NAIC Summer 2017 National Meeting Update

Table of Contents

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The National Association of Insurance Commissioners (NAIC) recently held its Summer 2017 National Meeting. The following summarizes selected updates on the activities of the Statutory Accounting Principles (E) Working Group (SAPWG) that took place both during this meeting and SAPWG's June 8, 2017, conference call.

More information is available on the NAIC website at http://www.naic.org/meetings_events.htm.

Asset Valuation Reserve (AVR) and Interest Maintenance Reserve (IMR)

SAPWG previously requested information from both Interested Parties and regulators regarding the current practices of how industry is allocating losses between AVR and IMR when an other than temporary impairment is recognized. NAIC staff noticed inconsistencies in the guidance for this allocation between the annual statement instructions and SSAP No. 26R "Bonds." Interested Parties commented that industry generally follows the guidance in SSAP No. 26R requiring credit related losses to AVR and interest related losses to IMR and uses the guidance within the annual statement instructions to determine what losses are credit related versus interest related. Interested Parties also commented that current allocation practices do not present a solvency concern for regulators and any changes in practices would result in costly investment system changes. On June 8, 2017, after considering comments received from Interested Parties, SAPWG proposed revisions to SSAP No. 26R to clarify that other than temporary impairment losses will be recorded to AVR and IMR in accordance with the annual statement instructions. These revisions were adopted at the 2017 Summer National Meeting.

Bank Loans

SAPWG previously exposed for comment the categorization of loans directly issued by a reporting entity defined as "bank loans" within current statutory accounting guidance. In the exposure, SAPWG posed whether directly issued bank loans should be captured as bonds on Schedule D and permitted as a fixed income instrument within the scope of SSAP No. 26R or moved to a new SSAP and captured within Schedule BA. Interested Parties commented that loans issued directly by an insurer should not be treated differently for statutory accounting purposes than any other fixed income investment. Interested Parties further commented that bank loans are similar to private placement bonds and should remain within the scope of SSAP No. 26R and reported on Schedule D. Interested Parties recommended a change to the definition of bank loans within statutory accounting guidance for purposes of clarifying that direct insurer originations should also be included within the scope of this definition. SAPWG exposed this definition for additional comment and recommends comments on whether a separate reporting line is needed in Schedule D for these types of loans. SAPWG has also requested a referral from the Valuation of Securities (E) Task Force regarding this matter which recommended that loans originated directly by a reporting entity should be separated from loans acquired on Schedule D.

Impact of Future Settled Premiums on Option Valuations

SAPWG previously exposed revisions to SSAP No. 86 “Derivatives” to clarify the accounting and reporting of derivative contracts with future settled premiums. The intent of these revisions is to clarify liability recognition for the cost to acquire derivatives with deferred or financing premium with the suggestion of recording a separate “non-derivative” payable for any future settled premiums, as well as specific disclosure and reporting for these premiums. In response, Interested Parties provided a suggested revised Schedule DB with two additional columns added to increase transparency for future settled premiums on option valuations. Interested Parties also suggested additional disclosures regarding this matter in Footnote 8 of the Annual Statement. Interested Parties further commented that current proposed revisions to the accounting guidance surrounding these derivatives are not appropriate as Interested Parties are of the opinion that the premium cost including any deferred premiums of an option contract are already considered in the recorded fair value of these derivatives and therefore bifurcating the deferred premium component separately on the balance sheet would not be proper. During the 2017 Summer National Meeting, SAPWG exposed revisions to capture additional reporting information recommended by Interested Parties with revisions proposed by NAIC staff. The exposure will indicate that this information will be required in narrative format for purposes of the 2017 Annual Statement filing with modifications to Schedule DB for year-end 2018. SAPWG will sponsor a proposal to the Blanks (E) Working Group for such modifications. Proposed disclosures include:

1) Identification of financing premiums in derivative contracts. Amount should include the non-discounted aggregate total amount due in each of the following five years (with the total due after five years to equal the aggregate total). This disclosure shall also include the aggregate fair value of derivative instruments excluding the impact of deferred or financing premiums.
2) For each derivative contract with deferred financing premiums: a) whether the premium cost is paid throughout the contract, or at derivative maturity; b) next premium cost payment due; c) total premium cost; d) premium cost paid in prior years; e) current year premium cost paid; and f) future unpaid premium cost.
3) Fair value of derivative, excluding impact of deferred or financing premiums

NAIC also recommended that SAPWG solicit further information regarding the accounting revisions to SSAP No. 86 and Interested Parties’ comments regarding these revisions.

Settlement of Variation Margin

SAPWG previously exposed a request for comment from industry regarding the potential impact that the legal settlement of variation margins could have on statutory accounting. Variation margin refers to collateral required to be posted daily on an over-the-counter derivative transaction (mainly swaps) privately negotiated between two counterparties. This collateral historically has been recorded separately from the derivative instrument. Certain exchanges through which these derivative contracts are cleared have recently recognized this variation margin as a legal settlement. Despite this development, Interested Parties have commented that for statutory accounting purposes they are of the opinion that the collateral related to these type of derivatives should continue to be reported separately on the balance versus netted against the book value of the derivative instrument.

Additionally, Interested Parties commented on the diversity in practice regarding the recording of fair value changes of exchange traded futures contracts. Currently, some insurance carriers record the changes in the related variation margin as realized while others record them as unrealized. Interested Parties suggested modifying SSAP No. 86 to allow both approaches or alternatively, if the NAIC prefers, that these changes be recorded as unrealized to allow this change to be made on a prospective basis.

SAPWG exposed non-substantive revisions to SSAP No. 86 to require changes to variation margin to be recorded as unrealized gains or losses until the derivative contract matured, terminated or expired. This guidance will be effective on a prospective basis beginning January 1, 2018. SAPWG did not conclude regarding whether the variation margin should still be addressed as collateral on the balance sheet.

Variable Annuity Contracts

SAPWG continued its discussion to develop and adopt changes to SSAP No. 86 to allow hedge accounting treatment under SSAP No. 86 for certain limited derivative contracts used to hedge variable annuity risks that otherwise do not meet hedge effectiveness requirements with additional consideration as to if the requirement to meet hedge effectiveness can be replaced by some other information that demonstrates strong risk management is in place over the identified hedges. On April 8, 2017, SAPWG exposed a revised issue paper addressing this matter after considering Interested Parties' comments to date. Interested Parties expressed certain concerns with the revised issue paper stating that it does not accommodate how dynamic hedging strategies work in practice. Interested Parties have also expressed concerns regarding the proposed maximum amortization period of ten years on unrecognized gains and losses recorded as deferred assets or liabilities related to these contracts with a preference to increase the proposed maximum amortization period to twenty years. Additional concerns raised by Interested Parties include the continued accounting treatment of deferred assets and liabilities on expired derivatives, the calculation of deferred assets and liabilities on the balance sheet and grandfathering of accounting treatments previously deployed by insurance carriers pertaining to these contracts that differ from the revised issue paper. NAIC staff recommends further deliberation regarding some of these matters by SAPWG as well as obtaining further information from Interested Parties regarding certain Interested Parties' comments and obtaining comments regarding some of these issues from the Variable Annuities Issues (E) Working Group.

Accounting Standards Updates issued by the Financial Accounting Standards Board

SAPWG re-exposed adoption of the following FASB ASU in order to better align statutory accounting with U.S. GAAP:

1) FASB ASU 2016-9 Compensation – Stock Compensation (Topic 718): "Improvements to Employee Share-Based Payment Accounting." Revisions to SSAP No. 104R "Share-Based Payments" were recommended.

SAPWG adopted with modification the following ASU recently issued by the FASB:

1) FASB ASU 2016-18 Statement of Cash Flows (Topic 230): "Restricted Cash." SAPWG adopted minor revisions to the cash flow statement and added a revision within SSAP No. 69 "Statement of Cash Flow" clarifying that the related effective date and transition guidance be consistent with the guidance stipulated in FASB ASU 2016-18.

SAPWG rejected the following ASU recently issued by the FASB:

1) FASB ASU 2017-8 Receivables – Nonrefundable Fees and Other Costs (Subtopic 310-20): "Premium Amortization on Purchased Callable Debt Securities."

Goodwill

SAPWG exposed potential revisions to current statutory accounting guidance for goodwill generated from the purchase of a subsidiary, controlled and affiliated entity (SCA). The revisions propose adjusting the current aggregate threshold of goodwill allowed to be admitted on a reporting entities balance sheet from 10% of the adjusted capital and surplus of the books of the insurance reporting entity to one of the following:

1) 5% of the adjusted capital and surplus of the books of the insurance reporting entity.
2) Apply the 10% limitation. Then apply an additional limitation between 10% and 25% of the dollar value of goodwill remaining.
3) Limit the amount of goodwill as the asset or net asset value of the SCA.
4) Eliminate the admissibility of goodwill altogether.
5) Do not change the amount of goodwill admissible as an admitted asset.

Interested Parties have not yet commented on this matter.

Surplus Notes

SAPWG exposed revisions to SSAP No. 41R "Surplus Notes." SAPWG expressed concerns that there is a lack of clarity in SSAP No. 41R regarding the accounting treatment of surplus notes issued at a discount. SAPWG exposed substantive changes to SSAP No. 41R and clarified that the net balance of a surplus note recorded to a reporting entities surplus can never be greater than the amount of cash and liquid admitted assets received on issue. SAPWG also clarified that any amounts incurred in excess of cash and liquid admitted assets received is recognized as a liability. Interested Parties have not yet commented on this matter.

SAPWG also exposed revisions to SSAP No. 41R and SSAP No. 97 "Investments in Subsidiary, Controlled and Affiliated Entities" clarifying that a surplus note issued by a parent to an SCA creates a potential double counting situation regarding that surplus note upon consolidation by the Parent reporting entity of the SCA. The revisions clarify that care should be taken to ensure that such surplus note is eliminated by the parent reporting entity upon consolidation of the SCA. Interested Parties have not yet commented on this matter.

Use of Net Asset Value as a Practical Expedient to Fair Value

SAPWG exposed substantive revisions in statutory accounting guidance to broaden the use of net asset value per share as a practical expedient to fair value either when specifically named in an SSAP, or when certain conditions exist. These revisions are in response to FASB ASU 2009-12 Fair Value Measures and Disclosures (Topic 820): "Investments in Certain Entities that Calculate Net Asset Value Per Share (or Its Equivalent)" and FASB ASU 2015-07 Fair Value Measurement (Topic 820): "Disclosures for Investments in Certain Entities that Calculate Net Asset Value Per Share (or Its Equivalent)(a Consensus of the FASB Emerging Issues Task Force)" and are intended to mirror the concepts contained in these FASB ASUs for purposes of statutory accounting guidance. Interested Parties have not yet commented on this matter.

Other Working Groups

In addition to SAPWG, several other committees, working groups, and task forces met during the NAIC Summer 2017 National Meeting. The following are selected updates.

Investment Risk-Based Capital Working Group

The Investment Risk Based Capital Working Group previously exposed an "A Way Forward" document outlining its proposal to update the bond factors in the current Life RBC formula. It proposes expanding the granularity of NAIC bond designations from the current six to 20 for purposes of RBC. However, for statutory accounting purposes the six-designation system will still apply. At the meeting, the group continued its discussion regarding finalization of the updated bond factors for Life RBC purposes, including adjustments to reduce the factors for investment grade securities. The group also exposed changes to both the health and property and casualty RBC formula in which the NAIC bond designation granularity will be increased to 20 consistent with the Life RBC formula. The group and Interested Parties continued their deliberation towards finalizing these bond factors.

Cybersecurity Task Force

The Cybersecurity Task Force adopted version six of the Insurance Data Security Model Law (IDSML). This is considered the final version. Modifications consider comments received from Interested Parties on July 31, 2017. These modifications include: clarification that licensees who comply with the New York Cybersecurity Regulation are also in compliance with IDSML; a written statement certifying compliance with Section 4; modification to notifying producers of record to "as soon as practicable;" and adding a certification that the licensee has complied with the Health Insurance Portability and Accountability Act (HIPAA) provides an exemption from Section 4 of the law. This certification is not meant to exempt the licensee from the entire law but to exempt an insurer from having to duplicate the information security program already in place in accordance with HIPAA.

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