

**MEMORANDUM**

TO: Variable Annuities Issues (E) Working Group

FROM: Jim Armstrong, Chair, Variable Annuities Issues (E) Working Group

DATE: June 13, 2017

RE: Letter from SAPWG Regarding Hedges Discontinued or Ineffective

---

As you may recall, in the fall of 2015, the Financial Condition (E) Committee adopted a report from the Variable Annuities Issues (E) Working Group which represented a framework for changing the statutory framework for variable annuities as proposed by the Working Group. The framework for changes contemplated, among other things, how the current framework creates non-economic volatility and that changes should be made to the statutory framework to promote strong risk management.

One of the proposals in the framework for changes was to modify statutory accounting for its treatment of interest rate hedges. On April 19, I received a letter from the chair of the Statutory Accounting Principles (E) Working Group, along with the proposed issue paper that has been drafted to address this specific proposal related to statutory accounting. In summary, the proposed issue paper provides special accounting treatment for interest rate hedges of variable annuity guarantees that would reduce non-economic volatility in the financial statements, and in turn, promote strong risk management. It does this by requiring the hedge, if proven to meet all of the criteria within the proposed issue paper, to be marked to market but offset by a deferred asset or liability. More specifically, fair value fluctuations in the hedge that do not offset the current period change in the hedged item (the variable annuity reserve liability) shall be recognized as a deferred asset or a deferred liability, and amortized into unrealized gains or losses over the lesser of the Macaulay duration of the guarantee benefit cash flows or ten years.

As noted, the issue paper requires certain criteria to be met in order to receive such accounting, including among other things, a requirement to prove the hedges are effective. To the extent the criteria are no longer met for the overall hedging strategy, the issue paper requires any non-amortized deferred assets or deferred liabilities to be immediately recognized.

The letter from the Statutory Accounting Principles (E) Working Group requests input from the Variable Annuities Issue (E) Working Group on the future benefit of hedges once the effective hedging program has been discontinued or becomes ineffective. To answer the question, I think we all would agree that hedges, just like insurance, provide value to the holder over the entire life of the hedge, not just the point in time when the insured is indemnified. And just like insurance, it's important that they hedge remain in place after a claim is made, for its uncertain when the protection may be needed. From that standpoint, the response is that the hedges provide benefits and the statutory framework should not discourage their use in managing the ongoing risk.

Having said that, it's important to note that the purpose of the question seems to be driven by the overall concern that a regulator would have as the result of an unrecognized loss on an ineffective overall hedging strategy. Such is the case during a market uptick, when the customer base of the insurer can become disinterested with the

variable annuity product. Under these circumstances the liability cash flows are mostly fees that were going to materialize on the balance sheet under the original policyholder behavior assumptions and with above expectation lapse no longer will do so to the extent previously expected. The deferral of the loss recognition was meant to make the loss recognition coincide with the fee revenue recognition. If policies lapse, so too will the future profits. However, 100% recognition of any derivatives that are currently in a loss position would be inconsistent with the remaining reduced cash flows that do materialize. This lapse effect could also materialize in idiosyncratic insurer distress scenarios even though such scenarios are relatively unlikely as they would have to occur under very favorable capital markets conditions for there to be a deferred hedge loss asset.

I would propose the Working Group consider an approach that recognizes both sides of this issue. One that recognizes sound risk management and the value that hedges provide throughout their ownership, but balanced with the concern of any unrecognized losses associated with an overall hedging strategy that is no longer effective. I propose a response to the referral that suggests the identified deferred liabilities be recognized over the lesser of the remaining scheduled amortization or 5 years. This should be coupled with material public disclosures as suggested below to clearly identify the situation so the regulator can consider the information in their ongoing monitoring of the insurer's financial condition.

### **Proposed Disclosures**

The draft issue paper, exposed during the 2017 Spring National Meeting, includes the following two disclosures pertaining to ineffective or terminated hedges:

- a. Identification of outstanding hedging instruments previously captured within scope of this standard and subsequently identified as part of an ineffective hedging strategy. Disclosure shall identify the eliminated deferred assets and deferred liabilities, and the recognition of unrealized gains and unrealized losses resulting from the ineffective hedging strategy.
- b. Identification of any election by the reporting entity to terminate use of the special accounting provisions, the resulting elimination of deferred assets and deferred liabilities, and the impact to unrealized gains and unrealized losses and/or realized gains and realized losses.

With the suggestion to allow amortization of deferred assets and deferred liabilities over the remaining scheduled amortization, not to exceed five years, it is recommended that the disclosures be revised to encompass the following:

- a. For hedging strategies identified as ineffective previously captured within scope of this standard, information on the determination of ineffectiveness, including variations from prior assessments resulting in the change from an effective to ineffective hedge. This disclosure shall also include:
  - i. Identification of outstanding hedging instruments previously captured within scope of this standard and subsequently identified as part of an ineffective hedging strategy. This disclosure shall identify the date in which the domiciliary state was notified that the hedging strategy had been identified by the reporting entity as ineffective.
  - ii. Deferred assets and deferred liabilities previously recognized under the effective hedging strategy with a schedule that shows the amortization that would have occurred if the program had remained highly effective, as well as a schedule that details the amortization that will occur as the program has become ineffective (maximum five-year timeframe).
  - iii. Disclosure on whether the reporting entity is electing to expedite amortization (in advance of the remaining scheduled amortization or the maximum five-year timeframe) and how this election will impact the scheduled amortization.
- b. For situations in which the reporting entity has elected to terminate the hedging strategy and/or discontinue the special accounting provisions permitted within this SSAP, the reporting entity

shall disclose the key elements in the reporting's entity' decision to terminate, identifying changes in the reporting entity's objectives or perspectives from initial application. This disclosure shall also include:

- i. Identification of outstanding hedging instruments previously captured within scope of this standard and the accounting impact as a result of the termination / discontinuation. (Derivative transactions not captured within the special accounting provision would be subject to the accounting and reporting guidance within SSAP No. 86.) This disclosure shall identify the date in which the domiciliary state was notified that the hedging strategy or the election to use the special accounting provision in this SSAP had been terminated.
- ii. Deferred assets and deferred liabilities previously recognized under the hedging strategy and/or program, with a schedule that shows the amortization that would have occurred if the strategy and/or program had remained highly effective, as well as a schedule that details the amortization that will occur with the termination of the strategy and/or program (maximum five-year timeframe).
- iii. Disclosure on whether the reporting entity is electing to expedite amortization (in advance of the remaining scheduled amortization or the maximum five year timeframe) and how this election will impact the scheduled amortization.



---

To: Jim Armstrong, Chair of the Variable Annuities Issues (E) Working Group  
From: Dale Bruggeman, Chair of the Statutory Accounting Principles (E) Working Group  
Re: Special Accounting for Limited Derivatives – Accounting Guidance for Terminated Hedges  
Date: April 19, 2017

---

The purpose of this memo is to request input from the Variable Annuities Issues (E) Working Group on the future benefit of effective hedges offsetting a variable annuity guarantee reserve, if any, once the effective hedging program has been discontinued or becomes ineffective.

Pursuant to their 2017 charge, the Statutory Accounting Principles (E) Working Group is considering special accounting guidance for limited derivative contracts that hedge interest rate risk for certain variable annuity reserves. This guidance currently proposes to allow reporting entities to offset fair value fluctuations from hedging instruments as follows:

- Fair value fluctuations of the hedging instrument, as part of a highly-effective, qualifying hedge, that directly offsets the current-period change in the hedged item (variable annuity reserve) will be recognized concurrently with the reserve change, allowing for an immediate offsetting impact in the financials.
- After recognizing the fair value fluctuations that directly offset the reserve change, any remaining fair value fluctuations of the hedging instrument would be recognized as a deferred asset or deferred liability. (Unrecognized fair value losses would be reported as deferred assets, and unrecognized fair value gains would be reported as deferred liabilities.) These deferred assets and deferred liabilities will be amortized using a straight-line method into realized losses and gains. Although the maximum amortization period is still being debated, the current proposal for the amortization timeframe is to equal the Macaulay duration of the guarantee benefit cash flows based on the AG 43 Standard Scenario, with a maximum allowable timeframe. This approach intends to match the future expected benefits from the effective hedge to the reserve liability as best as possible and remove non-economic accounting volatility from the financials.

The issue currently being debated is whether deferred assets (unrecognized losses) and deferred liabilities (unrecognized gains) reflected under the special accounting provision should continue to be permitted to be recognized on the balance sheet, and amortized into gains/losses, when the overall derivative hedging program has been terminated or no longer qualifies under the guidance (e.g., the program becomes ineffective). To be clear, under the proposed guidance, individual hedging instruments of a qualifying effective hedge could be terminated without impacting the amortization of deferred assets and deferred liabilities. The inquiry in this referral is addressing the broader question of termination / non-qualification of the overall hedging strategy.

As a simple example:

- From January 2019 through December 2021, the reporting entity engaged in derivative activity to hedge guarantee reserve liabilities in accordance with the established special accounting provisions. In aggregate, this activity resulted in \$300 million in losses from the fair value fluctuations of the hedging instruments. Of this \$300 million, \$120 million was recognized as direct offsets to current-period reserve liability changes, and \$180 million was recognized as deferred assets. Based on the Macaulay duration calculation, the deferred assets were scheduled for amortization into realized losses over a 10-year timeframe when initially recognized. (See the charts below for information on the recognition / amortization of the deferred assets.)

Recognition of Deferred Asset				Amortization Schedule of Deferred Assets (10-Year Amortization - Only limited years shown.)				
Reporting Period	Derivative FV Losses	Recognized Loss**	Deferred Asset	2020	2021	2022	2023	2024
2019	(142)	52	90	9	9	9	9	9
2020	(100)	40	60	-	6	6	6	6
2021	(58)	28	30	-	-	3	3	3
<b>Total</b>	<b>300</b>	<b>120</b>	<b>180</b>	<b>9</b>	<b>15</b>	<b>18</b>	<b>18</b>	<b>18</b>

\*\* The loss recognized is the portion of the fair value fluctuations that directly offsets current period changes in the hedged item. After recognizing the fair value fluctuations that directly offset the reserve change, any remaining fair value fluctuations are recognized as a deferred asset.

Deferred Asset at Time of Hedge Termination / Ineffectiveness			
	Original Deferred Asset Recognized	Amortization Recognized Through 2021	Deferred Asset at time of Termination / Ineffectiveness
2019	90	18	72
2020	60	6	54
2021	30	-	30
<b>Total</b>	<b>180</b>	<b>24</b>	<b>156</b>

- In December 2021, the reporting entity elected to terminate the hedge accounting program. At that time, a total of \$156 million was recognized as deferred assets under the special accounting provisions. As illustrated in the charts, this \$156 million represented the unrecognized losses from fair value fluctuations of derivative instruments remaining after prior period amortization.
- With the termination of the overall hedge accounting program, the issue to be addressed is whether it is appropriate to conclude that the \$156 million of unrecognized losses (recognized as deferred assets under the special accounting provisions when the program was effective) will provide offsetting benefits for future reserve liability changes, even though the hedge program has been terminated and will not be in place when those future reserve liability changes occur.

As additional detail, the concept of deferred assets and deferred liabilities is not supported under existing statutory accounting concepts, or U.S. GAAP, and is being considered only within the confines of this special accounting provision. With unrecognized losses reported as deferred assets, the provision will improve the statutory financial statements of a reporting entity by increasing assets and deferring recognition of the loss (increasing current-period net income). These accounting entries result with an overall increase to surplus, and allow for the presentation and admittance of assets not available for policyholder claims. Although these provisions are outside of the standard statutory accounting concepts, the Working Group is considering these changes in order to encourage risk mitigation efforts for guaranteed benefits of variable annuity reserves, and provide a comprehensive view of derivatives and the impact of effective hedging strategies in the financial statements. With the guidance being proposed, derivative instruments would be reported at fair value, but the non-economic volatility (change in fair value for an effective hedge) will not impact the reporting entity's solvency presentation.

The original guidance proposed by NAIC staff suggested immediate recognition of the deferred assets and deferred liabilities when the overall hedging strategy has been terminated, or no longer qualifies under the special accounting provisions. Comments received from the American Council of Life Insurers (ACLI) opposed this guidance, and included the following statement:

We believe the risk of variability in the fair value of the AG 43 liability remains after the termination of a fair value hedge and as such, amounts deferred as part of the relationship will remain deferred and be amortized into income over the period the hedged item affects income. This termination guidance is

consistent with the concept in GAAP and statutory accounting and aligns with the spirit of the accounting guidance which forever links the hedged item to the hedging instrument prior to the termination event.

Although NAIC staff has noted disagreement with the ACLI's interpretation of the U.S. GAAP and SAP guidance, the key issue is whether the deferred assets (unrecognized losses) from previous fair value fluctuations of derivative instruments – recognized when the overall hedge strategy was in place and effective – should be perceived to offset future reserve changes even when the overall hedging strategy has been terminated or is ineffective. NAIC staff recognizes that these unrecognized losses (deferred assets) are likely going to be significant, therefore understands industry concern with immediate recognition in the financial statements. However, if the special accounting provisions were not established / followed, the statutory accounting provisions in SSAP *No. 86—Derivatives*, would require recognition of the hedging instruments at fair value, with changes in fair value recognized as unrealized gains or losses.

The Statutory Accounting Principles (E) Working Group is interested in the Variable Annuities Issues (E) Working Group's position on whether fair value fluctuations from effective hedges should be perceived to offset future guarantee reserve changes even when the hedging program has been terminated or does not qualify under the guidance. The Statutory Accounting Principles (E) Working Group is also interested in possible compromising proposals, perhaps allowing continued amortization of deferred assets and deferred liabilities for a shortened timeframe after the hedge program is terminated or becomes ineffective. (For example, if the fair value fluctuations may be perceived to offset future reserve changes for a limited number of years, accelerated amortization could be permitted for an additional 3-5 years after termination, but not be permitted for the duration allowed for ongoing effective derivative programs.)

The Statutory Accounting Principles (E) Working Group appreciates the review of the Variable Annuities Issues (E) Working Group on this particular issue, and invites additional comments on all aspects of the proposed special accounting guidance. An updated issue paper was exposed during the 2017 Spring National Meeting, with comments due May 19, 2017. This issue paper has been provided as an accompaniment to this referral, and is also available via the following web page: [http://www.naic.org/cmte\\_e\\_app\\_sapwg.htm](http://www.naic.org/cmte_e_app_sapwg.htm)

Thank you for providing input on this issue. Please contact SAPWG staff, Julie Gann, if you have any questions.

Cc: Julie Gann/Robin Marcotte/ Fatima Sediqzad/Jake Stultz/Dan Daveline





## Exposure Draft

### *Issue Paper 15X— Special Accounting Treatment for Limited Derivatives*

**Hearing Date:** Interim Call or 2017 Summer NM      **Location:** Interim Call or 2017 Summer NM

**Deadline for Written Notice of Intent to Speak:**      **Deadline for Receipt of Written Comments:**  
May 19, 2017      May 19, 2017

#### Notice of Public Hearing and Request for Written Comments

**Basis for hearings.** The Statutory Accounting Principles Working Group (SAPWG) will hold a public hearing to obtain information from and views of interested individuals and organizations about the standards proposed in this Exposure Draft. The SAPWG will conduct the hearing in accordance with the National Association of Insurance Commissioners (NAIC) policy statement on open meetings. An individual or organization desiring to speak must notify the NAIC in writing by **May 19, 2017**. Speakers will be notified as to the date, location, and other details of the hearings.

**Oral presentation requirements.** The intended speaker must submit a position paper, a detailed outline of a proposed presentation or comment letter addressing the standards proposed in the Exposure Draft by **May 19, 2017**. Individuals or organizations whose submission is not received by that date will only be granted permission to present at the discretion of the SAPWG chair. All submissions should be addressed to the NAIC staff at the address listed below.

**Format of the hearings.** Speakers will be allotted up to 10 minutes for their presentations to be followed by a period for answering questions from the SAPWG. Speakers should use their allotted time to provide information in addition to their already submitted written comments as those comments will have been read and analyzed by the SAPWG. Those submissions will be included in the public record and will be available at the hearings for inspection.

**Copies.** Exposure Drafts can be obtained on the Internet at the NAIC Home Page (<http://www.naic.org>). The documents can be downloaded using Microsoft Word.

**Written comments.** Participation at a public hearing is not a prerequisite to submitting written comments on this Exposure Draft. Written comments are given the same consideration as public hearing testimony.

The Statutory Accounting Principles Statement of Concepts was adopted by the Accounting Practices & Procedures (EX4) Task Force on September 20, 1994, in order to provide a foundation for the evaluation of alternative accounting treatments. All issues considered by the SAPWG will be evaluated in conjunction with the objectives of statutory reporting and the concepts set forth in the Statutory Accounting Principles Statement of Concepts. Whenever possible, establish a relationship between your comments and the principles defining statutory accounting.

The exposure period is not meant to measure support for, or opposition to, a particular accounting treatment but rather to accumulate an analysis of the issues from other perspectives and persuasive comments supporting them. Therefore, form letters and objections without valid support for their conclusions are not helpful in the deliberations of the working group. Comments should not simply register your agreement or disagreement without a detailed explanation, a description of the impact of the proposed guidelines, or possible alternative recommendations for accomplishing the regulatory objective.

Any individual or organization may send written comments addressed to the Working Group to the attention of Julie Gann at [jgann@naic.org](mailto:jgann@naic.org), Robin Marcotte at [rmarcotte@naic.org](mailto:rmarcotte@naic.org), Fatima Sediqzad at [fsediqzad@naic.org](mailto:fsediqzad@naic.org) and Jake Stultz at [jstultz@naic.org](mailto:jstultz@naic.org) no later than **May 19, 2017**. Electronic submission is preferred. Julie Gann is the NAIC Staff that is the project lead for this topic.

National Association of Insurance Commissioners  
1100 Walnut Street, Suite 1500, Kansas City, MO 64106-2197  
(816) 842-3600



## Special Accounting Treatment for Limited Derivatives Issue Paper Revisions and Related Discussion Points

Issue Paper – April 8, 2017

1. Paragraph 1 – Inclusion of updated charge.
2. Paragraph 5 – Inclusion of terms / concepts for use within the Statement.
3. Paragraph 7 – Inclusion of explicit direction that reporting entities shall bifurcate risks, with the provisions of the special accounting treatment shall apply to fair value changes due to interest rate risk. This guidance identifies that the fair value fluctuations not attributed to the hedged risk shall be recognized as unrealized gains or losses.
4. Paragraph 8a – Deletion of notification requirement to states in which a company is licensed. The ACLI commented that this notification requirement is unnecessary, and would place an undue burden with little benefit to regulators. They have identified that approval by the domiciliary state, along with disclosures and/or general interrogatories can accomplish the enhanced level of regulatory review. **Inquiry – Input is requested regarding this deletion, and whether the actuarial memo and proposed financial statement general interrogatories / disclosures are sufficient.**
5. Paragraph 8b & 8c – Revisions to reference the actuarial certifications of AG 43 requirements. The ACLI commented that the actuarial and financial officer certification should be implemented through the actuarial certification of AG 43, along with an addition to the Supplemental exhibits and Schedule Interrogatories asking if the certification has been filed and have suggested disclosure requirements. Staff suggests that reference to these items be retained within the guidance. Also, as revisions would likely be needed to AG 43, suggests a referral to the appropriate group to incorporate needed changes and to ensure the AG 43 certification requirements is in place prior to the effective date of the guidance. **Inquiry – Input is requested regarding the approach to verify certifications.**
6. Paragraph 10 – The ACLI commented that the notification upon any change in hedging strategy places undue administrative burden on reporting entities and state regulators. They have noted that documentation of hedging strategy in the actuarial memorandum (required in AG 43) and in the footnotes to the financial statements is sufficient to mitigate risk and provide governance and oversight of the program. From preliminary information received, communicating a change in hedging strategy is not considered an undue burden, and this information would be beneficial for regulator review. As such, no change has been proposed to reflect this ACLI comment.
7. Paragraph 10 – The ACLI has commented that a change in the hedge target shall not constitute a change in strategy as the entity's hedge strategy is to mitigate interest rate risk and sensitivity to a tolerable level. The ACLI has commented that entity tolerances can change as a result of the market environment or guarantee positions, and management must be able to react to changing economics without risk of losing hedge accounting. Staff has not incorporated changes to reflect these comments. As previously noted, staff is cautious of an approach that would allow changes in the hedge target without documentation of a change in hedging strategy. This comment was considered when drafting the issue paper, and the proposal for a “monthly reset” of the hedging strategy was noted as overly permissive if coupled with provisions that allow a flexible portfolio of contracts and a dynamic hedge (where hedging instruments can be rebalanced to match changes in the underlying). Staff also highlights that the issue paper already proposes to allow a designated portion of the cash flows to be the hedged item. This is more permissive than U.S. GAAP, as the GAAP guidance requires all contractual cash flows of the entire hedge to be used in calculating the change in the

hedged item's fair value attributed to the hedged risk. The concept to require a 3-month timeframe for the hedging strategy, with notation of the specific risk being hedged (which the issue paper identifies as the percentage of interest rate sensitivity) is consistent with the concepts for a "Clearly Defined Hedging Strategy" (CDHS) under AG 43. To qualify as a CDHS, the strategy must be in place for 3 months, with identification of various elements. (AG 43 does not specifically identify the percentage of interest rate, but it is specific with regards to the specific risks being hedged, hedged objectives, risks not being hedged, etc.) **Inquiry – Additional input is requested, particularly if regulators have a different view.**

8. Paragraph 11 – Deletion of requirement to document ineffective portion of the hedge. The ACLI commented against this disclosure, citing that the information would be incomplete and likely misleading. With the draft "targeted improvement" revisions for hedging instruments being considered under U.S. GAAP, FASB is currently proposing to delete this disclosure requirement. Information about hedge effectiveness will still be captured.
9. Paragraph 11 – New footnote incorporates suggested ACLI revisions to clarify that the retrospective assessment shall be based on the hedge target that was in effect during the retrospective periods.
10. Paragraph 12 – Revisions to incorporate suggested ACLI revisions to remove reference to FAS 133 and to indicate that the fair value comparison shall occur on the cumulative change, rather than the current-period change.
11. Paragraph 12 – Revisions to explicitly incorporate language that the excluded components of the hedging derivative shall be reported at fair value with the gains and losses recognized as unrealized. This is consistent with the ACLI comments to incorporate language on this issue.
12. Paragraphs 15 & 21 – The ACLI has provided comments noting a statutory disconnect in how derivative gains/losses are recognized in comparison to the AG 43 reserve change. These comments identify that the change in liability will be recognized in net income, and the fair value changes will be recognized (or amortized) to unrealized gains or losses (outside of net income). The ACLI is correct that this disconnect does not occur under U.S. GAAP, as offsetting fair value changes in hedged items and hedging instruments are concurrently recognized in earnings. Staff agrees that it would be best for offsetting impacts for hedged items and hedging instruments to be reflected in the same reporting line. Although it is inconsistent with current statutory accounting provisions, staff is recommending revisions to clarify that fair value changes in highly effective derivatives to be recognized (or amortized) to realized gains and losses. This would also address the tracking concerns noted by interested parties for when highly effective derivative instruments expire (as the recognition would continue to realized gains and losses). Staff is recommending use of unrealized gains and losses for excluded components / risks and for derivative instruments that are not highly effective. **Inquiry – In reviewing the statutory financials, staff believes this can be accomplished through an instruction change for the Exhibit of Capital Gains and Losses. (For derivative instruments that qualify, the gain/loss amounts would be captured in column 2 of this exhibit instead of column 4.) Staff requests input on whether this reporting change would have any unintended consequences that should be considered. Staff suggests that a disclosure be added to capture the aggregate amount of "realized" gains and losses for "open" derivative instruments so that information is known for comparison assessments.**
13. Paragraph 16 – The ACLI has suggested that the amortization timeframe for deferred assets and liabilities be based on the Macaulay duration of the guarantee benefit cash flows based on the AG 43 Standard Scenario, not to exceed 20-years. The ACLI identified 20-years as the shortest maximum length that would result in removing most of the non-economic accounting volatility from the statutory financial statements. The ACLI comments also supported the determination of the

amortization period for each deferred asset or liability at the time the deferred asset/liability is established. Staff is aware that a 10-year amortization has been used by at least one company through a permitted practice. This company identified that the Macaulay duration for their block would have exceeded 20+ years, and a simplified 10-year timeframe was utilized to ensure transparency. **Inquiry – The current issue paper incorporates a maximum 10-year timeframe for simplification and transparency. Staff is conducting additional research on prescribed and permitted practices to identify if there are consistent timeframes that have been approved by the states.**

14. Paragraph 18 – Although no revisions have been proposed to this paragraph, the ACLI has provided comments opposing the requirements to discontinue amortization (and recognized gains/losses) when a non-expired derivative instrument no longer qualifies within the standard, or if it is no longer an effective hedge. The ACLI has cited U.S. GAAP guidance as support for allowing the amortization timeframe to continue for deferred assets/liabilities in these scenarios. Although U.S. GAAP allows recognition of ineffective hedges to occur prospectively, this is because the impacts of the fair value hedge were reflected as a change in fair value / earnings when they occurred. As the hedged item is reported at fair value, the change in fair value is used to adjust the hedged item. Staff also highlights that existing SSAP No. 86 for forecasted transaction requires deferred gains or losses to be recognized immediately in unrealized gains or losses if the forecasted transaction is no longer probable. **Regulator Inquiry – Staff understands that the immediate recognition of gains and losses for ineffective / hedges that no longer qualify may have an undesirable impact on the statutory financial statements. However, there are concerns for amortizing an unrealized loss (as a deferred asset) for years after the derivative program was identified as ineffective. Staff will be conducting further research on this issue, and inquiring with the Variable Annuity Issues (E) Working Group regarding the impact of these prior effective hedges on the remaining / future AG43 liabilities.**

*Excerpts from U.S. GAAP – 815-251-35-1 and 815-25-35-2:*

Gains and losses on a qualifying fair value hedge shall be accounted for as follows:

- a. The gain or loss on the hedging instrument shall be recognized currently in earnings.
- b. The gain or loss (that is, the change in fair value) on the hedged item attributable to the hedged risk shall adjust the carrying amount of the hedged item and be recognized currently in earnings.

If the fair value hedge is fully effective, the gain or loss on the hedging instrument, adjusted for the component, if any, of that gain or loss that is excluded from the assessment of effectiveness under the entity's defined risk management strategy for that particular hedging relationship (as discussed in paragraphs 815-20-25-81 through 25-83), would exactly offset the loss or gain on the hedged item attributable to the hedged risk. Any difference that does arise would be the effect of hedge ineffectiveness, which consequently is recognized currently in earnings.

***SSAP No. 86, paragraph 24b (excerpt):***

If a forecasted transaction is determined to no longer be probable per the standards above, hedge accounting shall cease immediately and any deferred gains or losses on the derivative must be recognized in unrealized gains or losses. If an entity demonstrates a pattern of determining that hedged forecasted transactions probably will not occur, such action would call into question both the entity's ability to accurately predict forecasted transactions and the propriety of using hedge accounting in the future for similar forecasted transactions. Accordingly, hedge accounting for transactions forecasted by that entity will no longer be permitted.

15. Paragraph 26 – The ACLI commented that the individual tracking for these derivative transactions would be extremely burdensome given the volume of individual derivative contracts, and will not add value to the regulatory process. Although they agreed that an audit trail should be provided, they have recommended that documentation of deferred assets and liabilities and amortization be reflected in aggregate by reporting period. Revisions have been proposed to capture aggregate disclosures. Additionally, revisions have been proposed to separately capture information on the fair value change of excluded components recognized as unrealized gains and losses.
16. Proposed General Interrogatories - The ACLI suggested disclosures to identify whether a reporting entity uses the special accounting provisions and whether the provisions are consistent with AG 43. Rather than including in a disclosure, staff has proposed the inclusion of new GI to capture this information and for the reporting entity to attest to certain components of the program.
17. Schedule DB – The ACLI has suggested that Schedule DB be leveraged as much as possible for disclosures on derivatives that receive hedge accounting treatment for variable annuities, and have requested for the NAIC to add new subtotals to capture derivatives instruments subject to this issue paper. Although staff is supportive of leveraging Schedule DB, staff is uncertain that the inclusion of subtotals will likely be sufficient, particularly if different types of derivative instruments are used (e.g., futures), as information on the instruments could be divided across different DB schedules, and with the enhanced information that will be requested. **Inquiry – Input is requested regarding the form/structure of desired disclosures – including whether a separate DB schedule would be beneficial to capture the information for the transactions captured within this special accounting provision. Industry representatives are requested to provide an illustrated Schedule DB, with the revisions they would propose to capture these derivative structures.**

## Statutory Issue Paper No. XX

### Special Accounting Treatment for Limited Derivatives

#### STATUS

Exposure Draft – April 8, 2017

Type of Issue:  
Common Area

#### SUMMARY OF ISSUE

1. Current statutory accounting guidance for derivatives qualifying for hedging effectiveness is in *SSAP No. 86—Derivatives*. Based upon a recommendation from the Variable Annuities Issues (E) Working Group, the Financial Condition (E) Committee issued the following ~~2016-2017~~ charge to the Statutory Accounting Principles (E) Working Group:

~~Develop specific statutory accounting guidance for certain limited derivative contracts hedging variable annuity guarantees, subject to fluctuations as a result of interest rate sensitivity, reserved for in accordance with Actuarial Guideline XLIII—CARVM for Variable Annuities (AG 43). This guidance shall place an emphasis on reducing non-economic surplus volatility for these specific hedges in situations where strong risk-management is in place, with safeguards to ensure appropriate financial statement presentation and disclosures, sufficient transparency, and regulatory oversight. This charge shall be a high priority, with the earliest effective date feasible that allows for adequate development of guidance and related reporting schedules.~~

~~Develop and adopt changes to SSAP No. 86—Derivatives, with an effective date of January 1, 2017 or earlier, which allow hedge accounting treatment under SSAP No. 86 for certain limited derivative contracts (e.g. interest rate hedges with counterintuitive effects) that otherwise do not meet hedge effectiveness requirements. In adopting such an allowance, consider if the requirement to meet hedge effectiveness can be replaced by some other information that demonstrates strong risk management is in place over the identified hedges.—Essential~~

2. Pursuant to the direction from the Financial Condition (E) Committee, this issue paper has been drafted to detail substantive statutory accounting revisions to allow special accounting treatment for limited derivatives hedging variable annuity guarantees subject to fluctuations as a result of interest rate sensitivity. The provisions within this issue paper are proposed to be separate and distinct from the guidance in SSAP No. 86, as the items subject to the scope of this guidance, and the provisions within, would not qualify for hedge effectiveness under SSAP No. 86. Allowances provided within this issue paper are only permitted if all of the components of the issue paper are met, and shall not be inferred as an acceptable statutory accounting approach for derivative transactions that do not meet the stated qualifications or that are not specifically addressed within this guidance.

3. The guidance within this issue paper is anticipated to be included as a new SSAP applicable to the limited derivative situations addressed within. Upon adoption of the issue paper, the Working Group will conclude on the location of this guidance within statutory accounting.

#### SUMMARY CONCLUSION

4. This statement establishes statutory accounting principles to address certain, limited derivative transactions hedging variable annuity guarantees subject to fluctuations as a result of interest rate sensitivity. Eligibility for the special accounting provision within this standard is strictly limited to variable annuity contracts and other contracts involving certain guaranteed benefits similar to those offered with variable annuities that are reserved for in accordance with Actuarial Guideline XLIII,

CARVM for Variable Annuities (AG 43). The statutory accounting guidance within this statement is considered a special accounting provision, only permitted if all the components in the standard are met, and shall not be inferred as an acceptable statutory accounting approach for situations that do not meet the stated qualifications or that are not specifically addressed within this guidance.

### **Terms / Concepts (for purposes of this Statement)**

5. **The following terms reflect concepts specific to this Statement. (This listing only details the key concepts. Specific guidelines are reflected throughout the guidance.)**

- a. **Derivative Instrument: Means an agreement, option, instrument or series or combination thereof: (1) 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 (2) That has a price, performance, value or cash flow based primarily upon the actual or expected price, level, performance, value or cash flow of one or more underlying interests.**
- b. **Dynamic Hedging Approach: A dynamic hedging strategy allows for the portfolio of derivatives comprising the hedging instrument to be rebalanced in accordance with changes to the hedged item in order to adhere to the specified, documented hedging strategy.**
- c. **Hedged item: The hedged item may be an open or flexible portfolio (e.g., group of variable annuity contracts with different characteristics and liability durations) that allows for addition of newly issued contracts, subtraction of surrenders and fluctuations in balances. The hedged item shall reflect the present value of cash flows of a pool, or portion thereof, of variable annuity contracts exposed to interest rate risk.**
- d. **Hedging Instrument: The hedging instrument shall reflect a specified derivative, or a portfolio of specified derivatives, that hedges the interest rate sensitivity of the designated hedged item. The hedging instrument may reflect a dynamic hedging strategy in which a portfolio of derivatives comprising the hedging instrument is rebalanced in accordance with changes to the hedged item.**
- e. **Macro-Hedge: A macro-hedge refers to the ability to jointly designate a portfolio of variable annuity policies, such as an entire book of business or subsections thereof, as the hedged item.**

### **Special Accounting Provision**

4.6. **The is** special accounting provision **within this Statement** permits reporting entities to utilize a form of “macro-hedging” in which a portfolio of variable annuity policies, which could include the entire book of business or subsections thereof, are jointly designated as the hedged item, in a fair value hedge<sup>1</sup>, pursuant to a Clearly Defined Hedging Strategy (throughout this issue paper also referred to as “CDHS” or “hedging strategy”). This is considered a macro-hedge, as the designated hedged item (group of policies) may be a portfolio of variable annuity contracts with different characteristics and liability durations. Under this special accounting provision, the portfolio of hedged items is not required to be static, but can be revised to remove policies and/or include new policies to allow for continuous risk management (hedging) of the variable annuity guarantee reserves in accordance with the specific risks being hedged and the hedge objectives of the specified, documented hedging strategy. In designating the

<sup>1</sup> As detailed in paragraph 11, these hedges are required to be highly effective in achieving offsetting changes in fair value attributed to the hedged risk between the derivative hedging instruments and the hedged item (AG 43 liability) during the period that the hedge is designated.



hedged item, reporting entities are permitted to exclude specific components of the variable annuity contracts, but such exclusions must apply collectively to all policies included within the portfolio. For example, reporting entities may elect to only hedge the interest rate risk of rider cash flows, and if making this election, would define the hedged item as the “fair value of rider claims net of rider fees” for the portfolio of policies designated as the hedged item.

5.7. This special accounting provision permits reporting entities to utilize a specified derivative, or a portfolio of specified derivatives, as the hedging instrument within a fair value hedge to hedge the interest rate sensitively, or a specific percentage<sup>2</sup> of the interest rate sensitivity, of the designated hedged item. The hedging instrument may reflect a dynamic hedging strategy in which a portfolio of derivatives comprising the hedging instrument is rebalanced in accordance with changes to the hedged item in order to adhere to the specified, documented hedging strategy. Although the hedging instruments must address interest rate risk, this guidance does not preclude use of derivative instruments that may offset risks other than interest rate risk from being designated as the hedging instruments. For derivative instruments that are affected by multiple risk factors, including interest rate risk, reporting entities shall apply this special accounting treatment to the change in fair value due to interest rate risk. Reporting entities shall bifurcate the change in fair value due to the various risk factors (e.g., fair value volatility due to interest rates (rho), and other risk factors, such as equity level (delta) or volatility (vega). Pursuant to paragraph 12 and 15, fair value fluctuations not attributed to the hedged risk, including fair value changes from excluded open components, shall be recognized as unrealized gains or losses.

6.8. With the provisions in this standard to allow for flexibility in the hedged item (changes to variable annuity contracts within a portfolio) coupled with a dynamic hedging approach (rebalancing of derivative hedging instruments), there is a greater risk of misrepresentation of successful risk management and achievement of a highly effective hedging relationship. Although this risk cannot be eliminated, the following provisions intend to ensure governance of the program and provide sufficient tools to allow for regulator review:

- a. Prior to implementing a hedging program for application within scope of this standard, the reporting entity must obtain explicit approval from the domiciliary state commissioner allowing use of this special accounting provision. Upon approval from the domiciliary state to use the special accounting provision, the reporting entity must notify all states in which they are licensed of the approval to use this special accounting provision. The domiciliary state commissioner may subsequently disallow use of this special accounting provision at their discretion. Although this guidance does not restrict the state domiciliary commissioner on when to prohibit future use, disallowance should be considered upon finding that the reporting entity’s documentation, controls, measurement, prior execution of strategy or historical results are not adequate to support future use.
- b. Actuarial certifications of AG 43 reserves, consistent with Actuarial Guideline 43 requirements, which explicitly include the following:
  - i. Certification ~~An external, qualified actuary, approved by the domiciliary state commissioner, must provide certification~~ as to whether the hedging strategy is incorporated within the establishment of AG 43 reserves, and the impact of the hedging strategy within the AG 43 Conditional Tail Expectation Amount.
  - ii. Certification by Aa financial officer of the company (CFO, treasurer, CIO, or designated person with authority over the actual trading of assets and derivatives)

<sup>2</sup> In identifying the hedged risk, reporting entities must identify whether they are hedging the full, or a portion of (e.g., 40%), the interest rate sensitivity.

must certify that the hedging strategy meets the definition of a Clearly Defined Hedging Strategy within AG 43 and that the Clearly Defined Hedging Strategy is the hedging strategy being used by the company in its actual day-to-day risk mitigation efforts. This provision does not require reporting entities to use a hedging strategy in determining AG 43 reserves, nor does it require entities to use the special accounting provision within this standard. However, it does require reporting entities that use the special accounting provisions within this standard to certify that the hedging strategy within scope of this standard is a Clearly Defined Hedging Strategy and is reflected in the establishment of AG 43 reserves.

7.9. As identified in paragraph 4, eligibility for the special accounting provision within this standard is strictly limited to variable annuity contracts and other contracts involving certain guaranteed benefits similar to those offered with variable annuities that are reserved for in accordance with Actuarial Guideline XLIII, CARVM for Variable Annuities (AG 43). This special accounting provision requires the reporting entity to engage in highly effective fair value hedges that follow a Clearly Defined Hedging Strategy, as defined in AG 43, meeting all required provisions of AG 43 allowing the reporting entity to reduce the amount of the Conditional Tail Expectation (CTE) Amount. In order to qualify as a Clearly Defined Hedging Strategy, the strategy must meet the principles outlined in AG 43, be in place (implemented) for at least three months<sup>3</sup>, and shall at a minimum, identify:

- a. Specific risks being hedged<sup>4</sup>,
- b. Hedge objectives,
- c. Risks not being hedged,
- d. Financial instruments that will be used to hedge the risks,
- e. Hedge trading rules, including permitted tolerances from hedging objectives,
- f. Metric(s) used for measuring hedging effectiveness,
- g. Criteria that will be used to measure effectiveness,
- h. Frequency of measuring hedging effectiveness,
- i. Conditions under which hedging will not take place, and
- j. The individuals responsible for implementing the hedging strategy.

8.10. While an initially documented hedging strategy may subsequently change, any change in hedging strategy shall be documented, with notification to the domiciliary state commissioner, and include an effective date of the change in strategy. Reporting entities that elect to change a documented hedging strategy prior to the end of the three-month minimum implementation timeframe shall identify the hedging strategy, and all hedging instruments executed under the strategy, as ineffective. The three-month

<sup>3</sup> As detailed in AG 43, before a new or revised hedging strategy can be used to reduce the amount of the Conditional Tail Expectation (CTE) otherwise calculated, the hedging strategy should be in place (effectively implemented) for at least three months. As detailed in AG 43, the Company may meet the time requirement by having evaluated the effective implementation of the hedging strategy for at least three months without actually having executed the trades indicated by the hedging strategy (e.g., mock testing or by having effectively implemented the strategy with similar annuity products for at least three months.)

<sup>4</sup> The specific risk being hedged shall include a measure of the hedge coverage (e.g., percentage of interest rate sensitivity being hedged).

timeframe begins with the stated effective date of the hedging strategy regardless if any hedging instruments have been executed under the hedging strategy. Changes in a documented hedging strategy that occur after the three-month implementation timeframe do not necessitate an ineffective determination as long as hedged items and hedging instruments under the revised/new strategy continue to meet the requirements of a highly effective fair value hedge. Reporting entities are permitted to have more than one hedging strategy implemented, but all implemented strategies must qualify as a **component of a Clearly Defined Hedging Strategy** pursuant to paragraph 8.

### Assessing Hedge Effectiveness

~~9.11.~~ The provisions within this standard require the entity to use a specific method, as detailed in paragraph 11, to assess hedge effectiveness at inception and on an ongoing basis. At a minimum, hedge effectiveness assessment is required whenever financial statements are reported, at least every three months. Documentation requires prospective and retrospective<sup>5</sup> hedge effectiveness assessments, with ongoing assessment consistent with the originally documented risk management strategy. ~~In addition to assessing whether the hedge is highly effective, the quarterly documentation shall include a measure of the ineffective part of hedge. This standard does not require separate financial statement recognition of the effective and ineffective components of the hedging strategy; however, disclosure of these components is required.~~

~~10.12.~~ This standard requires a single measure for assessing whether the hedging strategy is highly effective, and in measuring hedge ineffectiveness. Both at inception, and on an ongoing basis, the hedging relationship must be highly effective in achieving offsetting changes in fair value attributed to the hedged risk during the period that the hedge is designated. In order to meet this requirement, reporting entities electing to use this special accounting provision must calculate the fair value of the hedged item (AG 43 guarantee reserve) at inception and on an ongoing basis ~~in a similar fashion as FAS 133~~, and compare the ~~cumulative current period~~ fair value change of the hedged item to the ~~cumulative current period~~ fair value change of the hedging instruments. This comparison is specific to the designated hedged risks and exposures, therefore, if only a portion of the interest rate risk is hedged or if the designated hedge only include specific components of the variable annuity policies (e.g., riders), for determining hedge effectiveness, the fair value comparisons is limited to those designated items. ~~If an entity's defined risk management strategy for a particular hedging relationship excludes specific components of the hedging derivative from the assessment of hedge effectiveness, the excluded open components shall be reported at fair value with gains or losses recognized as unrealized gains or losses.~~

~~11.13.~~ The term highly effective describes a fair value hedging relationship where the change in fair value of the derivative instrument is within 80 to 125 percent of the opposite change in fair value of the hedged item attributed to the hedged risk. It shall also apply when an R-squared of .80 or higher is achieved when using a regression analysis technique.

### Measurement / Recognition of **Unrealized** Gains and Losses of Outstanding (Open) Instruments

~~12.14.~~ All designated hedging instruments (all derivatives, including those reflected in portfolios) shall be reported in the financial statements at fair value.

~~13.15.~~ Fair value fluctuations in the measurement of outstanding (non-expired) derivatives within a highly effective hedging strategy shall be reflected as follows:

---

<sup>5</sup> ~~For situations in which there has been a change in hedging strategy pursuant to paragraph 10, when conducting retrospective hedge effectiveness assessments, reporting entities shall assess effectiveness based on the hedge target that was actually in effect during the retrospective time periods.~~

- a. Fair value fluctuations in the hedging instruments attributable to the hedged risk that offset the current period change in the hedged item (designated portion of the AG 43 reserve liability; e.g., guarantee cash flows)<sup>6</sup> shall be recognized as a realized gain or loss.
- ~~b. \_\_\_\_\_, and fair value fluctuations in the hedging instruments that are not attributable to the hedged risk, shall be recognized as unrealized gains or unrealized losses.~~
- e-b. Fair value fluctuations in the hedging instruments attributable to the hedged risk that do not offset the current period change in the hedged item (designated portion of the AG 43 reserve liability; e.g., guarantee cash flows) shall be recognized as deferred assets (admitted) and deferred liabilities. The ability to recognize a deferred asset and deferred liability is limited to only the portion of the fair value fluctuation in the hedging instruments that is attributed to the hedged risk and does not immediately offset changes in the hedged item. Reporting entities shall utilize the following calculation for establishing the deferred asset (also illustrated in Appendix A) unless a different method has been approved by the domiciliary state commissioner:
- i. Calculate the fair value gain or loss in the hedged item attributable to the hedged risk;
  - ii. Express the quantity calculated in 14.b.i. as a percentage of the change in the full-contract fair value (i.e., with all product cash flows) attributed to interest rate movements.
  - iii. Calculate the AG 43 liability change attributed to the hedged risk as the quantity calculated in 14.b.ii. multiplied by the AG 43 liability change attributable to interest rate.
  - iv. Establish the deferred asset or deferred liability in the amount of the fair value loss or (gain) of the designated hedging instruments attributed to the hedged risk less the AG 43 liability decrease or (increase) attributed to the hedged risk as calculated in 14.b.iii.
- c. As detailed in paragraph 12, fair value fluctuations in the hedging instruments that are not attributable to the hedged risk, shall be recognized as unrealized gains or unrealized losses.

16. Deferred assets and deferred liabilities recognized under paragraph 14.b. shall be amortized using a straight-line method into ~~unrealized gains~~ or ~~unrealized losses~~ over a finite amortization period. The amortization timeframe shall equal the Macaulay duration of the guarantee benefit cash flows based on the AG 43 Standard Scenario, but shall not exceed a period of 10 years, shall not exceed five (5) years unless there is explicit documentation demonstrating that a longer period is more closely linked to the expected liability duration of the hedged item. In situations in which a longer period is substantiated, and

<sup>6</sup> Hedge effectiveness is determined by comparing fair value fluctuations between the hedging instruments and the hedged item. However, in determining recognition in the financial statements, the fair value fluctuation of the hedging instruments is compared to the change in the reported value of the hedged item (designated AG 43 liability). The designated portion of the AG 43 liability is not reported at fair value in the statutory financial statements, as such, the offset reported as unrealized gains and losses is the portion of the fair value change in hedging instruments offset by the change in the hedged item based on the AG 43 reserve calculation. In accordance with the documented hedging strategy, reporting entities shall compare the fair value fluctuations to the change in the designated portion of the reserve liability, after considering recognized derivative income, when determining the recognition of fair value fluctuations.

~~approved by the domiciliary state commissioner, the amortization timeframe is not permitted to exceed ten (10) years.~~

- ~~d.a.~~ Future recognition of deferred assets or liabilities from fair value fluctuations attributed to the hedged risk that are not offset by the reserve liability change do not extend the amortization timeframe for previously recognized deferred assets or deferred liabilities. Reporting entities are required to separately track, with a schedule to show the initial deferred amount and amortization schedule, of the deferred assets and deferred liabilities recognized and outstanding at each reporting date.
- ~~e.b.~~ The amount reported on the financial statement at each reporting date shall reflect the net amount (net as either a deferred asset or deferred liability) for each hedging strategy captured within scope of this guidance.
- ~~f.c.~~ Reporting entities are permitted to amortize a greater portion of the deferred assets and/or deferred liabilities into ~~unrealized~~ gains or ~~unrealized~~ losses at any time in advance of the scheduled amortization period.

~~14.17.~~ For outstanding (non-expired) derivative instruments that were removed from a highly effective hedging strategy (rebalanced), subsequent gains and losses from fair value fluctuations shall not impact the previously recognized deferred assets or deferred liabilities. The deferred assets and deferred liabilities for these derivative instruments shall be “locked” and amortized under the remaining schedule unless the reporting entity elects to terminate or accelerate amortization.

~~15.18.~~ For outstanding (non-expired) derivative instruments in a hedging strategy that no longer qualifies within scope of this standard (e.g., AG 43 requirements are not met) or is no longer a highly effective hedge, any non-amortized deferred assets or deferred liabilities shall be immediately recognized as unrealized gains and/or unrealized losses. All future fair value fluctuations for these derivative instruments shall be recognized as unrealized gains or unrealized losses unless the instrument is subsequently designated as part of a highly effective hedging strategy. If the derivative is re-designated as part of a highly effective hedging strategy qualifying under this standard, subsequent fair value fluctuations (after the re-designation) may be accounted for under this special accounting provision.

~~16.19.~~ Reporting entities may elect to terminate use of this special accounting provision at any time. In those instances, if the derivative instruments are outstanding, all deferred assets and deferred liabilities shall be immediately eliminated with recognition as unrealized gains and/or unrealized losses. Regardless of whether the hedging strategy is determined to be highly effective, subsequent accounting of the derivatives within the hedging strategy shall follow the fair value accounting approach in SSAP No. 86<sup>7</sup>.

### **Measurement / Recognition of Realized Gains or Losses of Expired Derivatives**

~~17.20.~~ With the ability to rebalance the hedging instrument, this guidance allows for individual derivative instruments to expire and/or be removed from the portfolio of the hedging instrument, and not immediately trigger an assessment that the overall hedging strategy is no longer highly effective. Furthermore, special allowances are included to consider the tenure differences between a hedging instrument and AG 43 liability duration. These allowances permit expired<sup>8</sup> derivative instruments that were part of a highly effective hedging strategy at the time of expiration to continue amortizing the

<sup>7</sup> Macro-hedges and the ability to rebalance hedging instruments are not provisions permitted within “effective” hedges in scope of SSAP No. 86. As such, hedging strategies with these components accounted for under SSAP No. 86 shall follow the fair value accounting approach detailed in that standard.

<sup>8</sup> Throughout this standard the use of the word “expire” is intended to capture all instances in which the derivative is no longer outstanding. It includes maturities, terminations, sales, and/or other closing transactions of a derivative.

deferred gains and deferred losses over the previously established amortization timeframe even if the overall hedging strategy is subsequently terminated or subsequently identified as no longer qualifying as a highly effective hedge.

21. Reporting entities with expired derivative instruments that were part of a highly effective hedging strategy at the time of such expiration are not required to terminate the amortization schedule initially established for the deferred assets and deferred liabilities attributed to that derivative instrument. ~~Rather, at the time of expiration, previously recognized unrealized gains and losses for these expired derivatives shall be reclassified as realized gains and realized losses, and the subsequent amortization of deferred assets and deferred liabilities shall be recognized into realized gains and realized losses.~~

~~18-22.~~ Consistent with the guidance in paragraph 15.c., reporting entities are permitted to amortize a greater portion of the deferred assets and/or deferred liabilities from expired derivatives into realized gains or realized losses at any time in advance of the scheduled amortization period.

~~19-23.~~ Consistent with the guidance in paragraph 18, reporting entities may elect to terminate use of this special accounting provision at any time. In those instances involving expired derivatives, all remaining deferred assets and deferred liabilities shall be immediately eliminated with recognition as realized gains and/or realized losses.

### Derivative Income

~~20-24.~~ Derivative income (e.g., swap cash flows) shall be recognized as investment income when earned received.

~~21-25.~~ Pursuant to the documented hedging strategy as a fair value hedge, derivative income shall be considered as part of the overall hedging strategy and included in the assessments on whether the strategy is highly effective.

### Disclosures

~~22-26.~~ A reporting entity that has any outstanding derivatives accounted for under this special accounting provision, or that has unamortized deferred assets and/or deferred liabilities (representing previously unrecognized qualifying fair value fluctuations) from expired derivatives under the special accounting provision shall disclose the following within the financial statements:

- a. Discussion of hedged item (portfolio of variable annuity policies), including information on the guarantees sensitive to interest rate risk, along with information on the designated hedging instruments being used to hedge the risk. Discussion of the hedging instruments shall identify whether a hedging instrument is a single instrument or portfolio, as well as information on the hedging strategy, and assessing hedging effectiveness and compliance with the “Clearly Defined Hedging Strategy” of AG 43. Identification shall occur on whether the hedged item is intended to be fully hedged under the hedging strategy, or if the strategy is only focused on a portion of the liability characteristics or a portion of the interest rate sensitivity. Hedging strategies shall be identified as highly effective or ineffective. ~~For highly effective strategies that are not 100% effective, information on the ineffective components shall be disclosed. (For example, if the strategy for a particular hedging relationship excludes a specific component of the gain or loss, or related cash flows, from the assessment of hedge effectiveness, details on the excluded components shall be disclosed.)~~
- b. Aggregate Disclosure of the original cost and fair value of ~~all~~ hedging instruments (including all instruments within a portfolio) along with any investment income recognized during the reporting period. Additionally, disclose the fair value of the hedged

item, the change in fair value from the prior reporting period, and the portion of the fair value change attributed to the hedged risk (designated portion of interest rate sensitivity).

- c. Schedule showing the aggregate fair value change from the prior reporting period for the designated components for all hedging instruments, with identification of the fair value change the portion reflected in unrealized gains, unrealized losses, deferred assets, and deferred liabilities (outstanding derivatives), and the portion reflected in realized gains and realized losses (expired derivatives). This schedule shall also show the current period amortization, including any expedited amortization elected by the reporting entity, and the future scheduled amortization of the deferred assets and deferred liabilities. This schedule shall also identify the fair value of the excluded components of the hedging instruments, and the fair value change reflected in unrealized gain and unrealized loss.
- d. Identification of any outstanding hedging instruments previously captured within scope of this standard and subsequently identified as part of an ineffective hedging strategy. Disclosure shall identify the eliminated deferred assets and deferred liabilities, and the recognition of unrealized gains and unrealized losses resulting from the ineffective hedging strategy.
- e. Identification of any election by the reporting entity to terminate use of the special accounting provisions, the resulting elimination of deferred assets and deferred liabilities, and the impact to unrealized gains and unrealized losses and/or realized gains and realized losses.

Proposed new General Interrogatories: These would not be in the SSAP, but are included here for review. These revisions will be referred to the Blanks (E) Working Group.

26.1 Does the reporting entity have any hedging transactions reported on Schedule DB?

26.2 If yes, has a comprehensive description of the hedging program been made available to the domiciliary state? If no, attach a description with this statement.

26.3 Does the reporting entity utilize derivatives to hedge variable annuity guarantees subject to fluctuations as a result of interest rate sensitivity?

26.4 If so, does the reporting entity utilize:

Special Accounting Provision in SSAP No. XXX

Permitted Accounting Practice

Other Accounting Guidance

26.5 If the reporting entity utilizes the special accounting provision in SSAP No. XXX, the reporting entity shall attest to the following:

Reporting entity has obtained explicit approval from the domiciliary state.

Hedging strategy subject to the special accounting provisions is consistent with the requirements of Actuarial Guideline 43.

Actuarial certification has been obtained which indicates that the hedging strategy is incorporated within the establishment of Actuarial Guideline 43

reserves, and provides the impact of the hedging strategy within the Actuarial Guideline Conditional Tail Expectation Amount.

Financial Officer Certification has been obtained which indicates that the hedging strategy meets the definition of a Clearly Defined Hedging Strategy within Actuarial Guideline 43 and that the Clearly Defined Hedging Strategy is the hedging strategy being used by the company in its actual day-to-day risk mitigation efforts.

**Appendix A – Calculation of Deferred Asset or Deferred Liability**

Under the special accounting provisions within this issue paper, as detailed in paragraph 14.b., fair value fluctuations in the hedging instruments attributable to the hedged risk that do not offset the current period change in the hedged item (AG 43 reserve liability) shall be recognized as deferred assets (admitted) and deferred liabilities.

The ability to recognize a deferred asset and deferred liability is limited to only the portion of the fair value fluctuation in the hedging instruments that is attributed to the hedged risk and does not immediately offset changes in the hedged item.

Unless a different method has been approved by the domiciliary state commissioner, reporting entities shall utilize the following calculation (detailed in paragraph 14) for establishing the deferred asset:

- 14.b.i Calculate the fair value gain or loss in the hedged item attributable to the hedged risk (Step 1);
- 14.b.ii Express the fair value gain or loss calculated (Step 1) as a percentage of the change in the full-contract fair value (i.e., with all product cash flows) attributed to interest rate movements (Step 2).
- 14.b.iii Calculate the AG 43 liability change attributed to the hedged risk as the quantity calculated in Step 2 multiplied by the AG 43 liability change attributable to interest rate (Step 3).
- 14.b.iv Establish the deferred asset or deferred liability in the amount of the fair value loss or (gain) of the designated hedging instruments attributed to the hedged risk less the AG 43 liability decrease or (increase) attributed to the hedged risk as calculated in Step 3.

To illustrate the above calculation:

**Clearly Defined Hedging Strategy (CDHS) characteristics**

Hedged item	Rider claims less rider fees
Hedged risk	50% of the rho (first-order IR level sensitivity)

**Calculation of the deferred asset or liability**

*Note: positive values = increase in liability*

Fair value gain (loss) in hedged item attributable to interest rate movement	(500)
<b>14.b.i. - Fair value gain (loss) in hedged item attributable to hedged risk</b>	<b>(250)</b>

Hence, if the insurer were hedging per the CDHS perfectly, then the insurer should see a 250 fair value loss in the designated IR hedge instruments. To determine how much of that loss should be deferred:



Fair value gain (loss) in full-contract cash flows attributable to IR movement	(700)
<b>14.b.ii - Quantity calculated in 14.b.i. as a % of the (700) above</b>	<b>36%</b>
AG 43 liability increase (decrease) from beginning of period to end of period	400
AG 43 liability increase (decrease) attributable to interest rate movements	(100)
<b>14.b.iii - AG 43 liability increase (decrease) attributable to the hedged risk</b>	<b>(36)</b>

In this example, even though the AG 43 liability increased by 400 during the reporting period, interest rate movements actually contributed to a 100 *decrease*. The hedged risk (50% of the interest rate sensitivity of rider cash flows) accounts for 36% of this, or \$36 of the liability decrease. As such, \$36 of the fair value loss on the interest rate hedge instruments should be reflected immediately and the remainder deferred via a deferred asset equal in amount to  $250 - 36 = 214$ .

<b>14.b.iv – Deferred asset (14.b.i less 14.b.iii) attributable to hedged risk</b>	<b>(36)</b>
<i>(This is shown as a negative – to be consistent with the decrease in AG 43 liability – but represents a deferred asset. Deferred assets reflect fair value losses.)</i>	

### Effective Date and Transition

~~23~~.27. After adoption of this issue paper, the NAIC will release a Statement of Statutory Accounting Principle (SSAP) for comment. Users of the Accounting Practices and Procedures Manual should note that issue papers are not represented in the Statutory Hierarchy (See Section IV of the Preamble) and therefore the conclusions reached in this issue paper should not be applied until the corresponding SSAP has been adopted by the Plenary of the NAIC. It is expected that the SSAP will be effective for \_\_\_\_\_.

### **DISCUSSION - PENDING UPDATE FROM APRIL 3, 2017 REVISIONS:**

**(Staff will update the discussion section after the April 3 SSAP revisions are exposed and discussed by the Working Group.)**

~~24~~.28. The provisions within this issue paper are significantly different from what is currently allowed under SAP, U.S. Generally Accepted Accounting Principles (GAAP) and International Financial Reporting Standards (IFRS). The concept of allowing “effective hedge” accounting treatment for macro-hedges is currently not endorsed by any of the noted accounting standards. Provisions within this issue paper have been drafted with the intent to encourage risk-management transactions by insurers for limited, qualifying transactions in order to reduce non-economic surplus volatility and ensure appropriate financial statement presentation with sufficient transparency for regulator review.

### Application of SSAP No. 86 Guidance

~~25~~.29. The concepts within scope of this issue paper, particularly the allowance for macro-hedges and dynamic (rebalancing) hedging instruments are not permitted within SSAP No. 86. Although limited comments have been received indicating that macro-hedge transactions using a dynamic (rebalancing) approach for variable annuity guarantees could occur under the current concepts of SSAP No. 86, the Statutory Accounting Principles (E) Working Group does not agree with this interpretation. The Working Group agrees that separate guidance is needed to address these limited derivative situations to comply with the Financial Condition (E) Committee charge.

~~26~~.30. Hedge effectiveness determinations under SSAP No. 86 requires use of derivative instruments in hedging transactions that meet the criteria in SSAP No. 86, paragraphs 17 through 19. The application of the guidance in these paragraphs, as well as existing hedge effectiveness guidance under U.S. GAAP and IFRS, is contrary to the concept of a dynamic hedging as the existing guidance is designed primarily for static exposures in which it is necessary to identify a specific hedged item and hedging instrument, and designate them as linked in an individual hedging relationship.

~~27-31.~~ Existing SSAP No. 86 guidance for fair value hedges does allow for similar assets or similar liabilities to be aggregated and hedged as a portfolio. With the fair value hedge portfolio guidance, a particular risk exposure is ~~still~~ required to be designated, and the portfolio of similar assets or similar liabilities must share the risk exposure for which they are designated as being hedged. As detailed within paragraph SSAP No. 86, paragraph 20.e, the change in fair value attributed to the hedged risk for each individual item in a hedged portfolio must be expected to respond in a generally proportionate manner to the overall change in fair value of the aggregate portfolio attributed to the hedged risk. This guidance is adopted explicitly from U.S. GAAP. The FASB has specifically indicated that the “proportional” requirement was to be interpreted strictly, but did not require the term to reflect “identical” items. To illustrate, under a FASB example, percentage decreases within a range of 9 to 11 percent could be considered proportionate if that interest rate change reduced the fair value of the portfolio by 10 percent.

~~28-32.~~ SSAP No. 86 does not include guidance permitting cash flow hedges involving portfolios. SSAP No. 86 guidance is explicit that the hedging relationship shall be highly effective in achieving offsetting cash flows attributable to a particular risk during the term of the hedge. The guidance identifies that this exposure may be associated with an existing recognized asset or liability, or as a forecasted transaction<sup>9</sup>.

~~29-33.~~ With regards to forecasted transactions, SSAP No. 86 guidance allows single transactions and groups of individual transactions to be the hedged transaction. If the hedged transaction is a group of individual transactions, the transactions must share in the same risk exposure for which they are designated as being hedged. The guidance for forecasted transactions does allow more than one risk to be hedged (for example, the risk of changes in cash flows can be related to purchase/sales price, interest rate risk, foreign currency change risk, or default risk), however, the occurrence of the forecasted transaction (e.g., purchase/sale, cash inflow/outflow) must be probable. (SSAP No. 86 identifies that the term probable requires a significantly greater likelihood of occurrence than the phrase more likely than not.) Once a forecasted transaction is no longer probable, hedge accounting is to immediately cease and any deferred gains or losses are to be recognized immediately. Once a pattern occurs of forecasted transactions not being probable, the entity’s ability to accurately predict forecasted transactions is questioned and the entity is no longer permitted to use hedge accounting in the future for similar forecasted transactions.

~~30-34.~~ Furthermore, existing guidance in SSAP No. 86 is drafted to reflect derivative transactions hedging invested assets. Although the scope of SSAP No. 86 does not limit the guidance, the specific provisions within the standard do not provide guidance for hedging liabilities. As noted within the draft guidance, the new SSAP will be specific to derivative transactions hedging the AG 43 liability.

~~31-35.~~ The guidance reflected in the March 2016 original agenda item as the “Initial Staff Proposal for Discussion” (subsequently referred to as the “original agenda item”) proposed use of a “closed” portfolio concept. As detailed within the guidance in this issue paper, the requirement of a closed portfolio has been revised to allow use of a flexible portfolio as the hedged item, providing the ability to continuously adjust the hedged item to remove policies and/or include new policies to effectively manage risk. Use of an open portfolio further differentiates the hedging programs allowed within this issue paper from what is permitted as effective hedges under SSAP No. 86, U.S. GAAP and IFRS. This issue paper reflects the conclusion that the accounting provisions within are separate and distinct from the provisions within SSAP No. 86 and should not be inferred to any derivative transaction that does not explicitly qualify within the scope of this issue paper.

## Hedge Strategy

---

<sup>9</sup> A forecasted transaction is a transaction 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. For transactions detailed within this issue paper, the hedged items are recognized liabilities (AG 43 reserves); therefore the guidance for derivative forecasted transactions does not appear applicable for derivatives within scope of this issue paper.

32-36. The guidance within this issue paper requires reporting entities to engage in highly effective fair value hedges that follow a Clearly Defined Hedging Strategy (CDHS or “hedging strategy”) as defined in AG 43. The documentation required under a CDHS includes:

- a. The specific risks being hedged,
- b. The hedge objectives,
- c. The risks not being hedged,
- d. The financial instruments that will be used to hedge the risks,
- e. The hedge trading rules, including the permitted tolerances from hedging objectives,
- f. The metric(s) for measuring effectiveness,
- g. The criteria that will be used to measure effectiveness,
- h. The frequency of measuring hedging effectiveness,
- i. The condition under which hedging will not take place, and
- j. The person or persons responsible for implementing the hedging strategy.

33-37. While the hedging strategy may change over time, this issue paper requires each hedging strategy to be implemented for a minimum of three months. The provisions in AG 43 also require the hedging strategy to be effectively implemented for at least three months. As detailed in AG 43, reporting entities can meet the time requirement by having evaluated the effective implementation of the hedging strategy for at least three months without actually having executed any trades indicated by the hedging strategy (e.g., mock testing or by having effectively implemented the strategy with similar annuity products for at least three months). For purposes of this issue paper, the three month time-frame is the required timeframe before a change can occur in the documented hedging strategy without an inherent determination that the hedging strategies, and the derivatives within, were ineffective.

34-38. Any change in the hedging strategy shall be clearly documented and include an effective date of the change in strategy. Determination of whether the hedging instruments were highly effective shall be made in accordance with the hedging strategy in place at the time of assessment.

35-39. Comments received identified that most companies identify a target rate sensitivity and purchase interest rate derivatives that will hedge exposure to this target. These comments noted that the target can change with changes in risk appetite and suggested a monthly reset to reflect changes in risk appetite. These comments indicated that regardless of changes in the risk appetite that may occur throughout each month, the hedging strategy would be locked at the beginning of each month. Per these comments, the monthly reset of the overall hedging strategy would not trigger ineffectiveness as long as subsequent cash flows were considered effective under the updated hedging strategy. These comments suggested that reporting entities should be required to specify the operational practices in setting or determining hedging strategies to allow for these changes.

36-40. For the special accounting provisions being discussed in this agenda item, provisions have not been established to allow for a monthly reset of hedging strategies. Instead, hedging strategies are required to be implemented for at least three months. As detailed within the issue paper, reporting entities are allowed to engage in a dynamic hedging strategy in which the hedging instruments may be rebalanced to accommodate changes in the hedged item (which reflects a flexible portfolio of variable annuity contracts) to adhere to a specified, documented derivative strategy. With these provisions, it seems

unnecessary, and overly permissive, to incorporate provisions that allow monthly revisions to the hedging strategy. A three-month implementation timeframe still allows for timely revisions throughout a year if a company's risk appetite was to change and is consistent with AG 43 provisions. In situations in which the hedging strategy must be revised to reflect a revised risk appetite before the three-month implementation timeframe is over, the hedge should be terminated, and deemed ineffective, with subsequent establishment of a new hedging strategy to reflect the updated risk appetite and parameters for assessing hedge effectiveness.

### Hedge Designation - Fair Value Hedge Addressing Variability Attributed to Interest Rate Risk

~~37.41.~~ The guidance within this issue paper limits the hedge designation to a fair value hedge that addresses variable annuity guarantees sensitive to interest rate risk. Although variable annuity guarantees can be sensitive to other market factors, the guidance in this issue paper is only limited to interest rate risk. This issue paper acknowledges that the initial interest rate risk limitation was a scoping consideration (and not a result from a review of other risk factors) and should not preclude subsequent consideration, if supported by the Working Group, of other risks. Unless, and until, subsequent consideration of other risks are considered for inclusion within this guidance, hedges addressing other risks would be subject to the guidance in SSAP No. 86.

~~38.42.~~ The requirement for a fair value hedge is specific within the proposed guidance and requires assessment on whether the derivative instrument hedges changes in the fair value of hedged item (AG 43 liability or specific portion thereof) attributable to interest rate risk. In determining effectiveness, the hedging relationship shall be highly effective in offsetting changes in the fair value attributable to the hedge risk during the period in which the hedge is designated. The term highly effective describes a fair value hedging relationship where the change in fair value of the derivative hedging instrument is within 80 to 125 percent of the opposite change in the fair value of the hedged item attributable to the hedged risk. It shall also apply when an R-squared of 0.80 or higher is achieved when using a regression analysis technique.

~~39.43.~~ The use of a fair value hedge detailed within this issue paper is intended to allow for hedging relationships that consider all contractual cash flows in calculating the change in fair value, or if in accordance with the documented risk management hedging strategy, a designated portion of the contractual cash flows from the hedged item. This is inconsistent with existing guidance in SSAP No. 86 (as well as derivative guidance under U.S. GAAP) in which all contractual cash flows of the entire hedged item must be used in calculating the change in the hedged item's fair value attributed to changes in the benchmark interest rate. However, as noted by comments received, designating a portion of the cash flows as the hedged item is crucial; otherwise effectiveness may be compromised as fair value changes in cash flows from designated instruments may be more or less than the fair value changes in cash flows from the hedged item. Revisions in the designated portion of cash flows intended to be hedged in accordance with the documented risk management hedging strategy would be considered a change in hedging strategy and subject to the guidance in this issue paper for those situations. ~~(Staff Note: Both SSAP No. 86 and U.S. GAAP allow designation of a specific portion of an asset or liability to be the hedged item. However, once designated, all contractual cash flows related to that specified portion must be considered in calculating the change in the hedged item's fair value attributed to changes in the benchmark interest rate being hedged to determine hedge effectiveness. Pursuant to the provisions within this issue paper, From information received, it is staff's understanding that in addition to the designated portion of a specified liability, specific contractual cash flows of that explicit portion are also permitted to be designated. also need to be designated. However, staff requests clarification on this aspect.)~~

40-44. Under SSAP No. 86 and U.S. GAAP, hedge designations are required to be static and are not permitted to be revised over the hedge term. With the provisions in this issue paper, changes are not permitted unless, and until, the reporting entity documents a new hedging strategy. Unless there is a change in hedging strategy, subsequent assessments of effectiveness shall be consistent with the originally documented risk management strategy, and the designated portion of cash flows, for the hedged item. Fair value gains or losses on the derivative instrument that do not offset the change in the fair value of the hedged item attributable to the hedged risk, as detailed within the hedging strategy, are considered ineffective elements of the hedge, and depending on the degree of ineffectiveness could trigger assessment that the entire hedge is ineffective.

41-45. Despite comments initially received supporting use of a cash flow hedge approach, the general nature of the hedging strategies employed for these variable annuity contracts are more representative of a fair value hedge. However, as the hedged item (AG 43 reserve) is not reported at fair value, these hedging strategies do not qualify for a fair value hedge. Based on information received, reporting entities already calculate the fair value for the AG 43 reserve and use the fair value changes in the hedged item and hedging instruments to determine hedge effectiveness. Rather than pursue the cash flow hedge designation, this issue paper has been prepared to follow the method that is intuitively applied, although the standard requirements to qualify for a fair value hedge are not met. (With the hedged item recognized at an amount other than fair value (AG 43 reserve calculation), the gains or losses attributed to changes in the fair value do not adjust the AG 43 liability and are not recognized currently in earnings.)

#### **Hedged Item - Flexible Portfolio or Closed Portfolio**

42-46. The guidance within this issue paper proposes use of a flexible portfolio as the hedged item, reflecting the possibility to include variable annuity contracts with different characteristics and different liability durations (macro-hedge). The designated portfolio would not be required to be static in a closed portfolio, but could be revised to remove policies and/or include new policies to allow for continuous risk management of the variable annuity guarantee reserves.

43-47. The use of a flexible portfolio, rather than a closed portfolio, reflects consideration of industry comments regarding the current aggregate approach for risk-management strategies. Furthermore, consideration was given to comments indicating that requiring use of a closed portfolio would be operationally burdensome in accordance with documentation requirements and assessments of hedge effectiveness. Key elements noted by industry include:

- a. Open or flexible portfolio is imperative as the liability changes on a daily basis with changes to inforce business and capital market factors. Requiring the redesignation of a hedge relationship due to any change in the hedged item is operationally burdensome as new hedge documentation and assessments of effectiveness would be required frequently.
- b. Portfolio approach based on guarantee duration (detailed in the original agenda item) could result in an exorbitant amount of hedge relationships that become difficult to maintain. Sensitivity and risk profile can vary from policy to policy and within a policy by performance of the separate account underlying it. Combining policies by duration at inception of the hedge relationship is arbitrary.
- c. Multiple portfolio approach is challenging as most risk management strategies hedge at an aggregate level to capture the diversification inherent in the business. Additionally, a closed portfolio approach would require segmentation of the AG 43 calculation. As AG 43 was designed to be an aggregate projection of liabilities and assets of all variable annuity policies in force, the AG 43 calculation includes inherent diversification. The sum of a segmented AG 43 does not necessarily equal the calculation at an aggregate

level and could result in entities holding greater reserves than necessary by a material amount.

44.48. The IASB also has a project to consider a new accounting model for dynamic risk management. This project was driven from difficulties associated with applying existing hedge accounting requirements to a dynamically managed portfolio with continuous frequent changes in the risk positions that are hedged. Within this IASB project, the IASB identifies that under current hedge accounting guidelines, open portfolios are in effect forced into closed portfolios for hedge accounting purposes, and this practice makes it difficult to reflect dynamic risk management in the financial statements.

45.49. Moving towards a flexible portfolio is intended to better reflect the key features of dynamic risk management. As detailed in the IASB discussion paper and the related April 2014 *IFRS in Focus* (Deloitte)<sup>10</sup>, when derivatives are used to hedge risks which are not measured on the same basis (i.e., hedged item and hedging instruments both measured and reported at fair value with fair value fluctuations recognized as unrealized gains or losses), volatility arises, despite the risk management objective of reducing economic volatility. Hedge accounting helps to reduce this volatility; however, hedge accounting is not well suited to the hedging of dynamic portfolios. Hedge accounting requires the specific designation of hedged items and hedging instruments and requires specific mechanics and effectiveness testing to be performed. Such requirements are better suited to individual hedges or hedges of static groups of items (closed portfolios) rather than hedges of portfolios that are constantly changing with new exposures added and old exposures removed (open or dynamic portfolios) and where the portfolio of hedging derivatives is also frequently changing.

46.50. Consistent with issues identified by the IASB, the use of closed portfolios, following the general hedge accounting model, gives rise to various issues, including:

- a. Treating open portfolios as a series of closed portfolio hedges inevitably leads to profit or loss volatility from hedge ineffectiveness that is inconsistent with the economic position and reflective of the dynamic risk management applied.
- b. As the portfolio of hedged items and hedging instruments change, hedge accounting leads to frequent de-designations and re-designations which give rise to operational difficulties regarding tracking and amortization of hedge adjustments.

47.51. In the original agenda item, use of a closed portfolio was suggested as an ever-changing portfolio of variable annuity contracts would be difficult for regulators to actively review and assess for hedge effectiveness compliance. Additionally, there was concern that allowing for a variable portfolio, particularly if coupled with a flexible hedging instrument, could allow for companies to “control” the hedge effectiveness by adjusting both the hedged item and the hedging instruments. Although these concerns still exist, provisions within the issue paper have been included to incorporate a higher degree of review and approval for these derivative transactions. Particularly, provisions have been incorporated to require explicit approval from the domiciliary state prior to implementing a hedging program within scope of this guidance, and the guidance requires certifications from both an external actuary and a financial officer of the company on the use and impact of the hedging strategy on AG 43 reserves.

48.52. In reviewing the comments from industry, as well as the discussion elements supporting the IASB project, requiring the closed portfolio approach detailed in the original agenda item may not be successful in encouraging further risk-management transactions by insurers. The operational burden in applying the concepts of closed portfolios would likely limit the general application of the special accounting provisions being considered, further perpetuating concerns that existing accounting guidance may hinder insurers from engaging in appropriate risk-management activities.

---

<sup>10</sup> Deloitte: *IFRS in Focus - IASB Issues Macro Hedging Discussion Paper*, April 2014

**Hedging Instrument - Dynamic Hedging Strategy (Rebalancing)**

~~49~~53. The provisions within this issue paper permits reporting entities to utilize a specified derivative, or a portfolio of specified derivatives, as the hedging instrument. The portfolio of derivatives is allowed to be rebalanced in accordance with changes in the hedged item to adhere to a specified derivative strategy. The ability to rebalance derivatives designated as the hedging instrument is different from the guidance proposed in the original agenda item, but is supported from comments identifying that dynamic hedging is a prevalent industry practice and widely accepted as an appropriate risk management technique. Commenters noted that a dynamic hedging strategy rebalances derivative portfolios to result in targeted market sensitivity and is not a result of a flawed hedge. Irrespective of one open or multiple closed hedged items, a dynamic instrument is fundamental in applying adequate risk management measures for variable annuities as the sensitivity changes over time and life of the policies. Comments indicated that designating one static pool at inception could result in significant hedge accounting and economic ineffectiveness, and highlight that the instruments used to hedge a liability with a changing risk profile must be flexible.

~~50~~54. Although comments received indicated that the guidance in SSAP No. 86 supports the concept of dynamic hedging (rebalancing of hedging instruments), staff does not believe that interpretation is consistent with the intent of SSAP No. 86, nor is that interpretation consistent with derivative guidance under U.S. GAAP or IFRS. Pursuant to U.S. GAAP derivative guidance, separate financial instruments shall not be combined, and evaluated as a unit, unless two more derivative instruments in combination are jointly designated as the hedging instrument. As previously noted, guidance in SSAP No. 86, as well as U.S. GAAP and IFRS, are designed primarily for static exposures in which it is necessary to identify a specific hedged item and hedging instrument (including a unit of combined instruments), and designate them as linked in an individual hedging relationship.

**Hedging Criteria – Assessment of Effectiveness**

~~51~~55. Although the provisions within this issue paper incorporate new concepts for what is allowed as the hedged item and the hedging instrument, as well as incorporates a specific approach to determine hedge effectiveness, the concept of whether a fair value hedge is effective – and whether the hedging relationship achieves offsetting changes in fair value – is consistent with concepts established in SSAP No. 86 (as well as U.S. GAAP and IFRS) for assessing effectiveness. Key provisions include:

- a. Use of a specified method that will be used to assess hedge effectiveness at inception and on an ongoing basis, requiring hedge effectiveness assessment whenever financial statements are reported, with a minimum requirement of every three months. As detailed in the issue paper, in order to determine hedge effectiveness reporting entities must calculate the fair value of the hedged item (portion of AG 43 reserve liability) at inception and on an ongoing basis in a similar fashion as FAS 133, and compare the current period fair value change of the hedged item to the current period fair value change of the hedging instruments. This comparison is specific to the designated hedged risks and exposures, therefore, if only a portion of the interest rate risk is hedged or if the designated hedge only include specific components of the variable annuity policies (e.g., riders), for determining hedge effectiveness, the fair value comparisons is limited to those designated items.
- b. Documentation is required for both prospective and retrospective effectiveness assessment, with ongoing assessment consistent with the documented risk management strategy in effect at the time of assessment. (Changes from the original hedging strategy are permitted in accordance with this issue paper.)

- c. A highly effective hedging relationship is one where the change in fair value, is within 80 to 125 percent of the opposite change in fair value of the hedged item attributed to the hedged risk. A highly effective hedge also exists when an R-squared of .80 or higher is achieved when using a regression analysis.

~~52-56.~~ Unlike the guidance in SSAP No. 86 (as well as U.S. GAAP), the guidance within this issue paper does not allow reporting entities to determine how they will assess hedge effectiveness. Rather, this issue paper specifies a particular approach for assessing whether the hedging strategy is highly effective, and in measuring hedge effectiveness. The hedging relationship is expected to be highly effective in achieving offsetting changes in fair value attributed to the hedged risk between the hedged item and the hedging instrument during the period that the hedge is designated. With the dynamic / rebalancing approach detailed within this issue paper, an individual hedging instrument is considered to be part of the effective hedge if the entire portfolio of hedging instruments achieves offsetting changes in fair value during the period in accordance with the hedging strategy. Rebalancing individual hedging instruments within a portfolio does not result with an ineffective assessment as long as the entire hedging instrument (portfolio) continues to meet the hedge effectiveness requirements under the documented hedging strategy.

~~53-57.~~ As a continued GAAP to SAP difference, the requirements in this issue paper do not require reporting entities to separately report in the financial statements the ineffective portion of a highly-effective hedging transaction. For U.S. GAAP filers, in all instances, the actual measurement of cash flow hedge ineffectiveness is to be recognized in earnings each reporting period. The recognition of ineffectiveness is based on whether exact offset of cash flows is not achieved. As a change from SSAP No. 86, this issue paper does require measurement and disclosure of any ineffective part of the hedge.

### **Measurement of Open / Outstanding Derivative Instruments Hedging Criteria**

~~54-58.~~ This issue paper requires all derivative hedging instruments to be reported at fair value. Derivative instruments combined in a portfolio are also required to be separately reported at fair value. Although this is a measurement change from derivatives in effective hedges under SSAP No. 86, the fair value measurement approach is consistent with U.S. GAAP and IFRS. The FASB has identified that fair value is the only relevant measurement attribute for derivatives. Furthermore, the FASB specifically identified that amortized cost is not a relevant measurement because the historical cost of a derivative is often zero, yet a derivative can be settled or sold at any time for an amount equivalent to its fair value. The FASB reasoning supporting “held to maturity” instruments being held at amortized cost was noted as not suitable for derivatives.

~~55-59.~~ The requirement to use fair value under this special accounting provision is a change from SSAP No. 86 for derivatives that qualify as effective hedges. This change is appropriate under this accounting guidance for the following reasons:

- a. Fair value fluctuations in hedging instruments attributable to the hedged risk that offset the changes in the AG 43 liability shall be recognized as unrealized gains and losses. These offsets result in a neutral financial statement impact, with the financial statements reflecting the impact of the effective hedge. This offset is only possible under a fair value measurement method in which fair value fluctuations are reflected in the financial statements. Under an amortized cost measurement method, fair value fluctuations are not recognized in the financial statements. (Although AG 43 reserve changes impact income, it is appropriate to keep the fair value fluctuations from hedging instruments in unrealized gains and losses as “below the line” changes impacting surplus and not net income. As fair value fluctuations can reverse, under current statutory accounting provisions, these changes are not reported as net income adjustments, particularly if net income increases can impact dividends.)



Special Accounting Treatment for Limited Derivatives

- b. Provisions are established to allow for the recognition of a “deferred asset” or “deferred liability” for the portion of the fair value fluctuations attributed to the hedged risk that do not immediately offset the changes in the AG 43 liability. The recognition of these balance sheet items negates the surplus volatility from the non-offsetting fair value fluctuations.
- c. Use of fair value will result with consistent measurement methods for derivatives between SAP and U.S. GAAP. Additionally, the reporting of fair value and the development of the deferred assets and deferred liabilities will clearly present derivative positions under this special accounting provision. This is particularly important for instances in which gains and losses from expired derivatives are not immediately reflected in the financial statements, but are scheduled for amortization.

56-60. The provisions within this issue paper permitting recognition of a “deferred asset” and a “deferred liability” to reflect the non-offsetting portion of unrealized losses and unrealized gains as a result of fair value fluctuations attributed to the hedged risk is inconsistent with U.S. GAAP derivative guidance, as well as the general definitions for what constitutes an asset or liability under both SAP and U.S. GAAP. Gains and losses resulting from changes in the fair value of derivatives are not separate assets or liabilities because they have none of the essential characteristics of assets or liabilities. As noted by the FASB, the act of designating a derivative as a hedging instrument does not convert a subsequent loss or gain into an asset or a liability. A loss is not an asset because there is no future benefit associated with it. The loss cannot be exchanged for cash, a financial asset, or a nonfinancial asset used to produce something of value, or used to settle liabilities. Similarly, a gain is not a liability because no obligation exists to sacrifice assets in the future.

57-61. The reporting of derivative gains and losses from effective hedges as assets or liabilities is not new under statutory accounting. Currently, in SSAP No. 86, upon the sale, maturity, or other closing transaction of a derivative, which is an effective hedge, any gain or loss on the transaction will adjust the basis (or proceeds) of the hedged item(s) individually or in the aggregate. This “adjustment to the basis of the hedged item” reflects the recognition of derivative losses or gains as assets or liabilities. Although these provisions exist in SSAP No. 86, the impact is not easily identifiable in the assets or liabilities reported on the financial statements. With the exception of impairment assessments for the hedged item (pursuant to the SSAP in which the hedged item falls), increases in an asset basis of a hedged item as a result of derivative losses are not restricted, nor are they explicitly nonadmitted.

58-62. SSAP No. 86 also provides an alternative treatment, whereas if the item being hedged is subject to IMR, the gain or loss on the terminated hedging derivative may be realized and subject to IMR. This alternative approach also reflects the recognition of a balance sheet impact (increase or decrease in liabilities) for realized gains and losses that do not meet the definition of assets or liabilities. For IMR items, losses recognized from derivative instruments reduce the IMR liability, whereas gains from derivative instruments increase the IMR liability. With the provisions established for IMR, safeguards are in place to prevent recognition of a contra-liability (or asset) for realized losses that exceed realized gains. If realized losses exceed the IMR liability, resulting with a negative liability balance, the IMR liability is required to be shown as zero. A negative liability for IMR is not permitted to be reflected in the financial statements.

59-63. Although staff does not generally support the recognition of balance sheet items that do not meet the definitions of assets or liabilities, this process is proposed in this issue paper for the following reasons:

- a. The process to recognize the fair value of derivative instruments, coupled with the recognition of “deferred assets” and “deferred liabilities” (reflecting non-offsetting unrealized / realized gains and losses attributed to the hedged risk), provides a comprehensive view of the derivative impact in the balance sheet. With this approach, the

derivative is reported at fair value, but the non-economic volatility from market fluctuations does not impact the entity's solvency presentation.

- i. For example, a derivative acquired at zero cost currently in a liability position from fair value fluctuations will be reported as a derivative liability in the financial statements. The unrealized loss from fair value fluctuations attributed to the hedged risk which were not recognized as they did not offset AG 43 reserve changes will be shown as a deferred asset. This deferred asset would be admitted, although it does not meet the definition of an asset, or the concept of an admitted asset under SSAP No. 4, as it does not reflect a probable future benefit or something that would be available for policyholder benefits. However, by reporting both the derivative liability and the deferred asset, non-economic volatility in the financial statements is mitigated, while improving presentation as the derivative obligation (derivative liability) will be presented in the financial statements. In addition, under the narrow scope of this issue paper, it's important to consider accounting that captures what is relevant and a faithful representation of the business model of variable annuity life insurers, who as indicated elsewhere within this issue paper, utilize dynamic hedging as a risk management technique that if determined to be highly effective under the requirements of this statement, reduces risk, and helps the industry as a whole to better serve the marketplace. Under current guidance, using an amortized cost approach, the derivative would be reported at zero, and not be adjusted for fair value fluctuations, therefore the liability position of the derivative would not be shown in the financial statements.
- b. The process to recognize the fair value of derivative instruments is consistent with the U.S. GAAP guidance for reporting derivatives, therefore eliminating the GAAP or SAP difference on the reporting of these investments.
- c. The recognition of "deferred assets" and "deferred liabilities" and the separate amortization of these balances, outside of IMR, prevents the application of this special accounting provision from diluting or impacting the recognition of IMR. Pursuant to SSAP No. 7, IMR defers recognition of realized capital gains and losses resulting from changes in the general level of interest rates. As the recognition of deferred assets and deferred liabilities proposed within this issue paper initially reflects unrealized gains or losses, (and then realized gains and losses once the derivative instrument expired), using a separate amortization process of these items, and not commingling these items with IMR, retains the original intent of IMR.

~~60-64.~~ The guidance in this issue paper is focused on the accounting guidance for the derivative instruments that hedge an AG 43 liability, not the impact that a Clearly Defined Hedging Strategy, under the provisions of AG 43, can have on the recognized AG 43 liability. One question that arose during the development of this issue paper was whether there was any double counting of the impact of the hedge that would be recorded under this proposed issue paper and what would be recorded as part of the AG 43 liability. It was determined this was not an issue as the amount of credit given to a hedge (the asset to the company under this proposed accounting) under AG 43 is significantly muted by the mechanics and in fact many times actually works to the detriment of the company in AG 43 but is not considered to be material.

### **Amortization of Deferred Assets and Deferred Liabilities**

~~61-65.~~ This issue paper proposes that deferred assets and deferred liabilities from non-expired derivative contracts be amortized into unrealized gains and losses over period of five years, unless the reporting

entity can provide explicit documentation demonstrating that a longer period is more closely linked to the expected liability duration of the hedged item. Although it would be preferred for the amortization period to be linked directly to the AG 43 liability, it is not anticipated that a consistent approach could be determined across reporting entities. Although one commenter suggested a 25-year timeframe, as the amortization can reflect the delayed recognition of unrealized (and realized losses), this timeframe was identified as too long. In working with other industry representatives, a timeframe of 5-years was suggested to NAIC staff. Under the fair value accounting approach in SSAP No. 86, the derivative fair value fluctuations are recognized as they occur, so these commenters noted that a 5-year amortization timeframe would be a significant improvement to the current guidance. For companies that are able to adequately demonstrate a linkage to the expected AG 43 liability, these companies are permitted to extend the amortization, but not to exceed ten years. It is also noted that unrealized gains and losses recognized on a quarterly basis are required to be separately scheduled for amortization over the allowed timeframe. By limiting the amortization timeframe, the scheduling process is anticipated to be manageable, allowing for more effective regulator review.

62-66. This issue paper also allows for reporting entities to accelerate amortization or terminate use of the special accounting provision at any time. With this provision, all deferred assets and deferred liabilities recognized related to outstanding derivative instruments would be immediately eliminated and recognized as unrealized gains and losses. This accounting would be consistent with the fair value accounting method prescribed in SSAP No. 86 if it had been followed. If terminated, subsequently, all derivatives within the documented hedging strategy would be required to follow the fair value accounting under SSAP No. 86.

### **Measurement / Recognition of Realized Gains and Losses**

63-67. With the ability to rebalance derivative hedging instruments, this issue paper allows for individual derivative instruments to be removed from the portfolio, and/or expire, and not immediately result with an ineffective hedging assessment. Comments received indicate that this approach is consistent with guidance under SSAP No. 86, as gains and losses are either allowed to be an adjustment to the hedged item, or are realized and included in IMR. However, the guidance in this issue paper allows for derivatives to be removed from the hedging strategy and not be identified as an ineffective hedge. This concept is not supported by the existing guidance within SSAP No. 86.

64-68. The provisions within this issue paper is only intended to encompass situations in which the overall hedging strategy is highly effective at the time that the derivative is either removed from the portfolio of hedging instruments or expires. If the hedging strategy is highly effective at that time, then regardless of future determination of effectiveness, the deferred assets or deferred liabilities recognized for the derivative instrument will continue to be amortized under the remaining amortization scheduled established when the hedge was deemed highly effective.

65-69. Once a derivative has expired, the deferred asset and deferred liability will no longer be amortized into unrealized gains and losses, but will be amortized into realized gains or losses.

66-70. For derivatives that have not expired, but were removed from the portfolio of hedging instruments, subsequent gains and losses from fair value fluctuations shall not impact the previously recognized deferred assets or deferred liabilities, but rather be recognized directly as unrealized gains and losses. With this approach, the unrealized gains or losses, reflected as deferred assets or liabilities, will be “locked in” once the derivative is removed from the portfolio of hedging instruments.

### **Derivative Income**

67-71. This issue paper requires that all derivative income received for all derivative instruments within scope of this guidance shall be reported as investment income.

~~68~~:72. U.S. GAAP derivative guidance is focused on income statement matching. As such, under U.S. GAAP, the “effective” portion of gains and losses on a derivative instrument is reported consistently between the hedging instrument and hedged item resulting with an exact offset to gains and losses attributed to the hedged risk. The “ineffective” portion directly effects earnings because there is no offsetting adjustment for the ineffective aspect of the gain or loss. As the focus for statutory accounting is less on income statement matching, and more on the balance sheet impact of the hedged item and the derivative hedging instruments (reducing non-economic volatility), provisions to defer recognition of income received is not considered appropriate for statutory accounting.

~~69~~:73. The provisions to recognize income received is also consistent with the SSAP No. 86 guidance in situations in which the derivative is not combined with the hedged item. Pursuant to current guidance, periodic cash flows and accruals of income/expense are to be reported in a manner consistent with the hedged item, usually as net investment income or another appropriate caption within operating income.

(Staff notes that ~~t~~The SSAP No. 86 is drafted with an assumption that the hedged item is an asset, there is no guidance in SSAP No. 86 that reflects consideration of designating a liability as a hedged item.)

~~70~~:74. The cash flow guidance in SSAP No. 86 is different for situations in which the derivative is combined with the hedged item. Under that guidance, the income reported for the derivative on Schedule DB is zero, and the cash flows are to be reported with the hedged item instead of with the derivative. There are concerns with regards to this existing guidance (both in SSAP No. 86, as well as this issue paper), as income from derivative instruments would not be identifiable within the financial statements or Schedule DB. Staff is under the impression that this allowance is not often elected under SSAP No. 86, however, with the need for clear reporting under this special accounting provision, this approach is not presented as an option within this issue paper.

~~71~~:75. Comments received supported continuation of the concepts in SSAP No. 86, in which changes in the carrying value or cash flow of the derivative shall be recognized in the same period and in the same category of income or surplus as the amortization or fair value changes of the hedged item; e.g., net gain from operations, realized capital gains and losses on investments, unrealized capital gains and losses on investments, or unrealized foreign exchange capital gain or loss. The comments received also identify that as cash flows from swaps are included in the calculation of the hedged item (e.g., projected within AG 43), swap income will be accrued and recorded when it is earned consistently with the hedge item. This issue paper does not reflect these comments. Rather, consideration of income shall be recognized as received, and be included as a factor in determining the recognition of fair value fluctuations in the derivative instruments (e.g., the degree of offset between the AG 43 liability and the fair value fluctuations impacting the recognition of deferred assets and deferred liabilities). It is anticipated that this approach will not result in material differences in the financial statements, but will allow for proper recognition of income when received.

## Disclosures

~~72~~:76. The disclosure requirements in this issue paper are intended to result in a new schedule DB that specifically address the hedging strategies and related derivatives within this issue paper. The disclosure requirements also envision a schedule for all hedging instruments, with detailed information regarding the cost, fair value, unrealized gains and losses, deferred assets and deferred liabilities, and the amortization schedule. The intent of the proposed disclosures is to provide clear, transparent information regarding the use and impact of this special accounting provision within the financial statements.

**RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE**

**Statutory Accounting**

*(Staff Note – Excerpts of GAAP and SAP Guidance are planned for inclusion in the final version. These elements have been excluded from the preliminary draft to save space.)*

G:\DATA\Stat Acctg\3. National Meetings\A. National Meeting Materials\2017\Spring\NM Exposures\16-03 - IP VA - ED 4-8-17 - Fair Value Hedge.docx