

**Statutory Accounting Principles Working Group
Maintenance Agenda Submission Form
Form A**

Issue: FSP FAS 133-1 and FIN 45-4: Disclosures about Credit Derivatives and Certain Guarantees: An Amendment of FAS 133, FIN 45 and Clarification of the Effective Date of FAS 161.

Check (applicable entity):

	P/C	Life	Health
Modification of existing SSAP	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>
New Issue or SSAP	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>

Description of Issue:

FASB Staff Position (FSP) No. 133-1 and FIN 45-1: 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), issued in September 2008, requires disclosures by sellers of credit derivatives, including credit derivatives embedded in a hybrid instrument in FAS Statement No. 133, Accounting for Derivative Instruments and Hedging Activities (FAS 133). FSP FAS 133-1 and FIN 45-4 also requires an additional disclosure about the current status of the payment/performance risk of a guarantee in FASB Interpretation No. 45, Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others (FIN 45) and clarifies the Board's intent about the effective date of FASB Statement No. 161, Disclosures about Derivative Instruments and Hedging Activities.

This FSP applies to credit derivatives within the scope of FAS 133, hybrid instruments that have embedded credit derivatives and guarantees within the scope of FIN 45. A credit derivative is defined as a derivative instrument (a) in which one or more of its underlyings are related to the credit risk of a specified entity or an index based on the credit-risk-related events and (b) that exposes the seller to potential loss from credit-risk-related events specified in the contract. Examples include, but are not limited to, credit default swaps, credit spread options, and credit index products. A hybrid instrument is defined in FAS 133 as 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.

(This FSP does not apply to insurance contracts that may be similar to credit-risk-related guarantees that are within the scope of the FSP. Examples of those insurance contracts include, private mortgage insurance, credit insurance on trade receivables, and surety insurance.)

This FSP requires a seller of credit derivatives to disclose information about its credit derivatives, hybrid instruments that have embedded credit derivatives, and certain guarantees to enable users of financial statements to assess their potential effect on its financial position, financial performance and cash flows. 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 if an option-type contract, a credit default swap, or any other credit derivative contract.

Existing Authoritative Literature:

SSAP No. 86—Accounting for Derivative Instruments and Hedging Activities (SSAP No. 86) establishes statutory accounting principles for derivative instruments and hedging, income generation and replication using selected concepts outlined in FAS 133. Although only the "framework" was adopted for statutory purposes, most of the disclosures incorporated within SSAP No. 86 were taken from FAS 133.

FAS 133, Accounting for Derivative Instruments and Hedging Activities (FAS 133) was adopted with modification for statutory accounting. SSAP No. 86 adopted the framework established by FAS 133 for fair value and cash flow hedges, including the incorporation of disclosures.

FIN 45, Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others (FIN 45). This Interpretation elaborates on the disclosures to be made by a guarantor in its interim and annual financial statements about its obligations under certain guarantees that it has issued. It also clarifies that a guarantor is required to recognize, at the inception of a guarantee, a liability for the fair value of the obligation undertaken in issuing the guarantee. The consideration of FIN 45 is pending for statutory accounting. (Staff has been directed to draft an Issue Paper.)

FAS 161, Disclosures about Derivative Instruments and Hedging Activities, an amendment of FASB Statement No. 133 (FAS 161). This Statement requires enhanced disclosures about an entity's derivative and hedging activities and thereby improves the transparency of financial reporting. The consideration of FAS 161 is pending for statutory accounting.

The New York Division of Insurance has recently announced that they would begin regulating certain credit-default swaps that are specifically determined to be insurance products, as allowed within their jurisdiction, with new regulation taking effect on January 1, 2009. (Jurisdiction for New York regulation is about a fifth of the market.) The Working Group may want to give consideration to the work of the New York department to determine the impact of this regulation in determining additional disclosures or requirements for statutory accounting purposes.

Information or issues (included in *Description of Issue*) not previously contemplated by the SAPWG:

None.

Staff Recommendation:

The current statutory disclosure requirements do not adequately address the potential adverse effects of changes in credit risk on the statements of financial position, income, and cash flows of the sellers of credit derivatives or credit-related guarantees. The volume of credit default swaps has grown significantly over the past few years and was not a key element considered when SSAP No. 86 was finalized in 2002. As noted by the International Swaps and Derivatives Association, the estimated notional amount of outstanding credit default swaps was \$62.2 trillion in December 2007 compared to \$34.4 trillion in December 2006 and \$17.1 trillion in December 2005. Due to the significant growth of credit default swaps products, and as such swaps could have a significant impact on sellers during periods of adverse market conditions, NAIC staff recommends that thorough credit derivative and guarantee disclosures are necessary to provide state regulators the ability to fully understand the solvency condition of insurers that guarantee, or otherwise provide the credit-protection, for credit derivatives and credit-related guarantees.

Although the guidance in SSAP No. 86 did not adopt the FAS 133 guidance on accounting for hybrid instruments (i.e., embedded derivatives instruments within host contracts are not accounted for separately as a derivative instrument under SSAP No. 86), it is important for disclosures regarding credit risk from derivatives and certain guarantees to include embedded credit derivatives. As the revisions to FAS 133 require disclosure information for the entire hybrid instrument, not just the embedded derivative, staff suggests this disclosure would be consistent with how embedded derivatives are recorded for statutory even though the statutory treatment for embedded derivatives is different than GAAP. Thus, **NAIC staff recommends that the Working Group move this issue to the Nonsubstantive Active Listing and propose adoption of the credit derivative disclosures guidance, including disclosures for hybrid instruments, included within the amendments to FAS 133 from FSP FAS 133-1 and FIN 45-4 into**

SSAP No. 86—Accounting for Derivative Instruments and Hedging Activities, paragraph 53. To ensure comparable disclosures for guarantees on the indebtedness of others, staff also recommends revising SSAP No. 5—Liabilities, Contingencies and Impairment of Assets, paragraph 16 for the amendments to FIN 45 from FSP FAS 133-1 and FIN 45-4, paragraph A2.c. The proposed revisions to these SSAPs are as follows:

SSAP No. 86:

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 seller¹ of credit derivatives² shall disclose information³ about its credit derivatives and hybrid instruments⁴ that have embedded credit derivatives to enable users of financial statements to assess their potential effect on its financial position, income and cash flows. For annual and quarterly financial statements, 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.

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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

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¹ 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.

² 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).

³ 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).

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⁴ 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.

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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.

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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).

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f. For derivatives accounted for as cash flow hedges of a forecasted transaction, disclose:

- 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, b, c, e and f, shall be included in the annual audited statutory financial reports. Paragraph 55 of the Preamble states that disclosures made within specific schedules or exhibits to the Annual Statement need not be duplicated in a separate note.

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54. Refer to the preamble for further discussion regarding disclosure requirements.

SSAP No. 5:

16. Certain loss contingencies, the common characteristic of each being a guarantee, shall be disclosed in financial statements even though the possibility of loss may be remote. Examples include (a) guarantees of indebtedness of others, and (b) guarantees to repurchase receivables (or, in some cases, to repurchase related properties) that have been sold or otherwise assigned. The disclosure of those loss contingencies, and others that in substance have the same characteristics, shall be applied to statutory financial statements. The disclosure shall include the nature and amount of the guarantee. Consideration shall be given to disclosing, if estimable, the value of any recovery that could be expected to result, such as from the guarantor's right to proceed against an outside party.

a. For guarantees on indebtedness of others, disclosure shall include the nature of the guarantee, including the approximate term of the guarantee, how the guarantee arose, the events or circumstances that would require the guarantor to perform under the guarantee, and the current status as of the reporting date of the payment/performance risk of the guarantee. For example, the current status of the

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payment/performance risk of a credit-risk related guarantee could be based on either recently issued external credit ratings or current internal groupings used by the guarantor to manage its risk. An entity that uses internal groupings shall disclose how those groupings are determined and used for managing risk.

Although staff has not completed a full review of FIN 45, it is recommended that the Working Group proceed with adopting the disclosure revisions to SSAP No. 5 to ensure proper disclosure of a credit-risk-related guarantees.

Staff recommends that the other adopted amendments to FIN 45 and the clarification of the effective date of FAS 161 within FSP FAS 133-1 and FIN 45-4 be addressed when those standards are considered for statutory accounting.

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Staff Review Completed by:

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NAIC
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