

February 18, 2011

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Secretary  
U.S. Securities and Exchange Commission  
100 F St., NE  
Washington, D.C. 20549

David A. Stawick  
Secretary  
U.S. Commodity Futures Trading Commission  
Three Lafayette Centre  
1155 21<sup>st</sup> Street, NW  
Washington, D.C. 20581

Re: S7-39-10: Further Definition of “Swap Dealer,” “Security-Based Swap Dealer,”  
“Major Swap Participant,” “Major Security-Based Swap Participant,” and “Eligible  
Contract Participant.”

Dear Ms. Murphy and Mr. Stawick:

We write on behalf of the National Association of Insurance Commissioners (NAIC) to submit this comment regarding the Security and Exchange Commission’s and Commodity Futures Trading Commission’s (the Commissions) proposed rule to further define the terms “Swap Dealer,” “Security-Based Swap Dealer,” “Major Swap Participant,” “Major Security-Based Swap Participant,” and “Eligible Contract Participant” contained in Title VII of the Dodd-Frank Wall Street and Consumer Protection Act (the Act),<sup>1</sup> and related implementing regulations. Founded in 1871, the NAIC is the voluntary association of the chief insurance regulatory officials of the 50 states, the District of Columbia and the five U.S. territories. The NAIC serves the needs of state insurance regulators as they protect consumers and maintain the financial stability of the marketplace. The NAIC respectfully submits the following comments to the proposed rules published in the December 21 issue of the Federal Register as well as on the Commissions’ websites.

### **Guiding Principles for NAIC Comment**

As we indicated in our September 20, 2010 response to the Commissions’ Request for Advance Comment to implement the definitions contained in Title VII of the Act, our comments to the Commissions’ proposed rules is governed by two guiding principles. First, any implementing rules must not conflict with the states’ regulation of insurance products and insurers. Implicit in this first principle is recognition that the state-based system of insurance regulation allows insurers to engage in derivatives

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<sup>1</sup> Pub. L. No. 111-203.

transactions provided they comply with state investment and reporting laws, both of which were the subject of our follow-up letter dated November 9, 2010. Such transactions are permitted because, in conjunction with the state-based system's risk-based capital regime and reporting requirements, they ensure insurers remain solvent, pay claims as they come due, and keep premiums as low as possible.

Second, we indicated that any implementing rules should not create an unlevel playing field for insurers as compared to other institutions. An unlevel playing field can be created when there is not appropriate recognition of the different business models and regulatory regimes that apply to such entities. As we explained previously, insurance companies predominantly use derivatives for hedging commercial risks, most notably insurance risk, and approximately 92 percent of the derivatives that insurers hold are used for hedging, an activity that insurance regulators encourage. Annuity products that reduce market risk require significant hedging and those products are integral to the retirement planning of millions of consumers. We noted that state insurance regulation permits certain other well-defined uses of derivatives, but these are proportionately small in comparison to the industry's hedging activities.

We have reviewed the proposed rules further defining "Major Swap Participant," "Major Security-Based Swap Participant," "Swap Dealer," and "Security-Based Swap Dealer," as well as the supplementary information provided with the proposed rules. We are concerned that, in certain aspects, the proposed rules do not sufficiently account for the insurer business model, the important role of derivatives in that model, and the nature and extent of state regulation of both insurers generally and derivatives specifically. Moreover, while we acknowledge that some of our concerns might be alleviated by the interpretative guidance provided by the Commissions in the "supplementary information" section of the notice, we are troubled that the interpretative guidance is not incorporated in the rule itself. Set forth below are our specific comments to the proposed rules and related interpretative guidance.

### **Swap Dealer**

As a general matter, the characteristics that the Commissions have identified in the supplementary information section of the notice to determine whether an entity is a swap or security-based swap dealer appear to capture the characteristics of swap and security-based swap dealers. We agree with the Commissions that swap dealers and security-based swap dealers 1) tend to accommodate demand for swaps and security-based swaps; 2) are available to facilitate other parties' interests in entering those instruments; and 3) tend to enter into swap arrangements on their own standard terms or on terms they arrange in response to other parties' interests. We also agree that the SEC's use of the dealer/trader distinction is a reasonable approach to identify entities that are security-based swap dealers, and that entities engaged in hedging activities would not typically be considered security-based swap dealers.<sup>2</sup>

However, we are concerned that the proposed test does not sufficiently acknowledge cases where entities entering into swaps or security-based swaps for purposes other than those delineated in the test could incidentally fall within its ambit. Indeed, it is possible that an insurer may enter into a swap for the purposes of hedging insurance risk, but also at the same time be accommodating demand and responding to interests of another party. **In this regard, we believe the rule should clarify that entering into swaps as part of a regular business involves entering into swaps "for the purpose of accommodating demand," and "for the purpose of facilitating other parties' interest in engaging in such swap transactions."**

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<sup>2</sup> Notice of Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant," and "Eligible Contract Participant." 75 Fed. Reg. 80178 (December 21, 2010).

Also, as we indicated in our letter of September 20, 2010, many insurers have both a general account and separate investment accounts for certain regulated lines of business. Both are still subject to state mandated disclosure, capital, and reserving requirements. However, the investments in separate accounts are legally separate, not subject to creditors in a solvency proceeding, and typically done on behalf of customers with some level of customer direction. For example, certain variable annuity products, which are subject to dual regulation by the SEC and the state insurance regulators, are kept in separate accounts. The extent of customer direction for investments contained in such accounts varies based on the product. In most circumstances, per the terms of the contract, customers direct the insurer to take on a certain amount of investment risk. The insurer is responsible for managing that risk and covering the liability, which could mean an insurer deciding to enter into a swap to hedge such risk. **We believe insurers that have only a modicum of customer direction in their investment activities should not be considered swap dealers, and the requirement of an entity receiving specific direction by a customer to enter into a swap transaction should be incorporated into the final rule further clarifying a swap dealer.**

### **Entering into Swaps as Part of Regular Business**

As you may recall, in our letter comment of September 20, 2010, we specifically requested that the Commissions provide further clarity as to the third prong of the “swap dealer” and “security-based swap dealer” definitions as well as the exception that allows entities to enter into swaps for its own account, but not as part of a regular business. As with the other statutory definitions of swap dealer and security-based swap dealer, the text of the recently published proposed rule provides no guidance in these critical respects. Indeed, with the exception of providing additional clarity relating to the *de minimis* exception and the insured depository institution exception contained in the statutory definition of swap dealer, the proposed rule merely restates the definitions contained in Title VII itself. Many insurers would fall within the scope of the statutory language without further clarification, despite the important role swaps play in the insurance model. While we acknowledge the Commissions provided interpretative guidance within the “supplementary information” portion of the rule in an effort to address this third definition, this guidance is, in our opinion, relatively unclear, and does not substitute for inclusion in the rule itself.

In interpreting this provision and the related exception, the Commissions explain that “clause A(iii) of the definition of swap dealer and security-based swap dealer should be read in combination with the express exception set forth in subparagraph (C) of the swap dealer definition.”<sup>3</sup> The Commissions interpret the two provisions together to mean that “the difference between inclusion in clause (A)(iii) and the exclusion in subparagraph (C) is whether or not the person enters into swaps as a part of, or as an ordinary course of, a ‘regular business,’” and, consistent with the general guidance relating to the interpretation of the definition of swap dealer, those individuals are “those persons whose function is to accommodate demand for swaps from other parties and enter into swaps in response to interest expressed by other parties.”<sup>4</sup>

As a preliminary matter, the discussion of the interpretation of this specific provision and the related exception are found in the subsection entitled “Application to swap dealers” and is not discussed in the subsection relating to “Application to security-based swap dealers.” We assume based on the discussion that the intent is to apply the interpretation to both the definition and exception of swap dealer and security-based swap dealer.<sup>5</sup> If that is not the case, we respectfully request either 1) that the Commissions interpret such exception consistent with the interpretation of the exception for swap

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<sup>3</sup> *Id.* at 80177.

<sup>4</sup> *Id.*

<sup>5</sup> *Id.*

dealers and the discussion clarifying the definition of security-based swap dealers, particularly the clarification regarding hedging activities, taking into account, as appropriate, comments from the public; or 2) that the Commissions publish a clarifying notice addressing the exception as it applies to security-based swap dealers, and provide individuals and entities an opportunity to comment on the interpretation of such exception before issuing a final rule. As it stands presently, it is not entirely clear how this part of the definition of security-based swap dealer and its related exception would be interpreted.

Subject to our comments above, the Commissions' interpretation of this third prong is generally reasonable. Beyond that, though, **the rule should also make clear that persons who regularly enter into such swaps for the purpose of hedging commercial risks for their own account including, as described above, insurers who do so as part of their general account investment activities or separate account investment activities would typically not be considered swap dealers, absent other swap or security-based swap dealer-like activities.** Such an interpretation would be consistent with the guidance describing the functional role that the Commissions believe swap and security-based swap dealers fulfill in the market,<sup>6</sup> and, at the same time, ensure that insurance company hedges, a necessary part of the insurance business, are not brought within the ambit of the rule.<sup>7</sup>

### **Major Swap and Security-Based Swap Participant**

We have significant concerns that the proposed rules and interpretative guidance relating to defining major swap or security-based swap participant creates an unlevel playing field by not taking into account the distinguishing features of the insurance business model and the state insurance regulatory regime. In this regard, we urge that the rules incorporate a limited insurer exception for activities relating to hedging. In lieu of such exemption, we respectfully request that the Commissions amend their proposed rules to take into account these distinguishing characteristics.

#### **State Regulated Insurer Exception**

As part of the supplementary information section of the notice of the proposed rule, the Commissions specifically request comments on whether it would be appropriate to create an exception to the major swap and security-based swap participant definitions for state regulated insurance companies. We believe that certain aspects of the proposed rules create such an unlevel playing field for insurers that such an exception would be appropriate. Given that insurers primarily use derivatives to hedge risks and in light of the existing regulation of their use of such derivative instruments, **we respectfully request that the Commissions exempt state regulated insurers from being considered Major Swap or Security-Based Swap Participants to the extent that such insurers are 1) using derivatives for the purpose of hedging; and 2) are not engaging in systemically significant derivatives activities determined by the Financial Stability Oversight Council (FSOC) in consultation with the Commissions and the state insurance regulators.**<sup>8</sup>

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<sup>6</sup> *Id.* at 80178.

<sup>7</sup> We also note that, as the Commissions recognized, the definition of swap dealer in the Act excludes an insured depository institution “to the extent it offers to enter into a swap with a customer in connection with originating a loan with that customer.” *See*, Pub. L. No. 111-203, § 721. While we understand that Congress included such exclusion in the statute itself, we believe such exclusion creates an unlevel playing field by giving insured depository institutions special treatment in swaps regulation as compared to other financial institutions. We believe such treatment also calls for recognition of other financial institutions' unique characteristics and regulatory regimes, and, for this reason as well, we urge the Commissions to provide an exclusion for insurer hedging activities as described herein.

<sup>8</sup> Even then, we believe the state insurance regulatory regime's risk based capital rules are sufficiently robust such that it would be inappropriate to impose capital requirements inconsistent with such rules, though we recognize that there could be extraordinarily rare circumstances where an insurer might be part of a holding company structure considered systemically significant or engage in other non-insurance related systemically significant activities that would merit additional capital requirements.

If the Commissions do not believe such an exception appropriate, we respectfully request that the Commissions incorporate the following specific comments relating to each test of the Major Swap Participant Definition.

**Test 1: “Substantial Position” and “Hedging Commercial Risks”**

The Act has three tests for Major Swap or Security-Based Swap Participant. The first defines a Major Swap or Security-Based Swap Participant as an entity with a substantial position in any category of swaps excluding those used for hedging commercial risks. In this regard, we do not have concerns with the categories identified by the Commissions as “major swap categories” or the thresholds set by the Commissions for the purpose of identifying what constitutes a “substantial position” in swaps or security-based swaps.

We are troubled, however, that the rules proposed by the Commissions relating to this exception are different for swaps and security-based swaps. Specifically, though the approaches are consistent in other respects, only the exception for swaps incorporates an additional approach by excluding any derivative that 1) either qualifies as bona fide hedging for purposes of an exemption to position limits under the Commodity Exchange Act or qualifies hedging treatment under Financial Accounting Standards Board (FASB) Accounting Standards Codification Topic 815, and 2) such position is not held for speculation or investing or not held to hedge or mitigate the risk of other swaps. We believe inconsistent approaches undermine regulatory predictability and could lead to inconsistent applications for different types of swaps. In this regard, we request the Commissions, to the extent possible and recognizing the differences between the two types of swaps, further harmonize their approaches.

Moreover, **we specifically request that the Commissions add to the exception those swaps or security based swaps that qualify as an effective hedge under the statutory accounting rules specific to insurers** (attached as exhibit A). State insurance laws and regulations require insurers to follow statutory accounting rules. Several insurers are not public companies and, as a result, are not required to follow Generally Accepted Accounting Principles (GAAP) set up by FASB. Incorporating the state accounting treatment into the Commissions’ proposed rule will create a more level playing field for insurers and non-insurers.

We also have concerns that, as written, the definition of hedging commercial risk does not include the use of cash-flow hedges. Specifically, the language in 1.3(tt)(1)(i) and section 240.3a67-4 of the rules defining “hedging or mitigating commercial risk” of swaps and security-based swaps limits asset hedges to hedges of a “potential change” in such assets. However, many insurers as well as other institutions use cash-flow hedges, which do not relate to the “potential change” in the value of such assets, but can be related to asset yields or earnings. For example, in that case, a simple interest rate swap would not be related to the value of the bond or underlying loan. To this end, **we request that you modify the language to state that asset hedges would qualify for this exception where the risks “arise from the assets a person owns, produces, manufactures” as opposed to the “potential change in value of such assets.”**

**Test 2: “Substantial Counterparty Exposure” that could have “serious adverse effects” on the financial stability of the “banking or financial markets”**

The second test defines major swap participant or major security-based swap participant as entities that have “substantial counterparty exposure” that could have “adverse effects on the financial stability of the banking and financial markets.” In other words, this second test seeks to identify those firms with systemically risky swap and security-based swap exposures. We recognize that Title VII of

the Act includes this test in the definition of major swap (and security-based swap) participant and that Title VII provides authority to the Commissions to further define these terms. However, the Act also establishes a Financial Stability Oversight Council with the specific mission of addressing risks to the stability of the financial system. In this respect, Section 120 of Title I of the Act specifically grants the FSOC the authority to issue recommendations to primary financial regulatory agencies for more stringent regulation of activities of bank holding companies and non-bank financial companies under their jurisdiction that could “create or increase the risk of significant liquidity, credit, or other problems” spreading among such companies. The FSOC has three insurance expert members: a state insurance regulator, the Director of the Federal Insurance Office and a member with insurance expertise. Given that the Act established the FSOC to address systemic risks, and in light of the unique characteristics of the insurance business model and the nature of existing insurance regulatory requirements, the application of this second test to an insurer should be done by the FSOC and in consultation with the relevant state insurance commissioner, the primary financial regulatory authority for the entity in question. **We respectfully request that this procedure be incorporated into the rule and that the Commissions defer to FSOC’s authority when considering the designation of major swap participants under this second test.**<sup>9</sup>

Should the Commissions decide to apply the second test of the major swap and security-based swap participants approach in the absence of full participation by FSOC and its membership, certain adjustments should be made to reflect the extent to which hedging activities by insurers (and others) do not typically pose systemic risks to the financial markets. Barring circumstances where an entity has a substantial, concentrated position with a limited number of counterparties, who themselves pose a systemic risk, hedging activities typically would not have adverse effects on the financial markets. They would limit the risk in the financial markets by mitigating the risks of the individual participants.

In the case of insurers, as you are aware, state investment laws limit the extent of their derivatives transactions and, through robust reporting and examination requirements, the state insurance regulators monitor their derivatives positions closely. Under such circumstances, it is highly unlikely that an insurance company would be able to maintain large and concentrated swaps and security-based swaps positions with a small number of counterparties that would cause adverse impacts on the financial markets. **We, therefore, urge the Commissions to exclude from the determination of “substantial counterparty exposure” any swaps and security-based swap positions used for hedging commercial risk<sup>10</sup> provided that such positions are subject to state investment laws and ongoing monitoring by a state insurance regulatory authority.**<sup>11</sup>

**Test 3: Any “financial entity” that is “highly leveraged” and maintains a “substantial position” in swaps or security-based swaps**

The third test of the “Major Swap Participant” definition relates to “financial entities” that are “highly leveraged” and maintain a “substantial position” in swaps or security-based swaps. This test excludes entities that are subject to capital requirements established by an appropriate federal banking agency. We believe that if this rule is applied as proposed, it could effectively bring most of the insurance industry within its scope.

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<sup>9</sup> It would also be appropriate for the application of this test to be done by the FSOC for other types of financial entities with the appropriate consultation and consent of the primary financial regulator.

<sup>10</sup> We incorporate by reference our comments relating to the definition of “hedging commercial risk” in the first test of the major swap and security-based swap participant definitions.

<sup>11</sup> We also recognize that this exclusion could reasonably be applied to other types of financial entities that are subject to similar regulatory requirements and such application may be appropriate to ensure a level playing field among different financial institutions. We defer to the considerable expertise of the other primary financial regulators and the Commissions to determine whether an exclusion would be appropriate for the entities they regulate.

In the first instance, this definition creates an unlevel playing field between federally regulated banks and state regulated insurers by excluding those entities that are subject to capital requirements imposed by the federal banking agencies and not those imposed by state insurance regulators. While there are differences in the approaches that the regulators take, the capital requirements imposed by state insurance regulators on insurers are at least as stringent, and in some areas more stringent, than those imposed by the federal banking agencies. The state insurance regulatory risk-based capital regime is quite conservative and requires insurers to calculate capital charges based on the extent of the risks on their balance sheet including the relative riskiness of the investments they hold in their portfolio. In addition, there are fixed minimum capital and surplus requirements in order to be licensed as a specific type of insurer in each state. **For these reasons, we urge the Commissions to adopt a rule that excludes state regulated insurers from this third test of the major swap and major security-based swap participant definition.**

If the Commissions decide they can't or won't adopt such exclusion for state regulated insurers, we urge the Commissions to reevaluate the proposed rule defining "highly leveraged" financial entities. According to the proposed rule, the Commissions are considering defining "highly leveraged" as a ratio of total liabilities to equity of 15 to 1 or 8 to 1. Such ratio would be determined using GAAP.

As indicated above, there are many insurers who do not utilize GAAP in their financial statement reporting. State law requires that insurers file statements with the state insurance regulators on an annual and quarterly basis using the insurance regulatory regime's statutory accounting principles. Such principles form the foundation of the insurance regulatory regime's reporting and capital requirements. While it is true that publicly traded insurers who file quarterly and annual financial statements with the SEC do utilize GAAP for such filings, those insurers that are not publicly traded do not. Indeed, there are approximately 3,200 insurers that are not public companies, and, therefore, not required to file financial reports according to the GAAP. We have strong concerns that asking insurers to do so would create an unnecessary regulatory burden.

Of even greater concern are the leverage ratios themselves. The statute requires an analysis of whether an institution is "highly leveraged." Applying a single, simple ratio across all institutions to make such a determination does not adequately take into account the differences in business models, liability structures, and regulatory models. Insurers typically maintain higher liabilities because regulators require them to carry high reserves relative to potential claims. Thus, the "higher leverage" of insurers reflects a more conservative accounting regime, and not a higher risk profile.

Our analysis of the leverage ratios of the insurers we regulate is that applying a simple ratio would lead to many false positives. Indeed, many insurers have ratios that are well in excess of those proposed by the Commission and, yet, are healthy, solvent companies with strong claims paying ability. It is true that there are also companies with very high leverage ratios that are troubled, but, in those cases, the insurance regulator has become more engaged in the company's day-to-day operations and may have even placed it in receivership for rehabilitation, conservation, or liquidation. In such circumstances, it would be extraordinarily counterproductive for the Commissions to designate such entities as major swap participants and impose more stringent capital or other regulatory requirements.

Another example of different structures is the risk retention group (RRG) authorized by federal statute. RRGs operate with very low capital and surplus levels compared to non-RRG insurance entities, so their leverage ratios are typically very high. However, the nature of their business is highly restricted, therefore resulting in significantly lower operational risk. Simple leverage ratios in the absence of additional analysis of the entity's accounting/reserving requirements and business risk are simply not a useful tool for evaluating whether an insurance company is "highly leveraged." A better approach might

be to determine whether the insurer or other entity is “highly leveraged” specifically with respect to its swaps positions, and not the balance sheet as a whole.

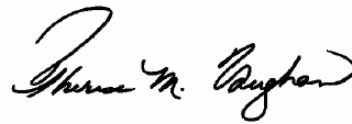
**Conclusion**

We appreciate the opportunity to comment and look forward to continuing the open and constructive dialogue we have had with the Commissions to date about the rulemaking process. Should you wish to discuss this comment or any other matter relating to the NAIC’s views on the rulemaking process, please do not hesitate to contact Ethan Sonnichsen, Director of Government Relations, at (202) 471-3980, Moira Campion McConaghy, Government Relations Manager, at (202) 649-4997, or Mark Sagat, Government Relations Analyst and Counsel, at (202) 471-3987.

Sincerely,



Susan E. Voss, Commissioner  
Iowa Insurance Division  
NAIC President



Therese M. Vaughan, Ph.D.  
NAIC Chief Executive Officer



# Exhibit A

# Statement of Statutory Accounting Principles No. 86

## Accounting for Derivative Instruments and Hedging, Income Generation, and Replication (Synthetic Asset) Transactions

### STATUS

Type of Issue:	Common Area
Issued:	Finalized May 14, 2002
Effective Date:	January 1, 2003
Affects:	Supersedes SSAP No. 31
Affected by:	No other pronouncements
Interpreted by:	INT 99-00, INT 04-20

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**Accounting for Derivative Instruments and Hedging Activities****SCOPE OF STATEMENT**

1. This statement establishes statutory accounting principles for derivative instruments and hedging, income generation, and replication (synthetic asset) transactions using selected concepts outlined in *FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities* (FAS 133).
2. This statement supersedes the provisions of *SSAP No. 31— Derivative Instruments*.

**SUMMARY CONCLUSION**

3. This statement addresses the recognition of derivatives and measurement of derivatives used in:
  - a. Hedging transactions;
  - b. Income generation transactions; and
  - c. Replication (synthetic asset) transactions

**Definitions** (for purposes of this statement)

4. “Derivative instrument” means an agreement, option, instrument or a series or combination thereof:
  - a. To make or take delivery of, or assume or relinquish, a specified amount of one or more underlying interests, or to make a cash settlement in lieu thereof; or
  - b. That has a price, performance, value or cash flow based primarily upon the actual or expected price, level, performance, value or cash flow of one or more underlying interests.
5. Derivative instruments include, but are not limited to; options, warrants used in a hedging transaction and not attached to another financial instrument, caps, floors, collars, swaps, forwards, futures and any other agreements or instruments substantially similar thereto or any series or combination thereof.
  - a. “Caps” are option contracts in which the cap writer (seller), in return for a premium, agrees to limit, or cap, the cap holder’s (purchaser) risk associated with an increase in a reference rate or index. For example, in an interest rate cap, if rates go above a specified interest rate level (the strike price or the cap rate), the cap holder is entitled to receive cash payments equal to the excess of the market rate over the strike price multiplied by the notional principal amount. Because a cap is an option-based contract, the cap holder has the right but not the obligation to exercise the option. If rates move down, the cap holder has lost only the premium paid. A cap writer has virtually unlimited risk resulting from increases in interest rates above the cap rate;
  - b. “Collar” means an agreement to receive payments as the buyer of an option, cap or floor and to make payments as the seller of a different option, cap or floor;
  - c. “Floors” are option contracts in which the floor writer (seller), in return for a premium, agrees to limit the risk associated with a decline in a reference rate or index. For example, in an interest rate floor, if rates fall below an agreed rate, the floor holder (purchaser) will receive cash payments from the floor writer equal to the difference between the market rate and an agreed rate multiplied by the notional principal amount;

- d. “Forwards” are agreements (other than futures) between two parties that commit one party to purchase and the other to sell the instrument or commodity underlying the contract at a specified future date. Forward contracts fix the price, quantity, quality, and date of the purchase and sale. Some forward contracts involve the initial payment of cash and may be settled in cash instead of by physical delivery of the underlying instrument;
  - e. “Futures” are standardized forward contracts traded on organized exchanges. Each exchange specifies the standard terms of futures contracts it sponsors. Futures contracts are available for a wide variety of underlying instruments, including insurance, agricultural commodities, minerals, debt instruments (such as U.S. Treasury bonds and bills), composite stock indices, and foreign currencies;
  - f. “Options” are contracts that give the option holder (purchaser of the option rights) the right, but not the obligation, to enter into a transaction with the option writer (seller of the option rights) on terms specified in the contract. A call option allows the holder to buy the underlying instrument, while a put option allows the holder to sell the underlying instrument. Options are traded on exchanges and over the counter;
  - g. “Swaps” are contracts to exchange, for a period of time, the investment performance of one underlying instrument for the investment performance of another underlying instrument, typically, but not always, without exchanging the instruments themselves. Swaps can be viewed as a series of forward contracts that settle in cash and, in some instances, physical delivery. Swaps generally are negotiated over-the-counter directly between the dealer and the end user. Interest rate swaps are the most common form of swap contract. However, foreign currency, commodity, and credit default swaps also are common;
  - h. “Warrants” are instruments that give the holder the right to purchase an underlying financial instrument at a given price and time or at a series of prices and times outlined in the warrant agreement. Warrants may be issued alone or in connection with the sale of other securities, for example, as part of a merger or recapitalization agreement, or to facilitate divestiture of the securities of another business entity.
6. “Firm commitment” is an agreement with an unrelated party, binding on both parties and expected to be legally enforceable, with the following characteristics:
- a. The agreement specifies all significant terms, including the quantity to be exchanged, the fixed price, and the timing of the transaction. The fixed price may be expressed as a specified amount of an entity’s functional currency or of a foreign currency. It may also be expressed as a specified interest rate or specified effective yield;
  - b. The agreement includes a disincentive for nonperformance that is sufficiently large to make performance probable; and
  - c. For investments in subsidiary, controlled, and affiliated entities (as defined by *SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities, A Replacement of SSAP No. 88 (SSAP No. 97)*) and investments in limited liability companies (as defined by *SSAP No. 48—Joint Ventures, Partnerships and Limited Liability Companies*) it must be probable that acquisition will occur within a reasonable period of time.
7. A hedging transaction is defined as a derivative(s) transaction which is entered into and maintained to reduce:

- a. The risk of a change in the fair value or cash flow of assets and liabilities which the reporting entity has acquired or incurred or has a firm commitment to acquire or incur or for which the entity has forecasted acquisition or incurrence; or
  - b. The currency exchange rate risk or the degree of foreign currency exposure in assets and liabilities which a reporting entity has acquired or incurred or has a firm commitment to acquire or incur or for which the entity has forecasted acquisition or incurrence.
8. “Income generation transaction” is defined as derivatives written or sold to generate additional income or return to the reporting entity. They include covered options, caps, and floors (e.g., a reporting entity writes an equity call option on stock that it already owns).
9. “Replication (Synthetic Asset) transaction” is a derivative transaction entered into in conjunction with other investments in order to reproduce the investment characteristics of otherwise permissible investments. A derivative transaction entered into by an insurer as a hedging or income generation transaction shall not be considered a replication (synthetic asset) transaction.
10. “Forecasted transaction” is a transaction that is expected to occur for which there is no firm commitment. Because no transaction or event has yet occurred and the transaction or event when it occurs will be at the prevailing market price, a forecasted transaction does not give an entity any present rights to future benefits or a present obligation for future sacrifices.
11. An “underlying” is a specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates, or other variable (including the occurrence or nonoccurrence of a specified event such as a scheduled payment under contract). An underlying may be a price or rate of an asset or liability but is not the asset or liability itself.

### **Embedded Derivative Instruments**

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

### **Impairment**

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

### **Recognition and Measurement of Derivatives Used in Hedging Transactions**

14. Derivative instruments represent rights or obligations that meet the definitions of assets (*SSAP No. 4—Assets and Nonadmitted Assets*) or liabilities (SSAP No. 5R) and shall be reported in financial statements. In addition, derivative instruments also meet the definition of financial instruments as defined in *SSAP No. 27—Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk* (SSAP No. 27). Should the cost basis of the derivative instrument be undefined (i.e., no premium is paid), the instrument shall be disclosed in accordance with paragraphs 43 through 46 of *SSAP No. 100—Fair Value Measurements* (SSAP No. 100).

Derivative instruments are admitted assets to the extent they conform to the requirements of this statement.

15. Derivative instruments used in hedging transactions that meet the criteria of a highly effective hedge shall be considered an effective hedge and valued and reported in a manner that is consistent with the hedged asset or liability (referred to as hedge accounting). For instance, assume an entity has a financial instrument on which it is currently receiving income at a variable rate but wishes to receive income at a fixed rate and thus enters into a swap agreement to exchange the cash flows. If the transaction qualifies as an effective hedge and a financial instrument on a statutory basis is valued and reported at amortized cost, then the swap would also be valued and reported at amortized cost. Derivative instruments used in hedging transactions that do not meet or no longer meet the criteria of an effective hedge shall be accounted for at fair value and the changes in the fair value shall be recorded as unrealized gains or unrealized losses (referred to as fair value accounting).

16. Entities shall not bifurcate the effectiveness of derivatives. A derivative instrument is either classified as an effective hedge or an ineffective hedge. Entities must account for the derivative using fair value accounting if it is deemed to be ineffective or becomes ineffective. Entities may redesignate a derivative in a hedging relationship even though the derivative was used in a previous hedging relationship that proved to be ineffective. An entity shall prospectively discontinue hedge accounting for an existing hedge if any one of the following occurs:

- a. Any criterion in paragraphs 19 through 31 is no longer met;
- b. The derivative expires or is sold, terminated, or exercised (the effect is recorded as realized gains or losses or, for effective hedges of firm commitments or forecasted transactions, in a manner that is consistent with the hedged transaction – see paragraph 17);
- c. The entity removes the designation of the hedge; or
- d. The derivative is deemed to be impaired in accordance with paragraph 13. A permanent decline in a counterparty's credit quality/rating is one example of impairment required by paragraph 13, for derivatives used in hedging transactions.

17. For those derivatives which qualify for hedge accounting, the change in the carrying value or cash flow of the derivative shall be recorded consistently with how the changes in the carrying value or cash flow of the hedged asset, liability, firm commitment or forecasted transaction are recorded. Upon termination of a derivative that qualified for hedge accounting, the gain or loss shall adjust the basis of the hedged item and be recognized in income in a manner that is consistent with 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.) Entities who choose the alternative method shall apply it consistently thereafter.

### **Hedge Designations**

18. An entity may designate a derivative instrument as hedging the exposure to:
- a. Changes in the fair value of an asset or a liability or an identified portion thereof that is attributable to a particular risk. This type of hedge can be utilized regardless of whether the hedged asset or liability is recorded in the financial statements at fair value;
  - b. Variability in expected future cash flows that are attributable to a particular risk. That exposure may be associated with an existing recognized asset or liability (such as all or certain future interest payments on variable-rate debt) or a forecasted transaction; or

- c. Foreign currency exposure. Specific examples include a fair value or cash flow hedge of a foreign-currency-denominated firm commitment or financial instrument.

### **Fair Value Hedges**

19. Fair value hedges qualify for hedge accounting if all of the following criteria are met:
  - a. At inception of the hedge, the formal documentation requirements of paragraph 34 are met;
  - b. Both at inception of the hedge and on an ongoing basis, the hedging relationship must be highly effective in achieving offsetting changes in fair value attributable to the hedged risk during the period that the hedge is designated. An assessment of effectiveness is required whenever financial statements or earnings are reported, and at least every three months. All assessments of effectiveness shall be consistent with the risk management strategy documented for that particular hedging relationship;
  - c. The term highly effective describes a cash flow 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 .80 or higher is achieved when using a regression analysis technique. Further guidance on determining effectiveness can be found within Exhibits A and B;
  - d. The hedged item is specifically identified as either all or a specific portion of a recognized asset or liability or of an unrecognized firm commitment. The hedged item is a single asset or liability (or a specific portion thereof) or is a portfolio of similar assets or a portfolio of similar liabilities (or a specific portion thereof); and
  - e. If similar assets or similar liabilities are aggregated and hedged as a portfolio, the individual assets or individual liabilities must share the risk exposure for which they are designated as being hedged. The change in fair value attributable to the hedged risk for each individual item in a hedged portfolio must be expected to respond in a generally proportionate manner to the overall change in fair value of the aggregate portfolio attributable to the hedged risk.

### **Cash Flow Hedges**

20. Cash flow hedges qualify for hedge accounting if all of the following criteria are met:
  - a. At inception of the hedge, the formal documentation requirements of paragraph 34 are met;
  - b. Both at inception of the hedge and on an ongoing basis, the hedging relationship shall be highly effective in achieving offsetting cash flows attributable to the hedged risk during the term of the hedge. An assessment of effectiveness is required whenever financial statements or earnings are reported, and at least every three months. All assessments of effectiveness shall be consistent with the originally documented risk management strategy for that particular hedging relationship; and
  - c. The term highly effective describes a cash flow hedging relationship where the change in cash flows or present value of cash flows of the derivative hedging instrument is within 80 to 125 percent of the opposite change in the cash flows or present value of the cash flows of the hedged item attributable to the hedged risk. It shall also apply when an R-



squared of .80 or higher is achieved when using a regression analysis technique. Further guidance on determining effectiveness can be found within Exhibits A and B.

### Hedging Forecasted Transactions

21. A forecasted transaction is eligible for designation as a hedged transaction in a cash flow hedge if all of the following additional criteria are met:

- a. The forecasted transaction is specifically identified as a single transaction or a group of individual transactions. If the hedged transaction is a group of individual transactions, those individual transactions must share the same risk exposure for which they are designated as being hedged. Thus, a forecasted purchase and a forecasted sale cannot both be included in the same group of individual transactions that constitute the hedged transaction.
- b. The occurrence of the forecasted transaction is probable. An assessment of the likelihood that a forecasted transaction will take place should not be based solely on management's intent because intent is not verifiable. The transaction's probability should be supported by observable facts and the attendant circumstances. Consideration should be given to the following circumstances in assessing the likelihood that a transaction will occur:
  - i. The frequency of similar past transactions;
  - ii. The financial and operational ability of the entity to carry out the transaction;
  - iii. Substantial commitments of resources to a particular activity (for example, a manufacturing facility that can be used in the short run only to process a particular type of commodity);
  - iv. The extent of loss or disruption of operations that could result if the transaction does not occur; and
  - v. The likelihood that transactions with substantially different characteristics might be used to achieve the same business purpose (for example, an entity that intends to raise cash may have several ways of doing so, ranging from a short-term bank loan to a common stock offering).

The term probable requires a significantly greater likelihood of occurrence than the phrase more likely than not. In addition, both the length of time until a forecasted transaction is projected to occur and the quantity of the forecasted transaction are considerations in determining probability. Other factors being equal, the more distant a forecasted transaction is, the less likely it is that the transaction would be considered probable and the stronger the evidence that would be needed to support an assertion that it is probable. For example, a transaction forecasted to occur in five years may be less likely than a transaction forecasted to occur in one year. However, forecasted interest payments for the next 20 years on variable-rate debt typically would be probable if supported by an existing contract. Additionally, other factors being equal, the greater the physical quantity or future value of a forecasted transaction, the less likely it is that the transaction would be considered probable and the stronger the evidence that would be required to support an assertion that it is probable. For example, less evidence generally would be needed to support forecasted investments of \$100,000 in a particular month than would be needed to support forecasted investments of \$950,000 in that month by an entity, even if its investments have averaged \$950,000 per month for the past 3 months.

A forecasted transaction that is expected to occur within 2 months of the original forecasted date (or time frame) may still be considered probable. If the transaction will not occur until greater than 2 months after the original forecasted date, it is no longer probable and will be accounted for as per the following paragraph.

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.

- c. If the hedged transaction is the forecasted purchase or sale of a nonfinancial asset, the designated risk being hedged is (1) the risk of changes in the functional-currency-equivalent cash flows attributable to changes in the related foreign currency exchange rates or (2) the risk of changes in the cash flows relating to all changes in the purchase price or sales price of the asset (reflecting its actual location if a physical asset), not the risk of changes in the cash flows relating to the purchase or sale of a similar asset in a different location or of a major ingredient.
- d. If the hedged transaction is the forecasted purchase or sale of a financial asset or liability or the variable cash inflow or outflow of an existing financial asset or liability, the designated risk being hedged is (1) the risk of changes in the cash flows of the entire asset or liability, such as those relating to all changes in the purchase price or sales price (regardless of whether that price and the related cash flows are stated in the entity's functional currency or a foreign currency), (2) the risk of changes in its cash flows attributable to changes in the designated benchmark interest rate, (3) the risk of changes in the functional-currency-equivalent cash flows attributable to changes in the related foreign currency exchange rates, or (4) the risk of changes in its cash flows attributable to default or changes in the obligor's creditworthiness, and changes in the spread over the benchmark interest rate with respect to the hedged item's credit sector at inception of the hedge. Two or more of the above risks may be designated simultaneously as being hedged. The benchmark interest rate being hedged in a hedge of interest rate risk must specifically be identified as part of the designation and documentation at the inception of the hedging relationship. An entity may not designate prepayment risk as the risk being hedged.
- e. If the hedged item is a financial asset or liability, a recognized loan servicing right, or a nonfinancial firm commitment with financial components, the designated risk being hedged is (1) the risk of changes in the overall fair value of the entire hedged item, (2) the risk of changes in its fair value attributable to changes in benchmark interest rate (3) the risk of changes in its fair value attributable to changes in the related foreign currency exchange rates, or (4) the risk of changes in its fair value attributable to both changes in the obligor's creditworthiness and changes in the spread over the benchmark interest rate with respect to the related financial asset's or liability's hedged item's credit sector at inception of the hedged (referred to as credit risk). If the risk designated as being hedged is not the risk in paragraph 21(e)(1) above, two or more of the other risks (benchmark interest rate risk, foreign currency exchange risk, and credit risk) may simultaneously be designated as being hedged.

The benchmark interest rate being hedged in a hedge of interest rate risk must be specifically identified as part of the designation and documentation at the inception of the hedging relationship. Ordinarily, an entity should designate the same benchmark interest rate as the risk being hedged for similar hedges; the use of different benchmark interest rates for similar hedges should be rare and must be justified. In calculating the change in the hedged item's fair value attributable to changes in the benchmark interest rate, the estimated cash flows used in calculating fair value must be based on all of the contractual cash flows of the entire hedged item. Excluding some of the hedged item's contractual cash flows (for example, the portion of the interest coupon in excess of the benchmark interest rate) from the calculation is not permitted.<sup>1</sup> An entity may not simply designate prepayment risk as the risk being hedged for a financial asset. However, it can designate the option component of a prepayable instrument as the hedged item in a fair value hedge of the entity's exposure to changes in the fair value of that "prepayment" option, perhaps thereby achieving the objective of its desire to hedge prepayment risk. The effect of an embedded derivative of the same risk class must be considered in designating a hedge of an individual risk. For example, the effect of an embedded prepayment option must be considered in designating a hedge of benchmark interest rate risk.

### Foreign Currency Hedges

22. If the hedged item is denominated in a foreign currency, an entity may designate the following types of hedges of foreign currency exposure, as specified in paragraphs 19 through 21:

- a. A fair value hedge of an unrecognized firm commitment or a recognized asset or liability;
- b. A cash flow hedge of a forecasted transaction, an unrecognized firm commitment, the forecasted functional-currency-equivalent cash flows associated with a recognized asset or liability, or a forecasted intercompany transaction; or
- c. A hedge of a net investment in a foreign operation.

23. The recognition in earnings of the foreign currency transaction gain or loss on a foreign-currency-denominated asset or liability based on changes in the foreign currency spot rate is not considered to be the remeasurement of that asset or liability with changes in fair value attributable to foreign exchange risk recognized in earnings. Thus, those criteria are not impediments to either a foreign currency fair value or cash flow hedge of such a foreign-currency-denominated asset or liability or a foreign currency cash flow hedge of the forecasted acquisition or incurrence of a foreign-currency-denominated asset or liability whose carrying amount will be remeasured at spot exchange rates. A foreign currency derivative instrument that has been entered into with another member of a holding company can be a hedging instrument in a fair value hedge or in a cash flow hedge of a recognized foreign-currency-denominated asset or liability or in a net investment hedge only if that other member has entered into an offsetting contract with an unrelated third party to hedge the exposure it acquired from issuing the derivative instrument to the affiliate that initiated the hedge.

24. The provisions in paragraph 23 that permit a recognized foreign-currency-denominated asset or liability to be the hedged item in a fair value or cash flow hedge of foreign currency exposure also pertain to a recognized foreign-currency-denominated receivable or payable that results from a hedged forecasted foreign-currency-denominated sale or purchase on credit. An entity may choose to designate a single

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<sup>1</sup> The first sentence of paragraph 21(a) that specifically permits the hedged item to be identified as either all or a specific portion of a recognized asset or liability or of an unrecognized firm commitment is not affected by the provisions in this subparagraph.

cash flow hedge that encompasses the variability of functional currency cash flows attributable to foreign exchange risk related to the settlement of a foreign-currency-denominated receivable or payable resulting from a forecasted sale or purchase on credit. Alternatively, an entity may choose to designate a cash flow hedge of the variability of functional currency cash flows attributable to foreign exchange risk related to a forecasted foreign-currency-denominated sale or purchase on credit and then separately designate a foreign currency fair value hedge of the resulting recognized foreign-currency-denominated receivable or payable. In that case, the cash flow hedge would terminate (be dedesignated) when the hedged sale or purchase occurs and the foreign-currency-denominated receivable or payable is recognized. Although the use of the same foreign currency derivative instrument for both the cash flow hedge and the fair value hedge is not prohibited, some ineffectiveness may result.

### Foreign Currency Fair Value Hedges

25. *Unrecognized firm commitment.* A derivative instrument or a nonderivative financial instrument that may give rise to a foreign currency transaction gain or loss can be designated as hedging changes in the fair value of an unrecognized firm commitment, or a specific portion thereof, attributable to foreign currency exchange rates. The designated hedging relationship qualifies for hedge accounting if all the fair value hedge criteria in paragraph 19 are met.

26. *Recognized asset or liability.* A nonderivative financial instrument shall not be designated as the hedging instrument in a fair value hedge of the foreign currency exposure of a recognized asset or liability. A derivative instrument can be designated as hedging the changes in the fair value of a recognized foreign-currency-denominated asset or liability (or a specific portion thereof) for which a foreign currency transaction gain or loss is recognized in earnings. All recognized foreign-currency-denominated assets or liabilities for which a foreign currency transaction gain or loss is recorded in earnings may qualify for hedge accounting if all the fair value hedge criteria in paragraph 19 are met.

27. *Securities carried at fair value.* A nonderivative financial instrument shall not be designated as the hedging instrument in a fair value hedge of the foreign currency exposure of security carried at fair value. A derivative instrument can be designated as hedging the changes in the fair values of an debt security carried at fair value (or a specific portion thereof) attributable to changes in foreign currency exchange rates. The designated hedging relationship qualifies for hedge accounting if all the fair value hedge criteria in paragraph 19 are met. An equity security carried at fair value can be hedged for changes in the fair value attributable to changes in foreign currency exchange rates and qualify for hedge accounting if all the fair value hedge criteria in paragraph 19 are met and the following two conditions are satisfied.

- a. The security is not traded on an exchange (or other established marketplace) on which trades are denominated in the investor's functional currency; and
- b. Dividends or other cash flows to holders of the security are all denominated in the same foreign currency as the currency expected to be received upon sale of the security.

28. Gain and losses on a qualifying foreign currency fair value hedge shall be accounted for as specified in paragraphs 15-17 and Exhibit C. The gain or loss on a nonderivative hedging instrument attributable to foreign currency risk is the foreign currency transaction gain or loss as determined under *SSAP No. 23— Foreign Currency Transactions and Translations* (SSAP No. 23).

### Foreign Currency Cash Flow Hedges

29. A nonderivative financial instrument shall not be designated as a hedging instrument in a foreign currency cash flow hedge. A derivative instrument designated as hedging the foreign currency exposure to variability in the functional-currency-equivalent cash flows associated with a forecasted transaction (for example, a forecasted sale to an unaffiliated entity with the price to be denominated in a foreign

currency), a recognized asset or liability, an unrecognized firm commitment, or a forecasted intercompany transaction (for example, a forecasted sale to a foreign subsidiary or a forecasted royalty from a foreign subsidiary) qualifies for hedge accounting if all the following criteria are met:

- a. The hedged transaction is denominated in a currency other than the hedging unit's functional currency.
- b. All of the criteria in paragraph 20 are met.
- c. If the hedged transaction is a group of individual forecasted foreign-currency-denominated transactions, a forecasted inflow of a foreign currency and a forecasted outflow of the foreign currency cannot both be included in the same group.
- d. If the hedged item is a recognized foreign-currency-denominated asset or liability, all the variability in the hedged item's functional-currency-equivalent cash flows must be eliminated by the effect of the hedge. (For example, with a variable-rate foreign-currency-denominated asset or liability a cash flow hedge cannot be used to hedge changes in exchange rates alone because the derivative would not eliminate all the variability in the functional currency cash flows.)
- e. If the hedged transaction is the forecasted purchase or sale of a financial asset or liability or the interest payments on that financial asset or liability or the variable cash inflow or outflow of an existing financial asset or liability, the designated risk being hedged is (1) the risk of overall change in the hedged cash flows related to the asset or liability, such as those relating to all changes in the purchase price or sales price (regardless of whether that price and the related cash flows are stated in the entity's functional currency or a foreign currency), (2) the risk of changes in its cash flows attributable to changes in the designated benchmark interest rate (referred to as interest rate risk), (3) the risk of changes in the functional-currency-equivalent cash flows attributable to changes in the related foreign currency exchange rates, or (4) the risk of changes in its cash flows attributable to default, changes in the obligor's creditworthiness, and changes in the spread over the benchmark interest rate with respect to the hedged item's credit sector at inception of the hedge (referred to as credit risk). Two or more of the above risks may be designated simultaneously as being hedged. An entity may not designate prepayment risk as the risk being hedged.

The benchmark interest rate being hedged in a hedge of interest rate risk must be specifically identified as part of the designation and documentation at the inception of the hedging relationship. Ordinarily, an entity should designate the same benchmark interest rate as the risk being hedged for similar hedges, consistent with FAS 133 paragraph 62; the use of different benchmark interest rates for similar hedges should be rare and must be justified. In a cash flow hedge of a variable-rate financial asset or liability, either existing or forecasted, the designated risk being hedged cannot be the risk of changes in its cash flows attributable to changes in the specifically identified benchmark interest rate if the cash flows of the hedged transaction are explicitly based on a different index, for example, based on a specific bank's prime rate, which cannot qualify as the benchmark rate. However, the risk designated as being hedged could potentially be the risk of overall changes in the hedged cash flows related to the asset or liability, provided that the other criteria for a cash flow hedge have been met.

30. A qualifying foreign currency cash flow hedge shall be accounted for in accordance with paragraphs 15-17 and Exhibit C.

**Hedges of the Foreign Currency Exposure of a Net Investment in a Foreign Operation**

31. A derivative instrument or a nonderivative financial instrument that may give rise to a foreign currency transaction gain or loss under SSAP No. 23 can be designated as hedging the foreign currency exposure of a net investment in a foreign operation. The gain or loss on a hedging derivative instrument (or the foreign currency transaction gain or loss on the nonderivative instrument) that is designated as, and is effective as, an economic hedge of the net investment in a foreign operation shall be reported in the same manner as a translation adjustment to the extent it is effective as a hedge. The hedged net investment shall be accounted for consistent with SSAP No. 23; the provisions of this statement for recognizing the gain or loss on assets designated as being hedged in a fair value hedge do not apply to the hedge of a net investment in a foreign operation.

**Hedge Effectiveness**

32. The measurement of hedge effectiveness for a particular hedging relationship shall be consistent with the entity's risk management strategy and the method of assessing hedge effectiveness that was documented at the inception of the hedging relationship, as discussed in paragraph 34.

33. The gain or loss on a derivative designated as a hedge and assessed to be effective is reported consistently with the hedged item. If an entity's defined risk management strategy for a particular hedging relationship excludes a specific component of the gain or loss, or related cash flows, on the hedging derivative from the assessment of hedge effectiveness (as discussed in Exhibit B), that excluded component of the gain or loss shall be recognized as an unrealized gain or loss. For example, if the effectiveness of a hedge with an option contract is assessed based on changes in the option's intrinsic value, the changes in the option's time value would be recognized in unrealized gains or losses. Time value is equal to the fair value of the option less its intrinsic value.

**Documentation Guidance**

34. At inception of the hedge, documentation must include:

- a. A formal documentation of the hedging relationship and the entity's risk management objective and strategy for undertaking the hedge, including identification of the hedging instrument, the hedged item, the nature of the risk being hedged, and how the hedging instrument's effectiveness in offsetting the exposure to changes in the hedged item's fair value or variability in cash flows attributable to the hedged risk will be assessed. There must be a reasonable basis for how the entity plans to assess the hedging instrument's effectiveness;
  - b. An entity's defined risk management strategy for a particular hedging relationship may exclude certain components of a specific hedging derivative's change in fair value, such as time value, from the assessment of hedge effectiveness, as discussed in paragraph 33 and Exhibit B;
  - c. Signature of approval, for each instrument, by person(s) authorized, either by the entity's board of directors or a committee authorized by the board, to approve such transactions; and
  - d. A description of the reporting entity's methodology used to verify that opening transactions do not exceed limitations promulgated by the state of domicile.
35. For all derivatives terminated, expired, or exercised during the year:

- a. Signature of approval, for each instrument, by person(s) authorized, either by the entity's board of directors or a committee authorized by the board, to approve such transactions;
  - b. A description, for each instrument, of the nature of the transaction, including:
    - i. The date of the transaction;
    - ii. A complete and accurate description of the specific derivative, including description of the underlying securities, currencies, rates, indices, commodities, derivatives, or other financial market instruments;
    - iii. Number of contracts or notional amount;
    - iv. Date of maturity, expiry or settlement;
    - v. Strike price, rate or index (termination price for futures contracts);
    - vi. Counterparty, or exchange on which the transaction was traded; and
    - vii. Consideration paid or received, if any, on termination.
  - c. Description of the reporting entity's methodology to verify that derivatives were effective hedges; and
  - d. Identification of any derivatives that ceased to be effective as hedges.
36. For derivatives open at quarter-end:
- a. A description of the methodology used to verify the continued effectiveness of hedges;
  - b. An identification of any derivatives that have ceased to be effective as hedges;
  - c. A description of the reporting entity's methodology to determine fair values of derivatives;
  - d. Copy of Master Agreements, if any, where indicated on Schedule DB Part D.

### **Recognition and Measurement of Derivatives Used in Income Generation Transactions**

#### **General**

37. 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 that it already owns).

38. 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.

39. 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.

40. 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 fair value (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 that 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

41. 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 if the original duration is less than one year, otherwise carry at amortized cost;
  - 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 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;
  - c. For life insurance companies, the gain or loss flows through the IMR if the covering asset or underlying interest is subject to the IMR using callable bond rules to determine the remaining life;
  - d. Reporting entities 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 shall be evaluated for write down or disclosure treatment in accordance with SSAP No. 5R. 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 unassigned funds (surplus) and income shall be considered.



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

STATUS OF OPTION	COVERING ASSET VALUED AT AMORTIZED COST	COVERING ASSET VALUED AT FAIR VALUE
Open	Record premium as deferred liability.  Carry at amortized value. (Alternatively carry at consideration received if original duration is less than 1 year to maturity.)  Alternatively, attach premium to covering asset and amortize (under yield to worse scenario) using standard callable bond accounting.	Record premium as deferred liability.  Changes in fair value recorded as unrealized adjustments to unassigned funds (surplus) – gain/loss.
Closed – Expired	Premium received recognized as realized capital gain.  Gain from expiration to flow through IMR, if applicable. (1)	Premium received recognized as realized capital gain.
Closed – Exercised	Adjust disposition proceeds. (Include in capital gain/loss of disposed asset.)  Gain or loss from disposition to flow through IMR, if applicable. (1)	Adjust disposition proceeds. (Include in capital gain/loss of disposed asset.)
Closed – Terminated	Recognize net amount as realized capital gain/loss.  Gain or loss from disposition to flow through IMR, if applicable. (1)	Recognize net amount as realized capital gain/loss.

NOTE (1) If premium is attached to covering asset, the accounting treatment for the covering asset applies.

**Written Covered Put Options**

43. 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.

44. Written covered put options shall be accounted for as follows:

<b>STATUS OF OPTION</b>	<b>UNDERLYING INTEREST VALUED AT AMORTIZED COST</b>	<b>UNDERLYING INTEREST VALUED AT FAIR VALUE</b>
Open	Record premium as deferred liability.  Carry at amortized value. (Alternatively carry at consideration received if original duration is less than 1 year to maturity.)	Record premium as deferred liability.  Changes in fair value recorded as unrealized adjustments to unassigned funds (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	Recognize 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.

### Written Fixed Income Caps and Floors

45. The principal features of written fixed income caps and floors are:
- a. The value of the premium received shall be amortized into income over the life of the contract. For caps and floors, where the entity is selling off possible excess interest/income, the value of the covering asset is not relevant;
  - b. Gain/loss may be subject to IMR. The expected maturity would be the derivative contract's maturity.

46. Written fixed income caps and floors shall be accounted for as follows:

STATUS OF OPTION	COVERING ASSET VALUED AT AMORTIZED COST	COVERING ASSET VALUED AT FAIR VALUE
Open	<p>Record premium as deferred liability.</p> <p>Carry at amortized value. (Alternatively carry at consideration received if original duration is less than 1 year to maturity.)</p> <p>Amortize over life of contract to produce constant yield.</p> <p>Record any interest expense as “Other Investment Income” – negative value.</p>	<p>Record premium as deferred liability.</p> <p>Changes in fair value recorded as unrealized adjustments to unassigned funds (surplus) – gain/loss.</p>
Closed – Matured	<p>Would usually mature at zero amortized value.</p> <p>Any remaining unamortized value recognized as ordinary income through a final amortization adjustment.</p>	<p>Premium received recognized as realized capital gain.</p>
Closed – Exercised	<p>Not applicable.</p>	<p>Not applicable.</p>
Closed – Terminated	<p>Recognize net amount as realized capital gain/loss.</p> <p>Gain/loss on termination to flow through IMR, if applicable.</p>	<p>Recognize net amount as realized capital gain/loss.</p>

**Recognition and Measurement of Derivatives Used in Replication (Synthetic Asset) Transactions**

47. Replication (Synthetic Asset) transaction means a derivative transaction entered into in conjunction with other investments in order to reproduce the investment characteristics of otherwise permissible investments. A derivative transaction entered into by an insurer as a hedging or income generation transaction shall not be considered a replication (synthetic asset) transaction.

48. Any premium paid or received shall be carried as an asset or liability on the balance sheet (Derivative line on the Assets (or) Liabilities pages). Premiums paid or received on the replication (synthetic asset) derivative should be amortized into investment income or expense until the exercise, termination or maturity date of the derivative.

49. If the replication (synthetic asset) transaction would be carried at amortized cost and the cash instrument used is carried at amortized cost, then the derivative used should be carried at amortized cost. The derivative may be valued at fair value when both the replication (synthetic asset) and the cash instrument are valued at amortized cost. This is consistent with the alternative valuation methods available for hedges. If the replication (synthetic asset) transaction would be carried at fair value and/or the cash instrument used is carried at fair value, then the derivative used should be carried at fair value.

	(a)	(b)	(c)	(d)
	If the Replication (Synthetic Asset) is Valued at:	And Cash Instrument(s) Used is (are) Valued at:	The Derivative is Valued at:	Alternative Derivative Value Basis:
1.	Amortized Cost	Amortized Cost	Amortized Cost	Fair value
2.	Fair value	Fair value	Fair value	N/A
3.	Amortized Cost	Fair value	Fair value	N/A
4.	Fair value	Amortized Cost	Fair value	N/A

50. In the case of No. 3 in the chart above, the fair values for the cash instrument and derivative, when added together, shall not exceed the replication (synthetic asset) statement value. If this does occur, the excess shall reduce the fair value of the derivative and shall be recorded as an unrealized gain separate from the AVR.

51. If the replication (synthetic asset) transaction involves the exchange of interest related cash flows (default free assets), then the cash flows should be accrued as investment income. If the replication (synthetic asset) transaction involves the exchange of total return or change in index cash flows, then the cash flows should be segregated between interest income and fair value (equity) changes. The interest income portion should be accrued as investment income.

52. If the derivative is carried at fair value, the periodic change in the fair value should be recorded as an unrealized gain or loss adjustment to surplus until the transaction is terminated. If the replication (synthetic asset) transaction involves the exchange of total return or change in index cash flows, then the cash flows should be segregated between interest income and fair value (equity) changes. The fair value (equity) change should be recognized as a deferred asset/liability until the termination of the contract. Gains or losses on the derivative at termination or sale should be recognized as realized.

### Disclosure Requirements

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

- a. General disclosures:
  - i. A description of the reporting entity's objectives for using derivatives, i.e., hedging, income generation or replication;
  - ii. A description of the context needed to understand those objectives and its strategies for achieving those objectives;

- iii. The description for hedging objectives shall identify the category, e.g., fair value hedges, cash flow hedges, or foreign currency hedges, and for all objectives, the type of instrument(s) used;
  - iv. A description of the accounting policies for derivatives including the policies for recognizing (or reasons for not recognizing) and measuring the derivatives used, and when recognized, where those instruments and related gains and losses are reported;
  - v. The net gain or loss recognized in unrealized gains or losses during the reporting period representing the component of the derivative instruments' gain or loss, if any, excluded from the assessment of hedge effectiveness; and
  - vi. The net gain or loss recognized in unrealized gains or losses during the reporting period resulting from derivatives that no longer qualify for hedge accounting.
- b. Disclosures by type of instrument outstanding, e.g., call options, floors, etc.:
- i. Notional or contract amounts;
  - ii. Carrying and fair values; and
  - iii. A discussion of the market risk, credit risk, and cash requirements of the derivatives.
- c. For derivatives held for other than hedging purposes in addition to a and b above:
- i. Average fair value of the derivatives during the reporting period together with the related end-of-period fair value distinguishing between assets and liabilities;
  - ii. Net gains or losses detailed 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.
- d. 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.
- e. A seller<sup>2</sup> of credit derivatives<sup>3</sup> shall disclose information<sup>4</sup> about its credit derivatives and

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<sup>2</sup> The term "seller" refers to the party that assumes credit risk, which could be a guarantor in a guarantee-type contract, and any party that provides the credit protection in an option-type contract, a credit default swap, or any other credit derivative contract. A seller is also sometimes referred to as a writer of the contract.

<sup>3</sup> A credit derivative instrument is (1) in which one or more of its underlyings are related to the credit risk of a specified entity (or a group of entities) or an index based on the credit risk of a group of entities and (2) that exposes the seller to potential loss from credit-risk-related events specified in the contract. Examples of credit derivatives within the scope of this paragraph include, but are not limited to, credit default swaps, credit spread options, and credit index products. This also includes a hybrid instrument that has an embedded credit derivative (e.g., a credit-linked note).

<sup>4</sup> One way to present the information for groups of similar credit derivatives would be first to segregate the disclosures by major types of contracts (single-name credit default swaps, traded indexes, other portfolio products and swaptions) and then, for each major type, provide additional subgroups for major types of referenced/underlying asset classes (e.g., corporate debt, sovereign debt, and structured finance).

hybrid instruments<sup>5</sup> that have embedded credit derivatives to enable users of financial statements to assess their potential effect on its financial position, income and cash flows. The seller of a credit derivative shall disclose the following information for each credit derivative, or each group of credit derivatives, even if the likelihood of the seller's having to make any payments under the credit derivative is remote. With respect to hybrid instruments that have embedded credit derivatives, the seller of the embedded credit derivative shall disclose the required information for the entire hybrid instrument, not just the embedded credit derivative.

- i. The nature of the credit derivative, including the approximate term of the credit derivative, the reason(s) for entering into the credit derivative, the events or circumstances that would require the seller to perform under the credit derivative, and the current status (that is, as of the date of the statement of financial position) of the payment/performance risk of the credit derivative. For example, the current status of the payment/performance risk of a credit derivative could be based on either recently issued external credit ratings or current internal groupings used by the seller to manage its risk. An entity that uses internal groupings shall disclose how those groupings are determined and used for managing risk.
  - ii. The maximum potential amount of future payments (undiscounted) the seller could be required to make under the credit derivative. That maximum potential amount of future payments shall not be reduced by the effect of any amounts that may possibly be recovered under recourse or collateralization provisions in the credit derivative (which are addressed under (d) below). If the terms of the credit derivative provide for no limitation to the maximum potential future payments under the contract, that fact shall be disclosed. If the seller is unable to develop an estimate of the maximum potential amount of future payments under the credit derivative, the seller shall disclose the reasons why it cannot estimate the maximum potential amount.
  - iii. The fair value of the credit derivative as of the date of the statement of financial position.
  - iv. The nature of (1) any recourse provisions that would enable the seller to recover from third parties any of the amounts paid under the credit derivative and (2) any assets held either as collateral or by third parties that, upon the occurrence of any specified triggering event or condition under the credit derivative, the seller can obtain and liquidate to recover all or a portion of the amounts paid under the credit derivative. The seller shall indicate, if estimable, the approximate extent to which the proceeds from liquidation of those assets would be expected to cover the maximum potential amount of future payments under the credit derivative. In its estimate of potential recoveries, the seller of credit protection shall consider the effect of any purchased credit protection with identical underlying(s).
- f. For derivatives accounted for as cash flow hedges of a forecasted transaction, disclose:

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<sup>5</sup> A hybrid instrument is considered a contract that includes the host contract and an embedded derivative. Unlike FAS 133, statutory accounting guidance in *SSAP No. 86—Accounting for Derivative Instruments and Hedging Activities* (SSAP No. 86) does not permit embedded derivatives to be separated from the host contract and accounted for separately as a derivative instrument. As noted in paragraph 53e., the seller of the hybrid instrument shall disclose the required information for the entire hybrid instrument, not just the embedded credit derivative.

- i. The maximum length of time over which the entity is hedging its exposure to the variability in future cash flows for forecasted transactions excluding those forecasted transactions related to the payment of variable interest on existing financial instruments; and
  - ii. The amount of gains and losses classified in unrealized gains/losses related to cash flow hedges that have been discontinued because it was no longer probable that the original forecasted transactions would occur by the end of the originally specified time period or within 2 months of that date.
- g. The disclosure requirements of 53 a., 53 b., and 53 f. shall be included in the Annual Statement. Refer to the preamble for further discussion regarding interim disclosure requirements. The disclosure requirements of paragraphs 53 a. through 53 f. shall be included in the annual audited statutory financial reports. Paragraph 59 of the Preamble states that disclosures made within specific schedules or exhibits to the Annual Statement need not be duplicated in a separate note.
54. Refer to the preamble for further discussion regarding disclosure requirements.

### Relevant Literature

55. This statement adopts the framework established by FAS 133, *FASB Statement No. 137, Accounting for Derivative Instruments and Hedging Activities—Deferral of the Effective Date of FASB Statement No. 133, An amendment of FASB Statement No. 133* (FAS 137) and *FASB Statement No. 138, Accounting for Certain Derivative Instruments and Certain Hedging Activities, An amendment of FASB Statement No. 133* (FAS 138), for fair value and cash flow hedges, including its technical guidance to the extent such guidance is consistent with the statutory accounting approach to derivatives utilized in this statement. This statement adopts the provisions of FAS 133 and 138 related to foreign currency hedges. With the exception of guidance specific to foreign currency hedges and amendments specific to refining the hedging of interest rate risk (under FAS 138, the risk of changes in the benchmark interest rate would be a hedged risk), this statement rejects FAS No. 137 and 138 as well as the various related Emerging Issues Task Force interpretations. This statement adopts paragraphs 4 and 25 of *FASB Statement No. 149: Amendment of Statement 133 on Derivative Instruments and Hedging Activities* (FAS 149) regarding the definition of an underlying and guidance for assessing hedge effectiveness. All other paragraphs in FAS 149 are rejected as not applicable for statutory accounting. This statement adopts FSP FAS 133-1 and FIN 45-5: *Disclosures about Credit Derivatives and Certain Guarantees, An Amendment of FASB Statement No. 133 and FASB Interpretation No. 45 and Clarification of the Effective Date of FASB Statement No. 161* (FSP FAS 133-1 and FIN 45-4) and requires disclosures by sellers of credit derivatives. This statement adopts revisions to ASC 815-20-25-15 as reflected within ASU 2010-08, *Technical Corrections to Various Topics*. It should be noted that the conclusions reached in this statement are not intended to usurp the rules and regulations put forth by states in their respective investment laws. The contents of this statement are intended to provide accounting guidance on the use of derivatives as allowed by an insurer's state of domicile. It is not intended to imply that insurers may use derivatives or cash instruments that the insurer's state of domicile does not allow under the state's insurance regulatory requirements, e.g., in replication transactions.

### Effective Date and Transition

56. This statement is effective for derivative transaction entered into or modified on or after January 1, 2003. A modification is any revision or change in contractual terms of the derivative. SSAP No. 31 applies to derivative transaction prior to January 1, 2003. Alternatively, an insurer may choose to apply this statement to all derivatives to which the insurer is a party as of January 1, 2003. In either case, the insurer is to disclose the transition approach that is being used.

**AUTHORITATIVE LITERATURE****Generally Accepted Accounting Principles**

- *FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities*
- *FASB Statement No. 138, Accounting for Certain Derivative Instruments and Certain Hedging Activities, An amendment of FASB Statement No. 133*
- *FASB Statement No. 149, Amendment of Statement 133 on Derivative Instruments and Hedging Activities*
- *FASB Staff Position FAS 133-1 and FIN 45-5: Disclosures about Credit Derivatives and Certain Guarantees, An Amendment of FASB Statement No. 133 and FASB Interpretation No.45 and Clarification of the Effective Date of FASB Statement No. 161*
- *FASB Emerging Issues Task Force No. 98-10, Accounting for Contracts Involved in Energy Trading and Risk Management Activities*
- *FASB Emerging Issues Task Force No. 98-12, Application of Issue No. 96-13 to Forward Equity Sales Transactions*
- *FASB Emerging Issues Task Force No. 99-01, Accounting for Debt Convertible into the Stock of a Consolidated Sub*
- *FASB Emerging Issues Task Force No. 99-02, Accounting for Weather Derivatives*
- *FASB Emerging Issues Task Force No. 99-03, Application of Issue No. 96-13 to Derivative Instruments with Multiple Settlement Alternatives*
- *FASB Emerging Issues Task Force No. 99-08, Accounting for Transfers of Assets That Are Derivative Instruments but That Are Not Financial Assets*
- *FASB Emerging Issues Task Force No. 99-09, Effect of Derivative Gains and Losses on the Capitalization of Interest*
- *FASB Emerging Issues Task Force No. 00-07, Application of Issue No. 96-13 to Equity Derivative Instruments That Contain Certain Provisions That Require Net Cash Settlement If Certain Events outside the Control of the Issuer Occur*
- *FASB Emerging Issues Task Force No. 00-09, Classification of a Gain or Loss from a Hedge of Debt That Is Extinguished*
- *FASB Derivatives Implementation Group (DIG) Issue E7: Hedging—General: Methodologies to Assess Effectiveness of Fair Value and Cash Flow Hedges*
- *DIG Issue E8: Hedging—General: Assessing Hedge Effectiveness of Fair Value and Cash*

**Statutory Accounting Principles**

- *SSAP No. 31—Derivative Instruments*
- *Emerging Accounting Issues Working Group June 7, 1999*
- *Flow Hedges Period-by-Period or Cumulatively under a Dollar-Offset Approach*
- *Purposes and Procedures Manual of the NAIC Securities Valuation Office—Part 13*

**RELEVANT ISSUE PAPERS**

- *Issue Paper No. 114—Accounting for Derivative Instruments and Hedging Activities*



**SSAP NO. 86 – EXHIBIT A****Discussion of Hedging Effectiveness**

The Financial Accounting Standards Board established the Derivatives Implementation Group in 1999 to address execution of FAS 133. The Derivatives Implementation Group addressed two issues related to effectiveness that are applicable to this statement. The issues have been authored by the FASB staff and represents the staff's views, although FASB has discussed the responses at a public meeting and chosen not to object to dissemination of those responses. Official positions of the FASB are determined only after extensive due process and deliberation.

**E7: Hedging—General: Methodologies to Assess Effectiveness of Fair Value and Cash Flow Hedges**

Paragraph references: 20(b), 22, 28(b), 62, 86, 87

Date cleared by FASB Board: May 17, 2000

QUESTION

1. Since Statement 133 provides an entity with flexibility in choosing the method it will use in assessing hedge effectiveness, must an entity use a dollar-offset approach in assessing effectiveness?

BACKGROUND

2. Paragraph 20(b) of Statement 133 states, in part:

Both at inception of the [fair value] hedge and on an ongoing basis, the hedging relationship is expected to be highly effective in achieving offsetting changes in fair value attributable to the hedged risk during the period that the hedge is designated. An assessment of effectiveness is required whenever financial statements or earnings are reported, and at least every three months.

3. Paragraph 28(b) indicates a similar requirement that the hedging relationship be expected to be highly effective in achieving offsetting changes in cash flows attributable to the hedged risk during the period that the hedge is designated.

4. Paragraph 22 of Statement 133 states, in part:

The measurement of hedge ineffectiveness for a particular hedging relationship shall be consistent with the entity's risk management strategy and the method of assessing hedge effectiveness that was documented at the inception of the hedging relationship, as discussed in paragraph 20(a).

5. Paragraph 62 emphasizes that each entity must "define at the time it designates a hedging relationship the method it will use to assess the hedge's effectiveness in achieving offsetting changes in fair value or offsetting cash flows attributable to the risk being hedged." It also states, "This Statement does not specify a single method for either assessing whether a hedge is expected to be highly effective or measuring hedge ineffectiveness."

RESPONSE

6. No. Statement 133 requires an entity to consider hedge effectiveness in two different ways—in prospective considerations and in retrospective evaluations.

a. Prospective considerations.

Upon designation of a hedging relationship (as well as on an ongoing basis), the entity must be able to justify an expectation that the relationship will be highly effective over future periods in achieving offsetting changes in fair value or cash flows. That expectation, which is forward-looking, can be based upon regression or other statistical analysis of past changes in fair values or cash flows as well as on other relevant information.

b. Retrospective evaluations.

At least quarterly, the hedging entity must determine whether the hedging relationship has been highly effective in having achieved offsetting changes in fair value or cash flows through the date of the periodic assessment. That assessment can be based upon regression or other statistical analysis of past changes in fair values or cash flows as well as on other relevant information. If an entity elects at the inception of a hedging relationship to utilize the same regression analysis approach for both prospective considerations and retrospective evaluations of assessing effectiveness, then during the term of that hedging relationship those regression analysis calculations should generally incorporate the same number of data points. Electing to utilize a regression or other statistical analysis approach instead of a dollar-offset approach to perform retrospective evaluations of assessing hedge effectiveness may affect whether an entity can apply hedge accounting for the current assessment period as discussed below.

7. Paragraph 62 requires that at the time an entity designates a hedging relationship, it must define and document the method it will use to assess the hedge's effectiveness. That paragraph also states that ordinarily "an entity should assess effectiveness for similar hedges in a similar manner; use of different methods for similar hedges should be justified." Furthermore, it requires that an entity use that defined and documented methodology consistently throughout the period of the hedge. If an entity elects at the inception of a hedging relationship to utilize a regression analysis approach for prospective considerations of assessing effectiveness and the dollar-offset method to perform retrospective evaluations of assessing effectiveness, then that entity must abide by the results of that methodology as long as that hedging relationship remains designated. Thus, in its retrospective evaluation, an entity might conclude that, under a dollar-offset approach, a designated hedging relationship does not qualify for hedge accounting for the period just ended, but that the hedging relationship may continue and hedge accounting may be applied without interruption because, under a regression analysis approach, there is an expectation that the relationship will be highly effective in achieving offsetting changes in fair value or cash flows in future periods. In its next period's retrospective evaluation, covering the entire period for which the hedge has been designated, if that entity concludes that, under a dollar-offset approach, the hedging relationship has not been highly effective in having achieved offsetting changes in fair value or cash flows, hedge accounting may not be applied.

8. If an entity elects at the inception of a hedging relationship to utilize a regression analysis (or other statistical analysis) approach for either prospective considerations or retrospective evaluations of assessing effectiveness, then that entity must periodically update its regression analysis (or other statistical analysis). For example, if there is significant ineffectiveness measured and recognized in earnings for a hedging relationship, which is calculated each assessment period, the regression analysis should be rerun to determine whether the expectation of high effectiveness is still valid. As long as an entity reruns its regression analysis and determines that the hedging relationship is still expected to be highly effective, then it can continue to apply hedge accounting without interruption.

9. The application of a regression or other statistical analysis approach to assessing effectiveness is complex. Those methodologies require appropriate interpretation and understanding of the statistical inferences.

**E8: Hedging—General: Assessing Hedge Effectiveness of Fair Value and Cash Flow Hedges Period-by-Period or Cumulatively under a Dollar-Offset Approach**

Paragraph references: 20(b), 28(b), 30, 62, 64, 67

Date cleared by FASB Board: June 28, 2000

**QUESTION**

1. In periodically assessing retrospectively the effectiveness of a fair value hedge (or a cash flow hedge) in having achieved offsetting changes in fair values (or cash flows), an entity compares the change in the hedging instrument's fair value (or cash flows) to the change in the hedged item's fair value (or hedged transaction's cash flows) attributable to the hedged risk. If an entity elects at inception of a hedging relationship to utilize the dollar-offset approach for retrospective evaluations of assessing effectiveness, then should that entity base that comparison on (a) the fair value (or cash flow) changes that have occurred during the period being assessed (that is, on a period-by-period basis) or (b) the cumulative fair value (or cash flow) changes to date from the inception of the hedge? Is that entity permitted to use either a period-by-period approach or a cumulative approach on individual fair value hedges (or cash flow hedges) under a dollar-offset approach?

**BACKGROUND**

2. Paragraph 20(b) of Statement 133 states, in part:

Both at inception of the [fair value] hedge and on an ongoing basis, the hedging relationship is expected to be highly effective in achieving offsetting changes in fair value attributable to the hedged risk during the period that the hedge is designated. An assessment of effectiveness is required whenever financial statements or earnings are reported, and at least every three months....All assessments of effectiveness shall be consistent with the risk management strategy documented for that particular hedging relationship.

3. Paragraph 28(b) states, in part:

Both at inception of the [cash flow] hedge and on an ongoing basis, the hedging relationship is expected to be highly effective in achieving offsetting cash flows attributable to the hedged risk during the term of the hedge, except as indicated in paragraph 28(d) below. An assessment of effectiveness is required whenever financial statements or earnings are reported, and at least every three months....All assessments of effectiveness shall be consistent with the originally documented risk management strategy for that particular hedging relationship.

4. Paragraph 30(b) specifies how effectiveness (on a derivative designated as a cash flow hedge) should be calculated. The calculation of effectiveness is, in part, based on "cumulative gain or loss on the derivative from inception of the hedge."

5. Paragraph 67 of the Statement states, in part:

If the hedge initially qualifies for hedge accounting, the entity would continue to assess whether the hedge meets the effectiveness test and also would measure any ineffectiveness during the hedge period. If the hedge fails the effectiveness test at any time (that is, if the entity does not expect the hedge to be highly effective at achieving offsetting changes in fair values or cash flows), the hedge ceases to qualify for hedge accounting.

RESPONSE

6. In periodically (that is, at least quarterly) assessing retrospectively the effectiveness of a fair value hedge (or a cash flow hedge) in having achieved offsetting changes in fair values (or cash flows) under a dollar-offset approach, Statement 133 permits an entity to use either a period-by-period approach or a cumulative approach on individual fair value hedges (or cash flow hedges). The period-by-period approach involves comparing the changes in the hedging instrument's fair values (or cash flows) that have occurred during the period being assessed to the changes in the hedged item's fair value (or hedged transaction's cash flows) attributable to the risk hedged that have occurred during the same period. The cumulative approach involves comparing the cumulative changes (to date from inception of the hedge) in the hedging instrument's fair values (or cash flows) to the cumulative changes in the hedged item's fair value (or hedged transaction's cash flows) attributable to the risk hedged. At inception of the hedge, an entity may choose either approach in designating how effectiveness will be assessed, depending on the nature of the hedge documented in accordance with paragraphs 20(a) and 28(a). For example, an entity may decide that the cumulative approach is generally preferred, yet may wish to use the period-by-period approach in certain circumstances.

7. Paragraph 62 requires that at the time an entity designates a hedging relationship, it must define and document the method it will use to assess the hedge's effectiveness. That paragraph also states that ordinarily "an entity should assess effectiveness for similar hedges in a similar manner; use of different methods for similar hedges should be justified." Furthermore, it requires that an entity use that defined and documented methodology consistently throughout the period of the hedge. If an entity elects at inception of a hedging relationship to base its comparison of changes in fair value (or cash flows) on a cumulative approach, then that entity must abide by the results of that methodology as long as that hedging relationship remains designated. Electing to utilize a period-by-period approach instead of a cumulative approach (or vice versa) to perform retrospective evaluations of assessing hedge effectiveness under the dollar-offset method may affect whether an entity can apply hedge accounting for the current assessment period.

8. If an entity elects to base its comparison of changes in fair value (or cash flows) on a period-by-period approach, the period cannot exceed three months. Fair value (or cash flow) patterns of the hedging instrument or the hedged item (or hedged transaction) in periods prior to the period being assessed are not relevant.

9. The foregoing guidance relates to an entity's periodic retrospective assessment and determining whether a hedging relationship continues to qualify for hedge accounting.

10. The above response has been authored by the FASB staff and represents the staff's views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.

**SSAP NO. 86 – EXHIBIT B****Assessment of Hedging Effectiveness**

The following is based on paragraphs 62-70 of FAS 133 to offer additional guidance on assessing hedging effectiveness. The intent of such is to remain consistent with FAS 133 with respect to assessing hedge effectiveness.

1. This statement requires that an entity define at the time it designates a hedging relationship the method it will use to assess the hedge's effectiveness in achieving offsetting changes in fair value or offsetting cash flows attributable to the risk being hedged. It also requires that an entity use that defined method consistently throughout the hedge period to assess at inception of the hedge and on an ongoing basis whether it expects the hedging relationship to be highly effective in achieving offset. If the entity identifies an improved method and wants to apply that method prospectively, it must discontinue the existing hedging relationship and designate the relationship anew using the improved method. Although this statement suggests a method for assessing whether a hedge is expected to be highly effective or measuring hedge ineffectiveness, the appropriateness of a given method of assessing hedge effectiveness can depend on the nature of the risk being hedged and the type of hedging instrument used. Ordinarily, however, an entity should assess effectiveness for similar hedges in a similar manner; use of different methods for similar hedges should be justified.
2. In defining how hedge effectiveness will be assessed, an entity must specify whether it will include in that assessment all of the gain or loss on a hedging instrument. As discussed in paragraph 33, this statement permits (but does not require) an entity to exclude all or a part of the hedging instrument's time value from the assessment of hedge effectiveness, as follows:
  - a. If the effectiveness of a hedge with an option contract is assessed based on changes in the option's intrinsic value, the change in the time value of the contract would be excluded from the assessment of hedge effectiveness.
  - b. If the effectiveness of a hedge with an option contract is assessed based on changes in the option's minimum value, that is, its intrinsic value plus the effect of discounting, the change in the volatility value of the contract would be excluded from the assessment of hedge effectiveness.
  - c. If the effectiveness of a hedge with a forward or futures contract is assessed based on changes in fair value attributable to changes in spot prices, the change in the fair value of the contract related to the changes in the difference between the spot price and the forward or futures price would be excluded from the assessment of hedge effectiveness.

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

3. In assessing the effectiveness of a cash flow hedge, an entity generally will need to consider the time value of money if significant in the circumstances. Considering the effect of the time value of money is especially important if the hedging instrument involves periodic cash settlements. An example of a situation in which an entity likely would reflect the time value of money is a tailing strategy with futures contracts. When using a tailing strategy, an entity adjusts the size or contract amount of futures contracts used in a hedge so that earnings (or expense) from reinvestment (or funding) of daily settlement

gains (or losses) on the futures do not distort the results of the hedge. To assess offset of expected cash flows when a tailing strategy has been used, an entity could reflect the time value of money, perhaps by comparing the present value of the hedged forecasted cash flow with the results of the hedging instrument.

4. Whether a hedging relationship qualifies as highly effective sometimes will be easy to assess. If the critical terms of the hedging instrument and of the entire hedged asset or liability (as opposed to selected cash flows) or hedged forecasted transaction are the same, the entity could conclude that changes in fair value or cash flows attributable to the risk being hedged are expected to completely offset at inception and on an ongoing basis. For example, an entity may assume that a hedge of a forecasted purchase of a commodity with a forward contract will be highly effective if:

- a. The forward contract is for purchase of the same quantity of the same commodity at the same time and location as the hedged forecasted purchase.
  - b. The fair value of the forward contract at inception is zero.
  - c. Either the change in the discount or premium on the forward contract is excluded from the assessment of effectiveness and included directly in unrealized gains and losses pursuant to paragraph 22B or the change in expected cash flows on the forecasted transaction is based on the forward price for the commodity.
5. However, assessing hedge effectiveness can be more complex. For example, hedge effectiveness would be reduced by the following circumstances, among others:

- a. A difference between the basis of the hedging instrument and the hedged item or hedged transaction (such as a Deutsche mark-based hedging instrument and Dutch guilder-based hedged item), to the extent that those bases do not move in tandem
- b. Differences in critical terms of the hedging instrument and hedged item or hedged transaction, such as differences in notional amounts, maturities, quantity, location, or delivery dates.

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

6. A hedge that meets the effectiveness test specified in paragraphs 19 b. and 20 b. (that is, both at inception and on an ongoing basis, the entity expects the hedge to be highly effective at achieving offsetting changes in fair values or cash flows) also must meet the other hedge accounting criteria to qualify for hedge accounting. If the hedge initially qualifies for hedge accounting, the entity would continue to assess whether the hedge meets the effectiveness test. If the hedge fails the effectiveness test at any time (that is, if the entity does not expect the hedge to be highly effective at achieving offsetting changes in fair values or cash flows), the hedge ceases to qualify for hedge accounting. The discussions of measuring hedge effectiveness in the examples in the remainder of this Exhibit assume that the hedge satisfied all of the criteria for hedge accounting at inception.

#### Assuming Effectiveness in a Hedge with an Interest Rate Swap

7. An entity may assume effectiveness in a hedging relationship of interest rate risk involving an interest-bearing asset or liability and an interest rate swap (or a compound hedging instrument composed of an interest rate swap and a mirror-image call or put option as discussed in paragraph 7(d) below) if all of the applicable conditions in the following list are met:

## Conditions applicable to both fair value hedges and cash flow hedges

- a. The notional amount of the swap matches the principal amount of the interest-bearing asset or liability being hedged.
- b. If the hedging instrument is solely an interest rate swap, the fair value of that swap at the inception of the hedging relationship is zero. If the hedging instrument is a compound derivative composed of an interest rate swap and mirror-image call or put option as discussed in paragraph 7(d), the premium for the mirror-image call or put option must be paid or received in the same manner as the premium on the call or put option embedded in the hedged item. That is, the reporting entity must determine whether the implicit premium for the purchased call or written put option embedded in the hedged item was principally paid at inception-acquisition (through an original issue discount or premium) or is being paid over the life of the hedged item (through an adjustment of the interest rate). If the implicit premium for the call or put option embedded in the hedged item was principally paid at inception-acquisition, the fair value of the hedging instrument at the inception of the hedging relationship must be equal to the fair value of the mirror-image call or put option. In contrast, if the implicit premium for the call or put option embedded in the hedged item is principally being paid over the life of the hedged item, fair value of the hedging instrument at the inception of the hedging relationship must be zero.
- c. The formula for computing net settlements under the interest rate swap is the same for each net settlement. (That is, the fixed rate is the same throughout the term, and the variable rate is based on the same index and includes the same constant adjustment or no adjustment.)
- d. The interest-bearing asset or liability is not prepayable (that is, able to be settled by either party prior to its scheduled maturity), except as indicated in the following sentences. This criterion does not apply to an interest-bearing asset or liability that is prepayable solely due to a call option provided that the hedging instrument is a compound derivative composed of an interest rate swap and a mirror-image call option. The call option is considered a mirror-image of the call option contained in the hedged item if (1) the terms of the two call options exactly match (see Statement 133 Implementation Issue No. E6: Hedging—General: The Shortcut Method and the Provisions That Permit the Debtor or Creditor to Require Prepayment) and (2) the entity is the writer of one call option and the holder (or purchaser) of the other call option. Similarly, this criterion does not apply to the interest-bearing asset or liability that is prepayable solely due to a put option provided that the hedging instrument is a compound derivative composed of an interest rate swap and a mirror-image put option.
- e. Any other terms in the interest-bearing financial instruments or interest rate swaps are typical of those instruments and do not invalidate the assumption of no ineffectiveness.

## Conditions applicable to fair value hedges only

- f. The expiration date of the swap matches the maturity date of the interest-bearing asset or liability.
- g. There is no floor or cap on the variable interest rate of the swap.
- h. The interval between repricings of the variable interest rate in the swap is frequent enough to justify an assumption that the variable payment or receipt is at a market rate (generally three to six months or less).

## Conditions applicable to cash flow hedges only

- i. All interest receipts or payments on the variable-rate asset or liability during the term of the swap are designated as hedged, and no interest payments beyond the term of the swap are designated as hedged.
  - j. There is no floor or cap on the variable interest rate of the swap unless the variable-rate asset or liability has a floor or cap. In that case, the swap must have a floor or cap on the variable interest rate that is comparable to the floor or cap on the variable-rate asset or liability. (For this purpose, comparable does not necessarily mean equal. For example, if a swap's variable rate is LIBOR and an asset's variable rate is LIBOR plus 2 percent, a 10 percent cap on the swap would be comparable to a 12 percent cap on the asset.)
  - k. The repricing dates match those of the variable-rate asset or liability.
  - l. The index on which the variable rate is based matches the index on which the asset or liability's variable rate is based.
8. The fixed rate on a hedged item need not exactly match the fixed rate on a swap designated as a fair value hedge. Nor does the variable rate on an interest-bearing asset or liability need to be the same as the variable rate on a swap designated as a cash flow hedge. A swap's fair value comes from its net settlements. The fixed and variable rates on a swap can be changed without affecting the net settlement if both are changed by the same amount. That is, a swap with a payment based on LIBOR and a receipt based on a fixed rate of 5 percent has the same net settlements and fair value as a swap with a payment based on LIBOR plus 1 percent and a receipt based on a fixed rate of 6 percent.
9. Comparable credit risk at inception is not a condition for assuming effectiveness even though actually achieving perfect offset would require that the same discount rate be used to determine the fair value of the swap and of the hedged item or hedged transaction. To justify using the same discount rate, the credit risk related to both parties to the swap as well as to the debtor on the hedged interest-bearing asset (in a fair value hedge) or the variable-rate asset on which the interest payments are hedged (in a cash flow hedge) would have to be the same. However, because that complication is caused by the interaction of interest rate risk and credit risk, which are not easily separable, comparable creditworthiness is not considered a necessary condition to assume effectiveness in a hedge of interest rate risk.



**SSAP NO. 86 – EXHIBIT C****Specific Hedge Accounting Procedures for Derivatives**

Synopsis: Derivatives may be designated as hedges of changes in the fair value or variability in expected cash flows of assets, liabilities, forecasted transactions or firm commitments due to one or more of the following risks: interest rate, security price, commodity price, foreign exchange rate, index of prices or rates or other variables (excluding risks of identifiable insurable events such as death, disability, accident, illness, damage to property or damage or injury to an insured or third party). Derivatives used in hedging transactions that meet the criteria of a highly effective hedge shall be considered an effective hedge and valued and reported in a manner that is consistent with the hedged asset or liability (referred to as hedge accounting). Under hedge accounting the valuation method used for the derivative shall be consistent with the valuation method used for the hedged item: e.g., amortized cost or fair value. Changes in the carrying value (i.e., amortization or fair value changes) 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 effects of hedge accounting are reflected in a manner that does not change the reporting of the item being hedged, consistent with the financial statement category that would normally be required under statutory accounting principles. Generally, if the change in the item being hedged is reported as a component of net gain from operations, the change in the derivative shall be reported in its appropriate component of net gain from operations. For example, a change in the aggregate reserve liabilities is reflected in its appropriate annual statement line change in aggregate reserves. A change in the related derivatives that are hedging that item is reflected through other income.

In the case where a portion of the item being hedged is reported as a component of net gain from operations, with the remainder reported as an other change to surplus, then the change in the hedging derivative is bifurcated; a portion is reported as a component of net gain from operations, in the appropriate category and included in the net gain from operations with the remainder reported as an other change to surplus.

For example, in the hedge of a foreign currency denominated asset the change in the value of the asset due to fluctuations in foreign exchange rates is recorded as unrealized capital gains or losses until the asset is sold. A derivative instrument that is in an effective hedging relationship of that item, shall have its change in value associated with fluctuations in foreign currency exchange rates bifurcated and recorded in unrealized capital gains and losses with the remaining change in value recorded consistent with the item being hedged (amortized cost or fair value).

A common purpose of entering into derivatives such as interest rate swaps and forwards as hedges is to change the interest rate characteristics of hedged items. Consistent with this purpose and the hedge accounting concept of matched accounting between the hedging and hedged item, hedged items may be viewed as bearing the changed interest rate characteristics and the cost of the derivatives may therefore be combined with the hedged items. All derivatives shall be reported on Schedule DB. When one or more derivatives hedge more than one asset, liability, forecasted transaction or firm commitment (or a portfolio of hedged items), a company may allocate the total derivative(s) to hedged items individually or in the aggregate. If derivatives are allocated to hedged items, indicate on Schedule DB the nature of the items hedged and the schedule or exhibit where they are presented.

An open derivative hedging a forecasted transaction or firm commitment shall be recorded at cost until the hedged transaction occurs. When the hedged forecasted transaction or firm commitment occurs, an open derivative shall be accounted for in a manner consistent with the hedged item (i.e., amortized cost or fair value).

Upon termination of a derivative that qualified for hedge accounting of an existing asset or liability or a forecasted transaction or firm commitment, the resulting gain or loss shall be recognized in income in a manner that is consistent with the hedged item. If the hedged item is recorded at amortized cost, the gain or loss shall adjust, individually or in the aggregate, the basis of the hedged item subject to amortization. Alternatively, if the item being hedged is subject to IMR, the gain or loss on the terminated hedging derivative may be realized and shall be subject to IMR upon termination. For terminated derivatives, indicate on Schedule DB, Section 2, Parts A and B the nature of the assets or liabilities so adjusted and the schedule or exhibit where they are presented.

Derivative instruments used in hedging transactions that (i) do not meet or no longer meet the criteria of an effective hedge or (ii) meet the required hedge criteria but the entity has chosen not to apply hedge accounting shall be accounted for at fair value and the changes in the fair value shall be recorded in surplus as unrealized gains or unrealized losses (referred to as fair value accounting). Hedge accounting may not be applied upon inception, redesignation or termination of a derivative designated in a hedging relationship if documentation is not maintained in accordance with SSAP No. 86 paragraphs 34-36.

Specific hedge accounting procedures for derivative instruments are outlined below.

1. Call and Put Options, Warrants, Caps, and Floors:
  - a. Accounting at Date of Acquisition (purchase) or Issuance (written): The premium paid or received for purchasing or writing a call option, put option, warrant, cap or floor shall either be (i) recorded as an asset (purchase) or liability (written) on the Derivative line on the Assets (or) Liabilities pages or (ii) combined with the hedged item(s) individually or in the aggregate;
  - b. Statement Value:
    - i. Open derivatives hedging items recorded at amortized cost:
      - (a) Options, warrants, caps, and floors purchased or written shall be valued at amortized cost in a manner consistent with the hedged item;
      - (b) The amortization period and methods used shall result in a constant effective yield over the life of the hedged item or program. (For floating rate hedged items, the estimated effective yield shall be based on the current rate so the changes in yields attributable to changes in interest rates will be recognized in the period of change). Specific treatment includes:
        - (1) Holdings in derivatives purchased or written within a year of maturity or expiry need not be amortized;
        - (2) For hedges of forecasted transactions or firm commitments, the derivative may be recorded at cost until the hedged transaction occurs or it is determined that the hedge was not effective (see (d) below in this section 1.b. i.);
        - (3) For other derivatives, the amortization period is usually from date of acquisition (issuance) of the derivative to maturity of the hedged item or program.
    - (c) For hedges where the cost of the derivative is combined with the hedged item, the statement value is zero. The fair value of the derivative and

hedged item shall be determined and reported separately, either individually or in the aggregate;

- (d) For hedges of forecasted transactions or firm commitments, the derivative shall be recorded at cost until (1) the hedged transaction occurs or (2) it is determined that the hedge was not effective (when the derivative is valued in accordance with (e) in this section below);
  - (e) If during the life of the derivative it or a designated portion of the derivative is no longer effective as a hedge, valuation at amortized cost ceases and the derivative or the designated portion of the derivative shall be valued at its current fair value with gains and losses recognized in unrealized gains or unrealized losses to the extent it ceased to be an effective hedge.
- ii. Open derivatives hedging items recorded at fair value (where gains and losses on the hedged item are recognized as adjustments to unassigned funds (surplus)):
- (a) Options, warrants, caps, or floors purchased or written shall be valued at current fair value with changes in fair value recognized currently consistent with the hedged item; this will result in unrealized gain/loss treatment with adjustment to unassigned funds (surplus).
  - (b) For hedges where the cost of the derivative is combined with the hedged item, the fair value of the derivative and hedged item will be determined and reported separately, either individually or in the aggregate. The cost (book value) basis used to figure unrealized gain/loss on the derivative on Schedule DB is zero.
  - (c) For hedges of forecasted transactions or firm commitments, the derivative shall be recorded at cost until the hedged transaction occurs or it is determined that the hedge was not effective (when fair value accounting is applied as described in the Introduction above).
- iii. Open derivatives hedging items recorded at fair value, where gains and losses on the hedged item are recognized currently in earnings: options, warrants, caps, or floors purchased or written shall be valued at current fair value with changes in fair value recognized currently in earnings together with the gains and losses on the hedged item.
- (a) For hedges of forecasted transactions or firm commitments, the derivative shall be recorded at cost until (1) the hedged transaction occurs or (2) it is determined that the hedge was not effective (when fair value accounting is applied as described in (b) of this section below).
  - (b) If during the life of the derivative it or a designated portion of the derivative is no longer effective as a hedge, recognition of changes in fair value through earnings ceases. The derivative or the designated portion of the derivative shall continue to be valued at its current fair value, but thereafter gains or losses shall be recognized in unrealized gains or unrealized losses to the extent it ceased to be an effective hedge.
- c. Cash Flows and Income
- i. Where the cost of the derivative is not combined with the hedged item:

- (a) Amortization of premium or discount on derivatives is an adjustment to net investment income or another appropriate caption within operating income consistent with the reporting of the hedged item;
      - (b) Periodic cash flows and accruals of income/expense shall be reported in a manner consistent with the hedged item, such as net investment income or interest and adjustments on policy or deposit-type contract funds (operating income) or net realized capital gains.
    - ii. Where the cost of the derivative is combined with the hedged item, the cash flows and income of the derivative on Schedule DB will be zero. All related amortization and cash flow accounting shall be reported with the hedged item instead of with the derivative.
  - d. Gain/Loss on Termination of an option, warrant, cap or floor accounted for under hedge accounting (includes closing, exercise, maturity, and expiry):
    - i. Exercise of an Option: The remaining book value of the derivative shall become an adjustment to the cost or proceeds of the hedged item(s) received or disposed of individually or in aggregate;
    - ii. Sale, maturity, expiry, or other closing transaction of a derivative which is an effective hedge—Any gain or loss on the transaction will adjust the basis (or proceeds) of the hedged item(s) individually or in aggregate. Alternatively, if the item being hedged is subject to IMR, the gain or loss on the terminated hedging derivative may be realized and shall be subject to IMR upon termination;
    - iii. Gain/loss on termination of derivatives will be recognized currently in net income (realized gain/loss) to the extent they ceased to be effective hedges.
    - iv. Upon the redesignation of a derivative from a currently effective hedging relationship-
      - (a) with an item(s) carried at amortized cost to another effective hedging relationship with an item(s) carried at amortized cost, the derivative shall continue to be recorded at amortized cost and no gain or loss on the derivative shall be recognized.
      - (b) with an item(s) carried at amortized cost or fair value to an effective relationship with an item(s) carried at fair value, the accounting for the derivative shall be consistent with (ii) above.
      - (c) with an item(s) carried at fair value to an effective relationship with an item(s) carried at amortized cost, the accounting for the derivative shall be consistent with (ii) above.
2. Swaps, Collars, and Forwards (see also discussion in Introduction above):
- a. Accounting at Date of Opening Position:
    - i. Any premium paid or received at date of opening shall either be (a) recorded on the Derivative line on the Assets (or) Liabilities pages or (b) combined with the hedged item(s), individually or in the aggregate;
  - b. Statement Value:

- i. Open derivatives hedging items recorded at amortized cost:
  - (a) Swaps, collars, and forwards shall be valued at amortized cost in a manner consistent with hedged item;
  - (b) The amortization period and methods used shall result in a constant effective yield over the life of the hedged item or program. (For floating rate hedged items the estimated effective yield shall be based on the current rate so the changes in yields attributable to changes in interest rates will be recognized in the period of change.) Specific treatment includes:
    - (1) Holdings in derivatives purchased or written within a year of maturity or expiry need not be amortized;
    - (2) For hedges of forecasted transactions or firm commitments, the derivative shall be recorded at cost until (a) the hedged transaction occurs or (b) it is determined that the hedge was not effective (see (5) in this section 2. (b)(i) below);
    - (3) For other derivatives the amortization period is usually from date of acquisition (issuance) of the derivative to maturity of the hedged item or program;
    - (4) For hedges where the cost of the derivative is combined with the hedged item, the statement value is zero. The fair value of the derivative and hedged item shall be determined and reported separately, either individually or in the aggregate;
    - (5) If during the life of the derivative it or a designated portion of the derivative is no longer effective as a hedge, valuation at amortized cost ceases and the derivative or a designated portion of the derivative shall be valued at its current fair value with gains and losses recorded in unrealized gains or unrealized losses to the extent that it ceased to be an effective hedge. Upon redesignation into an effective hedging relationship, the derivative's mark to fair value through unrealized gain or loss shall be reversed.
- ii. Open derivatives hedging items recorded at fair value (where gains and losses on the hedged item are recognized as adjustments to unassigned funds (surplus)):
  - (a) Swaps, collars, or forwards shall be valued at current fair value with changes in fair value recognized currently consistent with the hedged item; this will result in unrealized gain/loss treatment with adjustment to unassigned funds (surplus);
  - (b) For hedges where the derivative is combined with the hedged item, the fair value of the derivative and hedge item shall be determined and reported separately, either individually or in the aggregate. The cost (book value) basis used to figure gain/loss on the derivative is zero.

- iii. Open foreign currency swap and forward contracts hedging foreign currency exposure on items denominated in a foreign currency and translated into U.S. dollars where fair value accounting is not being used:
- (a) The foreign exchange premium (discount) on the currency contract shall be amortized into income over the life of the contract or hedge program. The foreign exchange premium (discount) is defined as the foreign currency (notional) amount to be received (paid) times the net of the forward rate minus the spot rate at the time the contract was opened.  
  
Amortization is not required if the contract was entered into within a year of maturity;
  - (b) A foreign currency translation adjustment shall be reflected as an unrealized gain/loss (unassigned funds (surplus) adjustment) using the same procedures as done to translate the hedged item;
  - (c) The unrealized gain/loss for the period equals the foreign currency (notional) amount to be received (paid) times the net of the current spot rate minus the prior period end spot rate;
  - (d) The statement value of the derivative equals the amortized (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 derivatives hedging forecasted transactions or firm commitments shall be deferred until the hedged transaction occurs. These deferred gains/losses will adjust the basis or proceeds of the hedged transaction when it occurs;
  - (f) For hedges where the cost of the foreign currency contract is combined with the hedged item, the statement value on Schedule DB is zero. The fair value of the derivative and hedged item shall be determined and reported separately, either individually or in the aggregate;
  - (g) If during the life of the currency contract it or a designated portion of the currency contract is not effective as a hedge, valuation at amortized cost shall cease. To the extent it ceased to be an effective hedge, a cumulative unrealized gain/loss (surplus adjustment) will be recognized equal to the notional amount or designated 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.
- iv. Open derivatives hedging items recorded at fair value, where gains and losses on the hedged item are recognized currently in earnings: swaps, collars and forwards shall be valued at current fair value with changes in fair value recognized currently in earnings together with the gains and losses on the hedged item.
- (a) If during the life of the derivative it or a designated portion of the derivative is no longer effective as a hedge, recognition of changes in fair

value through earnings ceases. The derivative shall continue to be valued at its current fair value, but thereafter gains or losses shall be recognized in unrealized gains or unrealized losses to the extent it ceased to be an effective hedge.

- c. Cash Flows and Income:
  - i. Where the cost of the derivative is not combined with the hedged item:
    - (a) Amortization of premium paid or received on derivatives is an adjustment to net investment income or another appropriate caption within operating income consistent with the reporting of the hedged item;
    - (b) Periodic cash flows and accruals of income/expense are to be reported in a manner consistent with the hedged item, usually as net investment income or another appropriate caption within operating income.
  - ii. Where the cost of the derivative is combined with the hedged item, the cash flows and income of the derivative on Schedule DB is zero. All related amortization and cash flow accounting shall be reported with the hedged item instead of with the derivative.
- d. Gain/Loss on Termination of a swap, collar or forward accounted for under hedge accounting (includes closing, exercise, maturity, and expiry):
  - i. Exercise—The remaining book value of the derivative shall become an adjustment to the cost or proceeds of the hedged item(s) received or disposed of individually or in aggregate;
  - ii. Sale, maturity, expiry, or other closing transaction of a derivative which is an effective hedge—Any gain or loss on the transaction will adjust the basis (or proceeds) of the hedged item(s) individually or in aggregate. Alternatively, if the item being hedged is subject to IMR, the gain or loss on the terminated hedging derivative may be realized and shall be subject to IMR upon termination;
  - iii. Gain/loss on termination of derivatives will be recognized currently in net income (realized gain/loss) to the extent they ceased to be effective hedges.
  - iv. Upon the redesignation of a derivative from a currently effective hedging relationship-
    - (a) with an item(s) carried at amortized cost to another effective hedging relationship with an item(s) carried at amortized cost, the derivative shall continue to be recorded at amortized cost and no gain or loss on the derivative shall be recognized.
    - (b) with an item(s) carried at amortized cost or fair value to an effective relationship with an item(s) carried at fair value, the accounting for the derivative shall be consistent with (ii) above.
    - (c) with an item(s) carried at fair value to an effective relationship with an item(s) carried at amortized cost, the accounting for the derivative shall be consistent with (ii) above.

3. Futures (see also discussion in Introduction above):

- a. Accounting at Date of Acquisition:
- i. Positions in futures contracts shall be initially valued at the amount of cash deposits (i.e., basis or book value of the contract), if any, placed with a broker and either be (a) recorded as an asset (paid) or liability (received) on the Derivative line on the Assets (or) Liabilities pages or (b) combined with the hedged item. 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 (hedge accounting).
- 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 variation margin portion of the cost of the futures contract is combined with the hedged item, the statement value of the futures contract would be equal to cash deposits outstanding, if any. The fair value of the futures contract and the hedged item will be determined and reported separately, either individually or in the aggregate. Fair value on futures contracts is limited to the value of the cash deposits outstanding;
- (d) For hedges of forecasted transactions or firm commitments, the derivative shall be recorded at cost (with the variation margin deferred) until (1) the hedged transaction occurs or (2) it is determined that the hedge was not effective (see (e) in this section below);
- (e) If during the life of the futures contract it or a designated portion of the futures contract is no longer effective as a hedge, hedge accounting for the variation margin ceases. A gain/(loss) equal to the variation margin received (paid) shall be recognized in unrealized gains or unrealized losses (surplus adjustment) to the extent it or a designated portion of the variation margin ceased to be an effective hedge. Statement value will be limited to the cash deposits outstanding, if any, and subsequent changes in the variation margin will be recognized in unrealized gains or unrealized losses (surplus adjustment).
- ii. Hedges of Items Recorded at Fair Value (where gains and losses on the hedged item are recognized as adjustments to unassigned funds (surplus)):
- (a) Changes in futures 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, if any;
- (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 fair value of the futures contract and



the hedged item will be determined and reported separately, either individually or in the aggregate.

- 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 fair value accounting is not being used):
- (a) The foreign exchange premium (discount) on the currency contract will be amortized into net investment income over the life of the contract or hedge program. The foreign exchange premium (discount) is defined as the foreign currency (notional) amount to be received (paid) times the net of the forward rate minus the spot rate at the time the contract was opened.  
  
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;
  - (c) The statement value of the currency futures contract is book value, including any cash deposits outstanding and increase (decrease) for amortization of foreign exchange (premium) discount plus the foreign exchange translation gain/(loss), which is reported as deferred variation margin;
  - (d) Recognition of unrealized gains/losses and amortization of foreign exchange premium/discount on derivatives hedging forecasted transactions or firm commitments shall be deferred until the hedged transaction occurs. These deferred gains/losses will adjust the basis or proceeds of the hedged transaction when it occurs;
  - (e) For hedges where the variation margin of the foreign currency contract is combined with the hedged item, the statement value of the foreign currency contract would equal the cash deposits outstanding, if any. The fair value of the derivative and the hedged item will be determined and reported separately, either individually or in the aggregate. Fair value on futures contracts is limited to the value of the cash deposits outstanding;
  - (f) If during the life of the currency contract it or a designated portion of the currency contract is not effective as a hedge, valuation at amortized cost ceases. To the extent it ceases to be an effective hedge, an unrealized gain/loss will be recognized equal to the notional amount or a designated portion of 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.

- iv. Open futures hedging items recorded at fair value, where gains and losses on the hedging item are recognized currently in earnings shall be valued at current fair value with changes in fair value recognized currently in earnings.
  - (a) If during the life of the futures contract it or a designated portion of the futures contract is no longer effective as a hedge, current recognition in earnings of changes in fair value ceases. Prospective changes in the variation margin shall be recognized in unrealized gains or unrealized losses (surplus adjustment) to the extent it or a designated portion of the variation margin ceased to be an effective hedge. Statement value of the derivative will thereafter be limited to the cash deposits outstanding, if any.
- c. Gain/Loss on Termination of a futures contract accounted for under hedge accounting:
  - i. Settlement at maturity of a futures contract—The remaining variation margin of the futures contract shall become an adjustment to the cost or proceeds of the hedged item(s) received, disposed of or held, individually or in aggregate;
  - ii. Sale, or other closing transaction of a futures contract 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. Alternatively, if the item being hedged is subject to IMR, the gain or loss on the terminated hedging derivative may be realized and shall be subject to IMR upon termination;
  - iii. Gain/loss on termination of futures contracts will be recognized currently in net income (realized gain/loss) to the extent they ceased to be effective hedges.
  - iv. Upon the redesignation of a derivative from a currently effective hedging relationship-
    - (a) with an item(s) carried at amortized cost to another effective hedging relationship with an item(s) carried at amortized cost, the derivative shall continue to be recorded at amortized cost and no gain or loss on the derivative shall be recognized.
    - (b) with an item(s) carried at amortized cost or fair value to an effective relationship with an item(s) carried at fair value, the accounting for the derivative shall be consistent with (ii) above.
    - (c) with an item(s) carried at fair value to an effective relationship with an item(s) carried at amortized cost, the accounting for the derivative shall be consistent with (ii) above.

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