

2014 Investment Accounting Changes

Every Insurance Investment Officer Needs to Know

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Joe Borgmann, CPA, Director of Investment Accounting at AAM reviews significant changes that every investment officer should keep in mind as the annual statement process kicks into high gear. Joe is a regular participant in various NAIC and FASB working groups and is a regular speaker at insurance conferences, helping to break down the complex world of insurance investment accounting into simple terms. Some of the topics covered in Joe's annual report include the following:

Update on FASB Financial Instruments Project and various other targeted GAAP changes:

- Hybrid Instrument Bifurcation
- Government Guaranteed Mortgage Loans
- Repurchase Agreements
- Investments in Qualified Affordable Housing Projects

Key Investment Updates from the NAIC:

- SSAP No. 40R – Real Estate Investments
- Investment Classification Project
- Various Annual and Quarterly Statement Updates

FASB Update

Impairment of Financial Instruments

On December 20, 2012, the Financial Accounting Standards Board (FASB) issued the proposed Accounting Standards Update (ASU), Financial Instruments - Credit Losses. This proposal includes the current expected credit loss (CECL) method, which requires reporting entities to establish an allowance for credit losses that are expected to be incurred over the lifetime of the assets. At each reporting period, the allowance should represent Management's current estimate of the expected credit losses. The estimate should be calculated after grouping the financial assets into pools based on their risk characteristics. If a financial asset cannot be grouped into a pool, it can be evaluated individually. The

movement in this allowance would be recognized in income. Therefore, this model allows for an immediate reversal of credit losses recognized on assets that have an improvement in expected cash flows.

On August 13, 2014, the FASB decided to remove securities classified as available-for-sale (AFS) from the scope of their December 2012 proposal. The impairment guidance for AFS securities will remain in ASC Topic 320. However, several targeted changes can be expected:

- An allowance would be used to recognize impairments. This approach allows for impairment losses to be reversed as credit losses or the impaired status evaporates.
- The requirement to consider the length of time a security has been underwater to determine if a credit loss exists would be removed.
- The requirement to consider additional declines in fair value or recoveries subsequent to the balance sheet date would no longer be required when estimating if a credit loss exists.

In addition to AFS securities, in October 2014, the FASB decided to remove the following financial assets from the proposal's scope:

- Loans made to participants by defined contribution employee benefit plans
- Policy loan receivables of an insurance entity
- Pledge receivables of a not-for-profit entity
- Related party loans and receivables

The FASB also decided in this update that they would not include guidance related to when an entity should stop accruing income on related securities.

Classification and Measurement of Financial Assets

In February and April of 2013, the FASB issued the proposed Accounting Standards Update, Financial Instruments – Overall – Recognition and Measurement of Financial Assets and Financial Liabilities. Throughout 2014, the FASB has deliberated the update and below are several of the key points:

- The FASB is no longer attempting to converge with the IASB on classification and measurement.
- The current classification and measurement model will remain in place, except for equities.
- Equities will be measured at fair value through net income, with the following two exceptions.

- Equities can be measured using the equity method if they meet the criteria noted in ASC Topic 323.
- Some equities may qualify for the "practicability exception," which relates to equities that do not have readily determinable fair values.
- The Fair Value Option, under Accounting Standards Codification (ASC) Topic 825 will remain in place.
- The requirement to bifurcate embedded derivatives within a hybrid instrument that are not clearly and closely related to its host contract will remain in place.

Bifurcation of Embedded Derivatives Within a Hybrid Instrument Issued in the Form of a Share (Convertible Preferred Stock)

Within GAAP, embedded derivatives that are not clearly and closely related to their host contract will typically be bifurcated and accounted for separately and embedded derivatives that are clearly and closely related to their host contract will typically not be bifurcated. The conversion features within a convertible instrument generally have equity like characteristics. If the preferred stock component (the host) of a hybrid instrument is considered more debt like and the conversion feature (the embedded derivative) is more equity like, the host and the embedded derivative would generally not be considered clearly and closely related and therefore be bifurcated. However, if the preferred stock component was more like a typical equity instrument, the host and the embedded derivative would both be more equity like and therefore could be considered clearly and closely related and therefore not bifurcated.

In November 2014, the FASB issued ASU 2014-16, *Determining Whether the Host Contract in a Hybrid Financial Instrument Issued in the Form of a Share Is More Akin to Debt or to Equity*. Within this update, the FASB clarifies that one must evaluate all components of the hybrid instrument to assess if the host is more akin to debt or equity. This evaluation should consider the exact substance of each relevant component and weight them according to how they impact the overall risks and rewards of the investment. For example, a security could have redemption rights, which would generally allow one to argue that the host is more debt-like. However, the update instructs users to evaluate the redemption rights in detail to determine the substance of the redemption rights. For example, redemption rights that are contingent have less substance than non-contingent or mandatory rights. Under current practice, users may not perform such detailed evaluation or may not consider all of the components of a hybrid instrument as a whole, which is prescribed in the new update.

The update is effective for public companies for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2015. For all other entities it is effective for fiscal years beginning after December 15, 2015, and interim periods within fiscal years beginning after December 15, 2016.

Foreclosure of Certain Government Guaranteed Mortgage Loans

In August 2014, the FASB issued the proposed Accounting Standards Update, *Receivables - Troubled Debt Restructurings by Creditors*. The ASU clarifies that when a mortgage loan, with an inseparable government guarantee enters foreclosure, the mortgage loan is derecognized and a new receivable is established. The new or other receivable should represent the amount of unpaid principal and interest associated with the original loan that is expected to be collected. Previously, some companies accounted for the foreclosed loans as real estate. This ASU is effective for the year-end 2014 for public entities and year-end 2015 for other entities.

Repurchase Agreements

In June 2014, the FASB issued the proposed Accounting Standards Update, *Transfers and Servicing - Repurchase-to-Maturity Transactions, Repurchase Financings, and Disclosures*. Under this update, Repurchase-to-Maturity and Repurchase Financing arrangements are accounted for as secured borrowings. Repurchase-to-Maturity transactions settle at the same time the transferred security matures. Previously these transfers were generally accounted for as sales. Repurchase financings are arrangements where a security is transferred and at the same time a repurchase agreement is established. These transactions were previously evaluated to determine if they were linked or should be accounted for separately. Linked arrangements could be combined and accounted for as a forward. Under this update, the transfer and the repurchase agreement would be accounted for separately. The transfer would be treated as a sale and a purchase and the repurchase agreement would be accounted for as a secured borrowing by both parties involved.

Investments in Qualified Affordable Housing Projects

In January 2014, the FASB issued the proposed Accounting Standards Update, *Investments - Equity Method and Joint Ventures, Accounting for Investments in Qualified Affordable Housing Projects*. Under certain conditions, this update allows reporting entities to select a new proportional amortization method, whereby the initial cost of the investment is amortized in proportion to the tax

credits and other tax benefits it receives and reports the amortization of the investment and tax benefits as a component of income tax expense (benefit) on a net basis. Previously, there were strict requirements that must be met, which would allow a reporting entity to use an effective yield amortization method. If these requirements were not met, the investment would be accounted for under the equity method or cost method. The update will ultimately allow more entities to avoid using the cost method or equity method to account for these types of investments.

Within SAPWG Ref # 2014-24 - *ASU 2014 -01 Accounting for Investments in Qualified Affordable Housing Projects*, the Statutory Accounting Principles Working Group (SAPWG) rejected the proportional amortization method option that is prescribed within the ASU. To allow for comparability, SSAPs normally do not allow for elective accounting treatment. Statutory guidance related to qualified affordable housing projects is included in *SSAP No. 93—Accounting for Low Income Housing Tax Credit Property Investments* and requires a modified amortization method. It also requires gross presentation of the tax benefits achieved and the amortization of the investment.

NAIC Update

Statutory Accounting Guidance

SSAP No. 40R - Real Estate Investments - Revised and Issue Paper No. 149 - Wholly-Owned Single Real Estate Property in an LLC

On December 12, the SAPWG adopted SSAP No. 40R - *Real Estate Investments - Revised and Issue Paper No. 149 - Wholly-Owned Single Real Estate Property in an LLC*. This updated guidance will shift single member and single-asset LLCs, where the insurer is the sole member and has complete control of the underlying real estate, from Schedule BA to Schedule A. Under the scope of Schedule BA, these LLCs are measured using the GAAP equity method. Effective Jan. 1, 2015, these LLCs will follow SSAP 40 accounting and reporting guidance, which measures these LLCs at depreciated cost, less encumbrances and also must maintain an appraisal. Since there are differences between the accounting prescribed in SSAP No. 40 and the GAAP Equity Method, we should expect this change to impact the carrying value of these LLCs. We can also expect favorable changes to the risk-based capital (RBC) treatment:

RBC Charge	Schedule A	Schedule BA
Life	15%	23% + 20% on any encumbrance
Property and Casualty	10%	20%

Investment Classification Project (Ref #2013-36)

Late in 2013, the NAIC initiated a project to review the overall scope and definitions included in many of the investment related SSAPs. Much of the current SSAP guidance places more emphasis on the structure of an investment (LLC, Partnership, etc.) rather than its substance (underlying investments/risk). It is believed that because RBC categories and charges are based upon the SSAP classification, the NAIC fields many questions by insurers seeking clarification and/or justification to have investments classified in such a way to optimize RBC treatment. The recent change in the accounting and reporting of wholly owned real estate LLCs is an example of an argument an insurer could make for a change in current SSAP. Overall the insurance industry supports this project, but believes the NAIC should exercise extreme caution when making changes. One possible outcome of the project could include new accounting guidance and capital treatment for investments in funds (exchange-traded funds, mutual funds, etc.) that focuses more on the underlying assets versus the structure of the fund.

Quarterly and Annual Filings

Schedules A, B, and BA - Underlying Property Information

An electronic column has been added to capture the postal codes of real estate reported on Schedule A or BA or the postal codes associated with the underlying real estate of loans reported on Schedule B or BA. Postal codes are required for the Schedule BA mortgage loan and real estate rows; if available. If multiple postal codes relate to a particular investment, each postal code should be listed from highest to lowest value associated with the underlying properties and separated by commas. Also, the state column has been modified to accept three character country codes.

Note 5 - Structured Notes (2014-06BWG)

Structured notes are bonds issued directly from a corporation, municipality, or government entity with either:

- Interest and/or principal payments that are linked to prices or payment streams related to an index or indices or to assets that have value unrelated to the issuer's credit quality

- Interest and/or principal payments that are the result of a formula that contains leverage

If the index or indices or the asset(s) that have value that is unrelated to the issuer's credit quality are related to real estate, the structured note is considered mortgage referenced.

The new data captured disclosure is effective in the fourth quarter of 2014 and requires the following:

- CUSIP
- Actual Cost
- Fair Value
- Book/adjusted Carrying Value
- Mortgage Referenced (Y/N)

Note 5 - Restricted Assets (2013-23BWG)

Investments in the Federal Home Loan Bank (FHLB) were added to the restricted assets disclosure. These changes were effective in the first quarter of 2014.

Note 5 - Working Capital Finance Investments (2013-13BWG)

A new disclosure was added for Working Capital Finance Investments. Book/adjusted carrying value by NAIC designation and aggregate maturity distribution on the underlying working capital finance programs must be disclosed. This is a data captured disclosure and is effective in the fourth quarter of 2014.

Note 5 - Offsetting and Netting of Assets and Liabilities (2013-26BWG)

The gross asset and liability amounts, which can be offset in accordance with SSAP. 64 - *Offsetting and Netting of Assets and Liabilities*, shall be disclosed. This note was effective in the third quarter of 2014.

AVR Default Component and Equity and Other Invested Assets Component (2013-27BWG)

Blank changes were made to bring the AVR in line with the RBC changes made in 2013 for commercial mortgages.

Valuation of Securities (VOS) Task Force

Catastrophe-Linked Bonds

An amendment to the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (P&P Manual) was adopted to include catastrophe-linked bonds in the 5*/6* rule noted in Part Two, Section Five of the P&P Manual.

Credit Rating Providers (CRP) / NAIC Designations

An amendment to the P&P Manual was adopted to clarify that NAIC designations are assigned to a specific issue/security. One cannot use broad issuer ratings (an issuer's senior unsecured rating) to derive an NAIC designation.

An amendment has been adopted, which requires NAIC CRP ratings to:

- Be monitored at least annually
- Be assigned to a specific security identifier (CUSIP)
- Apply to securities where the issuer guarantees repayment of principal and make interest/dividend payments
- Express an opinion as to the likelihood of the payment of contractual cash flows

U.S. Securities and Exchange Commission (SEC) Money Market Fund (MMF) Net Asset Value (NAV) Rule Change

In July 2014, the SEC announced that institutional prime MMFs would no longer be granted an exception to use a stable NAV of \$1/share. Effective October 14, 2016, they will be required to use a floating NAV, which represents the value of the underlying investments, on a per share basis. Due to the extended timeframe before this rule change becomes effective, the NAIC is deferring any action. It is also important to note that this rule change does not impact the MMFs on the NAIC U.S. Direct Obligations/Full Faith and Credit Exempt List.

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