Statement of Statutory Accounting Principles No. 31

Derivative Instruments

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Derivative Instruments

SCOPE OF STATEMENT

1. The purpose of this statement is to establish statutory accounting principles for derivative instruments (hereinafter referred to as derivatives).

SUMMARY CONCLUSION

2. Derivatives are defined as swaps, options, forwards, futures, caps, floors, and collars. The following are general definitions for these derivative instruments.

<u>Swaps</u>

3. 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.

Forwards

9. 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.

Futures

10. 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.

Caps

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

Floors

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

Collars

13. A collar is a combination of a cap and a floor (one purchased and one written). A collar fixes the rate between two levels (the strike prices of the cap and Tc 0.072ir7us

a. The risk of a change in the value, yield, price, cash flow, or quantity of assets or liabilities which the reporting entity has acquired or incurred or anticipates acquiring or incurring, or;

b. The currency exchange rate risk or the degree of exposure as to assets or liabilities which a reporting entity has acquired or incurred or anticipates acquiring or incurring.

16. Derivatives used by reporting entities in hedging activities shall be accounted for in a manner consistent with the item hedged. For example, if the item being hedged is accounted for at amortized cost, the hedging derivative also is accounted for at amortized cost. If the item being hedged is accounted for at market value, the hedging derivative also is accounted for at market value.

Criteria to Qualify for Hedge Accounting

17. To qualify for hedge accounting, the derivative shall be designated as a hedge of a specific asset, liability, or anticipated transaction. The specific asset, liability, or anticipated transaction to be hedged must expose the reporting entity to a risk and the designated derivative transaction must reduce that 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.

18. To satisfy the condition of risk reduction, the reporting entity shall demonstrate how the derivative 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.

19. Reporting entities shall set specific criteria at the inception of the hedge as to what will be considered effective in measuring the hedge and apply those criteria in the ongoing assessment of actual hedge results. For example, if correlation is used to measure the effectiveness of a hedge, high correlation of changes in the fair value of the derivative and the fair value of the item being hedged shall be probable so that such changes will substantially offset each other throughout the hedge period. Other methods used shall demonstrate a similar result to be considered effective. Also, at the inception of the hedge, formal documentation of the hedging instrument and the related hedged item, as provided in the documentation guidance section of this statement, shall be drafted and retained for future reference.

Gain or Loss Upon Termination

20. Upon termination of a derivative that qualifies for hedge accounting, the gain or loss shall adjust the basis of the hedged item. Alternatively, if the item being hedged is subject to IMR, the gain or loss on the hedging derivative may be realized and shall be subject to IMR upon termination. Reporting entities shall account for a derivative at estimated fair value if it ceases to be effective as a hedge (that is, the gains and losses on the derivative no longer offset the losses and gains on the hedged instrument) and recognize the gain or loss currently in earnings.

Settlement Accounting for Swaps

21. 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 accounting, periodic net cash settlements under the swap agreement are recognized in income when they accrue.

Mark to Market Accounting

22. Under the immediate recognition method of accounting, (i.e. mark to market) changes in fair value from one reporting period to a

d. Gain/Loss on Termination of an option, cap or floor accounted for under hedge gains and losses recognized in earnings to the extent that it ceased to be an effective hedge.

ii. Open derivatives hedging items recorded at market value (where gains and losses on the hedging item are recognized as adjustments to unassigned funds (surplus)):

(a) Swaps, collars, or forwards shall be valued at current market value (marked to market) with changes in market value recognized currently consistent with the hedged item;

(b) This will result in unrealized gain/loss treatment with adjustment to unassigned funds (surplus);

(c) For hedges where the derivative is combined with the hedged item, the market value of the hedging and hedged items shall be determined and reported separately. The cost (book value) basis used to figure gain/loss on the derivative is zero.

iii. Open foreign currency swap and forward contracts hedging foreign currency exposure on items denominated in a foreign currency and translated into U.S. dollars where the immediate recognition method of accounting is not being used:

(a) The foreign exchange premium (discount) on the currency contract shall be amortized into income over the life of the contract. 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.

Amortization is not required if the contract was entered into within a year of maturity;

(b) A foreign currency translation adjustment shall be reflected as an unrealized gain/loss (unassigned funds (surplus) adjustment) using the same procedures as done to translate the hedged item;

(c) The unrealized gain/loss for the period equals the foreign currency (notional) amount to be received (paid) times the net of the current spot rate minus the prior period end spot rate;

(d) The statement value of the currency contract equals the amortized (premium) discount plus the cumulative unrealized gain/(loss) on the contract. The cumulative unrealized gain/(loss) equals the foreign currency (notional) amount to be received (paid) times the net of the current spot rate minus the spot rate at the time the contract was opened;

(e) Recognition of unrealized gains/losses and amortization of foreign exchange premium/discount on 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;

(f) For hedges where the cost of the foreign currency contract is combined

Subsequent additions (reductions) in cash deposits plus changes in contract value from date of contract opening (i.e., variation margin) paid (received) will increase (decrease) the book value of the futures contract.

b. Statement Value:

i. Hedges of Items Recorded at Amortized Cost:

(a) Futures shall be valued at book value;

(b) Book value of open futures contracts need not be amortized;

(c) For hedges where the cost of the futures contract is combined with the hedged item, the statement value would be equal to 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;

(d) If during the life of the futures contract it is no longer effective as a hedge, valuation at book value (deferral accounting) ceases. A gain/(loss) equal to the variation margin received (paid) shall be recognized in earnings to the extent it ceased to be an effective hedge. Statement value will be limited to the cash deposits outstanding.

ii. Hedges of Items Recorded at Market Value (where gains and losses on the hedging item are recognized as adjustments to unassigned funds (surplus)):

(a) 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;

(b) This will result in unrealized gain/loss treatment with adjustment to unassigned funds (surplus);

(c) 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.

iii. 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 immediate recognition method of accounting is not being used:

(a) 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 shall be reported as recognized variation margin received or (paid).

Amortization is not required if the contract was entered into within a year of maturity;

(b) A foreign currency translation adjustment shall be reflected as an unrealized gain/loss (unassigned funds (surplus) adjustment) using the same procedures as 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 shall be reported as recognized variation margin received or (paid);

(c) The statement value of the currency futures contract is book value, including any d gi6 at the (nexchang 0.394 Tw T1[rec257e)-5(proc0.0rf thei)]TJ6 adiscv

Income Generation Transactions

General

29. Income generation transactions are defined as derivatives written or sold to generate additional income or return to the reporting entity. They include covered options, caps, and floors (e.g., a reporting entity writes an equity call option on stock which it already owns).

30. Because these transactions require writing derivatives, they expose the reporting entity to potential future liabilities for which the reporting entity receives a premium up front. Because of this risk, dollar limitations and additional constraints are imposed requiring that the transactions be "covered" (i.e., offsetting assets can be used to fulfill potential obligations). To this extent, the combination of the derivative and the covering asset works like a reverse hedge where an asset owned by the reporting entity in essence hedges the derivative risk.

31. 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.

32. 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 (e.g., common stocks) or (amortized) cost (e.g., bonds);

c. The gain/loss on termination of the derivative is a capital item. For life insurance companies, it shall be subject to IMR treatment if interest rate related;

d. For options which are exercised, the remaining premium shall adjust the proceeds (cost) associated with the exercise resulting in no explicit gain or loss reported for the derivative itself.

Written Fixed Income Covered Call Options

33. The principal features of written fixed income covered call options are:

a. The general approach is to value at cost (i.e., consideration received) without amortization over the life of the contract;

b. An alternative to the general approach combines the accounting of the written option with the covering asset and then uses standard accounting for callable bonds (yield to worst amortization) on the adjusted asset. This method prevents the possibility of future loss recognition upon exercise while at the same time providing recognition of the income feature(An altolco).w8tncipal featuretimAn altolco general approa2 lifeeba2 lifee0e written option

3. If premium is attached to covering asset, the accounting treatment for the covering asset applies.

Written Covered Put Options

35. The principal features of written covered put options are:

a. 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;

b. 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;

c. As with covered call writing, 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.

36. 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

Insurance Futures Contracts—Other-Than-Hedge Accounting

46. If the insurance futures position is no longer effective as a hedge, any increases (decreases) in the value of the insurance futures contract shall be reported as miscellaneous income. When the insurance futures positions close, any corresponding margin balance shall be transferred to cash or other assets, as appropriate.

Options on Insurance Futures Contracts

47. An insurance futures option is either a put or call option on an insurance futures contract. An insurance futures call option is a contract under which the holder has the right to purchase the underlying insurance futures contract covered by the option at a stated price (strike price) on or before a fixed expiration date. An insurance futures put option gives the holder the right to sell the underlying insurance futures contract. The consideration paid (received) for the purchase (sale) of an insurance futures option is referred to as a premium. Because all insurance futures options relate to an underlying insurance futures contract, the accounting treatment of insurance futures options generally follows the treatment afforded insurance futures contracts.

48. The amount of any premium paid for an insurance futures option shall be reported as other-than-invested assets. Similarly, the amount of any premium received for the sale (writing) of an insurance futures option shall be reported as a liability. The specific statutory accounting treatment of increases or decreases in the market value of the subject insurance futures option shall depend on whether such position constitutes a hedge of incurred losses. The determination of whether an insurance futures position constitutes a hedge shall be made consistent with the criteria identified in paragraphs 17-19.

Options on Insurance Futures Contracts—Hedge Accounting

49. Increases (decreases) in the market value of call options purchased, which effectively hedge incurred losses, shall be reported as an increase (decrease) in other income, when the call options correspond to incurred losses for the current reporting period. With respect to any call option which corresponds to a period beyond the current reporting period, any increases (decreases) in the market value of the underlying option shall be reported as a direct increase (decrease) in unassigned funds (surplus). When the option thereafter corresponds to a current reporting period, the initial increase (decrease) in direct unassigned funds (surplus) shall be reversed and the amount shall be reported as an increase (decrease) to other income along with any current changes in the market value of the option.

50. If the option position is terminated through a closing transaction, the corresponding balance of the asset (i.e., aggregate write-in for other-than-invested assets) shall be eliminated, with a corresponding charge to cash or other assets, as appropriate. If the option is exercised, the corresponding balance of the asset (i.e., aggregate write-in for other-than-invested assets) shall be eliminated, with a corresponding charge to either (a) insurance futures margin, to the extent of margin deposit requirements, or (b) cash or other assets, as appropriate. If the option expires, the corresponding balance of the asset shall be eliminated, with an appropriate decrease to the reporting entity's other income.

51. The accounting treatment for the sale (writing) of insurance futures put options is essentially the mirror image of the foregoing treatment presented with respect to purchased call options. Upon termination (through a closing transaction), exercise, or expiration of the put option, the corresponding balance of the liability shall be eliminated, in the mirror image of the foregoing treatment.

Options on Insurance Futures Contracts—Other-Than-Hedge Accounting

52. If the insurance futures option position is no longer effective as a hedge, any increases (decreases) in the value option shall be reported as miscellaneous income. Other-than-hedge accounting shall be used in the event that an original hedge position loses its character as such, until such time as the position is terminated.

Documentation Guidance

53. A reporting entity shall maintain documentation and records relating to derivatives opened during the year, instruments outstanding at year end, and instruments terminated during the year. Minimum required documentation is described in the following paragraphs.

54. For derivatives opened during the year:

a. A description, for each instrument, of the purpose of the transaction, including:

i. A brief description of the assets and/or liabilities hedged by the instrument;

ii. A brief description of the manner in which the instrument reduces risk;

iii. A reference to the reporting entity's hedge program under which such transaction is internally authorized.

b. Signature of approval, for each instrument, by person(s) authorized, either by the entity's board of directors or a committee authorized by the board, to approve such transactions;

c. A description, for each instrument, of the nature of the transaction, including:

i. The date of the transaction;

ii. A complete and accurate description of the specific derivative, including description of the underlying securities, currencies, rates, indices, commodities, derivatives, or other financial market instruments;

iii. Number of contracts or notional amount;

iv. Date of maturity, expents/( )Tj/Tanttrum's hedge program under which such transaction is internally authorized.

55. For derivatives terminated during the year:

a. Signature of approval, for each instrument, by person(s) authorized, either by the entity's board of directors or a committee authorized by the board, to approve such transactions;

b. A description, for each instrument, of the nature of the transaction, including:

i. The date of the transaction;

ii. A complete and accurate description of the specific derivative, including description of the underlying securities, currencies, rates, indices, commodities, derivatives, or other financial market instruments;

iii. Number of contracts or notional amount;

iv. Date of maturity, expiry or settlement;

v. Strike price, rate or index, (termination price for futures contracts);

vi. Counterparty, or exchange on which the transaction was traded;

vii. Consideration paid or received, if any, on termination.

c. Description of the reporting entity's methodology to verify that derivatives were effective hedges;

d. Identification of any derivatives that ceased to be effective as hedges.

56. For derivatives open at year end:

a. A description of the methodology used to verify the continued effectiveness of hedges;

b. An identification of any derivatives which have ceased to be effective as hedges;

c. A description of the reporting entity's methodology to determine market values of derivatives;

d. Copy of Master Agreements, if any, where indicated on Schedule DB Part E Section 1.

Disclosures

57. Reporting entities shall disclose the following for all derivative contracts outstanding:

a. Disclosures by category of instrument:

i. Notional or contract amounts;

ii. Carrying and fair values;

iii. A description of the accounting policies for derivatives;

iv. A discussion of the market risk, credit risk, and cash requirements of the derivatives.

c. *FASB Emerging Issues Task Force No. 87-2, Net Present Value Method of Valuing Speculative Foreign Exchange Contracts*;

d. *FASB Emerging Issues Task Force No. 88-8, Mortgage Swaps*;

e. *FASB Emerging Issues Task Force No. 90-17, Hedging Foreign Currency Risk with Purchased Options*;

f. *FASB Emerging Issues Task Force No. 91-1, Hedging Intercompany Foreign Currency Risks*;

g. *FASB Emerging Issues Task Force No. 91-4, Hedging Foreign Currency Risks with Complex Options and Similar Transactions*;

h. *FASB Emerging Issues Task Force No. 96-11, Accounting for Forward Contracts and Purchase Options to Acquire Securities Covered Under FASB Statement No. 115*.

Effective Date and Transition

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

AUTHORITATIVE LITERATURE

Generally Accepted Accounting Principles

- *FASB Statement No. 105, Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk*
- *FASB Statement No. 119, Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments*
- *FASB Emerging Issues Task Force No. 84-7, Termination of Interest Rate Swaps*
- *FASB Emerging Issues Task Force No. 84-36, Interest Rate Swap Transactions*

RELEVANT ISSUE PAPERS

- *Issue Paper No. 85—Derivative Instruments*