Western & Southern Financial Group

Insurance Accounting Monitor

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Reproduced by Fort Washington Investment Advisors, a subsidiary of Western & Southern Financial Group.

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FASB/SEC GAAP Accounting News

Financial Instruments: FASB Project Update

The FASB has taken a divergent path from the IASB in most aspects on this joint project. Expectations had been pointing to issuance of final guidance related to *Classification & Measurement and Impairment* but re-deliberations in these two areas will delay issuance of a final standard until at least the second quarter of 2015. The Board also resumed discussions on the third aspect of this project, *Hedging*. Below is an update on these three areas.

Classification & Measurement

Earlier in 2014, the FASB decided to abandon the proposed business model for determination of the classification of financial instruments, deciding instead to retain current guidance. While this has largely been received as a positive development, the FASB made an exception to this decision regarding the classification of equity investments. The Board has continued to affirm its decision to require equities to be reported at fair value through net income and has also concluded that equity method investments will be excluded from the scope of this project. The Board also decided to remove the "more likely than not" probability threshold from the impairment assessment for equity securities without readily determinable fair values.

Impairment

Following last quarter's decision to exclude available-for-sale debt securities from the scope of its proposed current expected credit loss (CECL) model, the Board addressed other financial instruments impacting the insurance industry at its October 2014 meeting. The Board voted to:

- scope out policy loans, related party loans and receivables and defined contribution plan participant loans from the CECL model
- scope in reinsurance receivables and
- require additional disclosures related to impairments including information related to factors influencing management's assessment of CECL and its policy for writing off uncollectible receivables

Hedging

At the November 2014 meeting, the Board officially added the hedging project to the technical agenda. The Board also decided to include the following items in the scope of the hedging project: hedge effectiveness requirements; component hedging; elimination of the shortcut and critical terms match methods; voluntary dedesignations of hedging relationships; recording ineffectiveness for cash flow underhedges; benchmark interest rates; simplification of hedge documentation requirements; and presentation and disclosure.

FASB to Issue Final Consolidation Project Guidance in Early 2015

The FASB decided in July that final consolidation guidance will be issued pending a review by key stakeholders for unintended consequences. The guidance specifically addresses the deferral of ASU 2009-17 (commonly referred to as FAS 167) for certain investment companies and similar entities, and is intended be a targeted improvement for how an entity assesses whether a limited partnership or similar investment is a variable interest entity (VIE) and would change how an entity determines whether to consolidate an investment in a VIE. The guidance is expected to permit a general partner to consider voting rights held by a simple majority of limited partnerships when determining whether the limited partnership is a VIE. The guidance is also expected to reduce the amount of criteria that must be met to determine that fees paid to a decision maker or service provider do not represent a variable interest in a VIE.

As the review process is still ongoing, the understanding of the decisions made by the FASB is subject to change. Impacted companies should continue to follow developments and look for the final guidance that is expected to be issued in early 2015. The guidance will be effective for public companies for annual periods that begin after December 15, 2015, and private companies for annual periods that begin after December 15, 2016.

Revenue Recognition Standard: Additional Guidance and Delay in Effective Date under Consideration

Update

The FASB and IASB are considering whether additional guidance is warranted on specific topics and jointly formed the Transition Resource Group (TRG) to evaluate the guidance in the standard and report on its findings. The TRG continues to assess issues such as the identification of performance obligations, the presentation of gross versus net revenue for specific situations and licenses of intellectual property.

The FASB is also currently evaluating whether the new revenue recognition standard's effective date should be delayed based on implementation issues and where companies are in the implementation process. It is expected that the FASB will make a decision on the proposal to delay the guidance by early in the second quarter of 2015. Although a delay is possible, financial services companies should continue to work on implementing the new revenue recognition accounting standard. Industry working groups established by the American Institute of Certified Public Accountants (AICPA), including those for the insurance industry, broker-dealers and depository institutions, continue to assess industry-specific implementation issues to help stakeholders across industries interpret and implement the revenue recognition standard.

Background

The FASB and IASB issued their final standards on revenue recognition in June 2014. The standards were issued separately, with the US standard issued as ASU 2014-09, *Revenue from Contracts with Customers*, but largely reflect a converged effort. Insurers with asset management business may need to revaluate their accounting for performance based fees, fees linked to a market index, or other items typically booked on an upfront basis with estimates. Under the new standard, there exists a heavy burden to recognize performance based or market based fees upfront. If there is a possibility that the revenue may be reversed in the future, those fees cannot be recognized on an upfront basis. Additionally, the sale of nonfinancial assets that are not an output of an entity's ordinary activities, such as the sale of real estate, fall within the scope of the new standard. The guidance first redefines whether or not a sale contract exists by establishing new criteria that must be met and then the guidance introduces a control model to determine when to derecognize the asset and record the gain or loss on the sale.

The new standard is effective for public entities in fiscal years beginning after December 15, 2016, and early adoption is not permitted. Nonpublic entities are granted an additional year to adopt but have the option to adopt as early as the public entity effective date.

FASB Issues Clarifying Guidance Related to Hybrid Instruments

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" in November 2014 to address diversity in practice amongst preparers in the approach used to determine whether the nature of the host contract in a hybrid instrument is more akin to debt or equity. Under the final ASU, entities are required to follow the "whole instrument" approach which considers all substantive terms and features of the hybrid instrument. Terms and features are then weighted based upon evaluation of facts and circumstances. In practice, some entities (most likely private entities) had been applying a "chameleon" approach, which evaluated all features of the hybrid instrument except the feature being analyzed when determining if the host contract is more like debt or equity. In 2007, the SEC provided guidance to registrants requiring consideration of all terms and features rather than legal form, thus the changes are primarily expected to impact private companies that were not following SEC guidance. The guidance is effective for public business entities for fiscal years and interim periods beginning after December 15, 2015. For all other entities it is effective for fiscal years and interim periods beginning after December 15, 2016. Early adoption is permitted. No new disclosures are required by the ASU.

Statutory Accounting Activity

The NAIC Fall National Meeting was held November 16-19, 2014. Below are brief updates on the more significant initiatives.

NAIC Review of Invested Asset Capital Charges (Investment Risk-Based Capital Working Group)

Update

The working group held a conference call in October 2014 to discuss initial feedback from industry groups, including the ACLI, on the proposed corporate bond factors and modeling process. Industry feedback focused on the need for disclosure of specific information included in the American Academy of Actuaries' (the Academy) proposal including the extent proposed C-1 factors are driven by assumptions versus changes in methodology, explanation of the approach, assumptions and scenarios tested, and how the representative portfolio was constructed.

At the Fall National Meeting, the working group discussed an ACLI letter emphasizing the implementation challenges associated with the project along with concern about the significant increase in risk factors for bonds currently falling in the NAIC 2 designation, which holds a large concentration of life insurer invested assets. Increasing the number of NAIC designations presents significant operational challenges for insurers due to the impact on investment systems and reporting. Increasing investment grade risk factors relative to below investment grade risk factors could also have the unintended consequence of providing incentive for companies to shift asset allocations to lower quality investments.

The Academy also shared results of meetings with Moody's related to ratings assigned to sovereign and municipal bonds. Moody's indicated that these ratings are based upon expected losses, which is consistent with corporate bonds. The Academy plans to meet with S&P to determine if the same holds true with their ratings. If both agencies use similar methodologies, the Academy may recommend that the proposed corporate bond C-1 factors also be applied to sovereign and municipal bonds.

At the 2013 Fall National Meeting, the working group proposed changes to reduce the real estate base factor from 15% to 8%. As subsequent feedback was received related to the initial proposal, the working group has questioned whether such a significant decrease in the base rate may incentivize insurers to increase exposure in this illiquid asset class. At the 2014 Summer National Meeting, the working group tentatively decided that to avoid this scenario the base factor should be adjusted by a beta factor to reflect varying risk associated with different property types, noting that hotels are riskier than other property types. At the Fall National Meeting, the ACLI expressed their preference for a higher base rate versus inclusion of a beta factor based upon property type. The working group will re-expose the real estate factor after re-deliberations.

The working group has begun assessing whether or not the corporate bond model developed for life C-1 factors could also be applied to non-AVR insurers or if new models will need to be developed. Initial feedback given to the working group has been that the cost of adopting the proposed bond methodology would outweigh any benefit for non-AVR companies. The working group decided to regroup on this topic and consider why asset risk does not have a significant impact on non-AVR companies.

The timeline for implementing new life C-1 factors remains uncertain, but the 2016 RBC calculation would appear to be the earliest date any changes could be implemented. Companies should monitor this activity closely to understand the potential impact to its capital ratios and other operational complexities that will eventually be introduced due to the plan to expand rating categories.

Background

In late 2011, the Capital Adequacy Task Force formed a working group (C-1 Factor Review Subgroup (renamed the Investment Risk-Based Capital Working Group)) to evaluate the current capital charges on invested assets used in the risk-based capital (RBC) calculation and make a recommendation to the Capital Adequacy Task Force and the Valuation of Securities Task Force regarding appropriate changes (if any). The working group has focused its efforts on the bond capital charges with an emphasis on evaluating whether increased granularity within the bond category is appropriate. The working group has worked with the Academy on modeling and consulted Moody's and S&P regarding default information.

In July 2014, the Academy gravitated toward a vector modeling approach, which is based only on credit ratings, for determining public corporate bond C-1 factors. Subsequently, at the 2014 Summer National Meeting, the Academy formally recommended expansion to 14 NAIC designation categories, an expansion from the current 6 designations. The Academy's recommended factors are generally higher for investment grade bonds and lower for below investment grade bonds, as compared to current C-1 factors.

Industry and regulators will need to thoroughly examine the effect of any proposal on reporting driven by these items in addition to RBC, such as the asset valuation reserve and investment policies. Initially, the working group expects the revised factors to only apply to the Life RBC formula. However, the new factors could be expanded to others in the future.

Investment Classification Review Project

Update

At the Fall National Meeting, industry suggested that the Working Group refocus division of this project into three areas: guidance where further clarification is needed; instruments where guidance regarding classification or scope is needed; and guidance that may need to be amended. The chair of the working group directed NAIC staff to proceed with working on the definition of a "security" within SSAP 26 and consideration of a requirement that SSAP 26 investments have a contractual amount of principal due. This would result in the creation of a new SSAP and investment schedule for "fund" investments. The chair also asked that mortgage loan participations be added to the list of investment to be reviewed.

Background

The SAP Working Group has initiated a comprehensive project to overhaul the investment SSAPs with the goal of clarifying scope, investment definitions, and accounting and reporting guidance. The characteristics of specific investments will be evaluated by NAIC resources against all existing statutory investment guidance to identify opportunities for new guidance that would promote consistent investment valuation and reporting. This effort will be a long-term undertaking and is expected to encompass more than just mutual funds, bonds and equity investments, for which it was originally targeted. The industry has suggested the NAIC should proceed with caution to the magnitude of this project and the possibility of unintended consequences.

Industry feedback in response to the SAP Working Group's initial exposure largely focused on the lack of clear direction, such as a failure to address if problems exist with current accounting and valuation, whether the rationale for current requirements have changed, and how significant industry holdings are for each investment type. In response to this concern, at the 2014 Summer National Meeting, the Working Group voted to draft a memo aimed at prioritizing discussion topics.

Clarification on Restricted Assets Disclosure Adopted

Certain insurers had been inappropriately applying the disclosure requirements in SSAPs 1 & 4 related to assets pledged as collateral or otherwise restricted if those assets were non-admitted. To resolve this issue, the SAP working group adopted revisions to these SSAPs to clarify that these assets should be reported in the restricted assets disclosure regardless of whether the asset is an admitted asset.

Changes Adopted to NAIC Purposes and Procedures Manual

Update
At the Fall National Meeting, documentation requirements for the annual modeling of Re-REMICs were adopted by the Valuation of Securities Task Force effective for the December 31, 2014, publication of the P&P Manual. The task force also voted to disband the Securitization Data Quality Working Group as the working group has completed the tasks for which it was charged.

Background
At the 2014 Summer National Meeting, the task force adopted the Securitization Data Quality Working Group's proposed amendment to the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* aimed at outlining instructions on information necessary to assess RMBS and CMBS for financial modeling. The proposal offers guidance for newly issued CUSIPs and guidance for issues subsequent to an initial filing. Initial filings would be required to provide assessments of items such as the form of the securitization, bankruptcy remoteness, and true sale characterization. Subsequent filings have an ongoing informational requirement which consists of tranche level data, trust level data, loan performance information, and models that govern the distribution of cash from the collateral pool. The amendments are part of the language in the newly-developed Part Seven of the Purposes and Procedures Manual that details the policies and procedures of the NAIC Structured Securities Group.

Guidance on Accounting for Initial and Variation Margin on Derivative Contracts

Update
The Investment RBC Working Group has proposed a change that would exclude cash collateral pledged for derivative transactions from separate RBC charges and creates a new RBC and AVR category for centrally cleared derivatives which would be assessed at a lower 0.4% RBC charge.

Diversity in practice currently exists, but companies have generally been including collateral related to derivatives in receivable for securities or aggregate write-ins for invested assets, both of which carried a 6.8% RBC charge. Industry believes the proposed changes are more reflective of the asset risk.

Background
During the 2012 Spring National Meeting, the Derivative Investment Reporting Subgroup of the Blanks Working Group was re-formed to review the derivative reporting schedules and recommend technical changes and/or clarifications to the blanks and annual and quarterly statement instructions as necessary. The need for changes and clarifications to the blanks and statement instructions arose from new legislation (e.g. the Dodd-Frank Act) that will result in different clearing and collateral requirements for some derivatives as well as analysis of derivative investment reporting by insurers and the need for consistency and accuracy in the reported data.

Guidance Adopted to Account for Real Estate held by Single-Member or Single-Asset LLCs Under SSAP 40

Update
A revised Issue Paper, which clarified that LLCs owned by a downstream holding company are not within the scope of the new guidance – even when the holding company is wholly-owned by the reporting entity, and changes to SSAP 40 where adopted by the Accounting Practices and Procedures Task Force and Financial Condition Committee during a joint conference call in December. The new guidance in SSAP 40R is effective January 1, 2015, is not permitted for early adoption, and is not elective for qualifying investments.

The accounting change will require disclosure in the notes to financial statements and will be treated as a change in accounting principle in accordance with *SSAP 3, Accounting Changes and Corrections of Errors*. Companies that are impacted by this accounting change should consider the financial (RBC, etc.) and operational impacts.

Background
The SAPWG exposed a proposal in the fall of 2013 that aimed to account for real estate held by certain LLC's at cost, under SSAP 40, as opposed to the current method which accounts for real estate under the equity method, per SSAP 48, when specific conditions are met. Those conditions are generally outlined to illustrate that if the substance of the transaction provides that the rights over the real estate, principally control, rest solely with the insurer, then the accounting and reporting in SSAP 40 should be applied.

Comments received from interested parties demonstrated support for the proposal and sought to expand the definition of SSAP 40 real estate to include multiple member LLCs when all the members reside within the same affiliated group. The working group decided to keep the proposal limited to single members in scope, but deferred further action until it receives RBC-related guidance from the Capital Adequacy Task Force.

Non-US GAAP/IFRS Accounting Standards

Update
At the Fall National Meeting, the Valuation of Securities Task Force adopted changes to the P&P Manual allowing insurers to file audited financial statements prepared using Canada's Accounting Standards for Private Enterprises and French GAAP. French GAAP statements must include additional documentation in order for the SVO to complete a credit analysis, including a consolidated statement of cash flows containing three years of data and additional disclosures related to pension obligations and leases.

At the meeting, the ACLI also informed the task force that United Kingdom national GAAP (UK GAAP) has been significantly modified with changes effective in 2015. The SVO will conduct a study of UK GAAP and make a recommendation to the task force related to necessary changes to the P&P manual.

Background
In 2014, the SVO initiated a project to evaluate the use of Canada's Accounting Standards for Private Enterprises and the national GAAP of France in order to determine whether the SVO can rely on those accounting standards to conduct credit analysis comparable to that performed using financial information prepared under US GAAP or IFRS. This would allow insurers to file audited financial statements prepared on the relevant national GAAP basis with the SVO when it submits securities from issuers that do not prepare GAAP or IFRS financial statements. Industry has advocated the use of pertinent national GAAP audited financial statements to fulfill filing requirements with the SVO and is actively working with the SVO to study these different accounting bases. Thus far the SVO has partnered with the ACLI to perform an analysis of various countries' national GAAP in an attempt to identify circumstances where additional disclosures or reconciliation to US GAAP is necessary to be filed with the SVO. Interested parties will want to follow this issue closely as it could have a significant impact on insurers investing in unrated debt private placements.

Money Market Fund Rule Changes

In July 2014, the SEC adopted rules that will no longer permit the use of a stable net asset value (NAV) of $1.00 per share by institutional money market funds. There will be a two-year transition period and the changes become effective on October 14, 2016.

The stable NAV is required for bond classification of money market funds. If money market funds on the Class 1 list are not re-structured to meet new stable NAV requirements the funds would transition to a floating NAV and no longer receive bond classification beginning in 2016. Government money market funds would continue to have a stable NAV. No immediate action will be taken by the SVO given the 2016 transition date, but money market funds will be evaluated as part of the SAP Working Group's Investment Classification project.

This change could have a significant impact on insurers' RBC calculations as Class 1 money market funds would begin applying common stock factors versus current use of bond factors. Insurers with subsidiaries involved in the institutional money market fund business will also be faced with evaluating the sustainability of this business in light of the SEC rule changes.

Blanks Working Group (BWG) Activity related to Investments ***(Note: All Blanks proposals, including those already adopted, can be viewed at the NAIC's webpage for the Blanks Working Group)***
The notable proposals adopted as final that are effective for 2014 reporting include:

- Additional lines have been added for commercial mortgage loans to the AVR Default Component and Equity and Other Invested Assets Component to align AVR treatment with Life-RBC treatment for commercial mortgages. (Annual, 2013-27 BWG)

- A new disclosure for Structured Notes in Note 5, Investments, has been added in accordance with changes to SSAP 26. (Annual, 2014-06 BWG)

- To better assess concentration risk, regulators amended Schedules A, B and BA have an electronic file requirement to add postal codes and property type. In addition, Schedules B and BA have an electronic file requirement to add maturity date. The State column has also been modified to accept 3-character country codes. (Annual, 2014-11 BWG)

- The instructions and illustrations for Notes 5 and 11 have been modified to in order to improve reporting for FHLB investments. (Quarterly, 2013-23 BWG)

- Disclosures previously included in Note 21 related to offsetting and netting of assets and liabilities have been moved to Note 5. (Annual, 2013-26 BWG)

The following proposal is adopted as final and is effective for 2015 reporting:

- Impact to amounts reported on the Asset Page, Liability Page, Notes to Financial Statements and Schedule DB. This proposal addresses inconsistent financial reporting as a result of offsetting derivative assets/liabilities when a valid right exists (SSAP 64) by amending annual statement schedules and instructions and clarifying language in SSAP 86. (Quarterly, BWG 2014-17).

You are invited to contact us to discuss what our investment professionals can do for you:

Margaret C. Bell
Managing Director, Business Development
& Relationship Management
Margaret.bell@fortwashington.com
(513) 361-7956

Lawrence M. Carone, CFA - Central/West
Vice President, Business Development
Larry.carone@fortwashington.com
(216) 970-0313

Alexander S. Fischer - Regional
Vice President, Business Development
Alex.fischer@fortwashington.com
(513) 361-7929

Martin W. Flesher - Central/West
Vice President, Business Development
Marty.flesher@fortwashington.com
(513) 361-7934

Barry D. Pavlo, CFA, CAIA - Northeast
Vice President, Business Development
Barry.pavlo@fortwashington.com
(216) 543-4528

About Fort Washington

- Over 25 years of insurance asset management
- $47.9 billion in Assets Under Management, of which $35.4 billion are insurance company assets[1]
- Fort Washington is the primary provider of investment management to W&SFG and its affiliates, providing a strong alignment with clients' interests
- Strong parent company – Western & Southern Financial Group (W&SFG) is ranked one of the strongest insurance companies in the world (AA Very Strong) by Standard & Poor's[2]
- 84 investment professionals

Insurance Asset Management Qualifications

- Sector and customized offerings that can stand alone or complement a core portfolio
- Strong knowledge of insurance company concerns such as risk-based capital, book yield, liability-driven strategies, rating agency concerns, gain/loss management and tax efficiency
- Access to Western & Southern executive resources for consultation on industry topics

[1]Assets as of 12/31/14. Includes assets under management by Fort Washington Investment Advisors, Inc. (Fort Washington) of $45.0 billion and $2.9 billion in commitments managed by Fort Washington Capital Partners Group (FW Capital), a division, and Peppertree Partners LLC, a subsidiary. [2]Ratings are as of 09/30/14 and refer to the financial strength of the insurance company and not to the safety, stability or performance of any investment product and are subject to change.

Proprietary Investment Capabilities

- Investment Grade Fixed Income
- High Yield Fixed Income
- Structured Securities (RMBS, CMBS, ABS)
- Private Placements
- Municipal Bonds
- Public Equity
- Private Equity
- Derivatives
- Midstream Energy/MLP
- Emerging Markets

About Fort Washington Investment Advisors, Inc.

Fort Washington Investment Advisors, Inc. (Fort Washington), founded in May 1990, is the primary investment subsidiary of Western & Southern Financial Group. Fort Washington's organizational assets and/or commitments under management were $47.9 billion at 12/31/14 including $45.0 billion managed by Fort Washington and $2.9 billion managed by Fort Washington Capital Partners Group, a division, and Peppertree Partners LLC, a subsidiary. Fort Washington is a registered investment advisor with expertise in Fixed Income, Public Equity, and Private Equity. Clients include institutions and high-net-worth individuals. For more information, visit FortWashington.com.

About Western & Southern Financial Group

Founded in Cincinnati in 1888 as The Western and Southern Life Insurance Company, Western & Southern Financial Group (Western & Southern) has grown into a diversified family of financial services companies. Its assets owned ($43 billion) and managed ($27 billion) totaled $70 billion as of Dec. 31, 2014. Western & Southern is one of the strongest life insurance groups in the world. Its six life insurance subsidiaries (The Western and Southern Life Insurance Company, Western-Southern Life Assurance Company, Columbus Life Insurance Company, Integrity Life Insurance Company, The Lafayette Life Insurance Company and National Integrity Life Insurance Company) maintain very strong financial ratings and a Comdex Ranking* of 96. Other member companies include Eagle Realty Group, LLC; Fort Washington Investment Advisors, Inc.[1]; IFS Financial Services, Inc.; Peppertree Partners LLC[1]; Touchstone Advisors, Inc.[1]; Touchstone Securities, Inc.[2]; W&S Brokerage Services, Inc.[2]; and W&S Financial Group Distributors, Inc. For more information on the Western & Southern family of companies, visit www.westernsouthern.com. Western & Southern is the title sponsor of the Western & Southern Open (www.wsopen.com), a premier event in the U.S. Open Series played each August by the world's top-ranked professional male and female tennis players.

* Lafayette Life is not rated by Moody's and has a 97 Comdex Ranking.

[1]A registered investment advisor.

[2]A registered broker-dealer and member FINRA/SIPC.

For current ratings, please visit http://www.westernsouthern.com/industry.asp.

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