Fields of Opportunities

STATE OF IOWA

THOMAS J. VILSACK
GOVERNOR

SALLY J. PEDERSON
LT. GOVERNOR

SUSAN E. VOSS
COMMISSIONER OF INSURANCE

BULLETIN
06-01

TO: Iowa Domestic Life Insurance Companies

FROM: Susan E. Voss, Commissioner of Insurance

DATE: April 26, 2006

RE: Accounting for Derivative Instruments Used to Hedge the Growth in Interest Credited for Index Products

Insurance companies offer products with insurance policy crediting mechanisms based upon changes in indices such as the Standard Poor's 500 Composite Stock Index. Insurance companies purchase derivative instruments to hedge the growth in interest credited to the policy as a direct result of increases in the related indices. Although the insurance company has economically hedged its exposure to the changes in the applicable indices, this type of hedge does not qualify for hedge accounting under Statement of Statutory Accounting Principle Number 86 (SSAP No. 86). Similarly, this type of hedge does not qualify for hedge accounting on a GAAP basis under Financial Accounting Standard 133 (FAS 133), the GAAP standard that serves as the framework for SSAP No. 86. However, unlike FAS 133, when a derivative instrument does not qualify for hedge accounting under SSAP No. 86, the change in fair value of the derivative instrument is recorded as an unrealized gain or loss directly in surplus.

This Agency has become aware that this provision of SSAP No. 86 results in a mismatch of the income and expenses related to the indexed products of insurance companies. The changes in indexed product reserves are reflected in the statement of operations while the changes in the fair value of the derivative instruments hedging the indexed products are recorded as an unrealized gain or loss directly in surplus.

This Agency believes that changes in the fair value of derivative instruments purchased to hedge indexed products should be recorded in the summary of operations consistently with how the changes in indexed product reserves are recorded. The insurance company is required to specifically identify and document the derivative instruments purchased to hedge indexed insurance product.

The following criteria is required for all economic hedges of products with insurance policy crediting mechanisms based upon changes in indices such as the Standard Poor's 500 Composite Stock Index:

330 MAPLE STREET / DES MOINES, IOWA 50319-0065 / 515-281-5705 / Facsimile 515-281-3059
http://www.iid.state.ia.us/

(i.) At inception of the hedge, or as of the date of this guidance if later, there must be formal documentation of the economic hedging relationship and the entity's risk management objective and strategy for undertaking the economic hedge, including identification of the specific derivative instruments purchased to hedge indexed insurance products, the related hedged liability or portion thereof applicable to the indexed insurance products, the nature of the particular risk being hedged, and how the hedging instrument's effectiveness will be assessed, retrospectively and prospectively, on a qualitative basis.

(ii.) At inception of the hedge and at each quarterly reporting period, maintain documentation that the economic hedge is expected to be and continues to be highly effective as defined by the criteria in (i.) above in achieving offsetting changes in fair value attributable to the hedged risk during the period that the economic hedge is designated.

Nothing in this bulletin would preclude a company to continue to follow SSAP No. 86.