

Statement of Statutory Accounting Principles No. 31

Derivative Instruments

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Derivative Instruments

SCOPE OF STATEMENT

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

SUMMARY CONCLUSION

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

Swaps

3. Swaps are contracts to exchange, for a period of time, the investment performance of one underlying instrument for the investment performance of another underlying instrument, typically without exchanging the instruments themselves. Swaps can be viewed as a series of forward contracts that settle in cash rather than by physical delivery. Swaps generally are negotiated over-the-counter directly between the dealer and the end user. Interest rate swaps are the most common form of swap contract. However, foreign currency and commodity swaps also are common.

4. An interest rate swap is a contractual agreement between two parties to exchange interest rate payments (usually fixed for variable) based on a specified amount of underlying assets or liabilities (known as the notional amount) for a specified period. The swap does not involve an exchange of principal. The result of these transactions is to transform payments from a variable rate to a fixed rate, from a fixed rate to a variable rate or from one variable rate index to another variable rate index.

5. Interest rate swaps have historically been entered into for the purpose of lowering borrowing costs, obtaining otherwise unavailable financing terms, and/or improving asset and liability management through a reduction of an entity's exposure to interest rate risk. Banks and brokers will enter into an interest rate swap with an interested party before a swap partner is found, creating a swap portfolio. This activity allows the entity that desires a swap transaction immediate access to the market. This secondary market also allows a swap participant a vehicle to unwind or reverse swap positions it no longer wants or to receive cash if the position to be disposed of is favorable in relation to the current market.

6. While swaps may involve the trading of interest on liabilities or assets, the insurance industry has used swaps to match return on assets to contract obligations. Insurers also have acted as an intermediary or broker in the process of arranging a swap. Swaps may involve long periods of time and significant amounts of interest on substantial notional amounts. Unmatched or naked swaps are sometimes written where no underlying asset or liability exists.

7. The risk to the parties of a swap agreement is reduced by the fact that no transfer of principal is involved. The cash exchanged between the parties is usually the net interest differential only.

Options

8. 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.

Forwards

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

Futures

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

Caps

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

Floors

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

Collars

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

14. To the extent a derivative is in an asset position, the instrument meets the definition of an asset as defined in *SSAP No. 4—Assets and Nonadmitted Assets* (SSAP No. 4) and is an admitted asset to the extent it conforms to the requirements of this statement. To the extent a derivative is in a liability position, the instrument meets the definition of a liability as defined in *SSAP No. 5—Liabilities, Contingencies and Impairments of Assets* (SSAP No. 5).

Hedge Accounting

General

15. A hedging transaction is defined as a derivative transaction which is entered into and maintained to reduce:

- a. The risk of a change in the value, yield, price, cash flow, or quantity of assets or liabilities which the reporting entity has acquired or incurred or anticipates acquiring or incurring, or;
- b. The currency exchange rate risk or the degree of exposure as to assets or liabilities which a reporting entity has acquired or incurred or anticipates acquiring or incurring.

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

Criteria to Qualify for Hedge Accounting

17. To qualify for hedge accounting, the derivative shall be designated as a hedge of a specific asset, liability, or anticipated transaction. The specific asset, liability, or anticipated transaction to be hedged must expose the reporting entity to a risk and the designated derivative transaction must reduce that exposure. Examples of items that expose the reporting entity to risk include change in the value, yield, price, cash flow, or quantity of, or degree of exposure with respect to assets, liabilities, or future cash flows which a reporting entity has acquired or incurred, or anticipates acquiring or incurring.

18. To satisfy the condition of risk reduction, the reporting entity shall demonstrate how the derivative reduces risk by using an appropriate method. There are a variety of methods available that can be used to demonstrate risk reduction, including methods which analyze the correlation of gains and losses on the derivative in relation to the losses and gains on the hedged asset, liability, or future cash flow.

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

Gain or Loss Upon Termination

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

Settlement Accounting for Swaps

21. Included in the concept of hedge accounting is the notion of settlement accounting for interest rate swaps that are matched through designation with an asset or a liability on the balance sheet. Under settlement accounting, periodic net cash settlements under the swap agreement are recognized in income when they accrue.

Mark to Market Accounting

22. Under the immediate recognition method of accounting, (i.e. mark to market) changes in fair value from one reporting period to another reporting period shall be recognized currently in earnings. The immediate recognition method of accounting (mark to market) shall be applied in situations where:

- a. A reporting entity enters into a derivative for other-than-hedging purposes;
- b. A portfolio has been hedged and the reporting entity is unable to assign the hedging instrument to specific assets and liabilities;
- c. There are derivatives that are not specifically addressed elsewhere in this guidance.

23. Other-than-hedging is defined as any transaction which does not qualify for hedge accounting, including active derivatives trading by a reporting entity who enters into derivatives for purposes of generating profits on short-term differences in market movements and not for risk reduction purposes. Unrealized gains and losses cannot be deferred when categorized as other-than-hedging.

24. Generally, mark to market accounting is used where it is impractical to allocate gains and losses to specific hedged assets, liabilities, or future cash flows. However, mark to market accounting is not precluded from being utilized in situations where the derivative qualifies for hedge accounting.

Consistent Application of Alternatives

25. The determination of hedge accounting or immediate recognition accounting shall be made for each individual instrument. A reporting entity may utilize immediate recognition accounting for certain derivatives within a category and hedge accounting for other derivatives within that same category. The reporting entity's choice between hedge accounting and mark to market accounting shall be applied consistently for each individual instrument over the life of the derivative. A change in method shall be justified by a significant change in circumstance.

Specific Accounting Procedures for Derivatives

26. Call and Put Options, Caps, and Floors shall be accounted for as follows:

- a. Accounting at Date of Acquisition (purchase) or Issuance (written): The premium paid or received for purchasing or writing a call option, put option, cap or floor shall be recorded as an asset (purchase) or liability (written) as an Aggregate Write-in for Invested Asset (or) Liability;
- b. Statement Value:
 - i. Open derivatives hedging items recorded at amortized cost:
 - (a) Options, 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 securities, 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 anticipatory hedges, the derivative may be recorded at cost until the anticipated hedged transaction occurs or it is determined that the hedge was not effective;
 - (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 market value of the hedging and hedged items shall be determined and reported separately;
 - (d) If during the life of the derivative it is no longer effective as a hedge, valuation at amortized cost ceases and the derivative shall be valued at its current market value (marked to market) with gains and losses recognized in earnings to the extent they ceased to be effective hedges.
 - ii. Open derivatives hedging items recorded at market value, (where gains and losses on the hedging item are recognized as adjustments to unassigned funds (surplus)):
 - (a) Options, caps, or floors purchased or written shall be valued at current market value (marked to market) with changes in market value recognized currently consistent with the hedged item;
 - (b) This will result in unrealized gain/loss treatment with adjustment to unassigned funds (surplus);
 - (c) For hedges where the cost of the derivative is combined with the hedged item, the market value of the hedging and hedged items will be determined and reported separately. The cost (book value) basis used to figure gain/loss on the derivative is zero.
 - iii. Open derivatives hedging items recorded at market value, where gains and losses on the hedging item are recognized currently in earnings and for open derivatives accounted for under the immediate recognition method, options, caps, or floors purchased or written shall be valued at current market value (marked to market) with changes in market value recognized currently in earnings.
- 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 (operating) income;
 - (b) Periodic cash flows and accruals of income/expense shall be reported in a manner consistent with the hedged item, usually as other investment income (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 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, 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;
 - 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.
27. Swaps, Collars, and Forwards shall be accounted for as follows:
- a. Accounting at Date of Opening Position:
 - i. Any premium paid or received at date of opening shall be recorded as an asset (paid) or liability (received) as an Aggregate Write-in for Invested Asset (or) Liability;
 - 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 securities 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 anticipatory hedges, the derivative may be recorded at cost until the anticipated hedged transaction occurs or it is determined that the hedge was not effective;
 - (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 market value of the hedging and hedged items shall be determined and reported separately;
 - (5) If during the life of the derivative it is no longer effective as a hedge, valuation at amortized cost ceases and the derivative shall be valued at its current market value (marked to market) with

gains and losses recognized in earnings to the extent that it ceased to be an effective hedge.

- ii. Open derivatives hedging items recorded at market value (where gains and losses on the hedging item are recognized as adjustments to unassigned funds (surplus)):
 - (a) Swaps, collars, or forwards shall be valued at current market value (marked to market) with changes in market value recognized currently consistent with the hedged item;
 - (b) This will result in unrealized gain/loss treatment with adjustment to unassigned funds (surplus);
 - (c) For hedges where the derivative is combined with the hedged item, the market value of the hedging and hedged items shall be determined and reported separately. The cost (book value) basis used to figure gain/loss on the derivative is zero.
- iii. Open foreign currency swap and forward contracts hedging foreign currency exposure on items denominated in a foreign currency and translated into U.S. dollars where the immediate recognition method of accounting is not being used:
 - (a) The foreign exchange premium (discount) on the currency contract shall be amortized into income over the life of the contract. The foreign exchange premium (discount) is defined as the foreign currency (notional) amount to be received (paid) times the net of the forward rate minus the spot rate at the time the contract was opened.

Amortization is not required if the contract was entered into within a year of maturity;
 - (b) A foreign currency translation adjustment shall be reflected as an unrealized gain/loss (unassigned funds (surplus) adjustment) using the same procedures as done to translate the hedged item;
 - (c) The unrealized gain/loss for the period equals the foreign currency (notional) amount to be received (paid) times the net of the current spot rate minus the prior period end spot rate;
 - (d) The statement value of the currency contract equals the amortized (premium) discount plus the cumulative unrealized gain/(loss) on the contract. The cumulative unrealized gain/(loss) equals the foreign currency (notional) amount to be received (paid) times the net of the current spot rate minus the spot rate at the time the contract was opened;
 - (e) Recognition of unrealized gains/losses and amortization of foreign exchange premium/discount on anticipated firm commitments may be deferred until the hedged transaction occurs. These deferred gains/losses will adjust the basis or proceeds of the hedged transaction when it occurs;

- (f) For hedges where the cost of the foreign currency contract is combined with the hedged item, the statement value is zero. The market value of the hedging and hedged items is determined and reported separately;
 - (g) If during the life of the currency contract it 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 will be recognized in earnings equal to the notional amount times the difference between the forward rate available for the remaining maturity of the contract (i.e., the forward rate as of the balance sheet date) and the forward rate at the time it ceased to be an effective hedge.
- iv. Open derivatives hedging items recorded at market value, where gains and losses on the hedging item are recognized currently in earnings and for open derivatives accounted for under the immediate recognition method, swaps, collars and forwards shall be valued at current market value (marked to market) with changes in market value recognized currently in earnings.
- 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 (operating) income;
 - (b) Periodic cash flows and accruals of income/expense are to be reported in a manner consistent with the hedged item, usually as other investment income (operating income).
 - 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;
 - 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;
28. Futures shall be accounted for as follows:
- 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.

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

- b. Statement Value:
 - i. Hedges of Items Recorded at Amortized Cost:
 - (a) Futures shall be valued at book value;
 - (b) Book value of open futures contracts need not be amortized;
 - (c) For hedges where the cost of the futures contract is combined with the hedged item, the statement value would be equal to cash deposits outstanding. The market value of the hedging and hedged items will be determined and reported separately. Market value on futures contracts is limited to the value of the cash deposits outstanding;
 - (d) If during the life of the futures contract it is no longer effective as a hedge, valuation at book value (deferral accounting) ceases. A gain/(loss) equal to the variation margin received (paid) shall be recognized in earnings to the extent it ceased to be an effective hedge. Statement value will be limited to the cash deposits outstanding.
 - ii. Hedges of Items Recorded at Market Value (where gains and losses on the hedging item are recognized as adjustments to unassigned funds (surplus)):
 - (a) Changes in contract value from date of contract opening (i.e., variation margin) shall be recognized currently consistent with the hedged item. Statement value will be limited to the cash deposits outstanding;
 - (b) This will result in unrealized gain/loss treatment with adjustment to unassigned funds (surplus);
 - (c) For hedges where the variation margin of the futures contract is combined with the hedged item, the market value of the hedging and hedged items will be determined and reported separately.
 - iii. Open foreign currency futures contracts hedging foreign currency exposure on item(s) denominated in a foreign currency and translated into U.S. dollars (where the immediate recognition method of accounting is not being used):
 - (a) The foreign exchange premium (discount) on the currency contract will be amortized into investment income over the life of the contract. The foreign exchange premium (discount) is defined as the foreign currency (notional) amount to be received (paid) times the net of the forward rate minus the spot rate at the time the contract was opened. The cumulative income recognized since the contract was opened shall be reported as recognized variation margin received or (paid).

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

- (b) A foreign currency translation adjustment shall be reflected as an unrealized gain/loss (unassigned funds (surplus) adjustment) using the same procedures as is done to translate the hedged item. The cumulative unrealized gain/(loss) which equals the foreign currency (notional) amount to be received (paid) times the net of the current spot rate minus the spot rate at the time the contract was opened shall be reported as recognized variation margin received or (paid);
 - (c) The statement value of the currency futures contract is book value, including any 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 anticipated firm commitments may be deferred until the hedged transaction occurs. These deferred gains/losses will adjust the basis or proceeds of the hedged transaction when it occurs;
 - (e) For hedges where the variation margin of the foreign currency contract is combined with the hedged item, the statement value would equal the cash deposits outstanding. The market value of the hedging and hedged items will be determined and reported separately. Market value on futures contracts is limited to the value of the cash deposits outstanding;
 - (f) If during the life of the currency contract it is not effective as a hedge, valuation at amortized cost ceases. To the extent it ceased to be an effective hedge, a cumulative unrealized gain/loss will be recognized in earnings equal to the notional amount times the difference between the forward rate available for the remaining maturity of the contract (i.e., the forward rate as of the balance sheet date) and the forward rate at the time it ceased to be an effective hedge.
- iv. Open derivatives hedging items recorded at market value, where gains and losses on the hedging item are recognized currently in earnings and for open derivatives accounted for under the immediate recognition method, futures shall be valued at current market value (marked to market) with changes in market value recognized currently in earnings.
- 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;
 - 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;

Income Generation Transactions

General

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

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

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

32. The principal features of income generation transactions are:

- a. Premium received is initially recorded as a deferred liability;
- b. The accounting of the covering asset or underlying interest controls the accounting of the derivative. The covering asset/underlying interest is accounted at either mark-to-market (e.g., common stocks) or (amortized) cost (e.g., bonds);
- c. The gain/loss on termination of the derivative is a capital item. For life insurance companies, it shall be subject to IMR treatment if interest rate related;
- d. For options which are exercised, the remaining premium shall adjust the proceeds (cost) associated with the exercise resulting in no explicit gain or loss reported for the derivative itself.

Written Fixed Income Covered Call Options

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

- a. The general approach is to value at cost (i.e., consideration received) without amortization over the life of the contract;
- b. An alternative to the general approach combines the accounting of the written option with the covering asset and then uses standard accounting for callable bonds (yield to worst amortization) on the adjusted asset. This method prevents the possibility of future loss recognition upon exercise while at the same time providing recognition of the income feature 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. 5. 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.

34. 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 MARKET VALUE
Open	Record premium as deferred liability. Carry at consideration received. (1) Alternatively, attach premium to covering asset and amortize (under yield to worse scenario) using standard callable bond accounting. (2)	Record premium as deferred liability. Mark to market with changes in market 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. (3)	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. (3)	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. (3)	Recognize net amount as realized capital gain/loss.

Notes

1. Reporting entities writing options for income generation purposes are responsible for the timely recognition of any probable losses that may occur as a result of the strategy due to holding and accounting for options on Schedule DB—Part B.
2. Report derivative and its market value on Schedule DB—Part B. Include accounting on Schedule D—Part 1.

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

Written Covered Put Options

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

STATUS OF OPTION	UNDERLYING INTEREST VALUED AT AMORTIZED COST	UNDERLYING INTEREST VALUED AT MARKET VALUE
Open	Record premium as deferred liability. Carry at consideration received. (1)	Record premium as deferred liability. Mark to market with changes in market value recorded as unrealized adjustments to 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.

Notes

1. Reporting entities writing options for income generation purposes are responsible for the timely recognition of any probable losses that may occur as a result of the strategy due to holding and accounting for options on Schedule DB—Part B.

Written Fixed Income Caps And Floors

37. 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.

38. 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 MARKET VALUE
Open	Record premium as deferred liability. Carry at amortized value. (Alternatively carry at consideration received if within 1 year of maturity.) Amortize over life of contract to produce constant yield. Record any interest expense as “Other Investment Income” – negative value.	Record premium as deferred liability. Mark to market with changes in market value recorded as unrealized adjustments to unassigned funds (surplus) – gain/loss.
Closed – Matured	Would usually mature at zero amortized value. Any remaining unamortized value recognized as ordinary income through a final amortization adjustment.	Premium received recognized as realized capital gain.
Closed – Exercised	Not applicable.	Not applicable.
Closed – Terminated	Recognize net amount as realized capital gain/loss. Gain/loss on termination to flow through IMR, if applicable.	Recognize net amount as realized capital gain/loss.

39. Examples of accounting and presentation based on varying assumptions can be found in the October 1, 1996 minutes of the Accounting Practices and Procedures (EX4) Task Force.

Insurance Futures and Insurance Futures Options

General

40. Accounting for futures or options is similar to that of insurance futures or insurance futures options accounting. However, for purposes of this statement, insurance futures are viewed as insurance-related transactions and not as investment-related transactions. This distinction results in different reporting for the results of insurance futures and insurance futures options. As a result separate guidance is provided for insurance futures and insurance futures options.

41. Insurers generally use insurance futures or insurance futures options, to hedge against adverse development in incurred losses. This strategy typically would involve any or a combination of:

- a. The purchase of insurance futures contracts;
- b. The purchase of a call option on insurance futures contracts;
- c. The sale (writing) of a put option on insurance futures contracts.

Insurance Futures Contracts

42. An insurance futures contract is a futures contract based on an underlying index of performance of insurance contracts (policies) or factors relating thereto. In connection with a given insurance futures position, a reporting entity is required by the listing exchange to maintain a margin deposit with respect to the underlying insurance futures contracts purchased.

43. A reporting entity shall report the amount of any margin deposit as an asset. The specific accounting treatment of increases or decreases in the value of the subject contracts will depend on whether the insurance futures position constitutes a hedge of the reporting entity's incurred losses. The determination of whether an insurance futures position constitutes a hedge shall be made consistent with the criteria identified in paragraphs 17-19.

Insurance Futures Contracts—Hedge Accounting

44. Increases (decreases) in the value of insurance futures contracts that effectively hedge incurred losses shall be reported as an increase (decrease) in other income when the insurance futures position corresponds to incurred losses for the current reporting period. With respect to any insurance futures position which corresponds to a period beyond the current reporting period, any increases (decreases) in the value of the underlying insurance futures contracts shall be reported as a direct increase (decrease) in unassigned funds (surplus). When the insurance futures position thereafter corresponds to a current reporting period, the initial increase (decrease) in direct unassigned funds (surplus) shall be reversed and the amount shall be reported as an increase (decrease) to other income for the current period, along with any current changes in value of the insurance futures contracts.

45. In either of the foregoing instances, the increase (decrease) in the market value of the insurance futures contracts shall either (a) increase (decrease) other-than-invested assets, to the extent that such increase (decrease) affects the corresponding margin deposit, or (b) increase (decrease) cash or other assets, to the extent of mark-to-market payments that are not maintained as a margin deposit. When the insurance futures position is closed, any corresponding margin balance shall be transferred to cash or other assets, as appropriate.

Insurance Futures Contracts—Other-Than-Hedge Accounting

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

Options on Insurance Futures Contracts

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

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

Options on Insurance Futures Contracts—Hedge Accounting

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

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

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

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

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

Documentation Guidance

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

54. For derivatives opened during the year:

- a. A description, for each instrument, of the purpose of the transaction, including:
 - i. A brief description of the assets and/or liabilities hedged by the instrument;
 - ii. A brief description of the manner in which the instrument reduces risk;
 - iii. A reference to the reporting entity's hedge program under which such transaction is internally authorized.
- b. Signature of approval, for each instrument, by person(s) authorized, either by the entity's board of directors or a committee authorized by the board, to approve such transactions;
- c. A description, for each instrument, of the nature of the transaction, including:
 - i. The date of the transaction;
 - ii. A complete and accurate description of the specific derivative, including description of the underlying securities, currencies, rates, indices, commodities, derivatives, or other financial market instruments;
 - iii. Number of contracts or notional amount;
 - iv. Date of maturity, expiry or settlement;
 - v. Strike price, rate or index, (opening price for futures contracts);
 - vi. Counterparty, or exchange on which the transaction was traded;
 - vii. Cost or consideration received, if any, for opening transaction.
- 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.

55. For derivatives terminated during the year:
- a. Signature of approval, for each instrument, by person(s) authorized, either by the entity's board of directors or a committee authorized by the board, to approve such transactions;
 - b. A description, for each instrument, of the nature of the transaction, including:
 - i. The date of the transaction;
 - ii. A complete and accurate description of the specific derivative, including description of the underlying securities, currencies, rates, indices, commodities, derivatives, or other financial market instruments;
 - iii. Number of contracts or notional amount;
 - iv. Date of maturity, expiry or settlement;
 - v. Strike price, rate or index, (termination price for futures contracts);
 - vi. Counterparty, or exchange on which the transaction was traded;
 - vii. Consideration paid or received, if any, on termination.
 - c. Description of the reporting entity's methodology to verify that derivatives were effective hedges;
 - d. Identification of any derivatives that ceased to be effective as hedges.
56. For derivatives open at year end:
- a. A description of the methodology used to verify the continued effectiveness of hedges;
 - b. An identification of any derivatives which have ceased to be effective as hedges;
 - c. A description of the reporting entity's methodology to determine market values of derivatives;
 - d. Copy of Master Agreements, if any, where indicated on Schedule DB Part E Section 1.

Disclosures

57. Reporting entities shall disclose the following for all derivative contracts outstanding:
- a. Disclosures by category of instrument:
 - i. Notional or contract amounts;
 - ii. Carrying and fair values;
 - iii. A description of the accounting policies for derivatives;
 - iv. A discussion of the market risk, credit risk, and cash requirements of the derivatives.

- b. General Disclosures:
- i. A description of the reporting entity's objectives for holding or issuing the derivatives, the context needed to understand those objectives, and its strategies for achieving those objectives, including the classes of derivatives used;
 - ii. A description of how each category of derivative is reported in the financial statements including the policies for recognizing (or reasons for not recognizing) and measuring the derivatives held or issued, and when recognized, where those instruments and related gains and losses are reported.
58. Reporting entities shall disclose the following for derivatives held for other-than-hedging purposes:
- a. Average fair value of the derivatives during the reporting period together with the related end-of-period fair value distinguishing between assets and liabilities;
 - b. Net gains or losses disaggregated by class, business activity or other category that is consistent with the management of those activities and where the net gains or losses are reported.
59. 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.
60. Refer to the preamble for further discussion regarding disclosure requirements. The disclosure requirements of paragraphs 58 and 59 shall be included in the annual audited statutory financial reports only.

Relevant Literature

61. This statement adopts *FASB Statement No. 105, Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk* (FAS 105) for all financial instruments with off-balance sheet risk with modification to the disclosure required in paragraph 17 to require that the disclosure distinguish between derivatives entered into for hedging purposes from those entered into for other-than-hedging purposes. Paragraph 19 is rejected as it addresses voluntary disclosures not required by this statement.
62. This statement adopts *FASB Statement No. 119, Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments* (FAS 119) with the modification to the disclosure required in paragraph 8 to distinguish between derivatives entered into for hedging purposes from those entered into for other-than-hedging purposes. The disclosures required for trading derivatives by paragraph 10 of FAS 119 shall be required for derivatives entered into for other-than-hedging purposes. Paragraphs 12 and 13 are rejected. This statement also adopts *FASB Emerging Issues Task Force No. 84-7, Termination of Interest Rate Swaps* and *FASB Emerging Issues Task Force No. 84-36, Interest Rate Swap Transactions*.
63. This statement rejects *FASB Statement No. 52, Foreign Currency Translation*, *FASB Statement No. 80, Accounting for Futures Contracts* and the following *FASB Emerging Issues Task Force* pronouncements:
- a. *FASB Emerging Issues Task Force No. 84-14, Deferred Interest Rate Setting*;
 - b. *FASB Emerging Issues Task Force No. 86-34, Futures Contracts Used as Hedges of Anticipated Reverse Repurchase Transactions*;

- c. *FASB Emerging Issues Task Force No. 87-2, Net Present Value Method of Valuing Speculative Foreign Exchange Contracts;*
- d. *FASB Emerging Issues Task Force No. 88-8, Mortgage Swaps;*
- e. *FASB Emerging Issues Task Force No. 90-17, Hedging Foreign Currency Risk with Purchased Options;*
- f. *FASB Emerging Issues Task Force No. 91-1, Hedging Intercompany Foreign Currency Risks;*
- g. *FASB Emerging Issues Task Force No. 91-4, Hedging Foreign Currency Risks with Complex Options and Similar Transactions;*
- h. *FASB Emerging Issues Task Force No. 96-11, Accounting for Forward Contracts and Purchase Options to Acquire Securities Covered Under FASB Statement No. 115.*

Effective Date and Transition

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

AUTHORITATIVE LITERATURE

Generally Accepted Accounting Principles

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

RELEVANT ISSUE PAPERS

- *Issue Paper No. 85—Derivative Instruments*