting. The exposure also includes a revised issue paper to detail discussions and decisions on the bond
Interested parties have not provided any comments on these exposures during this comment period as we have provided comments previously on similarly exposed items. Also, based on conversations with NAIC staff, interested parties believe that our comments can be optimized once the official Blanks items are exposed from the Blanks Working Group in March.

**Issue Paper: SSAP 86, Derivatives and Hedging**

The Working Group proposed a new issue paper to detail revisions previously adopted with the review of ASU 2017-12, Derivatives and Hedging and ASU 2022-01 Fair Value Hedging – Portfolio Layer Method.

Interested parties have no comments on this item.

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

The Working Group re-exposed revisions to the definition of a liability and issue paper to incorporate the concepts from Financial Accounting Standards Boards (FASB) Concepts Statement No. 8.

Interested parties are currently reviewing the additional materials provided by NAIC staff and will comment at a later date.

**Ref #2022-11: Collateral for Loans**

The Working Group re-exposed revisions to SSAP No. 21R to clarify that invested assets pledged as collateral for admitted collateral loans must qualify as admitted invested assets.

The impact of the new exposed language can be interpreted to affect requirements for collateral loans which are backed by investments in joint ventures, partnerships, and LLCs. As commented during the 2022 NAIC National Fall Meeting, we believe that audits of joint ventures, partnerships, and LLCs, while required under SSAP No. 97 and SSAP No. 48 for those assets held directly, are not necessarily suited for the task of assessing sufficiency of collateral, because an audit does not validate fair value of the investment, which is a core standard of collateral guidance, and audits may be unreasonably costly for this narrow purpose.

Interested parties noted that regulators indicated concern over arrangements in which the collateral asset or the collateral loan itself may be related to or affiliated with the reporting entity. We believe that this concern is more directly addressed in recent industry exposures and adoptions over related party reporting; a collateral loan involving a related party is required to be labeled as such in annual statement filings. A collateral loan which is backed by a related joint venture, partnership, or LLC, is expected to be disclosed as such under existing SSAP No. 25 guidance. It is our view that in cases where an audit is not performed, allowing an unrelated third party to perform a fair value assessment would address objectivity concerns for this narrow
purpose, noting that primary guidance over related party transactions is addressed elsewhere outside of SSAP No. 21R.

Interested parties propose that the following footnote be included in SSAP No. 21R which would effectively permit companies with these investments to obtain a third-party valuation assessment in place of an audit, where the third-party assessment would satisfy both the admitted asset requirement as well as the fair value sufficiency requirement applicable to collateral assets.

Footnote:
Because an audit, which is required for certain investments in joint ventures, partnerships, and LLCs to be admitted assets, does not necessarily provide assurance over the fair value of such an investment which is collateral for a loan, companies are permitted to obtain a fair value assessment provided by an unrelated third party in place of an audit, in order for a collateral asset which is a joint venture, partnership, or LLC to qualify as an admitted asset under this standard.

Ref #2022-12: Review of INT 03-02: Modification to an Existing Intercompany Pooling Arrangement

The Working Group moved this agenda item to the active listing, categorized as a SAP clarification, and re-exposed the intent to nullify INT 03-02. This re-exposure requested industry to provide comments on specific instances in which the interpretation was being applied. In addition, the following key points were noted for consideration during the exposure in response to some of the comments received.

Staff provided the following comments regarding some of the key points from industry. Interested parties’ response to each comment is provided in italics below following each comment:

1. In the current interest rate environment, the fair value of many bonds is below book value. For example, a bond with an amortized cost of $100 with a fair value of $85. The way INT 03-02 is written a bond with a fair value of 85 could be used to settle an intercompany reinsurance pooling obligation of $100. If the reporting entity paid with cash, they would be required to pay $100. The actual cash value of obligations when they are extinguished is a relevant measure of the transaction.

   *If a bond was transferred at market value in order to settle the $100 pooling obligation as proposed by NAIC staff in the example above, a bond with a fair value of $100 would have to be used to settle the obligation. In the event that the bond was in an unrealized loss position at the time of the transfer, a realized loss would be recognized on the transferring entity’s books and the combined pool’s books. To avoid this situation, a legal entity could use cash to settle the obligation, but the use of such cash may not be the most efficient use of the transferring entity’s resources.*
If the bond was transferred at FV as proposed by NAIC staff but the bond was in an unrealized gain position, a more significant issue would arise. Realized gains would be recorded in the financial statements of the transferring entity, thus resulting in an initial gain in surplus at the legal entity level of reporting as part of the intercompany pooling modification and requiring the intercompany pooling reinsurance to be accounted for as retroactive reinsurance.

There are extreme anomalies with transferring bonds at market value, as illustrated above.

2. Using book value for measurement of payments between affiliates can result in either unrecognized [gains or losses] of in effect dividend or losses. SSAP No. 25 requires such transfers of assets between affiliates to use fair value. If a subsidiary can pay the parent with assets that have a lower fair value than book value (ex, owes $100 but pays with a bond of 85), this has a similar effect as an unrecognized capital contribution to the subsidiary. SSAP No. 72 requires a capital contribution to be valued using fair value.

The hypothetical capital contribution noted by NAIC staff is mitigated by the fact that, in actual practice, the transferring company would likely have two options if it did not transfer the bond:

- The company could sell the bond, recognize a realized loss, and reinvest in a higher interest-bearing bond which would offset the realized loss over time.
- The company could hold the bond until maturity, at which point it is redeemed at the $100 par value.

We also note that modifications to intercompany pooling arrangements are subject to prior regulatory review and approval, and if the example noted by NAIC staff were part of a planned intercompany pooling transaction, the regulator could address it before granting approval to the intercompany pooling modification.

3. Staff agrees that at the ultimate parent level such transfer of assets (in accordance with SSAP No. 25 guidance) may be noneconomic in that the parent continues to hold an interest in the same assets. Therefore, at the parent level, such transfers of assets may result in the deferral of gains. Staff believes that losses would not be deferred at the ultimate parent level.

The issue noted by interested parties is not that the bond transaction may be economic at the subsidiary level but non-economic at the parent level. Rather, the interested parties letter notes that the transfer of reserves in an intercompany pooling modification is a non-economic transfer, and INT-03-02 treats the transfer of bonds consistently (i.e., non-economic) with the transfer of the liabilities.

4. Staff notes that while it may be more expedient to pay intercompany reinsurance pooling transactions with assets, the valuation used should be similar to if the obligation was extinguished with cash. Therefore, an entity can still choose to pay with assets, they just need to be valued consistently with SSAP No. 25 guidance.
This comment seems to imply that staff disagrees with the views of the Statutory Accounting Principles Working Group, which deliberated this issue in 2003 and decided that the appropriate guidance is SSAP No. 62 and not SSAP No. 25.

5. SSAP No. 62R, paragraph 36d provides an exception to retroactive reinsurance accounting guidance which allows for prospective accounting treatment for intercompany reinsurance among 100% owned affiliated provided there is no gain to the ceding entity. If there is a gain to the ceding entity, there is guidance in SSAP No. 62R, paragraph 37 which requires a more punitive method of accounting than either prospective or retroactive reinsurance accounting. Therefore, NAIC staff comment is that the statutory accounting objective is to provide different treatment for retroactive reinsurance contracts if there is a gain to the ceding entity. This is another reason that the guidance in INT 03-02 is problematic. The object is to correctly measure the effects of the contract, which drives the accounting. The objective is not to obscure whether there is a gain to the ceding entity, which can happen in the event that the assets used in payment are not measured correctly.

INT 03-02 avoids the gain in surplus issue by requiring that the transfer of bonds be at book value. This avoids inconsistent accounting of intercompany pooling modifications between prospective reinsurance accounting and retrospective reinsurance accounting. INT 03-02 provides consistent accounting for all such modification transactions.

Interested parties believe that INT 03-02 was not meant to address whether assets used as payments in an intercompany pooling modification are measured correctly, but rather the INT was meant to address which accounting is appropriate given the facts and circumstances of the transaction. We still believe that INT 03-02 provides a reasonable approach with respect to accounting for intercompany pooling modifications and provides consistency in reporting across companies.

6. Interested parties noted that modifications to intercompany pooling arrangements are typically effective retroactive to the beginning of the year. Staff notes that the payment value when the transaction is settled should be equivalent to the cash value of what is owed on the date of extinguishment of the liability.

This view raises the question of whether the “fair value” of the reserves need to be considered. That would be unprecedented and not consistent with any statutory accounting guidance.

7. Many of the interested parties’ comments regarding GAAP use of book value are more relevant to consolidated basis accounting which is not consistent with the legal entity basis of statutory accounting.

Interested parties respectfully disagree. The interested parties comment letter references the example of accounting for mergers, which is not the same as consolidation accounting.
8. Interested parties’ comments noted that there is a difference in treatment for intercompany pooling participants who are not 100% owned by a common parent. NAIC staff notes that retroactive pooling agreement changes with participants that are not 100% under common control do not meet the exception to retroactive accounting provided in SSAP No. 62R, paragraph 36d. NAIC staff notes that SSAP No. 62R, paragraph 37 provides guidance for retroactive reinsurance agreements among affiliates where there is a gain to the ceding entity.

This comment appears to conflate the issue of being under the control of a common parent versus under 100% common control of a group. The interested parties comment letter was distinguishing between intercompany pool entities which have a common parent versus intercompany pool entities which do not have a common parent. All of the intercompany pool entities are under 100% common control, but not necessarily under the same common parent.

As an example, there may be downstream insurance subsidiaries of two top-tier insurance entities. The downstream insurance subsidiaries do not have common parents but are under 100% common control of the group.

We believe that nullification of the existing INT will likely result in inconsistent interpretation of the guidance by both companies and regulators and will result in inconsistent accounting treatment.

Ref #2022-14: New Market Tax Credits

The Working Group moved this agenda item to the active listing, categorized as a new SAP concept, and exposed a discussion document to expand current statutory accounting guidance for low-income housing tax credits to capture all tax equity investments that provide general federal business tax credit and state premium tax credits if they meet specified criteria.

Interested parties agree with having uniformity in accounting and reporting for equity investments for which the return is earned primarily through tax credits. Interested parties agree that the proportional amortization method is an appropriate method to use for any type of investment (debt or equity) where the return is primarily earned through tax credits. We are providing responses to the questions exposed in the Discussion Paper in this document. There are two key take aways from our responses summarized as follows:

1. Interested parties ask the Working Group to consider allowing for the reporting of both the amortization of the investments and the use of the tax credits themselves in the same income statement line similar to what is required under U.S. GAAP.

2. Interested parties have concerns regarding tax credit investments that are issued in debt form and requiring those investments to be reported on Schedule BA instead of Schedule D. Interested parties believe that tax credit investments issued in debt form are better suited for Schedule D reporting.

We have provided responses to the questions in the Discussion Paper below for your
consideration.

1) Paragraph 1 – The scope intends to include programs that provide general business federal tax credits, which are income tax credits, and programs that meet the criteria that provide for state premium tax credits. This would be an extension from the FASB exposure that only permits income tax credits but is in line with comments received by the FASB that insurers receive credits for state premium tax. Comments are requested on the proposed inclusion for programs that meet the criteria in paragraph 3 that generate state premium tax credits.

Interested Parties Response: Interested parties agree that all investments, no matter what legal form, for which the return is earned primarily through tax credits should follow the proportional amortization method.

The proposal seems to only scope in equity investments in tax credit structures and a very limited set of debt tax credit investments. Interested parties note that there are also other types of debt investments for which the return is primarily earned through tax credits with many structures including cash payments as well. We have listed examples of such debt structures in the Appendix. We have the following comments specifically related to these debt investments for which the return is earned primarily through tax credits if the intent is to scope those investments as well into the proposal:

a. Currently, debt investments in CAPCOs which provide state tax credits follow the SSAP No. 26 guidance and reporting, including INT 06-02 Accounting and Reporting for Investments in a Certified Capital Company (CAPCO). It is unclear from the exposure whether these investments will continue to be reported on Schedule D and/or whether new investments under this program should follow the new revised guidance. See the Appendix for more information on these investments.

b. For companies that currently invest in bonds for which the return is primarily earned through tax credits, moving these investments to Schedule BA causes concerns since there are limitations on the amount of assets that can be reported on Schedule BA. These investments are sound and of high credit quality because the tax credits are highly probable and any contractual cash payments are typically escrowed in cash. Interested parties would also note that these programs are aimed at promoting the development and growth of distressed communities and moving them to Schedule BA may deter insurers from investing in these structures since the level of risk perceived from Schedule BA assets would not be commensurate with the return on these investments (more like debt returns versus more risky Schedule BA returns). Interested parties ask the Working Group to consider allowing for debt tax credit investments to be reported on Schedule D. Although tax credits in the legal form of debt may not result in a direct payment of cash from the borrower to the investor, there is a reduction in cash payments by the investor for income tax expenses, premium tax expenses, or state income taxes, depending on the nature of the tax credit investment. Interested parties note that cash is fungible so whether in the form of direct payments of cash from the borrower to the insurer for principal and interest or reduced insurer payments of taxes, the investment results in increased cash.
available to the insurer. The debt form of tax credit investments has contractual fixed payments of principal and interest in the form of reduced cash payments as noted. From this perspective, these instruments may meet the proposed principle-based bond definition.

c. Companies currently report tax credit debt investments on Schedule D with an NAIC designation, which usually comes from the SVO. If the intent is for these investments to move to Schedule BA, it is imperative that these investments are allowed to be reported with an NAIC designation (see high credit quality referenced in prior paragraph). We would like to stress the fact that the risk profile of tax credit investments is not commensurate with equity-type risk as these investments tend to be of high credit quality with a very good history of performance. It is very important to take into consideration any potential RBC impacts when making any accounting or reporting changes.

d. Interested parties also note that if the proposal intends to scope in all tax credit investments in debt form, which we would be supportive of, this needs to be clarified in the exposure as the exposure may be interpreted to only include equity investments. For example, the criteria currently included in the exposure to apply the proportional amortization method is very specific to investments made in equity form. If the proposal is scoping in debt investments as well, the criteria need to be updated so that it is tailored to debt investments as well.

2) Paragraph 3 – The criteria mirror the concepts included in the proposed FASB guidance. Under U.S. GAAP, the use of the portfolio allocation method is an election, but under SAP, the guidance would be required if the criteria are met. (This would be consistent with the existing guidance in SSAP No. 93 for LIHTC.) Based on the FASB comment letters reviewed, the criteria are expected to be met for most state premium-based tax equity investments. Should other criteria be considered or are there concerns with requiring application if the criteria are met?

Interested Parties Response: Interested parties agree that the same criteria currently required under U.S. GAAP should apply to SAP for application of the proportional amortization method. Interested parties do not have an issue with the proportional amortization method being a requirement, as opposed to an option, if the criteria are met. We have two observations regarding the criteria:

a. Criteria “d” requires that “substantially all of the projected benefits are from tax credits and other tax benefits, determined on a discounted basis using a discount rate that is consistent with the cash flow assumptions utilized by the reporting entity for the purpose of making a decision to invest in the project.” Interested parties would like to confirm that this criterion along with the rest of the criteria are assessed at the time of purchase of the investment and not at every reporting period. This is consistent with the Bond project proposals for the principles-based bond definition also. For certain tax credit investments such as renewable energy tax credit investments, this criterion is usually met at origination. However, if the project does
not produce the actual amount of production tax credits expected at origination, the investee may be contractually required to make cash distributions from operations in excess of what was originally anticipated to compensate investors for the reduction in expected tax credits. In this case, substantially all of the projected benefits may end up not being from tax credits and other tax benefits. This is why it is important for the criteria to be assessed at origination.

b. As explained under question #1 if the intent is to also scope in debt investments, the criteria need to be modified so that both types of investments are addressed. We have included some examples of tax credit investments issued in debt form in the Appendix.

3) Paragraphs 5-8 – The information details IRS provisions to qualify for the tax credit and overall information on the use of tax credits investments. Under the IRS rules, the federal business tax credits are not transferable, as only the entity that has a true equity interest can take the tax credit. Furthermore, the designs are most often established to have provisions to liquidate the equity investment (through a put/call) at the end of the timeframe. Comments are requested on whether other designs are prevalent as well as inclusion of this guidance in the SSAP and/or the Issue Paper.

Interested Parties Response: We agree with the discussion topics in paragraphs 5-8 regarding federal and premium tax credit programs with a few exceptions. As explained in the Appendix, there are other forms of debt investments for which the return is primarily earned through tax credits that do not seem to be addressed in the Discussion paper. Interested parties would also like to clarify that debt tax credit investments are usually transferrable, but for debt tax credit investments that require the purchase of an equity interest, they would have to be transferred along with the equity investment. Therefore, although the debt piece may not be transferable on its own for those types of deals, it is transferable along with the equity.

In addition, the Discussion paper states “a guarantee of return disqualifies the investor as obtaining a tax credit for federal income tax purposes. A limited exception to this structure can exist for NMTC using a financial institution syndicating a NMTC in which the financial institution guarantees the credit or returns.” Interested parties note that guarantees exist in structures other than New Market Tax Credit (NMTC) structures. For example, there are at least 2 financial institution syndicators actively offering LIHTC transactions with an 80% tax credit guarantee for which tax opinions have been obtained to ensure this still qualifies the investor as a “true partner.” There are also various guarantees offered in the Renewable Energy Tax Credit space where guarantees may be issued by financial institutions to provide for a dollar-for-dollar guarantee for the first 25% of tax credits recaptured or disallowed. Any guarantees issued by financial institutions on the tax credits are done in a way that still ensures the eligibility of the credits. Our reason for bringing this up is that the Discussion Paper seems to limit the existence of such guarantees to NMTC deals and we want to clarify that guarantees exist in other tax credit transactions. At the same time, for the debt deals where these guarantees exist, the risk profile is even stronger since the insurer will get a return of all or a portion of its initial investment if the tax credits do not emerge and as a
result, we believe whether a guarantee exists or not, should be irrelevant to the use of the proportional method and the proposed reporting.

4) Paragraphs 10-14 – This information mirrors guidance from the proposed ASU with SAP clarifications. Comments are requested on whether SAP modifications should be considered.

**Interested Parties Response:** Interested parties request that SAPWG consider applying the same geography requirements under U.S. GAAP to SAP. Currently under SAP for Low Income Housing Tax Credit Investments, the amortization of the investment is reported in net investment income (NII) and the tax credits are reported in the tax expense line for federal tax structures and in state premium tax or state income tax for state tax structures. Under U.S. GAAP, both the amortization and the tax credits are reported together in the income tax line. We believe that reporting both the amortization and the tax credits in tax expense for federal programs and in the state premium tax or state income tax lines for state programs more faithfully represents the intent of the credits, which is to reduce the expenses and thus is a much better presentation of these investments. When the amortization is reported in net investment income, these investments are reported as if they had a negative return since the amortization is divorced from the tax credits, which is not a true representation of the return on these investments. If the tax credits allow state income tax or premium tax credits to be taken by an insurer, the expense line of the income statement will result in much more volatility when the amortization of the credits is not matched with the tax credits themselves in the same income statement line item. Not matching could have an indirect impact on insurers “rate setting” process on P&C business.

Interested parties would be happy to work with the Working Group to determine the best way to present tax credit investments on the investment schedules with amortization being reported in the same income statement line item as the tax credits themselves. One item that would have to be addressed for federal tax programs is whether a deferred tax asset (DTA) would still be recorded for any tax credit carryforwards. Under U.S. GAAP, DTAs are not recorded for LIHTC investments accounted for under the proportional amortization method since both the amortization and the tax credits are reported in income tax expense.

5) Paragraphs 15-16 - This guidance details the application of the proportional amortization method for statutory accounting. It is more detailed, but generally consistent with SSAP No. 93. The existing SAP guidance was driven from EITF 94-1 and refers to recognition at the time a tax credit can be included in a tax return. However, that guidance is contradictory with the recognition of tax credit carryforwards under both current SAP and U.S. GAAP. The proposed guidance in paragraph 11 reflects the new GAAP guidance for recognition in the year in which the credit arises, and the guidance in paragraph 16 identifies how carryforwards would be considered a DTA.

**Interested Parties Response:** Interested parties agree that DTAs would be set up for any tax credits that can be carried over. As stated above, we understand that under U.S. GAAP, there are no DTAs set up for tax credit carryovers since the amortization and the tax credits are reported in the same line.
Paragraphs 17-20 – These paragraphs provide explicit SAP provisions for admittance. If the program does not generate tax credits or if the reporting entity cannot use the tax credits, the guidance requires nonadmittance. Consideration was given as to whether admittance should be permitted based on the ability to liquidate the investment, but that is not proposed. As detailed in the scope criteria, substantially all of the projected benefits from the investment should be from tax credits or other tax benefits. From information gathered for the federal tax credit programs, liquidation may be restricted for set periods of time or be contingent on finding a buyer for the equity interest. Although a put/call provision may be in place to revert the equity interest at the end of the life for the investment, such amounts are nominal to the original investment amount. With the guidance, if the tax credits will not be received or cannot be utilized, then the investment shall be nonadmitted. If an entity cannot obtain or utilize tax credits from the investment, and can liquidate the investment, then a reporting entity should consider liquidating the investment to have cash for reinvestment/admittance purposes. Until then, the investment is proposed to be nonadmitted.

**Interested Parties Response:** Interested parties believe that it is too punitive to require non-admission of the whole investment if an entity does not have taxable income in a given year. As stated above, insurers may be able to utilize the tax credits through carryback to the prior year. If not, insurers would usually set up a DTA for any tax credit carryforwards if there is an expectation that the credits will be utilized in future years. Therefore, interested parties believe that if there is no valuation allowance on the tax credit DTA and the DTA is admitted under the three-year turnaround criteria, then the investment should be fully admitted. This would not preclude impairment analysis on the investment itself.

The Discussion Paper also includes discussion about requiring a tax opinion for admissibility purposes. Interested parties would like to confirm that the tax opinion is required upon acquisition of the investment by the insurer and not at every reporting date.

It is also important to clearly distinguish between non-admission and impairment. Question #6 makes reference to the program not generating tax credits or the reporting entity not obtaining the tax credits. Under these circumstances, it seems that the guidance would point to impairment and not non-admission.

Paragraphs 21-24 – This guidance is generally consistent with SSAP No. 93, except the recognition of a liability for a future contribution follows the loss contingency guidance in SSAP No. 5R. This is consistent with the ‘probable’ threshold reflected under U.S. GAAP.

**Interested Parties Response:** Interested parties agree that the guidance in SSAP No. 5R regarding contingencies needs to be evaluated to determine if a commitment related to future contributions gives rise to a liability.

Paragraphs 25- Paragraph 25 is consistent with SSAP No. 93, except it incorporates fair value as the compared value. Current SSAP No. 93 uses the present value calculation, so it is retained as a proxy of fair value. U.S. GAAP uses fair value, and the existing disclosure in SSAP No. 93 also references fair value.
Interested Parties Response: Interested parties do not have an objection with incorporating fair value in the assessment of impairment. Since these investments do not trade frequently, most companies are probably already doing a present value calculation to determine fair value so this should not change what reporting entities are currently doing.

9) Paragraph 26 - This guidance incorporates concepts on whether the structure will continue to produce qualifying tax credits. The guidance specific to LIHTC from SSAP No. 93 is not retained. The guidance has divided the guidance for nonadmittance to reflect situations that impact a reporting entity’s use of tax credits and OTTI to reflect issues with the actual investment in generating qualified tax credits. Comments are requested on this approach and the principle concepts for OTTI.

Interested Parties Response: As stated under question #6, non-admitting the entire investment appears too punitive for companies that expect to utilize the credits in a later year. Interested parties agree that impairment would occur when the credits will not emerge at all. Question #6 needs to be clarified to explain these concepts since the way it is currently written, it seems to scope in the impairment criteria into the non-admission review.

10) Paragraph 27 – Disclosures in 27a-b are from U.S. GAAP.

Interested Parties Response: Interested parties do not have an objection with disclosing information about the nature of investments for which tax credits are earned. 27(b) seems repetitive with the other information that is being required under paragraph 28 regarding the amount of tax credits and other tax benefits during the years presented. If different information is being requested under 27b, it would be helpful for industry to get more clarity on what specifically is being requested under that item.

11) Paragraph 28 - Disclosures in paragraph 28 a-c come from U.S. GAAP. The disclosures in paragraphs 28d-e are based on concepts previously included SSAP No. 93. Comments are requested on whether those disclosures (or other disclosures from SSAP No. 93) should be included. (For 28d, the prior SSAP No. 93 disclosure was for a number of remaining years of unexpired tax credits and the required holding period, but since that is an individual investment disclosure, it has been modified to reflect an aggregate investment disclosure.)

Interested Parties Response: The proposed disclosures in paragraph 28 a-c are similar to what is already required under SSAP No. 93 so they should not be a concern. 28e will require additional work to be done since the requirement is to disclose the aggregate amount of tax credits to be earned each year on all tax credit investments for the next fifteen years, which is not currently disclosed. Such detail is not required for other investments. As a result, we would encourage SAPWG to evaluate whether it is needed.

12) Paragraph 30 – This disclosure is in SSAP No. 93 and comments are requested on whether it should be retained.

Interested Parties Response: This disclosure requires detailed balance sheet and income statement information for tax credit investments if, in the aggregate, tax credit investments exceed 10% of the total admitted assets of the reporting entity. It is probably rare for insurers
to hold tax credit investments that represent such a significant amount of total admitted assets. In addition, detailed balance sheet and income statement information for the underlying investees does not seem to provide very relevant information about these investments since the return on these investments is primarily through tax credits and not related to the earnings of the underlying investees. Interested parties believe that this disclosure requirement should be removed.

**Other Interested Party Comments**

Although the Discussion paper is focused on SSAP No. 93 and equity investments for which the return is primarily through tax credits, we provide the following observations regarding SSAP No. 94 as we understand that the Working Group may add another project to its agenda regarding this standard:

1. We believe that one of the key differences between SSAP No. 93 and SSAP No. 94 is that SSAP No. 93 relates to tax credit structures where the insurer is an actual investor (i.e. equity owner) whereas SSAP No. 94 addresses certificated state tax credits that are purchased outright without the insurer owning an equity or debt security. More clarity on the difference between both standards is welcomed especially since we understand that under the Inflation Reduction Act, there will be certificated federal tax credits available for purchase as well.

2. We note that the accounting under SSAP No. 94 requires for the certificates purchased to be reported as “other-than-invested” assets. Therefore, these certificates are not currently reported on Schedule BA. They are reported in the “Aggregate Write-Ins for Other Than Invested Assets” balance sheet line. We would like to make sure that the Working Group is aware of this difference in reporting.

3. The accounting for the certificates laid out in SSAP No. 94 requires that the carrying value of the tax credits be reduced as the credits are redeemed through a reduction of an insurer’s tax payable. Therefore, the way of amortizing the asset is similar to the proportional amortization method, except that under SSAP No. 94, the amortization and the tax credits are only reflected in the balance sheet. Any gains on these deals, which are usually related to the fact that they are purchased at a discount, are required to be reported in other income per SSAP No. 94, not NII. Interested parties look forward to further discussing the income statement presentation of these gains if changes are made to SSAP No. 93 regarding income statement presentation to ensure consistency in reporting.

Some of the feedback received from interested parties is that in practice, the offset to the tax liability account usually occurs in the year when the credit is available for use regardless of when the tax return is filed. Clarification may be needed on this point in the standard.
Ref #2022-15: SSAP No. 25 – Affiliate Reporting Clarification

The Working Group moved this agenda item to the active listing, categorized as a SAP clarification, and exposed revisions to SSAP No. 25 to clarify that any invested asset held by a reporting entity which is issued by an affiliated entity, or which includes the obligations of an affiliated entity is an affiliated investment.

Interested parties have no comments on this item.

Ref #2022-16: ASU 2022-03, Fair Value Measurement of Equity Securities Subject to Contractual Sale Restrictions

The Working Group moved this agenda item to the active listing, categorized as a SAP clarification, and exposed revisions to SSAP No. 100R to adopt ASU 2022-03, Fair Value Measurement of Equity Securities Subject to Contractual Sale Restrictions with modification to be consistent with statutory language in the respective statutory accounting statements, as illustrated above. Note that this agenda item does not recommend incorporating the new proposed GAAP disclosures on sales restrictions, but identifies those items restricted as to sale would be captured as restricted assets per SSAP No. 1 and subject to admittance considerations under SSAP No. 4.

Interested parties have no comments on this item.

Ref #2022-17: Interest Income Disclosure Update

The Working Group moved this agenda item to the active listing, categorized as a SAP clarification, and exposed revisions to SSAP No. 34, to add additional disclosures, and to data-capture the disclosures.

Interested parties propose that the exposed changes which are an outgrowth of the Bond project should share the same effective date. This will also allow companies to make the system changes needed to provide this information.

Interested parties also suggest the following editorial revisions to the disclosures contained in SSAP No. 34 for clarification and to be consistent with the proposed Blanks changes:

7. The following disclosures shall be made for investment income due and accrued in the financial statements. (SSAP No. 37 captures disclosures for mortgage loans on nonaccrual status pursuant to paragraph 6.)

   a. The bases by category of investment income for excluding (nonadmitting) any investment income due and accrued;
   b. Disclose total amount excluded;
c. Disclose the gross, nonadmitted and admitted amounts for interest income due and accrued.

d. Disclose aggregate deferred interest and cumulative amounts of paid-in-kind (PIK) interest included in the current principal balance.

e. Disclose cumulative amounts of paid-in-kind (PIK) interest included in the current principal balance.

Ref #2022-18: ASU 2022-04, Disclosure of Supplier Finance Program Obligations

The Working Group moved this agenda item to the active listing, categorized as a SAP clarification, and exposed revisions to SSAP No. 105R to reject ASU 2022-04 for statutory accounting as the disclosures are not relevant for insurance entity preparers.

Interested parties have no comment on this item.

Ref #2022-19: Negative IMR

The Working Group moved this agenda item to the active listing, categorized as a New SAP Concept and exposed the agenda item with a request for comments by industry on potential guardrails and details on unique considerations. The Working Group directed NAIC staff to coordinate with the Life Actuarial (A) Task Force and request regulator-only sessions with industry to receive specific company information.

ACLI will submit a separate comment letter on February 17, 2023.

* * *

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
Appendix A – Examples of Debt Tax Credit Structures

These are some of the debt tax credit structures of which industry is aware:

i. Bonds Issued by CAPCOs - Although the peak of these investments was in 2003, there has been a resurgence in functionally equivalent forms of this structure starting in 2010. Connecticut, Mississippi, Pennsylvania, Utah and Ohio have recently issued these bonds and legislative vehicles for these bonds are growing increasingly popular to address rural economic development. The bond is usually issued at a premium ranging from 50-90%. A material portion of the return in these structures is earned through cash payments (generally ranging from 40-60%). CAPCO and CAPCO-like deals are different from other state tax credit deals for a few reasons: (1) these entities have more time to invest the capital they receive than other state or federal deals; (2) they may have a smaller acquisition premium; (3) there is no equity investment required. Tax credit bonds issued by CAPCOs are usually only transferrable to affiliates of the reporting entity.

ii. Other State Tax Credits issued in Bond Form – Any state can issue debt investments where the investor earns tax credits outside of the CAPCO structures. Some of these are referred to as New Market Tax Credits (NMTC), which are different from the federal NMTC program. These programs multiplied as states saw the positive impact of the federal program on low-income communities. Unlike federal credits, these credits may be specially allocated by a partnership. In these deals, an issuer creates a special purpose vehicle (SPV), which purchases equity investments in entities that make investments in distressed communities. The SPV then issues securities to investors composed of tax credit debt and a small equity component (typically 1%) to be admitted as a partner and receive an allocation of credits. The tax credit debt has a higher acquisition premium than CAPCO and CAPCO-like structures (typically 90%). Although most of the return is earned through state tax credits, these investments earn about 10% of their return in cash. The tax credits earned by the SPV are passed on to the investors based on the SPV’s partnership agreement. This structure may be used in other contexts where credits can be specially allocated (e.g. state historic tax credits, low-income housing tax credits and other economic development tax credit programs). In order to transfer the bond investment, a sale of the equity interest must take place simultaneously to the same investor.

iii. State or Municipal Tax Credit Bond Strips – These include bonds issued by state or municipalities for certain projects such as school construction (i.e. Build America bonds). The bonds are stripped into a principal amount and the tax credit amount. Investors in the tax credit strips only earn a return through the tax credits provided by the municipality or state. These strips are transferable. There are no cash payments on the tax credit strips as the return is solely earned through tax credits.

iv. Federal NMTC programs – These are already addressed in the exposure. To summarize, an investor must purchase a pro rata share of the equity and the debt in these structures. Federal tax credits are earned as long as the investor is an equity investor as well. In order to transfer the bond investment, a sale of the equity interest must take place simultaneously to the same investor. The return on these investments is earned solely through tax credits. The investor
receives cash for the principal on the bond, which is usually less than 10% of
the original investment since these investments are issued at a significant
premium.
February 10, 2023

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: Interested Parties Comments on the SSAP No. 26R, SSAP No. 43R, and Other SSAP exposures related to the Principle-Based Bond Definition Project

Dear Mr. Bruggeman:

Interested parties appreciate the opportunity to comment on the above-mentioned documents that were exposed for comment by the Statutory Accounting Principles Working Group (Working Group) on November 16, 2022.

Interested parties also appreciate the collaborative effort on this project, the receptivity to our comments in our previous letter(s), and the disciplined thought that has gone into this project. We continue to believe this effort is headed in the right direction and look forward to continued collaboration on what undoubtedly is a complex and wide-ranging project.

In that spirit, interested parties would like to provide the following comments.

Paragraph 6d of SSAP No. 26

Paragraph 6d is arguably one of the more complex concepts within the principle-based bond definition. This paragraph attempts to define non-debt variables that are or could be embedded within a financial instrument, that call into question the overall instrument’s debt or bond like characteristics, while not also capturing embedded derivatives commonly found within debt instruments that do not call into question their overall debt or bond like characteristics. Interested parties believe this paragraph generally captures regulator concerns, while appropriately recognizing instances where such embedded derivatives are or should not be of concern. The following focuses on two instances where interested parties believe regulators did not intend to capture (and should not want to capture) embedded derivatives within financial instruments that
could be considered non-debt variables, and thus where the overall financial debt instruments would not be considered bonds for reporting on schedule D.

**Credit Rating-Related Interest Rate Adjustments**

Paragraph 6d, includes an exclusion that prevents certain embedded derivatives from “tainting” the host financial instrument and thereby preventing it from being reported as a bond where the embedded derivative does not call into question its bond-like characteristics. This exclusion includes “credit-rating related interest rate adjustments” where a bond coupon rate could be adjusted upward if the entity issuing the debt is down-graded by a rating agency. Such adjustments align the interests of debtholders and issuing entities by incentivizing the issuing entity to keep its financial house in order and compensating the debtholder if it does not.

Interested parties agree with this exclusion but suggest it be modified from “credit-rating related” to “credit-quality related” to encompass the broader range of such adjustments that align interests of debtholders and issuing entities (e.g., debt to EBITDA ratio, interest coverage ratio, debt service coverage ratio, etc.). Such bonds are very prevalent in insurer portfolios.

**Sustainability-Linked Bonds (SLBs) With De Minimis Interest Rate Adjustments**

Interested parties believe paragraph 6d also would inappropriately capture certain bonds with an interest coupon rate linked to sustainability goals. For example, the debt may have coupon interest equal to either a fixed or floating rate (e.g., SOFR) that is adjusted based on one or more sustainability goals or variables (e.g., the company’s CO2 emissions or workplace injury record). That is, the company’s performance against the metrics, in this example, could cause the interest rate to either decrease or increase 5 basis points for a total range off the potential base interest rate of 10 basis points. Both the CO2 emissions and workplace injury record are metrics of the borrower’s operation of physical assets owned by the company.

Interested parties understand that the NAIC wants to focus on solvency when developing standards, and not necessarily make special accommodation for social causes at solvency’s expense. Though insurers are increasingly focused on environmental, social, and governance attributes of investments they make, risk/reward remains an overriding consideration. In the case of SLBs, the contingent coupon adjustments generally do not factor into the insurer’s risk/reward calculations as they are uniformly de minimis. Interested parties do not believe SLBs, which are somewhat prevalent, warrant non-schedule D reporting and potentially punitive risk-based capital treatment.

Interested parties therefore suggest either a special exclusion for these type of debt instruments such as “SLB-linked bonds with de minimis interest rate adjustments” or “SLB-linked bonds with interest rate adjustments with the potential to adjust the total return from interest by no more than 10%”. Quite possibly, it may be more appropriate for such a “de minimis” exclusion to be applied to other non-debt variables more broadly so there is not an abrupt cliff effect for non-schedule D reporting due to the potentially punitive risk-based capital treatment, for de minimis non-debt variables in general.
Interested parties look forward to working with regulators and NAIC staff on this issue to appropriately thread the needle between preventing concerns of regulators while also not capturing de minimis types of adjustments that are potentially both prevalent and not the primary concern of regulators.

**Paragraph 22 of SSAP No. 21 and Other Debt Securities That do not Qualify as Bonds**

SSAP No. 21 has proposed changes for Debt Securities That Do Not Qualify as Bonds and is meant to capture any security which does not qualify as either an issuer credit obligation (ICO) or asset back security (ABS) and addresses the accounting and reporting for such securities. Such securities in scope would be limited to:

a. Debt securities for which the investment does not reflect a creditor relationship in substance,

b. Debt securities that do not qualify for bond reporting due to a lack of substantive credit enhancement, or

c. Debt securities that do not qualify for bond reporting due solely to a lack of meaningful cash flows.

These categories reflect instances where a debt instrument does not meet the principle-based bond definition as laid out in SSAP No. 26R. However, there may be further instances where a security does not meet the definition of a bond such as with paragraphs 5 and 7 of SSAP No. 26R (e.g., not meeting the definition of a security or not meeting the primary source of repayment requirements, respectively, etc.). Further, condition a. above is a potentially broad category inclusive of non-qualifying equity backed securities all the way toward financial instruments with embedded derivatives that are potentially de minimis. Interested parties would like to think this through with Staff if further refinement is necessary especially if the intent of these categories is to feed risk-based capital factors where additional refinement may be necessary.

Securities solely not meeting condition c. shall use the same accounting and measurement basis described in SSAP 43R – Asset-Backed Securities, including using a carrying value method determined by NAIC designation. Reporting entities that are reporting an amortized cost measurement shall obtain an NAIC designation in accordance with the parameters of the Purposes and Procedures Manual of the NAIC Investment Analysis Office and report the designation on Schedule BA. It is unclear if the NAIC designation required for accounting purposes would also be used for risk-based capital. Interested parties would like to think this through with Staff to understand the intent. For example, if the NAIC designation is not used for risk-based capital purposes, is it appropriate to require an NAIC designation for purely accounting purposes?

All other debt securities that do not meet conditions a. and b. shall be reported at acquisition cost, including brokerage and other related fees on Schedule BA. These securities are permitted as admitted assets, with subsequent measurement at the lower of amortized cost or fair value. Changes in measurement to reflect the lower value or to reflect changes in fair value shall be recorded as unrealized gains or losses.
Paragraph 22 includes the following:

Debt securities in scope for which the source of repayment is derived through rights to underlying collateral, qualify as admitted assets only to the extent they are secured by admitted invested assets. Any amounts in excess of the fair value of the underlying admitted invested assets shall be nonadmitted.

Interested parties believe we understand the rationale for why this was drafted. That is, if an ABS security does not meet either the substantive credit enhancement or meaningful cash flows criteria, the security in question is potentially very similar to a collateral loan. Nonetheless, this is a meaningful penalty (i.e., from bond treatment to non-admission) and interested parties would like a little more time to think through and discuss with Staff. This paragraph ultimately only came into our focus late in our review and we would like the opportunity to further think through the appropriateness of the abrupt cliff effect. For example, it is even conceivable, that a securitization would have the residual tranche be reported as an admitted asset while a more senior tranche would be a non-admitted asset.

Paragraph 10 (b) of SSAP No. 26R

Interested Parties noted that there is an inconsistency with the treatment of residual tranches between SSAP No. 43R and SSAP No. 26. SSAP No. 26 refers the reader to SSAP No. 21 to determine the accounting for residual tranches whereas SSAP No. 43R states that residuals are to be reported on Schedule BA as other invested assets at the lower of cost or market (SSAP No. 43R, paragraph 11.c). Since the revised SSAP No. 21 guidance only addresses debt securities (and does not address residual tranches) and we understand that the Working Group does not view residual tranches as debt instruments, we have the following proposed wording changes to SSAP No. 26 to address this inconsistency:

The first loss position may be issued as part of a securitization in the form of a debt or equity interest, or it may be retained by the sponsor and not issued as part of the securitization. If the first loss position (or a more senior position(s), if the first loss position(s) lacks contractual payments along with a substantive credit enhancement) is issued as part of the securitization, and does not have contractual principal and interest payments along with substantive credit enhancement and is held by a reporting entity, the investment(s) does not qualify for reporting as a bond and should be reported on Schedule BA: Other Long-Term Invested Assets at the lower of amortized cost or fair value consistent with the accounting treatment for residuals, as a non-bond security pursuant to SSAP No. 21R—Other Admitted Assets.

Paragraphs 43 – 46 of SSAP No. 26R

Paragraphs 43 - 46 of SSAP No 26R are related to effective date and transition. Interested parties believe the transition guidance is appropriate under the circumstances but propose some minor editorial adjustments which we believe provide more granular meaning to what we believe was
the intent. These proposed adjustments related to the second and third sentences of paragraph 44 as follows:

The bond definition requires assessments at the time of Acquisition (as of the origination date), and it is recognized that reporting entities may not have the means to complete historical assessments for securities held at the time of transition. For these instances, if information is not readily available for reporting entities to assess a security as of the date at acquisition origination, reporting entities may utilize current or acquisition information in concluding that a security qualifies for reporting as a bond as either an issuer obligation or asset-backed security.

Interested parties believe the transition guidance should also indicate that the disclosures should reflect that the revised bond categories from the annual statement prospectively beginning with the first year of adoption and not result in a restatement of the prior year’s reporting.

Further Clarification on RSATs

Replication Synthetic Assets (RSATs) are nuanced types of transactions, which must be approved by the Securities Valuation Office (SVO). Interested parties propose the following edits to ensure that RSATs, which have been historically allowed, continue to meet the replication accounting requirements regardless of changes to the definition of a Schedule D Bond. Besides the edits proposed below, as a result of the accounting convention for certain bonds being other than amortized cost, interested parties would like to work with Staff on the specific paragraphs of SSAP No. 86 that currently address the accounting for replication transactions as changes may be needed to coincide with the effective date of the principles-based bond definition.

Provide a Footnote after the first sentence of the structured note definition in paragraph 6di of SSAP No. 26R to clarify that one needs to also look to SSAP No. 86:

A replication (synthetic asset) transaction addressed in SSAP No. 86- Derivatives may reproduce the investment characteristics of an otherwise permissible investment that would not meet the principles-based bond definition (e.g., is distinct from a “structured note” as defined here); the admissibility, classification and measurement of a replication (synthetic asset) transaction are not preemptively determined by the principles-based bond definition, and should be evaluated in accordance with the guidance on replication (synthetic asset) transactions within SSAP No. 86- Derivatives.

Propose further clarification in SSAP No. 86 by adding the following to the end of Footnote 5 within the exposure:

A replication (synthetic asset) transaction addressed within this standard may reproduce the investment characteristics of an otherwise permissible investment that would not meet the principles-based bond definition (e.g., is distinct from a “structured note” as defined here); the admissibility, classification and measurement of a replication (synthetic asset) transaction are not preemptively determined by the principles-based bond definition, and
should be evaluated in accordance with the guidance on replication (synthetic asset) transactions within this standard.

SSAP No. 43R – Example 2

Interested parties appreciate the proposed changes to Example 2 within SSAP No. 26R as they provide an example where recourse to assets can be outside of a securitization. This is a good clarification and makes the examples in aggregate more broadly instructive. Interested parties have two suggested changes, which we believe are editorial in nature that provide a nuanced technical clarification and a more formal conclusion within the example rationale.

Example 2: A reporting entity invested in a debt instrument issued by a SPV. Payments under the instrument are secured by a note, a legal assignment from the borrower of a lease for real property and an assignment of the lease payments from an operating entity tenant. Additional security is provided by a mortgage on the leased property (the “underlying collateral”). The leased property is owned by the borrower under the note -- the SPV does not have any ownership interest in the underlying collateral, though it has legal recourse to it through the mortgage. The tenant makes contractually-fixed payments over the life of the lease to the borrower, who has assigned both the lease and the lease payments to the SPV as security for the debt. While the debt is outstanding, the lease, the lease payments, and the mortgage all serve as security for the debtholders. Should a default occur, the debtholders can foreclose on and liquidate the real property as well as submit an unsecured lease claim in the lessee’s bankruptcy for any all or a portion of the defaulted lease payments. The loan-to-value (as a percentage of property value) at origination is 100%.

Example 2 Rationale: The reporting entity determined that the debtholder was in a fundamentally different position than if the real estate was owned directly. The lease is a cash generating non-financial asset which is expected to generate a meaningful level of cash flows for the repayment of the bonds which covers all interest payments and 50% of the principal payments. The level of reliance on the collateral value for sale or refinancing is just over the cutoff for using the practical expedient (<50%), so a full analysis is required. In reaching its determination, the reporting entity considered the predictable nature of the cash flows, which are contractually fixed for the life of the debt instrument, as well as the ability of the underlying collateral value to provide for the balloon payment through sale or refinancing in light of its characteristics. While the real property may have some market value volatility and periods of lower liquidity at points in time, the cash flows produced by the lease were concluded to reduce the loan balance to a level (50% loan-to-value) that would be able to be recovered by sale or refinancing at the maturity of the loan.

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Interested parties continue to support the development of high-quality bond standards and believe they are headed in the right direction. Staff has tackled this project with appropriate rigor and their
collaboration with us has been greatly appreciated. We stand ready to continue to assist as this project gets nearer the finish line.

Sincerely,

D. Keith Bell

Rose Albrizio

cc: Interested parties
    NAIC staff
Mike Monahan  
Senior Director, Accounting Policy  
202-624-2324  
mikemonahan@acli.com

February 17, 2023

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

Dear Mr. Bruggeman:

Re: Exposure Ref #2022-19: SSAP No. 7 - IMR

The American Council of Life Insurers (ACLI) appreciates the opportunity to provide comments on the above referenced exposure as well as the thoughtful and timely attention this important topic is receiving from SAPWG and LATF.

The ACLI stands ready to continue working with the NAIC to create sufficient, yet practical, safeguards to ensure that the most appropriate treatment of Interest Maintenance Reserve (IMR) can be applied, and a company’s surplus and financial strength are properly reflected, while not disincentivizing prudent investment and risk management in the best interest of all.

A rising interest rate environment from historically low rates is generally favorable to the financial health of the life insurance industry. However, ACLI is concerned that without a change to the current treatment of negative IMR, the environment will give the inappropriate perception of decreased financial strength through lower surplus and risk-based capital ratios. This problem will only be exacerbated if interest rates remain at or near their current levels or increase further; therefore, it is imperative that we work together toward developing an industry-wide solution for implementation by year-end 2023.

Upon the sale of and subsequent reinvestment in a fixed income instrument, the reflection in surplus of either a gain or loss is not reflective of the true economics, as there is no change to solvency, liquidity, or claims paying ability because the difference between the reported amortized cost value and fair value is equal to the IMR. This letter addresses our assessment of the suitability of the five potential guardrails proposed at the SAPWG fall national meeting and raises two additional proposals for consideration.
Background

While this letter will focus on potential additional safeguards, as suggested at the SAPWG fall national meeting, this is a complex topic and we want to summarize, review, and expand on relevant background information largely included in our previous letter dated October 31, 2022.

The NAIC’s statutory accounting framework is largely an “amortized cost framework” in that fixed income investments are generally reported at amortized cost and long-term insurance liabilities are generally reported with locked and conservative assumptions.

We strongly support the NAIC framework, as it facilitates the issuance of long-term insurance products in the US market by not overly focusing on current market fluctuations. This is unlike many market valuation regimes where over-reliance or misapplication of current market conditions often distorts the financial solvency of insurance companies and can lead and has led to the decrease or elimination of such long-term product issuances in those regimes.

However, an amortized cost framework could also potentially distort the financial solvency of insurance companies through the misrepresentation of surplus. The IMR was developed as a safeguard to ensure surplus is properly reflected within the NAIC’s framework.

Specifically, in a declining interest rate environment, an insurance company could sell its fixed income investment portfolio, recognize gains, increase surplus and show increased financial strength. This increase in surplus would largely be illusory as the increased surplus would be offset by a lower yielding investment portfolio.

IMR requires deferrals of those gains from surplus, and the gains are amortized through income over the remaining life of the bonds sold to:

- Ensure accurate representation of a company’s reported surplus by eliminating the potential for overstatement of surplus, and
- Keep the relationship of anticipated investment yield consistent with that needed to support the liabilities.

But without IMR, a rising interest rate environment could result in similarly misleading surplus (in this case an illusory lack of surplus) because a company would be investing in higher yielding bonds.

When IMR was developed, it was anticipated that the IMR would work consistently for both net realized gains and losses; however, the allowance of a net negative IMR was not initially adopted upon implementation in 1992. It was expected that the issue would be addressed in subsequent years and remained on the SAPWG agenda at least until 2005 but was never addressed in any substantive way. This was largely because of a lack of urgency due to the decades-long declining interest rate environment where IMR was largely positive for life insurance companies.

This issue had been referred to SAPWG from the AVR/IMR working group which believed the basic rationale for the IMR would conclude that neither a maximum nor minimum is appropriate. It was fully expected that the IMR, whether negative or positive, would be included in asset adequacy testing and addressed by the actuarial opinion.
We are very appreciative that SAPWG and LATF are looking to substantively revisit the negative IMR issue as anticipated during its original development. The current interest rate environment has changed circumstances in a meaningful way. While rising interest rates from historically low levels are beneficial to insurance companies, the recent rapid rise of interest rates has increased the urgency to address the negative IMR issue to avoid the misrepresentation of capital positions of insurance companies.

The current interest rate environment or a further rise in interest rates would only exacerbate the urgency as losses from bond sales could result in a significantly inappropriate portrayal of surplus that would be inconsistent with the rationale for which IMR was initially developed. In this case, insurers would show a significant illusory lack of surplus because they would be investing in higher yielding bonds.

IMR is an important construct that effectively adjusts liabilities so that the balance sheet liabilities net of IMR remain on the same basis as the reported balance sheet assets, limiting artificial volatility within surplus. As discussed above, negative IMR, from an asset-liability perspective, represents either high future income from reinvestments or future reserve releases that will be available to pay claims from an asset liability perspective.

Although the status quo use of permitted practices may grant relief for specific companies, it may lead to an unlevel playing field. Consequently, the ACLI wants to emphasize the importance of developing a uniform national standard for consistently ensuring the appropriate theoretical and practical treatment of IMR (e.g., symmetrical treatment of both gains and losses).

The ACLI would like to work with the NAIC to fulfill the original intent of IMR that ensures surplus and financial strength are properly reflected and do not disincentivize prudent investment and risk management. At the same time, we want to work with regulators to ensure IMR cannot somehow be circumvented in a rising interest rate environment, whether intentionally or inadvertently, to misrepresent financial strength.

**Common Interest to not Disincentivize Prudent Behavior**

We want to reiterate the importance of not disincentivizing prudent portfolio and asset liability management.

In addition to prudent portfolio management and managing credit/investment risk exposure, insurance companies manage duration. These prudent risk management processes all require ongoing transactions that impact the IMR, such as whether it is sales and reinvestment in fixed income investments, which we discussed in our previous letter dated October 31, 2022, or use of derivatives to achieve the same appropriate end. We would note that bond sales may trigger derivative terminations that offset in IMR; however, derivatives settlements can impact IMR without an offset impact from a bond sale.

Hedging strategies are used to address product risks like contract guarantees, disintermediation, and reinvestment risks as part of prudent risk management practices utilized by life insurance companies. These hedging strategies may involve interest rate swaps, caps, floors, swaptions, interest rate futures, among others, that also may generate IMR gains and losses.
For example, negative IMR can be generated by hedging strategies utilized for pension risk transfers. Once the contract is executed, insurers will enter hedging contracts to ensure interest rate certainty while awaiting cash and assets in-kind and/or the right investment opportunities to meet the long-term goals for the accounts. As the hedges are unwound to meet pricing and investment targets, immediate losses and negative IMR may be generated as interest rates rise, but the losses are ultimately offset over time with higher fixed instrument yields.

Further, many life insurance and annuity products have significant long term reinvestment risk, where premiums are received for many decades before benefit payments may be made. Companies may use interest rate futures, swaps, or bond forwards, to reduce reinvestment risk by locking in interest rates at which the future premiums will be invested. When interest rates rise, these hedging transactions may settle, roll-over, or be terminated, leading to expected IMR losses but are ultimately offset by future higher reinvestment yields. Without these hedging transactions, returns might not be equivalent to policyowner obligations, exposing the company to significant interest rate risk.

Similarly, life insurance companies may utilize stochastic asset liability modeling to establish asset duration targets that may include setting different asset duration targets by product if appropriate, through an asset segmentation plan. This considers scenarios where interest rates increase rapidly (where there is potential for disintermediation risk) and very low interest rates (considering product guarantees). Such analysis is refreshed on a regular basis to update the duration target based both on the liability in force characteristics and the economic environment. Portfolio asset duration is managed to the target on an ongoing basis and requires asset sales/purchases or use of derivatives that affect IMR. These are but several distinct examples of the types of prudent risk management practices utilized by life insurance companies.

A rising interest rate environment is generally favorable to the financial health of the life insurance industry. Without a change to the treatment of negative IMR, a rising interest rate environment will give the inappropriate perception of decreased financial strength through lower surplus and risk-based capital ratios, which is both counterintuitive and not reflective of the economics. It may create undesirable incentives for companies to deviate from prudent investment/risk management to avoid creating negative IMR.

It essentially creates two equally objectionable alternatives for insurers and their policyowners.

- Applying the current statutory guidance will improperly reflect financial strength through understating surplus,
- Insurers could take steps to manage their current capital position by limiting trading of fixed income investments and/or usage of derivatives, which would diminish significant economic value or worse, create a mismatch between assets and liabilities and prevent the ability to fulfill long-term contract obligations. Insurers may avoid hedging or trading to ensure future reinvestment risks are mitigated, by being incentivized to overly focus on managing misrepresented short-term financial position by effectively keeping asset duration shorter than their liabilities and taking on interest rate risk.

We do not believe this is in the best interest of insurance companies or their policyowners and believe it is a common interest we share with regulators. Consequently, developing a national standard for allowing negative IMR with appropriate safeguards should be a common goal for all.
Existing Safeguards

As noted above, IMR itself is a safeguard for the NAIC’s amortized cost framework that accomplishes two main objectives:

- Addresses the risk of misrepresentation of surplus, and
- Keeps the relationship of anticipated investment yield consistent with that needed to support the liabilities.

Excess Withdrawal Safeguard

An Excess Withdrawal safeguard is already embedded in the IMR framework for the situations in which asset sales are “forced”, either due to reputational or disintermediation events, and the liability that the assets supported no longer exists. At such a point, deferring gains and losses to IMR ceases.

While we believe this safeguard was primarily developed to address troubled companies or potential disintermediation in a rising interest rate environment, we understand regulators may want to re-assess the safeguard’s robustness. The ACLI supports such a re-assessment and looks forward to working with the NAIC.

Asset Adequacy Testing (AAT)

AAT is an additional safeguard that helps protect against further unintended consequences when IMR goes negative. Reflecting all admitted negative IMR in AAT would replace assets that generate investment income in AAT, where the starting point is statutory assets are equal to statutory liabilities. Unless the remaining assets can earn a sufficient yield due to reinvestment, there will be negative impacts to the results, which could lead to additional asset adequacy reserves and hence a reduction in statutory surplus. AAT provides a framework to ensure that there are sufficient margins to support claims alongside a negative IMR asset that eventually amortizes to zero, hence ensuring adequate reserves and proper representation of surplus. A simplified example of how AAT works with negative IMR in different reinvestment scenarios is included in Appendix I of this letter.

While we believe that AAT provides a robust safeguard that prevents a misuse of allowable negative IMR, we understand the NAIC wants to contemplate additional safeguards, as AAT may not be applied uniformly across states and practitioners and is only shared with regulators annually.

Additional Potential Safeguards

At the SAPWG fall national meeting the following five potential safeguards were discussed:

1) Ensure there is reinvestment in fixed income securities (see below),
2) Enhancement to asset adequacy testing (see below),
3) Shorten the amortization period for negative IMR (see Appendix II),
4) Limit negative IMR as a percentage of surplus, assets, etc. (see Appendix II), or
5) Restrict surplus via the special surplus funds (see Appendix II).
ACLI proposes two additional possibilities:

1) Limit based on the risk-based capital framework (see below), or
2) Create an “Opt-in Framework” with structured governance (see below).

The remainder of this letter outlines a broad framework of the aforementioned additional safeguards that we believe are responsive to regulators’ specific concerns. Redundant or more arbitrary potential safeguards are further discussed in Appendix II attached to this letter.

Ensure there is reinvestment in fixed income securities

IMR theory assumes sales of fixed income investments are reinvested in new fixed income investments. When doing so, the reinvestment is done in the current interest rate environment, and the difference in earnings arising from the reinvestment is roughly equal in magnitude, but opposite in direction, to the gain or loss realized on the old investment.

In a rising interest rate environment, a sale essentially transforms the loss to negative IMR. There is essentially no difference in balance sheet economics pre- and post-trade, related to liquidity or claims paying ability, as the difference between the reported amortized cost value, and fair value, upon sale, is equal to the negative IMR.

While AAT would arguably address any deficit in reinvestment as illustrated in our example in Appendix I, ACLI is open to supporting additional demonstrations of reinvestment in fixed income investment. This could be done, for example, by generally requiring the sum of the proceeds from the sale and maturity of bonds (line 12.1) and mortgage loans (line 12.3) are less than the sum of the cost of bonds acquired bonds (line 13.1) and mortgage loans (line 13.3) from the cash flow statement ultimately submitted to regulators in the annual statement.

Such a requirement would provide the following benefits:

1) It is objective, easily verifiable, and ultimately rolls up into the audited financial statements,
2) It eliminates the issue surrounding the “fungibility of cash” – that is “proving” reinvestment of each sale, which would be difficult and potentially inappropriate, if on a macro basis there was a major shift to equities for example, and
3) It demonstrates on a macro basis significant reinvestment is occurring.

We note that even if there were a significant shift to equities, in theory, this should be captured by AAT with equity investments being appropriately stressed, but it would also significantly reduce risk-based capital ratios which would provide significant dis-incentivization for this to occur.

Lastly, such a metric could be coupled with the “Opt-in Approach” proposed below, that would provide additional structure by requiring documentation and controls on prudent strategies for investment management, asset liability management or hedging deemed appropriate and against which future transactions could subsequently be verified as appropriate by the company’s domiciliary regulator.
Enhancement to Asset Adequacy Testing

We propose that negative IMR should only be allowed if it is included in AAT. This would replace assets that generate investment income in AAT when starting with statutory assets equal to statutory liabilities. Unless the remaining assets can earn a higher yield through reinvestment at higher rates, there will be negative impacts to the results, which could lead to additional asset adequacy reserves and a reduction in statutory surplus.

Fixed income investments that sit in surplus or non-product portfolios could be sold generating IMR. Therefore, we recommend the allowance of negative IMR only if it is included in AAT. This would further prevent any potential balance sheet manipulation, whether intentional or unintentional, through shifting assets with losses to non-insurance portfolios and admitting losses on assets that are not offset by matched liabilities.

This concept could also be coupled with the “Opt-in Approach” proposed below.

Limit based on the risk-based capital framework

One potential safeguard that was not mentioned by SAPWG at the fall national meeting is to allow negative IMR only if a company’s risk-based capital threshold showed that they were financially strong. This would have the following benefits:

1) Address regulator concerns on allowing negative IMR if a company was or was nearing being financially troubled,
2) Would not be arbitrary and would be based on an objective and verifiable threshold that would be available to regulators, potentially quarterly, and provide early warning to any concerns they may have in this regard, and
3) Would essentially achieve the same ends as shortening the amortization period, restricting capital, or creating an arbitrary limit.

We are willing to work with the NAIC to think through an appropriate threshold as well as what would occur if that threshold was subsequently crossed so there would not be inappropriate cliff effects.

This concept could also be coupled with the “Opt-in Approach” proposed below.

Create an “Opt-in Framework” with Structured Governance

An “Opt-in Framework”, similar to the framework included within SSAP No. 108 – Derivative Hedging Variable Annuity Guarantees (SSAP No. 108), could be developed.

SSAP No. 108 recognizes the prudence of hedging guarantees embedded within variable annuity contracts while also recognizing the non-economic volatility created (and therefore inappropriate under/overstatement of surplus). It also recognized that this volatility was created because derivatives used in a dynamic hedging approach were required to be reported at fair market value, as they would not meet the strict hedge accounting requirements, while the liabilities did not require marking to market of the hedged guarantees.
To not disincentivize this prudent dynamic hedging, SSAP No. 108 requires additional structure and governance to avoid misrepresentation. The allowance of negative IMR has similar parallels.

Key provisions of SSAP No. 108 that could be considered for a framework for negative IMR allowability include:

- Explicit approval of a company’s domiciliary regulator prior to implementation,
- A clearly defined portfolio and asset liability management strategy (with documentation; analogous to SSAP No. 108 but tailored more appropriately for portfolio and asset liability management strategies),
- Actuarial certification of the asset liability management strategy, and
- Certification by a financial officer of the company (CFO, treasurer, CIO, or designated person with authority over the actual portfolio and asset liability management strategies).

This framework provides sufficient tools that allow for timely and appropriate regulatory review; additional tools could be specifically tailored for IMR.

In the context of a negative IMR, the approach could be tailored to incorporate documentation and controls of prudent strategies for investment management, asset liability management, and hedging strategies deemed appropriate and against which future transactions could subsequently be verified as necessary by the company’s domiciliary regulator.

Achieving the “opt-in” in the context of negative IMR could require satisfying these documentation requirements, in addition to incorporating and complying with a combination of one or more of the other potential safeguards mentioned above. This package of requirements and safeguards would constitute a national standard for allowing negative IMR that can be consistently applied across all companies.

*****

In the current interest rate environment, and with additional interest rate increases potentially on the horizon, the disallowance of negative IMR has become a serious and pressing issue for industry as we seek to execute prudent portfolio and risk management strategies that align with our economic realities. The ACLI looks forward to working with the NAIC to expedite a reasonable, permanent solution that fulfills the original intent of IMR and work on the appropriate additional safeguards that may be needed for year-end 2023 implementation. Lastly, ACLI recalls a specific question raised by regulators at the NAIC’s fall national meeting. We would like to understand this question and/or concern more fully and discuss with regulators or NAIC staff.

If you have any questions regarding this letter, please do not hesitate to contact us.
Sincerely,

[Signature]

Mike Monahan
Senior Director, Accounting Policy

[Signature]

Paul Graham
Senior Vice President, Policy and Legal
Appendix I

**Simplified Example – How AAT Works With Negative IMR in Different Reinvestment Scenarios**

This example illustrates the effectiveness of the AAT safeguard in ensuring company solvency even with an admitted negative IMR. In particular, the Appendix also illustrates how AAT bolsters the reinvestment guardrail.

Assumptions:
- A 10-year zero-coupon bond with a par value of $1,000 and interest rate of 3%.
- A 10-year endowment liability with a rate of 3% maturing for $1,344.
- The corresponding formulaic reserves at “time zero” would be $1,000 assuming a valuation rate of 3%.
- The assets and liabilities are cashflow matched and no AAT deficiencies are assumed. Investment income of $344 earned over ten years is sufficient to cover the increase in liability in the same period.

<table>
<thead>
<tr>
<th>Balance Sheet</th>
<th>12/31/22</th>
<th>12/31/32</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bonds</td>
<td>1,000</td>
<td>1,344</td>
</tr>
<tr>
<td>Total Assets</td>
<td>1,000</td>
<td>1,344</td>
</tr>
<tr>
<td>Liabilities</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Policy Reserves</td>
<td>1,000</td>
<td>1,344</td>
</tr>
<tr>
<td>IMR Liability</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Total Liabilities</td>
<td>1,000</td>
<td>1,344</td>
</tr>
<tr>
<td>Income Statement</td>
<td>12/31/22 – 12/31/32</td>
<td></td>
</tr>
<tr>
<td>------------------------------</td>
<td>---------------------</td>
<td></td>
</tr>
<tr>
<td><strong>Income</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net Investment Income before IMR</td>
<td>344</td>
<td></td>
</tr>
<tr>
<td>IMR Amortization</td>
<td>0</td>
<td></td>
</tr>
<tr>
<td><strong>Benefits and Expenses</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Benefits</td>
<td>0</td>
<td></td>
</tr>
<tr>
<td>Addition to Reserves</td>
<td>344</td>
<td></td>
</tr>
<tr>
<td><strong>Net Income (Loss)</strong></td>
<td>0</td>
<td></td>
</tr>
</tbody>
</table>
Rate Increase Scenario (with reinvestment opportunity)

If interest rates immediately rise to 4%, the insurer could sell the bond and reinvest (assume no policy surrenders):

- Formulaic reserves remain unchanged at $1,000 due to the valuation rate being locked in at 3% and no surrenders.
- The original bonds would be sold at a capital loss of $92 and would be reinvested in a higher yielding asset (earning 4%).
- The capital loss of $92 would be transferred into a negative IMR and amortized over ten years (remaining life).

In this scenario, even though the newly purchased bonds are recorded at $908, appearing lower than before the sale, the higher investment income of $436 is sufficient to cover the increase in liability and IMR amortization over ten years. No asset adequacy reserves would need to be established as part of the asset adequacy analysis.

<table>
<thead>
<tr>
<th>Balance Sheet</th>
<th>12/31/22 Before Asset Sale</th>
<th>12/31/22 After Asset Sale</th>
<th>12/31/32</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bonds</td>
<td>1,000</td>
<td>908</td>
<td>1,344</td>
</tr>
<tr>
<td>Total Assets</td>
<td>1,000</td>
<td>908</td>
<td>1,344</td>
</tr>
<tr>
<td>Liabilities</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Policy Reserves</td>
<td>1,000</td>
<td>1,000</td>
<td>1,344</td>
</tr>
<tr>
<td>IMR Liability</td>
<td>0</td>
<td>(92)</td>
<td>0</td>
</tr>
<tr>
<td>Total Liabilities</td>
<td>1,000</td>
<td>908</td>
<td>1,344</td>
</tr>
</tbody>
</table>

1 Asset adequacy testing requires that assets included in testing be no greater than the reserves and liabilities being tested. Even if there were other assets in addition to the $908 bonds, a robust AAT safeguard would require that admitted negative IMR be reflected in AAT, effectively constraining the income generating assets that can used in AAT to support liabilities when testing for deficiencies. AAT pressures to set up asset adequacy reserves will increase unless reinvestment into higher yielding assets occurs.
<table>
<thead>
<tr>
<th>Income Statement</th>
<th>12/31/22 – 12/31/32</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Income</strong></td>
<td></td>
</tr>
<tr>
<td>Net Investment Income before IMR</td>
<td>436</td>
</tr>
<tr>
<td>IMR Amortization</td>
<td>(92)</td>
</tr>
<tr>
<td><strong>Benefits and Expenses</strong></td>
<td></td>
</tr>
<tr>
<td>Benefits</td>
<td>0</td>
</tr>
<tr>
<td>Addition to Reserves</td>
<td>344</td>
</tr>
<tr>
<td><strong>Net Income (loss)</strong></td>
<td>0</td>
</tr>
</tbody>
</table>
Rate Increases, and Surrenders Scenario (No reinvestment opportunity)

Assume rates immediately rise to 4% and 50% of liabilities are immediately surrendered:
- 50% of the liability surrenders, with a surrender value of $500.
- Bonds are sold to fund withdrawals. Due to the rate increase, the book value of bonds sold ($551) is higher than their market value of ($500), resulting in a capital loss of $51.
- As withdrawal activity is not deemed to be excessive, the capital loss of $51 is transferred into negative IMR which is amortized over ten years.
- The remaining $449 of bonds would continue to earn their original interest rate of 3%.

In this scenario, the total assets included in asset adequacy analysis are $449 of original bonds (yielding 3%) and negative IMR at $51. However, these would be insufficient to cover the total remaining liability requirement of $672 after 10 years. Therefore, an AAT reserve of $51 would be established to cover this inadequacy, resulting in a P&L impact and ultimately a reduction to statutory surplus. Inclusion of the negative IMR in AAT accurately portrays the company’s surplus and results in additional reserves of $51. The additional assets (assumed to also earn 3% like the original bonds) backing the AAT reserves combined with the $449 of original bonds are now sufficient to cover the remaining liability requirement of $672 after 10 years.

<table>
<thead>
<tr>
<th>Balance Sheet</th>
<th>12/31/22 Before Asset Sale and Surrender</th>
<th>12/31/22 After Asset Sale and Surrender, but before AAT</th>
<th>12/31/22 After Asset Sale, Surrender, and AAT</th>
<th>12/31/32</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bonds</td>
<td>1,000</td>
<td>449</td>
<td>449</td>
<td>672</td>
</tr>
<tr>
<td>Extra Assets for AAT</td>
<td>0</td>
<td>0</td>
<td>51³</td>
<td>0</td>
</tr>
<tr>
<td><strong>Total Assets</strong></td>
<td>1,000</td>
<td>449</td>
<td>500</td>
<td>672</td>
</tr>
<tr>
<td><strong>Liabilities</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Policy Reserves</td>
<td>1,000</td>
<td>500</td>
<td>500</td>
<td>672</td>
</tr>
<tr>
<td>AAT Reserves</td>
<td>0</td>
<td>0</td>
<td>51</td>
<td>0</td>
</tr>
<tr>
<td>IMR Liability</td>
<td>0</td>
<td>(51)</td>
<td>(51)</td>
<td>0</td>
</tr>
<tr>
<td><strong>Total Liabilities</strong></td>
<td>1,000</td>
<td>449</td>
<td>500</td>
<td>672</td>
</tr>
</tbody>
</table>

² Assumes that a 50% surrender does not constitute Excess Withdrawal Activity as defined in the Life, Accident & Health/Fraternal Annual Statement Instructions. If it did constitute Excess Withdrawal Activity, deferring losses to IMR would cease and result in an instant hit to statutory surplus.
³ Extra assets of $51 would be a reduction to surplus in the year of testing when the additional AAT reserves are recorded.
<table>
<thead>
<tr>
<th>Income Statement</th>
<th>12/31/22 – 12/31/32</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Income</strong></td>
<td></td>
</tr>
<tr>
<td>Net Investment Income before IMR</td>
<td>172</td>
</tr>
<tr>
<td>IMR Amortization</td>
<td>(51)</td>
</tr>
<tr>
<td><strong>Benefits and Expenses</strong></td>
<td></td>
</tr>
<tr>
<td>Benefits</td>
<td>0</td>
</tr>
<tr>
<td>Addition to Reserves</td>
<td>121</td>
</tr>
<tr>
<td>Addition to AAT Reserves on 12/31/22</td>
<td>51</td>
</tr>
<tr>
<td><strong>Net Income (loss)</strong></td>
<td>(51)</td>
</tr>
</tbody>
</table>
Other Potential Safeguards

Shorten Amortization Period

As negative IMR is included in AAT, shortening the amortization period arguably would not be needed but also contradicts the theory of IMR. We believe that shortening the amortization period asymmetrically would obviate one of the objectives of IMR – to keep the relationship of anticipated investment yield consistent with that needed to support the liabilities. Further it would introduce a host of practical challenges.

Examples of practical challenges from shortening the amortization period include:

- Shorten the amortization period only when net negative balances occur?
- If so, in what discrete period?
- For the year?
- What happens when the balance switches from negative to positive (or vice versa) during the year and amortization had already been shortened at the start of the year?

We also wanted to address a further potential concern that has been raised and is best illustrated in the following example:

- There is a $1 billion IMR gain with a 20-year amortization period
- Subsequently it is offset to zero by a $1 billion loss with a 1-year amortization period.
- Does this accelerate the gain recognition which was really the impetus behind IMR in the first place?

This would not be the case as gains and losses are amortized separately regardless of whether the gross balances offset one another. While it is true that on day 1, there would be an offset to zero, both the gains and losses are amortized separately, and in this case, in year two approximately $950 million (assuming straight line amortization for simplicity) would be the total credit IMR balance representing the gains that still need to be amortized.

As shortening the amortization period:

- contradicts the theory and objectives of IMR,
- is arbitrary,
- would create practical challenges to implement,
- would penalize strong companies the same as weakly capitalized companies, and
- would be unduly punitive to companies with strong and weak AAT practices alike.

We do not believe this solution to be appropriate, or in line with prudent best practices.
Limit as a percentage of surplus, etc.

Limiting negative IMR to a percentage of surplus would again be an arbitrary limit that contradicts the theory of IMR and would penalize strong and weak companies alike, similar to shortening the amortization period, and we believe it does not best serve an appropriate safeguard.

While we are not against further safeguards, we believe any additional safeguards should address a very specific concern of regulators and/or a concern that is not already adequately addressed by existing safeguards or are more tailored to specific concerns such as with the “Opt-in Approach” recommended.

Restrict Surplus via the special surplus fund

The effect of AAT requiring additional reserves is equivalent to restricting surplus available for dividends to stockholders or participating policyowners. Thus, restricting surplus (the special surplus fund) for an amount equal to allowable negative IMR would be redundant when AAT requires additional reserves. Further, because dividends are governed by varying state laws, restricting surplus would provide inconsistent treatment, which is a suboptimal solution. The same ends could be achieved elsewhere such as with a limit based on the risk-based capital framework in combination with the “Opt-in Approach” recommended.