

## Statutory Issue Paper No. 27

### Disclosure of Information about Financial Instruments with Concentration of Credit Risk

#### STATUS

Finalized March 16, 1998

**Original SSAP and Current Authoritative Guidance: SSAP No. 27**

#### Type of Issue:

Common Area

#### SUMMARY OF ISSUE

1. In the normal course of business, insurance enterprises enter into transactions involving investment contractual relationships which include but are not limited to time deposits, short-term investments, bonds, preferred stocks, mortgage loans, deposit accounts and notes payable, collectively called financial instruments. Many of these transactions can result in concentrations of credit risks in that significant fluctuations in one area of a financial market could result in material adverse financial consequences to an insurance enterprise. With certain exceptions, current statutory guidance does not require financial statement disclosure of financial instruments with concentration of credit risk. GAAP has specific disclosure requirements for financial instruments which have concentration of credit risk. This issue paper establishes statutory accounting principles for disclosure of financial instruments with concentration of credit risk that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

#### SUMMARY CONCLUSION

2. Except as noted in paragraph 14 of *FASB Statement No. 105, Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk* (FAS 105), (included in the Relevant GAAP Guidance section of this Issue Paper), a reporting entity shall disclose all significant concentrations of credit risk arising from all financial instruments whether from an individual or group. Group concentrations of credit risk exist if a number of individuals or groups are engaged in similar activities and have similar economic characteristics that would cause their ability to meet contractual obligations to be similarly affected by changes in economic or other conditions. The following shall be disclosed in the notes to the financial statements about each significant concentration:

- a. Information about the (shared) activity, region, or economic characteristic that identifies the concentration
- b. The amount of the accounting loss due to credit risk the entity would incur if parties to the financial instruments that make up the concentration failed completely to perform according to the terms of the contracts and the collateral or other security, if any, for the amount due proved to be of no value to the entity
- c. The entity's policy of requiring collateral or other security to support financial instruments subject to credit risk, information about the entity's access to that collateral or other security, and the nature and a brief description of the collateral or other security supporting those financial instruments.

## DISCUSSION

3. The conclusion above adopts the provisions of FAS 105 as it relates to financial instruments with concentrations of credit risk (paragraphs 14 and 20). Disclosure of information about financial instruments with off-balance-sheet risk relating to derivative financial instruments is covered in *Issue Paper No. 85—Derivative Instruments* (Issue Paper No. 85) which contains all of the disclosure requirements for derivatives.

4. The Statement of Concepts states that “*Because these basic financial statements cannot be expected to provide all of the information necessary to evaluate an entity’s short-term and long-term stability, management must supplement the financial statements with sufficient disclosures (e.g., notes to the financial statements, management’s discussion and analysis, and supplementary schedules and exhibits) to assist financial statement users in evaluating the information provided.*” Disclosures of financial instruments with concentration of credit risk is consistent with that objective.

5. The following represent examples where disclosure of concentration of credit risk may be warranted. These examples are not intended to be all inclusive.

- a. Entities which invest in mortgage loans wherein a substantial portion of the loans are in farms and the debtors’ ability to honor the contract is dependent upon the agribusiness economic sector.
- b. Entities investing in mortgage loans wherein a substantial portion of the loans are located in one geographic region and the debtors’ ability to honor the contract is dependent upon the economic stability of that region.

### Drafting Notes/Comments

- Disclosure of information about financial instruments with off-balance-sheet risk is covered in *Issue Paper No. 85—Derivative Instruments*.

## RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

### Statutory Accounting

6. There is no statutory guidance on disclosures about concentrations of credit risk. However, the NAIC Annual Statement Instructions for Life and Accident and Health and for Property and Casualty Insurance Companies require information about the geographic location of certain investments which provides some information about concentrations of credit risk (e.g. Schedule B on mortgage).

### Generally Accepted Accounting Principles

7. FAS 105 discusses disclosure of concentration of credit risk as follows:

6. A financial instrument is cash, evidence of an ownership interest in an entity, or a contract that both:
  - a. Imposes on one entity a contractual obligation<sup>1</sup> (1) to deliver cash or another financial instrument<sup>2</sup> to a second entity or (2) to exchange financial instruments on potentially unfavorable terms with the second entity

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<sup>1</sup> Contractual obligations encompass both those that are conditioned on the occurrence of a specified event and those that are not. All contractual obligations that are financial instruments meet the definition of liability set forth in *FASB Concepts Statement No. 6, Elements of Financial Statements*, although some may not be recognized as liabilities in financial statements—may be “off-balance-sheet” —because they fail to meet some other criterion for recognition. For some financial instruments, the obligation is owed to or by a group of entities rather than a single entity.

<sup>2</sup> The use of the term financial instrument in this definition is recursive (because the term financial instrument is included in it), but it is not circular. It requires a chain of contractual obligations that ends with the delivery of cash or an ownership interest in an entity. Any number of obligations to deliver financial instruments can be links in a chain that qualifies a particular contract as a financial instrument.

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- b. Conveys to that second entity a contractual right<sup>3</sup> (1) to receive cash or another financial instrument from the first entity or (2) to exchange other financial instruments on potentially favorable terms with the first entity.
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<sup>3</sup> Contractual rights encompass both those that are conditioned on the occurrence of a specified event and those that are not. All contractual rights that are financial instruments meet the definition of asset set forth in Concepts Statement 6, although some may not be recognized as assets in financial statements—may be “off-balance-sheet”—because they fail to meet some other criterion for recognition. For some financial instruments, the obligation is held by or due from a group of entities rather than a single entity.

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7. The risk of accounting loss<sup>4</sup> from a financial instrument includes (a) the possibility that a loss may occur from the failure of another party to perform according to the terms of a contract (credit risk), (b) the possibility that future changes in market prices may make a financial instrument less valuable or more onerous (market risk),<sup>5</sup> and (c) the risk of theft or physical loss. This statement addresses credit and market risk only.

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<sup>4</sup> Accounting loss refers to the loss that may have to be recognized due to credit and market risk as a direct result of the rights and obligations of a financial instrument.

<sup>5</sup> A change in market price may occur (for example, for interest-bearing financial instruments) because of changes in general interest rates (interest rate risk), changes in the relationship between general and specific market interest rates (an aspect of credit risk), or changes in the rates of exchange between currencies (foreign exchange risk).

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8. Some financial instruments are recognized as assets, and the amount recognized reflects the risk of accounting loss to the entity. A receivable that is recognized and measured at the present value of future cash inflows, discounted at the historical interest rate (often termed amortized cost), is an example: the accounting loss that might arise from that account receivable cannot exceed the amount recognized as an asset in the statement of financial position.<sup>6</sup>

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<sup>6</sup> It is possible that an economic loss could exceed that amount if, for example, the current market value of an asset was higher than the amount recognized in the statement of financial position. This Statement, however, does not address that economic loss.

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12. This Statement requires disclosure of information about financial instruments that have off-balance-sheet risk and about financial instruments with concentrations of credit risk except as specifically modified by paragraphs 14 and 15. It does not change any requirements for recognition, measurement, or classification of financial instruments in financial statements.

14. The requirements of paragraphs 17, 18, and 20 do not apply to the following financial instruments, whether written or held:

- a. Insurance contracts, other than financial guarantees and investment contracts, as discussed in *FASB Statements No. 60, Accounting and Reporting by*

*Insurance Enterprises, and No. 97, Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*

- b. Unconditional purchase obligations subject to the disclosure requirements of *FASB Statement No. 47, Disclosure of Long-Term Obligations*<sup>9</sup>

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<sup>9</sup> Unconditional purchase obligations not subject to the requirements of Statement 47 are included in the scope of this Statement. That is, unconditional purchase obligations that require the purchaser to make payment without regard to delivery of the goods or receipt of benefit of the services specified by the contract and are not within the scope of Statement 47 (because they were not negotiated as part of a financing arrangement, for example) are included in the scope of this Statement.

- c. Employers' and plans' obligations for pension benefits, postretirement health care and life insurance benefits, employee stock option and stock purchase plans, and other forms of deferred compensation arrangements, as defined in *FASB Statements No. 35, Accounting and Reporting by Defined Benefit Pension Plans, No. 87, Employers' Accounting for Pensions, No. 81, Disclosure of Postretirement Health Care and Life Insurance Benefits, No. 43, Accounting for Compensated Absences*, as well as *APB Opinions No. 25, Accounting for Stock Issued to Employees*, and *No. 12, Omnibus Opinion--1967*
- d. Financial instruments of a pension plan, including plan assets, when subject to the accounting and reporting requirements of Statement 87.<sup>10</sup>

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<sup>10</sup> Financial instruments of a pension plan, other than the obligations for pension benefits, when subject to the accounting and reporting requirements of Statement 35 are included in the scope of this Statement.

- e. Substantively extinguished debt subject to the disclosure requirements of *FASB Statement No. 76, Extinguishment of Debt*, and any assets held in trust in connection with an in-substance defeasance of that debt.

16. Generally accepted accounting principles contain specific requirements to disclose information about the financial instruments noted in paragraphs 14 and 15, and this Statement does not change those requirements. For all other financial instruments, the requirements in this Statement are in addition to other disclosure requirements prescribed by generally accepted accounting principles.

### **Disclosure of Concentrations of Credit Risk of All Financial Instruments**

20. Except as noted in paragraph 14, an entity shall disclose all significant concentrations of credit risk arising from all financial instruments, whether from an individual counterparty or groups of counterparties. Group concentrations of credit risk exist if a number of counterparties are engaged in similar activities and have similar economic characteristics that would cause their ability to meet contractual obligations to be similarly affected by changes in economic or other conditions. The following shall be disclosed about each significant concentration:

- a. Information about the (shared) activity, region, or economic characteristic that identifies the concentration.
- b. The amount of the accounting loss due to credit risk the entity would incur if parties to the financial instruments that make up the concentration failed

completely to perform according to the terms of the contracts and the collateral or other security, if any, for the amount due proved to be of no value to the entity.

- c. The entity's policy of requiring collateral or other security to support financial instruments subject to credit risk, information about the entity's access to that collateral or other security, and the nature and a brief description of the collateral or other security supporting those financial instruments.

8. Paragraphs 9, 10, 11, 13, 15, 17, 18, and 19 of FAS 105 have been deleted from this section as they deal with Off-Balance sheet risk which will be addressed in Issue Paper No. 85.

## RELEVANT LITERATURE

### Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- NAIC *Annual Statement Instructions for Life and Accident and Health and for Property and Casualty Insurance Companies*

### Generally Accepted Accounting Principles

- *FASB Statement No. 105, Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk*

### State Regulations

- No additional guidance obtained from state statutes or regulations.

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