A. Consideration of Maintenance Agenda – Pending List

1. Ref #2019-32: Look-Through with Multiple Holding Companies
2. Ref #2019-33: SSAP No. 25 – Disclosures
3. Ref #2019-34: Related Parties, Disclaimers of Affiliation and Variable Interest Entities
4. Ref #2019-35: Update Withdrawal Disclosures
5. Ref #2019-36: Expand MGA and TPA Disclosures
7. Ref #2019-38: Financing Derivatives
9. Ref #2019-40: Reporting of Installment Fees and Expenses
11. Ref #2019-42: Cash Equivalent – Cash & Liquidity Pools
12. Ref #2019-43: ASU 2017-11, EPS, Distinguishing Liabilities from Equity, Derivatives & Hedging
15. Ref #2019-46: ASU 2016-14, Presentation of Financial Statements for Not-for-Profit Entities
16. Ref #2019-47: VM 21 Grading
17. Ref #2019-48: Disclosure Update for Reciprocal Jurisdiction Reinsurers
18. Ref #2019-49: Retroactive Reinsurance Exception

Meeting Tabs A-C

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Summary:
This agenda item was drafted in response to Working Group direction from the 2019 Summer National Meeting. A clarification question arose while discussing agenda item 2019-13, Clarification of a Look-Through Approach. The Working Group verbalized the conclusion that look-through is permitted for more than one downstream company so as long as each look-through entity complies with SSAP No. 97—Investment in Subsidiary, Controlled and Affiliated Entities. In response to interested party request for formal clarification, the Working Group directed a separate agenda item to provide this guidance in SSAP No. 97. This agenda item formally documents the multiple look through approach for statutory accounting.

Recommendation:
NAIC staff recommends that the Working Group move this item to the active listing, categorized as nonsubstantive and expose revisions to SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities, to clarify that a more-than-one holding company structure is permitted as a look-through if each of the holding companies within the structure complies with the requirements in SSAP No. 97.

The requirements permitting look-through in SSAP No. 97:

- Downstream holding company is an 8.b.iii entity.
- The downstream holding company does not own any other assets which are material to that downstream holding company other than the audited SCA entities and/or audited non SCA SSAP No. 48 entities, and
- The downstream noninsurance holding company is not subject to liabilities, commitments, contingencies, guarantees or obligations which are material to that downstream noninsurance holding company.
Summary:
This agenda item has been drafted to data-capture disclosures from SSAP No. 25—Affiliates and Other Related Parties. Currently, all disclosures from SSAP No. 25 are completed in a narrative (pdf) format. With the proposal to data-capture disclosures, the regulators can aggregate and query related party relationships.

This item is separate from an agenda item (Ref #2019-34) that is considering revisions to SSAP No. 25 to clarify the identification of related parties and consider enhanced disclosures for when there is a disclaimer of control approved by a domiciliary state and when a company outside of the holding company group owns more than 10% of the insurance reporting entity. This agenda item will follow a separate work stream to allow for year-end 2020 data capturing. If the revisions being considered under the separate agenda item are adopted by June 2020 (blanks deadline), then those disclosures may modify or expand the data templates proposed in this agenda item.

Recommendation:
NAIC staff recommends that the Working Group move this item to the active listing, categorized as nonsubstantive, and expose the proposed data-capture templates. A blanks proposal to expose is anticipated to occur concurrently with the Working Group exposure. With inclusion of the data templates, narrative (pdf) reporting shall still occur to provide additional information regarding the related party transactions. NAIC staff notes that the current narrative illustrations are fairly simple. NAIC staff requests comments on whether more robust illustrations are necessary, or whether the disclosures that historically have been provided in the financial statements have included the extent of information necessary and more detailed illustrations are not necessary in the annual statement instructions. Note: Transactions with affiliates detailed in Schedule Y – Part 2, Summary of Insurer’s Transactions with Any Affiliates would not need to be duplicated in these data-captured charts. Narrative disclosure information regarding the transactions captured in Schedule Y-2 shall continue to be reported consistently with past reporting.

Note: A few of the data-captured components are not specifically named in SSAP No. 25 but are anticipated elements that would be captured in existing SSAP No. 25 disclosure references. (For example, the due date of the written agreement is not explicitly noted but is presumed to be captured in the disclosure for “any other information considered necessary to obtaining an understanding of the effects of the transactions on the financial statements.”) All of these instances are detailed in the agenda item.

Summary:
The intent of this agenda item is to clarify identification of related parties and affiliates in SSAP No. 25—Affiliates and Other Related Parties and to incorporate new disclosures to ensure regulators have the full picture of complicated business structures.

The proposed SSAP revisions intend to address the following key aspects:

- Clarify the identification of related parties and ensure that any related party identified under U.S. GAAP or SEC reporting requirements would be considered a related party under statutory accounting principles (SAP).
- Clarify that non-controlling ownership over 10% results in a related party classification regardless of any disclaimer of control or disclaimer of affiliation.

- Clarify the impact of a disclaimer of control or disclaimer of affiliate under SAP. As detailed, such disclaimers impact holding company group allocation and reporting as an SCA under SSAP No. 97, but do not eliminate the classification as a “related party” and the disclosure of material transactions as required under SSAP No. 25.

- Proposes rejection of several U.S. GAAP standards addressing variable interest entities.

NAIC staff noted that the requirements for the SEC filings do not allow for a disclaimer of affiliation, as is allowed in the Insurance Holding Company System Regulatory Act (#440) and the Insurance Holding Company System Model Regulation (#450) and included in Appendix A-440. As a result, the statutory financial statements do not provide the full picture of some complicated business structures, which can be common among insurance companies. This agenda item intends to propose revisions to have the related party and affiliate reporting more closely match that of SEC filings. This will be done by adding language from SEC laws and regulation and clarifying the disclaimer of affiliation or control from a statutory reporting standpoint.

Additionally, this agenda item addresses the FASB Accounting Standards Updates (ASU) related to Variable Interest Entities (VIE) and Consolidation (Topic 810).

FASB defines a VIE as an entity (the investee) in which the investor holds a controlling interest that is not based on the majority of voting rights. This agenda item discusses several ASUs that established the initial guidance for VIEs and all subsequent ASUs to update and clarify this guidance. As a fundamental issue, the concept of consolidation has been rejected for statutory accounting. As such, the main concepts included in the ASUs that are discussed in this agenda item are proposed to be rejected for statutory accounting. While this agenda item is not intended to change the concept of consolidation for statutory accounting, NAIC staff believe that there is a need and justification for enhanced disclosures to supplement the reporting process of related parties and affiliates within a company structure. The proposed additions will ensure state insurance regulators have a full picture of the companies that they are regulating.

Recommendation:
NAIC Staff recommends that the Working Group move this item to the active listing, categorized as nonsubstantive and expose revisions to SSAP No. 25—Affiliates and Other Related Parties, to clarify the types of entities or persons that are included as related parties, to clarify that a non-controlling ownership interest greater than 10% is a related party and is subject to the related party disclosures, to clarify the guidance for disclaimers of affiliation and control for statutory accounting, and to reject the seven FASB Accounting Standards Updates listed in the agenda item for statutory accounting in SSAP No. 25. With exposure, NAIC staff recommends a referral notice to the Group Solvency Issues (E) Working Group.

As detailed in the agenda item, the Working Group had a prior item to clarify relationships that should be considered related parties. With the exposure of this new item, it is recommended that the Working Group dispose agenda item 2011-16, Definition of Related Party in SSAP No. 25.
Summary:
In November 2018, the Working Group updated the life, health and separate account liquidity disclosures to provide more granularity of the withdrawal characteristics by product type. These updates were developed by the Financial Stability (Ex) Task Force and were adopted in agenda item 2018-28: Updates to Liquidity Disclosures. Agenda item 2018-28 updated the liquidity disclosures in SSAP No. 51R—Life Contracts, SSAP No. 52—Deposit-Type Contracts, and SSAP No. 61R—Life, Deposit-Type and Accident and Health Reinsurance with an effective date of year-end 2019. This agenda item proposes minor clarifying edits to the disclosures identified subsequent to the adoption of the related 2019 annual statement blanks proposal.

Recommendation:
NAIC staff recommends that the Working Group move this item to the active listing, categorized as nonsubstantive and expose revisions to SSAP No. 51R, SSAP No. 56 and SSAP No. 61R to:

- Add a consistency revision to SSAP No. 51R to ensure separate account guaranteed products are referenced in all applicable paragraphs of the withdrawal characteristics disclosures.
- Correct an identified inconsistency in one of the new disclosures that was added regarding products that will move from the reporting line of having surrender charges at 5% or more to the reporting line of surrender charges at less than 5%. A clarification is being recommended to ensure consistency in annual statement reporting.
- Add a cross reference from SSAP No. 56—Separate Accounts to the existing disclosures by withdrawal characteristics in SSAP No. 51R and SSAP No. 61R as the disclosures include separate account products.

Summary:
Two states have requested that the existing annual statement disclosure regarding managing general agents or third-party administrators be expanded to include additional information.

The enhanced note would list any managing general agent (MGA) and third-party administrator (TPA) and the respective core service(s) provided to the insurer or authority granted by the insurer. Additionally, the affiliated, related party or unaffiliated relationship would be disclosed, along with whether the entity is independently audited and/or bonded. The disclosure is specific to legal names for TPAs and MGAs to ensure consistency in reporting and allow for aggregation assessment.

State insurance regulators and policyholders should be able to fully understand the level and extent core services and binding authority are provided by TPAs and MGAs. The state sponsors have advocated that this understanding would also help in the assessment of the Enterprise Risk Management (ERM) framework, Own Risk Solvency Assessment (ORSA) report, market analysis reviews, operational risks, group analysis, and recovery and resolution considerations.

Recommendation:
NAIC Staff recommends that the Working Group move this item to the active listing, categorized as nonsubstantive and expose revisions to the following statutory accounting statements to expand the MGA/TPA note:
• SSAP No. 51R—Life Contracts, paragraph 50;
• SSAP No. 53—Property Casualty Contracts—Premiums, paragraph 19;
• SSAP No. 54R—Individual and Group Accident and Health Contracts, paragraph 33 and
• SSAP No. 59—Credit Life and Accident and Health Insurance Contracts, paragraph 19

As detailed in the agenda item, new disclosures would include:

• Aggregate direct written premium and total premium written by MGA/TPA.
• Aggregate dollar amount of claims process / total claims processed by MGA/TPA.
• Information on related party / affiliate status and if the MGA/TPA is independently audited and or bonded.

An illustration of the draft revisions to the current annual statement note tables for annual statement note 19 which would be forwarded to the Blanks (E) Working Group is also provided.

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<td>Surplus Notes – Enhanced Disclosures</td>
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Summary:
Surplus notes are unique statutory accounting items which have the characteristics of both debt and equity addressed in SSAP No. 41R—Surplus Notes. Surplus notes are debt instruments that are required to be subordinated to policyholders, claimants and all other creditors; with interest and principal repayments requiring approval by the domiciliary commissioner. As such, surplus notes are reported as equity for statutory accounting purposes. (This treatment is specific to statutory accounting. Surplus notes are reported as debt under U.S. GAAP.) Pursuant to the requirements of SSAP No. 41R, proceeds received by the issuer of a surplus note must be in the form of cash or other admitted assets meeting both value and liquidity requirements of the state of domicile’s commissioner.

In conjunction with agenda item 2018-07, originally a referral from the Reinsurance (E) Task Force, the Statutory Accounting Principles (E) Working Group has been discussing surplus notes where an “associated” asset is received by the surplus note issuer. These discussions have questions whether a surplus note that does not result with an exchange of cash flows (as the cash flows of offset with an associated asset), shall be considered surplus notes under SSAP No. 41R. Although the discussion on how to treat these surplus notes will occur in agenda item 2018-07, the Working Group has directed that additional disclosures shall be captured in SSAP No. 41R. The intent of this agenda item is to consider new disclosures involving surplus notes to better identify these situations in the statutory financial statements.

Recommendation:
NAIC staff recommends that the Working Group move this item to the active listing, categorized as nonsubstantive and expose revisions to SSAP No. 41R to provide enhanced disclosures to identify when a surplus note has been issued in which anticipated or typical cashflows have been partially or fully offset through the terms of the asset provided by the note holder.
Summary:
This agenda item has been prepared to reconsider the accounting and reporting of financing derivative transactions pursuant to a review of information from the 2018 year-end statutory financial statements.

A financing derivative transaction is one in which the premium to acquire the derivative is paid throughout the derivative term or at maturity of the derivative. With the accounting and reporting that has been utilized by some companies, the “cash flows” (the derivative obtained and the premium liability owed) are netted, generally resulting with zero-value reporting at inception. Over the course of the derivative term, an unrealized loss is recognized for changes in the present value of the premium liability (increase), which may be offset by any value change in the underlying derivative (increase or decrease). (With derivative financing, a gain would only ever be recognized if the fair value change of the derivative exceeded the cost of the derivative.) When the derivative matures, the calculation of realized gains and losses reflects the deferred cost (amount owned), adjusted for any actual fair value change.

Several key concerns are noted in the agenda item; however, a few are highlighted as follows:

- Reporting is inconsistent, as not all insurers utilizing financing derivatives report using the net approach. Additionally, insurers acquiring (or writing) similar derivatives would represent the financial statement impact in substantially different ways based solely on when the cost to acquire the derivative is due.

- The amounts reported when derivative assets and liabilities are netted with financing components do not reflect actual derivative assets or liabilities, and the corresponding unrealized gains / losses do not solely reflect changes in derivative value. The amounts reported are impacted by both changes in fair value and the present value change in the premium cost for the derivative. (This approach, particularly with the recognition of unrealized losses for the premium liability owed, results with changes in AVR that do not reflect actual unrealized investment losses.)

- The impact of financing derivatives can have a significant impact on the reported derivative amounts, which impacts the assessment of derivatives and the activity reported in regulator tools (e.g., profile reports / financial analysis assessments). For example, in one instance where financing derivatives were reflected, if the derivative had been reported without the financing components, the reported derivatives assets would have increased 50%, and the derivative liabilities would have decreased 60%. These two changes would have doubled the amount of overall net derivatives used in the company’s profile report. With a net presentation, the use of financing derivatives may artificially mask derivative activity, causing difficulty in regulator review to ensure derivative limitations have not been exceeded.

- After reviewing the information reported in the 2018 year-end financial statements, it was noted that some entities both acquire and write derivatives using financing derivative components. For entities that are writing these derivatives, the entity has a receivable for the amount due, but the receivable is not subject to nonadmittance requirements as it is being commingled with the derivative.

The agenda item includes additional information regarding the proposed overall accounting and reporting concepts, application of the concepts to acquired and written derivatives, as well as information on the calculation of RBC and the impact to AVR. With the detail on RBC, information is also included on the impact of derivative collateral. As detailed in the recommendation, the agenda item includes a proposal to consider derivative premium receivable (and payable) as part of the counterparty risk assessment (similar to derivative collateral) for life RBC.
Recommendation:
NAIC staff recommends that statutory accounting revisions be considered to ensure consistency in the gross reporting of derivatives - without inclusion of financing components - and consistency in reporting amounts owed to / from the reporting entity from the acquisition or writing of derivatives. NAIC staff highlights that the concepts are consistent with existing statutory accounting guidelines but require clarification changes to ensure uniform application across the industry. **NAIC staff recommends that the Working Group move this item to the active listing, classified as nonsubstantive, and expose revisions to SSAP No. 86 to clarify the reporting of derivatives with financing premiums.** With the proposed revisions, NAIC staff is suggesting reporting revisions that would allow the present value of the derivative premium receivable (and payable) for financed derivatives to be factored into the counterparty risk assessment for life RBC.

In addition to the proposed revisions, comments are requested as to whether derivatives and related financing provisions that would generally not meet the SSAP No. 64 right to offset criteria and if explicit guidance allowing offset should be considered. (Allowing offset only impacts the amount reported on balance sheet and does not impact the gross amount reported on Schedule DB-A or DB-B. The offset provision would impact RBC for p/c and health companies but would not impact the RBC for life reporting entities.)

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<td>Acceptable Collateral for Derivatives</td>
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Summary:
Potential misinterpretation for Blank instructions on Schedule DB-D, section 1, column 4 (Fair Value of Acceptable Collateral) exist as collateral is reported as 1) the fair value of collateral pledged by a counterparty, or 2) for central clearinghouses as the net positive variation margin received by the reporting entity.

NAIC staff believes the intent of net positive variation margin was originally meant to reflect net realizable margin. For example, if a reporting entity originally paid $5k as collateral to initiate a position, then subsequently received $15k in variation margin true-up, the reporting entity should report $10k in the fair value of acceptable collateral (assuming the counterparty has the legal right to offset the original $5k received). With the legal right to offset, in this example the holder can only realize a net $10k in collateral if liquidation were to occur. As the instructions indicate “net positive variation margin,” the variation collateral of $15k could be reported, disregarding the $5k initial margin.

Conversely, had the reporting entity received $5k in initial margin, and a subsequent $20k in variation margin, a total of $25k should be reported as collateral, thus giving credit for the initial margin received. NAIC staff believe this intent is articulated in SSAP No. 86, as collateral is defined in the disclosures as “net assets held.”

This agenda item included proposed clarification language that states collateral shall be determined by the summation of any assets held less any collateral paid/pledged from collateral received, if the counterparty has a legal right to offset as defined in SSAP No. 64.

Recommendation:
NAIC staff recommends that the Working Group move this item to the active listing, categorized as nonsubstantive and expose revisions to SSAP No. 86 to clarify that the fair value of collateral received or held, for derivative disclosure purposes, shall be reported net of collateral paid/pledged, in the event a counterparty has the legal right to offset against as defined in SSAP No. 64. Further, minor updates to applicable annual statement instructions are proposed to be concurrently exposed.
Summary:
SSAP No. 53—Property Casualty Contracts—Premiums, paragraph 6, provides specific guidance that allows for installment fees that meet specified criteria to be excluded from premium and reported as other income. An installment fee is the amount the policyholder pays if they make the choice to pay their premium on an installment basis. This fee is allowed to be excluded from premium income if it is an avoidable amount by the policyholder and the policy would not be cancelled for nonpayment of the installment fee.

NAIC staff has received regulator requested clarifications regarding potential diversity in the application of the SSAP No. 53 installment fee guidance on the following issues:

1. The first issue recommends additional language to ensure that the installment fee guidance continues to be narrowly applied, because the regulator became aware of some reporting entities seeking to analogize the application of the installment fee guidance to exclude other fees from premium income. Given the historical discussion on this paragraph, NAIC staff notes that the installment fee guidance is intended to be applied narrowly to a specific instance described in SSAP No. 53, footnote 1 and it should not be used to exclude other fees from being reported as premium.

2. The second issue pertains to the reporting of expenses related to the installment fee (other revenue). The regulator noted that while reporting entities were reporting the installment fees in other income, there was diversity in practice for the related installment fee expenses. Most entities were reporting the installment fee expenses in underwriting expenses where there are clear reporting lines for such expenses in the underwriting exhibits. Other entities were reporting the installment fee expenses either as a contra amount to finance and service charges not included in premium or as a contra amount to “aggregate write-ins for miscellaneous income.” The amounts are being reported as “contra” to other income because there is not an explicit reporting line in the property and casualty statement of income for expenses not related to underwriting (See Authoritative Literature). This agenda item requests feedback to address potential diversity in reporting.

Recommendation:
NAIC staff recommends that the Working Group move this item to the active listing, categorized as nonsubstantive, and expose proposed revisions to SSAP No. 53 and request comments as detailed below. In addition, it is recommended that the Working Group request comments on reporting installment fee expenses as detailed below.

1. Installment fee and services charges guidance should be applied narrowly to the specific situation described and not analogized to exclude other fees from written premium.

2. Request comments on incurred installment fee expenses and notify the Casualty Actuarial (C) Task Force and the Property and Casualty Risk Based Capital (E) Working Group of the exposure, particularly regarding installment fee expenses. Questions for exposure:

   a. Should the Working Group develop guidance to allow installment fee expenses associated with fees that are reported in other income according to the criteria in SSAP No. 53 be permitted reported in or as an expense in “Other Income?”

   b. If included in Other Income, should the expense be classified as a contra revenue in or “Aggregate Write-Ins for Miscellaneous Income”?

   c. Installment fees and expenses are often immaterial for property and casualty except for nonstandard writers. Comments are also requested on allowing diversity in reporting installment fee expenses (that is optional to report as other expense category of contra other revenue Aggregate Write-Ins for Miscellaneous Income,” particularly for immaterial amounts.
In coordination with the Valuation of Securities (E) Task Force and the Blanks (E) Working Group, this agenda item proposes elimination of the multi-step modeling process (i.e. incorporating breakpoints) to determine final NAIC designations on RMBS and CMBS securities.

Current guidance allows the amortized cost basis to be used in determining the “final” NAIC designation for statutory accounting and reporting - including the assessment of AVR and for risk-based capital (RBC) purposes. By design, this practice allows for reporting diversity as identical securities, purchased at different price points (thus having different amortized/carrying values) may have differing reported NAIC designations. Thus, two identical reporting entities possessing the same security, may have differing NAIC designations.

The current RMBS/CMBS multi-step modeling practice is the only remaining approach that utilizes breakpoints to determine final NAIC designations. In March 2019, agenda item 2018-19 removed the multi-step modeling approach for modified filing exempt (MFE) securities. This change removed the carrying value from the designation determination analysis and accordingly now utilizes the original NAIC designation, without adjustment, to determine the measurement method under SSAP No. 43R and corresponding RBC charges. With this change, identical securities have an identical NAIC designation.

Recommendation:
NAIC staff recommends that the Working Group move this item to the active listing, categorized as nonsubstantive and expose revisions to SSAP No. 43R—Loan-backed and Structured Securities to eliminate the multi-step financial modeling designation guidance in determining final NAIC designations for RMBS/CMBS securities.

Although the Working Group is recommended to proceed with exposure on this agenda item and solicit comments for consideration, final action will not occur on this item until revisions eliminating the RMBS/CMBS multi-step modeling approach has been adopted by the Valuation of Securities (E) Task Force. NAIC SAPWG staff will coordinate with the VOSTF staff to stay current on their discussion and action on this item.

Summary:
Cash pooling, also known as liquidity bundling or liquidity pools, is a special form of liquidity management in which groups combine resources in order to make a more efficient use of idle cash. A cash pool is typically a structure in which several entities’ cash accounts are aggregated for numerous purposes, including optimizing earned interest, accessing additional short-term investments markets, and improving liquidity management. The investment goal is to optimize financial results by increasing investment access and lower transaction costs that would be incurred by each individual pool participant.

Contributed cash is typically placed in short-term investments, which may not have been previously available to a single affiliated reporting entity that possesses a lower cash balance. Affiliates with lower cash balances can leverage the financial strength of other related affiliates in order to access certain markets that contain significant initial investment requirements. Additionally, by pooling resources and making fewer (and larger) investments, transaction costs are reduced, thus giving the participants a more efficient use of cash resources.
This agenda item recommends revisions to allow specific structures that strictly hold cash, cash equivalents and short-term investments and other certain criteria, but do not meet the current requirements for cash equivalent reporting, to be reported as cash equivalents under SSAP No. 2R—Cash, Cash Equivalents, Drafts and Short-Term Investments.

**Recommendation:**
NAIC staff recommends that the Working Group move this item to the active listing, categorized as nonsubstantive and expose revisions to SSAP No. 2R—Cash, Cash Equivalents, Drafts and Short-Term Investments to specify the types of cash pooling organization structures and the investments they are required to maintain in order to qualify as cash equivalents.

NAIC staff is aware a circumstance where a Limited Liability Company was used as the primary structure for a Cash / Liquidity Pool. However, NAIC staff is not proposing changes to SSAP No. 48—Joint Ventures, Partnerships and Limited Liability Companies as the legal structure of such pools will vary. Comments are requested regarding the need for a Cash / Liquidity Pool reference in SSAP No. 48.

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<td><strong>ASU 2017-11, Earning Per Share, Distinguishing Liabilities from Equity, Derivatives &amp; Hedging</strong></td>
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**Summary:**
ASU 2017-11, Accounting for Certain Financial Instruments with Down Round Features; Replacement of the Indefinite Deferral for Mandatorily Redeemable Financial Instruments of Certain Noncontrolling Interests with a Scope Exception to address issues identified with applying U.S. GAAP for certain financial instruments with characteristics of liabilities and equity. The purpose of this agenda item is to review ASU 2017-11 and to consider statutory accounting guidance on distinguishing liabilities from equity.

This ASU addresses the complexity of accounting for certain freestanding financial instruments (or embedded features such as a conversion option) with down round features. A down round feature is a provision in certain financial instruments (most often warrants or convertible instruments) that allows for the reduction in the strike price of the financial instrument if the issuer sells additional shares of common stock for an amount less than the financial instrument’s stated strike price, or if the issuer issues another equity-linked instrument with a strike price below the current strike price of the original financial instrument. Down (financing) rounds typically occur when additional capital is required, but the company’s valuation is now lower than it was in an earlier stock offering. Financial instruments with down round features help protect the holder from declines in the issuer’s share price because if a company issues additional equity shares at a lower price than had been previously sold, the holder is allowed to exercise its purchase option at a lower strike price than was originally stated on the financial instrument.

**Recommendation:**
Staff Recommendation: NAIC staff recommends the Working Group move this item to the active listing, categorized as nonsubstantive, and expose revisions to SSAP No. 86 to reject ASU 2017-11 (Topics 480 & 815) and expose revisions to SSAP No. 5R and SSAP No. 72 to incorporate guidance on when certain freestanding instruments shall be recognized as liabilities and not equity.

Proposed changes to SSAP No. 5R and SSAP No. 72 incorporate key concepts from ASC 480 in that issued, freestanding financial instruments with characteristics of both liability and equity shall be reported as a liability to the extent the instruments embodies an unconditional obligation of the issuer. Several criteria items are proposed however summarized that in the issuer shall report a liability on financial instruments in which they are obligated to transfer assets and the transfer is unavoidable.
Summary:
The maintenance updates provide revisions to the *Accounting Practices and Procedures Manual*, such as editorial corrections, reference changes and formatting.

1. **SSAP No. 62R—Property and Casualty Reinsurance**: Update references in Exhibit A – Implementation Questions and Answers, question 31, which provides a retroactive reinsurance illustration. This revision does not revise the illustrated journal entries it just revises the referenced “item numbers” to the appropriate SSAP No. 62R, paragraph 34 references.

2. Update reference in paragraph 85 to match the current format of property casualty annual statement Schedule F - Reinsurance.

3. Revise all references to the annual statement instructions for consistency and combine the life and fraternal references.
   - Generic references: annual statement instructions
   - Specific Names:
     - *Property/Casualty Annual Statement Instructions*
     - *Life, Accident and Health/Fraternal Annual Statement Instructions*
     - *Title Annual Statement Instructions*
     - *Health Annual Statement Instructions*

   Note: Only the changes to combine the Fraternal and Life references will be tracked as edits to the AP&P Manual. Since the other changes are just consistency changes to existing title references, those changes will not be tracked in the AP&P Manual. (Since there are several instances, they are not individually shown in this Form A.)

Recommendation:
NAIC staff recommends that the Working Group move this agenda item to the active listing, categorized as nonsubstantive, and expose the editorial revisions as illustrated in the agenda with a shortened exposure period to allow for 2020 publication.

Summary:
*Topic 740, Income Taxes* did not include explicit guidance for the financial statement presentation of an “unrecognized tax benefit” when a net operating loss carryforward, a similar tax loss, or a tax credit carryforward exists. An unrecognized tax benefit generally reflects a tax position that does not meet the ASC 740 more-likely-than-not recognition threshold, but to a certain extent owes their existence to an uncertain tax position. A more-likely-than-not threshold requires a recognized benefit of having a greater than 50 percent likelihood of being realized upon settlement.
**Recommendation:**
NAIC staff recommends that the Working Group move this item to the active listing, categorized as nonsubstantive, and expose revisions to SSAP No. 101 to reject *ASU 2013-11* for statutory accounting.

By definition, unrecognized tax benefits have a lower than 50 percent likelihood of being utilized (resulting in future tax savings), and as such, should be recognized in current income taxes as required by SSAP No. 101, paragraph 3. This ASU allows, as an election of the reporting entity, reporting of unrecognized tax benefits on the balance sheet (as a reduction to deferred tax assets) while statutory accounting requires immediate recognition through current income tax expense. As these unrecognized tax benefits are not deferred tax items and NAIC SAP tries to limit optionality in the financial statements, NAIC staff proposes to reject the ASU and retain existing statutory accounting guidance.

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**Summary:**
The FASB issued ASU 2016-14 to provide more useful information to donors, grantors, creditors, and other financial statements users of not-for-profit (NFP) entities. This update is to improve the current net asset classification requirements and the information presented in financial statements regarding liquidity, financial performance, and cash flows. While several changes were implemented within this ASU, the main provisions include the presentation of two classes of net assets – with donor restrictions and without donor restrictions. Due to complexities regarding the appropriate use of the previous three classes of net assets (unrestricted, temporarily restricted, and permanently restricted) that focused on the absence or presence of donor-imposed restrictions and whether those restrictions were temporary or permanent, this ASU designates presentation of two classes of net assets. Changes in these two classes of net assets are to be reported on the statement of activities.

**Recommendation:**
Staff Recommendation: NAIC staff recommends that the Working Group move this item to the active listing, categorized as nonsubstantive, and expose revisions to *Appendix D—Nonapplicable GAAP Pronouncements* to reject *ASU 2016-14, Presentation of Financial Statements of Not-for-Profit Entities* as not applicable to statutory accounting.

This item is proposed to be rejected as not applicable as statutory accounting guidance does not separately present assets based on donor restrictions. If assets are restricted, they must be identified as restricted in the investment schedules and captured in the restricted note disclosure. Furthermore, the concept of donor-restrictions for insurance reporting entities is not identified to be a prevalent concept.
Summary:
At the 2019 Summer National Meeting, the NAIC Executive and Plenary adopted revisions drafted by the Life Actuarial (A) Task Force to Section 21 of the Valuation Manual Requirements for Principle-Based Reserves for Variable Annuities (VM-21) which provides comprehensive updates to the Commissioners Annuity Reserve Valuation Method of reserving for variable annuities. The revisions adopted to VM-21 represent an accounting change that must be recognized as a change in valuation basis under SSAP No. 51R—Life Contracts. Updates to SSAP No. 51R are needed to coordinate with the recent revisions to the variable annuity reserving methodology. In addition, the proposed revisions recommend deferring to VM-21 regarding future variable annuity reserving methodology phase-ins along with disclosure on phase in details.

Recommendation:
NAIC staff recommends that the Working Group move this item to the active listing, categorized as nonsubstantive and expose the revisions described and illustrated in the agenda item to SSAP No. 51R—Life Contracts, and adding reference to the additional grade-in disclosure requirements in SSAP No. 3—Accounting Changes and Corrections of Errors for reporting years beginning Jan. 1, 2020. In addition, NAIC staff plans a future agenda item regarding exercise of Commissioner Discretion in the VM. Proposed revisions detailed in the current agenda item:

1. Revises the existing guidance, which prohibits grading-in changes in valuation basis unless provided for in the statement, to allow a grade-in for changes in valuation basis if permitted by the statement or the Valuation Manual in section 21 Requirements for Principle-Based Reserves for Variable Annuities (VM-21). Historically choosing effective dates for major reserving changes for the Accounting Practices and Procedures Manual has been determined by Working Group, for example the 2001 CSO table (adopted in 2002) was effective for policies January 1, 2004 in Appendix A-820. This has been to promote consistent implementation and reporting. By deferring to the VM-21 on grade-in options with many varied features, there will be less comparability in reporting, because there is more optionality in reserve reporting. Therefore, additional disclosure regarding grade-in has been proposed.

2. A change in valuation basis under SSAP No. 51R is recognized through surplus. As the unrecognized graded-in reserve represents an unrecognized adjustment to surplus, the revisions require the unrecognized grade-in amount from a change in valuation basis, if resulting with an increase in reserves (decrease from surplus), to be reported as an allocation from unassigned funds to special surplus until the amount has been fully graded into unassigned funds. The reclassification from unassigned funds to special surplus does not reduce total surplus. This is to provide transparency regarding the increased reserve amount that has not been reflected into surplus. As amounts are graded-in to reduce surplus, the amount in special surplus is reclassified to unassigned funds.

3. The proposed revisions to SSAP No. 51R expand the disclosure for changes in valuation basis as a change in accounting principle under SSAP No. 3 to also include details regarding grade-ins of changes in valuation basis, including the grade-in period applied, the remaining amount to be graded-in, remaining time for the grade-in period and the initial grade-in amount and any adjustments to the original amount.

4. Adds a reference in SSAP No. 3 regarding additional disclosures of grade-in features.
Summary:
On June 25, 2019, NAIC Executive Committee and Plenary adopted revisions to the Credit for Reinsurance Model Law (#785) and the Credit for Reinsurance Model Regulation (#786) to incorporate relevant provisions from the “Bilateral Agreement Between the United States of America and the European Union on Prudential Measures Regarding Insurance and Reinsurance” and the “Bilateral Agreement Between the United States of America and the United Kingdom Regarding Insurance and Reinsurance” (collectively referred to as the Covered Agreement). The purpose of this agenda item is to revise one disclosure in SSAP No. 62R—Property and Casualty Reinsurance to reference “reciprocal jurisdictions”.

Recommendation:
NAIC staff recommends that the Working Group move this item to the active listing, categorized as nonsubstantive and expose revisions SSAP No. 62R to incorporate disclosure updates for reinsurers from Reciprocal Jurisdictions. The proposed revisions are illustrated below:

106. Unsecured Reinsurance Recoverables:
   a. If the entity has with any individual reinsurers, authorized, unauthorized, reciprocal jurisdiction, or certified an unsecured aggregate recoverable for losses, paid and unpaid including IBNR, loss adjustment expenses, and unearned premium, that exceeds 3% of the entity’s policyholder surplus, list each individual reinsurer and the unsecured aggregate recoverable pertaining to that reinsurer; and

Summary:
At the 2019 Summer National Meeting, the Statutory Accounting Principles (E) Working Group, the Casualty Actuarial and Statistical (C) Task Force and the Surplus Lines (C) Task Force received a request from the Committee on Property and Liability Financial Reporting (COPLFR) of the American Academy of Actuaries Working Group. The request was to clarify the accounting and reporting for retroactive reinsurance which meets the SSAP No. 62R—Property and Casualty Reinsurance exceptions to be accounted for as prospective reinsurance. The request specifically asked for the NAIC groups to:

- Provide consistent guidance on the reporting treatment to both the ceding entity and assuming entity, where both are members of the same group and are consolidated in the same Combined Annual Statement.
- Clarify the reporting method to be used if the ceding entity and assuming entity are not in the same group.

This agenda item is to address the inconsistencies in application of the reinsurance accounting and reporting guidance, particularly the impact on Schedule P – Analysis of Losses and Loss Expenses (Schedule P) that were highlighted in the request.

The request indicated that COPLFR has noted that the guidance for portfolio retroactive reinsurance that meets the exceptions to be accounted for as prospective reinsurance (SSAP 62R, paragraph 36) but that does not meet the definition of Run-Off Agreements (SSAP 62R, paragraphs 102-105) is ambiguous regarding reporting requirements, and specifically the reporting in the NAIC Statutory Annual Statement’s Schedule P. The ambiguity
has led to materially different presentations in Schedule P. The letter requested that this ambiguity in Schedule P presentation should be addressed, given that industry Schedule P is utilized for risk-based capital (RBC) purposes as well as other purposes, and given the increased propensity for companies to entertain partial loss portfolio transfers that do not fully meet the requirements of “Run-Off Agreements.”

Attached to the letter were two insurance company examples of publicly filed Schedule P’s illustrating this ambiguity. This resulted in different reporting in Schedule P of intercompany retroactive reinsurance agreements that met the intercompany exception for prospective accounting. Note that COPLFR did not state a preference for the approach and the impact on annual statement Schedule P.

- Entity A in the retroactive cession (accounted for prospectively) initially reported the reinsurance premium paid as current calendar year ceded earned premium. Initially, entity A included all of the ceded losses in accident year 2015. However, for the following year, entity A recorded the ceded losses across the subject accident years and prior. This approach distorted the initial calendar year and accident year loss ratios and the loss development patterns for accident years 2015 and 2012 and prior years.

- Entity G in the year of the retroactive cession (accounted for prospectively) to a parent reported the reinsurance premium paid as ceded earned premium spread to prior calendar years (based on the allocation of loss reserves by accident year as of January 1, 2014), with the ceded losses also spread across prior accident years. This avoided distorting the calendar year / accident year loss ratios but distorted the loss development patterns.

Recommendation:
NAIC staff agrees that there is diversity in practice and improved accounting and reporting guidance, with examples, would be beneficial. NAIC staff recommends that the Working Group move this item to the active listing, categorized as nonsubstantive and expose a request for comments and for industry and regulator volunteers to assist with developing guidance. The goal is to clarify both the accounting and reporting for retroactive contracts which are accounted for prospectively, including:

- Both the ceding entity and assuming entity, where both are members of the same group and are consolidated in the same Combined Annual Statement.

- The reporting method to be used if the ceding entity and assuming entity are not in the same group.

Comments are specially requested regarding the preferred approaches to reporting and the advantages and disadvantages to each approach being used, including both the Schedule P (and related loss analysis) and risk-based capital impacts.

NAIC staff also recommends that the Working Group direct a referral to notify the Casualty Actuarial (C) Task Force of the request for comments and the need for coordination.

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1 SSAP 62R gives guidance on the accounting treatment of “Run-Off Agreements,” but that definition only applies to situations where an insurer exits “essentially all the risks ... of a specific line” and no longer writes business in that line. That guidance does not address the increasingly common situation where an insurer cedes reserves from all or a portion of prior writings for a line but continues to write new/renewal business for that line, i.e., partial portfolio transfers.
B. Consideration of Maintenance Agenda – Active Listing

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<th>Title</th>
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<tr>
<td>SSAP No. 105</td>
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Summary:
During the Summer National Meeting, the Working Group received a referral from the Valuation of Securities (E) Task Force and directed NAIC staff to proceed with drafting revisions for subsequent exposure to substantively revise SSAP No. 105—Working Capital Finance Investments using 6 of the industry-proposed concepts supported by NAIC staff. During this discussion additional industry proposed revisions were presented, but not captured in the direction for initial revisions to SSAP No. 105.

Recommendation:
NAIC staff recommends exposing the substantive revisions to SSAP No. 105—Working Capital Finance Investments incorporating the industry proposed language for the specific items directed by the Working Group. NAIC staff recommends directing Staff to prepare an issue paper for discussion at the 2020 Spring National Meeting.

Summary of revisions detailed in the agenda item:

1. **Functionally Equivalent Foreign Regulators** - Removed the requirement that the SVO determine if the International Finance Agent is the functional equivalent of the U.S. Regulator. (paragraph 10.a)
2. **Commingling Prohibitions** - Removed the finance agent prohibitions on commingling. (paragraph 10.b)
3. **Investor Rights Edit** - Removed duplicative text regarding exercise of investor rights. (paragraph 11.b)
4. **Requirements for Filer to Certify Perfected Interest** – Removed requirements, with revisions allowing the SVO to determine if a first priority perfected interest has been obtained. (paragraphs 14 & 15)
5. **Finance Agent Validation Requirements** – The independent review requirements were broadened to allow independent review of the finance agent by either audit or through an internal control report. (paragraph 16)
6. **Default Date** - Changed the default provisions from 15 to 30 days so the default date and the cure period are consistent. This has the effect of changing the date of nonadmission for an investment in default for a period up to 30 days instead of up to 15 days. (paragraph 28)
ANY OTHER MATTERS

a. Ref # 2019-21: SSAP No. 43R – Equity Interests (Julie)

The Working Group has scheduled a conference call on January 8, 2020, at 10:00 AM, Central to discuss this agenda item. A notification was distributed to all Members, Interested Regulators and Interested Parties of the Statutory Accounting Principles (E) Working Group on October 10, 2019.

b. Ref #2018-07: Surplus Notes – (Julie)

Pursuant to the direction of the Working Group from the 2019 Summer National Meeting, NAIC staff is in the process of collecting information from a data-call on “linked” surplus notes. Responses from the data call are requested by Dec. 31, 2019. Once the data call concludes discussion on this agenda item will resume. Information on the data call, including the characteristics of surplus notes in scope, can be obtained directly from Jim Pinegar (jpinegar@naic.org).

As a reminder, state insurance departments are requested to assist with the data call request. Insurance company submissions can occur directly to the NAIC or be provided to NAIC staff through the domiciliary state insurance department.

c. Ref #2016-20: Credit Losses – (Jim)

Summary: The Working Group has had several discussions / exposures regarding ASU 2016-13: Credit Losses. As discussed during the 2019 Summer National Meeting, discussion on this ASU is deferred. No significant consideration has occurred since deferral.

Update: NAIC staff continues to monitor the Financial Accounting Standards Board (FASB) regarding discussions involving this topic. On October 18, 2019, the FASB board voted unanimously, delaying implementation of the Credit Loss accounting standard until 2023. While large SEC filers are required to follow CECL in 2020, small SEC reporting companies, financial institutions and other public business entities are granted a reprieve until 2023.

d. AP&P Update – Manual & Electronic Versions - (Julie)

Consistent with last year, a pre-order process will be used for everyone (regulators and non-regulators) that want to receive printed copies of the Manual. This year, if there are requests for printed copies of the Manual after all copies have been distributed, the requester will be limited to the electronic version. The deadline to reserve a printed version of the “As of 2020” AP&P Manual is Dec. 13, 2019. The reserving process is available now. (The product code is APP-CB-2020-HC.) Additionally, if anyone is planning to move towards the electronic version in 2020 and wants to receive the AP&P Manual updates for 2019, they can contact the Service Desk and request this option. (The product code for this option APP-2020-UPD-K.) Historically, access to the updates required pre-purchase of the hard copy Manual. This process has been incorporated to allow transitioning to the electronic product with the ability to see current year updates. Updates are included in the electronic version. Regulators and industry may order or renew at https://www.naic.org/account_manager.htm.

e. Review of GAAP Exposures – Attachment U - (Jim)

The attachment details the items currently exposed by FASB. NAIC staff recommends reviewing all the issued ASUs under the SAP Maintenance process.

Note: NAIC staff is actively monitoring the FASB discussion on “reference rate reform” (e.g., references to
LIBOR in hedging instruments and other financial instruments). Once the FASB ASU is issued, NAIC plans to immediately review and will likely request an interim exposure of the agenda item.

**Comment Deadlines:**

Comment deadline for the editorial agenda item (Ref #2019-44EP) is December 20, 2019 (two weeks) and for all other exposed items new items is **Friday, January 31, 2020**.
Statutory Accounting Principles (E) Working Group
Maintenance Agenda Submission Form
Form A

Issue: Look-Through with Multiple Holding Companies

Check (applicable entity):

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<th>Life</th>
<th>Health</th>
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<td>Interpretation</td>
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Description of Issue:
This agenda item was drafted in response to Working Group direction from the 2019 Summer National Meeting. A clarification question arose while discussing agenda item 2019-13, Clarification of a Look-Through Approach. The Working Group verbalized the conclusion that a look-through is permitted through more than one downstream company so long as each look-through entity complies with SSAP No. 97—Investment in Subsidiary, Controlled and Affiliated Entities. In response to interested party request for formal clarification, the Working Group directed a separate agenda item to provide this guidance in SSAP No. 97. This agenda item formally documents this guidance within statutory accounting.

Existing Authoritative Literature:

SSAP No. 97:

27. The process of admitting audited investments in entities owned by an unaudited downstream noninsurance holding company SCA entity will be known as a “look through.” In order to admit the investments in audited SCAs or the audited non SCA SSAP No. 48 entities owned by an unaudited downstream noninsurance holding company, a reporting entity may apply the look through approach, provided all of the following conditions are met:

   a. Downstream holding company is an 8.b.iii entity.

   b. The downstream holding company does not own any other assets which are material to the downstream holding company other than the audited SCA entities and/or audited non SCA SSAP No. 48 entities, and

   c. The downstream noninsurance holding company is not subject to liabilities, commitments, contingencies, guarantees or obligations which are material to the downstream noninsurance holding company.

If an investment in a downstream noninsurance holding company meets the requirements set forth above, the reporting entity can admit the individual audited SCA entities and/or audited non SCA SSAP No. 48 entities; however, unaudited immaterial assets of the downstream noninsurance holding company are to be carried at the lesser of the paragraph 8 valuation or nonadmitted (e.g., some equity method investments are required to be carried at a negative value due to either statutory adjustments or to parental obligations to keep funding the subsidiary).

Activity to Date (issues previously addressed by the Working Group, Emerging Accounting Issues (E) Working Group, SEC, FASB, other State Departments of Insurance or other NAIC groups): Agenda item 2019-13, Clarification of a Look-Through Approach was disposed at the Summer 2019 National Meeting. As part of the disposal action, the Statutory Accounting Principles (E) Working Group directed NAIC staff to draft a new
agenda item clarifying that a more-than-one holding company structure is permitted if each of the holding companies complies with SSAP No. 97.

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

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

Staff Recommendation:
NAIC staff recommends that the Working Group move this item to the active listing, categorized as nonsubstantive and expose revisions to SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities, to clarify that a more-than-one holding company structure is permitted as a look-through if each of the holding companies within the structure complies with the requirements in SSAP No. 97.

Proposed Revisions:

27. The process of admitting audited investments in entities owned by an unaudited downstream noninsurance holding company SCA entity will be known as a “look through.” In order to admit the investments in audited SCAs or the audited non SCA SSAP No. 48 entities owned by an unaudited downstream noninsurance holding company, a reporting entity may apply the look through approach, provided all of the following conditions are met:

   a. The downstream noninsurance holding company is an 8.b.iii entity, and
   b. The downstream noninsurance holding company does not own any other assets which are material to the downstream holding company other than the audited SCA entities and/or audited non SCA SSAP No. 48 entities, and
   c. The downstream noninsurance holding company is not subject to liabilities, commitments, contingencies, guarantees or obligations which are material to the downstream noninsurance holding company.

If an investment in a downstream noninsurance holding company meets the requirements set forth above, the reporting entity can admit the individual audited SCA entities and/or audited non SCA SSAP No. 48 entities; however, unaudited immaterial assets of the downstream noninsurance holding company are to be carried at the lesser of the paragraph 8 valuation or nonadmitted (e.g. some equity method investments are required to be carried at a negative value due to either statutory adjustments or to parental obligations to keep funding the subsidiary). If a holding company structure has more than one downstream non-insurance holding company, each downstream non-insurance holding company may be looked through, provided each downstream non-insurance holding company meets all of the conditions in paragraph 27.

Staff Review Completed by:
Fatima Sediqzad - NAIC Staff
September 2019
Statutory Accounting Principles (E) Working Group
Maintenance Agenda Submission Form
Form A

Issue: SSAP No. 25 – Disclosures

Check (applicable entity):

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Description of Issue:
This agenda item has been drafted to data-capture disclosures from SSAP No. 25—Affiliates and Other Related Parties. Currently, all disclosures from SSAP No. 25 are completed in a narrative (pdf) format. With the proposal to data-capture disclosures, the regulators can aggregate and query related party relationships.

This item is separate from an agenda item (Ref #2019-34) that is considering revisions to SSAP No. 25 to clarify the identification of related parties and consider enhanced disclosures for when there is a disclaimer of control approved by a domiciliary state and when a company outside of the holding company group owns more than 10% of the insurance reporting entity. This agenda item will follow a separate work stream to allow for year-end 2020 data capturing. If the revisions being considered under the separate agenda item are adopted by June 2020 (blanks deadline), then those disclosures may modify or expand the data templates proposed in this agenda item.

Existing Authoritative Literature:
(Note: The entire SSAP No. 25 has been included for ease of reference of existing guidance.)

SSAP No. 25—Affiliates and Other Related Parties

1. Related party transactions are subject to abuse because reporting entities may be induced to enter transactions that may not reflect economic realities or may not be fair and reasonable to the reporting entity or its policyholders. As such, related party transactions require specialized accounting rules and increased regulatory scrutiny. This statement establishes statutory accounting principles and disclosure requirements for related party transactions.

2. This statement shall be followed for all related party transactions, even if the transaction is also governed by other statutory accounting principles. Furthermore, this statement shall be followed in all transactions which involve unrelated parties as intermediaries between related parties. In determining whether a transaction is a related party transaction, consideration shall be given to the substance of the agreement and the parties whose actions or performance materially impact the insurance reporting entity under the transaction. For example, an investment acquired from a non-related intermediary in which the investment return is predominantly contingent on the performance of a related party shall be considered a related party investment. As a general principle, it is erroneous to conclude that the mere inclusion of a non-related intermediary eliminates the requirement to assess and properly identify the related party transaction in accordance with the provisions of this statement. It is also erroneous to conclude that the presence of non-related assets in a structure predominantly comprised of related party investments eliminates the requirement to assess and identify the investment transaction as a related party arrangement.

3. If a company receives the stock of an affiliated company as a capital contribution rather than through a purchase, the transaction shall be accounted for according to SSAP No. 25—Affiliates and Other Related Parties, SSAP No. 95—Nonmonetary Transactions, or SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities, based on the details of each transaction. The statutory purchase method within SSAP No. 68—Business Combinations is not applicable for stock received as a capital contribution.
SUMMARY CONCLUSION

4. Related parties are defined as entities that have common interests as a result of ownership, control, affiliation or by contract. Related parties shall include but are not limited to the following:
   a. Affiliates of the reporting entity, as defined in paragraph 5;
   b. Trusts for the benefit of employees, such as pension and profit-sharing trusts and Employee Stock Ownership Plans that are managed by or under the trusteeship of management of the reporting entity, its parent or affiliates;
   c. The principal owners of the reporting entity;
   d. The management of the reporting entity, its parent or affiliates (including directors);
   e. Members of the immediate families of principal owners and management of the reporting entity, its parent or affiliates and their management;
   f. Parties with which the reporting entity may deal if either party directly or indirectly controls or can significantly influence the management or operating policies of the other to an extent that one of the transacting parties might be prevented from fully pursuing its own separate interest;
   g. A party which can, directly or indirectly, significantly influence the management or operating policies of the reporting entity, which may include a provider who is contracting with the reporting entity. This is not intended to suggest that all provider contracts create related party relationships;
   h. A party which has an ownership interest in one of the transacting parties and can significantly influence the other to an extent that one or more of the transacting parties might be prevented from fully pursuing its own separate interests;
   i. Attorney-in-fact of a reciprocal reporting entity or any affiliate of the attorney-in-fact; and

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

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

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

   a. Any limited partner investment in a limited partnership, unless the limited partner is affiliated with the general partner.
   b. An entity where the insurer owns less than 50% of an entity and there is an unaffiliated individual or group of investors who own a controlling interest.
   c. An entity where the insurer has given up participation rights\(^1\) as a shareholder to the investee.

8. Transactions between related parties must be in the form of a written agreement. The written agreement must provide for timely settlement of amounts owed, with a specified due date. Amounts owed to the reporting entity over ninety days from the written agreement due date shall be nonadmitted, except to the extent this is specifically addressed by other statements of statutory accounting principles (SSAPs). If the due date is not addressed by the written agreement, any uncollected receivable is nonadmitted.

Related Party Loans

9. Loans or advances (including debt, public or private) made by a reporting entity to its parent or principal owner shall be admitted if approval for the transaction has been obtained from the domiciliary commissioner and the loan or advance is determined to be collectible based on the parent or principal owner's independent payment ability. An affiliate's ability to pay shall be determined after consideration of the liquid assets or revenues available from external sources (i.e., determination shall not include dividend paying ability of the subsidiary making the loan or advance) which are available to repay the balance and/or maintain its account on a current basis. Evaluation of the collectibility of loans or advances shall be made periodically. If, in accordance with SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets, it is probable the balance is uncollectible, any uncollectible receivable shall be written off and charged to income in the period the determination is made. Pursuant to SSAP No. 72—Surplus and Quasi-Reorganization, forgiveness by a reporting entity of any debt, surplus note or other obligation of its parent or other stockholder shall be accounted for as a dividend.

10. Loans or advances by a reporting entity to all other related parties shall be evaluated by management and nonadmitted if they do not constitute arm's-length transactions as defined in paragraph 13. Loans or advances made by a reporting entity to related parties (other than its parent or principal owner) that are economic transactions as defined in paragraph 13 shall be admitted. This includes financing arrangements with providers of health care services with whom the reporting entity contracts with from time to time. Such arrangements can include both loans and advances to these providers. Evaluation of the collectibility of loans or advances shall be made periodically. If, in accordance with SSAP No. 5R, it is probable the balance is uncollectible, any uncollectible receivable shall be written off and charged to income in the period the determination is made.

11. Any advances under capitation arrangements made directly to providers, or to intermediaries that represent providers, that exceed one month’s payment shall be nonadmitted assets.

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\(^1\) The term "participating rights" refers to the type of rights that allows an investor to effectively participate in significant decisions related to an investee's ordinary course of business and is distinguished from the more limited type of rights referred to as “protective rights”. Refer to the sections entitled: “Protective Rights” and “Substantive Participating Rights” in EITF 96-16, Investor's Accounting for an Investee When the Investor Owns a Majority of the Voting Stock but the Minority Shareholder or Shareholders Have Certain Approval or Veto Rights. The term “participating rights” shall be used consistent with the discussion of substantive participating rights in this EITF.
12. Indirect loans are loans or extensions of credit to any person who is not an affiliate, where the reporting entity makes loans or extensions of credit with the agreement or understanding that the proceeds of the transactions, in whole or in substantial part, are to be used to make loans or extensions of credit to, to purchase assets of, or to make investments in, any affiliate of the reporting entity making the loans or extensions of credit. The admissibility of indirect loans made by a reporting entity for the benefit of its parent or principal owner shall be determined in accordance with the guidelines in paragraph 9. Indirect loans or advances made for the benefit of all other related parties shall be evaluated and accounted for consistent with loans or advances to related parties as described in paragraph 10 and paragraph 11.

Transactions Involving the Exchange of Assets or Liabilities

13. 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.

14. 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.

15. 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.
entity unless and until arms-length transaction(s) with independent third parties give rise to appropriate recognition of the gain.

16. 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 15, 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.

17. 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 15);

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

18. 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.

19. Transactions involving services provided between related parties shall be recorded at the amount charged. 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

2 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.
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.

Disclosures

20. The financial statements shall include disclosures of all material related party transactions. In some cases, aggregation of similar transactions may be appropriate. Sometimes, the effect of the relationship between the parties may be so pervasive that disclosure of the relationship alone will be sufficient. If necessary to the understanding of the relationship, the name of the related party should be disclosed. Transactions shall not be purported to be arm's-length transactions unless there is demonstrable evidence to support such statement. The disclosures shall include:

   a. **The nature of the relationships involved;**

   b. **A description of the transactions for each of the periods for which financial statements are presented, and such other information considered necessary to obtain an understanding of the effects of the transactions on the financial statements.** Exclude reinsurance transactions, any non-insurance transactions which involve less than ½ of 1% of the total admitted assets of the reporting entity, and cost allocation transactions. The following information shall be provided if applicable:

      i. **Date of transaction;**

      ii. **Explanation of transaction;**

      iii. **Name of reporting entity;**

      iv. **Name of affiliate;**

      v. **Description of assets received by reporting entity;**

      vi. **Statement value of assets received by reporting entity;**

      vii. **Description of assets transferred by reporting entity; and**

      viii. **Statement value of assets transferred by reporting entity.**

   c. **The dollar amounts of transactions for each of the periods for which financial statements are presented and the effects of any change in the method of establishing the terms from that used in the preceding period;**

   d. **Amounts due from or to related parties as of the date of each balance sheet presented and, if not otherwise apparent, the terms and manner of settlement;**

   e. Any guarantees or undertakings, written or otherwise, shall be disclosed in accordance with the requirements of SSAP No. 5R. In addition, the nature of the relationship to the beneficiary of the guarantee or undertaking (affiliated or unaffiliated) shall also be disclosed;

   f. **A description of material management or service contracts and cost-sharing arrangements involving the reporting entity and any related party.** This shall include, but is not limited to, sale lease-back arrangements, computer or fixed asset leasing arrangements, and agency contracts, which remove assets otherwise recordable (and potentially nonadmitted) on the reporting entity’s financial statements;

   g. The nature of the control relationship whereby the reporting entity and one or more other enterprises are under common ownership or control and the existence of that control could result in operating results or financial position of the reporting entity significantly
different from those that would have been obtained if the enterprises were autonomous. The relationship shall be disclosed even though there are no transactions between the enterprises; and

h. The amount deducted from the value of an upstream intermediate entity or ultimate parent owned, either directly or indirectly, via a downstream subsidiary, controlled, or affiliated entity, in accordance with the *Purposes and Procedure Manual of the NAIC Investment Analysis Office*, “Procedures for Valuing Common Stocks and Stock Warrants.”

**Current Annual Statement Illustrations for Completing Disclosures:**

**Illustration:**


D. At December 31, 20__, the Company reported $__________ as amounts due to the Parent Company, The ABC Insurance Company. The terms of the settlement require that these amounts be settled within 30 days.

E. The Company has given XYZ Inc., an affiliated company, a standing commitment until January 1, 20__, in the form of guarantees in the event of a default of XYZ on various of its debt issues as disclosed in Note 14.

F. The Company has agreed to provide the Parent Company, The ABC Insurance Company, certain actuarial investment services with respect to the administration of certain large group insurance contracts that are subject to group experience rating procedures.

The Parent Company has agreed to provide collection services for certain contracts for the Company.

G. All outstanding shares of The Company are owned by the Parent Company, The ABC Insurance Company, an insurance holding company domiciled in the State of _______________.

H. The Company owns shares of the stock of its ultimate parent, The ABC Insurance Company. A wholly owned subsidiary of the Company, The XYZ Insurance Company, owns shares of The ABC Insurance Company. In accordance with Securities Valuation Office guidelines, the asset value of The ABC Insurance Company has been reduced by $___________, and the asset value of the XYZ Insurance Company has been reduced by $___________.

I. The Company owns a_______ % interest in ABC Non-Insurance Company, whose carrying value is equal to or exceeds 10% of the admitted assets of The Company. The Company carries ABC Non-Insurance Company at GAAP equity plus the remaining Goodwill balance of $ _______. Goodwill is amortized on a straight-line basis over a ten-year period.

At 12/31/20__, The Company’s interest in ABC Non-Insurance Company per the New York Stock Exchange quoted price was valued at $__________, that was $__________ in excess of the carrying value.

Based on The Company’s ownership percentage of ABC Non-Insurance Company, the statement value of ABC Non-Insurance Company assets and liabilities as of 12/31/20__ were $ _______ and $_______, respectively.

The Company’s share of net income of ABC Non-Insurance Company was $_______ for the year ended 12/31/20__.
The Company has a 25% limited partnership interest in XYC Real Estate Partners. The partnership investment in office properties in the NE United States has been adversely affected by corporate restructuring. This has affected the value of the properties that resulted in the write-down of the Company's investment in XYC Real Estate Partners of $_______ for the year ended 12/31/20__. The amount of the impairment was determined using appraisals from third parties.

Activity to Date (issues previously addressed by the Working Group, SEC, FASB, other State Departments of Insurance or other NAIC groups): On August 3, 2019, the Working Group adopted revisions to SSAP No. 25—Affiliates and Other Related Parties, SSAP No. 26R—Bonds, SSAP No. 32—Preferred Stock, SSAP No. 43R—Loan-backed and Structured Securities, and SSAP No. 48—Joint Ventures, Partnerships and Limited Liability Companies to clarify the application of SSAP No. 25, as well as an “affiliated” classification, when a transaction is in substance a related party transaction. The revisions to SSAP No. 25 clarified that when determining a related party transaction, consideration shall be given to the substantive of the agreements, and the parties whose actions or performance materially impact the insurance reporting entity under the transaction. From these revisions, the following guidance was added as a new paragraph 2 to SSAP No. 25:

2. This statement shall be followed for all related party transactions even if the transaction is also governed by other statutory accounting principles. Furthermore, this statement shall be followed in all transactions which involve unrelated parties as intermediaries between related parties. In determining whether a transaction is a related party transaction, consideration shall be given to the substance of the agreement, and the parties whose actions or performance materially impact the insurance reporting entity under the transaction. For example, an investment acquired from a non-related intermediary, in which the investment return is predominantly contingent on the performance of a related party, shall be considered a related party investment. As a general principle, it is erroneous to conclude that the mere inclusion of a non-related intermediary eliminates the requirement to assess and properly identify the related party transaction in accordance with the provisions of this statement. It is also erroneous to conclude that the presence of non-related assets in a structure predominantly comprised of related party investments, eliminates the requirement to assess and identify the investment transaction as a related party arrangement.

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

Convergence with International Financial Reporting Standards (IFRS) and U.S. GAAP: None

Staff Recommendation: NAIC staff recommends that the Working Group move this item to the active listing, categorized as nonsubstantive, and expose the proposed data-capture templates. A blanks proposal to expose is anticipated to occur concurrently with the Working Group exposure. With inclusion of the data templates, narrative (pdf) reporting shall still occur to provide additional information regarding the related party transactions. NAIC staff notes that the current narrative illustrations are fairly simple. NAIC staff requests comments on whether more robust illustrations are necessary, or whether the disclosures that historically have been provided in the financial statements have included the extent of information necessary and more detailed illustrations are not necessary in the annual statement instructions. Note: Transactions with affiliates detailed in Schedule Y – Part 2, Summary of Insurer’s Transactions with Any Affiliates would not need to be duplicated in these data-captured charts. Narrative disclosure information regarding the transactions captured in Schedule Y-2 shall continue to be reported consistently with past reporting.

Proposed Data Capture Templates:

1) **Detail of Material Related Party Transactions**

This data-template includes aspects from paragraphs 20, 20.b.i, 20.b.ii, 20.b.iii, 20.b.iv and 20.e.
Note – The information regarding the written agreement and due date are not specifically named in the SSAP No. 25 disclosure listing but are addressed in paragraph 7 of SSAP No. 25. Since paragraph 7 requires a written agreement with an established due date for admittance, these components are anticipated elements that would be disclosed in the 20.b provisions that require “description of the transactions for each of the periods in which financial statements are presented, and other such information considered necessary to obtaining an understanding of the effect of the transactions on the financial statements.”

Material related party transactions shall be captured in this template each year until the agreement / transaction has termination. (For example, if the agreement is a material service contract, it shall be disclosed in this template each year after origination of the contract until the contract is terminated.)

**Proposed Data-Capturing Templates:**

Each Material Related Party Transaction Listed Separately:
(Related parties may be listed more than once if more than one material related party transaction.)

Note: Transactions involving affiliates captured on Schedule Y-2 do not need to be duplicated in these charts.

<table>
<thead>
<tr>
<th>Date of Transaction</th>
<th>Name of Related Party</th>
<th>Nature of Relationship</th>
<th>Type of Transaction</th>
<th>Written Agreement (Y/N)</th>
<th>Due Date</th>
<th>Reporting Period</th>
<th>Amount Due From (To)</th>
</tr>
</thead>
</table>

Options for Type of Transaction:
- Loan
- Exchange of Assets or Liabilities (e.g., buys, sells and secured borrowing transactions)
- Management Services
- Cost-Sharing Agreement
- Other Transactions Involving Services
- Guarantee (e.g., guarantees to related parties, on behalf of, and when beneficiary is related party)
- Other

2) **Detail of Material Related Party Transactions Involving Services**

This data-template includes aspects from paragraphs 20, 20.b.ii, 20.c and 20.f. (This chart provides additional information on service arrangements captured in chart 1.)

Note – The information regarding the amount charged, and whether the amount charged was based on an allocation of costs or market rates are not specifically named in the SSAP No. 25 disclosure listing but are addressed in paragraph 17 of SSAP No. 25. These components are anticipated elements that would be addressed in disclosure 20f with the “description of material management or service contracts and cost-sharing arrangements involving the reporting entity and any related party.”

**Transactions Involving Services:**
Include transactions involving management services, cost-sharing agreements and other transactions involving services.

<table>
<thead>
<tr>
<th>Name of Overview</th>
<th>Amount</th>
<th>Amount Based</th>
<th>Amount</th>
</tr>
</thead>
</table>
## 3) Detail of Material Related Party Transactions Involving Exchange of Assets and Liabilities

This data-template includes aspects from paragraphs 20, 20.b.ii, 20.b.v, 20.b.vi, 20.b.vii, 20.b.viii, and 20.c. (This chart provides additional information on asset/liability exchanges captured in chart 1.)

**Transactions Involving Exchange of Assets and Liabilities:**  
*Include loans, buys, sells and secured borrowing transactions.*

<table>
<thead>
<tr>
<th>Name of Related Party</th>
<th>Overview Description</th>
<th>Description of Assets Received</th>
<th>Description of Assets Transferred</th>
<th>Statement Value of Assets Received</th>
<th>Statement Value of Assets Transferred</th>
<th>Have Terms Changed from Preceding Period? (Y/N)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
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</tr>
</tbody>
</table>

## 4) Detail of Amounts Owed To/From a Related Party

This data-template includes aspects from paragraph 20d. This data template shall include each related party that is identified with material transactions in chart 1 but shall include the total amount due from/to from that related party. If there are transactions with the related party that were not captured in Chart 1 (perhaps as they were not material), they should be captured in the overall amount due from/to the related party.

This chart shall include related parties with immaterial transactions (not captured in Chart 1), if the aggregation of all transactions with the related party would be material to the reporting entity. (It is not required to include related parties in this chart if the transactions with the related party were individually immaterial and immaterial in the aggregate.)

Note: Pursuant to SSAP No. 64, paragraph 5 amounts due to or from affiliates shall be offset and reported net only when the provisions of paragraph 2 (valid right of setoff exists).

### Aggregate Reporting by Related Party

<table>
<thead>
<tr>
<th>Name of Related Party</th>
<th>Aggregate Reporting Period / Amount Due From</th>
<th>Aggregate Reporting Period / Amount Due To</th>
<th>Amount Offset in Financial Statement (if qualifying)</th>
<th>Net Amount Recoverable / (Payable) by Related Party</th>
<th>Admitted Recoverable</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
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</tr>
</tbody>
</table>

- Each related party shall be included only once.

**Staff Review Completed by: Julie Gann – October 2019**
Statutory Accounting Principles (E) Working Group
Maintenance Agenda Submission Form
Form A

Issue: Related Parties, Disclaimers of Affiliation and Variable Interest Entities

Check (applicable entity):

<table>
<thead>
<tr>
<th>Modification of existing SSAP</th>
<th>P/C</th>
<th>Life</th>
<th>Health</th>
</tr>
</thead>
<tbody>
<tr>
<td>New Issue or SSAP</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interpretation</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Description of Issue:
The intent of this agenda item is to clarify identification of related parties and affiliates in SSAP No. 25—Affiliates and Other Related Parties and to incorporate new disclosures to ensure regulators have the full picture of complicated business structures.

The proposed SSAP revisions intend to address the following key aspects:

- Clarify the identification of related parties and ensure that any related party identified under U.S. generally accepted accounting principles (GAAP) or Securities Exchange Commission (SEC) reporting requirements would be considered a related party under statutory accounting principles (SAP).

- Clarify that non-controlling ownership over 10% results in a related party classification regardless of any disclaimer of control or disclaimer of affiliation.

- Clarify the impact of a disclaimer of control or disclaimer of affiliate under SAP. As detailed, such disclaimers impact holding company group allocation and reporting as an SCA under SSAP No. 97, but do not eliminate the classification as a “related party” and the disclosure of material transactions as required under SSAP No. 25.

- Incorporate a new disclosure of known non-arm’s-length transactions with any entity not identified as a related party.

- Proposes rejection of several U.S. GAAP standards addressing variable interest entities.

NAIC staff noted that the requirements for the SEC filings do not allow for a disclaimer of affiliation, as is allowed in the Insurance Holding Company System Regulatory Act (#440) and the Insurance Holding Company System Model Regulation (#450) and included in Appendix A-440. As a result, the statutory financial statements do not provide the full picture of some complicated business structures, which can be common among insurance companies. This agenda item intends to propose revisions to have the related party and affiliate reporting more closely match that of SEC filings. This will be done by adding language from SEC laws and regulation and clarifying the disclaimer of affiliation or control from a statutory reporting standpoint.

Additionally, this agenda item addresses the FASB Accounting Standards Updates (ASU) related to Variable Interest Entities (VIE) and Consolidation (Topic 810).

FASB defines a VIE as an entity (the investee) in which the investor holds a controlling interest that is not based on the majority of voting rights. This agenda item discusses several ASUs that established the initial guidance for VIEs and all subsequent ASUs to update and clarify this guidance. As a fundamental issue,
the concept of consolidation has been rejected for statutory accounting. As such, the main concepts included in
the ASUs that are discussed in this agenda item are proposed to be rejected for statutory accounting.
While this agenda item is not intended to change the concept of consolidation for statutory accounting,
NAIC staff believe that there is a need and justification for enhanced disclosures to supplement the reporting
process of related parties and affiliates within a company structure. The proposed additions will ensure state
insurance regulators have a full picture of the companies that they are regulating.

A brief description of the ASUs that are addressed in this agenda item are included below:

- **ASU 2009-17, Consolidations (Topic 810)—Improvements to Financial Reporting by Enterprises
  Involved with Variable Interest Entities** clarifies and establishes the basis of U.S. GAAP accounting
  for consolidation and VIEs. This ASU is a result of FASB Statement No. 167, Amendments to FASB
  Interpretation No. 46(R).
- **ASU 2010-02, Consolidation (Topic 810)—Accounting and Reporting for Decreases in Ownership
  of a Subsidiary—a Scope Clarification** addresses implementation issues related to the changes in
  ownership provisions in Subtopic 810-10, originally issued as FASB Statement No. 160,
  Noncontrolling Interests in Consolidated Financial Statements, which establishes the accounting
  and reporting guidance for noncontrolling interests and changes in ownership interests of a
  subsidiary.
- **ASU 2010-10, Consolidations (Topic 810)—Amendments for Certain Investment Funds** defers
  consolidation requirements for a reporting entity’s interest in an entity that has all the attributes of
  an investment company or for which it is industry practice to apply measurement principles for
  financial reporting purposes that are consistent with those followed by investment companies.
- **ASU 2014-07, Consolidation (Topic 810)—Applying Variable Interest Entities Guidance to
  Common Control Leasing Arrangements** permits a private company lessee (the reporting entity) to
  elect an alternative not to apply VIE guidance to a lessor entity in certain situations.
- **ASU 2015-02, Consolidation (Topic 810)—Amendments to the Consolidation Analysis** includes
  updates to limited partnerships and similar legal entities, evaluating fees paid to a decision maker
  or a service provider as a variable interest, the effect of fee arrangements on the primary beneficiary
determination, the effect of related parties on the primary beneficiary determination, and certain
investment funds.
- **ASU 2016-17, Consolidation (Topic 810)—Interests Held through Related Parties That Are under
  Common Control** provides that if a reporting entity satisfies the first characteristic of a primary
  beneficiary (such that it is the single decision maker of a VIE), these amendments require that
  reporting entity, in determining whether it satisfies the second characteristic of a primary
  beneficiary, to include all of its direct variable interests in a VIE and, on a proportionate basis, its
  indirect variable interests in a VIE held through related parties, including related parties that are
  under common control with the reporting entity.
- **ASU 2018-17, Consolidation (Topic 810)—Targeted Improvements to Related Party Guidance for
  Variable Interest Entities** includes updated VIE guidance for private companies and considers if
  indirect interests held through related parties under common control for determining whether fees
  paid to decision makers and service providers are variable interests.

**Existing Authoritative Literature:** Statutory accounting guidance is in **SSAP No. 25—Affiliates and Other
Related Parties**, model law and regulation provisions are included in **Insurance Holding Company System
Regulatory Act (#440)** and the **Insurance Holding Company System Model Regulation (#450)**.

From Model #440

**Section 4. Registration of Insurers**

K. Disclaimer. Any person may file with the commissioner a disclaimer of affiliation with any
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authorized insurer or a disclaimer may be filed by the insurer or any member of an insurance holding company system. The disclaimer shall fully disclose all material relationships and bases for affiliation between the person and the insurer as well as the basis for disclaiming the affiliation. A disclaimer of affiliation shall be deemed to have been granted unless the commissioner, within thirty (30) days following receipt of a complete disclaimer, notifies the filing party the disclaimer is disallowed. In the event of disallowance, the disclaiming party may request an administrative hearing, which shall be granted. The disclaiming party shall be relieved of its duty to register under this section if approval of the disclaimer has been granted by the commissioner, or if the disclaimer is deemed to have been approved.

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 2010, in response to the issuance of FAS 166, Accounting for Transfers of Financial Assets—an amendment of FASB Statement No. 140 and FAS 167, Amendments to FASB Interpretation No. 46(R), the SAPWG formed the “SAPWG FAS 166/167 Subgroup. FAS 167 was issued in June 2009 and revised the scope of the FASB consolidation guidance to ensure that entities previously considered qualifying special purpose entities were included within the GAAP consolidation. Additionally, FAS 167 requires consolidation for entities (variable interest entities) in which the reporting entity has the “controlling financial interest”. Those situations are specific to when the entity is not controlled by contract, but the reporting entity has: (1) the power to direct the activities of the entity that most significantly impact the entity’s economic performance; and (2) the obligation to absorb losses or receive benefits of the entity that could be potentially significant to the entity. Although the concept of consolidation was not supported for SAP, the Subgroup discussion was focused on considering new disclosures for variable interest entities. The discussion of this Subgroup was deferred as Agenda Item 2011-16, Definition of a Related Party in SSAP No. 25 was considering changes to clarify the relationships that should be considered related parties. Discussion on this agenda item was halted in 2012 and 2015 as FASB issued new ASUs pertaining to VIEs. With the issuance of this new agenda item (2019-34), it is recommended that the 2011 agenda item be disposed.

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


Staff Recommendation:
NAIC Staff recommends that the Working Group move this item to the active listing, categorized as nonsubstantive and expose revisions to SSAP No. 25—Affiliates and Other Related Parties, to clarify the types of entities or persons that are included as related parties, to clarify that a non-controlling ownership interest greater than 10% is a related party and is subject to the related party disclosures, to clarify the guidance for disclaimers of affiliation and control for statutory accounting, to clarify that the reporting entity must disclose if they knowingly engaged in any non-arms-length transactions with any entity, individual or company that has not been previously identified as a related party and to reject the seven FASB Accounting Standards Updates listed in the agenda item as not applicable for statutory accounting in SSAP No. 25.

Staff Review Completed by:
Jake Stultz, NAIC Staff – November 2019
Statement of Statutory Accounting Principles No. 25

Affiliates and Other Related Parties

STATUS

Type of Issue
Common Area

Issued
Initial Draft, November 2019 discussion draft

Effective Date
January 1, 2001

Affects
Supersedes SSAP No. 96 with guidance incorporated August 2011; Nullifies and incorporates INT 03-16

Affected by
No other pronouncements

Interpreted by
No other pronouncements

Relevant Appendix A Guidance
A-440

SCOPE OF STATEMENT

1. Related party transactions are subject to abuse because reporting entities may be induced to enter transactions that may not reflect economic realities or may not be fair and reasonable to the reporting entity or its policyholders. As such, related party transactions require specialized accounting rules and increased regulatory scrutiny. This statement establishes statutory accounting principles and disclosure requirements for related party transactions.

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2. This statement shall be followed for all related party transactions, even if the transaction is also governed by other statutory accounting principles. Furthermore, this statement shall be followed in all transactions which involve unrelated parties as intermediaries between related parties. In determining whether a transaction is a related party transaction, consideration shall be given to the substance of the agreement and the parties whose actions or performance materially impact the insurance reporting entity under the transaction. For example, an investment acquired from a non-related intermediary in which the investment return is predominantly contingent on the performance of a related party shall be considered a related party investment. As a general principle, it is erroneous to conclude that the mere inclusion of a non-related intermediary eliminates the requirement to assess and properly identify the related party transaction in accordance with the provisions of this statement. It is also erroneous to conclude that the presence of non-related assets in a structure predominantly comprised of related party investments eliminates the requirement to assess and identify the investment transaction as a related party arrangement.

3. If a company receives the stock of an affiliated company as a capital contribution rather than through a purchase, the transaction shall be accounted for according to SSAP No. 25—Affiliates and Other Related Parties, SSAP No. 95—Nonmonetary Transactions, or SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities, based on the details of each transaction. The statutory purchase method within SSAP No. 68—Business Combinations is not applicable for stock received as a capital contribution.

SUMMARY CONCLUSION

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

   a. Any person or entity that has been identified under U.S. GAAP or SEC reporting as a related party;

   b. Affiliates of the reporting entity, as defined in paragraph 5;

   c. Trusts for the benefit of employees, such as pension and profit-sharing trusts and Employee Stock Ownership Plans that are managed by or under the trusteeship of management of the reporting entity, its parent or affiliates;

   d. The principal owners, directors, officers who are engaged directly or indirectly in the activities of the reporting entity;

   e. Any immediate family member of a principal owner, director or executive officer of the reporting entity, which means any child, stepchild, parent, stepparent, spouse, sibling, mother-in-law, father-in-law, son-in-law, daughter-in-law, brother-in-law, or sister-in-law, or individual related by blood or marriage whose close association is equivalent to a family relationship of such director, executive officer or nominee for director, or any person (other than a tenant or employee) sharing the household of such director, executive officer or nominee for director;

   f. Companies and entities which share common control, such as principal owners, directors, or officers, including situations where a principal owners, directors, or officers have a controlling stake in another reporting entity;

   g. Any non-controlling ownership greater than 10% results in a related party classification regardless of any disclaimer of control or disclaimer of affiliation.

   h. The management of the reporting entity, its parent or affiliates (including directors);
e. Members of the immediate families of principal owners and management of the reporting entity, its parent or affiliates and their management;

f. Parties with which the reporting entity may deal if either party directly or indirectly controls or can significantly influence the management or operating policies of the other to an extent that one of the transacting parties might be prevented from fully pursuing its own separate interest;

g. A party which can, directly or indirectly, significantly influence the management or operating policies of the reporting entity, which may include a provider who is contracting with the reporting entity. This is not intended to suggest that all provider contracts create related party relationships;

h. A party which has an ownership interest in one of the transacting parties and can significantly influence the other to an extent that one or more of the transacting parties might be prevented from fully pursuing its own separate interests;

i. Attorney-in-fact of a reciprocal reporting entity or any affiliate of the attorney-in-fact; and


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

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

7. Control as defined in paragraph 6 shall be measured at the holding company level. For example, if one member of an affiliated group has a 5% interest in an entity and a second member of the group has an 8% interest in the same entity, the total interest is 13%, and therefore, each member of the affiliated group shall be presumed to have control. This presumption will stand until rebutted by an evaluation of all the facts and circumstances relating to the investment based on the criteria in FASB Interpretation No. 33, Criteria for Applying the Equity Method of Accounting for Investments in Common Stock, an Interpretation of APB Opinion No. 18. The corollary is required to demonstrate control when a reporting entity owns less than 10% of the voting securities of an investee. The insurer shall maintain documents substantiating its determination for review by the domiciliary commissioner. A non-controlling ownership interest greater than 10% is a related party and is subject to the related party disclosures within this statement. Examples of situations where the presumption of control may be in doubt include the following:

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

An entity where the insurer has given up participation rights as a shareholder to the investee.

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

8.9. Transactions between related parties must be in the form of a written agreement. The written agreement must provide for timely settlement of amounts owed, with a specified due date. Amounts owed to the reporting entity over ninety days from the written agreement due date shall be nonadmitted, except to the extent this is specifically addressed by other statements of statutory accounting principles (SSAPs). If the due date is not addressed by the written agreement, any uncollected receivable is nonadmitted.

Related Party Loans

9.10. Loans or advances (including debt, public or private) made by a reporting entity to its parent or principal owner shall be admitted if approval for the transaction has been obtained from the domiciliary commissioner and the loan or advance is determined to be collectible based on the parent or principal owner’s independent payment ability. An affiliate’s ability to pay shall be determined after consideration of the liquid assets or revenues available from external sources (i.e., determination shall not include dividend paying ability of the subsidiary making the loan or advance) which are available to repay the balance and/or maintain its account on a current basis. Evaluation of the collectibility of loans or advances shall be made periodically. If, in accordance with SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets, it is probable the balance is uncollectible, any uncollectible receivable shall be written off and charged to income in the period the determination is made. Pursuant to SSAP No. 72—Surplus and Quasi-Reorganization, forgiveness by a reporting entity of any debt, surplus note or other obligation of its parent or other stockholder shall be accounted for as a dividend.

10.11. Loans or advances by a reporting entity to all other related parties shall be evaluated by management and nonadmitted if they do not constitute arm’s-length transactions as defined in paragraph 14.13. Loans or advances made by a reporting entity to related parties (other than its parent or principal owner) that are economic transactions as defined in paragraph 14.13 shall be admitted. This includes financing arrangements with providers of health care services with whom the reporting entity contracts with from time to time. Such arrangements can include both loans and advances to these providers. Evaluation of the collectibility of loans or advances shall be made periodically. If, in accordance with SSAP No. 5R, it is probable the balance is uncollectible, any uncollectible receivable shall be written off and charged to income in the period the determination is made.

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1 The term "participating rights" refers to the type of rights that allows an investor to effectively participate in significant decisions related to an investee's ordinary course of business and is distinguished from the more limited type of rights referred to as "protective rights". Refer to the sections entitled: “Protective Rights” and “Substantive Participating Rights” in EITF 96-16, Investor's Accounting for an Investee When the Investor Owns a Majority of the Voting Stock but the Minority Shareholder or Shareholders Have Certain Approval or Veto Rights. The term “participating rights” shall be used consistent with the discussion of substantive participating rights in this EITF.
11.12. Any advances under capitation arrangements made directly to providers, or to intermediaries that represent providers, that exceed one month’s payment shall be nonadmitted assets.

12.13. Indirect loans are loans or extensions of credit to any person who is not an affiliate, where the reporting entity makes loans or extensions of credit with the agreement or understanding that the proceeds of the transactions, in whole or in substantial part, are to be used to make loans or extensions of credit to, to purchase assets of, or to make investments in, any affiliate of the reporting entity making the loans or extensions of credit. The admissibility of indirect loans made by a reporting entity for the benefit of its parent or principal owner shall be determined in accordance with the guidelines in paragraph 109. Indirect loans or advances made for the benefit of all other related parties shall be evaluated and accounted for consistent with loans or advances to related parties as described in paragraph 1140 and paragraph 1241.

**Transactions Involving the Exchange of Assets or Liabilities**

13.14. 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.

14.15. 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.
15.16. 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.

16.17. 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 16.15, 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.

17.18. 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 16.15);

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

18.19. 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.

49.20. Transactions involving services provided between related parties shall be recorded at the amount charged\(^2\). 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.

Disclosures

20.21. The financial statements shall include disclosures of all material related party transactions. In some cases, aggregation of similar transactions may be appropriate. Sometimes, the effect of the relationship between the parties may be so pervasive that disclosure of the relationship alone will be sufficient. If necessary to the understanding of the relationship, the name of the related party should be disclosed. Transactions shall not be purported to be arm’s-length transactions unless there is demonstrable evidence to support such statement. The disclosures shall include:

a. The nature of the relationships involved;

b. A description of the transactions for each of the periods for which financial statements are presented, and such other information considered necessary to obtain an understanding of the effects of the transactions on the financial statements. Exclude reinsurance transactions, any non-insurance transactions which involve less than \(\frac{1}{2}\) of 1% of the total admitted assets of the reporting entity, and cost allocation transactions. The following information shall be provided if applicable:

i. Date of transaction;

ii. Explanation of transaction;

iii. Name of reporting entity;

iv. Name of affiliate;

v. Description of assets received by reporting entity;

vi. Statement value of assets received by reporting entity;

vii. Description of assets transferred by reporting entity; and

viii. Statement value of assets transferred by reporting entity.

\(^2\) 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 dollar amounts of transactions for each of the periods for which financial statements are presented and the effects of any change in the method of establishing the terms from that used in the preceding period;

d. Amounts due from or to related parties as of the date of each balance sheet presented and, if not otherwise apparent, the terms and manner of settlement;

e. Any guarantees or undertakings, written or otherwise, shall be disclosed in accordance with the requirements of SSAP No. 5R. In addition, the nature of the relationship to the beneficiary of the guarantee or undertaking (affiliated or unaffiliated) shall also be disclosed;

f. A description of material management or service contracts and cost-sharing arrangements involving the reporting entity and any related party. This shall include, but is not limited to, sale lease-back arrangements, computer or fixed asset leasing arrangements, and agency contracts, which remove assets otherwise recordable (and potentially nonadmitted) on the reporting entity’s financial statements;

g. The nature of the control relationship whereby the reporting entity and one or more other enterprises are under common ownership or control and the existence of that control could result in operating results or financial position of the reporting entity significantly different from those that would have been obtained if the enterprises were autonomous. The relationship shall be disclosed even though there are no transactions between the enterprises; and

h. The amount deducted from the value of an upstream intermediate entity or ultimate parent owned, either directly or indirectly, via a downstream subsidiary, controlled, or affiliated entity, in accordance with the Purposes and Procedure Manual of the NAIC Investment Analysis Office, “Procedures for Valuing Common Stocks and Stock Warrants.”

21.22. Refer to the Preamble for further discussion regarding disclosure requirements.

**Relevant Literature**

22.23. This statement adopts *FASB Statement No. 57, Related Party Disclosures* with a modification to paragraph 4 to require disclosure of compensation arrangements, expense allowances, and other similar items in the ordinary course of business.

24.25. Guidance in paragraph 98 was incorporated from SSAP No. 96 as discussed in Issue Paper No. 128—Settlement Requirements for Intercompany Transactions, An Amendment to SSAP No. 25—Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties. SSAP No. 96 was nullified in 2011 with the guidance from that SSAP retained within this SSAP.

Effective Date and Transition

25.26. This statement is effective for years beginning January 1, 2001. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with SSAP No. 3—Accounting Changes and Corrections of Errors.

26.27. Guidance reflected in paragraph 98, incorporated from SSAP No. 96, is effective for reporting periods ending December 31, 2007. Early adoption is permitted. A change resulting from the application of this paragraph shall be accounted for as a change in accounting principle in accordance with SSAP No. 3—Accounting Changes and Corrections of Errors. Guidance reflected in paragraph 3, incorporated from INT 03-16: Contribution of Stock, was originally effective December 7, 2003.

REFERENCES

Other

- Purposes and Procedures Manual of the NAIC Investment Analysis Office

Relevant Issue Papers

- Issue Paper No. 25—Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties

- Issue Paper No. 128—Settlement Requirements for Intercompany Transactions, An Amendment to SSAP No. 25—Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties
Statutory Accounting Principles (E) Working Group
Maintenance Agenda Submission Form
Form A

Issue: Update Withdrawal Disclosures

Check (applicable entity):

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<th>P/C</th>
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<th>Health</th>
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Description of Issue:
In November 2018, the Working Group updated the life, health and separate account liquidity disclosures to provide more granularity of the withdrawal characteristics by product type. These updates were developed by the Financial Stability (Ex) Task Force and were adopted in agenda item 2018-28: Updates to Liquidity Disclosures. Agenda item 2018-28 updated the liquidity disclosures in SSAP No. 51R—Life Contracts, SSAP No. 52—Deposit-Type Contracts, and SSAP No. 61R—Life, Deposit-Type and Accident and Health Reinsurance with an effective date of year-end 2019.

This agenda item proposes minor clarifying edits to the disclosures identified subsequent to the adoption of the related 2019 annual statement blanks proposal. These items include:

- Addition of separate account guaranteed products in one of the illustrations to remedy its omission. As quoted in the authoritative literature section below, SSAP No. 51R, SSAP No. 52 and SSAP No. 61R currently reference both guaranteed and nonguaranteed separate account products. This adds a consistency revision to SSAP No. 51R to ensure separate account guaranteed products are referenced in all applicable paragraphs of the withdrawal characteristics disclosures.

- Correct an identified inconsistency in one of the new disclosures that was added regarding products that will move from the reporting line of having surrender charges at 5% or more to the reporting line of surrender charges at less than 5%. A clarification is being recommended to ensure consistency in annual statement reporting.

- Add a cross-reference from SSAP No. 56—Separate Accounts to the existing disclosures by withdrawal characteristics in SSAP No. 51R and SSAP No. 61R as the disclosures include separate account products.

Existing Authoritative Literature:
The below includes excerpts of text that was updated in agenda item 2018-28.

SSAP No. 51R—Life Contracts (Bolding added for emphasis):

45. For the disclosures noted below, disclose the amount of annuity actuarial reserves and deposit liabilities by withdrawal characteristics for the categories of general account, separate account with guarantees, separate account nonguaranteed as well as the total and percentage of the total, include a separate section for individual Annuities, Group Annuities, and Deposit-Type Contracts (with no life contingencies). Supplementary contracts with life contingencies are reported in the appropriate Annuities section (Individual or Group).

NOTE: Subparagraphs a-f omitted for brevity.
46. Disclose the amounts of account value, cash value and reserve for the breakouts of life insurance by withdrawal characteristics, separately for General Account products and Separate Account Nonguaranteed products, as follows:

a. Subject to discretionary withdrawal, surrender values, or policy loans:
   i. Term Policies with Cash Value
   ii. Universal Life
   iii. Universal Life with Secondary Guarantees
   iv. Indexed Universal Life
   v. Indexed Universal Life with Secondary Guarantees
   vi. Indexed Life
   vii. Other Permanent Cash Value Life Insurance
   viii. Variable Life
   ix. Variable Universal Life
   x. Miscellaneous Reserves

b. Not subject to discretionary withdrawal or no cash value:
   i. Term Policies without Cash Value
   ii. Accidental Death Benefits
   iii. Disability – Active Lives
   iv. Disability – Disabled Lives
   v. Miscellaneous Reserves

c. Total gross (Direct + Assumed)

d. Reinsurance ceded

e. Total net (Net: Total gross (paragraph 46.c.) less Reinsurance ceded (paragraph 46.d.))

The difference between the account value and the cash value is the surrender charge, if any. After the surrender period is over, there is no difference. Some contract types have no account value such as traditional whole life, term, etc. So, if there is no account value, leave it blank. UL typically has an account value and a cash surrender value. Just as account values are not reduced for policy loans taken and outstanding, the cash value amount reported in this disclosure should not be reduced for policy loans taken and outstanding. This will ensure the difference between account value and cash value is the actual surrender charge.

47. Reconcile total life insurance reserves amount disclosed to the appropriate sections of the Aggregate Reserves for Life Policies and Contracts Exhibit (Exhibit 5) of the Life, Accident and Health Annual Statement and the corresponding lines in the Separate Accounts Statement. The reconciliation is a single presentation including all amounts from the sections on Individual Life Insurance and Group Life Insurance.
SSAP No. 52—Deposit-Type Contracts (Bolding added for emphasis):

19. For the disclosures noted below, disclose the amount of annuity actuarial reserves and deposit liabilities by withdrawal characteristics for the categories of general account, separate account with guarantees, separate account nonguaranteed as well as the total and percentage of the total, include a separate section for Individual Annuities, Group Annuities, and Deposit-Type Contracts (with no life contingencies). Supplementary contracts with life contingencies are reported in the appropriate Annuities section (Individual or Group).

NOTE: Subparagraphs omitted for brevity.

SSAP No. 61R (Bolding added for emphasis):

69. For the disclosures noted below, disclose the amount of annuity actuarial reserves and deposit liabilities by withdrawal characteristics for the categories of general account, separate account with guarantees, separate account nonguaranteed as well as the total and percentage of the total, include a separate section for Individual Annuities, Group Annuities, and Deposit-Type Contracts (with no life contingencies). Supplementary contracts with life contingencies are reported in the appropriate Annuities section (Individual or Group).

NOTE: Subparagraphs omitted for brevity.

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): This agenda item proposes consistency edits related to the disclosures developed by the Financial Stability (Ex) Task Force, which were adopted in November 2018 in agenda item 2018-28: Updates to Liquidity Disclosures.

Information or issues (included in Description of Issue) not previously contemplated by the Working Group: The Blanks (E) Working Group addressed this issue for 2019 reporting in an editorial change in June 2019 and is proposing separate tables for the guaranteed and nonguaranteed separate account products for 2020 reporting in agenda item 2019-21BWG.

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

Staff Recommendation:

NAIC Staff recommends that the Working Group move this item to the active listing, categorized as nonsubstantive and expose revisions to SSAP No. 51R, SSAP No. 56 and SSAP No. 61R as described and illustrated below:

1. Add a consistency revision to SSAP No. 51R to ensure separate account guaranteed products are referenced in all applicable paragraphs of the withdrawal characteristics disclosures.

2. Correct an identified inconsistency in one of the new disclosures that was added regarding products that will move from the reporting line of having surrender charges at 5% or more to the reporting line of surrender charges at less than 5%. A clarification is being recommended to ensure consistency in annual statement reporting.

3. Add a cross reference from SSAP No. 56—Separate Accounts to the existing disclosures by withdrawal characteristics in SSAP No. 51R and SSAP No. 61R as the disclosures include separate account products.
Revisions recommended for exposure are as follows:

SSAP No. 51R—Life Contracts

45. For the disclosures noted below, disclose the amount of annuity actuarial reserves and deposit liabilities by withdrawal characteristics for the categories of general account, separate account with guarantees, separate account nonguaranteed as well as the total and percentage of the total, include a separate section for individual Annuities, Group Annuities, and Deposit-Type Contracts (with no life contingencies). Supplementary contracts with life contingencies are reported in the appropriate Annuities section (Individual or Group).

a. Subject to discretionary withdrawal:

i. With market value adjustment, where withdrawal of funds is payable at all times, or prior to specified maturity dates where such dates are more than one year after the statement date and:

(a) In a lump sum with adjustments to reflect general changes in interest rates, or asset values since receipt of funds by the insurer;

(b) In installments over five years or more, with or without a reduction in the interest rate during the installment period;

ii. At book value less current surrender charge, where the withdrawal of funds is payable at all times, or at any time within one year from the statement date in a lump sum subject to a current fixed surrender charge of 5% or more and it does not contain a meaningful bail out rate as described in paragraph 45.a.v.(d);

iii. At fair value, where the withdrawal of funds is payable at current fair value of the assets supporting the liabilities, the assets are stated at current fair value, and the liabilities are stated at the current fair value or per unit value of the assets supporting the liabilities. These liabilities are for contracts where the customer bears the entire investment risk;

iv. Total with adjustment or at fair value;

v. At book value without adjustment (minimal or no charge or adjustment), where the withdrawal of funds is either payable at all times, or at any time (including a withdrawal on a scheduled payment date) within one year from the statement date and:

(a) In a lump sum without adjustment;

(b) In installments over less than five years, with or without a reduction in interest rate during the installment period;

(c) In a lump sum subject to a fixed surrender charge of less than 5%;

(d) In a lump sum subject to surrender charge, but such charge is waived if the credited rate falls below a specified “bail out” rate and the “bail out” rate is more than the maximum statutory valuation rate for life insurance policies for more than 20 years for new issues;

b. Not subject to discretionary withdrawal;
c. Total gross;
d. Reinsurance ceded;
e. Total net.
f. Amount with current surrender charge of 5% or more included in the current year in paragraph 45.a.ii. that will have less than a 5% surrender charge (and thus be reported with the amounts at book value with minimal or no charge or adjustment noted in paragraph 45.a.v.) for the first time within the year subsequent to the balance sheet year. (Note that percentage of total is not required for this item.)

46. Disclose the amounts of account value, cash value and reserve for the breakouts of life insurance by withdrawal characteristics, separately for General Account products, Separate Account Guaranteed products and Separate Account Nonguaranteed products, as follows:

a. Subject to discretionary withdrawal, surrender values, or policy loans:
   i. Term Policies with Cash Value
   ii. Universal Life
   iii. Universal Life with Secondary Guarantees
   iv. Indexed Universal Life
   v. Indexed Universal Life with Secondary Guarantees
   vi. Indexed Life
   vii. Other Permanent Cash Value Life Insurance
   viii. Variable Life
   ix. Variable Universal Life
   x. Miscellaneous Reserves

b. Not subject to discretionary withdrawal or no cash value:
   i. Term Policies without Cash Value
   ii. Accidental Death Benefits
   iii. Disability – Active Lives
   iv. Disability – Disabled Lives
   v. Miscellaneous Reserves

c. Total gross (Direct + Assumed)
d. Reinsurance ceded
e. Total net (Net: Total gross (paragraph 46.c.) less Reinsurance ceded (paragraph 46.d.))

The difference between the account value and the cash value is the surrender charge, if any. After the surrender period is over, there is no difference. Some contract types have no account value such as
traditional whole life, term, etc. So, if there is no account value, leave it blank. UL typically has an account value and a cash surrender value. Just as account values are not reduced for policy loans taken and outstanding, the cash value amount reported in this disclosure should not be reduced for policy loans taken and outstanding. This will ensure the difference between account value and cash value is the actual surrender charge.

SSAP No. 56—Separate Accounts

Disclosures

30. Paragraphs 31-34 detail the separate account disclosure requirements that shall be included within the Life, Accident and Health Annual Statement Blank. Paragraphs 35-38 detail the separate account disclosure requirements that shall be included within the Separate Account Annual Statement Blank.

NOTE: paragraphs 31-34 omitted for brevity.

35. The disclosures in SSAP No. 51R—Life Contracts, and SSAP No. 61R—Life, Deposit-Type and Accident and Health Reinsurance related to the withdrawal characteristics of products include separate account products and shall be completed in the general account disclosures.

SSAP No. 61R—Life, Deposit-Type and Accident and Health Reinsurance

69. For the disclosures noted below, disclose the amount of annuity actuarial reserves and deposit liabilities by withdrawal characteristics for the categories of general account, separate account with guarantees, separate account nonguaranteed as well as the total and percentage of the total, include a separate section for Individual Annuities, Group Annuities, and Deposit-Type Contracts (with no life contingencies). Supplementary contracts with life contingencies are reported in the appropriate Annuities section (Individual or Group).

a. Subject to discretionary withdrawal:

i. With market value adjustment, where withdrawal of funds is payable at all times, or prior to specified maturity dates where such dates are more than one year after the statement date and;

(a) In a lump sum with adjustments to reflect general changes in interest rates, or asset values since receipt of funds by the entity;

(b) In installments over five years or more, with or without a reduction in the interest rate during the installment period.

ii. At book value less current surrender charge, where the withdrawal of funds is payable at all times, or at any time within one year from the statement date in a lump sum subject to a current fixed surrender charge of 5% or more and it does not contain a meaningful bail out rate as described in paragraph 69.a.v.(d) below;

iii. At fair value, where the withdrawal of funds is payable at current market value of the assets supporting the liabilities, the assets are stated at current fair value, and the liabilities are stated at the current fair value or per unit value of the assets supporting the liabilities. These liabilities are for contracts where the customer bears the entire investment risk;

iv. Total with adjustment or at fair value;
v. At book value without adjustment (minimal or no charge or adjustment), where the withdrawal of funds is either payable at all times, or at any time (including a withdrawal on a scheduled payment date) within one year from the statement date and:

(a) In a lump sum without adjustment;

(b) In installments over less than five years, with or without a reduction in interest rate during the installment period;

(c) In a lump sum subject to a fixed surrender charge of less than 5%;

(d) In a lump sum subject to surrender charge, but such charge is waived if the credited rate falls below a specified “bail out” rate and the “bail out” rate is more than the maximum statutory valuation rate for life insurance policies for more than 20 years for new issues.

b. Not subject to discretionary withdrawal;

c. Total gross (Direct + Assumed);

d. Reinsurance ceded;

e. Total net (Net: Total gross (paragraph 69.c.) less Reinsurance ceded (paragraph 69.d.)); and

f. Amount with current surrender charge of 5% or more included in the current year in paragraph 69.a.ii. that will have less than a 5% surrender charge (and thus be reported with the amounts at book value with minimal or no charge or adjustment noted in paragraph 69.a.v.) for the first time within the year subsequent to the balance sheet year. (Note that percentage of total is not required for this item.)

Staff Review Completed by:
Robin Marcotte – August 2019
NAIC Staff
Statutory Accounting Principles (E) Working Group
Maintenance Agenda Submission Form
Form A

Issue: Expand MGA and TPA Disclosures

Check (applicable entity):

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<thead>
<tr>
<th>Modification of Existing SSAP</th>
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<th>Life</th>
<th>Health</th>
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<tr>
<td>New Issue or SSAP</td>
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<td>Interpretation</td>
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</table>

Description of Issue:
Two states have requested that the existing annual statement disclosure regarding managing general agents or third-party administrators be expanded to include additional information.

The enhanced note would list any managing general agent (MGA) and third-party administrator (TPA) and the respective core service(s) provided to the insurer or authority granted by the insurer. Additionally, the affiliated, related party or unaffiliated relationship would be disclosed, along with whether the entity is independently audited and/or bonded. The disclosure is specific to legal names for TPAs and MGAs to ensure consistency in reporting and allow for aggregation assessment.

State insurance regulators and policyholders should be able to fully understand the level and extent core services and binding authority are provided by TPAs and MGAs. The state sponsors have advocated that this understanding would also help in the assessment of the Enterprise Risk Management (ERM) framework, Own Risk Solvency Assessment (ORSA) report, market analysis reviews, operational risks, group analysis, and recovery and resolution considerations.

Existing Authoritative Literature:

All of the following statements contain the same disclosure regarding managing general agents or third-party administrators.

- SSAP No. 51R—Life Contracts, paragraph 50;
- SSAP No. 53—Property Casualty Contracts—Premiums, paragraph 19;
- SSAP No. 54R—Individual and Group Accident and Health Contracts, paragraph 33 and
- SSAP No. 59—Credit Life and Accident and Health Insurance Contracts, paragraph 19

The disclosure in each of these paragraphs is as follows:

Disclose the aggregate amount of direct premiums written through managing general agents or third-party administrators. For purposes of this disclosure, a managing general agent means the same as in Appendix A-225. If this amount is equal to or greater than 5% of surplus, provide the following information for each managing general agent and third-party administrator:

a. Name and address of managing general agent or third-party administrator;
b. Federal Employer Identification Number;
c. Whether such person holds an exclusive contract;
d. Types of business written;
e. Type of authority granted (i.e., underwriting, claims payment, etc.);
f. Total premium written.
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

Sponsors:
Trey Hancock - Tennessee Department of Commerce and Insurance
Debbie Doggett - Missouri Department of Commerce and Insurance

Staff Review Completed by:
Robin Marcotte - NAIC Staff, November 2019

Staff Recommendation:
NAIC Staff recommends that the Working Group move this item to the active listing, categorized as nonsubstantive and expose revisions to the following statements to expand the MGA/TPA note (as the wording is the same in each paragraph, for brevity, it will be only illustrated once.)

1. SSAP No. 51R—Life Contracts, paragraph 50;
2. SSAP No. 53—Property Casualty Contracts—Premiums, paragraph 19;
3. SSAP No. 54R—Individual and Group Accident and Health Contracts, paragraph 33 and
4. SSAP No. 59—Credit Life and Accident and Health Insurance Contracts, paragraph 19.
5. Annual Statement illustration updates

The disclosures in this paragraph should be completed regarding Disclose the aggregate amount of direct premiums written through following regarding managing general agents (MGAs) or third-party administrators (TPAs) that write direct policies or provide claims adjusting or other services. For purposes of this disclosure, a managing general agent means the same as in Appendix A-225. If this the premium written amount is equal to or greater than 5% of surplus, or if the claims adjusting services are greater than 5% of annual average claims volume provide the following information for each managing general agent and third-party administrator:

a. Disclose the aggregate amount of direct premiums written through the MGA or TPA and the total premium written by those MGAs or TPAs,
b. Disclose the aggregate amount of claims payments processed by agent or administrator and the total claims processed by such agents or administrators,
c. Licensed name and address (city and state only) of managing general agent or third-party administrator;
d. Federal Employer Identification Number;
e. Whether such person holds an exclusive contract;
f. Types of business written;
g. Type of authority granted and services provided (i.e., underwriting, claims payment, etc.); and
h. Whether the MGA or TPA is affiliated, a non-affiliate related party or unaffiliated. and
i. Whether the MGA or TPA is independently audited, and/or bonded.
f. Total premium written.
The following is an illustration of the draft revisions to the current annual statement note tables are proposed for annual statement Note 19 to allow for data capture of the MGA and TPA disclosure which would be forwarded to the Blanks (E) Working Group

Managing general agents (MGA) and third-party administrators (TPA) who either write more than 5% of premium or process greater than 5% of claims.

<table>
<thead>
<tr>
<th>Licensed Name</th>
<th>Address (City and State Only) of Managing General Agent or Third-Party Administration</th>
<th>FEIN Number</th>
<th>Exclusive Contract (Yes/No)</th>
<th>Type of Business Written</th>
<th>Type of Authority and/or Service Granted (Multiple Codes Allowed)</th>
<th>Independently Audited (Yes/No)</th>
<th>Bonded Status (Yes/No)</th>
<th>Direct Written Premium/Produced By</th>
</tr>
</thead>
<tbody>
<tr>
<td>XYZ</td>
<td></td>
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</tr>
</tbody>
</table>

**Information regarding Independent Audit, Bonded, status:**

Independent Audit - subject to annual independent audit

Bonded – The work of the entity is bonded by either a fiduciary or surety bond

<table>
<thead>
<tr>
<th>Licensed Name</th>
<th>FEIN Number</th>
<th>Affiliated, Non-Affiliate Related Party, or Unaffiliated</th>
<th>Direct Written Premium/Produced</th>
<th>Claims Payments Processed by Agent or Administrator</th>
</tr>
</thead>
<tbody>
<tr>
<td>XYZ</td>
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<td>$</td>
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</tr>
<tr>
<td><strong>Total</strong></td>
<td></td>
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<td>$</td>
<td></td>
</tr>
</tbody>
</table>

**Codes for types of MGA/TPA Services and/or Authority:**

<table>
<thead>
<tr>
<th>Authority/Service Codes Sample Listing:</th>
</tr>
</thead>
<tbody>
<tr>
<td>C  Claims Payment</td>
</tr>
<tr>
<td>CA Claims Adjustment</td>
</tr>
<tr>
<td>R  Reinsurance Ceding</td>
</tr>
<tr>
<td>B  Binding Authority</td>
</tr>
<tr>
<td>P  Premium Collection</td>
</tr>
<tr>
<td>U  Underwriting</td>
</tr>
<tr>
<td>O  Other (Write-in) If other explain in the table below</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Licensed Name</th>
<th>Explanation of other codes regarding type of authority granted</th>
</tr>
</thead>
<tbody>
<tr>
<td>XYZ</td>
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</tbody>
</table>

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

**Issue:** Surplus Notes – Enhanced Disclosures

**Check (applicable entity):**

<table>
<thead>
<tr>
<th>Modification of Existing SSAP</th>
<th>P/C</th>
<th>Life</th>
<th>Health</th>
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<tr>
<td>Interpretation</td>
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**Description of Issue:**

Surplus notes are unique statutory accounting items which have the characteristics of both debt and equity addressed in *SSAP No. 41R—Surplus Notes*. Surplus notes are debt instruments that are required to be subordinated to policyholders, claimants and all other creditors; with interest and principal repayments requiring approval by the domiciliary commissioner. As such, surplus notes are reported as equity for statutory accounting purposes. (This treatment is specific to statutory accounting. Surplus notes are reported as debt under U.S. GAAP.) Pursuant to the requirements of SSAP No. 41R, proceeds received by the issuer of a surplus note must be in the form of cash or other admitted assets meeting both value and liquidity requirements of the state of domicile’s commissioner. In conjunction with agenda item 2018-07, originally a referral from the Reinsurance (E) Task Force, the Statutory Accounting Principles (E) Working Group has been discussing surplus notes where an “associated” asset is received by the surplus note issuer. These discussions have questions whether a surplus note that does not result with an exchange of cash flows (as the cash flows of offset with an associated asset), shall be considered surplus notes under SSAP No. 41R. Although the discussion on how to treat these surplus notes will occur in agenda item 2018-07, the Working Group has directed that additional disclosures shall be captured in SSAP No. 41R. The intent of this agenda item is to consider new disclosures involving surplus notes to better identify these situations in the statutory financial statements.

**Existing Authoritative Literature:**

Authoritative guidance is detailed in *SSAP No. 41R—Surplus Notes*. Current guidance does not require disclosure if a surplus note has been issued with the structure as described where little or no actual cashflows are exchanged.

Current Surplus Note Disclosures under SSAP No 41R:

**Disclosures**

18. The notes to the financial statements of a reporting entity that issues surplus notes shall disclose the following as long as the surplus notes are outstanding:

a. Date issued;

b. Description of the assets received;

c. Holder of the note or if public the names of the underwriter and trustee;

d. Amount of note;

e. Carrying value of note;

f. The rate at which interest accrues;

g. Maturity dates or repayment schedules, if stated;

h. Unapproved interest and/or principal;

i. Interest and/or principal paid in the current year;

j. Total interest and/or principal paid on surplus notes;
k. Subordination terms;
l. Liquidation preference to the reporting entity’s common and preferred shareholders;
m. The repayment conditions and restrictions.

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): Discussions on linked surplus notes is occurring within agenda item 2018-07. The Working Group directed NAIC staff to collect information via a data-call on “linked” surplus notes as of Sept. 30, 2019. This information is requested by Dec. 31, 2019. Improved disclosures on surplus notes in SSAP No. 41R will reduce the need for subsequent data-call collection.

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

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

Staff Recommendation:
NAIC staff recommends that the Working Group move this item to the active listing, categorized as nonsubstantive and expose revisions to SSAP No. 41R to provide enhanced disclosures to identify when a surplus note has been issued in which anticipated or typical cashflows have been partially or fully offset through the terms of the asset provided by the note holder.

Disclosures

18. The notes to the financial statements of a reporting entity that issues surplus notes shall disclose the following as long as the surplus notes are outstanding:

a. Date issued;
b. Description and fair value of the assets received;
c. Holder of the note or if public, the names of the underwriter and trustee with identification on whether the holder of the surplus note is a related party per SSAP No. 25;
d. Original issue amount of note;
e. Carrying value of note;
f. The rate at which interest accrues;
g. Maturity dates or repayment schedules, if stated;

h. Unapproved interest and/or principal;
i. Life-to-date and current year approved interest and/or principal recognized as “paid” with identification of the amount of approved interest and/or principal remitted to the holder of the surplus note (actual transfer of cash / assets) and the amount of approved interest and/or principal not remitted to the holder of the surplus note (no transfer of cash / assets);
j. Information regarding a 3rd party liquidity source including name, identification if a related party, cost of the liquidity guarantee, and maximum amount available should a triggering event occur.

h-k. Subordination terms;
l. Liquidation preference to the reporting entity’s common and preferred shareholders;
j. The repayment conditions and restrictions.

19. If a reporting entity is not remitting actual cash or assets to the holder of the surplus note for approved interest or principal (as reported under paragraph 18.h), because the reporting entity is offsetting
the amount owed under the surplus note with an amount receivable from a reported asset, the following information shall be disclosed regarding the offsetting asset:

a. Identification of asset, including the investment schedule where the asset is reported and reported NAIC designation.
b. Book/ adjusted carrying value of asset and interest income recognized in the current year.
c. Amount of principle return and interest income from the asset not received by the reporting entity as the amounts were offset with approved amounts owed by the reporting entity’s issued surplus note.

20. In addition to the above, a reporting entity shall identify all affiliates that hold any portion of a surplus debenture or similar obligation (including an offering registered under the Securities Act of 1933 or distributed pursuant to rule 144A under the Securities Act of 1933), and any holder of 10% or more of the outstanding amount of any surplus note registered under the Securities Act of 1933 or distributed pursuant to Rule 144A under the Securities Act of 1933.

Updates to the Blanks are proposed as a result of the SSAP No. 41R revisions. For readability and due to the amount of proposed changes, both the current and proposed Blanks revisions are detailed below.

**Current Blanks Disclosures:**

<table>
<thead>
<tr>
<th>Date Issued</th>
<th>Interest Rate</th>
<th>Par Value (Face Amount of Notes)</th>
<th>Carrying Value of Note</th>
<th>Interest And / Or Principal Paid Current Year</th>
<th>Total Interest And / Or Principal Paid</th>
<th>Unapproved Interest And / Or Principal</th>
</tr>
</thead>
<tbody>
<tr>
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<tr>
<td>1311999</td>
<td>Total</td>
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<td>XXX</td>
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</tbody>
</table>

**Proposed Blanks Disclosures:**

<table>
<thead>
<tr>
<th>Date Issued</th>
<th>Interest Rate</th>
<th>Original Issue Amount of Note</th>
<th>Fair Value of Assets Received Upon Issuance</th>
<th>Type of Assets Received Upon Issuance</th>
<th>Carrying Value of Note Prior Year</th>
<th>Carrying Value of Note Current Year</th>
<th>Unapproved Interest And / Or Principal Recognized Current Year</th>
<th>Approved Interest or Principal Offset with Amounts Owed from Surplus Note Holder? (Y/N)</th>
<th>Life-To-Date Interest Remitted (Actual Transfer of Cash/Assets) Remitted</th>
<th>Life-To-Date Principal (Actual Transfer of Cash/Assets) Remitted</th>
<th>Date of Maturity</th>
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</table>

*Include amounts offset with amounts owed from the holder of the surplus note.*
Staff Review Completed by: Jim Pinegar, October 2019

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Statutory Accounting Principles (E) Working Group
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Issue: Financing Derivatives

Check (applicable entity):

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Description of Issue:
This agenda item has been prepared to reconsider the accounting and reporting of financing derivative transactions pursuant to a review of information from the 2018 year-end statutory financial statements.

Note: Although the proposed revisions in this agenda item would impact common SSAPs, from the year-end 2018 detail, there are no P/C or health entities acquiring or writing derivatives with financing arrangements. As such, the changes proposed may not impact P/C and health entities and should only impact a limited number of life insurers (16 as of year-end 2018) that engage in derivative financing arrangements.

A financing derivative transaction is one in which the premium to acquire the derivative is paid throughout the derivative term or at maturity of the derivative. With the accounting and reporting that has been utilized by some companies, the “cash flows” (the derivative obtained and the premium liability owed) are netted, generally resulting with zero-value reporting at inception. Over the course of the derivative term, an unrealized loss is recognized for changes in the present value of the premium liability (increase), which may be offset by any value change in the underlying derivative (increase or decrease). (With derivative financing, a gain would only ever be recognized if the fair value change of the derivative exceeded the cost of the derivative.) When the derivative matures, the calculation of realized gains and losses reflects the deferred cost (amount owned), adjusted for any actual fair value change.

For example, if paying $5,000 at the end of a 5-year derivative, a 1,000 unrealized loss would be recognized each year for the present value of premium due, and at maturity, the reporting entity would recognize the 5,000 as a realized loss. If the derivative had a $500 fair value gain, this would decrease the extent of the premium owed recognized as a realized loss. The financial statement presentation of a derivative with financing premiums is significantly different from traditional recognition in which the reporting entity would recognize the $5,000 derivative at acquisition and ultimately recognize a realized gain for the $500 change in fair value.

Several key concerns are noted in the agenda item; however, a few are highlighted as follows:

- Reporting is inconsistent, as not all insurers utilizing financing derivatives report using the net approach. Additionally, insurers acquiring (or writing) similar derivatives would represent the financial statement impact in substantially different ways based solely on when the cost to acquire the derivative is due.

- The amounts reported when derivative assets and liabilities are netted with financing components do not reflect actual derivative assets or liabilities, and the corresponding unrealized gains / losses do not solely reflect changes in derivative value. The amounts reported are impacted by both changes in fair value and the present value change in the premium cost for the derivative. (This approach, particularly with the recognition of unrealized losses for the premium liability owed, results with changes in AVR that do not reflect actual unrealized investment losses.)
The impact of financing derivatives can have a significant impact on the reported derivative amounts, which impacts the assessment of derivatives and the activity reported in regulator tools (e.g., profile reports / financial analysis assessments). For example, in one instance where financing derivatives were reflected, if the derivative had been reported without the financing components, the reported derivatives assets would have increased 50%, and the derivative liabilities would have decreased 60%. These two changes would have doubled the amount of overall net derivatives used in the company’s profile report. With a net presentation, the use of financing derivatives may artificially mask derivative activity, causing difficulty in regulator review to ensure derivative limitations have not been exceeded.

After reviewing the information reported in the 2018 year-end financial statements, it was noted that some entities both acquire and write derivatives using financing derivative components. For entities that are writing these derivatives, the entity has a receivable for the amount due, but the receivable is not subject to nonadmittance requirements as it is being commingled with the derivative. Under standard reporting (with premium provided at origination), the premium received would have been reported as a derivative liability (showcasing the obligation to perform under the derivative), but with financing derivatives, the written derivative is reported as a net asset as the receivable owed to the reporting entity is combined with the issued derivative. In the prior discussion of this topic, it was unknown that reporting entities were writing derivatives without collecting premium upon issuance or requiring collateral. This information was only identified with review of the new Schedule DB electronic columns.

From discussions with other NAIC staff, “financing” premiums are non-standard derivative components. Derivatives with these components are generally not marketable (without the entity providing payment of any remaining deferred or financing premium), as any new party would essentially be acquiring the initial company’s debt (liability) to pay the cost of the derivative.

Proposed Accounting and Reporting Concepts:
This agenda item intends to incorporate specific direction for the accounting and reporting of derivatives with financing components that are acquired and/or written. The proposed revisions reflect the following:

- **The BACV and fair value columns of derivatives acquired and/or written in Schedule DB-A or Schedule DB-B shall reflect the value without inclusion of any impact from financing provisions.** With this change, the Schedule DB column that currently captures “fair value of derivative, excluding impact of financing premiums” will be revised to reflect the “fair value of the derivative, including impact of financing premiums.”

  Note: This proposal will result in a change from U.S. GAAP, however, derivatives reported under SAP already vary from U.S. GAAP as statutory accounting does not currently allow offsetting in accordance with master netting agreements. Under U.S. GAAP, the cash inflows / outflows (derivative and financing components) are netted to arrive at the fair value of the derivative.

  This practice is not appropriate for statutory accounting because: The netting of derivatives with financing components 1) hinders the ability to assess whether derivative activity is within state investment limitations; 2) hinders the ability to utilize financial analysis tools in assessing activity or fair value changes; 3) impacts RBC and IMR calculations and 4) does not adequately present component items for admissibility.

- **Recognition of interest-related unrealized gains/losses (and then realized gains/losses at termination), shall reflect the fair value fluctuation changes in the derivative and shall not be impacted by the present value change of premium owed or premium receivable from the derivative.** This will impact past practice in which present value change of the premium owed / receivable has impacted gains / losses, resulting with impacts to AVR (unrealized) and IMR (realized).
• **The resulting balance sheet derivative assets and liabilities shall reflect the fair value of the derivatives without inclusion of the impact from financing derivatives unless the amount owed or the amount due from a derivative with financing elements meets the requirements for a valid right to setoff under SSAP No. 64.** If this valid right of setoff exists, the amount shall be captured in Schedule DB-D with disclosures captured pursuant to SSAP No. 64.

• **Amounts owed to / from the reporting entity for derivatives written or acquired shall be separately captured in the balance sheet, unless the amounts qualify under the legal right to offset.** To the extent amounts owed by the reporting entity for derivatives acquired do not meet the legal right to offset, the amount shall be recognized separately from the acquired derivative as a payable for security. To the extent amounts owed to the reporting entity for derivatives written do not meet the legal right to offset, the amount shall be recognized separately from the written derivative as a receivable for security and subject to admissibility requirements in SSAP No. 5R and SSAP No. 21R.

Note: Under SSAP No. 21R, receivables for securities are not admitted if not received within 15 days from the settlement date. If the valid right to offset provisions are not met, consideration could be given to incorporate specific guidance for these derivative premium receivables.

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**Proposed RBC and AVR Concepts:**

In addition to the changes in the Schedule DB reporting for BACV and FV and the separate reporting of the amounts due to / from, the proposed concepts in this agenda item will result with key changes to AVR and RBC:

1. **Acquired Derivatives with Amount Owed to Derivative Counterparty**

   With separate reporting of the derivative asset and amount owed from the acquisition of the derivative, the BACV for the derivative asset and “net exposure” (Schedule DB-D) by counterparty will increase. (As the AVR reserve does not factor in the impact if there is legal right to offset, this AVR impact will occur regardless of offsetting provisions.) From the 2018 year-end detail reviewed, in most instances, reporting entities with financing derivatives will no longer report these derivatives as liabilities and will report the derivatives as assets.

   • The AVR reserve and the RBC impact for derivatives is based on derivative counterparty “net exposure.” As such, unless other adjustments are made, the reporting entity will either need to obtain additional collateral or engage in another offsetting derivative with the counterparty to eliminate the reported increased exposure (increased RBC charge). **To address concerns with RBC, since exposure is not actually increasing, this agenda item proposes adjustments to Schedule DB-D to incorporate the amount owed by the reporting entity to the counterparty in determining net exposure.** This adjustment would eliminate the need to obtain additional collateral or engage in another offsetting derivative to reduce counterparty exposure.

   (There is an RBC charge for off-balance sheet collateral (.0039) and collateral on-balance sheet is assessed the corresponding asset charge. As such, by using financing derivatives instead of acquiring collateral, the reporting entity mitigates these collateral charges.)

   • With the proposed changes, the present value change of the premium owed will not be recognized as an unrealized loss in AVR (and impact the determination of realized interest-related capital losses/gains at termination in the IMR). These changes will result in a greater AVR reserve as the liability owed for the derivative recognized over time (present value over term of derivative) will no longer reduce the AVR as an unrealized loss. **The present value change of the premium owed for acquiring a derivative should not be considered an unrealized loss or impact AVR, therefore this change is appropriate.**
2. **Written Derivatives with Amount Owed to Reporting Entity**

With separate reporting of a derivative written by the reporting entity and the premium amount owed to the reporting entity, the BACV for the derivative asset and “net exposure” (Schedule DB-D) by counterparty will decrease. (This will likely result in a currently-reported derivative asset reversing to reflect a derivative liability.) Furthermore, the present value change of the premium due to the reporting entity will not be recognized as an unrealized gain and will no longer impact AVR (or IMR). The amount due for the written derivative will likely be considered a “receivable for security” within scope of SSAP No. 21R—Other Admitted Asset. Current guidance requires nonadmittance for these items not received within 15 days from the settlement date.

- In this situation, the derivative is currently being reported as an asset, because the amount due to the reporting entity (receivable) is increasing the derivative value. Without the amount due to the reporting entity, the derivative would be in a liability position. This approach does not seem to provide derivative RBC relief (as the RBC charge is focused on derivative assets) but the current netting approach could prevent potential nonadmittance for receivables owed to the reporting entity. In reviewing examples from the year-end 2018 reporting, premium owed to the reporting entity may not be received for a few years (until derivative maturity), which is beyond the time allotted for admittance under SSAP No. 21R. There is an RBC charge for “receivable for securities” (.014 life and 0.25 p/c & health), but this would only apply if the receivable was admitted. (This charge would be less than the charge for the derivative asset.)

- If the right to offset provisions in SSAP No. 64 are met, there would be no net impact to the financial statements by reporting the written derivative asset without the financing provisions. In these situations, the BACV and fair value on Schedule DB-A would detail the derivative without the financing components, and on Schedule DB-D, the reported amount that ties to the balance sheet would be adjusted for the offsetting receivable. With the offset, the receivable for security would be eliminated from the balance sheet. With the offset / balance sheet elimination, the receivable is essentially given “admitted asset” status (as it reduces a liability) and is not assessed for RBC. (Under SSAP No. 64, this offset would be disclosed in the financial statements.) If the right to offset provisions are not met, then the “receivable for security” would be nonadmitted after 15 days under SSAP No. 21R. This would cause a financial statement impact for any nonadmitted asset. If the asset was admitted, there would be an RBC charge for the admitted receivable.

**NAIC staff is interested in whether the premium due to the reporting entity from a written derivative would generally meet the “valid right to setoff” provisions from SSAP No. 64. If the conditions would not generally be met, consideration could occur to allow offsetting presentation in Schedule DB-D for these specific situations. This would allow the amount owed to the reporting entity to decrease the derivative obligation regardless of when the amount due would be received. If this was supported, provisions may be warranted that allow the derivative liability to be reduced to zero, but not permit the derivative to reverse into an asset position without being nonadmitted.**

**Illustration of RBC Charges to Derivative Assets / Liabilities:**

**RBC Impact – P/C and Health Entities**

As detailed below for property/casualty and health entities, the RBC charge is solely driven by the amount of derivative assets reported on the balance sheet. (This is a distinctly different from life reporting entities.) For these entities, the charge does not vary if the derivative is in a liability position or if the entity has received collateral from the counterparty. (The amount reported on balance sheet is impacted by offsetting provisions, but only if there is a valid right to offset.)

If these entities were to engage in financing derivatives, and the impact was to reverse the presentation of the derivative from an asset to a liability, this would have a direct change to the RBC calculation.
**RBC Impact – Life Insurance Entities**

As detailed below for life entities, the RBC charge is not driven by the amount of derivative assets reported on the balance sheet. Instead, the RBC charge is driven by the “net exposure” after considering collateral. In both situations (asset exposure and off-balance sheet exposure), if the derivative is in a liability position, there is no RBC charge. Since the removal of financing components will generally result with previously reported derivative liabilities flipping to represent derivative assets, this could have an RBC impact unless the premium owed to the reporting entity is considered as part of the RBC calculation. The proposal in this agenda item would consider amounts owed from the counterparty for the derivative in determining net exposure.

<table>
<thead>
<tr>
<th>Life</th>
<th>RBC Factor</th>
</tr>
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<tbody>
<tr>
<td><strong>Asset</strong></td>
<td></td>
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<tr>
<td>Admitted Assets</td>
<td>Balance Sheet</td>
</tr>
<tr>
<td>Liabilities</td>
<td>Balance Sheet</td>
</tr>
<tr>
<td><strong>On BS Collateral</strong></td>
<td></td>
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<tr>
<td>Investment Schedules</td>
<td>Related Asset Charge</td>
</tr>
<tr>
<td><strong>Off BS Collateral</strong></td>
<td></td>
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<tr>
<td>Manually Entered in RBC</td>
<td>.0039 (Flat)</td>
</tr>
<tr>
<td><strong>Net Exposure</strong></td>
<td></td>
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<tr>
<td>Collateral less Net Asset</td>
<td>.0039 (NAIC 1)</td>
</tr>
<tr>
<td>Net Asset = BACV Assets less Liabilities</td>
<td>.0126 (NAIC 2)</td>
</tr>
<tr>
<td>Liability &gt; Asset = No Charge</td>
<td>.0446 (NAIC 3)</td>
</tr>
<tr>
<td>Collateral &gt; Net Asset = No Charge</td>
<td>.0970 (NAIC 4)</td>
</tr>
<tr>
<td>Collateral &lt; Net Assets = Charge based on NAIC designation of counterparty</td>
<td>.2231 (NAIC 5)</td>
</tr>
<tr>
<td></td>
<td>.300 (NAIC 6)</td>
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<tr>
<td><strong>Off BS Exposure</strong></td>
<td></td>
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<tr>
<td>Ex Traded &amp; CC</td>
<td>.0039</td>
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<tr>
<td>Potential Exposure is a Calculated Amount</td>
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<tr>
<td>(0.5% * Notional * square root of years to maturity)</td>
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<tr>
<td>Off-BS</td>
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<tr>
<td>Calculated Amount:</td>
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<tr>
<td>[Gross Assets Less Gross Liabilities Less Collateral]</td>
<td>.0039 (NAIC 1)</td>
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<tr>
<td>Add Calculated Potential Exposure] Less Exposure</td>
<td>.0126 (NAIC 2)</td>
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<tr>
<td>Net of Collateral</td>
<td>.0446 (NAIC 3)</td>
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<td>.0970 (NAIC 4)</td>
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<td>.2231 (NAIC 5)</td>
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<tr>
<td></td>
<td>.300 (NAIC 6)</td>
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</tbody>
</table>

Derivative Liability > Derivative Asset = No Charge
Derivative Collateral > Net Derivative Asset = Charge Based on Collateral Not on Derivative
Derivative Collateral < Net Derivative Asset = Derivative Charge Based on NAIC designation of Counterparty

**Existing Authoritative Literature:**

- **SSAP No. 64—Offsetting and Netting of Assets and Liabilities**
- **SSAP No. 86—Derivatives**
- **SSAP No. 100—Fair Value**

Key aspects from the standards cited above:

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SSAP No. 64—Offsetting and Netting of Assets and Liabilities

2. Assets and liabilities shall be offset and reported net only when a valid right of setoff exists except as provided for in paragraphs 3 and 4. A right of setoff is a reporting entity's legal right, by contract or otherwise, to discharge all or a portion of the debt owed to another party by applying an amount that the other party owes to the reporting entity against the debt. A valid right of setoff exists only when all the following conditions are met:

   a. Each of the two parties owes the other determinable amounts. An amount shall be considered determinable for purposes of this provision when it is reliably estimable by both parties to the agreement;

   b. The reporting party has the right to set off the amount owed with the amount owed by the other party;

   c. The reporting party intends to setoff; and

   d. The right of setoff is enforceable at law.

3. Assets and liabilities that meet the criteria for offset shall not be netted when prohibited by specific statements of statutory accounting principles. An example of such is in the case of reinsurance recoverables on paid losses and ceded premiums payable as provided for in SSAP No. 62R—Property and Casualty Reinsurance.

4. Netting of assets and liabilities for reporting purposes when no valid right of setoff exists shall be allowed only when provided for by specific statements of statutory accounting principles. An example of such is in the case of real estate investments required to be shown net of encumbrances as provided for in SSAP No. 40R—Real Estate Investments.

5. Amounts due to or from affiliates shall be offset and reported net only when the provisions of paragraph 2 are met.

Disclosures

6. The following quantitative information shall be disclosed (separately for assets and liabilities) at the end of each reporting period (interim and annual) when derivative, repurchase and reverse repurchase, and securities borrowing and securities lending assets and liabilities are offset and reported net in accordance with paragraph 2 (valid right to offset):

   a. The gross amounts of recognized assets and recognized liabilities

   b. The amounts offset in accordance with paragraph 2 (valid right to offset)

   c. The net amounts presented in the statement of financial positions.

7. Assets and liabilities that have a valid right to offset under paragraph 2, but are not netted as they are prohibited under paragraph 3, are not required to be captured in the disclosures in paragraph 6.

Relevant Literature

8. This statement adopts paragraphs 1, 7 and 13 of APB Opinion No. 10, Omnibus Opinion—1966 and FASB Interpretation No. 39, Offsetting of Amounts Related to Certain Contracts with modifications (1) to prohibit offsetting as provided in specific statements and require netting when provided in specific statements, and (2) to reject guidance in paragraphs 10, 10A, and 10B of FIN 39, as amended by FSP FIN 39-1, that permits a reporting entity election to offset fair value amounts recognized for derivative instruments and fair value amounts recognized for the right to reclaim cash collateral or the obligation to return cash collateral arising from the derivative instruments with the same counterparty under a master netting agreement. Offsetting for statutory accounting purposes is limited to situations meeting the...
conditions in paragraph 2 and 4 of this SSAP. This statement adopts FASB Emerging Issues Task Force No. 86-25, Offsetting Foreign Currency Swaps.

9. This statement rejects FSP FIN 39-1, Amendment of FASB Interpretation 39. This statement rejects FASB Interpretation No. 41, Offsetting of Amounts Related to Certain Repurchase and Reverse Repurchase Agreements. FIN 41 has an offsetting exception for repurchase and reverse repurchase agreements and permits offsetting when the reporting parties do not intend to set off. This guidance is rejected for statutory accounting, and payables under repurchase agreements may only be offset against amounts recognized as receivables under reverse repurchase agreements if there is a valid right to offset meeting all the conditions, including the intent to offset, detailed in paragraph 2. This statement rejects ASU 2011-11, Disclosures about Offsetting Assets and Liabilities and ASU 2013-01, Clarifying the Scope of Disclosures about Offsetting Assets and Liabilities. Statutory disclosure requirements for assets and liabilities reported net under a valid right to offset are detailed in paragraph 6.

**SSAP No. 86—Derivatives**

11. 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).

**Disclosure Requirements**

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

   a. For derivative contracts with financing premiums:

      i. Disclose the aggregate, non-discounted total premium cost for these contracts and the premium cost due in each of the following four years, and thereafter. Include the aggregate fair value of derivative instruments with financing premiums excluding the impact of the deferred or financing premiums.

      ii. For each derivative contract with financing premiums:

         (a) Whether premium cost is paid throughout the contract, or at derivative maturity;

         (b) Next premium cost payment date;

         (c) Total premium cost;

         (d) Premium cost paid in prior years;

         (e) Current year premium cost paid;

         (f) Future unpaid premium cost;

         (g) Fair value of derivative, excluding impact of financing premiums; and

         (h) Unrealized gain/loss, excluding impact of financing premiums.
b. All derivatives are required to be shown gross on Schedule DB. However, derivatives may be reported net in the financial statements (pages 2 and 3 of the statutory financial statements) in accordance with SSAP No. 64—Offsetting and Netting of Assets and Liabilities when a valid right to offset exists. Derivatives offset in accordance with SSAP No. 64 and reported net in the financial statement shall follow the disclosure requirements in SSAP No. 64, paragraph 6. (Derivative Assets and Derivative Liabilities reported on the balance sheet shall agree to columns 5 and 6, respectively, after netting, on Schedule DB – Part D – Section 1.)

c. The disclosure requirements of paragraphs 59.a., 59.b., and 59.g. shall be included in the annual statement. Refer to the Preamble for further discussion regarding interim disclosure requirements. The disclosure requirements of paragraphs 59.a. through 59.g. shall be included in the annual audited statutory financial reports. The disclosure requirements in paragraph 59.h. shall be included in statutory financial statements (annual and quarterly). Paragraph 62 of the Preamble states that disclosures made within specific schedules or exhibits to the annual statement need not be duplicated in a separate note.

SSAP No. 100—Fair Value

Definition of Fair Value

4. Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

5. Asset/Liability – A fair value measurement is for a particular asset or liability. Therefore, the measurement should consider attributes specific to the asset or liability, for example, the condition and/or location of the asset or liability and restrictions, if any, on the sale or use of the asset at the measurement date. The asset or liability might be a standalone asset or liability (for example, a financial instrument or an operating asset) or a group of assets and/or liabilities (for example, an asset group, a reporting unit, or a business).

6. Price – A fair value measurement assumes that the asset or liability is exchanged in an orderly transaction between market participants to sell the asset or transfer the liability at the measurement date. An orderly transaction is a transaction that assumes exposure to the market for a period prior to the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets or liabilities; it is not a forced transaction (for example, a forced liquidation or distress sale). The transaction to sell the asset or transfer the liability is a hypothetical transaction at the measurement date, considered from the perspective of a market participant that holds the asset or owes the liability. Therefore, the objective of a fair value measurement is to determine the price that would be received to sell the asset or paid to transfer the liability at the measurement date (an exit price).

11. Application to Assets – A fair value measurement assumes the highest and best use of the asset by market participants, considering the use of the asset that is physically possible, legally permissible, and financially feasible at the measurement date. In broad terms, highest and best use refers to the use of an asset by market participants that would maximize the value of the asset or the group of assets within which the asset would be used. Highest and best use is determined based on the use of the asset by market participants, even if the intended use of the asset by the reporting entity is different.

14. Application to Liabilities – Consideration of non-performance risk (own credit-risk) should not be reflected in the fair value calculation for liabilities (including derivative liabilities) at subsequent measurement. At initial recognition, it is perceived that the consideration of own-credit risk may be inherent in the contractual negotiations resulting in the liability. The consideration of non-performance risk for subsequent measurement is inconsistent with the conservatism and recognition concepts as well as the assessment of financial solvency for insurers, as a decrease in credit standing would effectively decrease reported liabilities and thus seemingly increase the appearance of solvency. Furthermore, liabilities reported or disclosed at “fair value” shall not reflect any third-party credit guarantee of debt.
**Fair Value at Initial Recognition**

15. When an asset is acquired or a liability is assumed in an exchange transaction for that asset or liability, the transaction price represents the price paid to acquire the asset or received to assume the liability (an entry price). In contrast, the fair value of the asset or liability represents the price that would be received to sell the asset or paid to transfer the liability (an exit price). Conceptually, entry prices and exit prices are different. Entities do not necessarily sell assets at the prices paid to acquire them. Similarly, entities do not necessarily transfer liabilities at the prices received to assume them.

16. In many cases, the transaction price will equal the exit price and, therefore, represent the fair value of the asset or liability at initial recognition. In determining whether a transaction price represents the fair value of the asset or liability at initial recognition, the reporting entity shall consider factors specific to the transaction and the asset or liability. For example, a transaction price might not represent the fair value of an asset or liability at initial recognition if:

a. The transaction is between related parties.

b. The transaction occurs under duress or the seller is forced to accept the price in the transaction. For example, that might be the case if the seller is experiencing financial difficulty.

c. The market in which the transaction occurs is different from the market in which the reporting entity would sell the asset or transfer the liability, that is, the principal or most advantageous market. For example, those markets might be different if the reporting entity is a securities dealer that transacts in different markets, depending on whether the counterparty is a retail customer (retail market) or another securities dealer (inter-dealer market).

d. For liabilities, differences may exist as non-performance risk (own credit risk) is not reflected in the fair value (i.e., exit price) determination of all liabilities (including derivatives).

**Disclosures about Fair Value of Financial Instruments**

54. A reporting entity shall disclose in the notes to the financial statements, as of each date for which a statement of financial position is presented in the quarterly or annual financial statements, the aggregate fair value or NAV for all financial instruments and the level within the fair value hierarchy in which the fair value measurements in their entirety fall. This disclosure shall be summarized by type of financial instrument, for which it is practicable to estimate fair value, except for certain financial instruments identified in paragraph 55. Fair value disclosed in the notes shall be presented together with the related admitted values in a form that makes it clear whether the fair values and admitted values represent assets or liabilities and to which line items in the Statement of Assets, Liabilities, Surplus and Other Funds they relate. Unless specified otherwise in another SSAP, the disclosures may be made net of encumbrances, if the asset or liability is so reported. A reporting entity shall also disclose the method(s) and significant assumptions used to estimate the fair value of financial instruments. If it is not practicable for an entity to estimate the fair value of the financial instrument or a class of financial instruments, and the investment does not qualify for the NAV practical expedient, the aggregate carrying amount for those items shall be reported as “not practicable” with additional disclosure as required in paragraph 48.

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

Agenda item 2016-48 considered accounting and reporting revisions for derivatives with financing premiums. Although discussion occurred proposing a gross accounting and reporting approach, the revisions adopted within that agenda item incorporated aggregate disclosures and new electronic columns in Schedule DB to capture the impact of financing premiums in derivative reporting. With the disclosure adoptions, the Working Group directed NAIC staff to reassess this issue once the impact identified from the data-captured disclosures would be available for review, noting that the earliest for this re-assessment would be Summer 2019.
Agenda item 2013-07, which considered ASU 2013-01: Clarifying the Scope of Disclosures About Offsetting Assets and Liabilities, was finalized on August 24, 2013. This ASU was issued to clarify that the scope of ASU 2011-11 applies to derivatives (including embedded derivatives), repurchase and reverse repurchase agreements, and securities borrowing and securities lending transactions that are either netted as they meet the right of setoff under ASC 210-20-45 or ASC 815-10-45, or are subject to a master netting agreement or similar agreement. The SAP adopted revisions allowed reporting entities to continue offsetting derivatives, repurchase and reverse repurchase agreements, and securities borrowing and securities lending transactions with a valid right of offset, but incorporated disclosures to illustrate the netting impact. This adoption action included a referral to the Blanks (E) Working Group for annual statement instruction revisions and to recommend development of additional schedules to reconcile the amount reported gross on DB to the amount reported net on the balance sheet.

Agenda item 2012-17, which considered ASU 2011-22, Disclosures about Offsetting Assets and Liabilities, was finalized by the Working Group on November 29, 2012. This agenda item adopted revisions to SSAPs No. 64, 86 and 103. The adopted revisions, effective January 1, 2013, 1) revise and clarify that offsetting is only allowed in accordance with SSAP No. 64, paragraphs 2-4; 2) modify the adoption of FIN 39 rejecting the ability to offset in accordance with master netting agreements and rejecting FSP FIN 39-1 and FIN 41; and 3) rejecting ASU 2011-11 for statutory accounting. The Working Group deferred adoption of the disclosures proposed to paragraphs 6-8 of SSAP No. 64 in the exposure as the FASB has recently exposed guidance to narrow the scope GAAP disclosures.

Overview of ASU 2011-11:
ASU 2011-11 was issued in December 2011 to require entities to disclose both gross information and net information about both instruments and transactions eligible for offset in the statement of financial position and instruments and transactions subject to an agreement similar to a master netting agreement. This ASU was issued as the differences in the offsetting requirements between U.S. GAAP and IFRS accounted for a significant difference in the amounts presented under those standards. These differences reduce the comparability of between U.S. GAAP and IFRS, and the users of financial statements requested that these differences be addressed expeditiously. The objective of the ASU 2011-11 amendments is to facilitate comparison between entities that prepare financial statements under U.S. GAAP and those prepared under IFRS. Reporting entities are required to apply the ASU 2011-11 amendments for annual reporting periods beginning on or after Jan. 1, 2013, and interim periods within those annual periods. Entities are required to provide the disclosures required by those amendments retrospectively for all comparative periods presented.

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

Staff Recommendation:
NAIC staff recommends that statutory accounting revisions be considered to ensure consistency in the gross reporting of derivatives - without inclusion of financing components - and consistency in reporting amounts owed to / from the reporting entity from the acquisition or writing of derivatives. NAIC staff highlights that the concepts are consistent with existing statutory accounting guidelines but require clarification changes to ensure uniform application across the industry. **NAIC staff recommends that the Working Group move this item to the active listing, classified as nonsubstantive, and expose revisions to SSAP No. 86 to clarify the reporting of derivatives with financing premiums.** With the proposed revisions, NAIC staff is suggesting reporting revisions that would allow the present value of the derivative premium receivable (and payable) for financed derivatives to be factored into the counterparty risk assessment for life RBC.

In addition to the proposed revisions, comments are requested as to whether derivatives and related financing provisions would generally not meet the SSAP No. 64 right to offset criteria and if explicit guidance allowing offset should be considered. (Allowing offset only impacts the amount reported on balance
sheet and does not impact the gross amount reported on Schedule DB-A or DB-B. The offset provision would impact RBC for p/c and health companies but would not impact the RBC for life reporting entities.)

(Regulator Inquiry) - Derivative profile reports are only provided for life reporting entities. These reports provide assessments on the overall net derivative position (assets less liabilities). Would it be beneficial to regulators if derivative profile reports were available for p/c and health entities and if the reports completed assessments based on derivative assets and derivative liabilities separately? (For example, a life company with $2.1 billion in derivative assets and $2.0 billion in derivative liabilities would currently have a derivative profile report for the $100 million net derivative asset. This report would detail changes in the net asset, but if derivative assets increased to $3.1 assets and derivative liabilities increased to $3.0, the profile report would not detail the change as the net asset would still reflect $100 million) It is staff’s interpretation that the limits on derivative activity per NAIC Model 280 are anticipated to be “absolute value” of derivative assets and derivative liabilities (and not the net between assets and liabilities). The language in the Model is consistent with the Supplemental Investment Risk Interrogatory that requests “aggregate” amounts with a percentage of admitted assets, with identification that the amount should agree to Schedule DB. **NAIC staff requests regulator comment on the interpretation of the word “aggregate” (and whether it is intended to be “absolute value” and whether the information in the statutory financials or ISITE tools (profile reports) provide the information needed for regulator assessments of derivative activity.**

Excerpt from Model 280, Investments of Insurers Model Act (Defined Limits Version):

B. Limitations on Hedging Transactions

An insurer may enter into hedging transactions under this section if, as a result of and after giving effect to the transaction:

1. **The aggregate statement value** of options, caps, floors and warrants not attached to another financial instrument purchased and used in hedging transactions does not exceed seven and one half percent (7.5%) of its admitted assets;
2. **The aggregate statement value** of options, caps and floors written in hedging transactions does not exceed three percent (3%) of its admitted assets; and
3. The aggregate potential exposure of collars, swaps, forwards and futures used in hedging transactions does not exceed six and one-half percent (6.5%) of its admitted assets.

As noted in the recommendation, the revisions are in line with existing SAP concepts. These concepts and excerpts are specifically detailed below:

1. **Gross Reporting** – SSAP No. 86, and the reporting instructions for Schedule DB, is explicit that derivatives are required to be shown gross on Schedule DB. Net reporting is permitted on the balance sheet when a valid right to offset exists, but derivatives offset under SSAP No. 64 are required to follow the disclosure requirements in SSAP No. 64:

   54.h. All derivatives are required to be shown gross on Schedule DB. However, derivatives may be reported net in the financial statements (pages 2 and 3 of the statutory financial statements) in accordance with **SSAP No. 64—Offsetting and Netting of Assets and Liabilities** (SSAP No. 64) when a valid right to offset exists. Derivatives offset in accordance with SSAP No. 64 and reported net in the financial statement shall follow the disclosure requirements in SSAP No. 64, paragraph 6. (Derivative Assets and Derivative Liabilities reported on the balance sheet shall agree to columns 5 and 6, respectively, after netting, on Schedule DB – Part D – Section 1.)
2. **Accounting at Date of Acquisition** – SSAP No. 86, and the reporting instructions for Schedule DB, is explicit that the premium paid or received for writing a derivative shall either be recorded as an asset (purchase) or liability (written) on the derivative line on the assets or liability page:

   Exhibit C:

   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;

3. **Liability Recognition** - The deferred premium (or financing premium) is a cost to acquire / enter into the derivative contract and is not impacted by an underlying interest of the derivative agreement (the cost to acquire is not impacted by derivative instrument performance). Upon entering the derivative contract the financing premium owed by the reporting entity meets the definition of a liability under SSAP No. 5R:

   10. 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).

   11. 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\(^1\) 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.

   **NOTE:** The deferred premium is a contractual element of the derivative contract and does not fluctuate or change as a result of the underlying derivative.

   Recognizing the liability is also consistent with the Statutory Accounting Statement of Concept of Recognition detailed in the Preamble (paragraph 37):

   **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).

4. Derivative Instrument - The deferred premium (or financing premium) is the cost to acquire a derivative and is not a “derivative instrument” per the definition in SSAP No. 86:

4. “Derivative instrument” means an agreement, option, instrument or a series or combination thereof:
   a. To make or take delivery of, or assume or relinquish, a specified amount of one or more underlying interests, or to make a cash settlement in lieu thereof; or
   b. That has a price, performance, value or cash flow based primarily upon the actual or expected price, level, performance, value or cash flow of one or more underlying interests.

13. An “underlying” is a specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates, or other variable (including the occurrence or nonoccurrence of a specified event such as a scheduled payment under contract). An underlying may be a price or rate of an asset or liability but is not the asset or liability itself.

5. Offsetting Disclosures: Guidance exists in SSAP No. 64 for the offsetting when there is a valid right to offset, and this guidance specifically references derivative transactions. This disclosure was added to ensure effective comparability across reporting entities, and ensure that the gross information reported on Schedule DB could be agreed to the information reported on the balance sheet:

6. The following quantitative information shall be disclosed (separately for assets and liabilities) at the end of each reporting period (interim and annual) when derivative, repurchase and reverse repurchase, and securities borrowing and securities lending assets and liabilities are offset and reported net in accordance with paragraph 2 (valid right to offset):
   d. The gross amounts of recognized assets and recognized liabilities
   e. The amounts offset in accordance with paragraph 2 (valid right to offset)
   f. The net amounts presented in the statement of financial positions.

Staff Review Completed by:
Julie Gann – NAIC Staff – October 2019

October 2019 - Proposed Revisions to SSAP No. 86:

4. “Derivative instrument” means an agreement, option, instrument or a series or combination thereof:
   a. To make or take delivery of, or assume or relinquish, a specified amount of one or more underlying interests, or to make a cash settlement in lieu thereof; or
   b. That has a price, performance, value or cash flow based primarily upon the actual or expected price, level, performance, value or cash flow of one or more underlying interests.

5. 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.
a. "Caps" are option contracts in which the cap writer (seller), in return for a premium, agrees to limit, or cap, the cap holder's (purchaser) risk associated with an increase in a reference rate or index. For example, in an interest rate cap, if rates go above a specified interest rate level (the strike price or the cap rate), the cap holder is entitled to receive cash payments equal to the excess of the market rate over the strike price multiplied by the notional principal amount. Because a cap is an option-based contract, the cap holder has the right but not the obligation to exercise the option. If rates move down, the cap holder has lost only the premium paid. A cap writer has virtually unlimited risk resulting from increases in interest rates above the cap rate.

b. "Collar" means an agreement to receive payments as the buyer of an option, cap or floor and to make payments as the seller of a different option, cap or floor.

c. "Floors" are option contracts in which the floor writer (seller), in return for a premium, agrees to limit the risk associated with a decline in a reference rate or index. For example, in an interest rate floor, if rates fall below an agreed rate, the floor holder (purchaser) will receive cash payments from the floor writer equal to the difference between the market rate and an agreed rate multiplied by the notional principal amount.

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

e. "Futures" are standardized forward contracts traded on organized exchanges. Each exchange specifies the standard terms of futures contracts it sponsors. Futures contracts are available for a wide variety of underlying instruments, including insurance, agricultural commodities, minerals, debt instruments (such as U.S. Treasury bonds and bills), composite stock indices, and foreign currencies.

f. "Options" are contracts that give the option holder (purchaser of the option rights) the right, but not the obligation, to enter into a transaction with the option writer (seller of the option rights) on terms specified in the contract. A call option allows the holder to buy the underlying instrument, while a put option allows the holder to sell the underlying instrument. Options are traded on exchanges and over the counter.

g. "Structured Notes" in scope of this statement are instruments (often in the form of debt instruments), in which the amount of principal repayment or return of original investment is contingent on an underlying variable/interest. Structured notes that are "mortgage-referenced securities" are captured in SSAP No. 43R—Loan-backed and Structured Securities.

h. "Swaps" are contracts to exchange, for a period of time, the investment performance of one underlying instrument for the investment performance of another underlying instrument, typically, but not always, without exchanging the instruments themselves. Swaps can be viewed as a series of forward contracts that settle in cash and, in some instances, physical delivery. Swaps generally are negotiated over-the-counter directly between the dealer and the end user. Interest

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1 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.
rate swaps are the most common form of swap contract. However, foreign currency, commodity, and credit default swaps also are common.

i. “Swaptions” are contracts granting the owner the right, but not the obligation, to enter into an underlying swap. Although options can be traded on a variety of swaps, the term “swaption” typically refers to options on interest rate swaps. A swaption hedges the buyer against downside risk, as well as lets the buyer take advantage of any upside benefits. That is, it gives the buyer the benefit of the agreed-upon rate if it is more favorable than the current market rate, with the flexibility of being able to enter into the current market swap rate if it is preferable. Conversely, the seller of swaptions assumes the downside risk, but benefits from the amount paid for the swaption, regardless if it is exercised by the buyer and the swap is entered into.

j. “Warrants” are instruments that give the holder the right to purchase an underlying financial instrument at a given price and time or at a series of prices and times outlined in the warrant agreement. Warrants may be issued alone or in connection with the sale of other securities, for example, as part of a merger or recapitalization agreement, or to facilitate divestiture of the securities of another business entity. Publicly traded stock warrants are captured in scope of SSAP No. 30R—Unaffiliated Common Stock. All other warrants, including non-publicly traded stock warrants, shall be captured in scope of SSAP No. 86.

6. “Derivative Premium” is the cost to acquire or write a derivative contract. Derivative premium is not an “underlying” in a derivative contract and is not impacted by changes in an underlying interest of the derivative agreement. A derivative with contract terms that finance the derivative premium, so that the cost is paid or received throughout the derivative term or at derivative maturity, does not result with an “embedded derivative” addressed in paragraph 16.

6.7. “Firm commitment” is an agreement with an unrelated party, binding on both parties and expected to be legally enforceable, with the following characteristics:

a. The agreement specifies all significant terms, including the quantity to be exchanged, the fixed price, and the timing of the transaction. The fixed price may be expressed as a specified amount of an entity’s functional currency or of a foreign currency. It may also be expressed as a specified interest rate or specified effective yield;

b. The agreement includes a disincentive for nonperformance that is sufficiently large to make performance probable; and

c. For investments in subsidiary, controlled, and affiliated entities (as defined by SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities (SSAP No. 97)) and investments in limited liability companies (as defined by SSAP No. 48—Joint Ventures, Partnerships and Limited Liability Companies) it must be probable that acquisition will occur within a reasonable period of time.

7.8. A hedging transaction is defined as a derivative(s) transaction which is entered into and maintained to reduce:

a. The risk of a change in the fair value or cash flow of assets and liabilities which the reporting entity has acquired or incurred or has a firm commitment to acquire or incur or for which the entity has forecasted acquisition or incurrence; or

b. The currency exchange rate risk or the degree of foreign currency exposure in assets and liabilities which a reporting entity has acquired or incurred or has a firm commitment to acquire or incur or for which the entity has forecasted acquisition or incurrence.

8.9. “Income generation transaction” is defined as derivatives written or sold to generate additional income or return to the reporting entity. They include covered options, caps, and floors (e.g., a reporting entity writes an equity call option on stock that it already owns).
9.10. “Replication (Synthetic Asset) transaction” is a derivative transaction entered into in conjunction with other investments in order to reproduce the investment characteristics of otherwise permissible investments. A derivative transaction entered into by an insurer as a hedging or income generation transaction shall not be considered a replication (synthetic asset) transaction.

10.11. “Forecasted transaction” is a transaction that is expected to occur for which there is no firm commitment. Because no transaction or event has yet occurred and the transaction or event when it occurs will be at the prevailing market price, a forecasted transaction does not give an entity any present rights to future benefits or a present obligation for future sacrifices.

11.12. An "underlying" is a specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates, or other variable (including the occurrence or nonoccurrence of a specified event such as a scheduled payment under contract). An underlying may be a price or rate of an asset or liability but is not the asset or liability itself.

12.13. "Benchmark Interest Rate" is a widely recognized and quoted rate in an active financial market that is broadly indicative of the overall level of interest rates attributable to high-credit-quality obligors in that market. It is a rate that is widely used in a given financial market as an underlying basis for determining the interest rates of individual financial instruments and commonly referenced in interest-rate-related transactions. In theory, the benchmark interest rate should be a risk-free rate (that is, has no risk of default). In some markets, government borrowing rates may serve as a benchmark. In other markets, the benchmark interest rate may be an interbank offered rate. In the United States, the interest rates on direct Treasury obligations of the U.S. government, the London Interbank Offered Rate (LIBOR) swap rate, the Fed Funds Effective Rate Overnight Index Swap Rate, the Securities Industry and Financial Markets Association (SIFMA) Municipal Swap Rate, and the Secured Overnight Financing Rate (SOFR) Overnight Index Swap Rate are considered to be benchmark interest rates.

13.14. "Weather derivatives" are defined as a forward-based or option-based contract for which settlement is based on a climatic or geological variable. One example of such a variable is the occurrence or nonoccurrence of a specified amount of snow at a specified location within a specified period of time.

14.15. "Notional amount" is defined as the face value of a financial instrument in a derivatives transaction as of a reporting date which is used to calculate future payments in the reporting currency. Notional amount may also be referred to as notional value or notional principal amount. The notional amount reported should remain static over the life of a trade unless the instrument is partially unwound or has a contractually amortizing notional. The notional amount shall apply to derivative transactions as follows:

a. For derivative instruments other than futures contracts (e.g., options, swaps, forwards), the notional amount is either the amount to which interest rates are applied in order to calculate periodic payment obligations or the amount of the contract value used to determine the cash obligations. Non-U.S. dollar contracts must be multiplied or divided by the appropriate inception foreign currency rate.

b. For futures contracts, with a U.S. dollar-denominated contract size (e.g., Treasury note and bond contracts, Eurodollar futures) or underlying, the notional amount is the number of contracts at the reporting date multiplied by the contract size (value of one point multiplied by par value).

c. For equity index and similar futures, the number of contracts at the reporting date is multiplied by the value of one point multiplied by the transaction price. Non-U.S. dollar

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2 The definition in paragraph 14 is intended to be a principle for determining notional for all derivative instruments. To the extent a derivative type is not explicitly addressed in paragraph 14.a. through paragraph 14.c., notional should be reported in a manner consistent with this principle.
contract prices must be multiplied or divided by the appropriate inception foreign currency rate.

45.16. "Variation Margin" reflects the daily change in market value of derivative contracts (e.g., daily gain/loss on a derivative contract due to market movements). Amounts received/paid to adjust variation margin on derivative contracts that are both cleared and settled on an exchange shall be recognized as an adjustment to the carrying value of the derivative contract (e.g., futures). Amounts received/paid to adjust variation margin on all other derivative contracts shall be recognized on the balance sheet as an asset or liability separate from the carrying value of the derivative instrument. This treatment shall occur under statutory accounting regardless if the counterparty/exchange considers amounts exchanged for variation margin to be legal settlement or collateral. Changes in variation margin shall not be treated as realized gains or adjustments to the basis of the hedged item until the derivative contract has been sold, matured or expired.

Embedded Derivative Instruments

46.17. Contracts that do not in their entirety meet the definition of a derivative instrument, such as bonds, insurance policies, and leases, may contain "embedded" derivative instruments—implicit or explicit terms that affect some or all of the cash flows or the value of other exchanges required by the contract in a manner similar to a derivative instrument. The effect of embedding a derivative instrument in another type of contract ("the host contract") is that some or all of the cash flows or other exchanges that otherwise would be required by the contract, whether unconditional or contingent upon the occurrence of a specified event, will be modified based on one or more underlyings. An embedded derivative instrument shall not be separated from the host contract and accounted for separately as a derivative instrument.

Impairment

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

Derivative Premium (New Section – All Other Sections Renumbered Accordingly)

19. Derivative premium is the amount paid (acquired derivative) or received (written derivative) to enter into a derivative contract. At inception, the premium generally represents the fair value of the derivative. Derivative premium that is not paid or received at inception represents a liability or receivable for the reporting entity. Derivatives with premiums not remitted at acquisition are considered “financed derivatives.” Financed derivatives shall be reported in accordance with the following provisions:

a. At acquisition and subsequently, the gross reported fair value of the derivative shall exclude the impact of financing premiums. Only market changes in the actual fair value of the derivative shall be reflected as unrealized gains or losses.

b. At acquisition and subsequently, premiums payable (acquired derivative) and premiums receivable (written derivatives) shall be separately reported as “payable for securities” and “receivables for securities.”

c. If premium payable or receivable meet the requirement for a valid right of setoff with the derivative in accordance with SSAP No. 64, the derivative asset can be reduced by a premium payable, and a derivative liability can be reduced by a premium receivable for overall reporting on the balance sheet. This offset provision does not permit a derivative asset to be reported as a derivative liability (or vice versa) due to premium payable or receivable. Rather, once a derivative asset (or liability) is fully reduced by a premium

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1 This paragraph does not include derivative premium financing arrangements. Derivatives and financed premiums are subject to separate reporting as detailed in paragraph 19.
liability (or receivable), any remaining premium liability (or receivable) shall be reported as a “payable for security” or “receivable for security” pursuant to paragraph 19.b. This net balance sheet reporting does not impact the gross presentation of open derivatives on Schedule DB-A or Schedule DB-B. If reported net on the balance sheet due to a valid right to offset, the offsetting adjustment shall be shown on schedule DB-D and the SSAP No. 64 disclosures are required.

Recognition and Measurement of Derivatives Used in Hedging Transactions

48.20. Derivative instruments represent rights or obligations that meet the definitions of assets (SSAP No. 4—Assets and Nonadmitted Assets) or liabilities (SSAP No. 5R) and shall be reported in financial statements. In addition, derivative instruments also meet the definition of financial instruments as defined in SSAP No. 27—Off-Balance-Sheet and Credit Risk Disclosures (SSAP No. 27). Should the cost basis of the derivative instrument be undefined (i.e., no premium is paid), the instrument shall be disclosed in accordance with paragraphs 44-47 of SSAP No. 100—Fair Value (SSAP No. 100). Derivative instruments are admitted assets to the extent they conform to the requirements of this statement.

19.21. 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).

Staff Note: Paragraphs 22-38 not duplicated.

Documentation Guidance

39. 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. 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 38 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

4 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.
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.

Staff Note: Paragraphs 40-58 not duplicated.

Disclosure Requirements

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

h. For derivative contracts with financing premiums:

i. Disclose the aggregate, non-discounted total premium cost for these contracts and the premium cost due in each of the following four years, and thereafter. Also disclose include the aggregate fair value of derivative instruments with financing premiums excluding the impact of the impact of the deferred or financing premiums.

ii. For each derivative contract with financing premiums:

(a) Whether premium cost is paid throughout the contract, or at derivative maturity;
(b) Next premium cost payment date;
(c) Total premium cost;
(d) Premium cost paid in prior years;
(e) Current year premium cost paid;
(f) Future unpaid premium cost;

(g) Fair value of derivative, excluding impact of financing premiums; and

(h) Unrealized gain/loss, excluding impact of financing premiums.

Staff Note: With the proposed revisions to clarify gross reporting without financing premiums, these disclosures will not be considered necessary. Comments are requested whether it would be beneficial to retain these columns and capture the fair value of the derivative with the impact of financing premiums.

i. All derivatives are required to be shown gross on Schedule DB. However, derivatives may be reported net in the financial statements (pages 2 and 3 of the statutory financial statements) in accordance with SSAP No. 64—Offsetting and Netting of Assets and Liabilities when a valid right to offset exists. Derivatives offset in accordance with SSAP No. 64 and reported net in the financial statement shall follow the disclosure requirements in SSAP No. 64, paragraph 6. (Derivative Assets and Derivative Liabilities reported on the balance sheet shall agree to columns 5 and 6, respectively, after netting, on Schedule DB – Part D – Section 1.)
**Proposed Revisions to Schedule DB-D – Counterparty Exposure**

As detailed in this agenda item, NAIC staff suggests consideration on whether premiums due to / from a counterparty should be used in determining the net derivative exposure. This approach would allow the clarifications for gross reporting (excluding financing derivatives) to not impact a life insurer’s RBC calculation for derivative activity as the financing premiums owed by the reporting entity would be considered similar to collateral received.

Below is a simplified version of Schedule DB-D with the potential column.

<table>
<thead>
<tr>
<th>1</th>
<th>2</th>
<th>4</th>
<th>New Column</th>
<th>5</th>
<th>6</th>
<th>7</th>
</tr>
</thead>
<tbody>
<tr>
<td>Description of Exchange, Counterparty or Central Clearinghouse</td>
<td>Master Agreement (Y / N)</td>
<td>Fair Value of Acceptable Collateral</td>
<td>Present Value of Financing Premiums</td>
<td>Contracts with BACV &gt; 0</td>
<td>Contracts with BACV &lt; 0</td>
<td>Exposure Net of Collateral</td>
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<td>Gross Totals</td>
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<td>Offset Per SSAP No. 64</td>
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<td>Net After Right to Offset</td>
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</table>

If this column was added, and the derivatives reported in column 5 and 6 were gross of financing premiums, the amount reported in column 7 would be determined as follows:

- **Column 7** – Exposure Net of Collateral (Book/Adjusted Carrying Value)

  For the aggregate reporting of Exchange-Traded Derivatives (Line 0199999999), show the amount in Column 5.

  For OTC counterparties, if no master agreement is in place, show the sum of the Book/Adjusted Carrying Values of all derivative instruments with the counterparty that has a positive Book/Adjusted Carrying Value, less any Acceptable Collateral and the Present Value of Financing Premiums (Column 5 – Column 4 – New Column).

  For OTC counterparties with a master agreement in place and central clearinghouses, show the net sum of the Book/Adjusted Carrying Values of all derivative instruments, less any acceptable collateral and the present value of financing premiums (Column 5 + Column 6 – Column 4 – New Column).

  This amount should not be less than zero.

For life insurance entities, the positive amount reported in column 7 is then accessed RBC based on the NAIC designation of the counterparty. When reporting the gross fair value of derivatives with capturing the financing premiums, the premiums due from or owed to the counterparty is factored into the calculation to reflect net counterparty exposure. This reporting will not impact P/C or Health entities (regardless if they engage in financing derivatives), as their RBC is based on derivative assets as reported on the balance sheet.
Statutory Accounting Principles (E) Working Group
Maintenance Agenda Submission Form
Form A

Issue: Acceptable Collateral - Counterparty Exposure for Derivative Instruments.

Check (applicable entity):

<table>
<thead>
<tr>
<th>Modification of Existing SSAP</th>
<th>P/C</th>
<th>Life</th>
<th>Health</th>
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</thead>
<tbody>
<tr>
<td>New Issue or SSAP</td>
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<tr>
<td>Interpretation</td>
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Summary of Issue:
Potential misinterpretation for Blank instructions on Schedule DB-D, section 1, column 4 (Fair Value of Acceptable Collateral) exist as collateral is reported as 1) the fair value of collateral pledged by a counterparty, or 2) for central clearinghouses as the net positive variation margin received by the reporting entity.

NAIC staff believes the intent of net positive variation margin was originally meant to reflect net realizable margin. For example, if a reporting entity originally paid $5k as collateral to initiate a position, then subsequently received $15k in variation margin true-up, the reporting entity should report $10k in the fair value of acceptable collateral (assuming the counterparty has the legal right to offset the original $5k received). With the legal right to offset, in this example the holder can only realize a net $10k in collateral if liquidation were to occur. As the instructions indicate “net positive variation margin,” the variation collateral of $15k could be reported, disregarding the $5k initial margin.

Conversely, had the reporting entity received $5k in initial margin, and a subsequent $20k in variation margin, a total of $25k should be reported as collateral, thus giving credit for the initial margin received. NAIC staff believe this intent is articulated in SSAP No. 86, as collateral is defined in the disclosures as “net assets held.”

This agenda item included proposed clarification language that states collateral shall be determined by the summation of any assets held less any collateral paid/pledged from collateral received, if the counterparty has a legal right to offset as defined in SSAP No. 64.

Further Background:
Schedule DB – Part D, Section 1 of the Blanks facilitates reporting of counterparty exposure from open derivative instruments. As described in the Blanks instructions, counterparty exposure is credit risk associated with certain types of transactions; in relation to schedule DB, it is the credit risk associated with the use of derivative instruments. Schedule DB-D, Section 1 displays the book/adjusted carrying value and the fair value of counterparty exposure, net of acceptable collateral held by or pledged to the reporting entity. Due to the nature of risk being calculated and displayed net of collateral, this Form A is to facilitate a discussion regarding the technical definition regarding determination of value as it relates to collateral.

In 2012, the Blanks (E) Working Group adopted modifications to numerous derivative statements and related instructions. These updates were driven by differing clearing and collateral requirements for certain types of derivative investments as well as the need to ensure consistent and accurate reporting of derivative investment activity of insurers.

Various concepts were introduced including Schedule DB – Part D, Section 2, which captures detailed collateral information for open derivative instruments. Collateral held or received through a pledge typically covers some or all of the credit risk the holder possesses due to transactions exchanged with a counterparty. In terms of derivative contracts, collateral may be pledged to exchanges, counterparties, clearing brokers or central clearinghouses by the reporting entity or pledged from these organizations to the reporting entity. While the specific items that are
considered acceptable collateral are detailed herein, a common term for collateral is “margin.” There are typically three types of margin that apply to these financial instruments, broadly defined as:

- Initial Margin - the minimum amount of equity that must be held/pledged to initiate a position.
- Maintenance Margin - the minimum amount of equity that must be maintained in order to not have the position forcibly liquidated. Also defined as the net sum of initial and variation margin.
- Variation Margin - payments generally made based on adverse price movements, often paid by clearing members to reduce exposures created by open derivative positions. Variation margin could also be as a result of changes in maintenance margin requirements. The term Variation Margin for statutory purposes is defined below.

In the normal course of business, all applicable cashflows are typically utilized in the reporting of an activity. In the instance of margin, initial margin plus/minus variation margin equals total margin. Remaining within SSAP No. 86—Derivatives, there are many instances that demonstrate this principal. As described for the initial carrying value of a futures contact (reported as an asset), paraphrased guidance states that positions should be valued at the initial amount of cash deposits plus/minus any subsequent cash flows. Additionally, options, warrants, caps, and floors are initially valued at total premium paid or received. While subsequent valuations may differ (amortized cost or fair value depending on the reporting of the item being hedged), all associated cash flows were utilized for reporting.

Existing Authoritative Literature:
While described in general terms above, statutory accounting guidance for variation margin is as follows:

SSAP No. 86 – Derivatives
15. “Variation Margin” reflects the daily change in market value of derivative contracts (e.g., daily gain/loss on a derivative contract due to market movements). Amounts received/paid to adjust variation margin on derivative contracts that are both cleared and settled on an exchange shall be recognized as an adjustment to the carrying value of the derivative contract (e.g., futures). Amounts received/paid to adjust variation margin on all other derivative contracts shall be recognized on the balance sheet as an asset or liability separate from the carrying value of the derivative instrument. This treatment shall occur under statutory accounting regardless if the counterparty/exchange considers amounts exchanged for variation margin to be legal settlement or collateral. Changes in variation margin shall not be treated as realized gains or adjustments to the basis of the hedged item until the derivative contract has been sold, matured or expired.

Blanks instructions regarding the reporting of acceptable collateral, as it relates to counterparty exposures from open derivative investments, is as follows:

Schedule DB – Part D – Section 1, Column 4 (Fair Value of Acceptable Collateral)

- Fair Value of Acceptable Collateral
- Leave blank for the aggregate reporting of Exchange-Traded Derivatives (Line 0199999999).
- For OTC counterparties, show the Fair Value of acceptable collateral pledged by the counterparty.
- For central clearinghouses, this amount would be the net positive variation margin received by the reporting entity.

“Acceptable collateral” means cash, cash equivalents, securities issued or guaranteed by the United States or Canadian governments or their government-sponsored enterprises, letters of credit, publicly traded obligations designated 1 by the SVO, government money market mutual funds, and such other items as may be defined as acceptable collateral in the Purposes and Procedures Manual of the NAIC Investment Analysis Office. For purposes of this definition, the term “letter of credit” means a clean, irrevocable and unconditional letter of credit issued or confirmed by, and payable and presentable at, a financial institution on the list of financial institutions meeting the standards for issuing such letter of credit...
SSAP No. 86 defines several disclosure items related to collateral. The primary intent of such disclosures is to reflect amounts available to cover exposure in the event the liquidation of collateral assets occurs. Key areas are highlighted herein.

**Disclosure Requirements**

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

  e. A seller of credit derivatives shall disclose information about its credit derivatives and hybrid instruments that have embedded credit derivatives to enable users of financial statements to assess their potential effect on its financial position, income and cash flows. The seller of a credit derivative shall disclose the following information for each credit derivative, or each group of credit derivatives, even if the likelihood of the seller’s having to make any payments under the credit derivative is remote. With respect to hybrid instruments that have embedded credit derivatives, the seller of the embedded credit derivative shall disclose the required information for the entire hybrid instrument, not just the embedded credit derivative.

  i. The nature of the credit derivative, including the approximate term of the credit derivative, the reason(s) for entering into the credit derivative, the events or circumstances that would require the seller to perform under the credit derivative, and the current status (that is, as of the date of the statement of financial position) of the payment/performance risk of the credit derivative. For example, the current status of the payment/performance risk of a credit derivative could be based on either recently issued external credit ratings or current internal groupings used by the seller to manage its risk. An entity that uses internal groupings shall disclose how those groupings are determined and used for managing risk.

  ii. The maximum potential amount of future payments (undiscounted) the seller could be required to make under the credit derivative. That maximum potential amount of future payments shall not be reduced by the effect of any amounts that may possibly be recovered under recourse or collateralization provisions in the credit derivative (which are addressed under paragraph 59.e.iv.). If the terms of the credit derivative provide for no limitation to the maximum potential future payments under the contract, that fact shall be disclosed. If the seller is unable to develop an estimate of the maximum potential amount of future payments under the credit derivative, the seller shall disclose the reasons why it cannot estimate the maximum potential amount.

  iii. The fair value of the credit derivative as of the date of the statement of financial position.

  iv. The nature of (1) any recourse provisions that would enable the seller to recover from third parties any of the amounts paid under the credit derivative and (2) any assets held either as collateral or by third parties that, upon the occurrence of any specified triggering event or condition under the credit derivative, the seller can obtain and liquidate to recover all or a portion of the amounts paid under the credit derivative. The seller shall indicate, if estimable, the approximate extent to which the proceeds from liquidation of those assets would be expected to cover the maximum potential amount of future payments under the credit derivative. In its estimate of potential recoveries, the seller of credit protection shall consider the effect of any purchased credit protection with identical underlying(s).

  f. A holder of a financial instrument with an embedded credit derivative that exposes the holder to the possibility (however remote) of being required to make future payments (not merely receive reduced cash inflows) because the possibility of those future payments is not caused by subordination (such as the subordination of one beneficial interest to another tranche of a securitization, thereby redistributing credit risk) shall provide the following disclosures for the entire hybrid instrument, not just the embedded credit derivative:
i. The nature of the embedded credit derivative, including the approximate term of the embedded credit derivative, the events or circumstances that would require the holder to perform under the embedded credit derivative, and the current status (that is, as of the date of the statement of financial position) of the payment/performance risk of the embedded credit derivative.

ii. The maximum potential amount of future payments (undiscounted) the holder could be required to make under the embedded credit derivative. That maximum potential amount of future payments shall not be reduced by the effect of any amounts that may possibly be recovered under recourse or collateralization provisions in the embedded credit derivative (which are addressed under paragraph 59.f.iv.). If the terms of the embedded credit derivative provide for no limitation to the maximum potential future payments under the contract, that fact shall be disclosed. If the holder is unable to develop an estimate of the maximum potential amount of future payments under the embedded credit derivative, the holder shall disclose the reasons why it cannot estimate the maximum potential amount.

iii. The fair value of the hybrid instrument containing the embedded credit derivative as of the date of the statement of financial position.

iv. The nature of (1) any recourse provisions that would enable the holder to recover from third parties any of the amounts paid under the embedded credit derivative and (2) any assets held either as collateral or by third parties that, upon the occurrence of any specified triggering event or condition under the embedded credit derivative, the holder can obtain and liquidate to recover all or a portion of the amounts paid under the credit derivative. The holder shall indicate, if estimable, the approximate extent to which the proceeds from liquidation of those assets would be expected to cover the maximum potential amount of future payments under the embedded credit derivative. In its estimate of potential recoveries, the holder of credit protection shall consider the effect of any purchased credit protection with identical underlying(s).

Activity to Date (issues previously addressed by the Working Group, Emerging Accounting Issues (E) Working Group, SEC, FASB, other State Departments of Insurance or other NAIC groups): None

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

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

Staff Recommendation:
NAIC staff recommends that the Working Group move this item to the active listing, categorized as nonsubstantive and expose revisions to SSAP No. 86 to clarify that the fair value of collateral received or held, for derivative disclosure purposes, shall be reported net of collateral paid/pledged, in the event a counterparty has the legal right to offset against as defined in SSAP No. 64. Further, minor updates to applicable annual statement instructions are proposed to be concurrently exposed.

Disclosure Requirements
60. Reporting entities shall disclose the following for all derivative contracts used:

e. A seller of credit derivatives shall disclose information about its credit derivatives and hybrid instruments that have embedded credit derivatives to enable users of financial statements to assess their potential effect on its financial position, income and cash flows.

A seller of credit derivatives shall disclose information about its credit derivatives and hybrid instruments that have embedded credit derivatives to enable users of financial statements to assess their potential effect on its financial position, income and cash flows. The seller of a credit derivative shall disclose the following
information for each credit derivative, or each group of credit derivatives, even if the likelihood of the seller’s having to make any payments under the credit derivative is remote. With respect to hybrid instruments that have embedded credit derivatives, the seller of the embedded credit derivative shall disclose the required information for the entire hybrid instrument, not just the embedded credit derivative.

i. The nature of the credit derivative, including the approximate term of the credit derivative, the reason(s) for entering into the credit derivative, the events or circumstances that would require the seller to perform under the credit derivative, and the current status (that is, as of the date of the statement of financial position) of the payment/performance risk of the credit derivative. For example, the current status of the payment/performance risk of a credit derivative could be based on either recently issued external credit ratings or current internal groupings used by the seller to manage its risk. An entity that uses internal groupings shall disclose how those groupings are determined and used for managing risk.

ii. The maximum potential amount of future payments (undiscounted) the seller could be required to make under the credit derivative. That maximum potential amount of future payments shall not be reduced by the effect of any amounts that may possibly be recovered under recourse or collateralization provisions in the credit derivative (which are addressed under paragraph 59.e.iv.). If the terms of the credit derivative provide for no limitation to the maximum potential future payments under the contract, that fact shall be disclosed. If the seller is unable to develop an estimate of the maximum potential amount of future payments under the credit derivative, the seller shall disclose the reasons why it cannot estimate the maximum potential amount.

iii. The fair value of the credit derivative as of the date of the statement of financial position.

iv. The nature of (1) any recourse provisions that would enable the seller to recover from third parties any of the amounts paid under the credit derivative and (2) any assets held either as collateral, or by third parties that, upon the occurrence of any specified triggering event or condition under the credit derivative, the seller can obtain and liquidate to recover all or a portion of the amounts paid under the credit derivative. The seller shall indicate, if estimable, the approximate extent to which the proceeds from liquidation of those assets would be expected to cover the maximum potential amount of future payments under the credit derivative. In its estimate of potential recoveries, the seller of credit protection shall consider the effect of any purchased credit protection with identical underlying(s).

f. A holder of a financial instrument with an embedded credit derivative that exposes the holder to the possibility (however remote) of being required to make future payments (not merely receive reduced cash inflows) because the possibility of those future payments is not caused by subordination (such as the subordination of one beneficial interest to another tranche of a securitization, thereby redistributing credit risk) shall provide the following disclosures for the entire hybrid instrument, not just the embedded credit derivative:

i. The nature of the embedded credit derivative, including the approximate term of the embedded credit derivative, the events or circumstances that would require the holder to perform under the embedded credit derivative, and the current status (that is, as of the date of the statement of financial position) of the payment/performance risk of the embedded credit derivative.

ii. The maximum potential amount of future payments (undiscounted) the holder could be required to make under the embedded credit derivative. That maximum potential amount of future payments shall not be reduced by the effect of any amounts that may possibly be recovered under recourse or collateralization provisions in the embedded credit derivative.

1 Collateral, as calculated on an individual derivative instrument basis, shall be determined by deducting collateral paid/pledged from collateral received if the counterparty has a legal right to offset as defined in SSAP No. 64.
(which are addressed under paragraph 59.f.iv.). If the terms of the embedded credit derivative provide for no limitation to the maximum potential future payments under the contract, that fact shall be disclosed. If the holder is unable to develop an estimate of the maximum potential amount of future payments under the embedded credit derivative, the holder shall disclose the reasons why it cannot estimate the maximum potential amount.

iii. The fair value of the hybrid instrument containing the embedded credit derivative as of the date of the statement of financial position.

iv. The nature of (1) any recourse provisions that would enable the holder to recover from third parties any of the amounts paid under the embedded credit derivative and (2) any assets held either as collateral or by third parties that, upon the occurrence of any specified triggering event or condition under the embedded credit derivative, the holder can obtain and liquidate to recover all or a portion of the amounts paid under the credit derivative. The holder shall indicate, if estimable, the approximate extent to which the proceeds from liquidation of those assets would be expected to cover the maximum potential amount of future payments under the embedded credit derivative. In its estimate of potential recoveries, the holder of credit protection shall consider the effect of any purchased credit protection with identical underlying(s).

Proposed Blank Instructions Updates – Schedule DB-B, Section 1, Column 4

Fair Value of Acceptable Collateral

Leave blank for the aggregate reporting of Exchange-Traded Derivatives (Line 0199999999).

For OTC counterparties, show the Fair Value of acceptable net collateral pledged by the counterparty.

For central clearinghouses, this amount would be the total net positive variation margin received by the reporting entity.

Staff Review Completed by: Jim Pinegar, October 2019

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2 See footnote 1.
Statutory Accounting Principles (E) Working Group
Maintenance Agenda Submission Form
Form A

Issue: Reporting of Installment Fees and Expenses

Check (applicable entity):

<table>
<thead>
<tr>
<th>Modification of existing SSAP</th>
<th>P/C</th>
<th>Life</th>
<th>Health</th>
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<tr>
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<td>Interpretation</td>
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Description of Issue:
NAIC staff has recently received questions regarding whether certain fees shall be reported as policy premium. SSAP No. 53—Property Casualty Contracts—Premiums, paragraph 6, provides specific guidance that allows for installment fees that meet specified criteria to be excluded from premium and reported as other income. An installment fee is the amount the policyholder pays if they make the choice to pay their premium on an installment basis. This fee is allowed to be excluded from premium income if it is an avoidable amount by the policyholder and the policy would not be cancelled for nonpayment of the installment fee.

NAIC staff has received regulator requested clarifications regarding potential diversity in the application of the SSAP No. 53 installment fee guidance on the following issues:

1. The first issue recommends additional language to ensure that the installment fee guidance continues to be narrowly applied, because the regulator became aware of some reporting entities seeking to analogize the application of the installment fee guidance to exclude other fees from premium income. Given the historical discussion on this paragraph, NAIC staff notes that the installment fee guidance is intended to be applied narrowly to a specific instance described in SSAP No. 53, footnote 1 and it should not be used to exclude other fees from being reported as premium.

2. The second issue pertains to the reporting of expenses related to the installment fee (other revenue). The regulator noted that while reporting entities were reporting the installment fees in other income, there was diversity in practice for the related installment fee expenses. Most entities were reporting the installment fee expenses in underwriting expenses where there are clear reporting lines for such expenses in the underwriting exhibits. Other entities were reporting the installment fee expenses either as a contra amount to finance and service charges not included in premium or as a contra amount to “aggregate write-ins for miscellaneous income.” The amounts are being reported as “contra” to other income because there is not an explicit reporting line in the property and casualty statement of income for expenses not related to underwriting (See Authoritative Literature). This agenda item requests feedback to address potential diversity in reporting.

Note that SSAP No. 35R—Guaranty Fund and Other Assessments also provides guidance regarding when a reporting entity is acting as an agent on behalf of a state or federal agency. This guidance is different than the installment fee guidance under discussion.

Existing Authoritative Literature:

SSAP No. 53—Property Casualty Contracts—Premiums (bolding added for emphasis)

3. Except as provided for in paragraph 4, written premium is defined as the contractually determined amount charged by the reporting entity to the policyholder for the effective period of the contract based on the expectation of risk, policy benefits, and expenses associated with the coverage provided by the terms of the insurance contract. Frequently, insurance contracts are subject to audit by the reporting entity and the amount of premium charged is subject to adjustment based on the actual exposure. Premium adjustments are discussed in paragraphs 10-13 of this statement.
4. For workers' compensation contracts, which have a premium that may periodically vary based upon changes in the activities of the insured, written premiums may be recorded on an installment basis to match the billing to the policyholder. Under this type of arrangement, the premium is determined and billed according to the frequency stated in the contract, and written premium is recorded on the basis of that frequency.

5. Premiums for prepaid legal expense plans shall be recognized as income on the gross basis (amount charged to the policyholder or subscriber exclusive of copayments or other charges) when due from policyholders or subscribers, but no earlier than the effective date of coverage, under the terms of the contract. Due and uncollected premiums shall follow the guidance in SSAP No. 6—Uncollected Premium Balances, Bills Receivable for Premiums, and Amounts Due From Agents and Brokers (SSAP No. 6), to determine the admissibility of premiums and related receivables.

6. Written premiums for all other contracts shall be recorded as of the effective date of the contract. Upon recording written premium, a liability, the unearned premium reserve, shall be established to reflect the amount of premium for the portion of the insurance coverage that has not yet expired. Flat fee service charges on installment premiums1 (fees charged to policyholders who pay premiums on an installment basis rather than in full at inception of contract) are reported in the Other Income section of the Underwriting and Investment Exhibit as Finance and Service Charges. Flat fee service charges on installment premiums, which do not meet the requirements outlined in footnote 1 (e.g., policy may be cancelled for non-payment of fee or fee is refundable), shall be recorded as written premium on the effective date of the contract and subject to the unearned premium guidelines included in paragraph 8.

Footnote: 1 If the policyholder elects to pay an installment rather than the full amount or the full remaining balance, the policyholder is traditionally charged a flat fee service charge on the subsequent billing cycle(s). The amount charged is primarily intended to compensate the insurer for the additional administrative costs associated with processing more frequent billings and has no relationship to the amount of insurance coverage provided, the period of coverage, or the lost investment income associated with receiving the premium over a period of time rather than in a lump sum. As described, there is no underwriting risk associated with this service charge. If a policyholder does not pay the service charge, the policy is not cancelled (unlike non-payment of premium), but instead the policy is converted back to an annual pay plan. If a policyholder cancels coverage, the premium is returned but the service charge is not, as the service charge is not a part of premium. Clarification of finance and service charges as other income should not be construed as having any bearing on whether such charges are subject to premium taxation, which remains an issue of state law and regulation.

SSAP No. 35R—Guaranty Fund and Other Assessments

Acting as an Agent for Collection and Remittance of Fees and Assessments

15. In certain circumstances, a reporting entity acts as an agent for certain state or federal agencies in the collection and remittance of fees or assessments. In these circumstances, the liability for the fees and assessments rests with the policyholder rather than with the reporting entity. The reporting entity’s obligation is to collect and subsequently remit the fee or assessment.(INT 02-22) When both the following conditions are met, an assessment shall not be reported in the statement of operations of a reporting entity:

a. The assessment is reflected as a separately identifiable item on the billing to the policyholder; and

b. Remittance of the assessment by the reporting entity to the state or federal agency is contingent upon collection from the insured.

16. The impact to the statement of operations depends on the nature of the charge:
a. For charges which are the ultimate responsibility of the policyholder, follow existing guidance in paragraph 15, and pass these charges and recoveries through the balance sheet with no impact to the statement of operations.

b. For charges which are the ultimate responsibility of the reporting entity and may be recovered all or in part, apply gross or net reporting in the statement of operations as appropriate based on the nature of the charge and recovery. For example, charges which are considered in rate development or for which the recovery is classified as premium should be reported gross, charges for which recovery is considered a reduction of the expense should be reported net.

c. For collection or administrative fees, report such fees as revenue in the statement of operations as "Finance and Service Charges Not Included in Premiums" or "Aggregate Write-Ins for Miscellaneous Income".

**SSAP No. 71—Policy Acquisition Costs**

2. Acquisition costs are those costs that are incurred in the acquisition of new and renewal insurance contracts and include those costs that vary with and are primarily related to the acquisition of insurance contracts (e.g., agent and broker commissions, certain underwriting and policy issue costs, and medical and inspection fees). Acquisition costs and commissions shall be expensed as incurred. Determination of when acquisition costs and commissions have been incurred shall be made in accordance with SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets.

**Property/Casualty Annual Statement Instructions**

**Statement of Income**

Line 13 – Finance and Service Charges Not Included in Premiums

Report finances and service charges pursuant to the recognition guidance in SSAP No. 53—Property Casualty Contracts—Premiums. If a company cedes 100% of its business to an affiliate or utilizes an intercompany pooling arrangement and pools finance and service charges, include intercompany assumed and ceded amounts (i.e., report such income net of intercompany pooling). Charges should also be reported on Schedule T by jurisdiction.

**Schedule T EXHIBIT OF PREMIUMS WRITTEN ALLOCATED BY STATES & TERRITORIES**

Column 8 – Finance and Service Charges Not Included in Premiums

Report finance and service charges on direct business pursuant to the recognition guidance in SSAP No. 53—Property Casualty Contracts—Premiums. If a company cedes 100% of its business to an pooling arrangement and pools such charges, exclude the intercompany assumed and ceded amount incorporated in Page 4, Line 13.

**APPENDIX**

**PROPERTY AND CASUALTY LINES OF BUSINESS**

These definitions should be applied when reporting all applicable amounts for the following schedules: Underwriting and Investment Exhibit Parts 1, 1A, 1B, 2, and 2A; Exhibit of Premiums and Losses (Statutory Page 14); and the Insurance Expense Exhibit. Policy fees, service charges or membership charges are to be included with the line of business or in Other Income, as determined by SSAP No. 53—Property Casualty Contracts—Premiums.
Staff Recommendation:
NAIC staff recommends that the Working Group move this item to the active listing, categorized as nonsubstantive, and expose proposed revisions to SSAP No. 53 and request comments as detailed below. In addition, it is recommended that the Working Group request comments on reporting installment fee expenses as detailed below.

1. Installment fee and services charges guidance should be applied narrowly to the specific situation described and not analogized to exclude other fees from written premium.

2. Request comments on incurred installment fee expenses and notify the Casualty Actuarial (C) Task Force and the Property and Casualty Risk Based Capital (E) Working Group of the exposure, particularly regarding installment fee expenses.

Detailed Recommendations:

Issue 1 – The installment fee and services charges guidance in SSAP No. 53—Property Casualty Contracts—Premiums, paragraph 6, footnote 1, for evaluating flat fee service charges on installment premiums, should be applied narrowly to the specific situation described and not analogized to exclude other fees from written premium.

Prior Working Group revisions (in agenda item 2001-34) to footnote 1 in SSAP No. 53 illustrate that the installment premium processing fee guidance is meant to be interpreted narrowly and that the payment in full or by installment

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### STATEMENT OF INCOME

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<tr>
<th>Description of Issue</th>
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<td>Underwriting income</td>
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<td>Investment income</td>
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<tr>
<td>Other income</td>
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#### UNDERWRITING INCOME

1. Premiums earned (Part 1, Line 35, Column 4)
2. Losses incurred (Part 2, Line 35, Column 7)
3. Loss adjustment expenses incurred (Part 3, Line 25, Column 1)
4. Other underwriting expenses incurred (Part 3, Line 25, Column 2)
5. Aggregate write-ins for underwriting deductions
6. Total underwriting deductions (Lines 2 through 5)
7. Net income of protected cells
8. Net underwriting gain (loss) (Line 1 minus Line 6 plus Line 7)

#### INVESTMENT INCOME

9. Net investment income earned (Exhibit of Net Investment Income, Line 17)
10. Net realized capital gains (losses) less capital gains tax of $……… (Exhibit of Capital Gains (Losses))
11. Net investment gain (loss) (Lines 9 + 10)

#### OTHER INCOME

12. Net gain (loss) from agents' or premium balances charged off
13. Finance and service charges not included in premiums
14. Aggregate write-ins for miscellaneous income
15. Total other income (Lines 12 through 14)
16. Net income before dividends to policyholders, after capital gains tax and before all other federal and foreign income taxes (Lines 8+11+15)
17. Dividends to policyholders
18. Net income, after dividends to policyholders, after capital gains tax and before all other federal and foreign income taxes (Line 16 minus Line 17)
19. Federal and foreign income taxes incurred
20. Net income (Line 18 minus Line 19) (to Line 22)
is a choice by the policyholder and represents an avoidable amount. The criteria is intentionally narrow and specific to installment fees. It is incorrect to apply this guidance to other fees. **Key underlying points to this response are:**

**Reporting** - All insurance reporting entities bear the cost of issuing a policy, issuing endorsements, and cancelling or reinstating policies whether that is accomplished directly or indirectly through an outside party. SSAP No. 71 provides that policy acquisition costs are expensed as incurred. Costs of issuing and servicing a policy are part of underwriting expenses therefore most “fees” are not intended to be excluded from premium.

**Premium tax** - NAIC staff notes that classifying amounts collected from policyholders by agents / managing general agents or third-party administrators as fees, which are excluded from written or earned premium, is an issue that many jurisdictions are familiar with as an attempt to avoid paying premium taxes. In addition, SSAP No. 53, paragraph 6, footnote 1 provides that “Clarification of finance and service charges as other income should not be construed as having any bearing on whether such charges are subject to premium taxation, which remains an issue of state law and regulation.”

**Risk Based Capital** - The classification of amounts out of premium revenue and into other income and other expense instead of underwriting expenses changes the risk-based capital charges for insurance risk. The RBC charge on insurance risk is based on the loss / loss adjustment expense ratio and the combined ratio which includes underwriting expenses.

### Issue 2 – Should incurred installment fee expenses be reported in other expenses?

- SSAP No. 53 allows for installment fee income that meets specified criteria to be excluded from premium and reported as other income with finance and service charges, however it does not separately address the related installment fee expenses incurred by the reporting entity.
- The annual statement instructions provide that the expenses that are most commonly associated with installment expense such as postage printing and stationery are reported in underwriting expenses. These expenses and their related revenue are typically immaterial for most property and casualty products but are material for some nonstandard product writers. Having a mismatch between underwriting revenue / underwriting expenses and other revenue / other expenses can affect a reporting entity’s combined ratio as the combined ratio considers the losses, loss adjusting expenses and underwriting expenses.
- From a purely conceptual basis, it might be more consistent if the installment fee expenses are reported in other expenses. This is because it is a theoretical mismatch in the annual statement to report the installment fees in other revenue and have the related expenses in underwriting expenses. While this might be better theoretical match to have both the revenue and expense in the same category, NAIC staff notes that not having “other expenses” in the property and casualty income statement seems to be an intentional choice as there are no “other expense” reporting lines. Therefore an “other expense” would have to be reported as a contra revenue.
- If incurred installment fee expenses were to be reported in other expenses, a reporting location would need to be determined as there is not an annual statement line to accommodate such reporting. If it was reported, it would most likely have to be reported as a contra amount in “Aggregate Write-Ins for Miscellaneous Income” (not in underwriting expenses) as netting it in Finance and service charges would not provide transparency. Further, if reported, limitations would need to be determined – i.e. expenses not to exceed installment fee revenue.

### Questions for exposure:

a. Should the Working Group develop guidance to allow installment fee expenses associated with fees that are reported in other income according to the criteria in SSAP No. 53 be permitted reported in or as an expense in “Other Income?”

b. If included in Other Income, should the expense be classified as a contra revenue in or “Aggregate Write-Ins for Miscellaneous Income”?
c. Installment fees and expenses are often immaterial for property and casualty except for nonstandard writers. Comments are also requested on allowing diversity in reporting installment fee expenses (that is optional to report as other expense category of contra other revenue Aggregate Write-Ins for Miscellaneous Income”, particularly for immaterial amounts.

Ultimately adoption of any such guidance would also require updates to the existing annual statement instructions.

**NAIC staff recommends that the Working Group expose the following revisions to the existing footnote in SSAP No. 53:**

6. Written premiums for all other contracts shall be recorded as of the effective date of the contract. Upon recording written premium, a liability, the unearned premium reserve, shall be established to reflect the amount of premium for the portion of the insurance coverage that has not yet expired. Flat fee service charges on installment premiums (fees charged to policyholders who pay premiums on an installment basis rather than in full at inception of contract) are reported in the Other Income section of the Underwriting and Investment Exhibit as Finance and Service Charges. Flat fee service charges on installment premiums, which do not meet the requirements outlined in *footnote 1* (e.g., policy may be cancelled for non-payment of fee or fee is refundable), shall be recorded as written premium on the effective date of the contract and subject to the unearned premium guidelines included in paragraph 8.

1 If the policyholder elects to pay an installment rather than the full amount or the full remaining balance, the policyholder is traditionally charged a flat fee service charge on the subsequent billing cycle(s). The amount charged is primarily intended to compensate the insurer for the additional administrative costs associated with processing more frequent billings and has no relationship to the amount of insurance coverage provided, the period of coverage, or the lost investment income associated with receiving the premium over a period of time rather than in a lump sum. As described, there is no underwriting risk associated with this service charge. If a policyholder does not pay the service charge, the policy is not cancelled (unlike non-payment of premium), but instead the policy is converted back to an annual pay plan. If a policyholder cancels coverage, the premium is returned but the service charge is not, as the service charge is not a part of premium. **Note that this footnote on flat fee service charges on installment premium is intentionally narrow and specific and this guidance should not be applied to other fees or service charges.** Clarification reporting of installment fees in of finance and service charges as other income should not be construed as having any bearing on whether such charges are subject to premium taxation, which remains an issue of state law and regulation.

**Staff Review Completed by:**
Robin Marcotte
October 2019
Statutory Accounting Principles (E) Working Group
Maintenance Agenda Submission Form
Form A

**Issue:** Eliminating Financial Modeling Process

**Check (applicable entity):**

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<th>P/C</th>
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<th>Health</th>
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<td>New Issue or SSAP Interpretation</td>
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**Description of Issue:** In coordination with a Valuation of Securities (E) Task Force and the Blanks (E) Working Group, this agenda item proposes elimination of the multi-step modeling process (i.e. incorporating breakpoints) to determine final NAIC designations on RMBS and CMBS securities.

Current guidance allows the amortized cost basis to be used in determining the “final” NAIC designation for statutory accounting and reporting - including the assessment of AVR and for risk-based capital (RBC) purposes. By design, this practice allows for reporting diversity as identical securities, purchased a different price points (thus having different amortized/carrying values) may have differing reported NAIC designations. Thus, two identical reporting entities possessing the same security, may have differing NAIC designations.

The current RMBS/CMBS multi-step modeling practice is the only remaining approach that utilizes breakpoints to determine final NAIC designations. In March 2019, agenda item 2018-19 removed the multi-step modeling approach for modified filing exempt (MFE) securities. This change removed the carrying value from the designation determination analysis and accordingly now utilizes the original NAIC designation, without adjustment, to determine the measurement method under SSAP No. 43R and corresponding RBC charges. With this change, identical securities have an identical NAIC designation.

The implemented change for MFE securities is being proposed for expansion to RMBS and CMBS securities for several reasons. In conjunction with the upcoming designation granularity expansion, the cost, complexity and technical issues to maintain the multi-step modeling process will be substantial for reporting entities. Each individual security will be required to develop an additional 19 price breakpoints to correspond with designation granularity reporting; insurance companies will need to substantially modify their investment accounting software to determine designations and designation categories. It is important to note that the current multi-step modeling approach has the potential to increase/improve a security’s NAIC designation – thus reducing RBC and AVR charges, however, could also work in an opposite manner decreasing NAIC designation. Despite the proposal to cease the multi-step model usage, industry appears supportive of the change as the cost and usage in both today’s environment and with the upcoming granularization reporting, does not adequately justify any potential benefit. A RMBS/CMBS security can be appropriately modeled, regardless of the amortized carrying value and will provide a single, nonadjustable NAIC designation. This will provide regulators with increased efficiency of oversight and improved comparability between various reporting entities carrying identical investments.

**Existing Authoritative Literature:**

**SSAP No. 43R—Loan-backed and Structured Securities**

**Reporting Guidance for All Loan-Backed and Structured Securities**

26. Loan-backed and structured securities shall be valued and reported in accordance with this statement, 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 or equivalent specified procedure. The carrying value method shall be determined as follows:
a. For reporting entities that maintain an Asset Valuation Reserve (AVR), loan-backed and structured securities 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, loan-backed and structured securities designated highest-quality and high-quality (NAIC designations 1 and 2, respectively) 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.

Designation Guidance

27. 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. The Purposes and Procedures Manual of the NAIC Investment Analysis Office provides detailed guidance. A general description of the processes is as follows:

a. Financial Modeling: The NAIC identifies securities where financial modeling must be used to determine the NAIC designation. NAIC designation based on financial modeling incorporates the insurers’ carrying value for the security. For those 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. Securities where modeling results in zero expected loss in all scenarios are automatically considered to have a final NAIC designation of NAIC 1, regardless of the carrying value. The three-step process for modeled securities is as follows:

i. Step 1: Determine Initial Designation – The current amortized cost (divided by remaining par amount) of a loan-backed or structured security is compared to the modeled breakpoint values assigned to the six (6) NAIC designations 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 26 based upon the initial NAIC designation from Step 1.

iii. Step 3: Determine Final Designation – The final NAIC designation that shall be used for investment schedule reporting is determined by comparing the carrying value (divided by remaining par amount) of a security (based on paragraph 27.a.ii.) to the NAIC CUSIP specific modeled breakpoint values assigned to the six (6) NAIC designations for each CUSIP. This final NAIC designation shall be applicable for statutory accounting and reporting purposes (including establishing the AVR charges). The final designation is not used for establishing the appropriate carrying value method in Step 2 (paragraph 27.a.ii.).

b. All Other Loan-Backed and Structured Securities: For loan-backed and structured securities not subject to paragraphs 27.a. (financial modeling) follow the established designation procedures according to the appropriate section of the Purposes and Procedures Manual of the NAIC Investment Analysis Office. 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 26. Examples of these securities include, but are not limited to, mortgage-referenced securities, equipment trust certificates, credit tenant loans (CTL), 5*/6* securities, interest only (IO) securities, securities with CRP ratings (excluding RMBS/CMBS), and loan-backed and structured securities with SVO assigned NAIC designations.
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 accordance with a Valuation of Securities (E) Task Force referral, agenda item 2018-19 eliminated the multi-step designation guidance, utilizing amortized cost basis and breakpoints for the determination of final NAIC designations of MFE securities. The revisions were adopted with an effective date of March 31, 2019, with early adoption permitted for year-end 2018.

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


Staff Recommendation:

NAIC Staff recommends that the Working Group move this item to the active listing, categorized as nonsubstantive and expose revisions to SSAP No. 43R—Loan-backed and Structured Securities to eliminate the multi-step financial modeling designation guidance in determining final NAIC designations for RMBS/CMBS securities.

Although the Working Group is recommended to proceed with exposure on this agenda item and solicit comments for consideration, final action will not occur on this item until revisions eliminating the RMBS/CMBS multi-step modeling approach has been adopted by the Valuation of Securities (E) Task Force. NAIC SAPWG staff will coordinate with the VOSTF staff to stay current on their discussion and action on this item.

Proposed Revisions to SSAP No. 43R—Loan-backed and Structured Securities

Reporting Guidance for All Loan-Backed and Structured Securities

26. Loan-backed and structured securities shall be valued and reported in accordance with this statement, 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 or equivalent specified procedure\(^\text{10}\). The carrying value method shall be determined as follows:

a. For reporting entities that maintain an Asset Valuation Reserve (AVR), loan-backed and structured securities 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, loan-backed and structured securities designated highest-quality and high-quality (NAIC designations 1 and 2, respectively) 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.

Designation Guidance

\(^\text{10}\) Securities within scope of this statement shall be reported with NAIC designations. The process to determine the NAIC designation may vary based on type of underlying investment and is directed in accordance with the Purposes and Procedures Manual of the NAIC Investment Analysis Office. For example, certain investments may use CRP ratings in determining the equivalent NAIC designation, whereas other investments, including, but not limited to, mortgage-referenced securities, equipment trust certificates, credit tenant loans (CTL), and interest only (IO) securities, may be required to obtain the NAIC designation directly from the NAIC Valuation of Securities product. For interim reporting instructions, refer to the Purposes and Procedures Manual of the NAIC Investment Analysis Office.
27.—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. The Purposes and Procedures Manual of the NAIC Investment Analysis Office provides detailed guidance. A general description of the processes is as follows:

a. Financial Modeling: The NAIC identifies securities where financial modeling must be used to determine the NAIC designation. NAIC designation based on financial modeling incorporates the insurers’ carrying value for the security. For those 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 those identified securities. Securities where modeling results in zero expected loss in all scenarios are automatically considered to have a final NAIC designation of NAIC 1, regardless of the carrying value. The three-step process for modeled securities is as follows:

i. Step 1: Determine Initial Designation — The current amortized cost (divided by remaining par amount) of a loan-backed or structured security is compared to the modeled breakpoint values assigned to the six (6) NAIC designations 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 26 based upon the initial NAIC designation from Step 1.

iii. Step 3: Determine Final Designation — The final NAIC designation that shall be used for investment schedule reporting is determined by comparing the carrying value (divided by remaining par amount) of a security (based on paragraph 27.a.ii.) to the NAIC-CUSIP specific modeled breakpoint values assigned to the six (6) NAIC designations for each CUSIP. This final NAIC designation shall be applicable for statutory accounting and reporting purposes (including establishing the AVR charges). The final designation is not used for establishing the appropriate carrying value method in Step 2 (paragraph 27.a.ii.).

b. All Other Loan-Backed and Structured Securities: For loan-backed and structured securities not subject to paragraphs 27.a. (financial modeling) follow the established designation procedures according to the appropriate section of the Purposes and Procedures Manual of the NAIC Investment Analysis Office. 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 26. Examples of these securities include, but are not limited to, mortgage-referenced securities, equipment trust certificates, credit tenant loans (CTL), 5*/6* securities, interest only (IO) securities, securities with CRP ratings (excluding RMBS/CMBS), and loan-backed and structured securities with SVO assigned NAIC designations.

Specific Interim Reporting Guidance for RMBS/CMBS Securities

28. The guidance in this paragraph shall be applied in determining the reporting method for residential mortgage-backed securities (RMBS) and commercial mortgage-backed securities (CMBS) 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 27, regardless of the quarterly methodology used.

a. Reporting entities that acquired the entire financial modeling database for the prior-year end are required to follow the financial modeling methodology (paragraph 27.a.) for all securities acquired in the subsequent year that were included in the financial modeling data acquired for the prior-year end.

b. 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 27.a.) for these securities acquired subsequent to year-end.
c. Reporting entities that do not acquire the prior year financial modeling information for current-year acquired individual CUSIPS, and are not captured within paragraphs 28.a. or 28.b., are required to follow the analytical procedures for non-financially modeled securities (paragraph 27.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.

d. 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 27.b., as appropriate).

For brevity, the remaining SSAP has been omitted, however remaining paragraphs will be renumbered accordingly.

**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**

<table>
<thead>
<tr>
<th>No.</th>
<th>Question</th>
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<tbody>
<tr>
<td>1</td>
<td>Are reporting entities permitted to establish an accounting policy to write down a SSAP No. 43R other-than-temporarily impaired security, for which a &quot;non-interest&quot; related decline exists, to fair-value regardless of whether the reporting entity intends to sell, or has the intent and ability to hold?</td>
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<td>2</td>
<td>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?</td>
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<td>3</td>
<td>Can reporting entities change their &quot;intend to sell&quot; or &quot;unable to hold&quot; assertions and recover previously recognized other-than-temporary impairments?</td>
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<td>4</td>
<td>How do the regulators intend the phrase &quot;intent and ability to hold&quot; as used within SSAP No. 43R to be interpreted?</td>
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<td>5</td>
<td>How do contractual prepayments affect the determination of credit losses?</td>
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<td>6</td>
<td>Are the disclosure requirements within paragraphs 51.f. and 51.g. of SSAP No. 43R required to be completed for the current reporting quarter only, or as a year-to-date cumulative disclosures?</td>
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<tr>
<td>7</td>
<td>If an impairment loss is recognized based on the &quot;present value of projected cash flows&quot; 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?</td>
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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.

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<td>8</td>
<td>Do LBSS 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?</td>
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<td>No.</td>
<td>Question</td>
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<td>9</td>
<td>The NAIC Designation process for LBSS 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?</td>
</tr>
<tr>
<td>10</td>
<td>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?</td>
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8. **Question** – Do LBSS 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 LBSS 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.

Staff Review Completed by:
Jim Pinegar, NAIC Staff – September 2019
Statutory Accounting Principles (E) Working Group
Maintenance Agenda Submission Form
Form A

Issue: Inclusion of Cash / Liquidity Pools - Cash Equivalents as defined in SSAP No. 2R.

Check (applicable entity):

<table>
<thead>
<tr>
<th>Modification of Existing SSAP</th>
<th>P/C</th>
<th>Life</th>
<th>Health</th>
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<tr>
<td>New Issue or SSAP Interpretation</td>
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Description of Issue: Cash pooling, also known as liquidity bundling or liquidity pools, is a special form of liquidity management in which groups combine resources in order to make a more efficient use of idle cash. A cash pool is typically a structure in which several entities’ cash accounts are aggregated for numerous purposes, including optimizing earned interest, accessing additional short-term investments markets, and improving liquidity management. The investment goal is to optimize financial results by increasing investment access and lower transaction costs that would be incurred by each individual pool participant.

Contributed cash is typically placed in short-term investments, which may not have been previously available to a single affiliated reporting entity that possesses a lower cash balance. Affiliates with lower cash balances can leverage the financial strength of other related affiliates in order to access certain markets that contain significant initial investment requirements. Additionally, by pooling resources and making fewer (and larger) investments, transaction costs are reduced, thus giving the participants a more efficient use of cash resources.

In general, pooling is restricted to groups in which several companies are organized under the management of a single corporate entity. Individual participating companies may be legally independent, however the group acts as a strategic unit, for the purposes of cash management.

Cash pooling structures are not a new market development; however, their potential uses and organizational structures can vary significantly. Under certain pool structures, positive cash balances of one member could cover the deficit cash balance of another member. In this type of structure, surplus funds are physically concentrated into a single account in order to maximize investment return while deficit accounts are covered by transfers from the cash pool. Within these structures, individual participants lose economic independence as the cash is managed centrally and may not be available to the extent desired by the participating entity. Pooling structures have also been formed for internal financing purposes as “sharing of cash” can be used to reduce reliance on external borrowing for short-term working capital needs, again potentially reducing the cash available by certain participants.

This agenda item recommends revisions to allow specific structures that strictly hold cash, cash equivalents and short-term investments and other certain criteria, but do not meet the current requirements for cash equivalent reporting, to be reported as cash equivalents under SSAP No. 2R—Cash, Cash Equivalents, Drafts and Short-Term Investments.

Existing Authoritative Literature:

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

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value because of changes in interest rates. Only investments with original maturities of three months or less qualify under this definition, with the exception of money market mutual funds, as detailed in paragraph 7. Regardless of maturity date, derivative instruments shall not be reported as cash equivalents and shall be reported as derivatives on Schedule DB. 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.

7. Money market mutual funds registered under the Investment Company Act of 1940 and regulated under rule 2a-7 of the Act shall be accounted for and reported as cash equivalents for statutory accounting. Investments in money market mutual funds shall be valued at fair value or net asset value (NAV) as a practical expedient. For reporting entities required to maintain an asset valuation reserve (AVR), the accounting for unrealized capital gains and losses shall be in accordance with SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve. For reporting entities not required to maintain an AVR, unrealized capital gains and losses shall be recorded as a direct credit or charge to surplus. Sales/reinvestments in money market mutual funds are excluded from the wash sale disclosure in SSAP No. 103R.

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): A question regarding cash pools was raised under the proposed short-term rolling provisions captured in agenda item 2019-20. With this question, it was noted that cash pools are not specifically addressed in SSAP No. 2R—Cash, Cash Equivalents, Drafts and Short-Term Investments. This agenda item proposes to incorporate specific guidance for these instruments. If revisions are adopted to clarify cash pools in scope of SSAP No. 2R, it is anticipated that revisions will also be proposed to exclude cash pools from the short-term rolling provisions, allowing qualifying cash pools to be continually reported as cash equivalents.

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


Staff Recommendation:

NAIC Staff recommends that the Working Group move this item to the active listing, categorized as nonsubstantive and expose revisions to SSAP No. 2R—Cash, Cash Equivalents, Drafts and Short-Term Investments to specify the types of cash pooling organization structures and the investments they are required to maintain in order to qualify as cash equivalents.

NAIC staff is aware a circumstance where a Limited Liability Company was used as the primary structure for a Cash / Liquidity Pool. However, NAIC staff is not proposing changes to SSAP No. 48—Joint Ventures, Partnerships and Limited Liability Companies as the legal structure of such pools will vary. Comments are requested regarding the need for a Cash / Liquidity Pool reference in SSAP No. 48.

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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.
Proposed Revisions to 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 of three months or less qualify under this definition, with the exception of cash pools that meet the requirements of paragraph 8 and money market mutual funds described in paragraph 7. Regardless of maturity date, derivative instruments shall not be reported as cash equivalents and shall be reported as derivatives on Schedule DB. 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.

7. Money market mutual funds registered under the Investment Company Act of 1940 and regulated under rule 2a-7 of the Act shall be accounted for and reported as cash equivalents for statutory accounting. Investments in money market mutual funds shall be valued at fair value or net asset value (NAV) as a practical expedient. For reporting entities required to maintain an asset valuation reserve (AVR), the accounting for unrealized capital gains and losses shall be in accordance with SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve. For reporting entities not required to maintain an AVR, unrealized capital gains and losses shall be recorded as a direct credit or charge to surplus. Sales/reinvestments in money market mutual funds are excluded from the wash sale disclosure in SSAP No. 103R.

8. Cash pooling is a technique, utilized by some companies under common control by which several entities’ cash accounts are aggregated for numerous purposes, including liquidity management, optimizing interest or investment returns and reducing investment or banking transaction fees. Cash pools can have numerous functions and structures, however only those that have obtained domiciliary regulator approval and meet the requirements may look through the ownership structure to report the assets held as cash equivalents.

   a. Members or participants in the pool are limited to affiliated entities as defined in SSAP No. 25.
   
   b. Investments held by the pool are limited to non-affiliated investments.
   
   c. The pool must permit each participant to withdraw, at any time, cash up to the amount it has contributed to the pool. Each participant must own an undivided interest in the underlying assets of the pool in proportion to the aggregate amount of cash contributed. All affiliates’ interests in the pool shall be of the same class, with equal rights, preferences and privileges. All membership interests shall be fully paid and non-assessable and shall have no preemptive, conversion or exchange rights. The liability of a participant’s debts and obligations of the pool shall be limited to the amount of its contributions and no participant shall be obligated to contribute money to the pool for any reason other than to participate in the pool’s investments. Additionally, participants shall not cover the debits or credits of another participant (commonly referred to as notional cash pooling).
   
   a-d. An audited U.S. GAAP annual report of the cash pool and schedules showing each affiliate’s prorated share of investments shall be provided annually to each participant as of December 31. The reporting entity shall determine if the investments would have qualified as cash, cash equivalents or short-term investments had the entity independently acquired the investments. To the extent the pool holds investments that do not meet the definition of cash, cash equivalents, short-term investments, or if the cash pool is not supported by an audited statement, the pool does not qualify within scope of this statement.

Disclosures

15. 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 30.f.

16. The financial statements shall disclose the reporting entity’s share of the cash pool by asset type (cash, cash equivalents, or short-term investments).

For brevity, the remaining paragraphs of SSAP No. 2R have been omitted but will be renumbered accordingly.

Staff Review Completed by:

NAIC Staff – Jim Pinegar, September 2019
Statutory Accounting Principles (E) Working Group
Maintenance Agenda Submission Form
Form A

Issue: ASU 2017-11 - Financial Instruments with Down Round Features

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Description of Issue: ASU 2017-11, Accounting for Certain Financial Instruments with Down Round Features: Replacement of the Indefinite Deferral for Mandatorily Redeemable Financial Instruments of Certain Noncontrolling Interests with a Scope Exception to address issues identified with applying U.S. GAAP for certain financial instruments with characteristics of liabilities and equity. The purpose of this agenda item is to review ASU 2017-11 and to consider statutory accounting guidance on distinguishing liabilities from equity.

This ASU addresses the complexity of accounting for certain freestanding financial instruments (or embedded features such as a conversion option) with down round features. A down round feature is a provision in certain financial instruments (most often warrants or convertible instruments) that allows for the reduction in the strike price of the financial instrument if the issuer sells additional shares of common stock for an amount less than the financial instrument’s stated strike price, or if the issuer issues another equity-linked instrument with a strike price below the current strike price of the original financial instrument. Down (financing) rounds typically occur when additional capital is required, but the company’s valuation is now lower than it was in an earlier stock offering. Financial instruments with down round features help protect the holder from declines in the issuer’s share price because if a company issues additional equity shares at a lower price than had been previously sold, the holder is allowed to exercise its purchase option at a lower strike price than was originally stated on the financial instrument.

Existing U.S. GAAP for financial instruments with down round features requires fair value measurement of the entire instrument or conversion option. Stakeholders asserted that accounting for freestanding and embedded instruments with down round features as liabilities, subject to fair value measurement, created a reporting burden and associated income statement volatility due to changes in an entity’s share price. Stakeholders also suggested that this accounting may not reflect the economics of the down round feature, which exist to protect certain investors from declines in the issuer’s share price. With the current accounting guidance, changes in fair value of an instrument with a down round feature are recognized in earnings for both increases and decreases in share price. However, down round features are only likely to be exercised in the event the share price decreases and the issuer engages in a subsequent equity offering.

Prior to this ASU’s issuance under U.S. GAAP, a free-standing financial instrument or embedded feature was not considered indexed to the issuer’s stock if it has a down round feature. Thus, the instrument was classified as a liability and if it meets the definition of a derivative, it must be measured at fair value with changes recorded through current period earnings. ASU 2017-11 changes the guidance in that a down round feature shall no longer be considered when determining whether the instrument is indexed to a company’s stock. As a result of the ASU, if the instrument is now deemed to be indexed and settled in company stock, a free-standing or embedded equity-linked financial instrument will be classified as equity and the embedded feature that was originally bifurcated and accounted for as a derivative may qualify for scope exception to also be treated as equity.

Revisions in ASU 2017-11 also include earning per share (EPS) guidance detailing that the effect of exercising a down round feature shall be treated as a dividend to reduce the income available to common shareholders for computing and reporting basic EPS. Recognition of the value of the down round feature is calculated when triggered and is measured as the difference between the fair value of the instrument (without regarding the down round...
feature) of the pre-trigger exercise price and the fair value of the instrument (again, without regarding the down round feature) using the reduced and executed exercise price.

Existing Authoritative Literature:

1. Earnings per share – Rejected as Not Applicable for Statutory Accounting:

   The concept of earnings per share (Topic 260) has previously been reviewed with the following U.S. GAAP standards rejected as not applicable in Appendix D—Nonapplicable GAAP Pronouncements:

   - FASB Statement No. 128, Earnings per Share (FAS 128)
   - EITF 07-04, Application of the Two-Class Method under FASB Statement No. 128 to Master Limited Partnerships

2. Distinguishing Liabilities from Equity / Derivatives and Hedging:

   With ASU 2017-11, entities will no longer consider a down round feature when determining whether a freestanding financial instrument is indexed to an entity’s stock. Consequently, upon adoption, these instruments which are currently being reported as a liability may be reclassified as equity. Additionally, fewer embedded features will likely have to be bifurcated and accounted for as a derivative and may qualify for scope exemption to be treated as equity.

   NAIC staff believes the spirit of freestanding down round features represents a quantifiable liability of the issuing company and should remain accounted for as a liability and not as equity. Down round features embedded in derivatives would not be separated from the host contract pursuant to SSAP No. 86—Derivatives.

   As detailed below, the down round feature satisfies the definition of a liability and recognition as a liability would be consistent with existing guidance for share-based payments.

   SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets, defines a liability with excerpts below:

   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.

   SSAP No. 104R—Share-Based Payments, Exhibit A – Classification Criteria: Liability or Equity, details circumstances under which certain financial instruments are to be identified as liabilities. While this guidance is limited to share-based payments, the overall accounting concepts are applicable in these situations. Specifically, Exhibit A, paragraph 7, supports recognition as a liability the company is obligated to sell additional common stock for an amount less than the originally stated strike price as both circumstances require a unilateral outflow of assets or equity. The liability associated with a down round feature, although settled with the issuance of additional shares (without the receipt of assets), will adversely affect the economic interests of current equity shareholders by diluting ownership. Additionally, paragraph 10 broadly indicates instruments that obligate the issuer to transfer assets are to be reported as liabilities.
Excerpts from SSAP No. 104R, Exhibit A:

Mandatorily Redeemable Financial Instruments

3. A mandatorily redeemable financial instrument shall be classified as a liability unless the redemption is required to occur only upon the liquidation or termination of the reporting entity.

4. A financial instrument that embodies a conditional obligation to redeem the instrument by transferring assets upon an event not certain to occur becomes mandatorily redeemable if that event occurs, the condition is resolved, or the event becomes certain to occur.

5. In determining if an instrument is mandatorily redeemable, all terms within a redeemable instrument shall be considered. The following items do not affect the classification of a mandatorily redeemable financial instrument as a liability:
   a. A term extension option
   b. A provision that defers redemption until a specified liquidity level is reached
   c. A similar provision that may delay or accelerate the timing of a mandatory redemption.

6. If a financial instrument will be redeemed only upon the occurrence of a conditional event, redemption of that instrument is conditional and, therefore, the instrument does not meet the definition of mandatorily redeemable financial instrument in this statement. However, that financial instrument would be assessed at each reporting period to determine whether circumstances have changed such that the instrument now meets the definition of a mandatorily redeemable instrument (that is, the event is no longer conditional). If the event has occurred, the condition is resolved, or the event has become certain to occur, the financial instrument is reclassified as a liability.

Obligations to Repurchase Issuer’s Equity Shares by Transferring Assets

7. An entity shall classify as a liability (or an asset in some circumstances) any financial instrument, other than an outstanding share, that, at inception, has both of the following characteristics:
   a. It embodies an obligation to repurchase the issuer’s equity shares, or is indexed to such an obligation, and
   b. It requires or may require the issuer to settle the obligation by transferring assets.

8. In this statement, “indexed to” is used interchangeably with “based on variations in the fair value of.” The phrase “requires or may require” encompasses instruments that either conditionally or unconditionally obligate the issuer to transfer assets. If the obligation is conditional, the number of conditions leading up to the transfer of assets is irrelevant.

9. Examples of financial instruments that meet the criteria in paragraph 7 of this Exhibit include forward purchase contracts or written put options on the issuer’s equity shares that are to be physically settled or net cash settled.

10. All obligations that permit the holder to require the issuer to transfer assets result in liabilities, regardless of whether the settlement alternatives have the potential to differ.

As noted in SSAP No. 86, paragraph 16, down round features embedded in derivative contracts (such as a warrant) would not be separated from the host contract. Such features would impact the fair value accounting for derivatives (assuming fair value accounting is followed) in recognizing the derivative asset or derivative liability. Recognizing freestanding down round features as a liability (and not as equity) would be consistent with the impact of such features embedded in a derivative contract.
SSAP No. 86—Derivatives

16. Contracts that do not in their entirety meet the definition of a derivative instrument, such as bonds, insurance policies, and leases, may contain “embedded” derivative instruments—implicit or explicit terms that affect some or all of the cash flows or the value of other exchanges required by the contract in a manner similar to a derivative instrument. The effect of embedding a derivative instrument in another type of contract (“the host contract”) is that some or all of the cash flows or other exchanges that otherwise would be required by the contract, whether unconditional or contingent upon the occurrence of a specified event, will be modified based on one or more underlyings. An embedded derivative instrument shall not be separated from the host contract and accounted for separately as a derivative instrument.

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): IAS 32 – Financial Instruments outlines the accounting requirements for the presentation of certain financial instruments, particularly as to the classifications into assets, liabilities, or equity. The fundamental principle of IAS 32 is that a financial instrument should be classified as either a financial liability or as an equity instrument according to the substance of the contract, not its legal form. IAS 32.20 states a contractual right or obligation to receive or deliver a number of its own shares or other equity instruments that varies so that the fair value of the entity’s own equity instruments to be received or delivered equals the fixed monetary amount of the contractual right or obligation is a financial liability.

Staff Recommendation: NAIC staff recommends the Working Group move this item to the active listing, categorized as nonsubstantive, and expose revisions to SSAP No. 86 to reject ASU 2017-11 (Topics 480 & 815) and expose revisions to SSAP No. 5R and SSAP No. 72 to incorporate guidance on when certain freestanding instruments shall be recognized as liabilities and not equity.

1) Proposed Revisions to SSAP No. 86—Derivatives:

63. 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.

a. This statement 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.
b. This statement rejects ASU 2017-11, Accounting for Certain Financial Instruments with Down Round Features; Replacement of the Indefinite Deferral for Mandatorily Redeemable Financial Instruments of Certain Noncontrolling Interests with a Scope Exception.

63-64. 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.

2) Proposed Revisions to SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets:

Although NAIC previously believed that instruments with both characteristics of debt and equity were not commonly issued by insurance entities, NAIC Staff has recently received a state query focused on this issue. NAIC staff recommends introducing key concepts from ASC Topic 480, Distinguishing Liabilities from Equity, Subsection 25, (which are materially identified in SSAP No. 104R—Share-Based Payments) into SSAP No. 5R.

SSAP No. 5R—Liabilities, Contingencies and Impairment of Assets.

Financial Instruments with Characteristics of both Liabilities and Equity

26. Issued, free-standing financial instruments with characteristics of both liability and equity shall be reported as a liability to the extent the instruments embodies an unconditional obligation of the issuer. (Pursuant to SSAP No. 86, embedded features in derivative contracts shall not be separated from the host contract for separate recognition.) Free-standing financial instruments that meet any of the criteria below meet the definition of a liability:

   a. A mandatorily redeemable financial instrument shall be classified as a liability unless the redemption is required to occur only upon the liquidation or termination of the issuing reporting entity.

   b. A financial instrument, other than an outstanding share, that at inception both 1) embodies an obligation to repurchase the issuer’s equity shares or is indexed to such an obligation and 2) requires or may require the issuer to settle the obligation by transferring assets.

   c. Obligations that permit the holder to require the issuer to transfer assets.

   d. A financial instrument is a liability if the issuer must settle the obligation by issuing a variable number of its equity shares and the obligation’s monetary value is based solely or predominantly on: 1) a fixed monetary amount, 2) variation in something other than the fair value of the issuer’s equity shares, or 3) variations inversely related to changes in the fair value of the issuer’s equity shares.

   e. Instruments in which the counterparty (holder) is not exposed to the risks and benefits that are similar to those of a holder of an outstanding share of the entity’s equity shall be classified as a liability.

27. If a free-standing financial instrument will be redeemed only upon the occurrence of a conditional event, redemption of that instrument is conditional and, therefore, the instrument does not meet the definition of mandatorily redeemable financial instrument. However, that financial instrument shall be assessed each reporting period to determine whether circumstances have changed such that the instrument meets the definition of a mandatorily redeemable instrument (that is, the event is no longer conditional). If the event has occurred, the condition is resolved, or the event has become certain to occur, the financial instrument shall be reclassified as a liability.
The classification of a free-standing financial instrument as a liability or equity shall only apply to the instrument issuer. Holders or purchasers of such instruments shall refer to the appropriate investment statement for valuation and reporting.

For brevity, the remaining paragraphs for SSAP No. 5R have been omitted but will be renumbered accordingly.

3) Proposed Revisions to SSAP No. 72—Surplus and Quasi-Reorganizations:

While proposed key concepts from ASC Topic 480 are detailed in SSAP No. 5R, additional reference language for the statutory accounting of capital stock is detailed below.

**SSAP No. 72—Surplus and Quasi-Reorganizations**

**Capital Stock**

3. The articles of incorporation set forth the number of authorized shares of capital stock and the par value of each share. The capital stock account represents the number of shares issued times the par value of each share. When no par value is set forth, the reporting entity shall declare a "stated value" and record such amount in the capital stock account. Changes in the par value of a reporting entity’s capital stock shall be reflected as a reclassification between the capital stock account and gross paid-in and contributed surplus. Issued, free-standing financial instruments with characteristics of both liability and equity shall be reported as a liability to the extent described in SSAP No. 5R.

**Staff Review Completed by: Jim Pinegar – October 2019**

**Status:**

G:\FRSDATA\Stat Acctg\3. National Meetings\A. National Meeting Materials\2019\FallMeeting\L - 19-43 - ASU 2017-11 - Earning Per Share, Distinguishing Liabilities from Equity.docx
Maintenance updates provide revisions to the Accounting Practices and Procedures Manual, such as editorial corrections, reference changes and formatting.

<table>
<thead>
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<th>SSAP/Appendix</th>
<th>Description/Revision</th>
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<tbody>
<tr>
<td>SSAP No. 62R</td>
<td>Update references in Exhibit A – Implementation Questions and Answers, question 31, which provides a retroactive reinsurance illustration. This revision does not revise the illustrated journal entries it just revises the referenced “item numbers” to the appropriate SSAP No. 62R, paragraph 34 references.</td>
</tr>
<tr>
<td>SSAP No. 62R</td>
<td>Update reference in SSAP No. 62R, paragraph 85 to match the current format of property casualty annual statement Schedule F - Reinsurance.</td>
</tr>
<tr>
<td>Various SSAPs</td>
<td>Revise all references to the annual statement instructions for consistency and combine the life and fraternal references.</td>
</tr>
<tr>
<td></td>
<td>• Generic references: annual statement instructions</td>
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<td>• Specific Names:</td>
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<tr>
<td></td>
<td>o Property/Casualty Annual Statement Instructions</td>
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<td></td>
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<td></td>
<td>o Title Annual Statement Instructions</td>
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<tr>
<td></td>
<td>o Health Annual Statement Instructions</td>
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Note: Only the changes to combine the Fraternal and Life references will be tracked as edits to the AP&P Manual. Since the other changes are just consistency changes to existing title references, those changes will not be tracked in the AP&P Manual.

(Since there are several instances, they are not individually shown in this Form A.)

Status:
NAIC staff recommends that the Statutory Accounting Principles (E) Working Group move this agenda item to the active listing, categorized as nonsubstantive, and expose editorial revisions, as illustrated below.
1. Update references in Exhibit A – Implementation Questions And Answers, question 31, which provides a retroactive reinsurance illustration. The revisions do not revise the illustrated journal entries. The revisions are to update the referenced “item numbers” to the appropriate related SSAP No. 62R, paragraph 34 references. For example, journal entry #1 includes a references retroactive reinsurance reserves with an explanatory note of “see item #3” becomes “see paragraph 34.c.” which discusses the accounting for retroactive reinsurance reserves. The item numbers are being updated to the related subparagraph of paragraph 34; “see item #4” becomes “see paragraph 34.d.” NAIC staff has verified that the referenced paragraph 34 subparagraphs are relevant to the journal entry explanatory note and illustrated SSAP No. 62R, paragraph 34 for ease of review below the changes.

SSAP No. 62R Property and Casualty Reinsurance - Tracked revisions

EXHIBIT A – IMPLEMENTATION QUESTIONS AND ANSWERS

31. Q: What accounting entries would a ceding entity make to report a retroactive reinsurance contract?

   A: Accounting Entries for a Ceding Entity to Report a Retroactive Reinsurance Contract:

   **Entry 1**
   
   Retroactive Reinsurance Reserves  
   Ceded or Assumed (B/S) 10,000  
   Retroactive Reinsurance Gain (I/S) 2,000  
   Cash 8,000  

   To record initial portfolio transfer see items #3paragraph 34.c. and #8paragraph 34.h. The ceding entity must establish the segregated surplus per item #4paragraph 34.d.

   **Entry 1A**
   
   Retro. Reins. Gain 2,000  
   Profit/Loss Account 2,000  

   To close gain from retroactive transaction.

   **Entry 1B**
   
   Profit/Loss Account 2,000  
   Special Surplus from Retro. Reins. 2,000  

   To close profit from retroactive reinsurance to special surplus.

   **Entry 2**
   
   Cash 2,000  
   Retroactive Reinsurance Reserves 2,000  
   Ceded or Assumed (B/S)  

   To record recovery of paid losses from the reinsurer. Outstanding ceded reserves after this recovery equals $8,000, and special surplus from retroactive reinsurance account equals $2,000; therefore, segregated surplus account is not changed per item #10paragraph 34.j.

   **Entry 3**
   
   Retroactive Reinsurance Reserves  
   Ceded or Assumed (B/S) 3,000  
   Retroactive Reinsurance Gain (I/S) 3,000  

   To record subsequent revision of the initial reserves ceded per item #10paragraph 34.j. The segregated surplus account is increased to $5,000 as a result of this upward development.

   **Entry 3A**
   
   Retro. Reinsurance Gain 3,000
Profit/Loss Account 3,000

To close profit from retroactive reinsurance.

**Entry 3B**

```
Profit/Loss (I/S) 3,000
Special Surplus from Retro. Reins. 3,000
```

To close profit and loss account to special surplus. (Retroactive reinsurance reserves ceded or assumed account balance equals $11,000. Special Surplus from retroactive reinsurance balance equals $5,000.)

**Entry 4**

```
Cash 4,000
Retroactive Reinsurance Reserves Ceded or Assumed (B/S) 4,000
```

To record recovery of paid losses from the reinsurer. Outstanding ceded reserves after this recovery equals $7,000, therefore segregated surplus account is not changed per item #10 paragraph 34.j.

**Entry 5**

```
Cash 3,000
Retroactive Reinsurance Reserves Ceded or Assumed (B/S) 3,000
```

To record recovery of paid losses from reinsurer. Outstanding ceded reserves after recovery equals $4,000, therefore the following entry is needed per items #6 paragraph 34.f. and #10 paragraph 34.j.

**Entry 5A**

```
Special Surplus—Retro. Reins. 1,000
Unassigned Funds 1,000
```

Retroactive Reinsurance reserves ceded or assumed after this entry equals $4,000.

**Entry 6**

```
Retroactive Reinsurance Loss (I/S) 1,000
Retroactive Reinsurance Reserves Ceded or Assumed (B/S) 1,000
```

To record subsequent revision of the initial reserves ceded per item #10 paragraph 34.j. The segregated surplus account is decreased as a result of this downward development to $3,000. The following entry is needed per items #6 paragraph 34.f. and #10 paragraph 34.j.

**Entry 6A**

```
Profit/Loss Account 1,000
Retro. Reins. Loss 1,000
```

To close loss to profit and loss account.

**Entry 6B**

```
Special Surplus from Retro. Reins. 1,000
Profit/Loss Account 1,000
```

To close profit and loss account to special surplus. (Remaining balance of retroactive reinsurance reserve ceded or assumed account equals $3,000.) (Special surplus from retro. reins. account balance equals $3,000.)

**Entry 7**

```
Cash 2,500
Retroactive Reinsurance Gain (I/S) 500
Retroactive Reinsurance Reserves
```

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Ceded or Assumed (B/S)  
3,000

Entry 7A
Profit and Loss Account  
500
Retro. Reins. Gain  
500

To close other income to profit and loss account.

Entry 7B
Special Surplus from Retro. Reins.  
500
Profit/Loss Account  
500

To close profit and loss account to special surplus. (Remaining balance of special surplus from retro. reins. account equals $2,500.) (Remaining balance of retroactive reinsurance reserve ceded or assumed account -0-.)

Entry 7C
Special Surplus from Retro. Reins.  
2,500
Unassigned Funds  
2,500

To close remaining special surplus account to unassigned surplus.

For ease of review, the referenced SSAP No. 62R, paragraphs 33 and 34 are illustrated below (No revisions are proposed to these paragraphs):

Accounting for Retroactive Reinsurance Agreements

33. Certain reinsurance agreements which transfer both components of insurance risk cover liabilities which occurred prior to the effective date of the agreement. Due to potential abuses involving the creation of surplus to policyholders and the distortion of underwriting results, special accounting treatment for these agreements is warranted.

34. All retroactive reinsurance agreements entered into, renewed or amended on or after January 1, 1994 (including subsequent development of such transactions) shall be accounted for and reported in the following manner:

a. The ceding entity shall record, without recognition of the retroactive reinsurance, loss and loss expense reserves on a gross basis on the balance sheet and in all schedules and exhibits;

b. The assuming entity shall exclude the retroactive reinsurance from loss and loss expense reserves and from all schedules and exhibits;

c. The ceding entity and the assuming entity shall report by write-in item on the balance sheet, the total amount of all retroactive reinsurance, identified as retroactive reinsurance reserve ceded or assumed, recorded as a contra-liability by the ceding entity and as a liability by the assuming entity;

d. The ceding entity shall, by write-in item on the balance sheet, restrict surplus resulting from any retroactive reinsurance as a special surplus fund, designated as special surplus from retroactive reinsurance account;

e. The surplus gain from any retroactive reinsurance shall not be classified as unassigned funds (surplus) until the actual retroactive reinsurance recovered exceeds the consideration paid;

f. The special surplus from retroactive reinsurance account for each respective retroactive reinsurance agreement shall be reduced at the time the ceding entity begins to recover
funds from the assuming entity in amounts exceeding the consideration paid by the ceding entity under such agreement, or adjusted as provided in paragraph 34.j.;

g. For each agreement, the reduction in the special surplus from retroactive reinsurance account shall be limited to the lesser of (i) the actual amount recovered in excess of consideration paid or (ii) the initial surplus gain resulting from the respective retroactive reinsurance agreement. Any remaining balance in the special surplus from retroactive reinsurance account derived from any such agreement shall be returned to unassigned funds (surplus) upon elimination of all policy obligations subject to the retroactive reinsurance agreement;

h. The ceding entity shall report the initial gain arising from a retroactive reinsurance transaction (i.e., the difference between the consideration paid to the reinsurer and the total reserves ceded to the reinsurer) as a write-in item on the statement of income, to be identified as Retroactive Reinsurance Gain and included under Other Income;

i. The assuming entity shall report the initial loss arising from a retroactive reinsurance transaction, as defined in the preceding paragraph 34.g., as a write-in item on the statement of income, to be identified as Retroactive Reinsurance Loss and included under Other Income;

j. Any subsequent increase or reduction in the total reserves ceded under a retroactive reinsurance agreement shall be reported in the manner described in the preceding paragraphs 34.h. and 34.i., in order to recognize the gain or loss arising from such increase or reduction in reserves ceded. The Special Surplus from Retroactive Reinsurance Account write-in entry on the balance sheet shall be adjusted, upward or downward, to reflect such increase or reduction in reserves ceded. The Special Surplus from Retroactive Reinsurance Account write-in entry shall be equal to or less than the total ceded reserves under all retroactive reinsurance agreements in-force as of the date of the financial statement. Special surplus arising from a retroactive reinsurance transaction shall be considered to be earned surplus (i.e., transferred to unassigned funds (surplus)) only when cash recoveries from the assuming entity exceed the consideration paid by the ceding entity as respects such retroactive reinsurance transaction; and

k. The consideration paid for a retroactive reinsurance agreement shall be reported as a decrease in ledger assets by the ceding entity and as an increase in ledger assets by the assuming entity.

(For an illustration of ceding entity accounting entries see question 31 in Exhibit A.)

2. Update reference in SSAP No. 62R, paragraph 85 to match the current format of property casualty annual statement Schedule F - Reinsurance.

Provision for Reinsurance

85. The NAIC Property/Casualty Annual Statement Instructions for Property and Casualty Companies for Schedule F, Part 3 - Ceded Reinsurance, references the Provision provision for Overdue Reinsurance, provides for a minimum reserve for uncollectible reinsurance with an additional reserve required if an entity’s experience indicates that a higher amount should be provided. The minimum reserve Provision for Reinsurance is recorded as a liability and the change between years is recorded as a gain or loss directly to unassigned funds (surplus). Any reserve over the minimum amount shall be recorded on the statement of income by reversing the accounts previously utilized to establish the reinsurance recoverable.
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Statutory Accounting Principles (E) Working Group
Maintenance Agenda Submission Form
Form A

Issue: ASU 2013-11, Presentation of an Unrecognized Tax Benefit

Check (applicable entity):

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<thead>
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<tr>
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Description of Issue:

Topic 740, Income Taxes did not include explicit guidance for the financial statement presentation of an “unrecognized tax benefit” when a net operating loss carryforward, a similar tax loss, or a tax credit carryforward exists. An unrecognized tax benefit generally reflects a tax position that does not meet the ASC 740 more-likely-than-not recognition threshold, but to a certain extent owes their existence to an uncertain tax position. A more-likely-than-not threshold requires a recognized benefit of having a greater than 50 percent likelihood of being realized upon settlement. Prior to ASU 2013-11, Income Taxes (Topic 740): Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists, there was diversity in the U.S. GAAP presentation of unrecognized tax benefits. Some entities reported unrecognized tax benefits as a liability in certain circumstances, while others presented unrecognized tax benefits as a reduction of a deferred tax asset for net operating loss or tax credit carryforwards.

The objective of ASU 2013-11 is to eliminate the reporting diversity to better reflect the manner in which an entity would settle additional income taxes that would result from the disallowance of a tax position when a net operating loss carryforward, similar tax loss, or tax credit carryforward exists.

ASU 2013-11 states that unrecognized tax benefits should generally be presented in the financial statements as a reduction to a deferred tax asset when a net operating loss carryforward, a similar tax loss, or a tax credit carryforward exists. This presentation should be followed except in circumstances in which a net operating loss / tax credit carryforward is not available as of the reporting date to settle any additional income taxes that would result from the disallowance of a tax position, or the entity does not intend to use the deferred tax asset for such purpose. In these cases, the unrecognized tax benefit should be presented in the financial statements as a liability and not combined with deferred tax assets.

The assessment of whether a deferred tax asset is available is based on the unrecognized tax benefit and deferred tax asset that exists at the reporting date and should be made presuming disallowance of the tax position at that reporting date.

The FASB definition of an Unrecognized Tax Benefit (per the FASB Codification Glossary) is as follows:

**Unrecognized Tax Benefit** - The difference between a tax position taken or expected to be taken in a tax return and the benefit recognized and measured pursuant to Subtopic 740-10.

Existing Authoritative Literature:

By definition, unrecognized tax benefits have a lower than 50 percent likelihood of being realized upon final settlement. As required in SSAP No. 5R—Liabilities, Contingencies and Impairment of Assets and again referenced in SSAP No. 101—Income Taxes, for the purposes of determining a tax contingency, it shall be presumed that the reporting entity will be examined by a relevant taxing authority. Further, as there is a lower than 50 percent likelihood of these items being sustained, they should be recognized in current income taxes as covered in SSAP No. 101.
**SSAP No. 101, paragraph 3 excerpts:**

3. "Income taxes incurred" shall include current income taxes, the amount of federal and foreign income taxes paid (recovered) or payable (recoverable) for the current year. Current income taxes are defined as:

   a. Current year estimates (including quarterly estimates) of federal and foreign income taxes payable or refundable, based on tax returns for the current and prior years, except as addressed in paragraph 3.b., and tax loss contingencies (including related interest and penalties) for current and all prior years, computed in accordance with SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets with the following modifications:

      i. The term “probable” as used in SSAP No. 5R shall be replaced by the term "more likely than not (a likelihood of more than 50 percent)” for federal and foreign income tax loss contingencies only.

      ii. For purposes of the determination of a federal and foreign income tax loss contingency, it shall be presumed that the reporting entity will be examined by the relevant taxing authority that has full knowledge of all relevant information.

      iii. If the estimated tax loss contingency is greater than 50% of the tax benefit originally recognized, the tax loss contingency recorded shall be equal to 100% of the original tax benefit recognized.

   b. Amounts incurred or received during the current year relating to prior periods, to the extent not previously provided, as such amounts are deemed to be changes in accounting estimates as defined in SSAP No. 3—Accounting Changes and Corrections of Errors.

   c. In determining when tax loss contingencies associated with temporary differences should be included in current income taxes under paragraph 3.a., and therefore included in deferred taxes under paragraph 7, a reporting entity is not required to "gross-up" its current and deferred taxes until such time as an event has occurred that would cause a re-evaluation of the contingency and its probability of assessment, e.g., the IRS has identified the item as one which may be adjusted upon audit. Such an event could be the reporting entity’s (or its affiliate or parent in a consolidated income tax return) receipt of a Form 5701, Proposed Audit Adjustment, or could occur earlier upon receipt of an Information Document Request. At such time, the company must reassess the probability of an adjustment, reasonably re-estimate the amount of tax contingency as determined in accordance with paragraph 3.a., make any necessary adjustment to deferred taxes, and re-determine the admissibility of any adjusted gross deferred tax asset as provided in paragraph 11.

**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):**

IFRS does not include specific guidance on the presentation of unrecognized tax benefits.

**Staff Recommendation:** NAIC staff recommends that the Working Group move this item to the active listing, categorized as nonsubstantive, and expose revisions to SSAP No. 101 to reject ASU 2013-11 for statutory accounting.

By definition, unrecognized tax benefits have a lower than 50 percent likelihood of being utilized (resulting in future tax savings), and as such, should be recognized in current income taxes as required by SSAP No. 101, paragraph 3. This ASU allows, as an election of the reporting entity, reporting of unrecognized tax benefits on the balance sheet...
(as a reduction to deferred tax assets) while statutory accounting requires immediate recognition through current income tax expense. As these unrecognized tax benefits are not deferred tax items and NAIC SAP tries to limit optionality in the financial statements, NAIC staff proposes to reject the ASU and retain existing statutory accounting guidance.

Staff Review Completed by: Jim Pinegar – August 2019

Status:
Proposed Revisions to SSAP No. 101:

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

**Issue:** ASU 2016-14, Presentation of Financial Statements of Not-for-Profit Entities

**Check (applicable entity):**

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**Description of Issue:** The FASB issued ASU 2016-14 to provide more useful information to donors, grantors, creditors, and other financial statements users of not-for-profit (NFP) entities. This update is to improve the current net asset classification requirements and the information presented in financial statements regarding liquidity, financial performance, and cash flows. While several changes were implemented within this ASU, the main provisions include:

- The presentation of two classes of net assets – *with donor restrictions* and *without donor restrictions*. Due to complexities regarding the appropriate use of the previous three classes of net assets (unrestricted, temporarily restricted, and permanently restricted) that focused on the absence or presence of donor-imposed restrictions and whether those restrictions were temporary or permanent, this ASU designates presentation of two classes of net assets. Changes in these two classes of net assets are to be reported on the statement of activities.

- The presentation of operating cash flows may continue to use the direct or indirect method of reporting, but no longer require the presentation or disclosure of the indirect method (reconciliation) if using the direct method.

Additionally, numerous disclosures enhancements were included this update, several are highlighted below:

- The composition of net assets with donor restrictions and how the restrictions affect the use of such resources.
- For resources without donor-imposed restrictions, the applicable amounts and designated purposes, appropriations, and similar actions that result in self-imposed limits on the use of such resources.
- Information that communicates how the NFP manages liquid resources to meet its cash needs for general expenditures for one year following the balance sheet date.
- Regarding ‘underwater endowment funds’ (a fund in which its fair value is less than the original gift amount or the amount required to be maintained by donor restrictions); disclosures concerning the NFP’s policy, and any actions taken during the period concerning appropriation from underwater endowment funds and the fair value of such funds. Additionally, disclosures regarding the original gift amounts (or level required by donor or law) to be maintained and amount by which the funds are deficient.
- Use, in the absence of donor restrictions, the placed-in-service approach for reporting expirations of restrictions on gifts of cash or other assets to be used to acquire or construct a long-lived asset, thus reclassifying amounts from “net assets with donor restrictions” to “net assets without donor restrictions” as long-lived assets that have been placed in service as of the beginning of the period of adoption (eliminating the previous option to release the donor-imposed restriction over the estimated useful life of the acquired asset).
**Existing Authoritative Literature:** While there is SAP guidance for the financial statement presentation of assets, the concept of separating assets based on imposed donor restrictions and the inclusion of other similar related disclosures is not a presentation format that is applicable for statutory accounting purposes.

**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 - There are no specific NFP accounting and reporting standards in IFRS.

**Staff Recommendation:** NAIC staff recommends that the Working Group move this item to the active listing, categorized as nonsubstantive, and expose revisions to Appendix D—Nonapplicable GAAP Pronouncements to reject ASU 2016-14, Presentation of Financial Statements of Not-for-Profit Entities as not applicable to statutory accounting.

This item is proposed to be rejected as not applicable as statutory accounting guidance does not separately present assets based on donor restrictions. If assets are restricted, they must be identified as restricted in the investment schedules and captured in the restricted note disclosure. Furthermore, the concept of donor-restrictions for insurance reporting entities is not identified to be a prevalent concept.

**Staff Review Completed by: Jim Pinegar – August 2019**

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Statutory Accounting Principles (E) Working Group
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Issue: Grade in of Variable Annuity Reserves

Check (applicable entity):

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Description of Issue:
At the 2019 Summer National Meeting, the NAIC Executive and Plenary adopted revisions drafted by the Life Actuarial (A) Task Force to Section 21 of the Valuation Manual Requirements for Principle-Based Reserves for Variable Annuities (VM-21) which provides comprehensive updates to the Commissioners Annuity Reserve Valuation Method of reserving for variable annuities. The revisions adopted to VM-21 represent an accounting change that must be recognized as a change in valuation basis under SSAP No. 51R—Life Contracts. Updates to SSAP No. 51R are needed to coordinate with the recent revisions to the variable annuity reserving methodology. In addition, the proposed revisions recommend deferring to VM-21 regarding future variable annuity reserving methodology phase-ins along with disclosure on phase in details.

The enhancements to the variable annuity framework resulting in revisions to AG 43 and VM-21 centered around the following:

- Reforming the standard scenario to enhance regulatory oversight of companies’ actuarial assumptions
- Mitigating asset-liability accounting mismatch between hedge instruments and statutory liabilities
- Improving interpretability of framework results and simplicity of calculations
- Facilitating greater harmonization across insurers and products for greater comparability

To achieve this focus the determination of the Conditional Tail Expectation (CTE) amount, Standard Scenario and the Standard Scenario amount has changed significantly resulting in the revised variable annuity reserves methodology.

The revisions to VM-21 in combination with the revisions to Actuarial Guideline XLIII CARVM For Variable Annuities (AG 43) applies retroactively to contracts issued between 1981 and Dec. 31, 2019 as follows:

- VM-21 changes affect reserving for contracts issued Jan. 1, 2017 through Dec. 31, 2019
- AG 43 changes affect reserving for contracts issued to 1981 through Dec. 31, 2016

These changes to the variable annuity reserving framework updated the principles and methodology and apply retroactively (see Authoritative Literature). Under SSAP No. 55 a change in valuation basis is recognized as a change in surplus rather than an increase in reserves recognized through income.

The VM-21 allows the following choices for phasing in the change in reserving valuation basis necessitated by variable annuity reserving methodology changes. Early adoption, beginning Dec. 31, 2019

- Adoption in full beginning Jan.1, 2020
- A reporting entity election to grade in over 3 years.
- An election to grade in over 7 years, subject to commissioner discretion.

In addition, it provides the following acceleration provisions:
• Early termination and full recognition,
• If there is a material decrease in the book of business by sale or reinsurance ceded, the company shall adjust the amount of the grade-in provision. The grade-in amount \((C = R_1 - R_2)\), as described below) must be scaled down in proportion to the reduction in the excess reserve, measured on the effective transaction date as the reserve amount in excess of cash surrender value before and after the impact of the transaction.
• The company must obtain approval for any other modification of the remaining grade-in amount.

**Existing Authoritative Literature:**

Valuation Manual – Section 21

Effective Date and Phase-In These requirements apply for valuation dates on or after Jan. 1, 2020. A company may elect to phase in these requirements over a 36-month period beginning Jan. 1, 2020. A company may elect a longer phase-in period, up to seven years, with approval of the domiciliary commissioner. The election of whether to phase in and the period of phase-in must be made prior to the Dec. 31, 2020, valuation. At the company’s option, a phase-in may be terminated prior to the originally elected end of the phase-in period; the reserve would then be equal to the unadjusted reserve calculated according to the requirements of VM-21 applicable for valuation dates on or after Jan. 1, 2020. If there is a material decrease in the book of business by sale or reinsurance ceded, the company shall adjust the amount of the phase-in provision. The phase-in amount \((C = R_1 - R_2)\), as described below) must be scaled down in proportion to the reduction in the excess reserve, measured on the effective transaction date as the reserve amount in excess of cash surrender value before and after the impact of the transaction. The company must obtain approval for any other modification of the remaining phase-in amount. The method to be used for the phase-in calculation is as follows:

**SSAP No. 51R—Life Contracts**

**Change In Valuation Basis**

36. A change in valuation basis for reserves determined under paragraphs 18-21, except for reserves defined under Actuarial Guideline XLIII—CARVM: For Variable Annuities (AG 43), as detailed in Appendix C of this Manual, shall be defined as a change in the interest rate, mortality assumption, or reserving method (e.g., net level, preliminary term, etc.) or other factors affecting the reserve computation of policies in force and meets the definition of an accounting change as defined in SSAP No. 3—Accounting Changes and Corrections of Errors (SSAP No. 3).

37. Changes in reserves developed under paragraph 22 or AG 43 shall be reviewed to determine whether the change represents a change in valuation basis and if it meets the definition of a change in accounting as defined in SSAP No. 3.

a. Changes in principle-based reserving assumptions are often the result of updating assumptions and other factors required by the existing reserving methodology. Reserve changes resulting from the application of principle-based reserving methodology including, but not limited to, updating assumptions based on reporting entity, industry or other experience, and having the reported reserve transition between net premium reserve, deterministic reserve or stochastic reserve, as required under existing guidance, shall not be considered a change in valuation basis. These types of changes also include, but are not limited to, periodic updates in Valuation Manual tables, such as industry valuation basic tables, asset spread tables and default cost tables.

b. A change in valuation basis for principle-based reserves shall include cases where the required reserve methodology has changed or the insurer makes a voluntary decision to choose one allowable reserving method over another. These types of changes include, but are not limited to, new standardized mortality tables such as Commissioners Standard Ordinary tables and regulatory changes in methodology.
38. Consistent with SSAP No. 3, any increase (strengthening) or decrease (destrengthening) in actuarial reserves resulting from such a change in valuation basis shall be recorded directly to surplus (under changes to surplus in the change in valuation basis annual statement line) rather than as a part of the reserve change recognized in the summary of operations.

39. The impact of a change in valuation basis on surplus is based on the difference between the reported reserve under the old and new methods as of the beginning of the year. This difference shall not be graded in over time unless this statement prescribes a new method and a specific transition that allows for grading. Some changes will meet the definition of a change in accounting as defined in SSAP No. 3 and a change in valuation basis as described in paragraphs 36-38 of this statement, but the adjustment to surplus will be zero. This can happen when the change in valuation basis is prospective and only applies to new policies and reserves meaning that policies in force for the prior year-end are not affected, or situations in which the change in reserving methodology did not change the reserves reported in the financial statements. The changes remain subject to the disclosures prescribed in SSAP No. 3. The Valuation Manual is effective prospectively for policies written on or after the operative date. Therefore, upon the initial prospective adoption of principle-based reserving, the change in valuation basis reflected as an adjustment to surplus will be zero. After initial adoption of the Valuation Manual, changes in valuation basis will need to be evaluated to determine the amount of any surplus adjustments.

SSAP No. 3—Accounting Changes and Corrections of Errors

Disclosures

13. Disclosure of material changes in accounting and correction of errors shall include:

   a. A brief description of the change, encompassing a general disclosure of the reason and justification for change or correction;

   b. The impact of the change or correction on net income, surplus, total assets, and total liabilities for the two years presented in the financial statements (i.e., the balance sheet and statement of income and operations); and

   c. The effect on net income of the current period for a change in estimate that affects several future periods, such as a change in the service lives of depreciable assets or actuarial assumptions affecting pension costs. Disclosure of the effect on those income statement amounts is not necessary for estimates made each period in the ordinary course of accounting for items such as uncollectible accounts; however, disclosure is recommended if the effect of a change in the estimate is material; and

   d. When subsequent financial statements are issued containing comparative restated results as a result of the filing of an amended financial statement, the reporting entity shall disclose that the prior period has been restated and the nature and amount of such restatement.

14. 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): None

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

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

Staff Review Completed by:
Robin Marcotte, NAIC Staff

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November 2019

Staff Recommendation:

NAIC staff recommends that the Working Group move this item to the active listing, categorized as nonsubstantive and expose the revisions described and illustrated below to SSAP No. 51R—Life Contracts, and adding reference to the additional grade-in disclosure requirements in SSAP No. 3—Accounting Changes and Corrections of Errors for reporting years beginning Jan. 1, 2020. In addition, NAIC staff plans a future agenda item regarding exercise of Commissioner Discretion in the VM. Proposed revisions detailed in the current agenda item:

1. Revises the existing guidance, which prohibits grading-in changes in valuation basis unless provided for in the statement, to allow a grade-in for changes in valuation basis if permitted by the statement or the Valuation Manual in section VM-21 Requirements for Principle-Based Reserves for Variable Annuities (VM-21). Historically choosing effective dates for major reserving changes for the Accounting Practices and Procedures Manual has been determined by Working Group, for example the 2001 CSO table (adopted in 2002) was effective for policies January 1, 2004 in Appendix A-820. This has been to promote consistent implementation and reporting. By deferring to the VM-21 on grade-in options with many varied features, there will be less comparability in reporting, because there is more optionality in reserve reporting. Therefore, additional disclosure regarding grade-in has been proposed.

2. A change in valuation basis under SSAP No. 51R is recognized through surplus. As the unrecognized graded-in reserve represents an unrecognized adjustment to surplus, the revisions require the unrecognized grade-in amount from a change in valuation basis, if resulting with an increase in reserves (decrease from surplus), to be reported as an allocation from unassigned funds to special surplus until the amount has been fully graded into unassigned funds. The reclassification from unassigned funds to special surplus does not reduce total surplus. This is to provide transparency regarding the increased reserve amount that has not been reflected into surplus. As amounts are graded-in to reduce surplus, the amount in special surplus is reclassified to unassigned funds.

3. The proposed revisions to SSAP No. 51R expand the disclosure for changes in valuation basis as a change in accounting principle under SSAP No. 3 to also include details regarding grade-ins of changes in valuation basis, including the grade-in period applied, the remaining amount to be graded-in, remaining time for the grade-in period and the initial grade-in amount and any adjustments to the original amount.

4. Adds a reference in SSAP No. 3 regarding additional disclosures of grade-in features.

NAIC staff plans to propose a new agenda item to address commissioner discretion in the VM. The exercise of commissioner discretion has been typically removed from Appendix A – Excerpts of Model Laws so that if it is exercised, it is disclosed as a permitted or prescribed difference in Note 1 to provide transparency and comparability. As the Valuation Manual incorporates Commissioner discretion that might not be reported as a prescribed or permitted practice, NAIC staff also recommends a future agenda item, regarding how to provide transparency on the use of commissioner discretion.

SSAP No. 51R:

Change In Valuation Basis

36. A change in valuation basis for reserves determined under paragraphs 18-21, except for reserves defined under Actuarial Guideline XLIII—CARVM: For Variable Annuities (AG 43), as detailed in Appendix C of this Manual, shall be defined as a change in the interest rate, mortality assumption, or reserving method (e.g., net level, preliminary term, etc.) or other factors affecting the reserve computation of policies in force and meets the definition of an accounting change as defined in SSAP No. 3—Accounting Changes and Corrections of Errors (SSAP No. 3).
37. Changes in reserves developed under paragraph 22 or AG 43 shall be reviewed to determine whether the change represents a change in valuation basis and if it meets the definition of a change in accounting as defined in SSAP No. 3.

   a. Changes in principle-based reserving assumptions are often the result of updating assumptions and other factors required by the existing reserving methodology. Reserve changes resulting from the application of principle-based reserving methodology including, but not limited to, updating assumptions based on reporting entity, industry or other experience, and having the reported reserve transition between net premium reserve, deterministic reserve or stochastic reserve, as required under existing guidance, shall not be considered a change in valuation basis. These types of changes also include, but are not limited to, periodic updates in Valuation Manual tables, such as industry valuation basic tables, asset spread tables and default cost tables.

   b. A change in valuation basis for principle-based reserves shall include cases where the required reserve methodology has changed, or the insurer makes a voluntary decision to choose one allowable reserving method over another. These types of changes include, but are not limited to, new standardized mortality tables such as Commissioners Standard Ordinary tables and regulatory changes in methodology.

38. Consistent with SSAP No. 3, any increase (strengthening) or decrease (destrengthening) in actuarial reserves resulting from such a change in valuation basis shall be recorded directly to surplus (under changes to surplus in the change in valuation basis annual statement line) rather than as a part of the reserve change recognized in the summary of operations.

39. The impact of a change in valuation basis on surplus is based on the difference between the reported reserve under the old and new methods as of the beginning of the year. This difference shall not be graded in over time unless this statement or the Valuation Manual in section VM-21 Requirements for Principle-Based Reserves for Variable Annuities (VM-21) prescribes a new method and a specific transition that allows for grading. If the grading permitted by this statement or Valuation Manual section VM-21 represents an increase in the reserve liabilities, the unrecognized change in valuation basis reserve increase shall initially be reflected as an allocation from unassigned funds to special surplus until fully recognized in reserving and unassigned funds. The reclassification from unassigned funds to special surplus does not reduce total surplus, but highlights the ungraded in amount for transparency as it represents an unrecognized adjustment (decrease) to total surplus. The allocation to special surplus is reversed to unassigned funds as the grading of the increase in reserving is recognized as a decrease to total surplus. Some changes will meet the definition of a change in accounting as defined in SSAP No. 3 and a change in valuation basis as described in paragraphs 36-38 of this statement, but the adjustment to surplus will be zero. This can happen when the change in valuation basis is prospective and only applies to new policies and reserves meaning that policies in force for the prior year-end are not affected, or situations in which the change in reserving methodology did not change the reserves reported in the financial statements. The changes remain subject to the disclosures prescribed in SSAP No. 3. In addition, if the Valuation Manual section VM-21 (on variable annuities) or this statement prescribes or permits a grading in period or provides the option of multiple grading periods, reporting entities shall also include in the change in accounting disclosures required by SSAP No. 3, disclosure of the following:

   a. the grade in period being applied, and the remaining time period of the grade in

   b. any adjustments to the grade in period.

   c. amount of change in valuation basis grade in, which has been recognized in unassigned funds and

   d. the remaining amount to be graded-in (reflected in special surplus if the ungraded in amount represents an increase in reserving).
40. Some changes will meet the definition of a change in accounting as defined in SSAP No. 3 and a change in valuation basis as described in paragraphs 36-38 of this statement, but the adjustment to surplus will be zero. This can happen when the change in valuation basis is prospective and only applies to new policies and reserves meaning that policies inforce for the prior year-end are not affected, or situations in which the change in reserving methodology did not change the reserves reported in the financial statements. The Valuation Manual is effective prospectively for policies written on or after the operative date, however, as the CARVM methodology was already principles based, some changes to the CARVM methodology in section VM-21 (on variable annuities) and to the related AG 43 may result in retroactive application to the reserving for existing contracts. Therefore, upon the initial prospective adoption of principle-based reserving, the change in valuation basis reflected as an adjustment to surplus will be zero. After initial adoption of the Valuation Manual, changes in valuation basis will need to be evaluated to determine the amount of any surplus adjustments.

**SSAP No. 3—Accounting Changes and Corrections of Errors**

**Disclosures**

Disclosure of material changes in accounting and correction of errors shall include:

a. A brief description of the change, encompassing a general disclosure of the reason and justification for change or correction;

b. The impact of the change or correction on net income, surplus, total assets, and total liabilities for the two years presented in the financial statements (i.e., the balance sheet and statement of income and operations); and

c. The effect on net income of the current period for a change in estimate that affects several future periods, such as a change in the service lives of depreciable assets or actuarial assumptions affecting pension costs. Disclosure of the effect on those income statement amounts is not necessary for estimates made each period in the ordinary course of accounting for items such as uncollectible accounts; however, disclosure is recommended if the effect of a change in the estimate is material;

d. Changes in accounting that are changes in reserve valuation basis as described in SSAP No. 51R—Life Contracts which have grade in or other optional application features, shall also include in the change in accounting disclosures information regarding the application of any grade in as provided for in SSAP No. 51R.

e. When subsequent financial statements are issued containing comparative restated results as a result of the filing of an amended financial statement, the reporting entity shall disclose that the prior period has been restated and the nature and amount of such restatement.
Statutory Accounting Principles (E) Working Group
Maintenance Agenda Submission Form
Form A

Issue: Disclosure Update for Reciprocal Jurisdiction Reinsurers

Check (applicable entity):

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Description of Issue:
On June 25, 2019, NAIC Executive Committee and Plenary adopted revisions to the Credit for Reinsurance Model Law (#785) and the Credit for Reinsurance Model Regulation (#786) to incorporate relevant provisions from the “Bilateral Agreement Between the United States of America and the European Union on Prudential Measures Regarding Insurance and Reinsurance” and the “Bilateral Agreement Between the United States of America and the United Kingdom Regarding Insurance and Reinsurance” (collectively referred to as the Covered Agreement). The purpose of this agenda item is to revise one disclosure in SSAP No. 62R—Property and Casualty Reinsurance to reference “reciprocal jurisdictions.”

Existing Authoritative Literature:
The Credit for Reinsurance Model Law (#785) and the Credit for Reinsurance Model Regulation (#786), as they are adopted by the states are the primary legal guidance for credit for reinsurance.

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): Revisions to Appendix A-785 were exposed at the Summer National Meeting, and a Blanks proposal will be exposed at the Reinsurance (E) Task Force at the Fall National Meeting and by the Blanks (E) Working Group after the Fall National Meeting.

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


Staff Recommendation:
NAIC Staff recommends that the Working Group move this item to the active listing, categorized as nonsubstantive and expose revisions SSAP No. 62R to incorporate disclosure updates for reinsurers from Reciprocal Jurisdictions. The proposed revisions are illustrated below:

106. Unsecured Reinsurance Recoverables:

   a. If the entity has with any individual reinsurers, authorized, reciprocal jurisdiction, unauthorized, or certified an unsecured aggregate recoverable for losses, paid and unpaid including IBNR, loss adjustment expenses, and unearned premium, that exceeds 3% of the entity’s policyholder surplus, list each individual reinsurer and the unsecured aggregate recoverable pertaining to that reinsurer; and

Staff Review Completed by: Jake Stultz—July 2019
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Accounting Principles (E) Working Group
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Form A

Issue: Retroactive Reinsurance Exception

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| At the 2019 Summer National Meeting, the Statutory Accounting Principles (E) Working Group, the Casualty Actuarial and Statistical (C) Task Force and the Surplus Lines (C) Task Force received a request from the Committee on Property and Liability Financial Reporting (COPLFR) of the American Academy of Actuaries Working Group. The request was to clarify the accounting and reporting for retroactive reinsurance which meets the SSAP No. 62R—Property and Casualty Reinsurance exceptions to be accounted for as prospective reinsurance. The request specifically asked for the NAIC groups to:

- Provide consistent guidance on the reporting treatment to both the ceding entity and assuming entity, where both are members of the same group and are consolidated in the same Combined Annual Statement.

- Clarify the reporting method to be used if the ceding entity and assuming entity are not in the same group.

This agenda item is to address the inconsistencies in application of the reinsurance accounting and reporting guidance, particularly the impact on Schedule P – Analysis of Losses and Loss Expenses (Schedule P) that were highlighted in the request.

The request indicated that COPLFR has noted that the guidance for portfolio retroactive reinsurance that meets the exceptions to be accounted for as prospective reinsurance (SSAP 62R, paragraph 36) but that does not meet the definition of Run-Off Agreements (SSAP 62R, paragraphs 102-105) is ambiguous regarding reporting requirements, and specifically the reporting in the NAIC Statutory Annual Statement’s Schedule P. The ambiguity has led to materially different presentations in Schedule P. The letter requested that this ambiguity in Schedule P presentation should be addressed, given that industry Schedule P is utilized for risk-based capital (RBC) purposes as well as other purposes, and given the increased propensity for companies to entertain partial loss portfolio transfers that do not fully meet the requirements of “Run-Off Agreements.”

Attached to the letter were two insurance company examples of publicly filed Schedule P’s illustrating this ambiguity. This resulted in different reporting in Schedule P of intercompany retroactive reinsurance agreements that met the intercompany exception for prospective accounting. Note that COPLFR did not state a preference for the approach and the impact on annual statement Schedule P.

- Entity A in the retroactive cession (accounted for prospectively) initially reported the reinsurance premium paid as current calendar year ceded earned premium. Initially, entity A included all of the ceded losses in accident year 2015. However, for the following year, entity A recorded the ceded losses across the subject accident years

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1 SSAP 62R gives guidance on the accounting treatment of “Run-Off Agreements,” but that definition only applies to situations where an insurer exits “essentially all the risks ... of a specific line” and no longer writes business in that line. That guidance does not address the increasingly common situation where an insurer cedes reserves from all or a portion of prior writings for a line but continues to write new/renewal business for that line, i.e., partial portfolio transfers.
and prior. This approach distorted the initial calendar year and accident year loss ratios and the loss development patterns for accident years 2015 and 2012 and prior years.

- Entity G in the year of the retroactive cession (accounted for prospectively) to a parent reported the reinsurance premium paid as ceded earned premium spread to prior calendar years (based on the allocation of loss reserves by accident year as of January 1, 2014), with the ceded losses also spread across prior accident years. This avoided distorting the calendar year / accident year loss ratios but distorted the loss development patterns.

COPLFR noted that:

Attached to this letter are two insurance company examples of filed Schedule P’s illustrating this ambiguity. We note that the Schedule P information is publicly available data.

In 2015 Allianz Global Risks US Insurance Company ("Allianz") ceded much of its 2012 & prior Workers Compensation ("WC") business to a U.S. affiliate, San Francisco Reinsurance ("San Francisco Re"). San Francisco Re is now named Allianz Reinsurance of America, Inc. ("Allianz Re"). In doing so it treated all the consideration paid as calendar year ("CY") 2015 ceded earned premium. Initially, as of December 31, 2015, Allianz included all of the ceded losses in accident year ("AY") 2015. However, for the following year (as of December 31, 2016), Allianz recorded the ceded losses across the subject AYs 2012 and prior. This approach distorted the 2015 CY and AY loss ratios and the loss development patterns for AYs 2015 and 2012 and prior. We have attached the relevant Schedule P excerpts from Allianz’s 2015 and 2016 Annual Statements as Attachment A. Descriptions of the transaction are described in the Allianz Re Statement of Actuarial Opinion as of December 31, 2018, also a public document, in Attachment A1SAO. The Management Discussion and Analysis for Allianz Re as of December 31, 2018, is attached as Attachment A2MDA.

In 2014, Government Employees Insurance Company ("GEICO") ceded half of its loss and Loss Adjustment Expense (hereinafter collectively referred to as "loss") reserves as of January 1, 2014, to its indirect parent, National Indemnity Company ("NICO"). In doing so it treated the consideration paid as ceded earned premium spread to prior CYs (based on the allocation of loss reserves by AY as of January 1, 2014), with the ceded losses also spread across prior AYs. This avoided distorting the CY/AY loss ratios but did distort the loss development patterns. We have attached the Schedule P and Note 21 excerpts from the 2014 GEICO Annual Statement as Attachment B.

Both transactions had the potential to materially distort industry totals with regard to loss development. They also most likely did distort data used in the RBC calculations for those companies. We note that it is unclear from either SSAP 62R or Schedule P instructions whether either should have done anything different. Whether to record ceded earned premium all to one CY, or to all the CYs with impacted AYs, appears to be up to the individual company’s option. We also note that these transactions can distort other schedules on the Annual Statement such as Page 3, the Underwriting and Investment Exhibits, and Schedule F.

For those agreements meeting the definition of “Run-Off Agreements” in SSAP 62R (paragraph 81), the required accounting is clear. The ceded earned premium from such agreements is to be recorded as a negative paid loss, so as not to distort the incurred development data by AY. But neither the GEICO nor the Allianz agreements were “run-off” agreements as they transferred only a portion of the prior book (and the ceding companies were still writing new business for that line/market).

We suggest that the NAIC expand the Annual Statement Instructions, and recommend SSAP 62R be clarified, as follows:

- Provide consistent guidance on the reporting treatment in these situations to both the ceding entity and assuming entity, where both are members of the same group and are consolidated in the same Combined Annual Statement.
• Clarify the reporting method to be used if the ceding entity and assuming entity are not in the same group.

We note that the treatment of these transactions impacts the industry RBC calculation. If both sides handle the transaction the same way and both are U.S. reporting entities, the industry RBC calculation might not be impacted. However, the industry RBC calculation would be impacted if the two sides handle the transaction differently, or if one side was a U.S. company and the other side was a non-U.S. company. Therefore, we recommend clarification to the Annual Statement Instructions and SSAP 62R.

Existing Authoritative Literature:

SSAP No. 62R

Accounting for Retroactive Reinsurance Agreements

33. Certain reinsurance agreements which transfer both components of insurance risk cover liabilities which occurred prior to the effective date of the agreement. Due to potential abuses involving the creation of surplus to policyholders and the distortion of underwriting results, special accounting treatment for these agreements is warranted.

34. All retroactive reinsurance agreements entered into, renewed or amended on or after January 1, 1994 (including subsequent development of such transactions) shall be accounted for and reported in the following manner:

a. The ceding entity shall record, without recognition of the retroactive reinsurance, loss and loss expense reserves on a gross basis on the balance sheet and in all schedules and exhibits;

b. The assuming entity shall exclude the retroactive reinsurance from loss and loss expense reserves and from all schedules and exhibits;

c. The ceding entity and the assuming entity shall report by write-in item on the balance sheet, the total amount of all retroactive reinsurance, identified as retroactive reinsurance reserve ceded or assumed, recorded as a contra-liability by the ceding entity and as a liability by the assuming entity;

d. The ceding entity shall, by write-in item on the balance sheet, restrict surplus resulting from any retroactive reinsurance as a special surplus fund, designated as special surplus from retroactive reinsurance account;

e. The surplus gain from any retroactive reinsurance shall not be classified as unassigned funds (surplus) until the actual retroactive reinsurance recovered exceeds the consideration paid;

f. The special surplus from retroactive reinsurance account for each respective retroactive reinsurance agreement shall be reduced at the time the ceding entity begins to recover funds from the assuming entity in amounts exceeding the consideration paid by the ceding entity under such agreement, or adjusted as provided in paragraph 34.j.;

g. For each agreement, the reduction in the special surplus from retroactive reinsurance account shall be limited to the lesser of (i) the actual amount recovered in excess of consideration paid or (ii) the initial surplus gain resulting from the respective retroactive reinsurance agreement. Any remaining balance in the special surplus from retroactive reinsurance account derived from any such agreement shall be returned to unassigned funds (surplus) upon elimination of all policy obligations subject to the retroactive reinsurance agreement;
h. The ceding entity shall report the initial gain arising from a retroactive reinsurance transaction (i.e., the difference between the consideration paid to the reinsurer and the total reserves ceded to the reinsurer) as a write-in item on the statement of income, to be identified as Retroactive Reinsurance Gain and included under Other Income;

i. The assuming entity shall report the initial loss arising from a retroactive reinsurance transaction, as defined in the preceding paragraph 34.g., as a write-in item on the statement of income, to be identified as Retroactive Reinsurance Loss and included under Other Income;

j. Any subsequent increase or reduction in the total reserves ceded under a retroactive reinsurance agreement shall be reported in the manner described in the preceding paragraphs 34.h. and 34.i., in order to recognize the gain or loss arising from such increase or reduction in reserves ceded. The Special Surplus from Retroactive Reinsurance Account write-in entry on the balance sheet shall be adjusted, upward or downward, to reflect such increase or reduction in reserves ceded. The Special Surplus from Retroactive Reinsurance Account write-in entry shall be equal to or less than the total ceded reserves under all retroactive reinsurance agreements in-force as of the date of the financial statement. Special surplus arising from a retroactive reinsurance transaction shall be considered to be earned surplus (i.e., transferred to unassigned funds (surplus)) only when cash recoveries from the assuming entity exceed the consideration paid by the ceding entity as respects such retroactive reinsurance transaction; and

k. The consideration paid for a retroactive reinsurance agreement shall be reported as a decrease in ledger assets by the ceding entity and as an increase in ledger assets by the assuming entity.

(For an illustration of ceding entity accounting entries see question 31 in Exhibit A.)

35. Portfolio reinsurance is the transfer of an insurer’s entire liability for in force policies or outstanding losses, or both, of a segment of the insurer’s business. Loss portfolio transactions are to be accounted for as retroactive reinsurance.

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;

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.

38. The accounting and reporting provisions applicable to retroactive reinsurance apply to all transactions transferring liabilities in connection with a court-ordered rehabilitation, liquidation, or receivership. The requirement to include stipulated contract provisions in the reinsurance agreements shall not apply to these transactions, with written approval of the ceding entity’s domiciliary commissioner.

39. Novations meeting the requirements of paragraph 36.b. shall be accounted for as prospective reinsurance agreements. The original direct insurer, or the original assuming insurer, shall report amounts paid as a reduction of written and earned premiums, and unearned premiums to the extent that premiums have not been earned. Novated balances (e.g., loss and loss adjustment expense reserves) shall be written off through the accounts, exhibits, and schedules in which they were originally recorded. The assuming insurer shall report amounts received as written and earned premiums, and obligations assumed as incurred losses in the statement of income.

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): This request was received at the 2019 Summer National Meeting by the Statutory Accounting Principles (E) Working Group, the Casualty Actuarial and Statistical (C) Task Force and the Surplus Lines Task Force.

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

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

Staff Recommendation:
NAIC staff agrees that there is diversity in practice and improved accounting and reporting guidance, with examples, would be beneficial. NAIC staff recommends that the Working Group move this item to the active listing, categorized as nonsubstantive and expose a request for comments and for industry and regulator volunteers to assist with developing guidance. The goal is to clarify both the accounting and reporting for retroactive contracts which are accounted for prospectively, including:

- Both the ceding entity and assuming entity, where both are members of the same group and are consolidated in the same Combined Annual Statement.
- The reporting method to be used if the ceding entity and assuming entity are not in the same group.

Comments are specially requested regarding the preferred approaches to reporting and the advantages and disadvantages to each approach being used, including both the Schedule P (and related loss analysis) and risk-based capital impacts.

NAIC staff also recommends that the Working Group direct a referral to notify the Casualty Actuarial (C) Task Force of the request for comments and the need for coordination.

Staff Review Completed by:
Robin Marcotte NAIC Staff
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Statutory Accounting Principles (E) Working Group
Maintenance Agenda Submission Form
Form A

Issue: Working Capital Finance Notes

Check (applicable entity):

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Modification of existing SSAP
New Issue or SSAP
Interpretation

Description of Issue:
The Valuation of Securities (E) Task Force has referred to the Working Group industry-prepared tracked revisions to SSAP No. 105—Working Capital Finance Investments and materials produced by the Securities Valuation Office (SVO) staff on the issues raised. The Task Force recommends that the Working Group consider the amendments, which the Task Force has previously exposed. This agenda item has been drafted to address the referral.

The industry-proposed revisions to SSAP No. 105 detailed in the referral can be grouped into the following categories:
1. Changes to program and or obligor credit quality requirements
2. Changes to program administration and/or documentation
3. Changes to regulatory compliance requirements
4. Changes to statutory reporting requirements.

Existing Authoritative Literature:
SSAP No. 105—Working Capital Finance Investments was originally effective on January 1, 2014.

Purposes and Procedures Manual of the NAIC Investment Analysis Office provides the following on NAIC Designations

NAIC 1 is assigned to obligations exhibiting the highest quality. Credit risk is at its lowest and the issuer’s credit profile is stable. This means that interest, principal or both will be paid in accordance with the contractual agreement and that repayment of principal is well protected. An NAIC 1 obligation should be eligible for the most favorable treatment provided under the NAIC Financial Regulation Standards and Accreditation Program.

NAIC 2 is assigned to obligations of high quality. Credit risk is low but may increase in the intermediate future and the issuer’s credit profile is reasonably stable. This means that for the present, the obligation’s protective elements suggest a high likelihood that interest, principal or both will be paid in accordance with the contractual agreement, but there are suggestions that an adverse change in circumstances or economic, financial or business conditions will affect the degree of protection and lead to a weakened capacity to pay. An NAIC 2 obligation should be eligible for relatively favorable treatment under the NAIC Financial Regulation Standards and Accreditation Program.

NAIC 3 is assigned to obligations of medium quality. Credit risk is intermediate and the issuer’s credit profile has elements of instability. These obligations exhibit speculative elements. This means that the likelihood that interest, principal or both will be paid in accordance with the contractual agreement is reasonable for the present, but an exposure to an adverse change in circumstances or economic, financial or business conditions would create an uncertainty about the issuer’s capacity to make timely payments. An NAIC 3 obligation should be eligible for less favorable treatment under the NAIC Financial Regulation Standards and Accreditation Program.
NAIC 4 is assigned to obligations of low quality. Credit risk is high and the issuer's credit profile is volatile. These obligations are highly speculative, but currently the issuer has the capacity to meet its obligations. This means that the likelihood that interest, principal or both will be paid in accordance with the contractual agreement is low and that an adverse change in circumstances or business, financial or economic conditions would accelerate credit risk, leading to a significant impairment in the issuer's capacity to make timely payments. An NAIC 4 obligation should be accorded stringent treatment under the NAIC Financial Regulation Standards and Accreditation Program.

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):

SSAP No. 105 permits admittance of Securities Valuation Office (SVO) designated WCFI programs that meet specific requirements. SSAP No. 105 was originally effective in 2014 and was controversial as it was developed at the request of a single life entity. At that time, some Working Group members objected to the development of a new statement of statutory accounting principles (SSAP), reporting changes and specific asset class risk-based capital (RBC) charges at the behest of a single company. The discussion at that time noted that the permitted practice concept was intended to address such situations.

In 2018, the single reporting entity that participates in these programs requested modifications to the adopted program and submitted a proposal for consideration. The Valuation of Securities (E) Task Force held discussion on the industry proposal in the third quarter of 2018, which was exposed for comment. The Task Force approved the referral at the 2019 Spring National Meeting.

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

Working Capital Finance Investments (WCFI) reported in the annual statement Schedule BA - Other Invested Assets continues to be limited to investments by the same single life entity that requested the development of SSAP No. 105. This company reported a total of $258 million in a total of seven WCFI programs for 2017 and $224 million in a total of six WCFI programs for 2018. The total of these amounts is immaterial to the reporting entity. No reporting entities disclosed any prescribed or permitted practices varying from SSAP No. 105 in annual statement Note 1 for 2017 or 2018.


Staff Review Completed by:
Robin Marcotte
NAIC Staff

Staff Recommendation:
Staff recommends that the Working Group receive the referral and provide initial direction on the referral, as it is still perceived as primarily impacting a single entity. If consideration of the referral, and revisions to SSAP No. 105 are supported, NAIC staff recommends that the Working Group direct NAIC staff to proceed with drafting revisions to SSAP No. 105, pursuant to the staff recommendations below which include a review of the industry proposed revisions. NAIC staff does support limited revisions to SSAP No. 105, but a few key elements requested by industry are not supported by NAIC staff.

The key industry proposed revisions included in the referral are under the heading “Details for Working Group Discussion.” If consideration of staff recommendations for the revisions to SSAP No. 105 are supported, NAIC staff will prepare updates to the industry proposal for future discussion based on the Working Group direction. Alternatively, the Working Group could choose to hold a separate call on this topic. The industry proposed revisions are substantive, but categorization could change based on the extent of the revisions.
The following is a summary of the NAIC Staff recommendations on the topics for Working Group discussion:

1. NAIC Staff **does not recommend** lowering the credit quality of the acceptable obligors from NAIC 1 (highest quality) and NAIC 2 (high quality) to allow NAIC designations of 3 (medium quality) and NAIC 4 (low quality) in the WCFI programs. The descriptions of NAIC designations in the *Purposes and Procedures Manual of the Investment Analysis Office note* that both NAIC designations of 3 and 4 have speculative elements (see Authoritative Literature and points for consideration). (paragraphs 6 & 7)

2. NAIC Staff **does not recommend** the proposed credit substitution methodology for unrated subsidiaries as it is overly complex, broad and difficult to apply. SVO staff memos also highlighted the difficulty in applying the industry proposed credit substitution methodology. (paragraph 7)

3. NAIC Staff **recommends the Working Group consider** removing the requirement that the SVO determine if the International Finance Agent is the functional equivalent of the US. Regulator. (paragraph 10.a)

4. NAIC Staff **recommends the Working Group consider** if removing the commingling requirements provide the desired degree of protection. In addition, the Working Group should discuss with the Task Force if the program revisions are functional for analysis purposes. The Working Group should also consider the potential impact of other proposed revisions including lower rated key participants and obligors (points for consideration are in the discussion below). (paragraph 10.b)

5. NAIC Staff **recommends the Working Group consider modifying** the finance agent independent review requirements as requested by industry. The industry proposal still provides independent review of the finance agent either by audit or through an internal control report. (paragraph 16)

6. NAIC SAPWG Staff **recommends the Working Group direct staff to prepare minor rewording** to paragraph 11b to improve readability and eliminate redundancy. (paragraph 11.b)

7. NAIC Staff **does not recommend** removing the statement that the reporting entity may need to seek approval from the domestic regulator as this is a statement rather than an explicit requirement and these investments may not fit into the normal investment law categories (points for consideration are in the discussion below). (paragraph 18)

8. NAIC Staff **recommends the Working Group consider modifying the filing certification requirements** and allowing the SVO to determine if a first priority perfected interest has been obtained. (paragraphs 14 & 15)

9. NAIC Staff **recommends the Working Group consider modifying** the default provisions from 15-30 days as it is more practical to have the default date and the cure period be consistent (points for consideration are in the discussion below). (paragraph 28)

10. NAIC Staff **does not recommend** the Working Group change the reporting requirements to move the WCFI investments from Schedule BA – Other Assets, to Schedule DA Short term Investments (points for consideration are in the discussion below). (paragraph 22)
Details for Working Group Discussion

A. Changes to program and or obligor credit quality requirements

SSAP No. 105 – Current provisions:

- Allow admitted asset treatment to receivables from WCFI programs that have high quality NAIC designations from the SVO (NAIC 1 or 2).
- Require the direct obligor to have a designation equivalent of NAIC 1 or 2.
- Nonadmits WCFNs if the program or the obligor falls below either credit threshold.

1. Admit Obligors and Program with Lower Credit Ratings – (Reference - SSAP No. 105, paragraph 7)

Industry proposal – Expand admitted asset treatment to include receivables from WCFI programs with NAIC SVO designations 3 and 4; and direct obligors with designation equivalents of NAIC 3 and 4.

1. NAIC Staff does not recommend lowering the credit quality of the acceptable obligors from NAIC 1 (highest quality) and NAIC 2 (high quality) to allow NAIC designations of 3 (medium quality) and NAIC 4 (low quality) in the WCFI programs. The descriptions of NAIC designations in the Purposes and Procedures Manual of the Investment Analysis Office note both NAIC designations of 3 and 4 have speculative elements (see Authoritative Literature).

- Assets that reflect “factored receivables” are nonadmitted in statutory accounting. The SAPWG created SSAP No. 105 to allow admission for only high-quality programs, from high quality obligors. Allowing obligors with lower credit assessments would be a fundamental change in program requirements.

- As noted in the P&P Manual:

  - NAIC 3 is assigned to obligations of medium quality. Credit risk is intermediate and the issuer’s credit profile has elements of instability. These obligations exhibit speculative elements. This means that the likelihood that interest, principal or both will be paid in accordance with the contractual agreement is reasonable for the present, but an exposure to an adverse change in circumstances or economic, financial or business conditions would create an uncertainty about the issuer's capacity to make timely payments. An NAIC 3 obligation should be eligible for less favorable treatment under the NAIC Financial Regulation Standards and Accreditation Program.

  - NAIC 4 is assigned to obligations of low quality. Credit risk is high and the issuer’s credit profile is volatile. These obligations are highly speculative, but currently the issuer has the capacity to meet its obligations. This means that the likelihood that interest, principal or both will be paid in accordance with the contractual agreement is low and that an adverse change in circumstances or business, financial or economic conditions would accelerate credit risk, leading to a significant impairment in the issuer's capacity to make timely payments. An NAIC 4 obligation should be accorded stringent treatment under the NAIC Financial Regulation Standards and Accreditation Program.

2. Unrated subsidiaries – (Reference - SSAP No. 105, paragraph 7)

Industry proposal has two aspects:

1. An unrated subsidiary obligor of a rated obligor - Proposes to attribute the credit strength of the rated parent to the unrated subsidiary obligor without the rated parent being a guarantor of the unrated subsidiary’s WCFI obligations. This proposal envisions the rated entity having some of its own obligations in the program
2. A rated obligor and its unrated subsidiaries which are key transaction participants, but not obligors. The industry proposal is to create criteria to allow the “program” to obtain an acceptable NAIC designation by evaluating if the unrated “key transaction participant” is able to perform its functions.

Industry proposes several different ways to attribute the rated entity’s credit rating to the unrated entity including:

- Documented operational control of unrated obligor, or
- An important inter-relationship with unrated obligor, or
- If the unrated key transaction participants are reasonably expected to perform their functions.

NAIC Staff does not recommend the proposed credit substitution methodology for unrated subsidiaries as it is overly complex, broad and difficult to apply. SVO staff memos excerpted below also highlighted the difficulty in applying the industry proposed credit substitution methodology.

SVO P&P Requirements – Note that it is possible for the program and the obligor to have different designations. SVO staff, noted that in their analysis key transaction participants could not have a lower designation than the entire program. Essentially their evaluation of a program is downgraded by the “weakest” link.

- Excerpts VOSTF October 2018 memo to the SAPWG:

SVO evaluated whether analytical discretion would enable it to designate WCFI programs with unrated obligors of a rated or designated parent. SVO evaluated whether operational and strategic linkages between a rated parent and unrated obligor can provide a basis to attribute the credit rating of one entity to the other. It concluded that no principle exists to permit an assumption that a legal entity can be held responsible for the debt of another without having contractually agreed to do so. While WCFI arrangements may be inherently different than the credit situations SVO assesses SVO lacks the experiential basis to opine on the idea that the difference permits attribution.

The SVO believes that it should be possible to develop performance criteria to evaluate the ability of the unrated entity to perform the functions expected of it. The goal would be to identify performance factors that could be evaluated in the exercise of analytical discretion to determine that the unrated entity could reliably perform the role expected of it.

B. Changes to Program Administration/Documentation Requirements

SSAP No. 105 – Current provisions:

- Requires the finance agent (bank, financial institution, financial intermediary or service provider) to fall under the jurisdiction of a financial regulator or that the investor be paid directly (No Commingling).
- If the finance agent is domiciled in another country that is on the SVO list of jurisdictions eligible for netting, it can be regulated by an agency that the SVO determines has a functional equivalent to the Board of Governors of the Federal Reserve System; 2) the Office of the Comptroller of the Currency; or 3) the Federal Deposit Insurance Corporation.
- As an alternative to having a regulated finance agent, SSAP No. 105 allows for the investor to be paid directly without funds flowing through the finance agent. The SSAP program requirements for admission excludes programs which commingle funds of the obligor, supplier, servicers or other investors.


Industry proposal – Remove the requirement for the SVO to determine functionally equivalent regulators of finance agents in other countries.
Excerpts from VOSTF October 2018 memo to the SAPWG:

The SVO either determines that an international finance agent’s regulator is the functional equivalent of specified US federal bank regulators or verifies that payments due to the investor are not commingled. Determining functional equivalence is not an analytical issue. Therefore, programs are evaluated on the commingling standard. However, the prohibition of commingling is a requirement so the SVO verifies that commingling can never occur or fails the program.

➢ **NAIC Staff recommends the Working Group consider removing the requirement that the SVO determine if the International Finance Agent is the functional equivalent of the US. Regulator.**

4. **Remove finance agent commingling requirements** – (Reference SSAP No. 105, paragraph 10.b.)

**Industry proposal** – As an alternative to having a regulated finance agent, allow the payments to be paid directly to the investor or paid into an account maintained by a regulated financial institution for the benefit of investors without the agent being the beneficiary of the payments. This would require removal of the commingling prohibition.

➢ **NAIC Staff recommends Working Group consider if removing the commingling requirements provide the desired degree of protection.** In addition, the Working Group should discuss with the Task Force if the program revisions are functional for analysis purposes. The Working Group should also consider the potential impact of other proposed revisions including lower rated key participants and obligors. Points for consideration:

- SVO staff noted in their October 2018 memo that some programs fail the commingling requirement. SVO staff noted if commingling were not a requirement it would consider commingling risk, when present, as a structural deficiency and balance it against the requirement that the Finance Agent be NAIC 1 or NAIC 2.

- Discussions with SVO staff indicated that although the Finance Agent is not required by SSAP No. 105 to be an NAIC 1 or NAIC 2, that as a key participant, the SVO analysis would require it to have an NAIC 1 or NAIC 2 in order for the program to meet the credit quality requirements. Note that if the program requirements were lowered, presumably the key participants could also have lower designations.

5. **Finance agent validation requirements** – (Reference SSAP No. 105, paragraph 16)

**SSAP No. 105** – Requires that the annual program filing to the SVO include an annual audit which is unqualified related to servicing. In addition, it requires either an independent report on the controls of the finance agent related to the administration of the investment (SSAE 16 report) or an annual audit of the internal controls. Consolidated reports which include the finance agent are acceptable. SSAP No. 105 allows for materiality judgment of the SVO relative to the report findings.

**Industry proposal** – Make the annual audit requirement one of two options, with either a SSAE 16 report (or its functional equivalent), or an annual audit of the financial statements which includes internal controls. Retain the requirement to only permit reports which do not contain qualifications related to servicing of WCFI.

➢ **NAIC Staff recommends the Working Group consider modifying the finance agent independent review requirements as requested by industry.** The industry proposal still provides independent review of the finance agent either by audit or through an internal control report.

6. **Confirmed Supplier Receivable** – (Reference SSAP No. 105, paragraph 11b)
SSAP No. 105 – Requires that the ability of the investor to exercise its creditor rights not be subject to the discretion of the finance agent, other lenders or investors. A separate sentence notes the same requirements but allows an exception that a cure period not to exceed 30 days is permissible.

Industry proposal – Remove the sentence “shall not be subject to the discretion of the finance agent other lenders or investors” but keep the subsequent sentence.

➢ NAIC SAPWG Staff recommends that the Working Group direct staff to prepare minor rewording to paragraph 11b to improve readability and eliminate redundancy.

C. Regulatory Compliance Requirements

SSAP No. 105 – paragraph 18 provides the following:

18. Reporting entity investors must have the ability to monitor the working capital finance program and the credit-related activities of the obligor. Reporting entity investors must provide information as requested to the state of domicile indicating that they have the ability to monitor on an ongoing basis the activities of the working capital finance program. Initial permission to invest in Working Capital Finance Investment Programs may be required by the domiciliary commissioner.

7. Domestic Regulator Approval – (Reference SSAP No. 105, paragraph 18)

Industry proposal – Remove reference to the possibility for the need of insurers to seek prior approval from their domestic regulator.

➢ NAIC Staff does not recommend removing the statement that the reporting entity may need to seek approval from the domestic regulator as this is a statement rather than an explicit requirement. NAIC Staff provides the following points for consideration:

• Issue Paper No. 147 documents that requiring domestic regulator approval was an intentional decision because of concerns regarding the ability of smaller entities to monitor the investments in such programs on an ongoing basis.
• The current guidance in SSAP No. 105 is not an explicit requirement, but only identifies that a domiciliary commissioner may require a company to receive initial permission before investing in WCFI.
• These investments may not fit into the normal investment law categories.
• The Industry proposal agrees that the asset class is not for most insurers as it requires relationships with finance agents beyond the traditional dealer insurer.
• The Industry proposal notes that the investor needs specialized knowledge, asset management operations and the ability to book and supervise the assets.
• The Industry proposal notes that the filing fees require sizable commitments to justify the costs, which would make it cost prohibitive for smaller players.

8. Filing certification – (Reference SSAP No. 105, paragraphs 14 and 15)

SSAP No. 105 – Program requirements for a confirmed supplier receivable require the investor to certify that they have the commercially reasonable belief that their participation in the WCFI program results in a first priority perfected interest and required meeting Uniform Commercial Code (UCC) requirements in a legalistic manner. Annual filings require the investor to certify that the they have a commercially reasonable belief that they have met the standard for creating a first priority security interest. There is also a requirement that the SVO deems the investor’s belief reasonable.
**Industry proposal** – Remove requirement for legal officer to certify compliance in a obtained a first priority perfected interest in accordance with UCC requirements for each annual submission and related SVO requirements.

- SVO staff has indicated that the criteria in paragraphs 14 and 15 are typically determined when contracting a program and similar objectives can be accomplished in more ways than the UCC lien process. Requiring the UCC lien process is overly prescriptive.

- The definition in SSAP No. 105 of a confirmed supplier receivable requires a first priority perfected interest and, SVO analytical staff should be able to determine if first priority interest has been achieved.

> **NAIC Staff recommends the Working Group consider modifying the filing certification** requirements and allowing the SVO to determine if a first priority perfected interest has been obtained.

9. **Default date** – (Reference SSAP No. 105, paragraph 28)

**SSAP No. 105** – A WCFI program is in default and nonadmitted when payments are uncollected within 15 days.

**Industry proposal** – Extend default and nonadmission date to 30 days.

> **NAIC Staff recommends that the Working Group consider modifying** the default provisions from 15-30 days as it is more practical to have the default date and the cure period be consistent. Key discussion points are:

- Waiting 30 days for a short-term asset can be material in relation to the life of the asset.

- Fifteen (15) days was previously chosen to be consistent with settlement guidance in **SSAP No. 21—Other Admitted Assets**, which nonadmits and reclassifies receivables for securities not settled within 15 days.

- The “cure period” noted in paragraph 11.b on confirmed supplier receivables is not to exceed 30 days so it may make sense for the default date and the end of the cure period to be consistent.

**D. Change to Statutory Reporting**

10. **Change Reporting Category** – (Reference SSAP No. 105 – paragraph 22)

**SSAP No. 105** – Requires WCFI receivables to be on annual statement Schedule BA- Other Long-term Assets on specifically created reporting lines. Capital Adequacy (E) Task Force reviewed the asset class and requires specific (relatively low) RBC charges based on the NAIC SVO WCFI program designation.

**Industry proposal** – Move the statutory reporting of Working Capital Finance Investments from Schedule BA-Other Long-term Assets to Schedule DA, Short Term Investments because the receivables within the rated WCFI programs are required to be less than one year.

> **NAIC Staff does not recommend the Working Group change the reporting requirements to move the WCFI investments from Schedule BA – Other Assets, to Schedule DA Short term Investments** (points for consideration are in discussion below). Key reasons include:
• This is an unique class. Issue Paper No. 147, documents the VOSTF recommendation for Schedule BA reporting. The Task Force discussed the relative benefits between Schedule BA and DA and concluded that WCFIs should be reported as Other Invested Assets and therefore Schedule BA provides an enhanced disclosure framework deemed more appropriate for the investment.

• This reporting was intentional because the long-term programs are designated, even though the different investments are short term.

• Annual statement lines and RBC charges have already been established and the current RBC charges based on program designation would not be functional if the reporting was on Schedule DA, because that schedule does not include designations.

Status:
On August 3, 2019, the Statutory Accounting Principles (E) Working Group received a referral from the Valuation of Securities (E) Task Force and directed staff to proceed with drafting revisions for subsequent exposure using the staff Summer 2019 recommendations. During this discussion additional industry proposed revisions were presented, but not captured in the direction for initial revisions to SSAP No. 105.

For Fall 2019 National Meeting Discussion:
NAIC staff recommends exposing the substantive revisions to SSAP No. 105—Working Capital Finance Investments incorporating the industry proposed language for the specific items directed by the Working Group and illustrated in the attached. The revisions in response to the industry request are summarized below. NAIC staff recommends directing Staff to prepare an issue paper for discussion at the 2020 Spring National Meeting.

1. **Functionally Equivalent Foreign Regulators** - Removed the requirement that the SVO determine if the International Finance Agent is the functional equivalent of the U.S. Regulator. (paragraph 10.a)

2. **Commingling Prohibitions** - Removed the finance agent prohibitions on commingling. (paragraph 10.b)

3. **Investor Rights Edit** - Removed duplicative text regarding exercise of investor rights. (paragraph 11.b)

4. **Requirements for filer to Certify Perfected Interest** – Removed requirements, with revisions allowing the SVO to determine if a first priority perfected interest has been obtained. (paragraphs 14 & 15)

5. **Finance Agent Validation Requirements** – The independent review requirements were broadened to allow independent review of the finance agent by either audit or through an internal control report. (paragraph 16)

6. **Default Date** - Changed the default provisions from 15 to 30 days so the default date and the cure period are consistent. This has the effect of changing the date of nonadmission for an investment in default for a period up to 30 days instead of up to 15 days. (paragraph 28)

In accordance with the Working Group direction, the following industry requested revisions were not incorporated:

1. **Possible Domestic Regulator Approval** - The statement that the reporting entity may need to seek approval from the domestic regulator was maintained (paragraph 18). **Points for consideration:**
• Issue Paper No. 147 documents that requiring domestic regulator approval was an intentional decision because of concerns regarding the ability of smaller entities to monitor the investments in such programs on an ongoing basis.
• The current guidance in SSAP No. 105 is not an explicit requirement, but only identifies that a domiciliary commissioner may require a company to receive initial permission.
• These investments may not fit into the normal investment law categories.
• The industry proposal notes:
  ▪ the asset class is not for most insurers as it requires relationships with finance agents beyond the traditional dealer insurer.
  ▪ the investor needs specialized knowledge, asset management operations and the ability to book and supervise the assets.
  ▪ the filing fees require sizable commitments to justify the costs, which would make it cost prohibitive for smaller players.
• Fall 2019 industry comments noted that state approval is not a practical risk mitigant. In addition, the speaker commented that he questioned the evaluation criteria that would be used by a state.

2. Only High-Quality Obligors – The current requirement which restricts designations of programs and obligors to being of high quality was maintained. NAIC Staff continues to not recommend lowering the credit quality of the acceptable obligors from NAIC 1 (highest quality) and NAIC 2 (high quality) to allow NAIC designations of 3 (medium quality) and NAIC 4 (low quality). Points for consideration:

• The descriptions of NAIC designations in the Purposes and Procedures Manual of the Investment Analysis Office note that both NAIC designations of 3 and 4 have speculative elements (see Authoritative Literature).
• Assets that reflect “factored receivables” are nonadmitted in statutory accounting. This program is the sole exception to the factored receivable rule. By lowering the allowable credit standards, an expanded class of factored receivables would be admitted, further deviating from statutory accounting concepts.
• The SAPWG created SSAP No. 105 to allow admission for only high-quality programs, from high quality obligors. Allowing obligors with lower credit assessments would be a fundamental change in program requirements. (paragraphs 6 & 7)

3. Unrated subsidiaries / Credit substitution - NAIC Staff does not recommend the proposed credit substitution methodology for unrated subsidiaries as it is overly complex, broad and difficult to apply. Further, credit substitution does not adequately address credit risk for an unrated affiliate. SVO staff memos also highlighted the difficulty in applying the industry proposed credit substitution methodology (paragraph 7). Excerpts VOSTF October 2018 memo to the SAPWG:

SVO evaluated whether analytical discretion would enable it to designate WCFI programs with unrated obligors of a rated or designated parent. SVO evaluated whether operational and strategic linkages between a rated parent and unrated obligor can provide a basis to attribute the credit rating of one entity to the other. It concluded that no principle exists to permit an assumption that a legal entity can be held responsible for the debt of another without having contractually agreed to do so. While WCFI arrangements may be inherently different than the credit situations SVO assesses SVO lacks the experiential basis to opine on the idea that the difference permits attribution.

Industry proposal for credit substitution has two aspects:

a. Credit substitution for unrated subsidiary obligors of a rated obligor – Industry proposes to attribute the credit strength of the rated parent to the unrated subsidiary obligor without the rated
parent being a guarantor of the unrated subsidiary’s WCFI obligations. This aspect envisions the rated entity having some of its own obligations in the program.

b. **Credit Substitution of rated obligor for its unrated subsidiaries which are key transaction participants, but not obligors.** The industry proposal is to create criteria to allow the “program” to obtain an acceptable NAIC designation by evaluating if the unrated “key transaction participant” is able to perform its functions. Industry proposes several different ways to attribute the rated entity’s credit rating to the unrated entity including:

- Documented operational control of unrated obligor, or
- An important inter-relationship with unrated obligor, or
- If the unrated key transaction participants are reasonably expected to perform their functions.

**NAIC Staff Credit Substitution Recommendation – Reference SVO P&P Requirements** – The Practices and Procedures Manual of the Investment Analysis Office (P&P) contains existing credit substitution methodology, however the industry is proposing to diverge from the existing methodology for this asset class. **NAIC staff recommends referencing the existing credit substitution methodology in the P&P.**

4. **Change Reporting Schedule** - NAIC Staff does not recommend the Working Group change the reporting requirements to move the WCFI investments from Schedule BA – Other Assets, to Schedule DA – Short term Investments (paragraph 22). Points for consideration:

- This reporting was intentional because the long-term programs are designated, even though the different investments are short term. Issue Paper No. 147, documents the VOSTF recommendation for Schedule BA reporting. The Task Force discussed the relative benefits between Schedule BA and DA and concluded that WCFIs should be reported as Other Invested Assets and that Schedule BA provides an enhanced disclosure framework deemed more appropriate for the investment.

- Annual statement lines and RBC charges have already been established on Schedule BA.

- Capital Adequacy (E) Task Force reviewed the asset class and requires specific designations (relatively low - just slightly higher than a bond of similar credit risk). RBC charges are based on the NAIC SVO WCFI program designation. The current RBC charges based on program designation would not be functional if the reporting was moved to Schedule DA, because that schedule does not include designations.
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Discussion draft for 2019 Fall National Meeting.

Statement of Statutory Accounting Principles No. 105

Working Capital Finance Investments

STATUS

Type of Issue
Common Area

Issued
December 15, 2013; November 2019 discussion draft

Effective Date
January 1, 2014

Affects
No other pronouncements

Affected by
No other pronouncements

Interpreted by
INT 06-07

Relevant Appendix A Guidance
None

SCOPE OF STATEMENT

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.

**SUMMARY CONCLUSION**

2. Working capital finance investments represent a confirmed short-term obligation\(^1\) to pay a specified amount owed by one party (the obligor) to another (typically a supplier of goods), generated as a part of a working capital finance investment program currently designated by the NAIC Securities Valuation Office. Pursuant to the working capital finance investment program, this short-term obligation has been transferred by the entity entitled to payment (typically a supplier of goods) to a third party investor.

3. Working capital finance investments held by a reporting entity represent a right of the reporting entity to receive future payment. This Statement provides accounting and reporting guidelines for the right to receive payment under working capital finance programs that meet particular criteria.

**Working Capital Finance Program - Definitions and Conditions**

4. A “working capital finance program” is an open account program under which an investor may purchase interests, or evidence thereof, in commercial non-insurance receivables. A working capital finance program is created for the benefit of a commercial investment-grade obligor and its suppliers of goods or services, and facilitated by a finance agent.

5. A working capital finance program transfers a right to payment to an investor from a short term obligation and arises from transactions among:
   a. a buyer of goods or services that becomes an obligor to the supplier of goods or services,
   b. the supplier(s) of those goods or services,
   c. a finance agent, and
   d. an investor.

6. A “working capital finance investment” is an interest in payment(s) from a confirmed supplier receivable issued pursuant to a working capital finance program. The payment (maturity) date must not exceed one year from the date of invoice from the supplier to the obligor. This investment is created when the investor purchases from a working capital finance program that is currently designated as NAIC “1” or “2” by the NAIC Securities Valuation Office, any of the following:
   a. One or more confirmed supplier receivables;
   b. in case of a participation, a participation interest in one or more confirmed supplier receivables issued by the finance agent or lead lender holding confirmed supplier receivables; or
   c. a certificate, note or other interest manifestation, documented in a way that is verifiable by regulators, representing a legally enforceable interest in a right to payment directly to the investor or from a trust, other special purpose entity or pool holding confirmed supplier receivables.

\(^{1}\) All references to short-term obligations in this statement to refer to obligations not exceeding one year.
7. “Obligor” is the party that purchases the goods or services that generates the original supplier receivable (and which is the payable for that Obligor). The obligor must be a single entity, which has have an NAIC designation of “1” or “2” or a Credit Rating Provider equivalent. The obligor must confirm the supplier receivable described in paragraph 11 as described in the confirmation process in paragraphs 12-13+4.

8. “Supplier” is the party that sells the goods or services to the obligor. The supplier sells the confirmed supplier receivable in accordance with the terms of the working capital finance program designated by the NAIC Securities Valuation Office at a price agreed to by the finance agent and/or investor.

9. “Investor” is the party purchasing a working capital finance investment in accordance with the terms of the working capital finance program designated by the NAIC Securities Valuation Office.

10. The “finance agent” is a bank, financial institution, other financial intermediary, or service provider that facilitates the working capital finance program, arranges the sale, assignment or transfer of the confirmed supplier receivable to the investor for a fee and administers the payment mechanism. In the case of participation, the finance agent must inform the reporting entity investor of a default or event of default as soon as it becomes aware of such default or event of default. For the working capital finance program to qualify under this SSAP, the finance agent must meet the requirements of either paragraph 10.a. or 10.b.:

   a. The finance agent is directly regulated by, or falls under the supervision of, a financial regulator of its domiciliary country provided that such country appears on the Purposes and Procedures Manual of the NAIC Investment Analysis Office List of Jurisdictions Eligible for Netting and that the Securities Valuation Office determines that the regulator is the functional equivalent of the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, or the Federal Deposit Insurance Corporation; or

   b. Payments from the obligor must be paid directly to the reporting entity (investor) or into an account maintained by a regulated financial institution for the benefit of investors in the working capital finance program, and, in either case, cannot flow through the finance agent. 2) there can be no commingling of payments or assets with those of the obligor, supplier, servicer or trust administrator or other investors.

11. A “confirmed supplier receivable” is a first priority perfected security interest 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 has been confirmed by the obligor committing and stating that the obligations under the agreement and any payment shall not be affected by the invalidity, unenforceability, existence, performance or non-performance of the underlying commercial trade transaction or any related contract or undertaking nor that it will not protest, delay, or deny, nor offer nor assert any defenses, personal or otherwise, against payment to the supplier or any party taking claims, interests, or rights to payments made by the supplier.

   a. The confirmed supplier receivable must be sold, assigned or otherwise transferred in a manner that results in an absolute, irrevocable and legally enforceable obligation that has been confirmed by the Obligor.

   b. In the case of a participation, the certificates or other evidence of participation provide an absolute, irrevocable, and legally enforceable obligation of the finance agent or holder of the confirmed supplier receivable to pay to the reporting entity investor all of the amounts due to it under the confirmed supplier receivable, without reduction or delay arising from any claims that the finance agent may have against the reporting entity investor. The reporting entity investor’s ability to exercise its rights as creditor, or to direct the finance
agent to exercise the rights of a creditor on its behalf, shall not be subject to the discretion of the finance agent or other lenders or investors. The reporting entity investor’s ability to exercise its rights as creditor, or to direct the finance agent to exercise the rights of a creditor on its behalf, shall not be subject to, other than during a cure period not to exceed thirty days, the discretion of the finance agent or other lenders or investors.

Confirmation Process

12. In the case of a purchase, the investor shall verify, prior to the sale that the obligor has confirmed the respective amounts, payment dates and related invoice numbers’ specified dates and has waived all defenses to payment. In the case of a participation, the finance agent must verify that the obligor has confirmed the respective amounts, payment dates and related invoice reference numbers’ specified due dates, and has waived all defenses to payment in accordance with the confirmation process.

13. The obligor must commit and state that upon confirmation of a supplier receivable it is obligated to pay to the investor, the finance agent, or any third party acting as agent or trustee for the investor, a sum equal to the full amount of that confirmed supplier receivable(s) on a date certain stated in the confirmation and that it waives any right of setoff or other defenses to avoid or delay the full and timely payment of that Confirmed Supplier Receivable. The documents establishing the working capital finance program or the confirmation must state and confirm that the obligation to pay must be independent of any other contracts or claims that might be raised in defense arising from any transaction financed in connection with the WCFP, the confirmed supplier receivable, or any other courses of performance or courses of dealing with the supplier.

14. In the case of participation, the investor must certify that it has a commercially reasonable belief that its participation interest meets the Uniform Commercial Code’s standards for creating and preserving first priority security interests in the payments due and in the confirmed supplier receivables. Commercially reasonable belief shall mean the SVO deems the investor’s belief reasonable in light of the systems, policies, or practices commonly recognized in the field of investing in participations. The investor must be able to demonstrate to a regulator or to the SVO, upon either’s request, the basis for its commercially reasonable belief that the WCFP creates and preserves the investor’s ability to enforce a first priority perfected security interest in the confirmed supplier receivables.

15. In the case of a certificate, note, or other manifestation, capable of verification, representing a right to payment from a trust, other special purpose entity, or special purpose pool holding confirmed supplier receivables, the investor must certify that it has a commercially reasonable belief that the documents establishing and governing the working capital finance program create and preserve interests in the confirmed supplier receivables capable of being enforced by the trustee or other entity holding confirmed supplier receivables as first priority perfected security interests under the Uniform Commercial Code. The investor must be able to demonstrate the basis for such belief to a regulator or to the SVO upon either’s request. Commercially reasonable belief shall mean the SVO deems the investor’s belief reasonable in light of the systems, policies, and practices commonly recognized in the field of investing in securitizations, loan-backed, structured, or trust-issued securities.

Program Requirements

16. The working capital finance program investor must provide in its annual filing with the Securities Valuation Office an annual audit of the consolidated financial statements of which the finance agent is part, which does not report any qualifications related to servicing, and one of the following:
a. An annual independent report according to Statement on Standards for Attestation Engagements (SSAE) No. 16 (or functional equivalent), reporting on controls at a service organization related to the administration of the investment; or

b. An annual audit of the financial statements and internal controls of the consolidated group of which the finance agent is part, which does not note any material weaknesses related to servicing working capital financial investments.

The NAIC Securities Valuation Office would review the materiality of the report findings in making their determination of the assignment of a designation.

If the credit rating of the working capital finance program or obligor falls to non-investment grade (below the equivalent of NAIC designation “1” or “2”), the reporting entity shall nonadmit the working capital finance investments obtained under the related working capital finance program and/or the related obligor. Due to the short-term nature of these investments, once an investment is nonadmitted due to the credit rating of the working capital finance program or the obligor, those investments will continue to be nonadmitted.

Reporting entity investors must have the ability to monitor the working capital finance program and the credit-related activities of the obligor. Reporting entity investors must provide information as requested to the state of domicile indicating that they have the ability to monitor on an ongoing basis the activities of the working capital finance program. Initial permission to invest in Working Capital Finance Investment Programs may be required by the domiciliary commissioner.

Exclusions

A working capital finance investment excludes any receivables financed through:

a. Factoring: the purchase of receivables in bulk from a supplier where the receivables represent the payment obligations of potentially thousands of buyers to a single supplier, in which the buyers have no relationship with or contractual obligation to pay the factor and retain all legal defenses to payment they may have against the supplier;

b. Forfaiting: the purchase of one or a series of receivables from exporters by a forfaiter to enable the exporter (seller) to finance a commercial transaction with a buyer in which the Obligor has no relationship with or contractual obligation to pay the forfaiter and retains all legal defenses to pay it may have against the seller; or

c. Invoice discounting: the advancement of funds by a finance company to a business entity with the funds advanced limited to a defined percentage of the business entity’s eligible and outstanding receivables.

Eligible Confirmed Supplier Receivables must not:

a. Include insurance or insurance related assets;
b. Be impaired or in default at the time of purchase;

c. Have a payment (maturity) date longer than one year from the date of the invoice from the Supplier to the Obligor giving rise to the confirmed supplier receivable, and the maturity date must not be subject to change or rolling; nor

d. Include any receivable of any parent or affiliate of the reporting entity investor, and neither the Obligor nor any Supplier may be affiliated with the reporting entity investor. Working Capital Finance Investments that have obligors or vendors that are affiliated with the investor are ineligible, and therefore, nonadmitted assets.

**Accounting and Reporting**

**22.20.** The right to receive payment generated by a working capital finance investment issued under a working capital finance program is considered to meet the definition of an asset as defined in *SSAP No. 4—Assets and Nonadmitted Assets*, and is an admitted asset to the extent the investment conforms to the requirements set forth in this Statement and the *Purposes and Procedures Manual of the NAIC Investment Analysis Office*. For programs that comply with all of these elements, working capital finance investments shall be valued and reported in accordance with this Statement, the *Purposes and Procedures Manual of the NAIC Investment Analysis Office*, and the designation assigned in the NAIC Valuations of Securities product. Programs that do not comply with the elements set forth in this Statement, or the provisions set forth in the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* are nonadmitted. Working capital finance investments are reported as other invested assets in the financial statements.

**23.21.** A working capital finance investment shall be recorded on the trade date. At acquisition, the Working Capital Finance Investment shall be initially reported at cost, excluding brokerage and other related fees, and all other costs (internal costs, or costs paid for origination, purchase or commitment to purchase such investments), which shall be expensed as incurred.

**24.22.** After initial acquisition, the Working Capital Finance Investment shall be reported at amortized cost until the specified maturity date, unless the investment, or a portion thereof, is deemed uncollectible or when an other-than-temporary impairment has occurred. In the event that a working capital finance investment is purchased by a reporting entity investor at a premium (amount to be received by the entity under the confirmed supplier receivable is less than the price paid for the investment), the excess paid by the reporting entity investor in comparison to the amount receivable under the confirmed supplier receivable must be immediately expensed.

**25.23.** For reporting entities required to maintain an Interest Maintenance Reserve (IMR), the accounting for realized capital gains and losses from working capital finance investments shall be in accordance with *SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve* (SSAP No. 7). For reporting entities not required to maintain an IMR, realized gains and losses from working capital finance investments 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).

**26.24.** A Working Capital Finance Investment may provide for a prepayment penalty or acceleration fee in the event the working capital finance investment is liquidated prior to its scheduled termination date. Such fees shall be reported as investment income when received.

**27.25.** *SSAP No. 34—Investment Income Due and Accrued* shall be followed for determining and recording investment income earned on working capital finance investments acquired at a discount. In accordance with *SSAP No. 34—Investment Income Due and Accrued*, investment income shall be reduced
for amounts that have been determined to be uncollectible, however amounts more than 15 days overdue are nonadmitted.

Default

28.26. A working capital finance investment payment that is uncollected by the reporting entity within fifteen-thirty days after the due date shall be considered in default and nonadmitted. If the reporting entity has any other working capital finance investment assets from the same defaulting counterparty, all other working capital finance investments from that counterparty shall be nonadmitted. All working capital finance investments from a counterparty identified in default shall be evaluated for impairment.

Impairment

29.27. An other-than-temporary impairment\(^\text{INT 06-07}\) 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 confirmed supplier receivable including the payment on the established due date. Pursuant to this guidance, assessment of other-than-temporary impairment shall include an evaluation of the financial condition and short-term prospects of the obligor. If it is determined that a decline in the fair value of a working capital finance investment below book/adjusted carrying value is due to an other-than-temporary impairment, an impairment loss shall be recognized as a realized loss equal to the entire difference between the working capital finance investment’s carrying value and fair value as of the reporting period for which the assessment is made. Fair value shall be determined in accordance with SSAP No. 100R—Fair Value (SSAP No. 100R), and reflect the price to sell the asset in an orderly market between market participants. As such, the fair value shall reflect the assumptions market participants will use in pricing the asset, including assumptions about risk.

30.28. For reporting entities required to maintain an AVR/IMR, the entire amount of the realized loss from the other-than-temporary impairment shall be recorded through the AVR, in accordance with SSAP No. 7.

30.29. Upon recognition of an other-than-temporary impairment, the fair value of the working capital finance investment on the measurement date shall become the new cost basis of the working capital finance investment and the new cost basis shall not be adjusted for subsequent recoveries in fair value. Once an investment is determined to be other-than-temporarily impaired, until all expected payments are received, the reporting entity must re-evaluate the investment quarterly and reassess fair value, with recognized realized losses for the difference between the book/adjusted carrying value and the current fair value. This process shall continue until either all expected payments are received, or the entity has recognized a realized loss for the entire uncollected carrying value.

Disclosures

32.30. The financial statements shall include the following disclosures:

a. Fair value in accordance with SSAP No. 100R.

b. Concentrations of credit risk in accordance with SSAP No. 27—Off-Balance-Sheet and Credit Risk Disclosures (SSAP No. 27) in the annual audited statutory financial reports only.

c. Information regarding the aggregate book/adjusted carrying value of working capital finance investment by designation including gross assets with nonadmitted and net admitted amounts annually. (Note that programs designated 3-6 are nonadmitted.)
### Statement of Statutory Accounting Principles

<table>
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<tr>
<th>WCFL Designation</th>
<th>Gross Asset CY</th>
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#### 33.31 Refer to the Preamble for further discussion regarding disclosure requirements.

#### Effective Date and Transition

34.32 This statement is effective for years on or after January 1, 2014. 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—Accounting Changes and Corrections of Errors.

#### REFERENCES

**Relevant Issue Papers**

- Issue Paper No. 147—Working Capital Finance Investments

G:\FRS\DATA\Stat Acctg\3. National Meetings\A. National Meeting Materials\2019\Fall\Meeting\T - 19-25 - SSAP No. 105 Fall 19 DD.docx
2019 Fall National Meeting - Review of GAAP Exposures for Statutory Accounting:

Pursuant to a 2014 direction from the SAPWG chair, there is a desire for the Statutory Accounting Principles (E) Working Group to be more proactive in considering FASB exposures that may be significant to statutory accounting and reporting. Historically, the SAPWG has commented on limited, key FASB exposures – mostly pertaining to insurance contracts and financial instruments. To ensure consideration of all FASB exposures, staff has prepared this memorandum to highlight the current exposures, comment deadlines, and to provide a high-level summary of the exposed item’s potential impact to statutory accounting. It is anticipated that this information would assist the Working Group in determining whether a comment letter should be submitted to the FASB on the issues. Regardless of the Working Group’s election to submit comments to the FASB on proposed accounting standards, under the NAIC Policy Statement on Statutory Accounting Principles Maintenance Agenda Process, issued US GAAP guidance noted in the hierarchy within Section V of the Preamble to the Accounting Practices and Procedures Manual must be considered by the Statutory Accounting Principles (E) Working Group.

FASB Exposures: http://www.fasb.org/jsp/FASB/Page/SectionPage&cid=1175805074609

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<th>Exposed FASB Guidance</th>
<th>Comment Deadline &amp; Initial Staff Comments</th>
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| Proposed Accounting Standards Update—Derivatives and Hedging (Topic 815): Codification Improvements to Hedge Accounting | January 13, 2020  
Review ASU under the SAP Maintenance Process |
| Update on Goodwill | See note below |


Information from FASB Exposure Draft:
The proposed ASU primarily addresses the change in hedged risk in a cash flow hedge. The original 2017 guidance (which only had limited adoption for Statutory Accounting) allowed the risk causing variability in cash flows of the forecasted transaction to change (for example, from one variable interest rate to another variable interest rate or from one commodity index to a different index for the same commodity) if certain criteria are met.

The proposed ASU would clarify whether that change can happen both prospectively (that is, before the forecasted transaction occurs) and retrospectively (that is, after the forecasted transaction occurs) and, if so, how hedge accounting guidance should be applied in those instances.

Staff Review and Commentary:
Comment deadline is January 13, 2020.  
Review ASU under the SAP Maintenance Process as detail in Appendix F—Policy Statements.

2. Update on Goodwill:

Earlier in 2019, the FASB issued an ‘Invitation to Comment,’ seeking input on further simplifying the subsequent accounting for goodwill and other intangible assets. An Invitation to Comment is a staff document in which the FASB does not express any preliminary views, and subsequent steps in the project may or may not result in amendments to existing standards.

Currently, private companies and non-for-profit entities are allowed to amortize goodwill in lieu of sole impairment testing; this project is to review allowing alternative accounting treatments (such as amortization) for public business entities.
Additionally, the FASB goodwill project is not only reviewing subsequent accounting methods (simplifying impairment, electing amortization, determining amortization periods, etc.), it is also reviewing other conceptual items such as defining goodwill, its measurement and recognition.

SAPWG support staff will continue to monitor this and all other FASB projects as a part of normal procedure.