3901-1-67 **Alternative derivative and reserve accounting practices.**

(A) Purpose

The purpose of this rule is to allow insurance companies to utilize certain alternative derivative and reserve accounting practices for eligible derivative instruments and indexed products, respectively, in order to better match derivative and reserve accounting as it relates to interest crediting for indexed products and to provide for a more true and fair representation of the capital position and net gain from operations of insurance companies that offer or have in force indexed products. Specifically, this rule addresses the mismatches related to the changes in value of an eligible derivative instrument as compared to the interest accrual in the reserve calculation for the underlying indexed product in two ways. This rule provides insurance companies with the ability, once certain criteria are met, to: (1) account for eligible derivative instruments using the amortized cost method, and (2) make an election at a policy level to use a reserve calculation methodology for indexed annuity products under which interest credits based upon one or more external indices are included in the reserve only after those interest credits have been credited to the contract holder under the terms of the annuity contract. In addition, regardless of the use of the ability provided for in the previous sentence, this rule provides insurance companies with the ability to record changes in, and settlement of, eligible derivative instruments through net investment income in the summary of operations.

(B) Authority

This rule is promulgated pursuant to the authority vested in the superintendent under sections 3901.77 and 3903.72 through 3903.7211 of the Revised Code.

(C) Definitions

For the purposes of this rule, the following definitions shall apply:

(1) "Eligible derivative instrument" means:

(a) A call or put option derivative instrument that is purchased to hedge the growth in interest credited to an indexed product as a direct result of changes in the related external index or external indices;

(b) A call or put option derivative instrument that is written to offset all or a portion of a call or put option derivative instrument that meets the criteria set forth in paragraph (C)(1)(a) of this rule; or

(c) Other derivative instruments, such as index futures, swaps and "swaptions," that may be used to hedge the growth in interest credited to indexed products as a direct result of changes in the related external index or external indices.

(2) "External index" means an index, a combination of indices, a combination of indices and other financial instruments, or an exchange traded fund that is published or disseminated by a source external to the insurance company and its affiliates.

(3) "Indexed annuity products" means fixed indexed or index-linked variable annuity contracts that include interest crediting provisions under which interest (which may be subject to caps, participation rates, spreads, floors, terms or similar limitations) is credited based upon the performance of one or more external indices.

(4) "Indexed life products" means fixed indexed or index-linked variable life insurance policies that include interest crediting provisions under which interest (which may be subject to caps, participation rates, spreads, floors, buffers, terms or similar limitations) is credited based upon the performance of one or more external indices.

(5) "Indexed products" means indexed annuity products and indexed life products.

(6) "Interest crediting period" means the period of time over which the performance of an external index or external indices is measured for purposes of determining the amount of interest credited under an indexed product.

(D) Derivative accounting

Insurance companies may elect to account for eligible derivative instruments at amortized cost with the ability to record settlement gains or losses through net investment income, if the insurance company can demonstrate that such eligible derivative instruments meet all of the following criteria for an economic hedge:

(1) At inception of the hedge, or as of the date that an insurance company elects to use the accounting practices prescribed by this rule if later, there must be formal documentation of the economic hedging relationship and the insurance company's risk management objective and strategy for undertaking the economic hedge, including identification of the specific eligible derivative instruments purchased to hedge indexed products, the nature of the particular risk being hedged, and how the eligible derivative instruments' effectiveness will be assessed, retrospectively and prospectively, on a qualitative basis.

(2) At inception of the hedge, or as of the date that an insurance company elects to use the accounting practices prescribed by this rule if later, and at the end of each

quarterly reporting period thereafter, the insurance company must maintain documentation that the economic hedge is expected to be and continues to be highly effective as defined by the criteria in paragraph (D)(1) of this rule in achieving offsetting changes in fair value attributable to the hedged risk during the period that the economic hedge is designated.

(3) Amortized cost will be based on the value at purchase for eligible derivative instruments defined in paragraphs (C)(1)(a) and (C)(1)(b) of this rule. For eligible derivative instruments defined in paragraph (C)(1)(c) of this rule, amortized cost will be established at the beginning of a policy's crediting term based upon the company's best estimate of the expected cost of the strategy using well-established financial market mathematical models, formulae, or equations that use assumptions that maximize the use of verifiable inputs. Deviations from this estimate or other breakage on dynamic trading strategies will be recognized immediately.

(4) All income associated with eligible derivative instruments shall be recorded in the summary of operations, and shall be consistent with how the changes in indexed products are recorded.

(E) Indexed annuity products reserve calculation methodology

Insurance companies account for indexed annuity product reserves in accordance with sections 3903.72 to 3903.7211 of the Revised Code, and with the applicable actuarial guidelines and statutory accounting principles. Based on the current guidelines, this rule provides insurance companies with the ability to make the following adjustment, on a policy level, to their indexed annuity product reserves for any index crediting period that the policy is hedged by eligible derivative instruments that are accounted for in accordance with paragraph (D) of this rule:

(1) If an insurance company determines indexed annuity product reserves based on Actuarial Guideline XXXV, the insurance company may assume the market value of the eligible derivative instruments associated with the current interest crediting period is zero, regardless of the observable market for such eligible derivative instruments. Cash surrender values used to determine the reserves shall be calculated consistently.

(2) At the conclusion of each interest crediting period, interest credited to an indexed annuity product shall be reflected in the reserves and cash surrender value as realized, based on the actual performance of the relevant external index.

(F) Indexed life product reserve calculation methodology

Insurance companies account for indexed life product reserves in accordance with the applicable actuarial guidelines and statutory accounting principles. This rule does not provide for any adjustment to the reserve calculation methodology for indexed life products.

(G) Other requirements

(1) Indexed annuity products. The alternative accounting practices prescribed by this rule must be applied during an index crediting period to both the eligible derivative instruments used to hedge indexed annuity products and the related indexed annuity product reserves.

(2) Indexed life products. The alternative accounting practices prescribed by this rule must be applied only to the eligible derivative instruments used to hedge indexed life products. This rule shall not impact the calculation of indexed life product reserves.

(3) If an insurance company elects to use the alternative accounting practices prescribed by this rule, it shall report quarterly to the superintendent, for analysis purposes:

(a) The market value of its eligible derivative instruments and what the related actuarial reserves would be using market value of such eligible derivative instruments, and the documentation the economic hedge is and remains highly effective required by paragraph (D)(2) of this rule.

(b) For hedging activity that uses the dynamic hedging strategy, the company shall report:

(i) The estimate of amortized cost, including the assumptions used in financial market models; and

(ii) The amount of deviation from the estimate of amortized cost recognized during the period reported.

(4) Application of this rule is not mandatory. An insurance company that elects to use the alternative accounting practices prescribed by this rule may not elect to change its accounting practices back to those that would apply in the absence of this rule without the prior approval of the superintendent.

(H) Severability

If any paragraph, term or provision of this rule is adjudged invalid for any reason, the judgment shall not affect, impair or invalidate any other paragraph, term or provision of this rule, but the remaining paragraphs, terms and provisions shall be and continue in full force and effect.

Effective:

Five Year Review (FYR) Dates:

Certification

Date

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