

## **Statutory Issue Paper No. 7**

### **Asset Valuation Reserve and Interest Maintenance Reserve**

#### **STATUS**

**Finalized March 16, 1998**

**Original SSAP and Current Authoritative Guidance: SSAP No. 7**

#### **Type of Issue:**

**Life and Accident and Health Insurance Companies**

#### **SUMMARY OF ISSUE**

1. Current statutory accounting guidance requires life and accident and health insurance companies to recognize liabilities for an asset valuation reserve (AVR) and an interest maintenance reserve (IMR). There is no such requirement for property and casualty insurance companies. The AVR is intended to establish a reserve to offset potential credit-related investment losses on all invested asset categories excluding cash, policy loans, premium notes, collateral notes and income receivable. The IMR captures the realized capital gains and losses resulting from changes in the general level of interest rates. These gains and losses are to be amortized into investment income over the expected remaining life of the investments sold. The IMR also applies to certain liability gains/losses related to changes in interest rates. These gains and losses are to be amortized into investment income over the expected remaining life of the liability released.
2. The purpose of this issue paper is to establish statutory accounting principles for AVR and IMR that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

#### **SUMMARY CONCLUSION**

3. The IMR and AVR shall be calculated and reported in accordance with Section 6. Interest Maintenance Reserve and Asset Valuation Reserve for Life Insurance Companies and Fraternal Benefit Societies of the Purposes and Procedures of the Securities Valuation Office of the NAIC (*Purposes and Procedures Manual of the NAIC Securities Valuation Office*).

#### **DISCUSSION**

4. This issue paper adopts current statutory guidance for AVR and IMR for Life and Accident and Health insurance companies.
5. This issue paper rejects paragraph 28 (subtitled, Reporting of Realized Investment Gains and Losses of Investments) of *FASB Statement No. 97, Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments* (FAS 97), as amended by *FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities* (FAS 115), for Life and Accident and Health Insurance Companies.
6. As stated in the draft discussion material from previous Life Codification projects, Chapter 16B, *Asset Valuation Reserve*, “*The purpose of the AVR is to establish a provision for the volatile incidence of asset losses and recognize appropriately the long term return expectations for equity type investments. The AVR provides a mechanism to absorb unrealized and credit-related realized gains and losses on all invested asset categories excluding cash, policy loans, premium notes, collateral notes and income receivable.*”

7. Chapter 16 A *Interest Maintenance Reserve*, in the draft discussion material from previous Life Codification projects states, “The purpose of the IMR is to protect surplus from investment transactions that are entered into as a reaction to interest rate movements. The IMR minimizes the effect that realized gains and losses attributable to interest rate movement have on current year operations by deferring and amortizing such capital gains and losses, net of tax, over the approximate remaining life of the investments sold.” These reserves serve to stabilize statutory surplus against fluctuations in the market value of securities and provide an extra layer of protection for policyholders. Furthermore, gains trading (i.e., selectively selling securities to include realized gains in earnings) opportunities are reduced by reporting an IMR. This is consistent with the Conservatism concept included in the Statement of Concepts, which states, “valuation procedures should, to the extent possible, prevent sharp fluctuations in surplus.”

8. The accounting policy to record AVR and IMR also is consistent with the “*ultimate objective of solvency regulations*” as stated in the Statement of Concepts. This states, “*the ultimate objective of solvency regulation is to ensure that policyholder, contract holder and other legal obligations are met when they come due and that companies maintain capital and surplus at all times and in such forms as required by statute to provide an adequate margin of safety.*”

9. Because AVR and IMR only pertain to life and accident and health insurance companies, there is a difference in how Life and Accident and Health Insurance Companies and how Property and Casualty Insurance Companies account for investments. Property and Casualty Insurance Companies are required to record bonds and preferred stock with a NAIC designation of 3 through 6 at the lower of amortized cost or market. This provides a conservative measure of such securities in accordance with the conservatism concept in the Statement of Concepts.

#### **Drafting Notes/Comments**

- Realized gains and losses for insurers not maintaining an IMR are addressed in specific invested asset issue papers.
- This issue paper references the *Purposes and Procedures Manual of the NAIC Securities Valuation Office*. The guidance for AVR/IMR was subsequently moved to the Annual Statement Instructions for Life and Accident and Health Insurance Companies. SSAP No. 7 references the Annual Statement Instructions.

### **RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE**

#### **Statutory Accounting**

10. Chapter 16, *Asset Valuation Reserve and Interest Maintenance Reserve*, in the Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies states the instructions for calculating the AVR and IMR are contained in the *Purposes and Procedures Manual of the NAIC Securities Valuation Office*.

11. Section 6. Interest Maintenance Reserve and Asset Valuation Reserve for Life Insurance Companies and Fraternal Benefit Societies of the Purposes and Procedures of the Securities Valuation Office of the NAIC contains the following excerpts (note that this is not quoted in its entirety):

This Section applies to all life insurance companies and fraternal benefit societies. The Section describes in general terms, principles of the calculation for Interest Maintenance Reserve (IMR) for realized gains and losses from fixed income investments and the Asset Valuation Reserve (AVR) on all invested assets held by a company. [Refer to the NAIC’s Life and Health Annual Statement Instructions published July 28, 1994 for specific accounting and reporting guidance.] The IMR is a single component reserve. The AVR breaks down into two major components and each component has two subcomponents:

## The Default Component--

- (i) The Bond and Preferred Stock Subcomponent
- (ii) The Mortgage Subcomponent

## The Equity Component--

- (i) The Common Stock Subcomponent
- (ii) The Real Estate and Other Invested Assets Subcomponent

(A) **Interest Maintenance Reserve (IMR).** This reserve applies to realized capital gains and losses net of tax on short-term and long-term fixed income investments. These gains and losses are from the disposal of investments as reported in Schedule D, Part 4 for long-term bonds and preferred stock; Schedule DA, short-term bonds; Schedule DB, interest rate hedges; Schedule B, mortgage loans; or Schedule BA for other fixed income investments. The reserve captures the realized capital gains and losses resulting from changes in the general level of interest rates. These gains and losses are to be amortized into investment income over the expected remaining life of the investments sold. The IMR also applies to certain liability gains/losses related to changes in interest rates. These gains and losses are to be amortized into investment income over the expected remaining life of the liability released.

The current year's IMR is equal to:

The beginning balance  
 plus (minus) the realized capital gains (losses) net of tax attributed to interest rate changes  
 plus (minus) realized liability gains (losses) net of tax attributed to interest rate changes  
 less an amortization amount

## (a) Interest Related Realized Capital Gains and Losses:

The gains and losses are to be reported net of applicable capital gains taxes allocated in accordance with an insurers established policy.

A realized gain or loss on each debt security and mortgage backed security will be an interest related gain or loss if the debt security's beginning NAIC rating did not change by more than one classification at the end of the holding period. The holding period is defined as the period from the date of purchase to the date of sale. For debt securities acquired before January 1, 1991, the debt security's rating as of December 31, 1990 should be the beginning rating used for this purpose. A debt security's gain or loss should not be included in this reserve if the debt security rating was ever a "6" during the holding period.

Preferred stock that did not have an NAIC/SVO rating classification of "PSF-4", "PSF-5", "PSF-6" or "P-4", "P-5" or "P-6" at any time during the holding period should be reported as interest related gains and (losses) in the Interest Maintenance Reserve if the stock's beginning NAIC/SVO rating did not change by more than one classification at the end of the holding period.

For preferred stocks acquired before January 1, 1993, the holding period is assumed to have begun in December 31, 1992.

Losses recognized on loan-backed bonds and other structured securities that have a negative effective yield at the date of valuation should be treated as realized losses and included in the reserve as if the security had been sold and the loss considered an interest rate loss. If the security is valued using the prospective adjustment methodology, a negative effective yield occurs when the net undiscounted sum of anticipated future cash flows of the security is less than the current book value of the security at the date of valuation. If the security is valued using the retrospective adjustment methodology, a

negative effective yield occurs when the net undiscounted sum of actual and anticipated cash flows is less than the original cost of the investment.

Capital gains and losses net of capital gains tax on mortgage loans, where interest is not more than 90 days past due, not in process of foreclosure, not in course of voluntary conveyance, or have not had restructured terms over the prior two years will be classified as an interest rate gain or loss. Prepayment penalties recorded as capital gains on mortgage securities are also considered to be due to interest rate changes.

Capital gains or (losses) due to interest rate changes on fixed income investments with less than one year to expected maturity should be captured in the IMR. Gains or (losses), net of capital gains tax, in the remaining categories are amortized according to the Group Amortization Schedule Section 6(B)(j) or the seriatim method.

Realized gains and losses on fixed income investments recorded on Schedule BA should be classified as an interest gain or loss if they are in the nature of those defined for bonds, preferred stocks and mortgages.

Realized gains and losses, net of capital gains tax, on derivative investments arising out of transactions entered into solely for the purpose of altering the interest rate characteristics of the company's assets and/or liabilities should be allocated to the IMR and amortized into income over the remaining life of the assets or liabilities associated with the derivative instruments.

(b) Liability gains/(losses) Subject to IMR Amortization

1) Reinsurance -

The interest rate related gain or loss (net of taxes) associated with the sale, transfer or reinsurance of a block of liabilities must be credited or charged to the IMR and then amortized into income provided:

1. the portion of the block reinsured represents more than 5% of a company's general account liabilities (Page 3, Line 26),
2. the transaction is irrevocable and is to a non-affiliate and
3. the transaction was completed in the current year.

The amount of the gain or loss that is interest rate related and its IMR amortization should be determined using the following procedure for the portion of the block sold, transferred or reinsured.

1. Identify the IMR balance and future amortization arising from the past and present dispositions of the assets associated with the block of liabilities.
2. Identify the IMR balance and future amortization that would result if the remaining assets associated with the block of liabilities were to be sold.
3. Define the interest rate related gain or (loss) net of taxes to be the negative of the sum of the IMR balances determined in steps 1 and 2. The future amortization of the gain or loss is the negative of the sum of the amortization determined in steps 1 and 2.

The associated assets are the assets allocable to the reinsured block of business for the purposes of investment income allocation. If the company has not been tracking the investment income of the block, it should retrospectively identify the assets using procedures consistent with its usual investment income allocation procedures. The

associated assets are not necessarily the same as the assets transferred as part of the transaction.

2) Market Value Adjustments

Material gains or losses resulting from market value adjustments on policies and contracts backed by assets that are valued at book, including the marginal tax impact, should be captured by the IMR and amortized in the same manner as capital gains and losses on fixed income investments. A gain or loss is considered material if it is in excess of both .01% of liabilities and \$1,000,000. The amortization schedules should be determined in a manner consistent with the determination of associated market value adjustment.

(d) Amortization into income:

There are two acceptable methods for accumulating and calculating the amortization schedule:

1. Seriatim Method— The amount of each capital gain or (loss), net of capital gains tax, amortized in a given year using the seriatim method is the excess of the amount of income that would have been reported in that year, had the asset not been disposed of, over the amount of income that would have been reported had the asset been repurchased at its sale price. The capital gains tax associated with or allocated to each gain or (loss) should be amortized in proportion to the amortization of the gain or (loss).

For loan-backed bonds and structured securities that are valued using currently anticipated prepayments use an amortization schedule developed using the anticipated future cash flows of the security sold consistent with the prepayment assumptions that would have been used to value the security had the security been purchased at its sale price.

For the year ending December 31, 1994, only loan-backed and structured securities that meet the following definition are required to be valued using currently anticipated prepayments:

Loan-backed and structured securities that have potential for loss of a significant portion of the original investment due to changes in interest rates or the prepayment rate of the underlying loans supporting the security. These securities should include, but are not limited to, interest-only structured securities and structured securities purchased at a significant premium over par value.

The seriatim calculation on an asset by asset basis is the desired approach, but since a seriatim approach may impose an administrative burden on some companies, each company may use the method employed by that company to amortize interest related capital gains and losses among lines of business and policyholders in accordance with the investment income allocation process as approved by the state insurance department.

2. Grouped Method— A company may use a standard “simplified method” by which the capital gains and (losses), net of capital gains tax, are grouped according to the number of calendar years to expected maturity.

The groupings are based on the years to expected maturity as of the date of sale.

- a. less than 1 calendar year to expected maturity
- b. 1 to 5 calendar years to expected maturity
- c. 6 to 10 calendar years to expected maturity

- d. 11 to 15 calendar years to expected maturity
- e. 16 to 20 calendar years to expected maturity
- f. 21 to 25 calendar years to expected maturity
- g. over 25 calendar years to expected maturity.

The amortization schedule for the current year is the sum of the gains and losses by maturity groupings times the appropriate factor for the current and future years. The maturity groupings and factors are found in 6(B)(j).

The presence of sinking fund payments, amortization schedules, expected prepayments, and adjustable interest rates complicate the determination of the number of calendar years to expected maturity. The expected maturity date is:

For fixed income instruments with fixed contractual repayment dates and amounts (including bonds, preferred stock, callable or convertible bonds and preferreds), the expected maturity is defined as the contractual retirement date that produces the lowest amortization value for Annual Statement purposes (lowest internal rate of return or "yield to worst"). Potential retirement dates include all possible call dates, and the contractual maturity date. When the instrument's contractual terms include scheduled sinking fund payments of fixed amounts, an additional calculation of yield to average life should be included in the analysis where average life is defined as the date at which the instrument is 50% repaid. For puttable instruments, where the exercise option rests with the investor, expected maturity is the put or maturity date that produces the highest internal rate of return. For perpetual instruments, the expected maturity is 30 years from the current date.

However, where a callable bond purchased at a premium is called or sold after the expected maturity date, there should be no amortization of the call premium or interest rate related gain or loss and the gain or loss should be taken into income immediately. Similarly there should be no amortization of any interest rate related gain or loss arising if a convertible bond or preferred stock is disposed of after the expected maturity date.

For liability gains and losses included in the IMR, amortization should be determined in a manner consistent with the determination of associated market value adjustment or assets transferred.

"Calendar years to expected maturity" means the calendar year of expected maturity minus the calendar year of sale date.

For purposes of the grouped method, the following additional assumptions are applicable:

- For fixed income investments, other than residential mortgages and residential mortgage pass-throughs, without a maturity date or sinking fund schedule, a maturity date 30 years from the current year should be used.
- For loan-backed bonds and other structured securities that are valued using currently anticipated prepayments use the remaining weighted average life of principal and interest payments consistent with the prepayment assumptions that would have been used to value the security had the security been repurchased at its sale price.
- For the year ending December 31, 1994, only loan-backed and structured securities that meet the following definition are required to be valued using currently anticipated prepayments:

Loan-backed and structured securities that have potential for loss of a significant portion of the original investment due to changes in interest rates or the prepayment rate of the underlying loans supporting the security. These securities should include, but are not limited to, interest-only structured securities and structured securities purchased at a significant premium over pay value.

- For residential mortgages and residential mortgage pass-throughs other than Real Estate Mortgage Investment Conduits (REMICs), not valued using currently anticipated prepayments, the number of calendar years to expected maturity is defined to be one half of the number of calendar years to final maturity.
- For REMICs and other asset backed investments not valued using currently anticipated prepayments, purchased at the time of original issuance, the calendar year of expected maturity is the calendar year of issue plus the weighted average life (rounded to the nearest whole number) as stated in the Offering Circular, using the prepayment assumption stated in the Circular to be used for Federal Income Taxation.
- For REMICs and other asset-backed investments not valued using currently anticipated prepayments, purchased after the original issuance, it is permissible for the Company to re-compute the weighted average life of the investment based on the same prepayment assumptions used to compute the purchase price, provided that this re-computation is done in a consistent manner for all similar asset-backed investments.

(e) Separate Accounts

Interest Maintenance Reserve (IMR) requirements for investments reported in the separate accounts statement are applied on an account by account basis. If an IMR is required for a separate account, all of the investments in the separate account are subject to the requirement. If an IMR is not required for a separate account, none of the investments in that separate account are subject to the requirement.

An IMR is required for separate accounts valued at book, but is not required for separate accounts valued at market. For example, separate accounts for traditional variable annuities, or variable life insurance do not require an IMR because assets and liabilities are valued at market.

If an IMR is required for investments in the separate accounts statement, it is kept separate from the general accounts IMR and accounted for in the separate accounts statement. For further details see rules as explained in Sec (6) (A) (f).

(f) Negative IMR

A negative IMR balance may be recorded as a negative liability in either the general account or the separate accounts statements of a company only to the extent that it is covered or offset by a positive IMR liability in the other statement.

The following information is presented to assist in determining the proper accounting:

<u>General Account</u> <u>IMR Balance</u>	<u>Separate Accounting</u> <u>IMR Balance</u>	<u>Net</u> <u>IMR Balance</u>
Positive	Positive	Positive (See rule a)
Negative	Negative	Negative (See rule b)
Positive	Negative	Positive (See rule c)
Positive	Negative	Negative (See rule d)
Negative	Positive	Positive (See rule e)
Negative	Positive	Negative (See rule f)

Rules:

- a) If both balances are positive, then report each as a liability in its respective statement.

- b) If both balances are negative, then no portion of the negative balances is allowable as a negative liability in either statement. Report a zero for the IMR liability in each statement. If there is any disallowed negative IMR balance in the general account statement, record the disallowed portion as a positive amount for Disallowed IMR in a write-in line for assets not admitted in Exhibit 14. If there is any disallowed negative IMR balance in the separate accounts statement, determine the change in the disallowed portion and make a direct charge or credit to the surplus account for the Change in Disallowed IMR.
- c) If the general account balance is positive, the separate accounts balance is negative and the combined net balance is positive, then all of the negative IMR balance is allowable as a negative liability in the separate accounts statement.
- d) If the general account balance is positive, the separate account balance is negative, and the combined net balance is negative, then the negative amount not covered by the positive amount is not allowable. Report only the allowable portion as a negative liability in the separate accounts statement, and follow the instructions in b) above for handling the disallowed portion of negative IMR balances in the separate accounts statement.
- e) If the general account balance is negative, the separate account balance is positive, and the combined net balance is positive, then all of the negative IMR balance is allowable as a negative liability in the general account statement.
- f) If the general account balance is negative, the separate account balance is positive, and the combined net balance is negative, the negative amount not covered by the positive amount is not allowable. Report only the allowable portion as a negative liability in the general account statement, and follow the instructions in b) above for handling the disallowed portion of negative IMR balances in the general account statement.

(B) **Asset Valuation Reserve (AVR).** This reserve shall apply to the specific risk characteristics of all the invested asset categories excluding cash, policy loans, premium notes, collateral loans and income receivables. The specific assets to be included in each subcomponent are:

#### The Default Component

The Bond and Preferred Stock Component shall include all fixed income investments that are corporate or governmental unit obligations, excepting those listed in subsection (g) as exempt from the AVR reserve, preferred stock and loan backed securities as reported in Schedule D, Part 1 and Part 2--Section 1 and Schedule DA, and counterparty exposure arising from derivative transactions as reported in Schedule DB, Part E, Section 1.

The Mortgage Subcomponent shall include all farm, commercial, residential mortgages as reported in Schedule B and Schedule DA.

#### The Equity Component

The Common Stock Subcomponent shall include all affiliated and unaffiliated common stock investments as reported in Schedule D, Part 2--Section 2.

The Real Estate and Other Invested Asset Subcomponent shall include all real estate reported on Schedule A and all Other Invested Assets as reported on Schedule BA and DA.

- (a) Calculation of the AVR:

The current year's AVR by subcomponent is equal to:



The beginning balance  
 plus (minus) the realized capital gains (losses) net of tax as allocated by the company on assets corresponding to the subcomponent  
 plus (minus) unrealized capital gains (losses) on assets corresponding to the subcomponent  
 plus (minus) transfers between components  
 plus an annual contribution  
 plus any voluntary contribution  
 plus (minus) an adjustment up to zero or down to maximum.

(b) Realized Capital Gains and Losses:

Report all realized credit-related (default) and equity capital gains and (losses), net of capital gains tax applicable to the assets in each component and subcomponent including those realized capital gains and (losses) that are incurred on Separate Accounts assets for which AVR treatment is required. Exclude all interest rate related capital gains and (losses) from the AVR.

A realized gain or loss on a debt security will be a credit related gain or loss if the debt security's beginning NAIC/SVO rating changed by more than one classification at the end of the holding period. The holding period is defined as the period from the date of purchase to the date of sale. For debt securities acquired before January 1, 1991 the debt securities rating as of December 31, 1990 should be the beginning rating used for this purpose. A debt security gain or loss should always be included in this reserve if the bond rating was ever a "6" during the holding period.

Preferred stock that had an NAIC/SVO rating classification of "PSF-4", "PSF-5", "PSF-6", "P-4", "P-5" or "P-6" at any time during the holding period shall be reported as credit related gains and (losses) in the Asset Valuation Reserve.

For preferred stocks acquired before January 1, 1993 the holding period is presumed to have begun on December 31, 1992.

In addition, all gains or losses, net of capital gains taxes, on mortgage loans, where interest is more than 90 days past due, in the process of foreclosure in course of voluntary conveyance, or have had restructured terms over the prior two years, would be classified as credit related gains or losses. Permanent impairment writedowns are also treated as credit losses.

Realized gains or losses net of capital gains tax on portfolio or general hedging instruments should be included with the hedged assets. Gains or losses net of capital gains tax on hedges used as specific hedges should be included only if the specific hedged asset is sold or disposed.

Realized gains or losses on derivative instruments not accounted for as specific (as opposed to general) hedge transactions should be allocated to the component and subcomponent of the assets associated with the derivative instruments used in the general hedge.

Realized gains or losses, net of capital gains resulting from the sale of U.S. Government Securities and the direct or guaranteed securities of agencies which are backed by the full faith and credit of the U.S. Government are exempt from the AVR. This category is detailed in Section 6(B)(g)(i).

The gains or (losses) are to be reported net of applicable capital gains taxes as allocated by the company.

## (c) Unrealized Capital Gains and Losses:

Unrealized gains and losses should be summarized by subcomponent asset type and included in the reserve computation including those unrealized capital gains and (losses) that are incurred on Separate Account assets for which AVR treatment is required. The equity method of accounting is allowed in accounting for the operating results of subsidiary, controlled or affiliated companies. If the equity accounting method is used, the amount of the undistributed income or loss reported in Exhibit 2 of the Annual Statement less the amount of any dividends received is to be included as an unrealized capital gain or loss when computing the Common Stock Subcomponent. Unrealized gains and (losses) for Affiliated Life Insurance Companies which are maintaining their own AVR are excluded since the maximum reserve factor for such companies is 0%.

Unrealized gains or losses on derivative instruments not accounted for as hedging transactions should be allocated to the component and subcomponent of the assets associated with the derivative instruments.

## (d) Transfers Between Components:

If the sum of a subcomponent's beginning balance, realized gains and losses and unrealized gains and losses is greater than the ending maximum of the subcomponent, and the balance of its sister subcomponent is below its maximum reserve, the excess must be transferred to the other subcomponent of the Default or Equity components up to that subcomponent's maximum.

If after the above transfers, the Equity or Default component is greater than total maximum for the component, the excess may be transferred to the other component or may be released to surplus.

If the balance before transfers of any of the four sub-components is negative, and the balance before transfers of its "sister" subcomponent within the same component is positive, the negative amount should be transferred to the "sister" sub-component to the extent that the transfer does not reduce the positive balance before transfers of the "sister" sub-component to less than 50% of its balance prior to the transfer.

No other transfers may be made without Commissioner approval.

## (e) Annual Contribution:

The formula for the annual contribution to a subcomponent is as follows:

The amortization rate times the subcomponent maximum amount minus the accumulated balance. (Accumulated balance is shown on Page 49, Line 6 of the Annual Statement).

## (f) Contribution Rate:

The contribution rate is 20% per year.

## (h) Voluntary Contribution to the Reserves:

Companies may make voluntary contributions to the subcomponents. Voluntary contributions will become a permanent part of the AVR once they have been reported and may not be removed in subsequent years.

12. Most state regulations refer to the literature of the NAIC for guidance on the calculation of AVR and IMR. An example is the Texas Administration Code, Title 28 - Insurance, Chapter 7, *Corporate and Finance*, which states:

(4) Asset valuation reserve (AVR) -- A reserve applied to the specific risk characteristics of all the invested asset categories except cash, policy loans, premium notes, collateral loans, and income receivables. Asset valuation reserves shall be calculated as prescribed by the NAIC and adopted from time to time by the State Board of Insurance under the Texas Administrative Code, Title 28, Chapter 7.

(12) Interest maintenance reserve (IMR) -- A reserve applied to realized capital gains and losses on short-term and long-term fixed investments. These gains and losses are from the disposal of investments as reported in Schedule D, part 1 -- Bonds, or Schedule B -- Mortgage Loans of the current annual statement. The reserve captures the realized capital gains and losses resulting from changes in the general level of interest rates as prescribed by the NAIC and adopted from time to time by the State Board of Insurance under the Texas Administrative Code, Title 28, Chapter 7.

### **Generally Accepted Accounting Principles**

13. AVR and IMR are not addressed in current GAAP literature.

14. Paragraph 28 of FAS 97, as amended by FAS 115, addresses the GAAP accounting for realized gains and losses. It states:

#### **Reporting of Realized Investment Gains and Losses of Investments**

28. Statement 60 required that insurance enterprises report realized gains and losses in the statement of earnings below operating earnings and net of applicable income taxes. This Statement precludes that practice. Realized gains and losses shall be reported in the statement of earnings as a component of other income, on a pretax basis, and shall not be deferred to future periods either directly or indirectly. The first sentence of paragraph 50 of Statement 60 is superseded by the following: Realized gains and losses on all investments (except investments that are classified as trading securities and those that are accounted for as hedges as described in FASB Statements No. 52, Foreign Currency Translation, and No. 80, Accounting for Futures Contracts) shall be reported in the statement of earnings as a component of other income, on a pretax basis. Realized gains and losses shall be presented as a separate item in the statement of earnings or disclosed in the notes to the financial statements. Realized gains and losses shall not be deferred, either directly or indirectly.

### **OTHER SOURCES OF INFORMATION**

15. The draft discussion material from previous Life Codification projects contains the following excerpts:

#### **Chapter 16A - Interest Maintenance Reserve**

All U.S. life insurance companies and fraternal benefit societies are required to establish an Interest Maintenance Reserve (IMR) for realized gains and losses resulting from changes in the overall level of interest rates on fixed income investments. The IMR is calculated in accordance with instructions promulgated by the Valuation of Securities (EX4) Task Force of the National Association of Insurance Commissioners and contained in the Life Accident and Health Annual Statement Instructions and the Valuation of Securities manual. Because the instructions for the calculation of the IMR are periodically revised, the current publications should be consulted.

The purpose of the IMR is to protect surplus from investment transactions that are entered into as a reaction to interest rate movements. The IMR minimizes the effect that realized capital gains and losses attributable to interest rate movement have on current year operations by deferring and amortizing such capital gains and losses, net of tax, over the approximate remaining life of the investments sold. The IMR applies to realized capital gains and losses, net of tax, on short-term and long-term fixed income securities, including bonds, notes, preferred stock and mortgages.

## Chapter 16B - Asset Valuation Reserve

All U.S. life insurance companies and fraternal benefit societies must include as a liability in their statutory financial statement an Asset Valuation Reserve (AVR) on fixed income and equity investments. The AVR is calculated in accordance with instructions promulgated by the Valuation of Securities (EX4) Task Force of the National Association of Insurance Commissioners and contained in the Life, Accident and Health Annual Statement Instructions and the Valuation of Securities manual. Because the instructions for the calculation of the AVR are periodically revised, the current publications should be consulted.

The purpose of the AVR is to establish a provision for the volatile incidence of asset losses and recognize appropriately the long term return expectations for equity type investments. The AVR provides a mechanism to absorb unrealized and credit-related realized gains and losses on all invested asset categories excluding cash, policy loans, premium notes, collateral notes and income receivable.

The AVR contains two components, default and equity, each designed to address specific asset risk areas. The default component is further divided into the bond and preferred stock subcomponent and the mortgage subcomponent; the equity component is comprised of the common stock subcomponent and the real estate and other invested asset subcomponent. Increases or decreases to the reserve are charged or credited directly to surplus. The AVR is limited to maximums by subcomponent, and no subcomponent of the AVR may be less than zero. Transfers between subcomponents or between components may be required or may be allowed without commissioner approval when negative or certain maximum subcomponent balances occur.

## RELEVANT LITERATURE

### Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- *Purposes and Procedures Manual of the NAIC Securities Valuation Office*, Section 6. Interest Maintenance Reserve and Asset Valuation Reserve for Life Insurance Companies and Fraternal Benefit Societies
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 16, *Asset Valuation Reserve and Interest Maintenance Reserve*

### Generally Accepted Accounting Principles

- *FASB Statement No. 97, Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*
- *FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities*

### State Regulations

- Texas Administration Code, Title 28 - Insurance, Chapter 7, *Corporate and Finance*

### Other Sources of Information

- Draft discussion material from previous Life Codification projects, Chapter 16A, *Interest Maintenance Reserve*, and Chapter 16B, *Asset Valuation Reserve*