SESSION OF 2019

SUPPLEMENTAL NOTE ON HOUSE BILL NO. 2177

As Recommended by House Committee on Insurance

Brief*

HB 2177 would create law permitting life insurance companies that offer fixed index annuities (FIAs) to utilize a alternative methodology accounting for FIA hedging and associated reserves.

Definitions

The bill would define several terms, including:

- "Eligible derivative asset" would mean an option (as defined in law relating to financial futures contracts [KSA 40-2b25]) that is purchased or written to hedge the growth in interest credited to an indexed product as a direct result of changes in each related external index;
  - "Option," as defined by KSA 40-2b25, means an agreement giving the buyer the right to buy or receive, sell or deliver, enter into, extend or terminate, or effect a cash settlement based on the actual or expected price, level, performance, or value of one or more underlying interests;
- "External index" would mean a list of securities, commodities, or other financial instruments that is published or disseminated by a source other than

*Supplemental notes are prepared by the Legislative Research Department and do not express legislative intent. The supplemental note and fiscal note for this bill may be accessed on the Internet at http://www.kslegislature.org an insurance company, including Standard & Poor's, NASDAQ, and Dow Jones; and

- "Indexed annuity products" and "indexed life products" would each mean life insurance policies that:
  - Provide a minimum guaranteed interest accumulation on a portion of all premium payments; and
  - Include provisions under which interest is credited based upon the performance of one or more external indices.

The term "hedging transaction" would be assigned its definition in KSA 40-2b25 and means a financial instrument transaction which is entered into and maintained to reduce the risk of a change in the value, yield, price, cash flow, or quantity of assets or liabilities which the insurer has acquired or incurred or anticipates acquiring or incurring, or the currency exchange-rate risk or the degree of exposure as to assets or liabilities which the insurer has acquired or incurred or anticipates acquiring or incurring.

The bill would also define "indexed products" and "interest-crediting period."

Criteria for Eligible Derivative Assets and Life Insurers

The bill would allow insurance companies to account for eligible derivative assets at amortized cost if the insurer can demonstrate these assets meet the following criteria for an economic hedge at the inception of the hedge, or as of the date the insurer begins using the accounting practices established by the bill:

- There must be a formal documentation of the economic hedging relationship and the insurer's risk management objective and strategy for undertaking the economic hedge, including certain information described by the bill; and

- At the end of each quarterly reporting period, the insurer must maintain documentation that the economic hedge is expected to be and continues to be highly effective in achieving offsetting changes in fair value attributable to the hedged risk during the period the economic hedge is designated.

The bill would further provide that eligible derivative assets purchased or written within a year or less to maturity or expiration shall not be required to be amortized.

Accounting Practices Applying to FIA Reserves

The bill would establish the following accounting practices and would further state this practice would not apply to the calculation of indexed life insurance product reserves:

- Indexed annuity product reserve calculations must be based on Actuarial Guideline XXXV assuming the market value of the eligible derivative assets associated with the current interest crediting period is zero, regardless of the observable market for the eligible derivative assets; and

- At the conclusion of each interest-crediting period, the interest credited to such product must be reflected in the indexed annuity product reserve as realized, based on the actual performance of the relevant external index or internal indices.

Reporting Requirements; Rules and Regulations

The bill would require insurers opting to use the alternative accounting practices established in the bill to report quarterly to the Commissioner of Insurance

(Commissioner) for analysis purposes, the market value of its eligible derivative assets, and what the Actuarial Guideline XXXV reserve would be, using the market value of such assets. The bill would further prescribe that an insurer electing to use this methodology shall not change its accounting practices back to those that would apply in the absence of the statute without the prior approval of the Commissioner.

Finally, the bill would state the Commissioner shall have the power to adopt all reasonable rules and regulations necessary to implement provisions of the bill.

Background

The bill was introduced by the House Committee on Insurance at the request of its chairperson, Representative Vickrey, on behalf of Security Benefit. In the House Committee hearing, the Vice President and Associate General Counsel for the Security Benefit Life Insurance Company stated the purpose of the bill is to allow life insurance companies to utilize certain accounting practices that provide a truer and fairer representation of their capital position and financial results in connection with hedging of fixed index annuity products (referred to as FIAs). The representative noted Security Benefit has used the accounting practice allowed by the bill since 2011 through an annual request and authorization as a “permitted practice” by the Kansas Insurance Department (Department). Passage of the bill, the representative continued, would put Kansas life insurers on the same footing, without the need to seek a permitted practice annually, and would level the playing field with competitors from other states. At the time the House Committee considered its action on the bill, a representative of the Department appeared before the Committee and offered support for the bill.

According to the fiscal note prepared by the Division of the Budget, the Department indicates enactment of the bill would require the agency to analyze insurance companies' capital under alternative accounting methods. The agency states it would be able to absorb this analysis within its existing analysis with a negligible effect on workload and expenditures. Any fiscal effect associated with enactment of the bill is not reflected in *The FY 2020 Governor's Budget Report*.