

Statutory Issue Paper No. 85

Derivative Instruments

STATUS

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Original SSAP and Current Authoritative Guidance: SSAP No. 27 and SSAP No. 86

Type of Issue:

Common Area

SUMMARY OF ISSUE

1. Chapter 8 of the Accounting Practices and Procedures Manuals for Life and Accident and Health and for Property and Casualty Insurance Companies (Life/A&H and P&C Accounting Practices and Procedures Manuals) contains guidance on accounting for derivative instruments. This guidance provides two alternatives for accounting for derivative instruments: (a) Hedge accounting, or (b) Immediate recognition (mark to market) accounting. Specific accounting guidance for Income Generation Transactions was adopted by the Financial Condition (EX4) Subcommittee on December 14, 1996.

2. GAAP is not applied uniformly for different types of derivatives because there is no comprehensive authoritative accounting guidance. To the extent that specific accounting guidance does not exist for some derivatives, practice is based on analogy to the literature that does exist for other derivatives. The key GAAP accounting literature applicable to derivatives, which is primarily addressed in *FASB Statement No. 80, Accounting for Futures Contracts* (FAS 80), *FASB Statement No. 52, Foreign Currency Translation* (FAS 52), and *FASB Emerging Issues Task Force Issue No. 84-36, Interest Rate Swap Transactions* (EITF 84-36), is based on hedge accounting for futures and foreign exchange contracts, settlement accounting for interest rate swaps and mark to market accounting.

3. The purpose of this issue paper is to establish statutory accounting principles for derivative instruments (hereinafter referred to as derivatives), that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

4. This issue paper adopts the Derivative Instruments guidance of Chapter 8 of the Life/A&H and P&C Accounting Practices and Procedures Manuals. Paragraphs 6 through 10 herein summarize the key provisions of the guidance. Derivatives shall be defined as swaps, options, forwards, futures, caps, floors, and collars. The following are general definitions for these derivative instruments:

- a. Swaps: Swaps are contracts to exchange, for a period of time, the investment performance of one underlying instrument for the investment performance of another underlying instrument, typically without exchanging the instruments themselves. Swaps can be viewed as a series of forward contracts that settle in cash rather than by physical delivery. Swaps generally are negotiated over-the-counter directly between the dealer and the end user. Interest rate swaps are the most common form of swap contract. However, foreign currency and commodity swaps also are common;
- b. Options: Options are contracts that give the option holder (purchaser of the option rights) the right, but not the obligation, to enter into a transaction with the option writer (seller of the option rights) on terms specified in the contract. A call option allows the holder to

- buy the underlying instrument, while a put option allows the holder to sell the underlying instrument. Options are traded on exchanges and over the counter;
- c. Forwards: Forward contracts are agreements (other than a futures) between two parties that commit one party to purchase and the other to sell the instrument or commodity underlying the contract at a specified future date. Forward contracts fix the price, quantity, quality, and date of the purchase and sale. Some forward contracts involve the initial payment of cash and may be settled in cash instead of by physical delivery of the underlying instrument;
 - d. Futures: Futures are standardized forward contracts traded on organized exchanges. Each exchange specifies the standard terms of futures contracts it sponsors. Futures contracts are available for a wide variety of underlying instruments, including insurance, agricultural commodities, minerals, debt instruments (such as U.S. Treasury bonds and bills), composite stock indices, and foreign currencies;
 - e. Caps: Caps are option contracts in which the cap writer (seller), in return for a premium, agrees to limit, or cap, the cap holder's (purchaser) risk associated with an increase in a reference rate or index. For example, in an interest rate cap, if rates go above a specified interest rate level (the strike price or the cap rate), the cap holder is entitled to receive cash payments equal to the excess of the market rate over the strike price multiplied by the notional principal amount. Because a7.158ITJ25.51 0 cd

exposure. Examples of items that expose the reporting entity to risk include change in the value, yield, price, cash flow, or quantity of, or degree of exposure with respect to assets, liabilities, or future cash flows which a reporting entity has acquired or incurred, or anticipates acquiring or incurring. To satisfy the condition of risk reduction, the reporting entity shall demonstrate how the derivative instrument reduces risk by using an appropriate method. There are a variety of methods available that can be used to demonstrate risk reduction, including methods which analyze the correlation of gains and losses on the derivative in relation to the losses and gains on the hedged asset, liability, or future cash flow. Included in the concept of hedge accounting is the notion of settlement accounting for interest rate swaps that are matched through designation with an asset or a liability on the balance sheet. Under settlement

14. As with derivatives in general, these instruments include a wide variety of terms regarding maturities, range of exercise periods and prices, counterparties, underlying instruments, etc.
15. The principal features of income generation transactions are:
 - a. Premium received is initially recorded as a deferred liability;
 - b. The accounting of the covering asset or underlying interest controls the accounting of the derivative. The covering asset/underlying interest is accounted at either mark-to-market

17. Written fixed income covered call options shall be accounted for as follows:

STATUS OF

18. The principal features of written covered put options are:
- The accounting for the underlying interest instead of the covering asset governs the accounting of the written put while it is open. For example, if a reporting entity wrote a put requiring it to purchase a certain common stock (underlying interest) at a specific price, the reporting entity might cover that option by holding cash or cash equivalents (covering asset). The accounting for the common stock would govern the accounting of the option in this case;
 - As with covered call writing for life insurance companies, gain/loss on termination may be subject to IMR over the remaining life of the underlying interest;
 - As with covered call writing, reporting entities writing put options for income generation purposes are responsible for timely recognition of any probable losses that may occur as a result of the strategy;
19. Written covered put options shall be accounted for as follows:

STATUS OF OPTION	UNDERLYING INTEREST VALUED AT AMORTIZED COST	UNDERLYING INTEREST VALUED AT MARKET VALUE
Open	Record premium as deferred liability. Carry at consideration received. (1)	Record premium as deferred liability. Mark to market with changes in market value recorded as unrealized adjustments to surplus – gain/loss.
Closed – Expired	Premium received recognized as realized capital gain. Gain from expiration to flow through IMR, if applicable.	Premium received recognized as realized capital gain.
Closed – Exercised	Adjust acquisition cost by premium received.	Adjust acquisition cost by premium received.

- iv. A discussion of the market risk, credit risk, and cash requirements of the derivative instruments.
 - b. General Disclosures:
 - i. A description of the reporting entity's objectives for holding or issuing the derivatives, the context needed to understand those objectives, and its strategies for achieving those objectives, including the classes of derivatives used;
 - ii. A description of how each category of derivative is reported in the financial statements including the policies for recognizing (or reasons for not recognizing) and measuring the derivatives held or issued, and when recognized, where those instruments and related gains and losses are reported.
24. Reporting entities shall disclose the following for derivatives held for other-than-hedging purposes:
- a. Average fair value of the derivative instruments during the reporting period together with the related end-of-period fair value distinguishing between assets and liabilities;
 - b. Net gains or losses disaggregated by class, business activity or other category that is consistent with the management of those activities and where the net gains or losses are reported.
25. The financial statements shall disclose details of covered items and/or written transactions to allow evaluation of cash flow implications for all written covered options used for income generation.

DISCUSSION

26. The Summary Conclusion adopts the aforementioned sections of current statutory accounting principles (Chapter 8) for derivatives including insurance futures and insurance futures options. These principles are consistent with the Statement of Concepts because they provide recognition of derivatives as assets or liabilities, and recognition of income (gains) or expense (losses) based on how the reporting entity uses the derivative to reduce risk related to an existing exposure. It also provides a consistent approach to accounting for the many types of derivatives currently available to reporting entities.

27. This issue paper clarifies that the immediate recognition method of accounting (mark to market) shall be applied in situations where a reporting entity enters into a derivative for other-than-hedging purposes, when a portfolio has been hedged, or for derivatives that are not specifically addressed elsewhere in this guidance. Other-than-hedging is defined as any transaction which does not qualify for hedge accounting, including active derivatives trading by a reporting entity who enters into derivatives for purposes of generating profits on short-term differences in market movements and not for risk reduction purposes. This clarification is added so that unrealized gains and losses, particularly losses, cannot be deferred when categorized as other-than-hedging. This is consistent with the conservatism concept in the Statement of Concepts. Further, the immediate recognition method of accounting is not precluded from being utilized in situations where the derivative qualifies for hedge accounting.

28. This issue paper also provides that the determination of hedge accounting or immediate recognition accounting shall be made for each individual instrument. A reporting entity may utilize immediate recognition accounting for certain derivatives within a category and hedge accounting for other derivatives within that same category. This is a change from current statutory accounting principles, which provide that the categories to which immediate recognition accounting treatment is applied should be consistent from period to period.

29. While there is a separate section in the current statutory accounting guidance for insurance futures and related instruments, the accounting is similar to that of other derivatives. Therefore, the conclusion does not differentiate futures or options accounting from insurance futures or insurance futures options accounting, however, the distinctions in current statutory guidance in accounting and reporting for these instruments are adopted. The separate section for insurance futures and insurance futures options was incorporated into the current Life/A&H and P&C Accounting Practices & Procedures Manuals because insurance futures are viewed by insurance regulators as insurance-related transactions and not as investment-related transactions. As a result, insurance futures and insurance futures options are reported on Schedule DC and not Schedule DB as for other non-insurance derivatives. Also, income related to insurance futures and insurance futures options is reported as an aggregate write-in for miscellaneous income not as investment income and any asset is recorded as an aggregate write-in for other-than-invested assets.

30. Current statutory accounting does not specifically address settlement accounting for interest rate swaps. Under certain conditions (as set forth in EITF Issue No. 84-36), GAAP permits settlement accounting for interest rate swaps. Therefore, EITF Issue Nos. 84-36 and 84-7 are adopted.

31. Under settlement accounting, periodic net cash settlements under the swap agreement are recognized in income when they accrue. Settlement accounting is considered a conservative approach, and in many instances, produces an accounting result which is similar to hedge accounting. Such accounting is widely accepted in practice and provides an accounting approach that is consistent with the purpose of entering into such an instrument; that is, to change the interest rate characteristics of the balance sheet item to which it is matched. When this issue paper refers to hedge accounting, it encompasses the notion of settlement accounting for interest rate swaps that are matched through designation with an asset or a liability on the balance sheet.

32. The accounting and reporting for derivative instruments used for income generation is intended to meet (1) regulatory needs focusing on company and industry solvency, (2) company needs focusing on administrative and cost considerations, and (3) the general need to provide meaningful and relevant information regarding the substance of the transactions and holdings for all users of the financial statements.

- a. The approach is conservative and reduces the potential for income manipulation. Income is not recognized early in the holding period only to be reversed by future losses. This consideration is particularly important for options which could have lower exercise prices than the combined statement values of the derivative and the covering asset;
- b. The approach is reasonably simple and consistent with Statutory accounting. It builds on accounting guidance which already exists in the NAIC Accounting Practices and Procedures Manual and in the Annual Statement Instructions regarding hedging;
- c. The approach looks to the substance of the transactions involved:
 - i. It matches the accounting of the derivative with the accounting of the covering asset or underlying interest;
 - ii. It includes an alternative treatment which combines the derivative with the covering asset. This results in a treatment analogous to callable bonds where the option feature is combined with the asset rather than in two pieces;
 - iii. It allows for recognition of the time value/interest rate factor implicit in the pricing of these instruments, particularly relevant for derivatives with longer maturities.

33. Under GAAP, although there is no authoritative accounting guidance for written covered options, written options are generally reported at fair value w

RELEVANT STATUTORY AND GAAP GUIDANCE**Statutory Accounting**

40. Chapter 8 in the Life/A&H and P&C Accounting Practices and Procedures Manuals contains the following guidance relating to derivative instruments:

Derivative Instruments

Derivative instruments are reported in Schedule DB of the annual statement using the definitions below. Specific accounting procedures for each derivative instrument will depend on the definition below that best describes the instrument. State investment laws and regulations should be consulted for applicable limitations on the use of derivative instruments.

Definitions:

“Underlying Interest” means the asset(s), liability(ies) or other interest(s) underlying a Derivative Instrument, including, but not limited to, any one or more securities, currencies, rates, indices, commodities, Derivative Instruments or other financial market instruments.

“Option” means an agreement giving the buyer the right to buy or receive, sell or deliver, enter into, extend or terminate, or effect a cash settlement based on the actual or expected price level, performance or value of, one or more Underlying Interests.

“Cap” means an agreement obligating the seller to make payments to the buyer, each payment under which is based on the amount, if any, that a reference price, level, performance or value of one or more Underlying Interests exceeds a predetermined number, sometimes called the strike/cap rate or price.

“Floor” means an agreement obligating the seller to make payments to the buyer, each payment under which is based on the amount, if any, that a predetermined number, sometimes called the strike/floor rate or price, exceeds a reference price, level, performance or value of one or more Underlying Interests.

“Collar” means an agreement to receive payments as the buyer of an Option, Cap or Floor and to make payments as the seller of a different Option, Cap or Floor.

“Swap” means an agreement to exchange or net payments at one or more times based on the actual or expected price, level, performance or value of one or more Underlying Interests.

“Forward” means an agreement (other than a Futures) to make or take delivery of, or effect a cash settlement based on the actual or expected price, level, performance or value of, one or more Underlying Interests.

“Futures” means an agreement traded on an exchange, board of trade or contract market, to make or take delivery of, or effect a cash settlement based on the actual or expected price, level, performance or value of, one or more Underlying Interests.

General Accounting Guidance:

Hedging:

Derivative instruments used by insurers in hedging transactions should be accounted for in a manner consistent with the item hedged prior to termination. Upon termination, the gains and losses from the derivative instrument will adjust the basis of the hedged item.

Alternatively, companies may mark derivative instruments of a given type to market from inception to termination with gains and losses recognized currently. Generally this alternative is used where it is impractical to allocate gains and losses to specific hedged assets or liabilities. The accounting treatment and categories to which this accounting treatment is applied should be consistent from period to period. However, derivative instruments hedging items which are subject to IMR will follow hedge accounting (amortized book value) while the instruments are still open and that the gains/losses will be subject to IMR upon termination.

For a derivative instrument to qualify for hedge accounting, the item to be hedged must expose the company to a risk and the designated derivative transaction must reduce that exposure. Examples include the risk of a change in the value, yield, price, cash flow, or quantity of, or degree of exposure with respect to assets, liability

- (4) A description of the company methodology used to verify that opening transactions do not exceed limitations promulgated by the insurers state of domicile.
- (b) For derivative instruments terminated during the year:
- (1) Signature of approval, for each instrument, by person(s) authorized, either by the insurer's board of directors or a committee authorized by the board, to approve such transactions.
 - (2) A description, for each instrument, of the nature of the transaction, including:
 - The date of the transaction.
 - A complete and accurate description of the specific derivative instrument, including description of the underlying securities, currencies, rates, indices, commodities, derivative instruments, or other financial market instruments.
 - Number of contracts or notional amount.
 - Date of maturity, expiry or settlement.
 - Strike price, rate or index, (termination price for futures contracts).
 - Counterparty, or exchange on which the transaction was traded.
 - Consideration paid or received, if any, on termination.

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(2) Statement Value:

- Open derivative instruments hedging items carried at amortized cost (where company does not elect to recognize gain/loss currently):
 - Options, caps and floors purchased or written shall be valued at amortized cost in a manner consistent with the hedged item.
 - The amortization period and methods used should in general result in a constant effective yield over the life of the hedged item or program. (For floating rate securities, the estimated effective yield should be based on the current rate so the changes in yields attributable to changes in interest rates will be recognized in the period of change.) Specific treatment includes:
 - Holdings in derivative instruments purchased or written within a year of maturity or expiry need not be amortized;
 - For anticipatory hedges, the derivative instrument may be carried at cost until the anticipated hedged transaction occurs or it is determined that the hedge was not effective;
 - For other derivative instruments, the amortization period is usually from date of acquisition (issuance) of the derivative instrument to maturity of the hedged item or program.
 - For hedges where the cost of the derivative instrument is combined with the hedged item, the statement value would be zero. The market value of the hedging and hedged items will be determined and reported separately.
 - If during the life of the derivative instrument, it is no longer effective as a hedge, valuation at amortized cost ceases and the derivative instrument shall be valued at its current market value (marked to market) with gains and losses recognized as adjustments to surplus to the extent they ceased to be effective hedges.
 - Open derivative instruments hedging items carried at market value, (where company does not elect to recognize gain/loss currently):
 - Options, caps or floors purchased or written shall be valued at current market value (marked to market) with changes in market value recognized currently consistent with the hedged item.
 - Usually this will result in unrealized gain/loss treatment with adjustment to surplus.

- For hedges where the cost of the derivative instrument is combined with the hedged item, the market value of the hedging and hedged items will be determined and reported separately. The cost (book value) basis used to figure gain/loss on the derivative instrument will be zero.
- Companies which elect to recognize gain/loss currently on derivative instruments acting as hedges shall make that determination at the start of the transaction and shall apply the methodology consistently between periods and by category.
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(1) Accounting at Date of Opening Position:

Any premium paid or received at date of opening shall be carried as an asset (paid) or liability (received) on the balance sheet (Aggregate Write-in for Invested Asset (or) Liability).

(2) Statement Value:

- Open derivative instruments hedging items carried at amortized cost (where the company does not elect to recognize gain/loss currently):
 - Swaps, collars and forwards shall be valued at amortized cost in a manner consistent with hedged item.
 - The amortization period and methods used should in general result in a constant effective yield over the life of

- If during the life of the currency contract it is not effective as a hedge, valuation at amortized cost ceases. To the extent it ceased to be an effective hedge, a cumulative unrealized gain/loss will be recognized as an adjustment to surplus equal to the notional amount times the difference between the forward rate available for the remaining maturity of the contract (i.e., the forward rate as of the balance sheet date) and the forward rate at the time it ceased to be an effective hedge.
 - Companies which elect to recognize gain/loss currently on derivative instruments acting as hedges shall make that determination at the start of the transaction and shall apply the methodology consistently between periods and by category.
 - For hedges of items which are not subject to IMR, derivative instruments shall be valued at current market value (marked to market) with unrealized gains/losses recognized as adjustments to surplus.
 - For hedges of items which are subject to IMR, derivative instruments shall be valued at amortized cost as in (2)(a) above.
- (3) Cash Flows and Income:
- Where the cost of the derivative instrument is not combined with the hedged item:
 - Amortization of premium or discount on derivative instruments is an adjustment to net investment (operating) income through Exhibit 2.
 - Periodic cash flows and accruals of income/expense are to be reported in a manner consistent with the hedged item, usually as other investment income (operating income) to be reported in Exhibit 2.
 - Where the cost of the derivative instrument is combined with the hedged item, the cash flows and income of the derivative instrument on Schedule DB will be zero. All related amortization and cash flow accounting will be reported with the hedged item instead of with the derivative instrument.
- (4) Gain/Loss on Termination (includes closing, exercise, maturity, and expiry):
- Exercise — The remaining book value of the derivative instrument shall become an adjustment to the cost or proceeds of the hedged item(s) received or disposed of individually or in aggregate.
 - Sale, maturity, expiry, or other closing transaction of a derivative instrument 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 aggregate.

- Changes in contract value from date of contract opening (i.e., variation margin) shall be recognized currently consistent with the hedged item. Statement value will be limited to the cash deposits outstanding.
- Usually this will result in unrealized gain/loss treatment with adjustment to surplus.
- For hedges where the variation margin of the futures contract is combined with the hedged item, the market value of the hedging and hedged items will be determined and reported separately.
- Open foreign currency futures contracts hedging foreign currency exposure on item(s) denominated in a foreign currency and translated into U.S. dollars (where the company does not elect to recognize gain/loss currently):
 - The foreign exchange premium (discount) on the currency contract will be amortized into investment income over the life of the contract. The foreign exchange premium (discount) is defined as the foreign currency (notional) amount to be received (paid) times the net of the forward rate minus the spot rate at the time the contract was opened. The cumulative income recognized since the contract was opened should be reported as recognized variation margin received or (paid).
 - Amortization is not required if the contract was entered into within a year of maturity.
 - A foreign currency translation adjustment should be reflected as an unrealized gain/loss (surplus adjustment) using the same procedures as is done to translate the hedged item. The cumulative unrealized gain/(loss) which equals the foreign currency (notional) amount to be received (paid) times the net of the current spot rate minus the spot rate at the time the contract was opened should be reported as recognized variation margin received or (paid).
 - The statement value of the currency futures contract is book value, including any increase (decrease) for amortization of foreign exchange (premium) discount ((c)(i) above) plus the foreign exchange translation gain/(loss) ((c)(ii) above), which is reported as deferred variation margin.
 - Recognition of unrealized gains/losses and amortization of foreign exchange premium/discount on anticipated firm commitments may be deferred until the hedged transaction occurs. These deferred gains/losses will adjust the basis or proceeds of the hedged transaction when it occurs.

- For hedges where the variation margin of the foreign currency contract is combined with the hedged item, the statement value would equal the cash deposits outstanding. The market value of the hedging and hedged items will be determined and reported separately. Market value on futures contracts is limited to the value of the cash deposits outstanding.
- If during the life of the currency contract it is not effective as a hedge, valuation at amortized cost ceases. To the extent it ceased to be an effective hedge, a cumulative unrealized gain/loss will be recognized as an adjustment to surplus equal to the notional amount times the difference between the forward rate available for the remaining maturity of the contract (i.e., the forward rate as of the balance sheet date) and the forward rate at the time it ceased to be an effective hedge.
- Companies which elect to recognize gain/loss currently on futures contracts acting as hedges shall make that determination at the start of the transaction and shall apply the methodology consistently between per

- For insurers subject to IMR the gain/loss will be subject to IMR if the hedged items are subject to IMR.

41. Chapter 8 in the Life/A&H and P&C Accounting Practices and Procedures Manuals contain the following guidance relating to insurance futures and insurance future options:

Insurance Futures and Insurance Futures Options

The statutes, regulations and administrative rulings of the insurers domiciliary state establish the authority to engage in transactions with respect to insurance futures and insurance futures options. In the absence of specific written authority, the Insurance Department of the insurers domiciliary state should be consulted as to such authority.

In those jurisdictions which authorize transactions with respect to insurance futures and insurance futures options, an insurance company is generally permitted, subject to applicable quantitative limitations, to use such instruments to hedge against adverse development in its incurred losses. This strategy typically would involve any or a combination of (i) the purchase of insurance futures contracts, (ii) the purchase of a call option on insurance futures contracts, or (iii) the sale (writing) of a put option on insurance futures contracts.

Insurance Futures Contracts:

An insurance futures contract is a futures contract based on an underlying index of performance of insurance contracts (policies) or factors relating thereto. An insurance futures contract also may be defined more specifically under the statutes, regulations and administrative rulings of a particular state. In connection with a given insurance futures position, an insurer is required by the listing exchange to maintain a margin deposit with respect to the underlying insurance futures contracts purchased.

An insurer should report the amount of any margin deposit as an asset on its balance sheet, which deposit should be reflected as an aggregate write-in for other-than-invested assets. The specific statutory accounting treatment of increases or decreases in the value of the subject contracts will depend on whether the insurance futures position constitutes a hedge of the insurers incurred losses. The determination of whether an insurance futures position constitutes a hedge is typically determined pursuant to the statutes, rules and administrative rulings of an insurers domiciliary state. Although many states prohibit an insurer from taking an insurance futures position that does not constitute a hedge, the following presents both hedge accounting and other-than-hedge accounting treatment. Other-than-hedge accounting should be used in the event that an original hedge position loses its character as such, until such time as the position is terminated as required by state law.

Insurance Futures - Hedge Accounting: de6aggregat88a aestho(sureremarkelosseor desse(as3puition is.15 Td 105a

increase (decrease) effects the corresponding margin deposit, or (ii) increase (decrease) cash or other assets, to the extent of mark-to-market payments that are not maintained as a margin deposit. When the insurance futures position is eventually closed, any corresponding margin balance (i.e., aggregate write-in for other-than-invested assets) shall be transferred to the insurers cash or other assets, as appropriate.

Insurance Futures – Other-Than-Hedge Accounting:

If the insurance futures position is no longer effective as a hedge, any increases (decreases) in the value of the insurance futures contracts should be reported as an aggregate write-in for miscellaneous income. When the insurance futures positions eventually close, any corresponding margin balance (i.e., aggregate write-in for other-than-invested assets) should be transferred to the insurers cash or other assets, as appropriate.

Options on Insurance Futures Contracts:

An insurance futures option is either a put or

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Illustration for All Other Derivatives Listed in Schedule DB (Caps, Collars, Futures, etc.):

The note(s) may resemble the illustration for interest rate swaps. For additional illustrations, see C.M. Antis' *Financial Accounting Series Special Report, Illustrations of Financial Instrument Disclosures* (No. 144-c), December 1994, published by the Financial Accounting Standards Board.

43. The following guidance for derivatives used for income generation was adopted by the Financial Condition (EX4) Subcommittee on December 14, 1996:

INCOME GENERATION ACCOUNTING PROJECT
EXECUTIVE SUMMARY
JULY 10, 1996

INTRODUCTION

Income Generation transactions are ones where the company writes (or sells) derivative instruments to generate additional income or return to the company. They include covered options, caps and floors such as when a company writes an equity call option on stock which it already owns. Currently they represent a small portion of the insurance industry's derivative activity in terms of number of companies involved, number of transactions, and dollar amounts involved. The possibility of greater company involvement in the future exists given recent guidance and inclusion in the Model Investment Law.

Because these transactions involve writing derivative transactions, they expose the company to potential future liabilities for which the company receives a premium up front. Because of this risk, state laws and the Model Investment Law impose dollar limitations and additional constraints requiring that they be "covered," i.e., that there be offsetting assets which can be used to fulfill potential obligations. To this extent the combination of instruments works like a reverse hedge where an asset owned by the company in essence hedges the derivative risk.

As with derivatives in general these instruments include a wide variety of terms regarding maturities, range of exercise periods and prices, counterparties, underlying instruments, etc.

GENERAL ATTRIBUTES

The proposed accounting and reporting approach is intended to meet (1) Regulatory needs focusing on company and Industry solvency (2) company needs focusing on administrative and cost considerations, and (3) the general need to provide meaningful and relevant information regarding the substance of the transactions and holdings for all users of the financial statements.

1. The approach is conservative and reduces the potential for income manipulation. Income is not recognized early in the holding period only to be reversed by future losses. This consideration is particularly important for options which could have lower exercise prices than the combined statement values of the derivative and the covering asset.
2. The approach is reasonably simple and consistent with Statutory accounting. It builds on accounting guidance which already exists in the *NAIC Accounting Practices and Procedures Manual* and in the *Annual Statement Instructions* regarding hedging.
3. The approach looks to the substance of the transactions involved.
 - It matches the accounting of the derivative with the accounting of the covering asset or underlying interest.

- It includes an alternative treatment which combines the derivative with the covering asset. This results in a treatment analogous to callable bonds where the option feature is combined with the asset rather than in two pieces.
- It allows for recognition of the time value/interest rate factor implicit in the pricing of these instruments, particularly relevant for derivatives with longer maturities.

ACCOUNTING SPECIFICS

The accounting specifics attached are presented in table form. Completed sections include

- Covered Call Writing
 - Covering Item at Amortized Cost
 - Covering Item at Market
- Covered Put Writing
 - Underlying Interest at Amortized Cost
 - Underlying Interest at Market
- Covered Cap and Floor Writing
 - Covering Item at Amortized Cost
 - Covering Item at Market
- Accounting Examples
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feature of the option over time. This approach would appear most relevant for longer-lived covered European call options, which are in substance like callable bonds.

3. For life insurance companies the gain or loss flows through the IMR if the underlying interest or covering asset is subject to the IMR using callable bond rules to determine the remaining life.
4. Companies writing options for income generation purposes are responsible for timely recognition of any probable losses that may occur as a result of the strategy. If the exercise price is below the covering asset's book value, the asset should be evaluated for write down or disclosure treatment along the lines of Codification Issue Paper #5 *Definition of Liabilities, Loss Contingencies, and Impairments of Assets* taking into consideration all relevant factors such as whether the option is currently exercisable, the fair value of the bond relative to its exercise price, to what extent the statement value of the option premium offsets any loss on the asset, or how any IMR transaction on exercise would affect surplus and income.

Puts

The principal features are:

1. The accounting for the underlying interest instead of the covering asset governs the accounting of the written put while it is open. For example, if a company wrote a put requiring it to purchase a certain common stock (underlying interest) at a specific price, the company might cover that option by holding cash or cash equivalents (covering asset). The accounting for the common stock would govern the accounting of the option in this case.
2. As with covered call writing for life insurance companies, gain/loss on termination may be subject to IMR over the remaining life of the underlying interest.
3. As with covered call writing, companies writing put options for income generation purposes are responsible for timely recognition of any probable losses that may occur as a result of the strategy.

Fixed Income Caps and Floors

The principal specific features are:

1. The value of the premium received would be amortized into income over the life of the contract. For caps and floors, where the company is selling off possible excess interest/income, the value of the covering asset is not relevant.
2. Again, gain/loss may be subject to IMR. The expected maturity would be the derivative contract's maturity.

WRITTEN CALL OPTIONS – INCOME GENERATION
 PROPOSED STATUTORY ACCOUNTING TREATMENT
 APPLICABLE TO ALL INSURANCE COMPANIES
 JULY 30, 1996

STATUS OF OPTION	COVERING ASSET AT AMORTIZED COST	COVERING ASSET AT MARKET VALUE
Open	<p>Record premium as deferred liability.</p> <p>Carry at consideration received. (1)</p> <p>Alternatively, attach premium to covering asset and amortize (under yield to worse scenario) using standard callable bond accounting. (2)</p>	<p>Record premium as deferred liability.</p> <p>Mark to market with changes in market value recorded as unrealized adjustments to surplus – gain/loss.</p>
Closed – Expired	<p>Premium received recognized as realized capital gain.</p> <p>Gain from expiration to flow through IMR if applicable. (3)</p>	<p>Premium received recognized as realized capital gain.</p>
Closed – Exercised	<p>Adjust disposition proceeds. (Include in capital gain/loss of disposed asset.)</p> <p>Gain or loss from disposition to flow through IMR if applicable. (3)</p>	<p>Adjust disposition proceeds. (Include in capital gain/loss of disposed asset.)</p>
Closed – Terminated	<p>Recognize net amount as realized capital gain/loss.</p> <p>Gain or loss from disposition to flow through IMR if applicable. (3)</p>	<p>Recognize net amount as realized capital gain/loss.</p>

NOTES

1. A general statement will be added to the instructions stating that companies writing options for income generation purposes are responsible for the timely recognition of any probable losses that may occur as a result of the strategy due to holding and accounting for options on Schedule DB – Part B.
2. Report derivative and its market value on Schedule DB – Part B. Include accounting on Schedule D – Part 1.
3. If premium is attached to covering asset, the accounting treatment for the covering asset applies.

WRITTEN PUT OPTIONS – INCOME GENERATION
 PROPOSED STATUTORY ACCOUNTING TREATMENT
 APPLICABLE TO ALL INSURANCE COMPANIES
 JULY 30, 1996

STATUS OF OPTION	UNDERLYING INTEREST AT AMORTIZED COST	UNDERLYING INTEREST AT MARKET VALUE
Open	Record premium as deferred liability. Carry at consideration received. (1)	Record premium as deferred liability. Mark to market with changes in market value recorded as unrealized adjustments to surplus – gain/loss.
Closed – Expired	Premium received recognized as realized capital gain. Gain from expiration to flow through IMR if applicable.	Premium received recognized as realized capital gain.
Closed – Exercised	Adjust acquisition cost by premium received.	Adjust acquisition cost by premium received.
Closed – Terminated	Recognized net amount as realized capital gain/loss. Gain or loss from disposition to flow through IMR if applicable.	Recognize net amount as realized capital gain/loss.

NOTES

1. A general statement will be added to the instructions stating that companies writing options for income generation purposes are responsible for the timely recognition of any probable losses that may occur as a result of the strategy due to holding and accounting for options on Schedule DB – Part B.

for the hedged item so that changes in the market value of the futures contract are recognized in income when the effects of related changes in the price or interest rate of the hedged item are recognized.

4. In applying this Statement, both of the following conditions shall be met for a futures contract to qualify as a hedge:
 - a. The item to be hedged exposes the enterprise to price (or interest rate) risk. In this Statement, risk refers to the sensitivity of an enterprise's income for one or more future periods to changes in market prices or yields of existing assets, liabilities, firm commitments, or anticipated transactions. To meet this condition, the item or group of items intended to be hedged must contribute to the price or interest rate risk of the enterprise. In determining if this condition is met, the enterprise shall consider whether other assets, liabilities, firm commitments, and anticipated transactions already offset or reduce the exposure. An enterprise that cannot assess risk by considering other relevant positions and transactions for the enterprise as a whole because it conducts its risk management activities on a decentralized basis can meet this condition if the item intended to be hedged exposes the particular business unit that enters into the contract.
 - b. The futures contract reduces that exposure and is designated as a hedge. At the inception of the hedge and throughout the hedge period, high correlation of changes in (1) the market value of the futures contract(s) and (2) the fair value of, or interest income or expense associated with, the hedged item(s) shall be probable so that the results of the futures contract(s) will substantially offset the effects of price or interest rate changes on the exposed item(s). In addition to assessing information about the correlation during relevant past periods, the enterprise also shall consider the characteristics of the specific hedge, such as the degree of correlation that can be expected at various levels of higher or lower market prices or interest rates. A futures contract for a commodity or a financial instrument different from the item intended to be hedged may qualify as a hedge provided there is a clear economic relationship between the prices of the two commodities or financial instruments, and provided high correlation is probable.
45. Paragraph 21 of FAS 52 states, in part:

A gain or loss on a forward contract or other foreign currency transaction that is intended to hedge an identifiable foreign currency commitment (for example, an agreement to purchase or sell equipment) shall be deferred and included in the measurement of the related foreign currency transaction...A foreign currency transaction shall be considered a hedge of an identifiable foreign currency commitment provided both of the following conditions are met:

 - a. The foreign currency transaction is designated as, and is effective, as a hedge of a foreign currency commitment.
 - b. The foreign currency commitment is firm.
46. The key GAAP literature relating to interest rate swap transactions is EITF 84-36, in which the Task Force concluded that:

...if there is an underlying debt obligation on the balance sheet of the company entering into the swap transaction, the company should account for the swap agreement like a hedge of the obligation and record interest expense using the revised interest rate, with any fees or other payments amortized as yield adjustments.
47. FAS 105, as amended by FAS 119, provides the following guidance on disclosures for financial instruments with off-balance sheet risk, including derivatives:

- b. The nature and terms, including, at a minimum, a discussion of (1) the credit and market risk of those instruments, (2) the cash requirements of those instruments, and (3) the related accounting policy pursuant to the requirements of APB Opinion No. 22, *Disclosure of Accounting Policies*.¹³

* Similar disclosures are required for derivative financial instruments without off-balance-sheet risk in paragraph 8 of FASB Statement No. 119, *Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments*.

¹² In this Statement, category of financial instrument refers to class of financial instrument, business activity, risk, or other category that is consistent with the management of those instruments. If disaggregation of financial instruments is other than by class, the entity also shall describe for each category the classes of financial instruments included in that category. Practices for grouping and separately identifying—classifying—similar financial instruments in statement of financial position, in notes to financial statements, and in various regulatory reports have developed and become generally accepted, largely without being codified in authoritative literature. In this Statement, *class of financial instrument* refers to those classifications.

¹³ Paragraph 12 of Opinion 22 as amended by FASB Statement No. 95, *Statement of Cash Flows*, says:

Disclosure of accounting policies should identify and describe the accounting principles followed by the reporting entity and the methods of applying those principles that materially affect the determination of financial position, statement of cash flows, or result of operations. In general, the disclos

11. Entities that hold or issue derivative financial instruments for purposes other than trading shall disclose the following:

- a. A description of the entity's objectives for holding or issuing the derivative financial instruments, the context needed to understand those objectives, and its strategies for achieving those objectives, including the classes of derivative financial instruments used⁴
- b. A description of how each class of derivative financial instrument is reported in the financial statements including the policies for recognizing (or reasons for not recognizing) and measuring the derivative financial instruments held or issued, and when recognized, where those instruments and related gains and losses are

Generally Accepted Accounting Principles

- *FASB Statement No. 52, Foreign Currency Translation*

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