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"NEW" INVESTMENT ACCOUNTING

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MR. JOSEPH A. TOMLINSON: Recently, insurance companies have accelerated extension of their role in financial services far beyond traditional insurance services. For example, many mutual life insurance companies have formed downstream holding companies and, within these complexes, have either built or acquired companies engaged in a wide variety of financial services including real estate development, securities brokerage, venture capital, and specialized financial planning services. The press recently has focused much attention on insurance companies purchasing brokerage firms and the insurance industry's drive to acquire banking powers.

Although less major, a few of the large life companies have delved into another new financial service -- equipment leasing. As lessors, such companies are actual owners of portfolios of capital equipment which is leased to other corporations. Prudential has been engaged in leasing for more than ten years through its PruCapital subsidiary. Equitable has been in the business for similar length of time through its Equico Lessors subsidiary, which, in the past two years, has undergone a major expansion and a name change to Equitable Life Leasing Corporation. Metropolitan has entered the business in the past two years through the purchase of Seafirst Leasing from Seattle First National

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Bank and has renamed the subsidiary MetLife Capital Corporation. Within the past month, Metropolitan has further expanded its role through the purchase of Litton Credit, the leasing subsidiary of Litton Industries. My own company, John Hancock, entered the business in 1980 with the formation of John Hancock Financial Services, Inc.

The Equipment Leasing Business

The equipment leasing industry is a major source of financing for capital investment. In 1984, American companies leased approximately \$75 billion of capital equipment which represented just under 30 percent of the total capital expenditure in the United States for durable equipment. It has been estimated that 80 percent of American companies lease capital equipment. Although leasing is a major source of financing, insurance companies are just beginning to enter this market and currently contribute less than \$2 billion of the \$75 billion total. The major equity investors today include captive finance subsidiaries of capital equipment manufacturers, independent leasing companies, and banks. Practically all major banks offer equipment leasing services.

How Leasing Works

Leasing can perhaps be understood best from the perspective of the user of capital equipment, also known as the lessee. Leasing comes into play in any situation where we have a user of capital equipment with a specific equipment need combined with the desire to, in some way, pay for the use of the equipment over time. Transactions may range from several thousand dollars worth of office equipment to multimillion dollar power-generation facilities. Printing presses, commercial airliners, agricultural equipment, and medical equipment are among the many types of equipment which may be acquired through lease. In leasing, a key consideration from the standpoint of the user of equipment will be the term of the lease. If the user feels he may have only a short-term need for the piece of equipment or if he is concerned about technological obsolescence, he may opt for what is known as an operating lease. In that case, he might go to a company which specializes in operating leasing, offering short-term leases of equipment ranging from perhaps one month to two years. On the other hand, if the user feels that he will have a long-term need for the equipment, it may make more sense to enter into a full payout lease which has a fixed, noncancelable lease term substantially covering the full economic life of the piece of equipment.

From the lessor's perspective, operating leasing is quite different from full payout leasing; therefore, leasing companies tend to specialize in either one area or the other. The operating lease business involves intensive equipment management with substantial resources devoted to equipment repair, refurbishment, and the sale or re-leasing of equipment coming off lease. Although a well-managed operating leasing company can be very profitable, the activity is extremely labor-intensive and risky, because of the short-term leases.

Full payout leasing is much less labor-intensive, more akin to a financing or lending activity. In full payout leasing, the leasing

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company does not maintain an inventory of equipment available for lease, but instead provides financing for the lessees acquisition of equipment from manufacturers or dealers. Typical lease terms substantially cover the full economic life of equipment, and maintenance and repairs are left as the responsibility of the lessee or equipment user. For such business, more emphasis is placed on the credit worthiness of prospective lessees than the value of collateral.

A key consideration in leasing is who retains ownership of the equipment for tax purposes. Actual ownership may rest with the leasing company, which will receive not only the rentals but also the tax benefits of investment tax credits and accelerated depreciation in addition to the residual value of the equipment at the end of the lease term. Alternatively, ownership of the associated tax benefits may rest with the use of the equipment. In this case, the leasing company is providing financing secured by the collateral value of the equipment. Rates charged for leasing will vary substantially as a function of who receives the tax benefits. For example, secured financing rates may range from 12-15 percent in today's marketplace, whereas lease rates with the leasing company receiving the tax benefits may range from 7-10 percent. The latter alternative may prove especially attractive to companies which cannot use tax benefits because of insufficient taxable income due to either losses or substantial capital investment, which has reduced taxes through investment tax credits and accelerated depreciation.

Insurance Companies in Leasing

Among financial institutions, large commercial banks have been active as lessors of capital equipment while, until recently, insurance companies have done little in this area. Property/casualty insurers have used tax-exempt municipal bonds rather than leasing as a tax-sheltering vehicle. Municipal bonds provide property/casualty insurers with easy-to-manage liquid investment but at some yield penalty versus the returns available from leasing. Municipal bonds are available in today's marketplace at tax-exempt rates ranging from 5.5-10.5 percent depending on the term and credit quality. Returns on equity from a well-run leasing operation should run between 10 and 15 percent after tax.

Equity investments in leases, like other tax-advantaged investments, have not been attractive for life companies because of low marginal tax rates. However, recently many life companies have expanded their noninsurance activities through subsidiaries which pay taxes at regular corporate rates; it makes sense to follow the route banks have taken in forming leasing companies to provide tax shelter.

Besides tax sheltering, there are other important reasons why a company may wish to invest in leasing. An effective leasing operation can produce investment returns which significantly exceed the returns available on traditional bond and mortgage investments. In today's environment, bonds and mortgages may be yielding 12 percent before tax, or 7.5 percent after tax, to a life company. By comparison, equity in a leasing operation should be yielding 10-15 percent after tax.

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However, because of the extra risk involved, a company should not view an investment in leasing as a replacement for safer bonds and mortgages but instead as a use of risk money that might be invested in such things as common stocks or new ventures. Leasing can offer returns comparable to those available from investments in publicly traded common stocks with less volatility of returns.

The leasing business can provide an additional financial service to existing clients. For example, John Hancock Financial Services does a significant volume of agricultural equipment leasing to existing customers of the parent company's agricultural investment department. For such customers, John Hancock can provide land-based mortgage financing through the agricultural investment department and equipment leasing through John Hancock Financial Services. Perhaps the most important marketing consideration, however, for entering the equipment leasing business is that it provides insurance companies with a service they can offer to companies smaller than those traditionally serviced by insurance company corporate finance departments. Equipment leasing can be an important component of an overall marketing thrust to provide services to the smaller corporate sector of the economy.

Accounting and Tax Considerations

For many of the newer types of investments which have attracted insurance companies, the issue of statutory versus generally accepted accounting principles (GAAP) accounting is important and sometimes complicated. However, for those few insurance companies that have delved into equipment leasing, statutory accounting has not been a major issue because such companies have gotten into leasing by setting up separate subsidiary companies accounting for their operations strictly on a GAAP basis. Such subsidiaries are carried on the statutory balance sheet of the parent at a net worth calculated on a GAAP basis.

GAAP accounting for lease transactions has been carefully defined in the Federal Accounting Standards Board (FASB) Statement No. 13, "Accounting for Leases," which can be obtained from all major accounting firms. For leases, FASB Statement No. 13 prescribes two different methods of accounting, the choice of which depends on whether the lease is what the FASB defines as a "direct financing lease" or an "operating lease." There are a number of specific tests to determine in which category a lease belongs. The intent of all these tests can be summarized by saying that direct financing leases tend to be longer-term where the lessor is receiving the bulk of the economic return from rentals to be received over the noncancelable lease term. An example of a direct financing lease might be a mainframe computer leased for a term of five years. Operating leases tend to be shorter-term where the lessor's economics depend heavily on renewal of the lease or sale of the equipment at the end of the lease term. This type of lease term can be illustrated by a one- or two-year lease on a piece of construction equipment. As for the accounting distinction between these two types of leases, the book income from operating leases is recorded as the difference between rental income received and book depreciation. Book depreciation is typically calculated as straight-line depreciation over the estimated useful economic life of the equipment.

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Such depreciation is different than tax depreciation, which may be taken on a more accelerated basis. By contrast, the direct financing leases are accounted for much like mortgage investments where payments are split into principle and interest portions to provide a level rate of return over the term of the lease. Like mortgages, these direct financing leases will have a relatively low proportion of the rental allocated to principle amortization during the early part of the lease term, and a much greater proportion later on. For tax purposes, such transactions will be eligible for accelerated depreciation on the same basis as are the operating leases. Both operating and direct financing leases involve the equipment leasing company actually owning the equipment and, therefore, being eligible for the tax benefits. There are also transactions where the user owns the equipment, and the leasing company provides asset-based financing. Such financings are simply accounted for as loans for both book and tax purposes.

Equipment that is owned and leased to others is subject to exactly the same tax accounting rules as any equipment ownership. Prior to 1981, owners of equipment were allowed to write off or depreciate equipment over its estimated useful economic life. Such depreciation could either be based on facts and circumstances, or on guidelines for different types of equipment published by the Internal Revenue Service (IRS). Also, the owner was allowed to choose from a number of different methods of depreciation, such as Sum of the Years Digits or Double Declining Balance. The result was a complicated and confusing system for both the owners of capital equipment and the IRS. As part of The Economic Recovery Tax Act of 1981, the depreciation rules were simplified greatly by assigning almost all types of equipment to a five-year depreciation class with a single accelerated method roughly equivalent to 150 percent declining balance. The principal exception to the five-year class was for autos and light duty trucks, which were placed in a three-year class.

Because equipment can be written off more rapidly for tax purposes than is done for book purposes, the substantial differences between book and taxable income are useful. For instance, a leasing company earning \$1 or \$2 million on a book basis, at the same time, could be generating taxable losses on the order of \$15 to \$20 million. Through consolidation, such losses can be used to shelter profits from other income-producing subsidiaries. In addition to the depreciation, shelter is also provided through investment tax credits currently equal to 10 percent of equipment cost for purchases of new equipment. It is more important to note that such investment tax credits operate as credits against the amount of tax payable rather than as a deduction from taxable income.

MR. DAVID E. ROGERS:

Background and Scope of GAAP Accounting for Futures Contracts

FASB Statement No. 80, "Accounting for Futures Contracts," establishes accounting standards for all exchange-traded futures contracts, except those related to foreign currencies. The FASB added this subject to its agenda in 1981 at about the same time it received the

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second of two American Institute of Certified Public Accountants (AICPA) issues papers on related subjects. The final provisions of Statement No. 80 depart somewhat from the conclusions in these issues papers. Therefore, companies that have participated in the futures market in the past should review Statement No. 80 carefully to determine whether its issuance will necessitate different accounting for contracts entered into after the effective date.

The Statement does not apply to foreign currency futures. FASB Statement No. 52, "Foreign Currency Translation," continues to govern the accounting and reporting of these types of contracts. Also, the Board stated forward-placement or delayed-delivery contracts are not covered by Statement No. 80, because those contracts generally are not traded on established exchanges; the amount and timing of their cash flows differ from future contracts; and there is a potential for default on those contracts.

General Principles

Statement No. 80 requires immediately recognizing in income changes in the market value of a futures contract. An exception to this general principle is when the contract meets the Statement's hedge criteria. In those cases, market value changes are applied to the carrying amount of the asset or liability being hedged. Unrecorded but firm commitments and anticipated transactions also can be hedged. The market value changes of these futures contracts are included in measuring the subsequent transaction that satisfies the commitment or confirms the anticipated transaction. Earlier recognition of the market value changes may be required, however, such as under the lower-of-cost-or-market accounting principle.

The hedge criteria are based on a company's exposure to risk by the item being hedged and on the reduction of that exposure by the futures contract. Also, to identify management's intent to hedge an item, the futures contract must be so designated. If the risk reduction criterion is not met throughout the duration of the contract, hedge accounting must cease, and the previously deferred gains or losses should be recognized in income to the extent that they have not been offset by changes in the value of the hedged item.

Effective Dates and Disclosure

Futures contracts entered into after December 31, 1984, should be accounted for under the provisions of Statement No. 80. Earlier application is encouraged, but must be done prospectively (i.e., no retroactive restatements or cumulative-effect adjustments are permitted).

The Statement's disclosure requirements are applicable for financial statements for periods ending after December 15, 1984. Therefore, calendar year-end companies will have to disclose the nature of any items being hedged and the method of accounting for the related contracts in their 1984 financial statements.

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Applying the Statement

Items underlying futures contracts are becoming more intangible and diverse. For example, contracts on stock indexes are now traded. Determining valid "cross-hedge" situations with such a contract and measuring the contract's price correlation with the hedged item are far different from the century-old practice of hedging a commodity such as corn with corn futures. Additionally, management's intent to either speculate or hedge with futures contracts is a key factor in determining when gains or losses, resulting from changes in the market value of the contracts, should be recognized in income.

To accommodate many situations, the Board laid out broad guidelines in Statement No. 80 instead of specific and narrow rules. Many of the Statement's subtleties will become apparent when companies begin to apply the rules to their particular circumstances.

As a result, we expect implementation problems to arise. The discussion in the pamphlet of the Statement's provisions and the effects of those provisions on financial statements covers those questions identified to date. The pamphlet also discusses special considerations applicable to financial institutions. Finally, a brief discussion of the treatment of futures contracts under U.S. federal income tax law is included.

Scope and Effective Dates

The provisions of Statement No. 80 specifically apply only to futures contracts other than those for foreign currency, to which Statement No. 52 continues to apply. Statement No. 80 does not apply to forward-placement or delayed-delivery contracts or options. The Board's reasoning for excluding these items is that the nature, terms, and characteristics of their marketplaces differ from exchange-traded futures contracts. The principles of Statement No. 80 probably will guide accounting for these instruments when appropriate, since this is the only authoritative accounting guidance on similar transactions. The AICPA is studying option accounting, and the FASB commented in Statement No. 80 that it may consider that topic after an issues paper is prepared.

The accounting provisions of the Statement must be applied to futures contracts entered into after December 31, 1984. Earlier application is encouraged, however. In contrast, the disclosure requirements for hedge transactions are effective for financial statements for periods ending after December 15, 1984, regardless of whether the accounting provisions have been implemented as of that date. As a result, Statement No. 80 rescinds FASB Technical Bulletin No. 81-1, "Disclosure of Interest Rate Futures Contracts and Forward and Standby Contracts." However, the provisions of Accounting Principles Board (APB) Opinion No. 22, "Disclosure of Accounting Policies," continue to require disclosure of the methods of accounting for material-forward and standby contracts as well as options.

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Transitional Rules on Early Application

The Statement encourages earlier application of its accounting provisions. However, this is limited to futures contracts entered into during, and outstanding at the beginning of, periods for which financial statements have not been issued. Although not specifically mentioned in the Statement, we understand the FASB believes that previously issued interim financial statements, in addition to annual statements, should not be restated to reflect retroactive adoption of Statement No. 80. This proscription recognizes the fact that to qualify for hedge accounting, a company must make certain decisions, determine certain price relationships, and document these matters at the inception of the futures contract.

As a result, a calendar year-end company, which has already issued its third-quarter financial statements, should not retroactively apply Statement No. 80 to contracts open during that period. But, the company could change to the Statement's provision in the fourth quarter.

The Statement also will allow the early application of its accounting provisions to contracts that are open when the Statement is first adopted. Therefore, a calendar year-end company that elects early adoption of the Statement at the beginning of its fourth quarter can choose to apply it to contracts open as of that date. This is optional, however, and the company may decide to apply Statement No. 80 only to contracts entered into during the period of adoption.

If a company chooses to apply the hedge accounting provisions to contracts open at the adoption of the Statement, it may find that a contract considered to be a hedge prior to Statement No. 80 no longer qualifies. Such a contract would prospectively become a nonhedge or speculative contract.

On the other hand, if a company has accounted for a contract as a hedge prior to the adoption of Statement No. 80, and if it also meets all of Statement No. 80's hedge criteria on adoption, the contract should be designated as a hedge upon adoption. Although not expressly prohibited by the Board, it would not be appropriate to view the adoption of Statement No. 80 as a time when redesignation as a hedge or speculation should be made on open contracts. Prospective redesignation could occur subsequently.

Reporting an Accounting Change

When a company's adoption of Statement No. 80 results in a material change in accounting principle, information about it should be included in a note to the annual financial statements in the year of change and thereafter until all years are presented consistently. Although not specified by the Statement, companies should disclose the effect of the change on net income and related per-share amounts in accordance with APB Opinion No. 20.

A company that reports interim financial information to its shareholders and adopts Statement No. 80 in other than the fourth quarter is

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required to disclose the nature of and justification for the accounting change, if material, and the effect of the change on the quarter's net income and related per share amounts.

Accounting Provisions

The Statement's accounting provisions are based on the nature of futures contracts, which the FASB considers unique compared to other types of executory contracts and transactions. The accounting provisions are also based on the purpose of entering into a particular contract and whether doing so increases or reduces a company's risk to future price or interest rate changes.

Nature

A basic question the FASB considered was whether the contract itself should be recorded as an asset which offsets liability in the financial statements. The FASB did not require this accounting because futures contracts generally are not entered into to acquire assets or incur liabilities.

The contract obligates the seller to deliver a commodity at a certain price on a certain date. The buyer incurs an obligation to acquire the commodity on the specified terms. These obligations are similar to those of other executory contracts, such as purchase orders, which normally are not recognized in the financial statements. Additionally, because futures contracts rarely are held until the last day of trading, the probability that delivery will occur is remote. In the instances in which delivery or receipt is intended, special premium or discount accounting provisions may apply.

Purpose

Although the contract itself is not recorded in the financial statements, the market value changes of the contract must be accounted for. According to the FASB, this is because the unique feature of futures trading -- daily settlement of gains or losses in cash with the broker, as required by the futures exchanges -- establishes adequate measurement and recognition conditions.

Accounting for these market value changes is based on the existence of risk and the company's reason for entering the futures market. Examples of the effects of a futures contract on two companies' exposure to risk will illustrate this point:

A farmer grows wheat and expects to deliver the crop to the market in three months. The farmer is satisfied with the market price of wheat today but thinks the price may change during the next three months. To protect his margin against a decrease in price, the farmer sells futures contracts on wheat, effectively locking in the selling price at today's prices. But by hedging the risk of falling prices, the farmer foregoes the benefit he would obtain if wheat prices rose.

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A speculator, on the other hand, invests in futures contracts solely to take advantage of his expectation of price changes. Because such a speculator does not own or plan to own wheat, he is not protecting an existing or anticipated position against price fluctuation. Rather, he is speculating with the contracts and hopes to profit from the market price fluctuations of wheat.

Hedges

Companies often enter into futures contracts to protect or hedge against the risk that interest rate or price fluctuation will adversely affect their future operations. Immediately recognizing in income the market value changes of contracts that hedge this risk would incorrectly imply that there is increased exposure to interest rate or price risk, when, in fact, such exposure is reduced by the futures contract. To recognize that hedging activities reduce risk, the Statement provides that gains or losses on those contracts which meet the hedge criteria and are designated as hedges should be deferred and recognized as an adjustment to the carrying amount of the existing asset or liability being hedged.

Hedge accounting can also apply to unrecorded firm commitments and to anticipated transactions. Of course, in those instances, the hedged item does not yet appear on the balance sheet. Therefore, changes in the market value of these contracts should be included in measuring the transaction that satisfies the commitment or anticipated transaction. Then those changes in market value should be accounted for in a manner consistent with the method of accounting for the asset or liability subsequently acquired or incurred; prior to the occurrence of the transaction, these changes in market value should be presented as a deferred charge or credit.

Deferral of a contract's market value changes is not appropriate if the hedged item is carried at fair value, such as investments of pension funds or investment companies. In this case, as the hedged item is adjusted to market, the contract's market value change should be recognized similarly in income (or reflected in shareholder's equity).

Speculations

A company may enter the futures market to take advantage of expectations of fluctuations in interest rates or market prices. Because the company does not have a position at risk like the hedging company, this company is exposed to the risk that if it predicted incorrectly, it would incur a loss; therefore, it is speculating with the futures contracts. To recognize this speculation, changes in the market value of these contracts are recognized in income as they occur.

By requiring recognition of gains on open contracts, the FASB departed from the lower-of-cost-or-market accounting specified for marketable equity securities in Statement No. 12, "Accounting for Certain

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Marketable Securities." This is principally because of the daily settlement between the broker and the contract holder.

The Board concluded that the ease with which an open position can be closed out also supports the immediate recognition of gains or losses. Commonly, a contract can be closed out at any time at the holder's discretion and, in fact, usually is closed out before the end of the contract period. According to the Board, this ability plus the daily settlement complete the earnings process.

Subsequent Income Recognition of Market Value Changes

Existing Items

When the existing hedged item or firm commitment is or will be carried at cost or lower-of-cost-or-market, the market value changes of the contract should be reflected in income when the effects of the related price changes of the hedged item are recognized (e.g., when hedged inventory is sold or written down to market).

Market value changes of contract, which hedge either interest-bearing securities carried at amortized cost or long-term debt, should be amortized as an adjustment of interest income or expense over the expected remaining life of the instrument. This amortization must commence no later than the date the contract is closed out. The Board's objective in establishing the latest point at which amortization should commence was to prevent the permanent deferral of gains or losses through the process of continually "rolling over" futures contracts.

The Board also added guidance on income recognition of deferred market value changes when the volume and frequency of cash or futures market transactions make the identification of the futures results with specific items impractical -- for example, commodity dealers or mortgage bankers. In those circumstances, the company should use a consistent and reasonable method to allocate the futures results between items on hand or existing commitments at the end of the period and those disposed of during the period. The method selected should match the hedging strategy and characteristics of the item being hedged as closely as possible.

Anticipated Transactions

Anticipatory hedges involve the protection of cash transactions that have not yet occurred. As a result, Statement No. 80 includes special accounting rules for such hedges. If the contract is closed before the anticipated transaction occurs, the gain or loss should be carried forward as a deferred charge or credit to be included in the measurement of the subsequent transaction.

If it becomes likely that the quantity of the anticipated transaction will be less than what was originally planned, a "pro rata portion" of the deferred gain or loss should be recognized immediately in income. The Statement does not specify a basis for the pro rata allocation.

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Considering the general tone of the Statement, the basis should be logical and applied consistently, such as using the relationship of revised quantity to original quantity.

When the future transaction is no longer anticipated, any deferred amount should be recognized immediately in income.

Premium or Discount

The Statement allows, but does not require, companies to recognize separately a premium or discount on the hedge contract. This premium or discount, which represents an interest or carrying charge, is the difference between the futures price and the fair value of the hedged item at the inception of the hedge. Like Statement No. 52 for foreign currency contracts, this amount would be amortized over the life of the contract.

However, all of the following conditions must be met before this accounting is available:

1. The commodity or instrument must be deliverable under the contract.
2. The retention of both the hedged item and the contract through the contract's delivery date must be probable.
3. The contract must not be cross-hedge.

The Board believes "relatively few" hedges will meet these conditions.

Margin Deposit

Accounting for the margin deposit is not addressed in the final Statement. However, in considering the Exposure Draft and an example in an appendix to the Statement, we believe the deposit should be reflected in financial statements as a receivable (amount due from broker). If the initial deposit consists of government securities rather than cash, those securities would continue to be classified as such and not as a receivable.

Hedge Criteria

Determining when hedge accounting is appropriate is key in implementing Statement No. 80. The Statement's broad guidelines, as well as certain provisions that contain some practical compromises, may be interpreted differently and, hence, may produce differing results.

In summary, for a contract to qualify as a hedge, the following criteria must be met.

1. The item to be hedged (existing asset, liability, firm commitment, or anticipated transaction) must expose the company to price or interest rate risk. Therefore, risk assessment must be made.

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2. The futures contract must reduce the exposure to risk. This is demonstrated if, at the inception of the hedge and throughout the hedge period, high correlation between the changes in the prices of both the contract and the hedged item is probable. This is necessary so that the results of the futures contract will substantially offset the effects of price changes of the exposed item.
3. The contract must be designated as a hedge.

The first two criteria combined require both the existence of an entity-wide exposure to risk and the identification of a specific item creating that exposure. This enables a company to demonstrate that its futures contracts fit the hedging strategy of reducing exposure to risk.

Two additional criteria must be met for anticipated transactions to qualify for hedge accounting: (1) significant characteristics and expected terms of the anticipated transaction must be identified; and (2) occurrence of the anticipated transaction must be probable.

Risk

Exposure to Risk

Statement No. 80 defines risk as the potential for gain or loss that can result from changes in the market price or yield of an existing asset, liability, firm commitment, or anticipated transaction that eventually will be reflected in the financial statements. Risk must be assessed on an "overall basis" by considering whether the item to be hedged exposes the company to risk or is offset by other circumstances, positions, or decisions made within the company. It is necessary to identify the specific items contributing to this exposure so that a hedging strategy can be developed and futures contracts, intended to hedge the risk, can be entered into.

For example, if there are no offsetting circumstances within the company, the following situations expose an entity to risk:

1. Anticipated but unordered raw material requirements, when finished product and raw material prices do not move together.
2. Assets bearing fixed rates and terms (e.g., mortgage loans), funded by variable rate liabilities (e.g., customer money market accounts). Or other "mismatches" due to asset maturities and repricing dates that do not correspond to those of the liabilities.
3. Anticipated issuance of long-term debt.

Other circumstances can exist which will offset exposure to risk. For example, companies would not be exposed to risk when:

1. The prices of finished products and anticipated but unordered raw material requirements move together because this provides natural protection against price risk.

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2. Firm fixed-price sales commitments have been entered into for items in inventory.
3. Interest-bearing assets with fixed rates and terms are funded by liabilities having similar maturities and repricing characteristics.
4. Fixed-rate instruments are being held to maturity, with a low likelihood of default.

Decentralized Risk Management

The FASB's Exposure Draft would have required a "total enterprise" assessment of whether the risk created by a particular item is offset by other business factors. However, certain multinational companies that operate and manage risk in a decentralized manner commented that it would be impractical for them to comply with an overall risk-assessment requirement. Therefore, Statement No. 80 allows identification of exposure to risk for each business unit when the decentralized nature of a company's operations makes it impossible to consider the total position of the entire enterprise.

Determining a meaningful business unit for this purpose often will be difficult, because the existence or mitigation of risk can transcend a company's organization chart. While a company may assign accountability for assets to one profit center and liabilities to another, the exposure to risk, created by the individual profit centers, frequently is managed so that it is offset.

Generally, we believe the following attributes are necessary before determining that a separate business unit exists for risk-assessment purposes:

1. Geographic separation.
2. Management of and responsibility for both assets and liabilities, separate and unique from any other business unit within the entity.
3. Assets, liabilities, results of operations, and activities clearly distinguishable from the other assets, liabilities, results of operations, and activities of the entity.

For example, it is common for the investments, lending, and operations areas of financial institutions to be discrete areas of management responsibility. But, because these functions cannot exist by themselves as an entity, risk assessment for applying hedge accounting provisions in such cases should be centralized, and the entire entity should be considered a single business unit.

Normally, we expect that all domestic or regional branches of a financial institution would be assessed with the corporate operations, and considered one business unit for risk exposure determination. However, the institution's foreign branches that independently manage their asset and liability positions or an independently managed real

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estate joint venture may qualify for treatment as separate business units for Statement No. 80 purposes.

Manufacturing or agricultural companies that use futures contracts to hedge inventory price risk would have one business unit for the purposes of assessing risk if they have centralized purchasing functions.

Ongoing Assessment of Risk

Statement No. 80 specifically requires an ongoing assessment that the high correlation criterion is being met. However, there is no similar requirement regarding the exposure to risk criterion, and the Statement does not specifically address the propriety of hedge accounting if risk ceases to exist.

An example of such a situation is a company that sold futures contracts to hedge its inventory because it did not yet have a firm sales price commitment. If the company located a purchaser a month later and entered into a firm sales price commitment, there no longer would be any risk associated with the inventory.

If a company determines that the contracts no longer reduce exposure to risk, hedge accounting would not portray the economics of the futures transaction and should be terminated. Normally, this would not be an issue because such a company would either close out its contracts when the initial exposure to risk ceases (unless it decides to maintain them as a speculation), or designate the contracts as a hedge against price risk on a different item that qualifies for hedge accounting. Any gain or loss on the futures contract through the date when the initial exposure to risk ceased should be deferred. If they are not closed out, subsequent changes in the market value of the contracts should be accounted for as speculations or as new hedges, depending on the circumstances.

High Correlation

The purpose of a hedge is to offset price changes in the hedged item with similar but opposite price changes in the futures position. An intricate part of a hedging strategy is the correlation of price or interest rate movements. High correlation occurs when changes in the market price of the futures contract move in the same direction and with similar magnitude as changes in the market price of the item being hedged.

This theory is the basis for the Board's second hedge criterion -- that the futures contract reduce the exposure to risk created by the item to be hedged. This reduction of risk will be demonstrated if, at the inception of the hedge and throughout its term, it is probable that there will be a high correlation between the market value changes of the contract and the item to be hedged, so that one will offset the effects of the other. Also, ongoing high correlation is necessary for continued use of hedge accounting.

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Hedges

Normally, the best price correlation will exist when the item being hedged and the item underlying the futures contract are identical - for example, hedging an inventory of wheat with a futures contract that covers an identical grade of wheat. Although high correlation is expected in these situations, companies nevertheless should document the effectiveness of the hedge in achieving the objective of protecting prices or interest rates.

Cross-hedges

Typically, it is more difficult to establish a hedging strategy and to demonstrate high correlation for cross-hedges because the item being hedged is similar but not identical to the item underlying the futures contract.

The practice of cross-hedging has developed in response to certain constraints in the futures markets. For example, a company may wish to hedge an item on its balance sheet (or underlying a firm commitment or anticipated position), such as a portfolio of investments in corporate bonds, but may find that a futures contract on the specific item to be hedged is not available. Other reasons for cross-hedging are lack of a sufficient number of specific contracts, varying liquidity of futures contracts, and differing delivery dates. Hedging the corporate bond portfolio with T-bond futures contracts is an example of a cross-hedge.

Statement No. 80 allows hedge accounting for cross-hedges if a high correlation between the prices of the contract and the hedged item is probable and if a clear economic relationship exists between the prices of the item underlying the contract and the hedged item.

Using deferral accounting for cross-hedges departs from Statement No. 52, which remains unchanged by Statement No. 80. Under Statement No. 52, cross-hedges of foreign currencies are considered rare. The Board's final standards on cross-hedging for futures contracts appear to have been influenced by the Exposure Draft commentators. The Exposure Draft was very restrictive in what would qualify as a cross-hedge, and stated that cross-hedging would be acceptable only if it is "not practical" for a company to enter into a futures contract for the identical item. This requirement was dropped from the final Statement.

Determining high correlation between the prices of the cross-hedged item and the contract may be difficult. There are several areas that may give rise to implementation problems.

Determining Probability of High Correlation

The Board states that, in assessing the probability of high correlation, companies should evaluate the degree of correlation that can be expected at different market prices or interest rates, as well as the correlation during relevant past periods.

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History would indicate whether continual high correlation existed in the past, and initially this is the primary basis for concluding that high correlation in the future is possible. Two factors are critical to this historical analysis:

1. The period involved should include a full range of market conditions.
2. The data should be recent enough to represent present and future conditions.

In analyzing historical market trends and relationships, companies could compare changes in the gross dollar market value or yield of the contract and the cash price or yield of the item being hedged. Information on the historical cash prices of items underlying futures contracts and futures prices of actively traded contracts may be obtained from:

1. "Annual Statistical" published by Chicago Board of Trade
2. "Commodity Futures Trading Bibliography" published by Chicago Board of Trade
3. "Sources of Financial Futures Information: A Bibliography" published by Chicago Board of Trade
4. "Statistical Yearbook" published by New York Mercantile Exchange
5. Yearbook of the Chicago Mercantile Exchange
6. Statistical Annual of the Coffee, Sugar & Cocoa Exchange, New York
7. Statistical Yearbook of the New York Cotton Exchange
8. Commodity Yearbook of the Commodity Research Bureau, Inc.
9. New York Journal of Commerce
10. Wall Street Journal

The Statement does not define high correlation or provide parameters within which correlation should fall. Therefore, a primary implementation question would be what degree of correlation is necessary to demonstrate high correlation. Any answer to this will be very judgmental.

In choosing contracts for acceptable cross-hedges, the Statement does not require that companies select the most closely correlated contract available. Companies can select from among any contracts that meet the hedge criteria. For example, T-note futures may be the most closely correlated to a particular corporate bond portfolio, but T-bond futures may also result in an adequate (although not as close) correlation. Companies may find that the T-bond futures market is more liquid, and

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therefore, that using T-bond futures represents a better business decision than using T-note futures.

It is common to establish hedge ratios to achieve high dollar correlation and thus maximize hedge effectiveness. The hedge ratio represents the historical relationship between the market values of the futures position and the cash position being hedged. For example, using five \$100,000 contracts to hedge a \$400,000 asset would be a 1.25 hedge ratio. The hedge ratio that results in the maximum possible reduction in the variability of the futures and cash positions is sometimes referred to as the minimum risk hedge ratio. A ratio different than 1.0 generally is necessary because of the increased risk associated with higher rates and longer holding periods.

This type of hedging strategy probably would not violate the high correlation criterion if a clear economic relationship exists between the item being hedged and the item underlying the futures contracts. Also, the company must demonstrate, through historical analyses, that such weighting is necessary before high correlation can be expected. Of course, if the actual results of the futures transaction, based on a weighted number of contracts, are significantly different from what was expected, the ongoing high correlation condition would not be met, and hedge accounting should cease.

Some companies cross-hedge by using a combination of futures contracts. Believing this can be more effective since it averages the price changes and affords greater liquidity. The net price change may demonstrate higher correlation to the market price change of the item being hedged than a contract on a single item. Obviously, this would have to be demonstrated based on the specific circumstances.

A company need not hedge the entire item, exposing it to risk. For example, a company may designate that only \$1 million of a \$5 million portfolio of securities is being hedged. In these instances, the company must identify individual items within the portfolio that expose it to risk.

Length of Historical Correlation

How long should a company track price movements to demonstrate adequate historical correlation? Is one year long enough, or should a company plot five years of historical information? A reasonable answer depends upon the circumstances. Some types of futures contracts have not existed for five years, such as the gasoline and stock index futures. Most of the companies we have discussed this with have indicated that at least a one-year period is appropriate.

Would it be appropriate to use a shorter period of time but require a higher correlation, versus a longer period but less close correlation? We do not believe there is an offsetting relationship between the time period considered and the extent of correlation. Statement No. 80 indicates that high correlation must be probable. To satisfy this test, high correlation should exist over whatever historical period is considered representative.

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Because contracts are settled daily, substantial data exist as to market value changes in both the futures and cash markets. The frequency with which the correlation analysis is made (e.g., daily, monthly, quarterly) should be based on the hedging strategy and the characteristics of the items being hedged. For example, if short-term commercial paper having an average life of twenty days is being hedged with three-month contracts, the company may wish to track correlation on a daily basis. On the other hand, if long-term fixed-rate mortgage loans are being hedged, less frequent, perhaps monthly, assessments may be made.

When Does High Correlation Cease?

Because Statement No. 80 requires that ongoing high correlation is necessary for continued use of hedge accounting, another difficulty is determining if correlation has ceased. What degree of disparity in correlation disqualifies a contract from hedge accounting, recognizing that no hedge is perfect? Also, what is the relative importance of direction, magnitude, and frequency? For example, if the general direction and average magnitude of the changes are similar, how important is the difference in the frequency of the individual changes?

If a company performs the following procedures, we believe it will demonstrate a reasonable effort to evaluate the contract within the parameters of Statement No. 80, document management's intent, and support judgmental decisions:

1. Establish a method of determining correlation.
2. Determine a reasonable point at which a divergence or series of divergences represent cessation of high correlation.
3. Document these policies in writing.
4. Monitor and document adherence to the policies.
5. Apply the policies consistently.
6. Periodically, reassess the reasonableness of the policies in light of additional experience, industry norms or trends, actual and expected changes in the market, and changes in management's philosophy (e.g., investment in futures contracts that are clearly speculative).

For example, if market price movements in opposite directions are clearly temporary and such fluctuations have occurred in the past, this temporary deviation in correlation would not necessarily cause one to conclude that overall high correlation has ceased.

Accounting After Correlation Ceases

Once high correlation is determined as no longer being achieved, the contract should be considered speculative, and hedge accounting should cease. At this point, the "ineffective" portion of the futures contract

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results should be recognized in income. The ineffective portion is defined as the gain or loss on the futures contract that has not been offset by the market value changes of the hedged item since inception of the hedge.

For example, a \$2 million investment in redeemable preferred stock, accounted for at cost, was being hedged with T-bond futures contracts. The loss in the market value of the stock and the gain on the futures contracts since the inception of the hedge were \$480,000 and \$615,000, respectively; at this point, it was determined that high correlation had ceased. The carrying value of the preferred stock would have been adjusted for the results of the futures transaction since the inception of the hedge.

Once a contract is disqualified from hedge accounting, it could not be redesignated as a hedge later, because there would not be a reasonable expectation of high correlation.

Clear Economic Relationship for Cross-Hedges

Statement No. 80 sets forth a test that must be met, in addition to high correlation, for cross-hedges to satisfy the risk reduction criterion. This test provides that the market price of the item being hedged should bear a "clear economic relationship" to the price of the item underlying the contract.

Assume that a food processor wishes to hedge an inventory of sugar beets with sugar futures. To meet the high correlation standard, the market prices of the sugar beets and sugar futures must move together. Also, the market prices of the sugar beets and sugar itself must demonstrate a clear economic relationship.

The purpose of this test, applicable only to cross-hedges, is to ensure that historical correlation is more than coincidental. For example, assume that the price of sugar beets was highly correlated to the price of cattle over a short period. Because no economic relationship is apparent between the prices of these two commodities, a cross-hedge of sugar beets with cattle futures would not qualify for deferral accounting under Statement No. 80. Also, the economic relationship between short-term interest-bearing instruments and long-term securities is questionable given different interest rate sensitivities and price movements.

Normally, the clear economic relationship criterion would not be difficult to meet because the prices of like items tend to move together. Generally, similar-term interest-bearing securities with a 10 percent interest rate would decrease in value when the market rate is 12 percent. Similarly, the price of like commodities (for example, live cattle and feeder cattle) are subject to the same market influences and tend to move together. Therefore, only in extreme cases of unrelated cross-hedging would we expect the clear economic relationship criterion of Statement No. 80 to be a problem.

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Designation

Statement No. 80 requires designating a futures contract to be a hedge as a prerequisite for hedge accounting. Not only does designation establish management's intent to hedge, it also establishes the point at which hedge accounting should begin.

Aside from mentioning that designation should be made, no further guidance is provided in the Statement as to when or how a contract should be designated as a hedge. Therefore, the following questions may arise:

1. Can a futures contract, designated as a hedge at inception, be redesignated later as a speculation?
2. If a contract would meet the hedge criteria but is not so designated, can it later be designated and therefore qualify as a hedge?

According to the provisions of Statement No. 80, a contract that had been designated as a hedge can later be designated as a speculative contract. This is consistent with the election a company makes at the inception of the contract (i.e., whether to designate the contract as a hedge). However, we believe there should be a clear change in circumstances before a second redesignation -- from speculative back to hedging -- occurs.

Contracts meeting the hedge criteria, but not initially designated as hedges can be so designated subsequently. Hedge accounting would be applied starting with the designation date, rather than retroactively to the inception of the contract.

Additionally, although not required by the Statement, we recommend that companies designate contracts as speculations if this is their intent. This will establish management's intent at the inception of the contract and will clearly indicate the proper accounting to be applied. Such designation is particularly important if a company both speculates and hedges using the same type of futures contracts.

Documentation and Other Internal Control Matters

Companies also should document their intent to hedge when the contract is entered into, and specifically match a contract with the item to be hedged. The intent to hedge should be reflected in the accounting records, such as separate subsidiary ledgers prepared for memorandum control, brokers' advices, and other securities documentation. The overall hedging strategy and intent also should be reflected in the company's investment or purchasing policies. We encourage board approval of the hedging strategy.

A company's system of internal control should require approval for both the execution of and intended accounting for the futures contracts. Among the control procedures a company should consider are:

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1. Position limits established aggregately for the company and individually for persons authorized to execute transactions; adherence to limits monitored by management and board of directors and investment committee.
2. Contract positions reviewed individually and in total and valued on a regular basis.
3. Mark-to-market adjustments independently verified by reference to brokers' advice.
4. Independent review of documentation as to purpose (i.e., hedge or speculation) of contract positions and identification of asset or liability position being hedged.
5. Independent review of study of correlation between market value and contract gains and losses.
6. General-ledger memorandum accounts or commitment registers used to record transactions regularly reconciled.
7. Independent review conducted to ensure contract gains and losses recognized in accordance with original intent of transaction.
8. Comparison of price and date of the futures contract order as placed with the company's instructions to the trader to ensure the order was executed in a timely manner and that the execution price was consistent with the limit placed by the trader.
9. Documentation supporting the change in market value of the futures contract is reviewed prior to cash margin account transactions.

Anticipatory Hedges

Companies often use futures contracts to hedge anticipated transactions. Unlike Statement No. 52, which proscribes hedge accounting for anticipated foreign currency transactions, Statement No. 80 permits the application of hedge accounting to other futures contracts related to anticipated transactions. The FASB concluded that anticipated transactions can expose a company to risk from a "practical perspective," citing that anticipated transactions without an established price can create risk. Examples would be:

1. Requirements for price-sensitive inventory not covered by a firm purchase price commitment.
2. Planned issuance of short-term debt or other liabilities.
3. Liabilities with variable interest rates that are used to fund longer-term fixed-rate investments.

Therefore, since exposure to risk is the cornerstone of Statement No. 80's hedge-accounting provisions, rules differing from those in

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Statement No. 52 evolved during the Statement No. 80 standards-setting process.

Because of the tentative nature of these transactions, the Board states that management's intent, while important, should not be the sole determinant of the probability of a transaction subsequently occurring. Therefore, the Statement provides two tests that must be met in addition to those for existing items before the contract can be considered a hedge for accounting purposes.

The first one is identification of the significant characteristics and expected terms of the anticipated transaction, including:

1. Expected date of transaction.
2. Commodity or instrument that will be acquired or incurred by the subsequent transaction.
3. Expected quantity to be purchased or sold.
4. Expected maturity of interest-bearing financial instruments.

Second, the occurrence of the transaction must be probable. Factors supporting probability include:

1. Frequency of similar transactions in the past.
2. Ability (financial and operational) of the company to carry out the transaction.
3. Substantial commitment of resources to a particular activity that will use the item to be hedged (such as investment plans or production process).
4. Length of time to the expected date of the transaction (shorter period of time implying a higher likelihood that the transaction will occur).
5. Negative impact on operations if the transaction does not occur.
6. Low likelihood that a substantially different alternate transaction might be used instead.

Special Considerations for Financial Institutions

Macro-hedging

Financial institutions are exposed to a primary risk that arises from changes in their net interest margin. This risk results from the existence of interest-bearing assets and liabilities that have different contractual maturities and repricing provisions.

Although the FASB recognizes that "mismatched" assets and liabilities expose an institution to risk, it proscribes hedge accounting for futures

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contracts that are "macro-hedges" (i.e., hedges of an overall exposed position and thus not associated with identifiable assets, obligations, commitments, or anticipated transactions). The FASB believes the effectiveness of a macro-hedge cannot be gauged objectively because futures contracts are not available on net spreads. Therefore, reducing the uncertainty about future interest spreads must be accomplished by changing either the income or expense side of the spread through hedges of existing or anticipated asset or liability positions.

Hedging Strategy -- Designation and Amortization

An institution must make two important and related decisions so that the results of its hedging strategy are appropriately reflected in its financial statements:

1. Designate the asset or the liability as the hedged item.
2. Determine the method of amortizing the deferred market value changes of the futures contracts.

Because it is the combined characteristics of the assets and liabilities that expose an institution to risk, the Statement allows an institution to designate a contract as a hedge of either the asset or the liability, provided the hedge criteria are met for the strategy selected. An institution hedging fixed-rate long-term loans is protecting its yield on an existing asset position. Alternatively, if the institution hedges the three-month certificates of deposit (CDs) that fund the loans, it would be protecting itself against the anticipated need to reprice or replace the customer CDs.

The Statement requires that deferred gains or losses be amortized commencing no later than when the contract is closed out, regardless of whether the contract is replaced by a similar contract with a later delivery (i.e., rolled over). Because perfect matching would be achieved only by commencing amortization when the contracts change in value (e.g., daily), the Board recognizes that such accounting would be cumbersome. It believes that by requiring amortization to commence not later than when the contracts are closed out, inconsistencies would be minimized, and the permanent deferral of gains or losses through the continual rolling over of the futures contracts would be prevented. Additionally, the Board feels that termination of the contract is more objective in determining when amortization should begin.

Designating either the existing asset or the anticipated transaction involving the liabilities as a hedge generally will not result in significantly different net income if the institution's amortization practices are consistent with its hedging strategy. Designation, however, can have significant financial statement effects if an institution's amortization policy does not reflect its hedging strategy.

Consider a ten-year investment hedged because it is funded with one-year liabilities. After six months, the futures contracts mature and are rolled over. The Statement requires that the gain or loss from the

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closed contracts begin to be amortized over the remaining life of the asset at the time the contracts are closed. However, in this example, the liability will not reprice or renew for six more months, and beginning amortization prior to that will change the net interest margin between this asset and liability even though the liability has not repriced, and the net interest margin should be stable. This situation can be avoided by designating the contracts as a hedge of the anticipated repricing or reissuance of the liability.

In other circumstances, one element of a mismatched asset/liability position might reprice before the futures positions are closed out or rolled over. When this occurs, the changed interest rates on the repriced item would begin to be reflected in the financial statements. Higher interest rates on liabilities would adversely affect net interest margins; lower rates would improve net interest margins.

Assuming the futures contracts are highly correlated, however, those margins do not reflect the entire situation. The contracts would be generating gains or losses that would offset the change in interest margins. But unless the gains or losses on the contracts begin to be amortized when the actual position reprices, the financial statements will not reflect stable interest margins. This emphasizes the significance of Statement No. 80 permitting amortization of futures contract results at a date earlier than when the contracts are closed. We encourage institutions to take advantage of this and adopt an amortization policy that is consistent with their hedging strategies.

Disclosures

The Statement does not explicitly require separate disclosure of dollar effects that futures contract transactions have on financial statements. During the Exposure Draft stage, the Board asked commentators whether such disclosures would be useful. The majority of respondents did not favor these disclosures. They reasoned that hedging with futures is an integral part of operations for many companies, and its effects are no more noteworthy than other business decisions that are not disclosed separately in the financial statements. The Board agreed and decided that disclosure of specific dollar effects of futures contracts on financial statements would not be required.

However, the Board requires the following disclosures about contracts designated as hedges:

1. Nature of the assets, liabilities, firm commitments, or anticipated transactions that are being hedged with futures contracts.
2. Methods of accounting for the contracts, including a description of the events or transactions that result in recognition in income of the market value changes of the contracts.

This second disclosure may be difficult to implement because of all of the possibilities that result in income recognition. For example, the following events can trigger income recognition of previously deferred changes:

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1. Cessation of high correlation.
2. Accounting for the results of the hedge consistent with that of the item being hedged (e.g., lower-of-cost-or-market accounting for inventory).
3. Anticipated transaction not fully consummated.
4. Allocation of futures results between items disposed of during the period and items still on hand at the end of the period.

Companies should disclose only those events, leading to income recognition, that will probably occur. That is, if an event is remote and not foreseeable, disclosure of that event would not be necessary. By following this approach, companies would be disclosing only expected events, instead of every conceivable situation.

Income Tax Considerations

The federal income taxation of transactions involving commodity futures contracts is quite complex. Different rules apply depending on the type of contract as well as the type of transaction.

The futures contracts governed by Statement No. 80 will most likely involve the use of regulated futures contracts (RFCs). For federal tax purposes, an RFC is defined as a contract that is subject to daily cash settlement of gains and losses and is traded on an approved exchange. All futures contracts currently traded on U.S. exchanges qualify as RFCs under present tax law.

Generally, speculative futures contracts must be marked to market at the close of the taxable year. Any resulting gains or losses normally are considered capital in nature and are treated as if they were 60 percent long-term and 40 percent short-term - without regard to the actual holding period.

RFCs that are part of hedging transactions are exempt from many of the tax rules that would otherwise apply. For example, unrealized gains and losses at year end on RFCs used in hedging transactions are not included in taxable income under the mark-to-market rule.

Additionally, the so-called loss deferral rule, which generally defers the current recognition of losses in certain straddles, does not apply to hedging transactions.

The tax definition of a hedging transaction is similar to the Statement No. 80 definition. For federal tax purposes, Internal Revenue Code Section 1256(e)(2) defines a hedging transaction as follows:

A transaction entered into in the normal course of the taxpayer's trade or business primarily (1) to reduce risk of price change or currency fluctuations with respect to property which is held or to be held by the taxpayer, or (2) to reduce risk of interest rate or price changes or currency

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fluctuations with respect to borrowings made or to be made, or obligations incurred or to be incurred, and

The gain or loss on such transactions (includes both the RFC and the hedge item) is treated as ordinary income or loss, and

Before the close of the day on which such transaction was entered into (or such earlier time as prescribed by Internal Revenue Service regulation), the taxpayer clearly identifies such transaction as being a hedging transaction.

In general, banks do not have to meet either of the two purpose requirements of the first criterion regarding risk reducing to qualify a transaction as a hedging transaction. Furthermore, special rules may apply to hedging transactions conducted by certain limited partnerships, S-corporations, and other similar entities.

Thus, by definition, an RFC gain or loss stemming from a hedging transaction will be treated for federal income tax purposes as ordinary income or loss as opposed to capital gain or loss. Such ordinary income or loss will generally be recognized for federal tax purposes when the RFC is closed out by offset in the marketplace. In certain circumstances, RFC hedging gains and losses may be incorporated into taxpayer's inventory computations. In any event, if abuses of the hedging rules are detected by the IRS, it has the authority to require taxpayers to employ accounting methods that clearly reflect their income.

The identification requirement contained in the hedging transaction definition is presently causing some concern since no clarifying regulations have yet been issued. It appears to be the intent of Congress that both the RFC and the hedged item be properly identified as a hedging transaction. However, it is anticipated that any regulations will attempt to minimize bookkeeping identification problems where practical, such as for banks and securities dealers who conduct numerous hedging transactions. In such cases, the mere identification of an entire account or portfolio as hedge items will probably suffice absent poor records or significant tax manipulation opportunities.

MR. WILLIAM D. WARD:

Financial Futures Contracts

A financial futures contract is between a buyer or seller and the clearinghouse of a futures exchange. Its terms obligate a purchaser to accept or a seller to make delivery of a standardized quantity of a financial instrument, or make cash settlement in lieu thereof, at a specified date for a specified price.

The regulators have several primary concerns about this:

1. There is potential for a rapid "loss of shirt" for the unsophisticated or unwary.

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2. There is a need for care and vigilance.
3. There should be careful planning and monitoring of an insurer's futures trading activities.

Specifically, the regulator has had to address the following issues with respect to futures:

1. Lack of usual investment characteristics
 - a. The instrument is neither debt or equity interest -- not an investment security in the usual sense; it is a commodity.
 - b. The holder is also the obligor.
 - c. How do you measure exposure or investment?
 - d. The instrument is nonincome producing.
2. Liquidity exposure -- daily settlement of gains and losses
3. Potential for abuse
 - a. Leveraging of investments
 - b. Speculation (risk of betting the company)
 - c. Broker defalcation
4. Control of insured assets -- assets may not be under insurer's control (assets may be taken from or put back at the holder's option)
5. Unauthorized activity -- nature of instrument; i.e., cost per unit is small; transaction can be made by phone; activity is relatively transparent

Currently, the National Association of Insurance Commissioners (NAIC) has general requirements for accounting for financial futures contracts. Companies must report any cash deposited with a broker as an asset and adjust by any gain or loss on a contract which can be deferred, i.e., certain hedging transactions. (If securities are deposited, they are escrowed and thus disclosed.) Companies must currently recognize changes in the contract's market value, unless hedging criteria are satisfied. If hedging criteria are satisfied, changes in market value of the contract must be recognized consistently with changes in value of the hedged item if the contract is for a market-valued underlying instrument.

There are various hedging transaction requirements. The generic criteria for a hedging transaction (definition of a hedging transaction varies by state) are (a) exposure to price or interest rate risk must exist; (b) the transaction must reduce risk; and (c) the transaction must be "effective" as a hedge.

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Accounting for a hedging transaction includes amortized cost items. Gains or losses on the contract, i.e., changes in market value, are deferred until completion of the hedge and the determination that an underlying transaction will not take place. If during the life of the contract, the hedge is not effective, deferral accounting ceases, and a gain or loss is recognized to the extent the hedge is not effective. If a determination is made that the underlying transaction will not take place, deferral accounting ceases and a gain or loss on the contract (since inception) is recognized currently. Upon completion of the hedge, the deferred gain or loss is added to the basis of the hedged item and used in the measurement of the underlying transaction. Adjustments to the basis of hedged items are amortized into income over the remaining life of the hedged item.

Accounting for a hedging transaction also includes market value items. Changes in market value of contracts are recognized currently. Changes are reported consistently with reporting of changes in value of the underlying hedged items, e.g., unrealized gains or losses for hedges of common stock. Nonhedging transactions are activities generally limited or prohibited by statute, regulation, and so on. Where they are permitted, the accounting is the same as the accounting for hedging of market value items.

When reporting hedging transactions under Schedule DB, information is split between long and short positions and is required for (a) positions open at the end of the period and (b) activities consummated during the year, i.e., opened or terminated. The required detail information includes (a) the number of contracts with description, (b) the original price, current or closing price, difference, and gain or loss on termination, and (c) disposition of gains or losses, i.e., deferred, recognized, used to adjust basis.

The primary areas of differences among state statutes and regulations include:

1. Hedging criteria
2. Types of futures contracts allowed: debt, equity, index
3. Permitted underlying financial instruments
4. Investment limitations
5. Accounting considerations

Options Contracts

Under an options contract, the holder has the right to purchase (in the case of a call option) or the right to sell (in the case of a put option) the amount of the underlying financial instrument covered by the contract at a stated price. Insurers can use an options contract for basically the same purposes as futures contracts:

1. To hedge a long-term interest rate commitment

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2. To hedge the anticipated purchase or sale of an asset against market value fluctuations
3. Where permitted by statute, to use as a surrogate investment or for income enhancement

Options have been used by insurers in a limited capacity for a number of years and generally are more widely accepted by regulators. Recently, various statutes have given insurers new flexibility, and thus, the regulators' concerns are similar to those related to futures. These include:

1. Potential for abuse (leveraging of investments, speculation)
2. Control of insurer's assets (Control of assets may not be in hands of insurer. Some states prohibit the writing or purchase of put options because of this concern).
3. Nonincome producing (purchases)

Current NAIC accounting for options contracts requires (a) recording the consideration, i.e., "premium" paid as an asset in the case of options purchased, or received as a liability in the case of options written; (b) marking to market of the contract and the current recognition of a gain or loss during the life of the options, unless hedge criteria are satisfied; and (c) if hedging criteria are satisfied, the recognition of changes in market value of the contract in a manner consistent with the recognition of changes in value of the hedged item.

The generic criteria for options contracts are the same as for futures. Exposure to price or interest rate risk must exist. The transaction must reduce risk and be "effective" as a hedge.

Accounting includes amortized cost items. During the life of the option, premium paid is recorded as an asset valued at cost with no gain or loss recognition. If the hedge is no longer effective, valuation at cost ceases and mark-to-market accounting is required. Upon expiration, exercise, termination, and if the hedge is effective, premium paid for the option is added to the basis of the hedged item or deducted from consideration received upon the sale of the hedged item. Upon expiration, exercise, termination, and if the hedge is not effective, (a) if exercised, the accounting would be the same for as an effective hedge; (b) if expired or terminated, the resulting gain or loss is recognized at the date of exercise, termination or expiration. Accounting for an option written (sold) is the mirror image of the accounting for options purchased.

Accounting also includes market value items. During the life of the option, (1) premium paid is recorded as an asset, (2) the asset is valued at current market, and (3) changes in market value are treated as an unrealized gain or loss. Upon exercise, premium paid for the option is added to the basis of the hedged item or deducted from consideration received upon sale of an asset. Upon expiration or termination, the transaction results in a realized gain or loss. Accounting for options

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written (sold) is the mirror image of the accounting for the purchase of options use to hedge market value items. Nonhedging transaction activities are generally limited or prohibited by states. Accounting for non-hedging transactions are the same as for hedging of market value items.

When reporting options contracts under Schedule DB, information is split between puts and calls and is required for (a) options owned and written and (b) activities consummated during the year, i.e., acquired, written, and terminated. The required detail information includes:

1. Description -- including underlying security[ies] or contract[s]
2. Exercise price, premium paid or received, market value, statement value, and gain or loss
3. Disposition of gain or loss -- deferred, recognized, used to adjust basis

The primary areas of difference among state statutes and regulations relate to:

1. Hedging criteria
2. Whether hedging is a requirement
3. Types of permitted transactions
 - a. Is writing of naked calls permitted?
 - b. Is purchase of puts permitted?
 - c. Is purchase of calls permitted?
4. Permissible underlying instruments -- debt, equity, futures
5. Investment limitations
6. Accounting considerations (minor)

Transfer of Marketable Securities with Put Option "Put Option Transactions"

Put option transactions are the transfer or sale of securities (generally lower yield tax-exempts) to a third party who remarkets. Typically a put is attached to the remarketed security. The put allows the ultimate investor to sell back the securities at a stated price at established times in the future. Generally, the insurer must repurchase any securities returned to the third party by the investors in cases where the third party issued the put. These transactions are used primarily by property and casualty companies to convert tax-exempt income to taxable income. There are few transactions to date (under ten known) with considerable variance in terms.

The regulators are concerned with:

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1. The nature of the transaction, i.e., put option, reverse repurchase agreement
2. The control of insurer assets
3. The manipulation of surplus -- not recording loss or recording inappropriate gain
4. The value to place on returned securities

There are no specific GAAP standards to account for put option transactions. You must look to the sale of receivable with recourse. Collateral borrowing arises if probable securities will come back. Transferred securities remain on the books. Liability for proceeds (or strike amount) is established.

California's accounting bulletin calls for: (a) treating the transaction as collateral borrowing, (b) establishing a liability for full strike price, and (c) special Schedule D identification of securities transferred and securities acquired with proceeds. Connecticut requires collateral borrowing. New York's one-year limitation prevents most transactions. These transactions are not permitted under Illinois statutes.

The issue is under study by the New Investment Vehicles Study Group from the NAIC. The Study Group recommends that if admitted assets are used, (1) transferred securities should be removed from books; (2) a liability should be established for the difference between proceeds and book value assuming proceeds are greater than book; and (3) liability should be increased to the difference between book and strike price. If nonadmitted assets are used, (1) transferred assets should remain on books; (2) a liability should be established for proceeds received; and (3) liability should be increased up to the strike price.

The NAIC will vote on formal adoption in June. There are flaws in the NAIC position. It doesn't account for differences in deals, e.g., puts not issued by insurer, guarantees, recourse provisions. It ignores economics, i.e. proceeds generally will not exceed book value. Securities in almost all cases will come back; thus, the question is whether they should be removed from books.

MR. MATTHEW S. EASLEY: Right now interest rates seem to be down a bit. Some life insurance companies have longer securities from prior to going into segmentation and so on. What is the possible use of those types of securities as a hedge against some of these long bonds that we don't want to unload.?

MR. CARNEY: Interest rate swaps are obviously being used by some companies in place of futures. I have seen some swaps that are tied to the Libor grades.

MR. ROGERS: Most states say that there are some questions regarding proper accounting, and whether we are permitted to do interest rate swaps. The regulator's problem is in what pigeonhole should interest rate swaps belong. If the regulators can figure out where it belongs,

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then maybe they can come to grips with the proper accounting for it. It has been suggested that if we ever complete our work on futures and options and now this put bond, perhaps this new investment group may take up the topic; it is on their list.

MR. CARNEY: Anybody interested in financial futures might read the book by Art Rebel and Gail Gorden called Financial Futures and Investment Strategies, published by Dow Jones-Irwin Press. This is an excellent book, written from the standpoint of an insurance company.

MR. JAMES P. A. KNIGHT: Discounted collateralized mortgage obligations (CMOs) are bought assuming certain levels of prepayments. What is the proper statutory accounting when those prepayments, in fact, are made?

MR. WARD: The desire is, of course, to make them income gains instead of capital gains.

MR. RALPH H. GOEBEL: No one has mentioned the interesting situation when you have a bond that you carry at amortized or book value, but which currently has a market value of say 70 or 80 cents on the dollar. You sell futures to hedge that. This has some interesting complications as far as the statutory statement is concerned. If the interest rates decline, the market value of that bond goes up, but it might not go up to the carrying value on your books. So you don't get any gain from that aspect of the transaction. But you have a hedge loss. Am I correct?

MR. WARD: You're correct. You would want to think about it. The statutory presentation would result in just exactly what you said, during the life of that hedge.

MR. CARNEY: One of the problems from an insurance company's standpoint is the couple of components to the hedge. Let's say you put on a hedge transaction, and you're buying a treasury bond future. If interest rates go down, then the price of your bond that you've hedged against has gone up in value. However, the chief executive officer (CEO) comes downstairs and says, "How are we doing on our futures hedge?" You say, "Well, we've lost a million dollars." He says, "This isn't good. We've paid out a million dollars in cash. This doesn't sound like a great deal. What are we in the hedge business for?" The components of the two are not necessarily looked at together, and that could account for some of the perceived problems.

MR. STEVE D. SCHULTZ: If a company is doing business in all fifty states, what do the laws boil down to? Can we use futures for a valid hedge?

MR. WARD: That is a difficult question. I believe Massachusetts is a state that permits the utilization of futures. New York certainly is fairly permissive for a life insurer for hedges of fixed-income futures. However, there are certain other states (e.g., Minnesota) whose statutes are extraterritorial. In other words, you have a problem whereby in some states you may have to adjust on the statement you file with that

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particular state. When you're writing a covered call option, it's difficult to make a sweeping statement that you can or cannot, in fifty states, write the remaining kinds of options and futures. The language is specific, and it is difficult to draw a general conclusion. In general, Connecticut, Massachusetts, New Jersey, and Minnesota companies have been able to do futures with little problem. If you're domiciled in other states, Texas for example, read their laws with considerable care. While the language may sound enabling, when you analyze it, you may find that they all but prohibit. A summary of American Council of Life Insurance (ACLI) General Bulletin 3543 appears in Attachment I. Consult the Bulletin for descriptions of the positions of individual state insurance departments and the statutory references.

MR. CARNEY: It's also interesting to read the New York and California provisions. In New York you are allowed to do one thing in terms of options, and that's all you're allowed to do. California statutes state that that's exactly the one thing you cannot do. There's obviously a lot of concern about the investments and the investment laws in the extraterritorial nature of some of the states as to how they interpret either their reserves statutes or their investment loss. Most people are looking to their own state of domicile's laws and satisfying them. If some other states suggest otherwise, then those people will change their statement for that state.

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ATTACHMENT I

FINANCIAL FUTURES IN THE INSURANCE INDUSTRY

SUMMARY OF STATE AND DISTRICT OF COLUMBIA

INSURANCE DEPARTMENT POSITIONS

DECEMBER 18, 1984

Allowed by Statute	-	18
Allowed through a Basket or Leeway Clause	-	11
Prohibited by Statutory Construction and/or Informal Policy	-	9
Allowed through Informal Policy Administrative Rule, Regulation, or Insurance Department Bulletin	-	7
No Specific Policy	-	4
Proposed Statute Would Allow	-	1
Proposed Regulation Would Allow	-	1

