Statutory Accounting Principles (E) Working Group
Hearing Agenda
October 13, 2020
1:00 P.M. – 3:00 P.M. Central
ROLL CALL

Dale Bruggeman, Chair	Ohio	Judy Weaver	Michigan
Carrie Mears/Kevin Clark, Vice Chairs	Iowa	Doug Bartlett	New Hampshire
Richard Ford	Alabama	Bob Kasinow	New York
Kim Hudson	California	Melissa Greiner/Kim Rankin	Pennsylvania
Kathy Belfi/William Arfanis	Connecticut	Jamie Walker	Texas
Dave Lonchar	Delaware	Doug Stolte/David Smith	Virginia
Eric Moser	Illinois	Amy Malm	Wisconsin
Caroline Fletcher/Stewart Guerin	Louisiana		

NAIC Support Staff: Julie Gann, Robin Marcotte, Jim Pinegar, Fatima Sediqzad, Jake Stultz

Note: The SAPWG public call may be recorded on WebEx for subsequent use.

REVIEW AND ADOPTION of NON-CONTESTED POSITIONS

The Working Group may individually discuss the following items or may consider adoption in a single motion. *(Agenda item 2020-31 is included per industry request; all other items reject U.S. GAAP.)*

1. Ref #2020-31: Early Adoption of SSAP No. 32R
2. Ref #2020-26: *ASU 2015-10, Technical Corrections and Improvements*
3. Ref #2020-27: *ASU 2019-09, Financial Services – Insurance, Effective Date*
4. Ref #2020-28: *ASU 2020-01, Investments ASU 2020-01, Investments—Equity Securities, Investments—Equity Method and Joint Ventures, and Derivatives and Hedging*
5. Ref #2020-29: *ASU 2020-05, Revenue from Contracts with Customers and Leases, Effective Dates for Certain Entities*

Ref #	Title	Attachment #	Agreement with Exposed Document?	Comment Letter Page Number
2020-31 SSAP No. 32R (Jim)	**Early Application of SSAP No. 32R—Preferred Stock**	**1 – Agenda Item**	**No Comments**	**IP - 16**

Summary:
On July 30, the Working Group adopted *Issue Paper No. 164—Preferred Stock* and substantively revised *SSAP No. 32R—Preferred Stock* with an effective date of Jan. 1, 2021. After adoption, in response to industry request, on Aug. 17, the Working Group exposed nonsubstantive edits to allow early adoption for year-end 2020.

Interested Parties' Comments: Interested parties have no comments on this item.

Recommended Action:
NAIC staff recommends that the Working Group adopt the exposed nonsubstantive revisions to *SSAP No. 32R—Preferred Stock.* SSAP No. 32R was substantially revised during the Summer National Meeting with an effective date of Jan. 1, 2021. These revisions would allow early adoption for year-end 2020.

Ref #	Title	Attachment #	Agreement with Exposed Document?	Comment Letter Page Number
2020-26 Appendix D (Fatima)	***ASU 2015-10, Technical Corrections & Improvements***	**2 – Agenda Item**	**No Comment**	**IP - 13**

Summary:
On July 30, 2020, the Working Group moved this agenda item to the active listing, categorized as nonsubstantive, and exposed revisions to *Appendix D—Nonapplicable GAAP Pronouncements* to reject *ASU 2015-10, Technical Corrections & Improvements* as not applicable to statutory accounting. FASB issued ASU 2015-10 to update the FASB Accounting Standards Codification for minor corrections or clarifications. Each update/modification was reviewed for a possible statutory accounting impact with rational detailing the recommendation for rejection.

Interested Parties' Comments: Interested parties have no comments on this item.

Recommended Action:
NAIC staff recommends that the Working Group adopt the exposed revisions to *Appendix D—Nonapplicable GAAP Pronouncements* to reject *ASU 2015-10, Technical Corrections & Improvements* as not applicable for statutory accounting.

Ref #	Title	Attachment #	Agreement with Exposed Document?	Comment Letter Page Number
2020-27 Appendix D (Fatima)	***ASU 2019-09, Financial Services – Insurance; Effective Date***	**3 – Agenda Item**	**No Comment**	**IP – 13**

Summary:
On July 30, 2020, the Working Group moved this agenda item to the active listing, categorized as nonsubstantive, and exposed revisions to *Appendix D—Nonapplicable GAAP Pronouncements* to reject *ASU 2019-09—Financial Services – Insurance* as not applicable to statutory accounting. FASB issued ASU 2019-09 to defer the effective date of the amendments in *ASU 2018-12, Targeted Improvements to the Accounting for Long-Duration Contracts*. ASU 2018-12 was previously rejected for statutory accounting.

Interested Parties' Comments: Interested parties have no comments on this item.

Recommended Action:
NAIC staff recommends that the Working Group adopt the exposed revisions to *Appendix* to *Appendix D—Nonapplicable GAAP Pronouncements* to reject *ASU 2019-09—Financial Services – Insurance* as not applicable for statutory accounting.

Ref #	Title	Attachment #	Agreement with Exposed Document?	Comment Letter Page Number
2020-28 SSAP Nos. 48, 86 & 97 (Fatima)	***ASU 2020-01, Investments—Equity Securities (Topic 321), Investments—Equity Method and Joint Ventures (Topic 323), and Derivatives and Hedging (Topic 815), Clarifying the Interactions between Topic 321, Topic 323, and Topic 815***	**4 – Agenda Item**	**No Comment**	**IP - 13**

Summary:
On July 30, 2020, the Working Group moved this agenda item to the active listing, categorized as nonsubstantive, and exposed revisions to reject *ASU 2020-01, Investments—Equity Securities (Topic 321), Investments—Equity Method and Joint Ventures (Topic 323), and Derivatives and Hedging (Topic 815), Clarifying the Interactions between Topic 321, Topic 323, and Topic 815* in *SSAP No. 48—Joint Ventures, Partnerships and Limited Liability Companies*, *SSAP No. 86—Derivatives,* and *SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities*. In Jan. 2016, FASB issued *ASU 2016-01, Financial Instruments, Recognition and Measurement of Financial Assets and Financial Liabilities,* to allow entities to measure certain equity securities at cost, less any impairments. ASU 2016-01 was previously rejected for statutory accounting.

Interested Parties' Comments: Interested parties have no comments on this item.

Recommended Action:
NAIC Staff recommends that the Working Group adopt the exposed revisions to reject *ASU 2020-01, Investments—Equity Securities (Topic 321), Investments—Equity Method and Joint Ventures (Topic 323), and Derivatives and Hedging (Topic 815), Clarifying the Interactions between Topic 321, Topic 323, and Topic 815* for statutory accounting in SSAP No. 48, SSAP No. 86 and SSAP No. 97.

Ref #	Title	Attachment #	Agreement with Exposed Document?	Comment Letter Page Number
2020-29 Appendix D (Jake)	***ASU 2020-05—Effective Dates for Certain Entities***	**5 – Agenda Item**	**No Comment**	**IP - 13**

Summary:
On July 30, 2020, the Working Group moved this agenda item to the active listing, categorized as nonsubstantive, and exposed revisions to *Appendix D—Nonapplicable GAAP Pronouncements* to reject *ASU 2020-05, Revenue from Contracts with Customers (Topic 606) and Leases (Topic 842), Effective Dates for Certain Entities* as not applicable to statutory accounting. ASU 2020-05 updates the effective dates for *ASU 2014-19, Revenue from Contracts with Customers (Topic 606)* and *ASU 2016-02, Leases (Topic 842),* both rejected for statutory accounting.

Interested Parties' Comments: Interested parties have no comments on this item.

Recommended Action:
NAIC staff recommends that the Working Group adopt the exposed revisions to *Appendix D—Nonapplicable GAAP Pronouncements* to reject *ASU 2020-05, Revenue from Contracts with Customers (Topic 606) and Leases (Topic 842), Effective Dates for Certain Entities* as not applicable to statutory accounting.

The comment letter with the non-contested positions is included as Attachment 6 (16 pages).

REVIEW AND DISCUSSION ON SSAP NO. 43R ISSUE PAPER

Ref #	Title	Attachment #	Agreement with Exposed Document?	Comment Letter Page Number
2019-21 SSAP No. 43R (Julie)	**SSAP No. 43R—Loan-backed and Structured Securities**	**7 – IA Proposal 8 – Issue Paper**	**Comments Received**	**Attachment 9**

The Working Group appreciates the detailed comment letter received from interested parties on the exposed SSAP No. 43R issue paper. Due to the extent of detail provided, the Working Group has elected to initially focus on two key themes within the comment letter. For purposes of this Oct. 13, 2020 conference call, the Working Group will hear comments and focused discussion on the following two areas:

1. Classification as *SSAP No. 26R—Bonds* or *SSAP No. 43R—Loan-Backed and Structured Securities*
2. Definition of Asset-Backed Security

Topic 1: Classification in SSAP No. 26R—Bonds or SSAP No. 43R—Loan-Backed and Structured Securities

Although the issue paper did not introduce new guidance to differentiate between SSAP No. 26R and SSAP No. 43R, it provided historical context and the current definition in SSAP No. 43R, which identifies LBSS as securities issued through a trust established by a sponsoring parent obligation. Furthermore, it provided info that NAIC staff's interpretation of the revisions adopted in 2009 were intended to capture investments issued from a SPV in SSAP No. 43R. The comments received have identified inconsistencies in practice with regards to the current application and have proposed to allow all structures issued from a trust / SPV without prepayment or extension risk to be within scope of SSAP No. 26R and reported as an "Issuer Obligation" on Schedule D-1.

Interested Parties' Comments: (Note – Only excerpts are included. The full letter is in the attachments.)
The following elements are key excerpts from the interested parties' comment letter:

Interested Parties' Comment Letter: Preamble – Page 4:

3) Today, there are essentially two accounting paradigms for bonds – SSAP No. 26R ("regular" amortized cost) and SSAP No. 43R ("modified" amortized cost that is adjusted periodically for changes in prepayment assumptions). Today, the scope of SSAP No. 26R includes all bonds with a specific carve-out for securities that qualify for the scope of SSAP No. 43R. The Exposure generally proposes to keep this distinction but clarifies that SSAP No. 43R includes all securities issued from a Trust or SPV even if they do not have prepayment or extension risk (which was the impetus for the modified amortized cost accounting in SSAP No. 43R). This is an important point; SSAP No. 43R securities (e.g., loan backed and structured securities), many of which are issued from a Trust or SPV, have this different accounting due to prepayment and extension risk and not because they are issued from a Trust or SPV.

   Interested parties unequivocally believe that many of the securities issued from a Trust or SPV should continue to follow the regular amortized cost accounting within SSAP No. 26R, as they do not have prepayment or extension risk. Therefore the modified amortized cost within SSAP No. 43R is not appropriate, as there is no need to update prepayment and extension assumptions as required under SSAP No. 43R. Examples include but are not limited to 1) where there is a direct guarantee from a corporate or government entity (e.g., certain Issuer Obligation Municipal Bonds), even if the security is issued from a Trust or SPV for legal or other reasons (i.e., an otherwise qualifying SSAP No. 26R security, with the exception of being issued from a Trust or SPV) or 2) project finance investments which are typically issued from an SPV. Many insurance companies currently report these securities as SSAP No. 26R investments. Interested parties and many others as well (industry, regulators, SVO, and NAIC staff) believe these are Schedule D bonds where regular amortized cost accounting is appropriate.

Indeed, interested parties continue to question whether the presence of a Trust or SPV should form any part of an accounting classification. In many deals the trust nomenclature may appear, when in fact there is no separate trust entity. The term SPV is even more ambiguous, as there is no commonly accepted definition. There are many regulated businesses, non-for-profit corporations, and other entities that by law, regulation or charter are established and exist for a single purpose. Are these SPVs? There is no easy answer.

Any use of the terms Trust or SPV, to segregate for purposes of accounting or scoping, would require that they be defined with sufficient clarity to both reflect the substance of these terms and ensure that any such new standard is operational, including the appropriate accounting treatment with no unintended consequences.

Even if Trust and SPV can be defined with some precision, business entities will continue to evolve. In Section 5 of the Issue Paper, it is suggested that reporting entities should know to classify CEF Debt within the scope of SSAP No. 43R "due to the presence of the trust structure". However, most closed end funds are corporations, and there has been no reason to classify their debt as anything other than within the scope of SSAP No. 26R (e.g., there is no prepayment or extension risk). This example highlights the difficulty of making the type of issuing entity a decisive factor for accounting classification.

Ultimately, if the SAPWG determines all securities issued from a Trust or SPV should be included within the scope of SSAP No. 43R, it is imperative that both sufficient scope clarity be developed and all bonds with no prepayment or extension risk, even if issued from a Trust or SPV, receive the appropriate accounting (i.e., "regular" amortized cost accounting). It is therefore premature for the Issue Paper to suggest any class of security should utilize lower of amortized cost or market accounting, based on whether it meets some components of a somewhat arbitrary or ambiguous definition, without providing an appropriate rationale for doing so.

Interested Parties' Comment Letter: Section 1 – Summary of Issue – Page 10:

Much of the history and development of key concepts in this section is useful and accurate. However, in some ways it appears to be used in a way that does not present a complete and accurate accounting of such history and development.

For example, we note the following from paragraph 4:

> *"Although most of the guidance between the original SSAP No. 26 and SSAP No. 43 was the same, the guidance in SSAP No. 43 recognized the need to review (at least quarterly) the prepayment assumptions and resulting cash flows of the underlying loans, as changes in assumptions would necessitate a recalculation of the effective yield."*

Interested parties agree with this characterization and it should not be forgotten. Today, there are essentially two accounting paradigms for bonds – SSAP No. 26R (regular amortized cost) and SSAP No. 43R (modified amortized cost that is adjusted periodically for changes in prepayment assumptions).

SSAP No. 26R scope includes all bonds with a specific carve-out for securities that qualify for scope of SSAP No. 43R. Judging from the staff note in paragraph 9, the Exposure generally proposes to keep this distinction but clarifies that SSAP No. 43R includes all securities issued from a Trust or SPV even if they do not have prepayment or extension risk (which was the impetus for the modified bond accounting in SSAP No. 43R):

> *"Staff Note: With the revisions adopted in 2010, NAIC staff is under the impression that all securities issued from an SPV/trust structure were intended to be in scope of SSAP No. 43R. This provision is expected to be discussed and clarified in accordance with this issue paper."*

The different accounting paradigms is an important point – SSAP No. 43R securities (e.g., loan backed and structured securities), while issued from a Trust or SPV, have this different accounting due to prepayment and extension risk, not because they are issued from a Trust or SPV.

Further, interested parties believe NAIC staff's impression that all securities issued from a Trust or SPV structure were intended to be in scope of SSAP No. 43R is not wholly accurate for the following reasons:

1) Not all securities have prepayment/extension risk which renders the accounting of SSAP No. 43R moot,
2) Nowhere, as a result of the revisions adopted in 2010, did it change the scope of SSAP No. 43R to explicitly state all securities issued from a Trust or SPV are included,
3) Industry continues to hold multiple billions of dollars of securities issued from a Trust or SPV reported under SSAP No. 26 and neither regulators nor auditors have taken exception to this, and
4) Industry does not believe this was the intent of Matti Peltonen, at the time a member of the New York State Department of Financial Services, who was the impetus behind the 2010 changes. For example, after the 2010 changes were adopted, there were many open working calls with interested parties and Mr. Peltonen, where attempts were made to determine which securities within a Trust or SPV were ABS in accordance with SSAP No. 43R. Further, in a 2010 presentation to the North American Securities Valuation Association (NASVA), which we are happy to share with SAPWG, Mr. Peltonen concluded with the following observations:

> *"The preceding pages are not meant to be definite guidance on how to report municipal bonds: some are clearly Issuer Obligations, some are clearly LBaSS – and there are probably some that are clearly in between."*
>
> *"The definite determination on how to report, if in doubt, needs to be done by studying a security's prospectus, and comparing the terms with the annual statement guidance, and SSAP26 and 43R."*

Mr. Peltonen's focus was not on whether a security was issued from a Trust or SPV, but rather if a security was clearly an Issuer Obligation or a Loan-Backed (or Asset Backed) security with attributes of a proportional payments, as noted in paragraph 2 of SSAP No. 43R:

> *"Loan-backed securities are defined as securitized assets not included in structured securities, as defined below, for which the payment of interest and/or principal is directly proportional to the payments received by the issuer from the underlying assets, including but not limited to pass-through securities, lease-backed securities, and equipment trust certificates.'*

Examples of municipal bonds sometimes issued from a Trust or SPV, and often reported under SSAP No. 26R today, are special revenue bonds including toll roads or bridges, water and wastewater (sewer) utilities, prisons, and electrical generation facilities, among potentially many other similar "businesses". As Mr. Peltonen noted in his presentation:

> "*When a municipal agency (that operates as a business) issues bonds they are issuer Obligations"*
>
> *"When a municipal agency puts assets in a blind trust that are the sole collateral for the issued bonds, they are LBaSS"*

Some examples of securities potentially issued from a Trust or SPV that are generally accounted for under SSAP No. 26R are as follows:

- Issuer Obligation Municipal Securities,
- Project Finance Debt,
- CEF Debt and similar CFOs with proper collateralization,
- Sports Deals (e.g., MLB, NBA, NFL),
- And various others.

Interested parties unequivocally believe that many of the securities issued from a Trust or SPV should continue to follow the regular amortized cost accounting within SSAP No. 26R, as they do not have

prepayment or extension risk. Therefore, the modified amortized cost within SSAP No. 43R is not appropriate, as there is no need to update prepayment and extension assumptions as required under SSAP No. 43R. Examples include but are not limited to 1) where there is a direct guarantee from a corporate or government entity (e.g., certain Issuer Obligation Municipal Bonds), even if the security is issued from a Trust or SPV for legal or other reasons (i.e., an otherwise qualifying SSAP No. 26R security, with the exception of being issued from a Trust or SPV) or 2) project finance investments which are typically issued from an SPV. Many insurance companies currently report these securities as SSAP No. 26R investments. Interested parties and many others as well (industry, regulators, SVO, and NAIC staff) believe these are Schedule D bonds where regular amortized cost accounting is appropriate.

Indeed, interested parties continue to question whether the presence of a Trust or SPV should form any part of an accounting classification. In many deals the trust nomenclature may appear, when in fact there is no separate trust entity. The term SPV is even more ambiguous, as there is no commonly accepted definition. There are many regulated businesses, non-for-profit corporations, and other entities that by law, regulation or charter are established and exist for a single purpose. Are these SPVs? There is no easy answer.

Any use of the terms Trust or SPV, to segregate for purposes of accounting or scoping, would require that they be defined with sufficient clarity to both reflect the substance of these terms and ensure that any such new standard is operational, including the appropriate accounting treatment with no unintended consequences.

Even if Trust and SPV can be defined with some precision, business entities will continue to evolve. In Section 5 of the Issue Paper, it is suggested that reporting entities should know to classify CEF Debt within the scope of SSAP No. 43R "due to the presence of the trust structure". However, most closed end funds are corporations, and there has been no reason to classify their debt as anything other than within the scope of SSAP No. 26R (e.g., there is no prepayment or extension risk). This example highlights the difficulty of making the type of issuing entity a decisive factor for accounting classification.

Ultimately, if the SAPWG determines all securities issued from a Trust or SPV should be included within the scope of SSAP No. 43R, it is imperative that both sufficient scope clarity be developed and all bonds with no prepayment or extension risk, even if issued from a Trust or SPV, receive the appropriate accounting (i.e., regular amortized cost accounting). It is therefore premature for the Issue Paper to suggest any class of security should utilize lower of amortized cost or market accounting, based on whether it meets some components of a somewhat arbitrary or ambiguous definition, without providing an appropriate rationale for doing so.

Discussion: Classification as SSAP No. 26R—Bonds or SSAP No. 43R—Loan-Backed and Structured Securities

The following elements / concerns have been identified with the interested parties' proposal to capture all investments issued from an SPV in scope of SSAP No. 26R:

- There is inconsistency in practice within industry on accounting and reporting. As identified by interested parties there are differing interpretations of the revisions adopted in 2009, and the existing guidance in SSAP No. 43R, paragraph 4:

    4. **Loan-backed securities are issued by special-purpose corporations or trusts (issuer) established by a sponsoring organization**. The assets securing the loan-backed obligation are acquired by the issuer and pledged to an independent trustee until the issuer's obligation has been fully satisfied. The investor only has direct recourse to the issuer's assets, but may have secondary recourse to third parties through insurance or guarantee for repayment of the obligation. As a result, the sponsor and its other affiliates may have no financial obligation under the instrument, although one of those entities may retain the responsibility for servicing the underlying assets. Some sponsors do guarantee the performance of the underlying assets.

- Reporting an investment as an "Issuer Obligation" on Schedule D-1 excludes the investment from certain reporting information on Schedule D-1 (for example the collateral code column) and would permit

(presumably) a filing exempt (FE) designation, instead of potentially being captured as a "bespoke" security or a non-filing exempt investment that requires submission of the investments details to the SVO for review. Regulators reviewing the investments would be unable to identify structures that reflect actual "issuer obligations" (where the credit quality of the issuer has a primary impact towards payment) from an investment that relies on other underlying aspects (cash flows from structure / underlying collateral that flow through the SPV) in determining whether payment or a default could occur.

- Investments in scope of SSAP No. 26R and SSAP No. 43R are both reported on Schedule D-1. It has been identified that some structures that would qualify for Schedule D-1 reporting under the interested party proposal (as they do not possess prepayment risk) may not be what regulators intend for Schedule D-1. Investments that have been identified as concerning – in the context of inclusion of SSAP No. 43R – could qualify for SSAP No. 26R and continue to be reported on Schedule D-1. It is perceived that simple changes could be incorporated to eliminate prepayment / extension risk in various SPV-issued structures and move more investments issued from SPVs from SSAP No. 43R to SSAP No. 26R, increasing the opaqueness of the financial statements in identifying these investments.

- Investments in SSAP No. 26R and SSAP No. 43R have the same measurement method and RBC charges. Although interested parties referenced a "modified amortized cost" approach for SSAP No. 43R, that phrase describing a measurement method is not captured within the SSAP. Rather, under SSAP No. 43R, reporting entities are required to assess changes in expected cash flows to update the effective yield and determine whether an impairment needs to be recognized. If there are no expected changes in cash flows, no changes are reflected. They key differences between SSAP No. 26R and 43R pertain to impairment (where SSAP No. 43R has a bifurcated impairment model based on the assessment of cash flows and the intent and ability to hold) and recognition to the accretable yield (where SSAP No. 43R only accretes to expected cash flows). As such, moving an investment from SSAP No. 43R to SSAP No. 26R, when there is no prepayment risk does not result in any key change in accounting or reporting for industry when there is no prepayment risk, but it would make it more difficult to differentiate investments that reflect actual issuer obligations (debt of an operating entity) from structures that reflect a different dynamic.

- Regulator comments have identified that the current definition of a bond in SSAP No. 26R is overly broad and encompasses more investments than originally intended. These comments have identified that virtually any investment could be structured to reflect "securities representing a creditor relationship, whereby there is a fixed schedule for one or more future payments." This has been noted with recent "equity-driven" SPV structures reviewed (from recent investments filed with the NAIC SVO) as well as comments received on non-conforming credit tenant loans, which are considered mortgage loans under the Model Law definition.

- From a review of investment submissions to the NAIC SVO, it seems that some companies are requesting NAIC designations to substantiate a SSAP No. 43R reporting classification. Information provided to NAIC staff has identified that if the NAIC designation is not obtained, reporting entities may request a designation from a CRP as a private letter rating. As a reminder, in accordance with the NAIC Policy Statement on Coordination of the AP&P Manual and P&P Manual of the NAIC Investment Analysis Office, obtaining an NAIC designation does not change an investment's applicable SSAP , reporting schedule or override SSAP guidance for the investment to be admitted.. The SSAP and schedule is based on the investment.

- It is noted that reporting on Schedule D-1, in scope of SSAP No. 26R or SSAP No. 43R, is desirable by the industry for the following reasons:

    - Favorable measurement method (amortized cost) and favorable RBC charges.
    - Exclusion from state investment limits – (captured in the "bond" bucket)
    - Permits investment by third-party investment advisors/mgrs. Per some contracts, moving investments to Schedule BA would preclude acquisition from these third-party advisors/mgrs.

Updated Proposal

After review of the interested parties' comments regarding the SSAP No. 26R / SSAP No. 43R distinction, **a proposal was received from the Iowa Insurance Division identifying that the classification between SSAP No. 26R and 43R as an important topic, but secondary to the primary purpose of this project, which is determining whether investments should qualify as "bonds" for Schedule D-1 reporting.**

This letter identifies that the definition of a bond under current statutory accounting principles is broad and includes, "any securities representing a creditor relationship, whereby there is a fixed schedule for one or more future payments." Given the broad definition, it is possible for an insurer to acquire any asset through a debt-issuing trust or special purpose vehicle and report it as a Schedule D-1 bond, even if that asset would be otherwise inadmissible if held directly, and even if there is no economic substance to the trust. In other words, the insurer could be in an identical economic position to holding the inadmissible asset directly and still qualify for Schedule D-1 reporting.

Pursuant to the comment letter, the IA Division recommends that the Working Group focus its efforts on developing a principles-based definition for those assets that qualify for Schedule D-1 reporting treatment as the initial step for this project. Once the Working Group has reached consensus regarding those assets that qualify for Schedule D-1 reporting, there may be certain characteristics that, while they do not impair qualification as a bond, may warrant separate identification on Schedule D-1. This, along with clarification of the classification between SSAP 26R and SSAP 43R and review of the accounting and measurement methodologies will be important secondary objectives of the project. But it is first necessary to answer the question of what qualifies as a bond before these secondary objectives can be fully addressed.

*Note: This proposal is to first clarify what should be **reported** on Schedule D-1: Long-Term Bonds. This initial proposal is not suggesting to reclassify ABS investments from SSAP No. 43R to SSAP No. 26R. Also, although an item may ultimately meet criteria for D-1, this proposal identifies that investments may contain characteristics that requires separate reporting (perhaps on a new schedule "D") instead of Schedule D-1.*

Recommendation

NAIC Staff recommends that the Working Group expose the Iowa Insurance Division draft definition for distinguishing between the two types of investments reported on Schedule D-1 – issuer obligations and asset backed securities. As detailed, this initial draft definition is intended to facilitate discussions of the Working Group and industry:

- Issuer obligations are those backed by the credit of an operating entity. A debt security that is issued by an entity whose purpose is the pass-through of collateral cash flows is not an issuer obligation.

- The definition of asset backed securities specifies that they involve the securitization of **financial assets**. When an insurer invests in a securitization of assets, it is important that the nature of those assets lend themselves to the production of cash flows. Therefore, the securitization of non-financial assets should receive bond treatment only in instances where the nature of the assets lends itself to the production of cash flows. Those specific instances should be separately identified for Schedule D-1 qualification, as is currently the case with lease-backed securities and equipment trust certificates.

- The definition of asset backed securities also stipulates that an asset backed security redistributes the risk of the underlying collateral such that the investor is in a different position than if the underlying collateral were held directly. Under this definition, an entity that simply passes through the proceeds of the underlying collateral has done nothing to alter the nature of the investment, has no economic substance, and should therefore be looked through to determine the appropriate accounting.

- A key characteristic of a bond and what makes it a debt investment, rather than an equity-like investment, is that it represents a senior or priority interest in the assets of the issuer. This is true for issuer obligations as well as asset backed securities. Therefore, in order for something to meet the definition of a bond, there must be a more-than-insignificant subordinated interest present, or said another way, overcollateralization. The residual position is akin to an equity investment and should not qualify for Schedule D-1 reporting.

Topic 2: Definition of Asset-Backed Security

The exposed issue paper proposed using a two-step approach (informally described as "broad brushes") for determining which investments would be captured in scope of SSAP No. 43R before further assessment of the security was necessary. The two broad brushes captured the following:

- Investments that would qualify as "asset-backed securities" pursuant to the Code of Federal Regulations (CFR) as detailed in 17 CFR 229.1101(c). This reference was used, as this definition of ABS is referenced in determining registration of an NRSRO to issue credit ratings for asset-backed securities.

- For securities that did not meet the CFR definition, the issue paper proposed four principle concepts to determine whether a securitization structure should be captured in scope of SSAP No. 43R. Securities that would not meet either the CFR definition or the principles would fall out for separate review and assessment. The four principles are detailed below:

    - Principle 1: Securitization and issuance of debt securities are from a trust / SPV that is separate and distinct as well as bankruptcy remote from the sponsoring organization.

    - Principle 2: In order to serve as collateral backing issued debt instruments, the assets held in the trust / SPV shall predominantly represent contractual obligation to make payments. Only contracts such as leases, mortgages, loans, and agreements that define payment obligations create the contractual cash flows necessary for securitization. ("Hard" assets shall not serve as the primary collateral for securitizations. Although hard assets (real estate, airplanes, etc.,) may be ultimately available to repay the investor (if needed), these assets only provide secondary security. For securities that are backed by leases, the repayment may be reliant on the residual value of the physical assets to the extent allowed under the CFR ABS definition. (This is currently detailed in 17 CFR 229.1101 (c)(2)(v).)

    - Principle 3: The contractual obligations to make payments (assets held in trust / SPV) are owed by many diverse payers. (The term "many" is not defined, but is intended to reflect characteristics of traditional securitizations, in which a broad, diverse population safeguards the performance of the securitization. For this principle, the amount of cash flow generating assets and the payers should be commensurate with the type of securitization. For example, securitized airplane leases would likely meet the "many" requirements with fewer obligations and involved airlines then what would be expected in a securitization of credit card receivables.)

    - Principle 4: Each securitization distributes periodic performance reports to investors that provide information about the underlying collateral composition, credit quality of obligors and payment performance. (Payment performance shall include the current cash flows and terms related to particular assets and whether payment terms change over time.)

Interested Parties' Comments:
The following elements are key excerpts from the interested parties' comment letter:

Interested Parties Comment Letter: Preamble – Page 2:

2) Importantly, the Exposure includes two definitions of ABS – 1) the Securities Exchange Act of 1934 definition (paragraph 19 – hereafter referred to as the "1934 Act Definition") and the definition set forth in 17 CFR Section 229.1191(c) (paragraph 20 – hereafter referred to as the "1933 Act Definition"). Each definition has been subject to regulatory and judicial interpretations, each includes single obligor ABS, and each exists for a different purpose.

   The 1934 Act Definition was enacted by Congress as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank). The purpose of the definition is to encompass a wide range of securities commonly viewed as ABS in the context of Dodd-Frank's risk retention requirements.

   The 1933 Act Definition was promulgated by the Securities and Exchange Commission (SEC) in 2006 and thus predates the 1934 Act Definition. The 1933 Act Definition is narrower in scope (e.g., does not include certain collateralized loan obligations "CLOs", for example) and is not relevant for 144A securities and private placement debt securities. The purpose of the 1933 Act Definition was to identify which types of ABS are eligible for the short form registration statement. In 2006, the S-3 was the only short-form registration statement; now there is an SF-3 registration form designed for ABS. That the 1933 Act Definition now exists solely for the SF-3 form illustrates its narrow scope.

   Interested parties believe the 1934 Act Definition is the more appropriate starting point to define ABS for statutory accounting, as this definition was most recently evaluated and utilized by Congress to subject a wide range of instruments to risk retention rules. Even the 1934 Act Definition, however, does not cover many securities commonly viewed by the market as ABS. This is because the 1934 Act Definition requires that the underlying assets of an ABS be self-liquidating, and thereby excludes a range of assets with predictable cash flows, but that are not self-liquidating (e.g., royalties and cell towers).

   The "Four Principles", as proposed in paragraph 33 of the Exposure, likewise reference self-liquidating assets, and thus would need to be revised to better reflect ABS. Interested parties believe that it may be better to define, with interested parties, a revised set of principles, while potentially maintaining the 1934 Act Definition as a "safe harbor" to facilitate classification of ABS. A further brief timeline of the development of the 1933 Act and 1934 Act Definitions is included in Appendix I to this letter. As shown in that timeline, these definitions were not intended to capture the entire ABS market, but rather were targeted to specific regulatory and legislative goals.

   Interested parties understand that NAIC staff chose the 1933 Act Definition, versus the 1934 Act Definition, because NAIC staff believed certain regulators wanted to limit the definition to ABS that could be rated only by Nationally Recognized Statistical Ratings Organizations (NRSROs) "approved" by the SEC to rate ABS.

   As a technical clarification[1] any NRSRO can assign a rating to any ABS, regardless of whether the ABS meets the 1933 Act Definition. Every NRSRO is registered with the SEC to rate at least one asset class. Registration indicates that the NRSRO has special expertise in rating securities of a certain type (such as ABS) or issued by certain entities (such insurance companies). The NRSRO must submit to annual SEC examinations to maintain such registration. At present, six of the nine NRSROs are registered to rate ABS (each, an "NRSRO Registered for ABS").

   It is entirely up to the NRSRO whether it wants to apply to be registered to rate multiple asset classes. For example, Japan Credit Rating Agency is registered for insurance company securities, but not for ABS. In those instances where federal law requires that securities held by federally regulated institutions be rated, only a rating from an NRSRO registered for securities of that type qualifies as a rating letter. Japan Credit

[1] The Exposure Draft's focus on NRSRO ratings in relation to the definitions is somewhat unclear. The SEC eliminated the requirement that securities registered on Form SF-3 have an investment grade rating from an NRSRO a number of years ago. Most other federal regulations also have eliminated NRSRO rating requirements and references, as required under the Dodd-Frank, although we do see them used, for instance, in TALF 2.0. NRSROs do register with respect to certain asset classes, but that does not mean that they are not allowed to rate non-registered transactions. The questions about ratings in general seem tied to the SVO process rather than the classification of the securities for purposes of the SSAPs.

Rating Agency is free to assign ratings to ABS as defined in the 1933 Act Definition, and the federally regulated institution is free to subscribe to or otherwise receive and review the Japan Credit Rating Agency rating; however, the rating is just another credit opinion and does not count toward the particular requirement of federal law.

Since the financial crisis of 2008-2009, many references in federal law to ratings have been removed. As a result, the concept of registered NRSRO now has less legal consequence. Nonetheless, the status of being a registered NRSRO does provide market credibility to NRSROs, which is why NRSROs go through the cost and effort of maintaining such status.

Regulators might ask – which NRSRO ratings should entitle an insurance company holder of ABS to filing exemption? Putting aside the confusion arising from federal law, paragraph 35 of the Issue Paper indicates that NAIC staff prefer that only rating letters from an NRSRO Registered for ABS should be counted as valid ratings for ABS meeting either the 1933 Act Definition or the Four Principles.

If the 1934 Act Definition is adopted as the cornerstone of SSAP No. 43R, which interested parties believe is more appropriate than the 1933 Act Definition, interested parties are open to applying the NRSRO Registered for ABS limitation to the 1934 Act Definition (i.e., if state regulators want to mirror what few remaining provisions of federal law do for ABS securities). Interested parties would also be open to discussing the extension of such concept to the Four Principles, when and if they are finalized.

The NRSRO Registered for ABS limitation should by definition apply only to ABS. The limitation should not apply to debt issued by closed end funds registered under the Investment Company Act of 1940 (CEF Debt), project finance bonds, certain "issuer obligation" municipal bonds (e.g., certain toll road municipal bonds), credit tenant loans (CTLs), ground lease financings (GLFs), equipment trust certificates (ETCs), enhanced equipment trust certificates (EETCs), and any other security issued from a Trust or special purpose vehicle (SPV), that is not an ABS but which NAIC staff and SAPWG move to SSAP No. 43R, only by virtue of their issuance from a Trust or SPV. Such securities will need explicit mention within the scope of SSAP No. 43R, beyond any refinement of the Four Principles, likely with separate reference to the specific asset classes themselves.

If SAPWG decides to proceed in this fashion, after defining such securities within the scope of SSAP No. 43R, interested parties would support special code identifiers on Schedule D to identify any specific asset class for which regulators feel they would benefit.

Lastly, with respect to using any SEC definition as a cornerstone, two other issues also would need to be addressed.

First, does the definition used incorporate both existing and future SEC interpretations as to whether a security-type meets the definition? Without incorporating existing and future interpretations, additional clarification would be needed for statutory accounting purposes, even if further principles are developed. Regulators and industry would otherwise be left with significant uncertainty as to scope. At a minimum, the NAIC would need to develop similar interpretative guidance which would likely be both voluminous and require continual update to keep pace with market evolution.

Second, the 1934 Act Definition, by its design, encompasses both registered and unregistered securities. The 1933 Act Definition is technically for securities that are registered with the SEC. Many 144A securities or private placement debt securities would meet this definition, but are not registered with the SEC. Therefore, any such scope utilizing the 1933 Act Definition, would need to ensure this distinction is made; that is, any security, whether registered with the SEC or not, is within the scope of SSAP No. 43R if it meets this definition. However, interested parties reiterate that the 1934 Act Definition is more appropriate for statutory accounting if a SEC cornerstone is to be adopted.

Interested Parties' Comment Letter: Section 2 – Defining ABS – Page 14:

As discussed in the preamble to this letter, interested parties believe all bonds should be reported on Schedule D while applying either SSAP No. 26R or 43R accounting, as appropriate. Investors, the capital

markets, and US GAAP define bonds regardless of how the underlying cash flows are generated to pay the principal and interest (e.g., CFOs with underlying equity, leases, EETC/ETC bonds, cash flows that may vary based on volume, etc.). When determining which SSAP to apply, interested parties believe SSAP No. 43R should be applied if the instrument is an ABS that has prepayment and/or extension risk; otherwise SSAP No. 26R should be applied. Although an approach such as using the 1933 Act Definition (or, alternatively, the 1934 Act Definition as proposed in our letter) along with a set of principles as the anchors for the scope of assets in SSAP 43R may be reasonable, we believe there is a simpler way to meet the objective of reasonably identifying ABS. For example, instead of using the 1933 Act Definition or 1934 Act Definition, it might be less complicated, and would avoid the drawbacks inherent in those definitions, if SAPWG developed a cohesive set of principles for ABS (independent of the securities law definitions). These principles would be less difficult and onerous for insures to apply than either of the securities law definitions. It would also simplify matters considerably if inclusion within the scope of SSAP No. 43R did not depend in any way on whether the security was issued from a Trust or SPV.

Interested parties believe that the scope of SSAP No. 43R should follow the original design for modified cost accounting and aim to include securities with prepayment or extension risk. In addition, another consideration for inclusion in scope of SSAP No. 43R may be if the investor has recourse only to the underlying collateral (i.e., is not a business) and has prepayment and/or extension risk. If a bond is issued and supported by a business, and does not have prepayment and extension risk, consideration should be given to accounting and reporting the bond under SSAP No. 26. The use of simplified principles would be less difficult to apply than the SEC definitions as discussed further below. However, should SAPWG elect to use either the 1933 Act Definition or the 1934 Act Definition, in conjunction with principles, we provide the comments and feedback below.

Question 1 above: Are there concerns with the use of the CFR ABS definition as the general principle concept for SSAP No. 43?

To answer this question, interested parties worked with two law firms to better understand what types of ABS are included in the 1933 Act Definition. Interested parties also performed an initial analysis ("deep dive") into our investment portfolios to begin identifying the types of investments reported as and accounted for as SSAP No. 43R investments as well as investments issued by a Trust or SPV that are reported as and accounted for as SSAP No. 26R investments. The analysis was performed by seven insurance companies with large investment portfolios. The analysis only "touched the surface" of identifying types of investments that must be considered as the rescoping of SSAP No. 43R moves forward (starting with this Exposure). Appendix II to this letter includes only the types of assets identified thus far and helps illustrate how complex the assets are, how many variations exist for the asset types, how difficult it is to determine if each asset meets the 1933 Act Definition or 1934 Act Definition and the amount of judgment involved in the analysis. While any scope determination will require an analysis at an individual asset level, with a significant amount of analysis related to each asset's own set of facts and circumstances, the newness of these definitions, combined with their shortfalls, has resulted in an incomplete analysis at this time.

As a result of the analysis with the law firms and the initial deep dive efforts, interested parties have the following observations:

1) If an SEC definition is to be used as an anchor for ABS within SSAP No. 43R, we do not recommend that the 1933 Act Definition be used; rather, the 1934 Act Definition should be used. We believe this is a more appropriate definition for the following key reasons as also discussed in the preamble to this letter:
    a. The intended use of the 1933 Act Definition was to determine the manner in which an ABS may be offered to potential investors and the amount of information provided to investors (e.g., registered through a more simplified S-3 registration form versus a longer S-1 registration). It was not intended to identify the entire population of investments that investors and the capital markets consider to be ABS.

b. The more widely used definition of an ABS is contained in the 1934 Act Definition and was relied upon by Congress for the Dodd-Frank Act to determine which ABS issuances must comply with the risk retention rules. That means the 1934 Act Definition was more recently evaluated, versus the 1933 Act Definition, and determined to be an appropriate definition of ABS.
c. The key types of ABS that are included in the 1934 Act Definition and not in the 1933 Act Definition include the following, which are considered by investors in the capital markets to be ABS securities:
    i. CLOs that do not have a static pool of assets (i.e., the underlying loans are managed), which is a very significantly sized asset class in the ABS market. Those CLOs where the underlying loans are set at inception (i.e., new assets are not purchased during the life of the CLO) are in scope of the 1933 Act Definition.
    ii. ABS offered in private placements or 144A offerings, for which the 1933 Act Definition has no relevance, as it applies in the context of registration requirements.
    iii. ABS registered for public offer using the SF-1 or S-1 (because the assets being securitized do not satisfy the asset-type limitations set forth in the 1933 Act Definition).
d. Interested parties note that residual asset risk is discussed in both the 1933 Act Definition and 1934 Act Definition and both allow for a similar degree of residual asset risk. Residual asset risk is discussed further in section 5f of this letter.

2) However, if the 1934 Act Definition were to be used as the anchor, we would recommend one modification to the 1934 Act Definition. The 1934 Act Definition has verbiage in it that an asset is in scope only if some of the tranches issued by the securitization are owned by a third-party unrelated to the issuing entity. We understand that the purpose of this verbiage was to clarify that, in the situation where a securitization is sponsored by a company and the tranches issued by the securitization were 100% owned by the company and its related parties, the risk retention rules were not required to be applied. This seems appropriate as risk retention would not be applicable in that situation given all securities issued by the securitization were retained by the sponsoring entity and its related parties. Because this language was solely related to risk retention rules, it is not relevant if the 1934 Act Definition is used to determine the scope of SSAP No. 43R investments and should not be included in any final revised SSAP.

3) As noted, if SAPWG's ultimate decision is that an SEC-related definition must be used, then we believe the 1934 Act Definition of an ABS should be used to identify those ABS that would qualify for SSAP No. 43R reporting and accounting. The focus of the 1933 Act Definition is on which types of ABS are eligible to use the SF-3 registration form. Whether a security is in scope of SSAP No. 43R should not hinge on what registration statement a publicly offered security can use. To apply such a rule to a security issued in a private placement or pursuant to Rule 144A, one could ask the hypothetical question – would the security have been eligible to use the SF-3 registration form? Having the scope of a security under SSAP No. 43R dependent on the answer to such a question makes little sense to interested parties. Among the advantages of the 1934 Act Definition is that it was intended to apply to registered and unregistered securities alike. As a result, any investment that meets the 1934 Act Definition should be in scope of SSAP No. 43R regardless of whether it is registered with the SEC for public offering. Also, we are aware of certain ABS investments issued in loan form that would in all other respects conform to the 1934 Act Definition. Interested parties believe these should also be in scope of SSAP No. 43R.

4) In discussions with NAIC Staff, interested parties understand that one of the objectives of anchoring the SSAP No. 43R scope on the 1933 Act Definition of an ABS is to ensure that only NRSROs Registered for ABS are eligible to issue ratings for ABS purchased by reporting entities. If so, then this reflects a misunderstanding of the SEC's regulation of NRSROs. Rating agencies need ongoing approval from the SEC to maintain NRSRO status. However, no NRSRO needs the SEC's *approval* to rate any type of ABS, CFR or otherwise. The SEC makes available to NRSROs a voluntary system of registration, under which NRSROs can be recognized as having specific expertise to rate bonds of

certain types (such as corporate bonds or ABS) or issued by certain types of entities (such as insurance companies or government organizations). Why do some NRSROs go through the arduous process of obtaining and maintaining this registration? First, there is a perceived marketing advantage. Second, in those instances of federal law that require ratings, the rating letter is usable by the holder only if issued by the NRSRO with the corresponding registration. An NRSRO without the registration is free to rate the deal, but for federal law purposes, the NRSRO's work product is just a credit opinion. In practice, NRSROs that are not registered with the SEC to rate ABS are typically not chosen by issuers to rate widely syndicated, publicly registered offerings of plain vanilla ABS. But issuers of any other ABS, such as ABS issued in 144A offerings, may well choose any NRSRO, particularly if the targeted purchasing base does not need any rating benefit under federal law.

Thus, narrowing the definition of ABS cannot be relied upon to shut out NRSROs that are not NRSROs Registered for ABS. Instead, the insurance regulations would need to state that only ratings from NRSROs Registered for ABS are usable by reporting entities.

Therefore, interested parties do not believe that there is a strong argument to limit the SSAP No. 43R scope definition to only the 1933 Act Definition due to its linkage to NRSRO registration status. The scope could be expanded to the 1934 Act Definition without any consequence regarding NRSROs.

Interested parties would be open to discussing the possibility of limiting Filing Exemption (limiting Filing Exemption is discussed in paragraph 35 of the Exposure) for securities that meet the 1934 Act Definition and/or the Four Principles (Four Principles are listed in paragraph 33 of the Exposure) to only those ABS that are rated by an NRSRO Registered for ABS, if SAPWG believes that only ABS that are rated by an NRSRO Registered for ABS should get such designation. If an investment ends up in scope of SSAP No. 43R only because it has been issued by a Trust or SPV, its Filing Exempt status should not be impacted by whether the CRP rating is from an NRSRO registered for ABS. The requirement that a rating be from an NRSRO Registered for ABS should only be applied to ABS.

Interested Parties' Comment Letter: Section 4 – Accounting and Reporting of Non-CFR ABS – Page 21:

Interested parties have the following comments related to the Four Principles ("Principles"). The following is intended to provide comments related to the three questions posed above in the Exposure.

In summary, we would like to work closely with SAPWG in further developing the Principles and believe more simplified principles may be developed and used instead of a combination of the Principles and one of the securities law definitions (i.e., 1933 Act Definition or 1934 Act Definition). As noted in Section 2 of our letter and as illustrated in Appendix II, we believe the many different types of debt investments should be reported as bonds and accounted for under either SSAP No. 43R or SSAP No. 26R. That is, all would be reported for and accounted for as Schedule D bonds; however, the SSAP would determine if they qualify for regular amortized cost or modified amortized cost accounting based on whether they are ABS subject to prepayments or extensions.

The Exposure sets forth the Principles that may be leveraged to identify investments in scope of SSAP No. 43R. Those Principles include investments issued by a bankruptcy remote entity, where the underlying collateral is self-liquidating (has contractual cash flows), the underlying collateral has more than a single obligor, and the securitization provides periodic performance reports to investors. The Exposure proposes that although some investments may not meet either the 1933 Act Definition or the 1934 Act Definition, they would still be in scope of SSAP No. 43R and be filing exempt, if they meet the Principles. As noted above and in the following paragraph, we believe that the Principles should be revised, if they are used in a final SSAP, to include a broader range of assets with predictable cash flows.

Interested parties believe that the 1934 Act Definition is a better starting point than the 1933 Act Definition, although we note that some investments falling outside the 1934 Act Definition are widely and properly viewed as ABS (e.g., are considered ABS by investors and the capital markets). We believe the use of Principles to capture and identify such investments (paragraph 33 of the Exposure) may be a reasonable

approach. However, as currently proposed, the Principles are too limiting in that they would unintentionally exclude various types of assets, which should be considered ABS, that are discussed below. We recommend SAPWG and interested parties work closely together to develop the appropriate Principles; however, we offer a few recommendations thus far (not necessarily all inclusive as more work is needed to appropriately define the Principles) to more closely align the Principles with the definition of an ABS as follows:

a. Interested parties note that both the 1933 Act Definition and the 1934 Act Definition include securities whose underlying collateral is backed by a single obligor. As a result, interested parties recommend the Principle requiring more than one obligor be removed to align the Principles more closely with the 1933 Act Definition and the 1934 Act Definition. Interested parties note that at least half of all commercial mortgage-backed securities ("CMBS") issued today have underlying collateral (a commercial mortgage loan) from only a single obligor. All of these single-asset CMBS deals are ABS that meet the 1933 Act Definition and 1934 Act Definition. To require more than one obligor in the Principles would be inconsistent with this. Interested parties also believe single obligor transactions in ABS markets may grow in the future (e.g., Property Assessed Clean Energy; PACE bonds).

b. The 1934 Act Definition requires that the underlying assets be self-liquidating. Certain assets with variable future cash flows (i.e., future flow assets), such as royalties (e.g., where the cash flow generated is a function of volume and/or sales price) may be perpetual in nature and hence not self-liquidating. Our interested parties comment letter would recommend that these be considered ABS under SSAP No. 43R, because the capital markets consider them to be ABS, which are debt, and they are reported as debt for US GAAP. If they are not in scope of SSAP No. 43R (e.g., no prepayment/extension risk), then they should be in the scope of SSAP No. 26R bonds. They also provide various forms of protection (such as over collateralization ranging from 50-60%), resulting in them being debt-like.

c. ETCs/EETCs were not considered when the SEC defined ABS under the 1933 Act Definition or when Congress defined ABS under the 1934 Act Definition. As a result, they do not fall in scope of either Act. Interested parties believe such investments should be reported as Schedule D bonds as discussed throughout our letter.

d. Regarding debt tranches of CFOs, as mentioned in Section 2 of our letter, we believe they should be reported as Schedule D bonds and apply "regular" amortized cost accounting. They are debt in that they have fixed return of principal, are considered debt in US GAAP, and are considered debt by investors and capital markets.

e. Both the 1933 Act Definition and the 1934 Act Definition include assets with re-leasing risk. As a result, we believe the Principles should be modified to clarify that this is permissible. This concept is more thoroughly explored in Section 5f of our letter.

f. Regarding residual asset risk, also more thoroughly explored in Section 5f or our letter, we believe this should not be relevant when determining the classification of bonds.

Discussion: Definition of Asset-Backed Security

The following elements / concerns have been identified after review of the comments received:

- There appear to be differences in opinion on the investments that are captured within the cited Code of Federal Regulations. It should be noted that the exposed issue paper did not include any reference or discussion involving the 1933 or 1934 Exchange Acts. Rather, the issue paper simply intended to identify that if a security was qualified as an ABS, such that an NRSRO registered to review and rate ABS could provide a rating, then that investment would seem to qualify as a "traditional ABS" that should be captured

in SSAP No. 43R. The interested parties' comment letter identified that the SEC use of the Code of Federal Regulation for NRSRO ABS registration is limited to the 1933 Exchange Act.

- Although industry comments have supported revising the ABS definition to include securities captured in scope of 1933 and 1934 Exchange Acts, it is identified that some securities captured in scope of the 1934 are not considered "traditional" securitizations. As such, if including that reference, those securities will not be subject to further assessment on whether they should, in fact, be in scope of SSAP No. 43R.

- It has been identified that the Exchange Acts, and subsequent revisions to the Acts, can be considered a complex set of legal provisions that can be subject to further review and changes. If citing either of the Acts in the guidance, continuous review would be required to ensure that changes did not expand (or eliminate) the scope of the standard in a manner that was not intended to impact SSAP No. 43R.

- Although industry provided a very detailed and beneficial list of securities – with identification of whether the securities would be in the 1933 and/or 1934 Exchange Act, this detail did not identify whether the security would be captured in the proposed principles of SSAP No. 43R, and captured in scope regardless of the 1933/1934 Exchange Act distinction. In reviewing the securities, NAIC staff believes a significant number would be captured within the proposed principles, and those that would not be captured may be intended for additional assessment before being classified as SSAP No. 43R.

Updated Proposal

After review of the interested parties' comments regarding the use of the CFR citation as an initial scope determinant for ABS, and the discussion of the 1933/1934 Exchange Acts, **NAIC staff proposes to revise this approach and simply use principles in determining whether a security reflects an ABS that should be reported on Schedule D-1. With this proposal, the reference to the CFR citations will be eliminated (removing any perceived linkage to either the 1933 or 1934 Exchange Acts.) It is anticipated that the establishment of principles to define asset backed securities will work in tandem with the draft definition per the IA Insurance Proposal:**

- The definition of asset backed securities specifies that they involve the securitization of **financial assets**. When an insurer invests in a securitization of assets, it is important that the nature of those assets lend themselves to the production of cash flows. Therefore, the securitization of non-financial assets should receive bond treatment only in instances where the nature of the assets lends itself to the production of cash flows. Those specific instances should be separately identified for Schedule D-1 qualification, as is currently the case with lease-backed securities and equipment trust certificates.

- The definition of asset backed securities also stipulates that an asset backed security redistributes the risk of the underlying collateral such that the investor is in a different position than if the underlying collateral were held directly. Under this definition, an entity that simply passes through the proceeds of the underlying collateral has done nothing to alter the nature of the investment, has no economic substance, and should therefore be looked through to determine the appropriate accounting.

Recommendation

NAIC staff recommends that the Working Group consider a principle-based definition of asset backed security. Consistent with the prior recommendation, NAIC staff recommends for the Working Group to expose and request comments on the proposed IA Division draft definition for Schedule D-1. *Note: Continued discussion on the various discussion points in the issue paper is expected to occur. However, it was identified that discussion on fundamental concepts on what should be reported on Schedule D-1 should occur as a first step.*

The industry comment letter on the exposed issue paper is included as Attachment 9 (67 pages).

