NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

Virtual Meeting

Statutory Accounting Principles (E) Working Group
Thursday, August 26, 2021
2:00 – 4:00 p.m. ET / 1:00 – 3:00 p.m. CT / 12:00 – 2:00 p.m. MT / 11:00 a.m. – 1:00 p.m. PT

OVERVIEW AGENDA

Agenda Packet #1

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The comment deadline for all exposed items is Friday, October 1, 2021.

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Agenda Package #1

Statutory Accounting Principles (E) Working Group
Hearing Agenda
August 26, 2021
1:00 p.m. – 3:00 p.m. CT

ROLL CALL

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

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

REVIEW AND DISCUSSION - AGENDA ITEMS WITH DISCUSSION

Ref #	Title	Attachment #	Agreement with Exposed Document?	Comment Letter Page Number
2021-04 SSAP No. 97 (Fatima)	**Valuation of Foreign Insurance SCAs**	**1– Agenda Item**	**Yes**	**IP – 1 NYL - 3**

Summary:
On May 20, the Working Group exposed a modified version of the language proposed by New York Life. The language restricts the *SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities,* paragraph 9 limited statutory adjustments for foreign insurance SCAs (8.b.iv) and will result in a valuation floor of zero if the entity is not engaged in providing services to, or holding assets on behalf of, the U.S. insurers. In addition, some additional SSAP No. 48 language was also exposed to clearly indicate that the equity method valuation referenced in SSAP No. 97 can result in a negative equity valuation.

Background:
This agenda item was created because of comments received during the March 2020 development of agenda item 2018-26 – SCA Loss Tracking – Accounting Guidance adopted revisions in *SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities* to state that reported equity method losses of an investment in a subsidiary controlled or affiliated entity (SCA) would not create a negative value in a SCA investment, thus equity method losses would stop at zero. However, the agenda item also clarified that to the extent there was a financial guarantee or commitment, it would require recognition under *SSAP No. 5R—Liabilities, Contingencies and Impairment of Assets.* Further, in November 2020, the Working Group adopted agenda item 2020-18 - SSAP No. 97 Update which removed a lingering, superseded reference regarding negative equity method loss valuations.

Guidance in SSAP No. 97 requires specific limited statutory basis of accounting adjustments to 8.b.ii (insurance related SCA) and 8.b.iv (foreign insurance SCA) entities. These long-standing adjustments are to prevent assets held by an SCA from receiving more favorable treatment than had the assets been held directly by the insurer. (For example, if an insurer held assets that would be nonadmitted, but the SCA would not have that same restriction.) Per SSAP No. 97, the equity method of accounting for 8.b.ii and 8.b.iv entities is the beginning point from which limited statutory adjustments are made (commonly referred to as SSAP No. 97, paragraph 9 adjustments). It is

important to note that it was an intentional decision that the outcome of these adjustments can result in a negative equity valuation of the investment. During the discussion of the agenda item, 2018-26 industry comments requested consideration of whether 8.b.iv entities should continue to be subject to the current explicit provisions of SSAP No. 97, specifically that paragraph 9 adjustments may result in a negative SCA valuation. Industry's primary response that foreign insurance operations are subject to foreign jurisdiction and should be allowed to stand independently of a domestic insurer – thus in the absence of a guarantee or commitment, equity valuation should not go negative and would stop at zero. Comments received from industry noted that the circumstances that would cause a foreign insurance reporting entity to record negative equity are uncommon, however indicated the potential to arise in the future such as investment decreases when interest rates rise.

The industry discussion expanded to include certain investments in scope of *SSAP No. 48—Joint Ventures, Partnerships and Limited Liability Companies* and whether the required SSAP No. 97, paragraph 9 limited statutory adjustments should be modified for SSAP No. 48 investments which are foreign insurers. Under the guidance in SSAP No. 48, unless there is a minor ownership interest, those investments are to be reported using an equity method as defined in SSAP No. 97, paragraphs 8.b.i through 8.b.iv. The industry comments have indicated that foreign insurance entities including those held through a partnership, LLC or joint venture under SSAP No. 48 should also be permitted to stop the equity value at zero without reflecting a negative valuation in response to statutory adjustments.

NAIC staff notes it is important to separate the paragraph 13 equity method adjustments which stop at zero from the paragraph 9 limited statutory basis adjustments, which intentionally do not stop at zero. However, it is noted that reporting entities with investments captured under SSAP No. 48, which requires an audit for admittance, may not be completing U.S. GAAP financials. If these SSAP No. 48 investments are not audited, reporting entities may have difficulty calculating the required adjustments to be made pursuant to SSAP No. 97, paragraph 9.

Interested Parties' Comments:

Interested parties appreciate the opportunity to provide comments on Ref# 2021-04 (the "exposure draft"), which was re-exposed by the Statutory Accounting Principles Working Group (the "Working Group") on May 20, 2021.

The exposure draft proposes to make the following changes to the SSAP No. 97 and SSAP No. 48:

SSAP No. 97 Paragraph 9

> Note that the outcome of these adjustments can result in a negative equity valuation of the investment for all paragraph 8.b.ii. entities. For a paragraph 8.b.iv. entity, the application of these adjustments will stop at zero, and will not result in negative equity valuation unless the 8.b.iv entity provides services to the reporting entity or its affiliates or holds assets on behalf of the reporting entity. If such services, including reinsurance transactions, are occurring, the adjustments required in this paragraph can result in a negative equity valuation. (See additional equity method application guidance in paragraph 13.e. regarding guarantees and financial support.)

SSAP No. 48 Paragraph 6

> Investments in these ventures, except for joint ventures, partnerships and limited liability companies with a minor ownership interest, shall be reported using an equity method as defined in *SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities*, paragraphs 8.b.i. through 8.b.iv. (The equity method calculation may result with a negative valuation of the investment, therefore the SSAP No. 97 equity method calculation shall occur regardless of whether the investment is supported by an audit and the reporting entity will nonadmit the investment.) A reporting entity whose shares of losses in a SSAP No. 48 entity exceeds its investment in the SSAP No. 48 entity shall disclose the information required by SSAP No. 97, paragraph 35.a.

Interested parties agree with these changes. As stated in our previous comment letters on this topic, there are significant differences between 8.b.ii and 8.b.iv subsidiaries that warrant different accounting treatment. Interested parties believe that the proposed edits to SSAP No. 97 provide for the appropriate accounting for 8.b.iv subsidiaries while at the same time providing effective guardrails to prevent any potential abuses of the rules.

New York Life

New York Life ("NYL") appreciates the opportunity to provide comments on Item 2021-04 (the "Exposure"), which was re-exposed by the Statutory Accounting Principles (E) Working Group (the "SAPWG") on May 20, 2021.

The Exposure proposes to make the following changes to the SSAP No. 97 and SSAP No. 48

SSAP No. 97 Paragraph 9

> Note that the outcome of these adjustments can result in a negative equity valuation of the investment for all paragraph 8.b.ii. entities. For a paragraph 8.b.iv. entity, the application of these adjustments will stop at zero, and will not result in negative equity valuation unless the 8.b.iv entity provides services to the reporting entity or its affiliates or holds assets on behalf of the reporting entity. If such services, including reinsurance transactions, are occurring, the adjustments required in this paragraph can result in a negative equity valuation. (See additional equity method application guidance in paragraph 13.e. regarding guarantees and financial support.)

SSAP No. 48 Paragraph 6

- Investments in these ventures, except for joint ventures, partnerships and limited liability companies with a minor ownership interest, shall be reported using an equity method as defined in *SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities*, paragraphs 8.b.i. through 8.b.iv. (The equity method calculation may result with a negative valuation of the investment, therefore the SSAP No. 97 equity method calculation shall occur regardless of whether the investment is supported by an audit and the reporting entity will nonadmit the investment.) A reporting entity whose shares of losses in a SSAP No. 48 entity exceeds its investment in the SSAP No. 48 entity shall disclose the information required by SSAP No. 97, paragraph 35.a.

NYL agrees with the proposed changes to both SSAPs. We believe that the language being proposed reflects the appropriate accounting for an 8.b.iv entity and at the same time prevents potential interpretations that would allow an 8.b.iv entity's equity to be floored at zero if the 8.b.iv is only in existence to benefit the reporting entity.

Recommended Action:

NAIC staff recommends that the Working Group adopt the exposed nonsubstantive revisions to *SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities* and *SSAP No. 48—Joint Ventures, Partnerships and Limited Liability Companies*. These revisions restrict the SSAP No. 97, paragraph 9 limited statutory adjustments for foreign insurance SCAs (8.b.iv) and will result in a valuation floor of zero if the entity is not engaged in providing services to, or holding assets on behalf of, the U.S. insurers and to clearly indicate that the equity method valuation referenced in SSAP No. 97 can result in a negative equity valuation for SSAP No. 48 entities.

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Ref #	Title	Attachment #	Agreement with Exposed Document?	Comment Letter Page Number
2021-10 SSAP No. 32R (Jim)	**SSAP No. 32R – Clarification of Effective Call Price**	**2– Agenda Item**	**Yes**	**N/A***

Summary:
On July 20, through an e-vote, the Working Group exposed revisions to *SSAP No. 32R—Preferred Stock* to clarify that the 'effective call price' valuation limitation, for all instruments within scope of the standard, shall only apply if the call is currently exercisable by the issuer or if the issuer has announced that the instrument will be redeemed/called.

In July 2020, the Working Group adopted *Issue Paper No. 164—Preferred Stock* and substantively revised *SSAP No. 32R.* The substantively revised guidance requires that perpetual preferred (as well as publicly traded preferred stock warrants) be reported at fair value, with a valuation ceiling that is not to exceed any currently effective call price. This agenda item addresses the application of the valuation ceiling by clarifying that the limitation should only apply in situations where the call is currently exercisable by the issuer, or the issuer has provided notice of its intent to call the preferred stock.

Interested Parties' Comments:

* While an official comment letter was not received, informal comments indicate that "[Interested parties] support this proposal."

Recommended Action:
NAIC staff recommends that the Working Group adopt the exposed edits to *SSAP No. 32R—Preferred Stock* to clarify that the 'effective call price' valuation limitation, for all instruments within scope of the standard, shall only apply if the call is currently exercisable by the issuer or if the issuer has announced that the instrument will be redeemed/called.

The comment letters are included in Attachment 3 (4 pages).

Statutory Accounting Principles (E) Working Group
Meeting Agenda

A. Consideration of Maintenance Agenda – Pending List

1. Ref #2021-11: SSAP No. 43R – Credit Tenant Loans - Scope
2. Ref #2021-12EP: Editorial Process
3. Ref #2021-13: Salvage -Legal Recoveries

Ref #	Title	Attachment #
2021-11 SSAP No. 43R (Julie)	**SSAP No. 43R – Credit Tenant Loans - Scope**	**A – Agenda Item**

Summary:
On July 15, 2021, the Valuation of Securities (E) Task Force adopted revisions to the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (P&P Manual) to clarify that the definition of a credit tenant loan (CTL), which defines CTLs as mortgage loans, is specific to "mortgage loans in scope of SSAP No. 37." This limited amendment to the P&P Manual was suggested by the chair and vice chair of the Statutory Accounting Principles (E) Working Group to clarify that the application of the structural assessment to identify CTLs is limited to direct mortgage loans and relates to the potential reclassification of investments from Schedule B (Mortgage Loans) to Schedule D (Bonds) for qualifying investments. The amendment also clarifies that security structures, which are excluded from SSAP No. 37, are not subject to the P&P Manual CTL structural assessments and should be captured for accounting and reporting in accordance with the applicable SSAP within the *NAIC Accounting Practices and Procedures Manual*. With this Task Force discussion, it was highlighted that there is a current Working Group project to define principal concepts for bond reporting.

With the adoption of the Task Force guidance, NAIC staff has assessed whether *INT 20-10: Reporting Nonconforming CTLs* should be nullified and whether other revisions should be incorporated into SSAP No. 43R prior to the adoption of guidance in advance of the principle-based bond proposal project.

Review of INT 20-10:
INT 20-10 was adopted Dec. 28, 2020, to provide reporting exceptions for year-end 2020. This interpretation permitted continued reporting on Schedule D for nonconforming CTLs (and other structures which met the characteristics of a CTL) if they had been filed for an SVO-assigned designation by Feb. 15, 2021. Although an SVO-assigned designation was not required to be received before filing the statutory financial statements, reporting entities were required to disclose the nonconforming CTLs captured on Schedule D with a CRP rating in Note 1. Once the SVO-assigned designation was received, then the reporting entity would begin reporting the SVO-assigned designation (instead of the CRP rating) and the Note 1 disclosure would no longer be required. This interpretation also clarified that there would be no requirement to move investments to Schedule D (and file them with the SVO) if they had previously been reported on a different schedule (such as Schedule B or Schedule BA). This interpretation was set to expire Oct. 1, 2021. This limited effective date was set to allow for further review and consideration of these structures prior to year-end 2021 reporting.

Assessment of INT 20-10:
With the adoption of the Task Force edits, which clarify that security structures shall be assessed for accounting and reporting in accordance with the provisions in SSAP No. 26R and SSAP No. 43R, NAIC staff does not believe there is a need to retain INT 20-10 as the reporting exception provided within would no longer be necessary for security structures. (The identification of nonconforming CTLs as of year-end 2020 solely encompassed security structures with underlying real estate risk and did not include any direct mortgage loans that had been reclassified from Schedule B to Schedule D without meeting the SVO structural analysis.) With the nullification of INT 20-10 and Task Force clarifications, only direct mortgage loans would be assessed for reclassification from mortgage

loans to bonds under the CTL structural provisions. With the limited focus on these specific structures, there is no perceived need to reconsider the current structural provisions that need to be met (namely the 5% residual risk threshold) for those investments to be reclassified from mortgage loans to bonds. With the nullification of INT 20-10, the following guidance would be applicable:

- Mortgage loans in scope of SSAP No. 37 will continue past practice, with reporting entities having the ability to file the structures with the SVO for a structural assessment to determine whether the mortgage loan can be reclassified from Schedule B to Schedule D as a CTL.

- Security structures that have underlying real estate risk, whether they are referred to as CTLs or by another named (e.g., lease-backed securities) that qualify in scope of *SSAP No. 26R—Bonds* or *SSAP No. 43R—Loan-Backed and Structured Securities* shall follow the accounting and reporting provisions of those SSAPs. Investments that qualify within these SSAPs are reported on Schedule D-1: Long-Term Bonds. This is consistent with past intent of the SSAPs as the highest level of the statutory hierarchy (pursuant to Section V – Statutory Hierarchy of the Preamble to the AP&P Manual) as well as guidance in the *NAIC Policy Statement on Coordination of the AP&P Manual and the P&P Manual*. Per that guidance, obtaining an NAIC designation does not change in investment's applicable SSAP, annual or quarterly statement reporting schedule or override other SSAP guidance required for an investment to be an admitted asset. That guidance identifies that there are limited instances in which a SSAP specifically identifies within its scope, the inclusion of specific SVO-Identified investments based on structural assessments (such as SVO-Identified Bond ETFs in scope of SSAP No. 26R). However, that guidance is specific to the inclusion of qualifying investments into the scope of a specific SSAP and does not provide the ability to remove investments from a specific SSAP that qualify under the SSAP's scope provisions.

Assessment of SSAP No. 43R:
NAIC staff has recognized that the scope guidance of SSAP No. 43R does not name mortgage loans that qualify as CTLs after an SVO structural assessment. Furthermore, it has been identified that there are examples of securities in paragraph 27.b that have been cited as structures that are in scope of SSAP No. 43R. Paragraph 27 is not a scope paragraph but is in the section of the SSAP that addresses determination of the designation based on whether the investment is subject to the financial modeling guidance. (The original source of these examples was in a paragraph that identified investments that would not be financially modeled or that did not receive CRP ratings subject to the "modified filing exempt" provisions. Since the "MFE" concept was removed in 2020, SSAP No. 43 investments are either financially modeled or captured as an "all other loan-backed or structured security.") With the removal of the MFE guidance, paragraph 27.b is now applicable to all securities not subject to financial modeling, but these examples are still included. *(Note: NAIC staff has an impression that there could be industry concern with removing these examples as it will cause questions on whether they can be reported in scope of SSAP No. 43R.)*

Although there is current "bond project" to establish principal concepts in determining whether an investment qualifies as a bond, the finalization and implementation of that project is expected to take time to complete. To address immediate issues with regards to clarifying the reporting of mortgage loan CTLs and other securities, NAIC staff proposes nonsubstantive revisions to remove the examples from paragraph 27.b and explicitly incorporate applicable provisions in the scope paragraphs of SSAP No. 43R.

Recommendation:

NAIC staff recommends that the Working Group move this item to the active listing, categorized as nonsubstantive and take the following action:

1) Nullify INT 20-10 as no longer applicable. (If preferred, rather than nullifying immediately, this INT could continue and expire automatically on Oct. 1, 2021, without consideration of further extension.)
2) Dispose agenda item 2020-24: Accounting and Reporting of Credit Tenant Loans without statutory revisions. This agenda item had two exposures regarding CTLs prior to the development of INT 20-10 and the SVO adoption that clarified the definition of CTLs.

3) Expose revisions to *SSAP No. 43R—Loan-Backed and Structured Securities* to explicitly identify the SVO-Identified CTLs in scope of SSAP No. 43R. These revisions also propose to delete the examples of "other LBSS" in paragraph 27.b If there are concerns that this deletion inadvertently removes any specific investment from the scope of SSAP No. 43R, those comments are requested to be shared during the exposure period.

It is noted that these modifications are intended to simply clarify current guidance prior to the adoption of bond proposal.

Proposed edits to SSAP No. 43R:

1. This statement establishes statutory accounting principles for investments in loan-backed securities, structured securities and mortgage-referenced securities. In accordance with *SSAP No. 103R—Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, retained beneficial interests from the sale of loan-backed securities and structured securities are accounted for in accordance with this statement. In addition, mortgage loans in scope of SSAP No. 37 that qualify under a SVO structural assessment are in scope of this statement as credit tenant loans (CTLs). Items captured in scope of this statement are collectively referred to as loan-backed securities.

Designation Guidance

1. For RMBS/CMBS securities within the scope of this statement, the initial NAIC designation used to determine the carrying value method and the final NAIC designation for reporting purposes is determined using a multi-step process. The P&P Manual provides detailed guidance. A general description of the processes is as follows:

   b. All Other Loan-Backed and Structured Securities: For securities not subject to paragraph 27.a. (financial modeling) follow the established designation procedures according to the appropriate section of the P&P Manual. The NAIC designation shall be applicable for statutory accounting and reporting purposes (including determining the carrying value method and establishing the AVR charges). The carrying value method is established as described in paragraph 26. ~~Examples of these securities include, but are not limited to equipment trust certificates, credit tenant loans (CTL), 5*/6* securities, interest only (IO) securities, securities with CRP ratings (excluding RMBS/CMBS), loan-backed and structured securities, and mortgage-referenced securities with SVO assigned NAIC designations.~~

Ref #	Title	Attachment #
2021-12EP Various (Robin)	**Editorial Updates**	**B – Agenda Item**

Summary:
Maintenance updates provide revisions to the NAIC *Accounting Practices and Procedures Manual*, such as editorial corrections, reference changes and formatting as summarized below:

- *Preamble* – Incorporates a paragraph number for the existing statutory hierarchy section.
- *Appendix A-001* - Updates designation codes for preferred stock as noted in section 2 of *Appendix A-001: Investments of Reporting Entities.*
- Appendix C - Updates reference to the *former* Emerging Actuarial Issues (E) Working Group as well as adding reference to the Valuation Analysis (E) Working Group's use of included interpretations.
- *Appendix C-2* - Updates reference to the *former* Emerging Actuarial Issues (E) Working Group as well as adding reference to the Valuation Analysis (E) Working Group's use of included interpretations.

- *SSAP No. 21R—Other Admitted Assets* - Updates improve the readability of paragraph 9 regarding receivables for securities.

Recommendation:
NAIC staff recommends that the Working Group move this agenda item to the active listing, categorized as nonsubstantive, and expose the editorial revisions detailed in the agenda item.

Ref #	Title	Attachment #
2021-13 SSAP No. 55 (Robin)	**Salvage - Legal Recoveries**	**C – Agenda Item**

Summary:
This agenda item recommends nonsubstantive revisions to *SSAP No. 55—Unpaid Claims, Losses and Loss Adjustment Expenses* to clarify that salvage and subrogation estimates and recoveries can include amounts related to both claims/ losses and loss adjusting expenses. The corresponding estimates should be reported as a reduction of losses and/or loss adjusting expense (LAE) reserves. Once the amounts for salvage and subrogation and COB are received, they are reported as a reduction of paid losses and LAE depending on the nature of the costs being recovered.

SSAP No. 55 contains salvage and subrogation guidance. Key points of the guidance regarding salvage, subrogation and coordination of benefits recoveries (COB) are as follows:

- Salvage, subrogation and coordination of benefits recoveries are estimated using the same techniques used for estimating unpaid claims/losses and unpaid loss adjusting expenses.
- Separate recoverables are not established. Estimated salvage, subrogation and coordination of benefit recoveries (net of associated expenses) are deducted from the liability for unpaid claims or losses (for reporting entities that choose to anticipate such recoveries).
- Salvage, subrogation and coordination of benefits recoveries received (net of associated expenses) are reported as a reduction to paid losses/claims.

This agenda item is in response to an industry request. The proposed clarification provides additional detail regarding loss adjusting expenses for salvage, subrogation and coordination of benefits that is believed to be consistent with current practice by a majority of reporting entities. For example, if legal fees are recovered in a subrogation lawsuit, it is believed that such amounts are currently being reported as reduction in paid adjusting expenses for legal fees. SSAP No. 55 does not explicitly discuss the recovery of loss adjusting expenses in the discussion of salvage, subrogation and COB. However, the property and casualty annual statement instructions, which are level two on the statutory hierarchy of authoritative literature, includes an explicit reference to reduce loss adjusting expenses for such amounts in the Schedule P instructions.

Recommendation:
NAIC staff recommends that the Working Group move this agenda item to the active listing, categorized as nonsubstantive, and expose revisions to SSAP No. 55, which clarify that subrogation recoveries should be reported as a reduction of losses and/or loss adjusting expense LAE reserves, depending on the nature of the costs being recovered. In addition, updates to the disclosure in paragraph 17h are recommended. In conjunction, with the agenda item, NAIC staff should be directed to coordinate develop conforming revisions to the annual statement instructions. While NAIC staff believes the proposed clarification is consistent with the current practice of most entities, the Working Group should notify the Casualty Actuarial and Statistical (C) Task Force, the Life Actuarial (A) Task Force and the Health Actuarial (B) Task Force of the exposure.

15. For each line of business and for all lines of business in the aggregate, management shall record its best estimate of its liabilities for unpaid claims, unpaid losses, and loss/claim adjustment expenses. Because the ultimate settlement of claims (including IBNR for death claims and accident and health claims) is subject to future events, no single claim or loss and loss/claim adjustment expense reserve can be considered accurate with certainty. Management's analysis of the reasonableness of claim or loss and loss/claim adjustment expense reserve estimates shall include an analysis of the amount of variability in the estimate. If, for a particular line of business, management develops its estimate considering a range of claim or loss and loss/claim adjustment expense reserve estimates bounded by a high and a low estimate, management's best estimate of the liability within that range shall be recorded. The high and low ends of the range shall not correspond to an absolute best-and-worst case scenario of ultimate settlements because such estimates may be the result of unlikely assumptions. Management's range shall be realistic and therefore, shall not include the set of all possible outcomes but only those outcomes that are considered reasonable. Management shall also follow the concept of conservatism included in the Preamble when determining estimates for ~~claims~~ claim and loss and loss/claim adjustment expense reserves. However, there is not a specific requirement to include a provision for adverse deviation in claims.

16. In the rare instances when, for a particular line of business, after considering the relative probability of the points within management's estimated range, it is determined that no point within management's estimate of the range is a better estimate than any other point, the midpoint within management's estimate of the range shall be accrued. It is anticipated that using the midpoint in a range will be applicable only when there is a continuous range of possible values, and no amount within that range is any more probable than any other. For purposes of this statement, it is assumed that management can quantify the high end of the range. If management determines that the high end of the range cannot be quantified, then a range does not exist, and management's best estimate shall be accrued. This guidance is not applicable when there are several point estimates which have been determined as equally possible values, but those point estimates do not constitute a range. If there are several point estimates with equal probabilities, management should determine its best estimate of the liability.

17. If a reporting entity chooses to anticipate salvage and subrogation recoverables (including amounts recoverable from second injury funds, other governmental agencies, or quasi-governmental agencies, where applicable), the recoverables shall be estimated in a manner consistent with paragraphs 10-12 of this statement. Estimated salvage and subrogation recoveries (net of associated recovery expenses) shall be deducted from the liability for unpaid claims, unpaid losses, and unpaid loss/claim adjustment expenses, depending on the whether the subrogation represents a recovery of claims/losses or loss/claims adjustment expenses ~~or losses~~. If a reporting entity chooses to anticipate coordination of benefits (COB) recoverables of Individual and Group Accident and Health Contracts, the recoverables shall be estimated in a manner consistent with paragraphs 11-13 of this statement and shall be deducted from the liability for unpaid claims or losses. A separate receivable shall not be established for these recoverables. In addition, all of these recoverables are also subject to the impairment guidelines established in *SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets* (SSAP No. 5R) and an entity shall not reduce its reserves for any recoverables deemed to be impaired. Salvage and subrogation recoveries received (net of associated recovery expenses) are reported as a reduction to paid losses/claims and/or paid loss/claim adjustment expenses. Coordination of benefits (COB) recoveries received of Individual and Group Accident and Health Contracts (net of associated recovery expenses) are reported as a reduction to paid claims.

Disclosures

17. The financial statements shall include the following disclosures for each year full financial statements are presented. The disclosure requirement in paragraph 17.d. is also applicable to the interim financial statements if there is a material change from the amounts reported in the annual filing. Life and annuity contracts are not subject to this disclosure requirement.

a. Estimates of anticipated salvage and subrogation (including amounts recoverable from second injury funds, other governmental agencies, or quasi-governmental agencies, where applicable), deducted from the liability for unpaid claims, ~~or~~ losses or their associated adjusting expenses.

Ref #	Title	Attachment #
2021-14 Policy Statement (Julie)	**Policy Statement Terminology Change – Substantive & Nonsubstantive**	**D – Agenda Item E - Referral**

Summary:
Pursuant to the Aug. 14, 2021 referral from the Financial Condition (E) Committee, the discussion involving *SSAP No. 71—Policy Acquisition Costs and Commissions*, has highlighted that the statutory accounting terminology of "substantive" and "nonsubstantive" to describe statutory accounting revisions being considered by the Statutory Accounting Principles (E) Working Group to the *Accounting Practices and Procedures Manual* (AP&P Manual) could be misunderstood by users that are not familiar with the specific definitions and intended application of those terms. To avoid the incorrect perception that these terms may reflect the degree of financial impact to companies based on their common usage, the Financial Condition (E) Committee requests that the Statutory Accounting Principles consider updating these terms to prevent future misunderstandings.

Additional Referral Excerpts:

> The Financial Condition (E) Committee understands the terms "substantive" and "nonsubstantive" were crafted as part of the statutory accounting principles (SAP) codification, which was finalized in 1998, and were intended to be simple, concise terms to differentiate whether proposed revisions reflect new SAP concepts (substantive) or clarification of existing SAP concepts (nonsubstantive). The source location for the definitions and classification criteria of these terms is the NAIC Policy Statement on Maintenance of Statutory Accounting Principles, but it is noted that the terms and definitions are referred to throughout SAP guidance, other policy statements, issue papers, and agenda items.
>
> The Working Group should consider eliminating "substantive" and "nonsubstantive" and instead refer to the type of revisions in accordance with the general nature in which those terms were intended to reflect. As such a revision that would have previously been considered "substantive" could be referred to as a "New SAP Concept" and a revision that would have previously been considered as "nonsubstantive" could be referred to as a "SAP Clarification." The Committee is not proposing that the Working Group reassess the classification criteria but is simply requesting terminology changes to prevent future misinterpretations or assessments by others. As such, unless the Working Group believes further revisions are necessary, statutory revisions that would have been previously classified as "nonsubstantive" are anticipated to continue to fall within that definition and be captured under the new terminology as a "SAP Clarification."

The referral also includes proposed revisions to the *NAIC Policy Statement on Maintenance of Statutory Accounting Principles* as potential suggestions to incorporate the proposed guidance change. (These proposed edits are shown in the Aug. 26, 2021, proposed edits for exposure.)

Recommendation:
NAIC staff recommends that the Working Group receive the referral from the Financial Condition (E) Committee, move this item to the active listing and expose revisions to the *NAIC Policy Statement on Maintenance of Statutory Accounting Principles,* as suggested by the Committee in their Aug. 14, 2021, referral, to alter the terminology used when discussing types of statutory accounting revisions.

Due to the extent that these terms are currently used throughout the AP&P Manual, upon adoption of this terminology change, NAIC staff will utilize the new terminology on a go-forward basis. These updates will be limited to the guidance that describes the use of these terms and will not capture previously adopted SSAPs, issue papers or agenda items. The terms used in previously adopted guidance will remain, with the new terms being used prospectively when considering future revisions to statutory accounting.

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B. <u>Consideration of Maintenance Agenda – Active Listing</u>

1. Ref #2019-24: Levelized and Persistency Commission

Ref #	Title	Attachment #
2019-24 SSAP No. 71 (Robin)	**Levelized and Persistency Commission**	**F- Issue Paper**

Summary:
At the 2021 Spring Meeting the Working Group adopted nonsubstantive revisions to *SSAP No. 71—Policy Acquisition Costs and Commissions* which clarify the guidance in SSAP No. 71 regarding levelized commissions with a Dec. 31, 2021, effective date. The Working Group affirmed the nonsubstantive classification of these revisions as consistent with the original intent of SSAP No. 71. In addition, the Working Group exposed a new annual statement general interrogatory to identify the use of a third party for the payment of commission expenses, which will be concurrently exposed with the Blanks (E) Working Group. The Working Group also directed NAIC staff to update the Issue Paper which has been drafted to document the historical discussions, to reflect the most recent actions regarding the agenda item.

The *Issue Paper No. 16x:Levelized Commission* has been updated and is ready for its initial exposure.

Recommendation:
NAIC recommends that the Working Group expose *Issue Paper No. 16x:Levelized Commission* for comment to document the historical discussion on this topic. As a reminder the revisions to SSAP No. 71 have been through the NAIC committee process and Issue Papers are not authoritative, but provide historical background regarding discussions during the development of the authoritative guidance.

<u>ANY OTHER MATTERS</u>

a. Receive and Respond to the VOSTF Referral on Working Capital Finance Investments (Referral - Attachment G, VOSTF Exposure - Attachment H, Draft SAPWG response - Attachment I)

The Valuation of Securities (E) Task Force (VOSTF) met on July 15 actions and took the following actions related to **Working Capital Finance Investments (WCFI):**

1. Adopted changes to the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* to conform with the Working Group revisions to *SSAP No. 105R—Working Capital Finance Investments* adopted in May 2020.

2. Directed a 30-day exposure and a referral to the Statutory Accounting Principles (E) Working Group on proposed edits regarding unrated and nonguaranteed subsidiary obligors in WCFI programs (**Attachments G and H**). Although the exposure period ends August 16, the SVO staff has confirmed that the Working Group will have additional time to respond to the referral.

Summary of the VOSTF WCFI referral (Attachment G):

Pursuant to the referral received July 28, 2021, the Valuation of Securities (E) Task Force exposed a policy change that would direct the SVO to rely upon the NAIC designation of an unrated subsidiary obligor's parent entity for Working Capital Finance Investments (WCFI), without notching for the subsidiary. A referral was provided to the Statutory Accounting Principles (E) Working Group, as a qualifying NAIC designation of the obligor is a required element for admittance of WCFI receivables under *SSAP No. 105R—Working Capital Financial Investments.*

Key Excerpts of the VOSTF Exposed Language (Attachment H):

> 120. Solely for purposes of WCFI transactions, the Task Force directs the SVO to rely upon the NAIC Designation or Eligible NAIC CRP Rating equivalent of the obligor, subsidiary or affiliate's parent entity if: a) the obligor, subsidiary or affiliate does not have an Eligible NAIC CRP Rating and the SVO cannot assign an NAIC Designation to it.
>
> 122. For the avoidance of doubt, while though the Task Force directs the SVO to use the NAIC Designation or Eligible NAIC CRP rating equivalent of the obligor's parent entity, due to the SVO's authority to notch such NAIC Designation or rating, the SVO, based on its analytical judgement and in its sole discretion, may assign an NAIC Designation to the obligor which differs from the correlated Eligible NAIC CRP rating equivalent of the obligor's parent entity or choose not to assign any NAIC Designation to the working capital finance program, based on aspects of the working capital finance program which are unrelated to the relationship between the obligor, subsidiary or affiliate and its parent entity.
>
> 123. The Task Force acknowledges that reliance upon the NAIC Designation or Eligible NAIC CRP rating equivalent of the obligor's parent entity in the absence of a binding legal obligation for the parent to assume the financial obligations of the obligor, such as a guarantee, is not a generally accepted technique or methodology (as explained in "Use of Generally Accepted Techniques or Methodologies" in Part One of this Manual) and is inconsistent with the credit substitution guidelines detailed in "Credit Substitution" in Part Three of this manual, but it is directing the SVO to so rely.

Key Elements of Task Force Exposure and Proposed Response:

The Task Force exposure is a variation of the industry recommendations previously rejected by the Working Group, which proposes to require the rating of the WCFI program parent to be relied on for unrated, unguaranteed obligors. If the Task Force agrees and deems it essential that the SVO assign NAIC designations to WCFI transactions with unrated, non-guaranteed obligors, then this policy change will impact how NAIC Designations are assigned to WCFI transactions. The policy would direct SVO staff to apply/ imply the credit rating of the parent to unrated unguaranteed subsidiaries for WCFI programs only even if they do not have financial information on the subsidiary. This direction is noted in the exposed SVO memo as contrary to current SVO credit substitution methodology and is noted as not a generally accepted credit rating technique. The memo further notes that such implied parent support is not legally enforceable.

Although the Task Force oversees the process to determine NAIC designations, the proposed methodology is a major departure for how SVO ratings are otherwise assigned. Working Group members could make comments directly to the Task Force regarding the policy if desired.

Recommended Working Group Action

1. Receive the VOSTF referral

2. Review and approve (or modify) the draft Working Group referral response

Draft Working Group Referral Response (Attachment I):

The Working Group has considered this exposure and acknowledges that establishment of NAIC designations is within the purview of the Task Force. However, the provisions within SSAP No. 105R were established in accordance with the historical approaches utilized in determining NAIC designations which allowed the SVO to apply its credit substitution methodology as it does for other asset classes. The proposed policy would require the SVO to imply an NAIC designation to an unrated entity based on the parent entity's credit quality without guarantees or other legally-binding provisions that provide assurance that the parent will be legally or contractually obligated to financially cover the obligations of the unrated entity. Although, for a given program, and not related to the parent/sub relationship, the SVO may notch or otherwise not give a rating to that program.

If the Task Force chooses to move away from the historical application of financial analysis and use of the credit substitution methodology in determining NAIC designations for WCFI programs, the Working Group may deem it necessary to incorporate additional guardrail provisions to SSAP No. 105R as the NAIC designation of the obligor may no longer provide the intended safeguard for WCFI programs. As WCFI are complex arrangements, the credit quality of the obligor – who is ultimately responsible for satisfying the debt owed to the insurance reporting entity – is of paramount importance. Furthermore, the referral and exposure documentation memo seem to understand this dilemma, as it specifically identifies that "no generally accepted analytical technique or methodology supports the assumption that a parent entity will necessarily support its subsidiary in times of financial distress." Consideration of changes that the Working Group would deem necessary, if any, would be expected to occur after any such edits to the P&P Manual are adopted.

If the Task Force chooses to move forward with the issuance of "implied" NAIC designations to unrated entities for WCFI programs, the Working Group offers the following two components for additional consideration:

1. The exposed P&P Manual language seems to contradict with SSAP No. 105R, paragraph 7. Specifically, the Task Force language identifies that the implied approach is an alternative method to obtaining an NAIC designation. If the Task Force is going to permit an implied approach to an unrated sub, then to avoid conflicts with SSAP No. 105R, this implied designation would need to be considered an "NAIC Designation." If the guidance is adopted with the inconsistency, the guidance in SSAP No. 105R requiring an NAIC designation would be the authoritative guidance. Therefore, the Working Group would recommend coordination to address any inconsistencies.

2. Although the implied designation would need to be considered an "NAIC Designation" to satisfy the requirements of SSAP No. 105R, the Working Group recommends that NAIC designations determined under the implied methodology have a specific identifier so that WCFI programs with rated obligors and unrated obligors can be separately identifiable by state insurance regulators. This is considered necessary as without this identification, regulators could erroneously conclude that an unrated obligor has been individually determined to be of high-credit quality, or that the parent entity has guaranteed or is otherwise legally obligated to pay the obligations of the unrated entity.

The comment deadline for all exposed items is Friday, October 1, 2021.

https://naiconline.sharepoint.com/teams/FRSStatutoryAccounting/National Meetings/A. National Meeting Materials/2021/9. August 26/0 - 8-26-21 - SAPWG Hearing - 32R and 97.docx

Statutory Accounting Principles (E) Working Group
Maintenance Agenda Submission Form
Form A

Issue: SSAP No. 97 – Valuation of Foreign Insurance SCAs

Check (applicable entity):

	P/C	Life	Health
Modification of existing SSAP	☒	☒	☒
New Issue or SSAP	☐	☐	☐
Interpretation	☐	☐	☐

Description of Issue:
In March 2020, agenda item 2018-26 – SCA Loss Tracking – Accounting Guidance adopted guidance in *SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities* to state that reported equity method losses of an investment in a subsidiary controlled or affiliated entity (SCA) would not create a negative value in a SCA investment, thus equity method losses would stop at zero. However, the agenda item also clarified that to the extent there was a financial guarantee or commitment, it would require appropriate recognition under *SSAP No. 5R—Liabilities, Contingencies and Impairment of Assets.*

In November 2020, the Working Group adopted agenda item 2020-18 - SSAP No. 97 Update and removed a lingering, superseded reference regarding negative equity method loss valuations.

However guidance in SSAP No. 97 also requires specific adjustments to 8.b.ii (insurance related SCA) and 8.b.iv (foreign insurance SCA) entities. These long-standing adjustments require the non-admission of certain assets to achieve a limited statutory basis of accounting. The adjustments have typically been viewed as necessary in order to prevent assets being held by SCA receiving more favorable treatment than had the assets been held directly by the insurer. (e.g., requiring the nonadmittance of certain assets per *SSAP No. 20—Nonadmitted Assets*). Per SSAP No. 97, an equity method of accounting for 8.b.ii and 8.b.iv entities would be a beginning point which would then be adjusted by the provisions of SSAP No. 97, paragraph 9 (see "authoritative literature section"). It is important to note the outcome of these adjustments can result in a negative equity valuation of the investment. Again, this is so assets held by an SCA aren't reported at a higher value than had they been held directly by the insurer.

During the discussion of agenda item 2020-18, industry comments requested consideration of whether 8.b.iv entities should be subject to the provisions of SSAP No. 97, specifically that paragraph 9 adjustments may result in a negative equity valuation. While stating many positions, industry's primary response that foreign insurance operations are subject to foreign jurisdiction and should be allowed to stand independently of a domestic insurer – thus in the absence of a guarantee or commitment, equity valuation should not go negative and thus stop at zero. Comments were received from industry noted that the circumstances that would cause a foreign insurance reporting entity to record negative equity is not prevalent, however indicated the potential to arise in the future.

At the direction of the NAIC staff have drafted this agenda item to determine if further edits to SSAP No. 97 are required, specifically if the required statutory adjustments to 8.b.iv entities should no longer be able to result in a negative equity valuation.

One note, NAIC staff reviewed all SCA filings for the last 3 years, noting that less than 7% of all SCA filings were 8.b.iv entities. It was further noted that there was not a single instance of an 8.b.iv in a negative equity situation.

Existing Authoritative Literature:
Paragraph 9 of SSAP No. 97 details the modifications that are necessary to adjust audited U.S .Generally Accepted Accounting Principle (GAAP) financial statements to a limited statutory basis of accounting. These

long-standing adjustments ensure that assets held by an SCA are not accounted for in a more favorable manner than had the assets been held directly by the insurer.

SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities

9. The limited statutory basis of accounting for investments in noninsurance SCA entities, subject to paragraph 8.b.ii. and foreign insurance SCA entities, subject to paragraph 8.b.iv., shall be adjusted for the following:

a. Nonadmit assets pursuant to the following statutory accounting principles as promulgated by the NAIC in the *Accounting Practices and Procedures Manual*;

i. *SSAP No. 6—Uncollected Premium Balances, Bills Receivable for Premiums, and Amounts Due From Agents and Brokers*

ii. *SSAP No. 16R—Electronic Data Processing Equipment and Software*

iii. *SSAP No. 19—Furniture, Fixtures, Equipment and Leasehold Improvements*

iv. *SSAP No. 20—Nonadmitted Assets*

v. *SSAP No. 21R—Other Admitted Assets* (e.g., collateral loans secured by assets that do not qualify as investments are nonadmitted under SAP)

vi. *SSAP No. 29—Prepaid Expenses*

vii. *SSAP No. 105R—Working Capital Finance Investments*

b. Expense costs that are capitalized in accordance with GAAP but are expensed pursuant to statutory accounting as promulgated by the NAIC in the *Accounting Practices and Procedures Manual* (e.g., deferred policy acquisition costs, preoperating, development and research costs, etc.);

c. Adjust depreciation for certain assets in accordance with the following statutory accounting principles:

i. *SSAP No. 16R—Electronic Data Processing Equipment and Software*

ii. *SSAP No. 19—Furniture, Fixtures, Equipment and Leasehold Improvements*

iii. *SSAP No. 68—Business Combinations and Goodwill*

d. Nonadmit the amount of goodwill of the SCA in excess of 10% of the audited U.S. GAAP equity of the SCA's last audited financial statements.

e. Nonadmit amount of the net deferred tax assets (DTAs) of the SCA in excess of 10% of the audited U.S. GAAP equity of the SCA's last audited financial statements.

f. Nonadmit any surplus notes held by the SCA issued by the reporting entity.

g. Adjust the U.S. GAAP annuity account value reserves of a foreign insurance SCA, with respect to the business it wrote directly, using the commissioners' annuity reserve valuation method (CARVM) as defined in paragraphs 14 and 15 of Appendix A-820 (including the reserving provisions in the various Actuarial Guidelines which support CARVM). The valuation interest rate and mortality tables to be used in applying CARVM should be that prescribed by the foreign insurance SCA's country of domicile. If the Foreign SCA's country of domicile does not prescribe the necessary tables and/or rates, no reserve adjustment shall be made.

Note that the outcome of these adjustments, can result in a negative equity valuation of the investment.

SSAP No. 97, Exhibit C:

7. **Q – Is it possible for an SCA investment valued using an equity method to be reported as a negative value?**

7.1 **A –** Yes, the equity method noninsurance SCA could have a negative equity. For example, SSAP No. 97, paragraph 8.b.ii., relating to noninsurance SCA entities, may require some assets to be reported as a negative value (nonadmitted) in paragraph 9. In this example, a paragraph 8.b.ii. SCA subsidiary that is only holding furniture, which is nonadmitted, would be reflected with negative equity to the extent the value of the nonadmitted asset(s) exceed(s) reported equity. It should be noted that although SSAP No. 97, paragraph 13.e., discusses some situations in which the equity method should be discontinued, this does not apply to SCA entities, which meet the requirements of paragraph 8.b.ii. In addition, SSAP No. 97, paragraph 13.e., lists some situations where the equity method for 8.b.ii and 8.b.iv entities would result in a valuation that is less than zero.

Activity to Date (issues previously addressed by the Working Group, Emerging Accounting Issues (E) Working Group, SEC, FASB, other State Departments of Insurance or other NAIC groups): Agenda items 2018-26 – SCA Loss Tracking – Accounting Guidance and 2020-18 – SSAP No. 97 Update were previously adopted. Agenda item 2018-26 resulted in revisions to *SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets* and *SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities* stating that equity losses of an SCA would not go negative (thus stopping at zero), however the guaranteed liabilities would be reported to the extent there is a financial guarantee or commitment. Agenda item 2020-18 resulted in revisions with clarifying edits to Exhibit C, question 7, in SSAP No. 97, as well as removed a superseded statement that guarantees or commitments from the insurance reporting entity to the SCA could result in a negative equity valuation of the SCA.

Information or issues (included in *Description of Issue*) not previously contemplated by the Working Group:
None

Convergence with International Financial Reporting Standards (IFRS): N/A

Staff Recommendation:
Staff recommends that the Working Group move this item to the active listing, categorized as nonsubstantive and expose the intent to move this item to the disposal listing without statutory edits. Per staff's review of SCA Sub 2 filings filed with an 8b(iv) valuation method, there were no noted instances of negative value SCAs, therefore we do not recommend revisions to the existing guidance. This exposure will allow industry to determine if they are aware of any prevalent examples of a negative equity valuation in a foreign insurance SCA (8.b.iv) and provide detailed information to NAIC staff for assessment.

NAIC staff highlights that if such an event (negative equity due to nonadmitted assets) was to actually occur at some point, and the company was to question whether the negative equity in the SCA should be reported, that this should be addressed directly with the state of domicile. With this approach, the domiciliary state would be able to assess the limited statutory edits that were performed, the extent to which assets are held in the SCA that would be nonadmitted if held directly by the insurer, and how the SCA obtained those assets.

Staff Review Completed by: Fatima Sediqzad - NAIC Staff
February 2021

Status:
On March 15, 2021, the Statutory Accounting Principles (E) Working Group moved this agenda item to the active listing, categorized as nonsubstantive, and exposed the intent to move this agenda item to the disposal listing without statutory edits. Industry is requested submit comments on any prevalent examples of a negative equity valuation in a foreign insurance subsidiary, controlled or affiliated (SCA) investment with detailed information for assessment.

On May 20, 2021, the Statutory Accounting Principles (E) Working Group exposed revisions to *SSAP No. 48—Joint Ventures, Partnerships and Limited Liability Companies* and *SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities*, as shown below, to indicate that the equity method valuation referenced in SSAP No. 97 can result in a negative equity valuation and to limit the statutory adjustments in SSAP No. 97, paragraph 9. The exposure includes proposed guidance based on comments received, which propose that foreign insurance SCAs shall stop at zero (and thus not be subject to negative equity valuations) when applying paragraph 9 adjustments in cases where the foreign insurance subsidiary is not engaged in providing services to, or holdings assets on behalf of, U.S. insurers.

Exposed Revisions:

SSAP No. 97, paragraph 9

9. The limited statutory basis of accounting for investments in noninsurance SCA entities, subject to paragraph 8.b.ii. and foreign insurance SCA entities, subject to paragraph 8.b.iv., shall be adjusted for the following:

a. Nonadmit assets pursuant to the following statutory accounting principles as promulgated by the NAIC in the *Accounting Practices and Procedures Manual*;

i. *SSAP No. 6—Uncollected Premium Balances, Bills Receivable for Premiums, and Amounts Due From Agents and Brokers*

ii. *SSAP No. 16R—Electronic Data Processing Equipment and Software*

iii. *SSAP No. 19—Furniture, Fixtures, Equipment and Leasehold Improvements*

iv. *SSAP No. 20—Nonadmitted Assets*

v. *SSAP No. 21R—Other Admitted Assets* (e.g., collateral loans secured by assets that do not qualify as investments are nonadmitted under SAP)

vi. *SSAP No. 29—Prepaid Expenses*

vii. *SSAP No. 105R—Working Capital Finance Investments*

b. Expense costs that are capitalized in accordance with GAAP but are expensed pursuant to statutory accounting as promulgated by the NAIC in the *Accounting Practices and Procedures Manual* (e.g., deferred policy acquisition costs, preoperating, development and research costs, etc.);

c. Adjust depreciation for certain assets in accordance with the following statutory accounting principles:

i. *SSAP No. 16R—Electronic Data Processing Equipment and Software*

ii. *SSAP No. 19—Furniture, Fixtures, Equipment and Leasehold Improvements*

iii. *SSAP No. 68—Business Combinations and Goodwill*

d. Nonadmit the amount of goodwill of the SCA in excess of 10% of the audited U.S. GAAP equity of the SCA's last audited financial statements.

e. Nonadmit amount of the net deferred tax assets (DTAs) of the SCA in excess of 10% of the audited U.S. GAAP equity of the SCA's last audited financial statements.

f. Nonadmit any surplus notes held by the SCA issued by the reporting entity.

g. Adjust the U.S. GAAP annuity account value reserves of a foreign insurance SCA, with respect to the business it wrote directly, using the commissioners' annuity reserve valuation method (CARVM) as defined in paragraphs 14 and 15 of Appendix A-820 (including the reserving provisions in the various Actuarial Guidelines which support CARVM). The valuation interest rate and mortality tables to be used in applying CARVM should be that prescribed by the foreign insurance SCA's country of domicile. If the Foreign SCA's country of domicile does not prescribe the necessary tables and/or rates, no reserve adjustment shall be made.

Note that the outcome of these adjustments can result in a negative equity valuation of the investment for all paragraph 8.b.ii. entities. For a paragraph 8.b.iv. entity, the application of these adjustments will stop at zero, and will not result in negative equity valuation unless the 8.b.iv entity provides services to the reporting entity or its affiliates or holds assets on behalf of the reporting entity. If such services, including reinsurance transactions, are occurring, the adjustments required in this paragraph can result in a negative equity valuation. (See additional equity method application guidance in paragraph 13.e. regarding guarantees and financial support.)

SSAP No. 48, paragraph 6

6. Investments in these ventures, except for joint ventures, partnerships and limited liability companies with a minor ownership interest, shall be reported using an equity method as defined in *SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities*, paragraphs 8.b.i. through 8.b.iv. (The equity method calculation may result with a negative valuation of the investment, therefore the SSAP No. 97 equity method calculation shall occur regardless of whether the investment is supported by an audit and the reporting entity will nonadmit the investment.) A reporting entity whose shares of losses in a SSAP No. 48 entity exceeds its investment in the SSAP No. 48 entity shall disclose the information required by SSAP No. 97, paragraph 35.a.

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Statutory Accounting Principles (E) Working Group
Maintenance Agenda Submission Form
Form A

Issue: SSAP No. 32R – Clarification of 'Effective Call Price'

Check (applicable entity):

	P/C	Life	Health
Modification of Existing SSAP	☒	☒	☒
New Issue or SSAP	☐	☐	☐
Interpretation	☐	☐	☐

Description of Issue: For a brief historical context, in July 2020, the Working Group adopted *Issue Paper No. 164—Preferred Stock* and substantively revised *SSAP No. 32R—Preferred Stock.* The substantively revised SSAP No. 32R was effective January 1, 2021, however in October 2020, agenda item 2020-31, permitted early application of the newly revised standard.

NAIC staff have received implementation questions regarding the application of a valuation ceiling for certain callable instruments in scope of SSAP No. 32R. The valuation ceiling requires that perpetual preferred, mandatory convertible preferred stock as well as publicly traded preferred stock warrants be reported at fair value, with a valuation ceiling that is **not to exceed any currently effective call price.** Questions on both the application and interpretation of this limitation have been brought to NAIC staff, accordingly this agenda item has been drafted to propose a clarification of this valuation ceiling.

Callable preferred stock is a type of preferred stock in which the issuer has the right to call or redeem at a pre-set price on or after a pre-defined calendar date. The call redemption terms such as price, premium and other applicable characteristics are specified in the instrument's prospectus. It is important to note that callable preferred stock generally have a five-year lock out period in which the issuer cannot call the preferred stock. Additionally, prior to redemption (call), the issuer must send notice to the shareholders, detailing the date and conditions of the redemption.

NAIC staff recommend that an appropriate interpretation for the application of the valuation ceiling is that the limitation should only apply in situations where the call is *currently exercisable* by the issuer, or the issuer has provided notice of its intent to call the preferred stock. If the valuation ceiling were to apply earlier (in advance of the call date), in situations where preferred stock is purchased in advance of its available call date, a reporting entity would be required to artificially limit the preferred stock's value, despite being able to liquidate it on the open market for fair value. This limitation could apply for years as calls are typically not available to the issuer for a period of at least 5 years post issuance.

For example, if perpetual preferred stock were purchased at $140 (its current fair value), but the preferred stock had a call available to the issuer at $120 in 5 years, a reporting entity would be required to report a day 1 unrealized loss for $20. To require the recognition of an unrealized loss in these situations does not appear to appropriately reflect the economics of the equity investment, especially when the instrument can be sold at its current fair value without incurring a loss. It is important to note that market conditions will likely influence the market value of the preferred stock as a call date nears – gradually decreasing any excess of fair value over the call price by the time the security is callable by the issuer. NAIC staff support maintaining a (clarified) valuation limitation to protect against unlikely scenarios where a callable security's fair value increases but will be called at a lower price.

Existing Authoritative Literature: The 'currently effective call price' valuation ceiling is referenced in numerous sections within *SSAP No. 32R—Preferred Stock* and is applicable to both perpetual and mandatory convertible preferred stock as well as publicly traded preferred stock warrants. For emphasis, relevant guidance has been bolded below.

Balance Sheet Amount

11. Preferred stock shall be valued based on (a) the underlying characteristics (redeemable, perpetual or mandatory convertible), (b) the quality rating expressed as an NAIC designation, and (c) whether an asset valuation reserve (AVR) is maintained by the reporting entity:

a. For reporting entities that do not maintain an AVR:

i. Highest-quality or high-quality redeemable preferred stocks (NAIC designations 1 and 2), which have characteristics of debt securities, shall be valued at cost or amortized cost. All other redeemable preferred stocks (NAIC designations 3 to 6) shall be reported at the lower of cost, amortized cost, or fair value.

ii. Perpetual preferred stock and publicly traded preferred stock warrants shall be reported at fair value, **not to exceed any currently effective call price**.

iii. Mandatory convertible preferred stocks (regardless if the preferred stock is redeemable or perpetual) shall be reported at fair value, **not to exceed any currently effective call price**, in the periods prior to conversion. Upon conversion to common stock, these securities shall be in scope of SSAP No. 30R.

iv. For preferred stocks reported at fair value, unrealized gains and losses shall be recorded as a direct credit or charge to unassigned funds (surplus)

b. For reporting entities that maintain an AVR:

i. Highest-quality, high-quality or medium quality redeemable preferred stocks (NAIC designations 1 to 3) shall be valued at amortized cost. All other redeemable preferred stocks (NAIC designations 4 to 6) shall be reported at the lower of amortized cost or fair value.

ii. Perpetual preferred stock and publicly preferred stock warrants shall be valued at fair value, **not to exceed any currently effective call price**.

iii. Mandatory convertible preferred stocks (regardless if the preferred stock is redeemable or perpetual) shall be reported at fair value, **not to exceed any currently effective call price**, in the periods prior to conversion. Upon conversion to common stock, these securities shall be in scope of SSAP No. 30R.

iv. For preferred stocks reported at fair value, the accounting for unrealized gains and losses shall be in accordance with *SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve.*

Impairment of Redeemable Preferred Stock

12. An other-than-temporary impairment shall be considered to have occurred if it is probable that the reporting entity will be unable to collect all amounts due according to the contractual terms of the preferred stock in effect at the date of acquisition. An assessment of other-than-temporary impairment shall occur whenever mandatory redemption rights or sinking fund requirements do not occur. A decline in fair value which is other-than-temporary includes situations where the reporting entity has made a decision to sell the preferred stock prior to its maturity at an amount below its carrying value (i.e., amortized cost). If it is determined that a decline in the fair value of a redeemable preferred stock is other-than-temporary, an impairment loss shall be recognized as a realized loss equal to the entire difference between the redeemable preferred stock's carrying value and its fair value, **not to exceed any currently effective call price,** at the balance sheet date of the reporting period for which the assessment is made. The measurement of the impairment loss shall not include partial recoveries of fair value subsequent to the balance sheet date. For reporting entities required to maintain an AVR, realized losses shall be accounted for in accordance with SSAP No. 7.

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13. In periods subsequent to the recognition of other-than-temporary impairment loss for a redeemable preferred stock, the reporting entity shall account for the other-than-temporarily impaired preferred stock as if the preferred stock had been purchased on the measurement date of the other-than-temporary impairment. The fair value of the redeemable preferred stock on the other-than-temporary impairment measurement date shall become the new cost basis of the redeemable preferred stock and the new cost basis shall not be adjusted for subsequent recoveries in fair value. The discount or reduced premium recorded for the preferred stock, based on the new cost basis, shall be amortized over the remaining life of the preferred stock in the prospective manner based on the amount and timing of future estimated cash flows. The preferred stock shall continue to be subject to impairment analysis for each subsequent reporting period. Future declines in fair value which are determined to be other-than-temporary shall be recorded as realized losses.

Activity to Date (issues previously addressed by the Working Group, Emerging Accounting Issues (E) Working Group, SEC, FASB, other State Departments of Insurance or other NAIC groups): Previous activity was summarized above, in the 'Description of Issue' section.

Information or issues (included in *Description of Issue*) not previously contemplated by the Working Group: None

Convergence with International Financial Reporting Standards (IFRS): N/A

Staff Recommendation:
NAIC staff recommends that the Working Group move this item to the active listing, categorized as nonsubstantive and expose revisions to *SSAP No. 32R—Preferred Stock* clarifying that for the 'effective call price' valuation ceiling to occur that 1) the call be currently exercisable by the issuer, or 2) the issuer of the security has announced that the instruments will be redeemed/called.

Proposed edits to SSAP No. 32R:

Balance Sheet Amount

11. Preferred stock shall be valued based on (a) the underlying characteristics (redeemable, perpetual or mandatory convertible), (b) the quality rating expressed as an NAIC designation, and (c) whether an asset valuation reserve (AVR) is maintained by the reporting entity New Footnote (FN):

a. For reporting entities that do not maintain an AVR:

i. Highest-quality or high-quality redeemable preferred stocks (NAIC designations 1 and 2), which have characteristics of debt securities, shall be valued at cost or amortized cost. All other redeemable preferred stocks (NAIC designations 3 to 6) shall be reported at the lower of cost, amortized cost, or fair value.

ii. Perpetual preferred stock and publicly traded preferred stock warrants shall be reported at fair value, not to exceed any currently effective call price.

iii. Mandatory convertible preferred stocks (regardless if the preferred stock is redeemable or perpetual) shall be reported at fair value, not to exceed any currently effective call price, in the periods prior to conversion. Upon conversion to common stock, these securities shall be in scope of SSAP No. 30R.

iv. For preferred stocks reported at fair value, unrealized gains and losses shall be recorded as a direct credit or charge to unassigned funds (surplus)

b. For reporting entities that maintain an AVR:

i. Highest-quality, high-quality or medium quality redeemable preferred stocks (NAIC designations 1 to 3) shall be valued at amortized cost. All other redeemable preferred

stocks (NAIC designations 4 to 6) shall be reported at the lower of amortized cost or fair value.

ii. Perpetual preferred stock and publicly preferred stock warrants shall be valued at fair value, not to exceed any currently effective call price.

iii. Mandatory convertible preferred stocks (regardless if the preferred stock is redeemable or perpetual) shall be reported at fair value, not to exceed any currently effective call price, in the periods prior to conversion. Upon conversion to common stock, these securities shall be in scope of SSAP No. 30R.

iv. For preferred stocks reported at fair value, the accounting for unrealized gains and losses shall be in accordance with *SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve.*

Impairment of Redeemable Preferred Stock

12. An other-than-temporary impairment shall be considered to have occurred if it is probable that the reporting entity will be unable to collect all amounts due according to the contractual terms of the preferred stock in effect at the date of acquisition. An assessment of other-than-temporary impairment shall occur whenever mandatory redemption rights or sinking fund requirements do not occur. A decline in fair value which is other-than-temporary includes situations where the reporting entity has made a decision to sell the preferred stock prior to its maturity at an amount below its carrying value (i.e., amortized cost). If it is determined that a decline in the fair value of a redeemable preferred stock is other-than-temporary, an impairment loss shall be recognized as a realized loss equal to the entire difference between the redeemable preferred stock's carrying value and its fair value, not to exceed any currently effective call price, at the balance sheet date of the reporting period for which the assessment is made. The measurement of the impairment loss shall not include partial recoveries of fair value subsequent to the balance sheet date. For reporting entities required to maintain an AVR, realized losses shall be accounted for in accordance with SSAP No. 7.

New Footnote (FN) – In all situations noted in this statement in which the fair value is limited to the currently effective call price, this limitation only applies when the call is 1) currently exercisable by the issuer, or 2) the issuer has announced that the instruments will be redeemed/called.

Staff Review Completed by: Jim Pinegar, NAIC Staff – June 2021

Status:

On July 20, 2021, in response to an e-vote to expose, the Statutory Accounting Principles (E) Working Group moved this agenda item to the active listing, categorized as nonsubstantive, and exposed revisions to *SSAP No. 32R—Preferred Stock* to clarify that the 'effective call price' valuation limitation, for all instruments within scope of the standard, shall only apply if the call is currently exercisable by the issuer or if the issuer has announced that the instrument will be redeemed/called.

https://naiconline.sharepoint.com/teams/FRSStatutoryAccounting/National Meetings/A. National Meeting Materials/2021/9. August 26/2 - 21-10 - SSAP No. 32R - Clarification of Effective Call Price.docx

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Attachment 3

Statutory Accounting Principles (E) Working Group
Comment Letters Received

TABLE OF CONTENTS

COMMENTER / DOCUMENT	PAGE REFERENCE
Comment Letters Received for Items Exposed for the August 26th Interim Meeting	
Interested Parties – July 15, 2021 ○ Ref #2021-04: SSAP No. 97 – Valuation of Foreign Insurance SCAs	1-2
New York Life Insurance Company – July 15, 2021 ○ Ref #2021-04: SSAP No. 97 – Valuation of Foreign Insurance SCAs	3-4

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July 15, 2021

Mr. Dale Bruggeman, Chairman
Statutory Accounting Principles Working Group
National Association of Insurance Commissioners
1100 Walnut Street, Suite 1500
Kansas City, MO 64106-2197

RE: Comments on Ref# 2021-04: *SSAP No. 97 – Valuation of Foreign Insurance SCAs*

Dear Mr. Bruggeman:

Interested parties appreciate the opportunity to provide comments on Ref# 2021-04 (the "exposure draft"), which was re-exposed by the Statutory Accounting Principles Working Group (the "Working Group") on May 20, 2021.

The exposure draft proposes to make the following changes to the SSAP No. 97 and SSAP No. 48:

SSAP No. 97 Paragraph 9

> Note that the outcome of these adjustments can result in a negative equity valuation of the investment for all paragraph 8.b.ii. entities. For a paragraph 8.b.iv. entity, the application of these adjustments will stop at zero, and will not result in negative equity valuation unless the 8.b.iv entity provides services to the reporting entity or its affiliates or holds assets on behalf of the reporting entity. If such services, including reinsurance transactions, are occurring, the adjustments required in this paragraph can result in a negative equity valuation. (See additional equity method application guidance in paragraph 13.e. regarding guarantees and financial support.)

SSAP No. 48 Paragraph 6

> Investments in these ventures, except for joint ventures, partnerships and limited liability companies with a minor ownership interest, shall be reported using an equity

> method as defined in *SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities*, paragraphs 8.b.i. through 8.b.iv. (The equity method calculation may result with a negative valuation of the investment, therefore the SSAP No. 97 equity method calculation shall occur regardless of whether the investment is supported by an audit and the reporting entity will nonadmit the investment.) A reporting entity whose shares of losses in a SSAP No. 48 entity exceeds its investment in the SSAP No. 48 entity shall disclose the information required by SSAP No. 97, paragraph 35.a.

Interested parties agree with these changes. As stated in our previous comment letters on this topic, there are significant differences between 8.b.ii and 8.b.iv subsidiaries that warrant different accounting treatment. Interested parties believe that the proposed edits to SSAP No. 97 provide for the appropriate accounting for 8.b.iv subsidiaries while at the same time providing effective guardrails to prevent any potential abuses of the rules.

* * *

Thank you for considering interested parties' comments. If you have any questions in the interim, please do not hesitate to contact us.

Sincerely,

D. Keith Bell Rose Albrizio

cc: NAIC staff
Interested parties

New York Life Insurance Company
51 Madison Avenue, New York, NY 10010

July 15, 2021

Mr. Dale Bruggeman, Chairman
Statutory Accounting Principles Working Group
National Association of Insurance Commissioners
1100 Walnut Street, Suite 1500
Kansas City, MO 64106-2197

RE: New York Life's Comments on Item 2021-04 *SSAP No. 97 – Valuation of Foreign Insurance SCAs*

Dear Mr. Bruggeman:

New York Life ("NYL") appreciates the opportunity to provide comments on Item 2021-04 (the "Exposure"), which was re-exposed by the Statutory Accounting Principles (E) Working Group (the "SAPWG") on May 20, 2021.

The Exposure proposes to make the following changes to the SSAP No. 97 and SSAP No. 48

SSAP No. 97 Paragraph 9

> Note that the outcome of these adjustments can result in a negative equity valuation of the investment for all paragraph 8.b.ii. entities. For a paragraph 8.b.iv. entity, the application of these adjustments will stop at zero, and will not result in negative equity valuation unless the 8.b.iv entity provides services to the reporting entity or its affiliates or holds assets on behalf of the reporting entity. If such services, including reinsurance transactions, are occurring, the adjustments required in this paragraph can result in a negative equity valuation. (See additional equity method application guidance in paragraph 13.e. regarding guarantees and financial support.)

SSAP No. 48 Paragraph 6

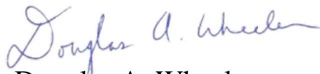
> Investments in these ventures, except for joint ventures, partnerships and limited liability companies with a minor ownership interest, shall be reported using an equity method as defined in *SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities*, paragraphs 8.b.i. through 8.b.iv. (The equity method calculation may result with a negative valuation of the investment, therefore the SSAP No. 97 equity method calculation shall occur regardless of whether the investment is supported by an audit and the reporting entity will nonadmit the investment.) A reporting entity whose shares of losses in a SSAP No. 48 entity exceeds its investment in the SSAP No. 48 entity shall disclose the information required by SSAP No. 97, paragraph 35.a.

NYL agrees with the proposed changes to both SSAPs. We believe that the language being proposed reflects the appropriate accounting for an 8.b.iv entity and at the same time prevents potential interpretations that would allow an 8.b.iv entity's equity to be floored at zero if the 8.b.iv is only in existence to benefit the reporting entity.

Thank you for considering our comments.

Sincerely,

Robert M. Gardner
Senior Vice President and Controller



Douglas A. Wheeler
Senior Vice President, Office of Governmental Affairs

Statutory Accounting Principles (E) Working Group
Maintenance Agenda Submission Form
Form A

Issue: SSAP No. 43R – Credit Tenant Loans - Scope

Check (applicable entity):

	P/C	Life	Health
Modification of Existing SSAP	☒	☒	☒
New Issue or SSAP	☐	☐	☐
Interpretation	☐	☐	☐

Description of Issue: On July 15, 2021, the Valuation of Securities (E) Task Force adopted revisions to the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (P&P Manual) to clarify that the definition of a credit tenant loan (CTL), which defines CTLs as mortgage loans, is specific to "mortgage loans in scope of SSAP No. 37." This limited amendment to the P&P Manual was suggested by the chair and vice chair of the Statutory Accounting Principles (E) Working Group to clarify that the application of the structural assessment to identify CTLs is limited to direct mortgage loans and relates to the potential reclassification of investments from Schedule B (Mortgage Loans) to Schedule D (Bonds) for qualifying investments. The amendment also clarifies that security structures, which are excluded from SSAP No. 37, are not subject to the P&P Manual CTL structural assessments and should be captured for accounting and reporting in accordance with the applicable SSAP within the *NAIC Accounting Practices and Procedures Manual*. With this Task Force discussion, it was highlighted that there is a current Working Group project to define principal concepts for bond reporting.

With the adoption of the Task Force guidance, NAIC staff has assessed whether *INT 20-10: Reporting Nonconforming CTLs* should be nullified and whether other revisions should be incorporated into SSAP No. 43R prior to the adoption of guidance in advance of the principle-based bond proposal project.

<u>Review of INT 20-10:</u>
INT 20-10 was adopted Dec. 28, 2020, to provide reporting exceptions for year-end 2020. This interpretation permitted continued reporting on Schedule D for nonconforming CTLs (and other structures which met the characteristics of a CTL) if they had been filed for an SVO-assigned designation by Feb. 15, 2021. Although an SVO-assigned designation was not required to be received before filing the statutory financial statements, reporting entities were required to disclose the nonconforming CTLs captured on Schedule D with a CRP rating in Note 1. Once the SVO-assigned designation was received, then the reporting entity would begin reporting the SVO-assigned designation (instead of the CRP rating) and the Note 1 disclosure would no longer be required. This interpretation also clarified that there would be no requirement to move investments to Schedule D (and file them with the SVO) if they had previously been reported on a different schedule (such as Schedule B or Schedule BA). This interpretation was set to expire Oct. 1, 2021. This limited effective date was set to allow for further review and consideration of these structures prior to year-end 2021 reporting.

Assessment of INT 20-10:
With the adoption of the Task Force edits, which clarify that security structures shall be assessed for accounting and reporting in accordance with the provisions in SSAP No. 26R and SSAP No. 43R, NAIC staff does not believe there is a need to retain INT 20-10 as the reporting exception provided within would no longer be necessary for security structures. (The identification of nonconforming CTLs as of year-end 2020 solely encompassed security structures with underlying real estate risk and did not include any direct mortgage loans that had been reclassified from Schedule B to Schedule D without meeting the SVO structural analysis.) With the nullification of INT 20-10 and Task Force clarifications, only direct mortgage loans would be assessed for reclassification from mortgage loans to bonds under the CTL structural provisions. With the limited focus on these specific structures, there is no perceived need to reconsider the current structural provisions that need to be met (namely the 5% residual risk

threshold) for those investments to be reclassified from mortgage loans to bonds. With the nullification of INT 20-10, the following guidance would be applicable:

- Mortgage loans in scope of SSAP No. 37 will continue past practice, with reporting entities having the ability to file the structures with the SVO for a structural assessment to determine whether the mortgage loan can be reclassified from Schedule B to Schedule D as a CTL.

- Security structures that have underlying real estate risk, whether they are referred to as CTLs or by another named (e.g., lease-backed securities) that qualify in scope of *SSAP No. 26R—Bonds* or *SSAP No. 43R—Loan-Backed and Structured Securities* shall follow the accounting and reporting provisions of those SSAPs. Investments that qualify within these SSAPs are reported on Schedule D-1: Long-Term Bonds. This is consistent with past intent of the SSAPs as the highest level of the statutory hierarchy (pursuant to Section V – Statutory Hierarchy of the Preamble to the AP&P Manual) as well as guidance in the *NAIC Policy Statement on Coordination of the AP&P Manual and the P&P Manual*. Per that guidance, obtaining an NAIC designation does not change in investment's applicable SSAP, annual or quarterly statement reporting schedule or override other SSAP guidance required for an investment to be an admitted asset. That guidance identifies that there are limited instances in which a SSAP specifically identifies within its scope, the inclusion of specific SVO-Identified investments based on structural assessments (such as SVO-Identified Bond ETFs in scope of SSAP No. 26R). However, that guidance is specific to the inclusion of qualifying investments into the scope of a specific SSAP and does not provide the ability to remove investments from a specific SSAP that qualify under the SSAP's scope provisions.

Assessment of SSAP No. 43R:
NAIC staff has recognized that the scope guidance of SSAP No. 43R does not name mortgage loans that qualify as CTLs after an SVO structural assessment. Furthermore, it has been identified that there are examples of securities in paragraph 27.b that have been cited as structures that are in scope of SSAP No. 43R. Paragraph 27 is not a scope paragraph but is in the section of the SSAP that addresses determination of the designation based on whether the investment is subject to the financial modeling guidance. (The original source of these examples were in a paragraph that identified investments that would not be financially modeled or that did not receive CRP ratings subject to the "modified filing exempt" provisions. Since the "MFE" concept was removed in 2020, SSAP No. 43 investments are either financially modeled or captured as an "all other loan-backed or structured security.") With the removal of the MFE guidance, paragraph 27.b is now applicable to all securities not subject to financial modeling, but these examples are still included. *(Note: NAIC staff has an impression that there could be industry concern with removing these examples as it will cause questions on whether they can be reported in scope of SSAP No. 43R.)*

Although there is current "bond project" to establish principal concepts in determining whether an investment qualifies as a bond, the finalization and implementation of that project is expected to take time to complete. To address immediate issues with regards to clarifying the reporting of mortgage loan CTLs and other securities, NAIC staff proposes nonsubstantive revisions to remove the examples from paragraph 27.b and explicitly incorporate applicable provisions in the scope paragraphs of SSAP No. 43R.

Existing Authoritative Literature:

1. This statement establishes statutory accounting principles for investments in loan-backed securities, structured securities and mortgage-referenced securities. In accordance with *SSAP No. 103R—Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, retained beneficial interests from the sale of loan-backed securities and structured securities are accounted for in accordance with this statement. Items captured in scope of this statement are collectively referred to as loan-backed securities.

Designation Guidance

27. For RMBS/CMBS securities within the scope of this statement, the initial NAIC designation used to determine the carrying value method and the final NAIC designation for reporting purposes is determined

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using a multi-step process. The P&P Manual provides detailed guidance. A general description of the processes is as follows:

a. Financial Modeling: Pursuant to the P&P Manual, the NAIC identifies select securities where financial modeling must be used to determine the NAIC designation. NAIC designation based on financial modeling incorporates the insurers' carrying value for the security. For those securities that are financially modeled, the insurer must use NAIC CUSIP specific modeled breakpoints provided by the modelers in determining initial and final designation for these identified securities. As specified in the P&P Manual, securities where modeling results in zero expected loss in all scenarios and that would be equivalent to an NAIC designation and NAIC designation category of NAIC 1 and NAIC 1.A. respectively, if the filing exemption process in the P&P Manual was applied, are automatically considered to have a final NAIC designation of NAIC 1 and NAIC designation category of NAIC 1.A., regardless of the carrying value. The three-step process for modeled securities is as follows:

   i. Step 1: Determine Initial Designation – The current amortized cost (divided by remaining par amount) of a loan-backed or structured security is compared to the modeled breakpoint values assigned to the six (6) NAIC designations for each CUSIP to establish the **initial** NAIC designation.

   ii. Step 2: Determine Carrying Value Method – The carrying value method, either the amortized cost method or the lower of amortized cost or fair value method, is then determined as described in paragraph 26 based upon the initial NAIC designation from Step 1.

   iii. Step 3: Determine Final Designation – The final NAIC designation is determined by comparing the carrying value (divided by remaining par amount) of a security (based on paragraph 27.a.ii.) to the NAIC CUSIP specific modeled breakpoint values assigned to the six (6) NAIC designations for each CUSIP. The final designation is mapped to an NAIC designation category according to the instructions in the P&P Manual. This final NAIC designation shall be applicable for statutory accounting and reporting purposes and the NAIC designation category will be used for investment schedule reporting and establishing RBC and AVR charges. The final NAIC designation is not used for establishing the appropriate carrying value method in Step 2 (paragraph 27.a.ii.).

b. All Other Loan-Backed and Structured Securities: For securities not subject to paragraph 27.a. (financial modeling) follow the established designation procedures according to the appropriate section of the P&P Manual. The NAIC designation shall be applicable for statutory accounting and reporting purposes (including determining the carrying value method and establishing the AVR charges). The carrying value method is established as described in paragraph 26. **Examples of these securities include, but are not limited to equipment trust certificates, credit tenant loans (CTL), 5*/6* securities, interest only (IO) securities, securities with CRP ratings (excluding RMBS/CMBS), loan-backed and structured securities, and mortgage-referenced securities with SVO assigned NAIC designations.**

Activity to Date (issues previously addressed by the Working Group, Emerging Accounting Issues (E) Working Group, SEC, FASB, other State Departments of Insurance or other NAIC groups): Previous activity was summarized above, in the 'Description of Issue' section. A prior agenda item 2020-24: Accounting and Reporting of Credit Tenant Loans in response to a Task Force referral was also developed

Information or issues (included in *Description of Issue*) not previously contemplated by the Working Group: None

Convergence with International Financial Reporting Standards (IFRS): N/A

Staff Recommendation:
NAIC staff recommends that the Working Group move this item to the active listing, categorized as nonsubstantive and take the following action:

1) **Nullify INT 20-10 as no longer applicable. (If preferred, rather than nullifying immediately, this INT could continue and expire automatically on Oct. 1, 2021, without consideration of further extension.)**

2) **Dispose agenda item 2020-24: Accounting and Reporting of Credit Tenant Loans without statutory revisions. This agenda item had two exposures regarding CTLs prior to the development of INT 20-10 and the SVO adoption that clarified the definition of CTLs.**

3) **Expose revisions to *SSAP No. 43R—Loan-Backed and Structured Securities* to explicitly identify the SVO-Identified CTLs in scope of SSAP No. 43R. These revisions also propose to delete the examples of "other LBSS" in paragraph 27.b If there are concerns that this deletion inadvertently removes any specific investment from the scope of SSAP No. 43R, those comments are requested to be shared during the exposure period.**

It is noted that these modifications are intended to simply clarify current guidance prior to the adoption of bond proposal.

Proposed edits to SSAP No. 43R:

1. This statement establishes statutory accounting principles for investments in loan-backed securities, structured securities and mortgage-referenced securities. In accordance with *SSAP No. 103R—Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, retained beneficial interests from the sale of loan-backed securities and structured securities are accounted for in accordance with this statement. In addition, mortgage loans in scope of SSAP No. 37 that qualify under a SVO structural assessment are in scope of this statement as credit tenant loans (CTLs). Items captured in scope of this statement are collectively referred to as loan-backed securities

Designation Guidance

27. For RMBS/CMBS securities within the scope of this statement, the initial NAIC designation used to determine the carrying value method and the final NAIC designation for reporting purposes is determined using a multi-step process. The P&P Manual provides detailed guidance. A general description of the processes is as follows:

    a. Financial Modeling: Pursuant to the P&P Manual, the NAIC identifies select securities where financial modeling must be used to determine the NAIC designation. NAIC designation based on financial modeling incorporates the insurers' carrying value for the security. For those securities that are financially modeled, the insurer must use NAIC CUSIP specific modeled breakpoints provided by the modelers in determining initial and final designation for these identified securities. As specified in the P&P Manual, securities where modeling results in zero expected loss in all scenarios and that would be equivalent to an NAIC designation and NAIC designation category of NAIC 1 and NAIC 1.A. respectively, if the filing exemption process in the P&P Manual was applied, are automatically considered to have a final NAIC designation of NAIC 1 and NAIC designation category of NAIC 1.A., regardless of the carrying value. The three-step process for modeled securities is as follows:

        i. Step 1: Determine Initial Designation – The current amortized cost (divided by remaining par amount) of a loan-backed or structured security is compared to the modeled breakpoint values assigned to the six (6) NAIC designations for each CUSIP to establish the **initial** NAIC designation.

        ii. Step 2: Determine Carrying Value Method – The carrying value method, either the amortized cost method or the lower of amortized cost or fair value method, is then

determined as described in paragraph 26 based upon the initial NAIC designation from Step 1.

iii. Step 3: Determine Final Designation – The final NAIC designation is determined by comparing the carrying value (divided by remaining par amount) of a security (based on paragraph 27.a.ii.) to the NAIC CUSIP specific modeled breakpoint values assigned to the six (6) NAIC designations for each CUSIP. The final designation is mapped to an NAIC designation category according to the instructions in the P&P Manual. This final NAIC designation shall be applicable for statutory accounting and reporting purposes and the NAIC designation category will be used for investment schedule reporting and establishing RBC and AVR charges. The final NAIC designation is not used for establishing the appropriate carrying value method in Step 2 (paragraph 27.a.ii.).

b. All Other Loan-Backed and Structured Securities: For securities not subject to paragraph 27.a. (financial modeling) follow the established designation procedures according to the appropriate section of the P&P Manual. The NAIC designation shall be applicable for statutory accounting and reporting purposes (including determining the carrying value method and establishing the AVR charges). The carrying value method is established as described in paragraph 26. ~~Examples of these securities include, but are not limited to equipment trust certificates, credit tenant loans (CTL), 5*/6* securities, interest only (IO) securities, securities with CRP ratings (excluding RMBS/CMBS), loan-backed and structured securities, and mortgage-referenced securities with SVO assigned NAIC designations.~~

Staff Review Completed by: Julie Gann, NAIC Staff – July 2021

https://naiconline.sharepoint.com/teams/FRSStatutoryAccounting/National Meetings/A. National Meeting Materials/2021/9. August 26/A - 21-11 - SSAP No. 43R - CTL 2021.docx

NAIC Accounting Practices and Procedures Manual
Editorial and Maintenance Update
August 26, 2021

Maintenance updates provide revisions to the *Accounting Practices and Procedures Manual*, such as editorial corrections, reference changes and formatting.

SSAP/Appendix	Description/Revision
Preamble	Incorporates a paragraph number for the existing statutory hierarchy section.
Appendix A-001	Updates designation codes for preferred stock as noted in section 2 of *Appendix A-001: Investments of Reporting Entities.*
Appendix C	Updates reference to the *former* Emerging Actuarial Issues (E) Working Group as well as adding reference to the Valuation Analysis (E) Working Group's use of included interpretations.
Appendix C-2	Updates reference to the *former* Emerging Actuarial Issues (E) Working Group as well as adding reference to the Valuation Analysis (E) Working Group's use of included interpretations.
SSAP No. 21R	Updates improve the readability of paragraph 9 regarding receivables for securities.

Recommendation:
NAIC staff recommend that the Statutory Accounting Principles (E) Working Group move this agenda item to the active listing, categorize as nonsubstantive, and expose editorial revisions as illustrated below.

Status:

Preamble
41. The multitude of unique circumstances and individual transactions makes it virtually impossible for any codification of accounting principles to be totally comprehensive. Application of SAP, either contained in the SSAPs or defined as GAAP and adopted by the NAIC, to unique circumstances or individual transactions should be consistent with the concepts of conservatism, consistency, and recognition.

V. Statutory Hierarchy

42. The following Hierarchy is not intended to preempt state legislative and regulatory authority.

Level 1

- SSAPs, including U.S. GAAP reference material to the extent adopted by the NAIC from the FASB Accounting Standards Codification[1] (FASB Codification or GAAP guidance)

Level 2

- Consensus positions of the Emerging Accounting Issues (E) Working Group as adopted by the NAIC (INTs adopted before 2016)
- Interpretations of existing SSAPs as adopted by the Statutory Accounting Principles (E) Working Group (INTs adopted in 2016 or beyond)

Level 3

- NAIC Annual Statement Instructions
- Purposes and Procedures Manual of the NAIC Investment Analysis Office

Level 4

- Statutory Accounting Principles Preamble and Statement of Concepts[2]

Level 5

- Sources of nonauthoritative GAAP accounting guidance and literature, including: (a) practices that are widely recognized and prevalent either generally or in the industry, (b) FASB Concept Statements, (c) AICPA guidance not included in FASB Codification, (d) International Financial Reporting Standards, (e) Pronouncements of professional associations or regulatory agencies, (f) Technical Information Service Inquiries and Replies included in the AICPA Technical Practice Aids, and (g) Accounting textbooks, handbooks and articles

43~~2~~. If the accounting treatment of a transaction or event is not specified by the SSAPs, preparers, regulators and auditors of statutory financial statements should consider whether the accounting treatment is specified by another source of established statutory accounting principles. If an established statutory accounting principle from one or more sources in Level 2 or 3 is relevant to the circumstances, the preparer, regulator or auditor should apply such principle. If there is a conflict between statutory accounting principles from one or more sources in Level 2 or 3, the preparer, regulator or auditor should follow the treatment specified by the source in the higher level—that is, follow Level 2 treatment over Level 3. Revisions to guidance in accordance with additions or revisions to the NAIC statutory hierarchy should be accounted for as a change in accounting principle in accordance with *SSAP No. 3—Accounting Changes and Corrections of Errors*.

[1] Effective September 15, 2009, the FASB Codification is the source of authoritative U.S. generally accepted accounting principles. As of that date, the FASB Codification superseded all then-existing non-SEC accounting and reporting standards. All other nongrandfathered, non-SEC accounting literature not included in the FASB Codification is nonauthoritative. As of September 15, 2009, AICPA Statements of Position are no longer reviewed as part of the statutory maintenance process as they are no longer considered authoritative GAAP literature. If the AICPA were to address an issue that affects the FASB Codification, an accounting standard update (ASU) would be issued and reviewed for applicability to statutory accounting.

[2] The Statutory Accounting Principles Statement of Concepts incorporates by reference FASB Concepts Statements One, Two, Five and Six to the extent they do not conflict with the concepts outlined in the statement. However, for purposes of applying this hierarchy the FASB Concepts Statements shall be included in Level 5 and only those concepts unique to statutory accounting as stated in the statement are included in Level 4.

Appendix A-001 Investments of Reporting Entities

Update designation codes for preferred stock – the codes marked for deletion are no longer in use. Note: the blanks have already been updated through an editorial update that occurred in March 2021.

Section 2. Investment Risks Interrogatories

3. Amounts and percentages of the reporting entity's total admitted assets held in bonds and preferred stocks by NAIC designation:

	Bonds	1	2		**Preferred Stocks**	3	4
3.01	NAIC – 1	$................	.............%	3.07	NAIC ~~P/RP~~ – 1	$.............	.... %
3.02	NAIC – 2	$................	.............%	3.08	NAIC ~~P/RP~~ – 2	$.............	.... %
3.03	NAIC – 3	$................	.............%	3.09	NAIC ~~P/RP~~ – 3	$.............	.... %
3.04	NAIC – 4	$................	.............%	3.10	NAIC ~~P/RP~~ – 4	$.............	.... %
3.05	NAIC – 5	$................	.............%	3.11	NAIC ~~P/RP~~ – 5	$.............	.... %

3.06	NAIC – 6	$................	............%	3.12	NAIC P/RP – 6	$.............	.... %

Appendix C Actuarial Guidelines - Appendices

Updates reference to the *former* Emerging Actuarial Issues (E) Working Group as well as adding reference the Valuation Analysis (E) Working Group's use of included interpretations.

Includes interpretations from the former Emerging Actuarial Issues (E) Working Group adopted by the Financial Condition (E) Committee. The Financial Analysis (E) Working Group and the Valuation Analysis (E) Working Group follows these interpretations inwhen performing its reviews of the reserving methodologies under *Actuarial Guideline XXXVIII—The Application of the Valuation of Life Insurance Policies Model Regulation* (AG 38).

Appendix C-2 Interpretations of the Emerging Actuarial Issues (E) Working Group

Updates reference to the *former* Emerging Actuarial Issues (E) Working Group as well as adding reference the Valuation Analysis (E) Working Group's use of included interpretations.

Introduction

The former Emerging Actuarial Issues (E) Working Group (EAIWG) and the current Valuation Analysis (E) Working Group (VAWG) responds to questions of application, interpretation and clarification with respect to *Actuarial Guideline XXXVIII—The Application of the Valuation of Life Insurance Policies Model Regulation* (AG 38). Following an abbreviated public comment and review period of no less than seven days, the Working Group will adopt by consensus formal interpretations on issues presented before it. These interpretations will then be reported to the Financial Condition (E) Committee, which, after adopting, will direct the Financial Analysis (E) Working Group to follow the interpretations in performing its reviews of the reserving methodologies under AG 38. These interpretations will not become effective until formally adopted by the Financial Condition (E) Committee. In no event shall a consensus opinion of the former EAIWGWorking Group or current VAWG supersede or otherwise conflict with AG 38.

SSAP No. 21R—Other Admitted Assets

Updates improve the readability of paragraph 9 regarding receivables for securities.

9. Sales of securities are recorded as of the trade date. A receivable due from the broker is established in instances when a security has been sold, but the proceeds from the sale have not yet been received. Unless the receivable for securities, meets the criteria set forth in paragraph 11, the receivable for securities is an admitted asset to the extent it conforms to the requirements of this statement. For other than a receivables arising from the sale of a security which was acquired on a "To Be Announced" ("TBA") basis, or from the sale of securities that are received as stock distributions that may be restricted (unregistered) or in physical form, and which has yet to be actually received, admissibility shall be in accordance with (see paragraph 12.), meets the criteria set forth in paragraph 11, the receivable for securities is an admitted asset to the extent it conforms to the requirements of this statement.

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Statutory Accounting Principles (E) Working Group
Maintenance Agenda Submission Form
Form A

Issue: Salvage - Legal Recoveries

Check (applicable entity):

	P/C	Life	Health
Modification of Existing SSAP	☒	☒	☒
New Issue or SSAP	☐	☐	☐
Interpretation	☐	☐	☐

Description of Issue:
This agenda item recommends nonsubstantive revisions to *SSAP No. 55—Unpaid Claims, Losses and Loss Adjustment Expenses* to clarify that salvage and subrogation estimates and recoveries can include amounts related to both claims/ losses and loss adjusting expenses. The corresponding estimates should be reported as a reduction of losses and/or loss adjusting expense (LAE) reserves. Once the amounts for salvage and subrogation and COB are received, they are reported as a reduction of paid losses and LAE depending on the nature of the costs being recovered.

SSAP No. 55 contains salvage and subrogation guidance. Key points of the guidance regarding salvage, subrogation and coordination of benefits recoveries (COB) are as follows:

- Salvage, subrogation and coordination of benefits recoveries are estimated using the same techniques used for estimating unpaid claims/losses and unpaid loss adjusting expenses.
- Separate recoverables are not established. Estimated salvage, subrogation and coordination of benefit recoveries (net of associated expenses) are deducted from the liability for unpaid claims or losses (for reporting entities that choose to anticipate such recoveries).
- Salvage, subrogation and coordination of benefits recoveries received (net of associated expenses) are reported as a reduction to paid losses/claims.

This agenda item is in response to an industry request. The proposed clarification provides additional detail regarding loss adjusting expenses for salvage, subrogation and coordination of benefits that is believed to be consistent with current practice by a majority of reporting entities. For example, if legal fees are recovered in a subrogation lawsuit, it is believed that such amounts are currently being reported as reduction in paid adjusting expenses for legal fees. SSAP No. 55 does not explicitly discuss the recovery of loss adjusting expenses in the discussion of salvage, subrogation and COB. However, the property and casualty annual statement instructions, which are level two on the statutory hierarchy of authoritative literature, includes an explicit reference to reduce loss adjusting expenses for such amounts in the Schedule P instructions (See Existing Authoritative Literature below).

Existing Authoritative Literature:

SSAP No. 55 provides the following (bolding added for emphasis):

General

11. The liability for claim reserves and claim liabilities, unpaid losses, and loss/claim adjustment expenses shall be based upon the estimated ultimate cost of settling the claims (including the effects of inflation and other societal and economic factors), using past experience adjusted for current trends, and any other factors that would modify past experience. These liabilities shall not be discounted unless authorized for specific types of claims by specific SSAPs, including SSAP No. 54R and *SSAP No. 65—Property and Casualty Contracts*.

12. Various analytical techniques can be used to estimate the liability for IBNR claims, future development on reported losses/claims, and loss/claim adjustment expenses. These techniques generally consist of statistical analysis of historical experience and are commonly referred to as loss reserve projections. The estimation process is generally performed by line of business, grouping contracts with like characteristics and policy provisions. The decision to use a particular projection method and the results obtained from that method shall be evaluated by considering the inherent assumptions underlying the method and the appropriateness of those assumptions to the circumstances. No single projection method is inherently better than any other in all circumstances. The results of more than one method should be considered.

13. For each line of business and for all lines of business in the aggregate, management shall record its best estimate of its liabilities for unpaid claims, unpaid losses, and loss/claim adjustment expenses. Because the ultimate settlement of claims (including IBNR for death claims and accident and health claims) is subject to future events, no single claim or loss and loss/claim adjustment expense reserve can be considered accurate with certainty. Management's analysis of the reasonableness of claim or loss and loss/claim adjustment expense reserve estimates shall include an analysis of the amount of variability in the estimate. If, for a particular line of business, management develops its estimate considering a range of claim or loss and loss/claim adjustment expense reserve estimates bounded by a high and a low estimate, management's best estimate of the liability within that range shall be recorded. The high and low ends of the range shall not correspond to an absolute best-and-worst case scenario of ultimate settlements because such estimates may be the result of unlikely assumptions. Management's range shall be realistic and, therefore, shall not include the set of all possible outcomes but only those outcomes that are considered reasonable. Management shall also follow the concept of conservatism included in the Preamble when determining estimates for claims reserves. However, there is not a specific requirement to include a provision for adverse deviation in claims.

14. In the rare instances when, for a particular line of business, after considering the relative probability of the points within management's estimated range, it is determined that no point within management's estimate of the range is a better estimate than any other point, the midpoint within management's estimate of the range shall be accrued. It is anticipated that using the midpoint in a range will be applicable only when there is a continuous range of possible values, and no amount within that range is any more probable than any other. For purposes of this statement, it is assumed that management can quantify the high end of the range. If management determines that the high end of the range cannot be quantified, then a range does not exist, and management's best estimate shall be accrued. This guidance is not applicable when there are several point estimates which have been determined as equally possible values, but those point estimates do not constitute a range. If there are several point estimates with equal probabilities, management should determine its best estimate of the liability.

15. If a reporting entity chooses to anticipate salvage and subrogation recoverables (including amounts recoverable from second injury funds, other governmental agencies, or quasi-governmental agencies, where applicable), the recoverables shall be estimated in a manner consistent with paragraphs 11-13 of this statement. Estimated salvage and subrogation recoveries (net of associated expenses) shall be deducted from the liability for unpaid claims or losses. If a reporting entity chooses to anticipate coordination of benefits (COB) recoverables of Individual and Group Accident and Health Contracts, the recoverables shall be estimated in a manner consistent with paragraphs 11-13 of this statement and shall be deducted from the liability for unpaid claims or losses. A separate receivable shall not be established for these recoverables. In addition, all of these recoverables are also subject to the impairment guidelines established in *SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets* and an entity shall not reduce its reserves for any recoverables deemed to be impaired. Salvage and subrogation recoveries received (net of associated expenses) are reported as a reduction to paid losses/claims. Coordination of benefits (COB) recoveries received of Individual and Group Accident and Health Contracts (net of associated expenses) are reported as a reduction to paid claims.

16. Changes in estimates of the liabilities for unpaid claims or losses and loss/claim adjustment expenses resulting from the continuous review process, including the consideration of differences between estimated and actual payments, shall be considered a change in estimate and shall be recorded in accordance with *SSAP No. 3—Accounting Changes and Corrections of Errors*. SSAP No. 3 requires

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changes in estimates to be included in the statement of operations in the period the change becomes known. This guidance also applies to the period subsequent to the March 1 filing deadline for annual financial statements through the filing deadline of June 1 for audited annual financial statements.

Disclosures

17. The financial statements shall include the following disclosures for each year full financial statements are presented. The disclosure requirement in paragraph 17.d. is also applicable to the interim financial statements if there is a material change from the amounts reported in the annual filing. Life and annuity contracts are not subject to this disclosure requirement.

a. The balance in the liabilities for unpaid claims and unpaid losses and loss/claim adjustment expense reserves at the beginning and end of each year presented;

b. Incurred claims, losses, and loss/claim adjustment expenses with separate disclosures of the provision for insured or covered events of the current year and increases or decreases in the provision for insured or covered events of prior years;

c. Payments of claims, losses, and loss/claim adjustment expenses with separate disclosures of payments of losses and loss/claim adjustment expenses attributable to insured or covered events of the current year and insured or covered events of prior years;

d. The reasons for the change in the provision for incurred claims, losses, and loss/claim adjustment expenses attributable to insured or covered events of prior years. The disclosure should indicate whether additional premiums or return premiums have been accrued as a result of the prior-year effects. (For Title reporting entities, “provision” refers to the known claims reserve included in Line 1 of the Liabilities page, and “prior years” refers to prior report years);

e. Information about significant changes in methodologies and assumptions used in calculating the liability for unpaid claims and claim adjustment expenses, including reasons for the change and the effects on the financial statements for the most recent reporting period presented;

f. A summary of management’s policies and methodologies for estimating the liabilities for losses and loss/claim adjustment expenses, including discussion of claims for toxic waste cleanup, asbestos-related illnesses, or other environmental remediation exposures;

g. Disclosure of the amount paid and reserved for losses and loss/claim adjustment expenses for asbestos and/or environmental claims, on a direct, assumed and net of reinsurance basis (the reserves required to be disclosed in this section shall exclude amounts relating to policies specifically written to cover asbestos and environmental exposures). Each company should report only its share of a group amount (after applying its respective pooling percentage) if the company is a member of an intercompany pooling agreement; and

h. **Estimates of anticipated salvage and subrogation (including amounts recoverable from second injury funds, other governmental agencies, or quasi-governmental agencies, where applicable), deducted from the liability for unpaid claims or losses**.

The Property and Casualty Annual Statement Instructions for Schedule P, part 1 discuss salvage and subrogation regarding loss reserve and paid claims and **then provide additional detail regarding losses and loss adjusting expenses in a later paragraph as excerpted below** (**bolding added for emphasis**);

> Cumulative salvage and subrogation received and losses and expenses paid should be reported for each specific year. For “prior,” report only salvage and subrogation received and losses and expenses paid in current year.

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In Schedule P, Part 1, salvage and subrogation received should be reported net of reinsurance, if any. Loss payments are to be reported net of salvage and subrogation received in Schedule P.

Adjusting & Other Payments, Column 9, should only reflect ceded recoveries made in 1997 and subsequent. Adjusting & Other Payments, Column 8, should reflect net payments in 1996 and prior and direct and assumed payments for 1997 and
subsequent.

Premiums earned and losses paid, unpaid, and incurred should reconcile with the Statement of Income page. The workpapers that show a reconciliation explaining reinsurance, discounting, and salvage and subrogation adjustments should be available for examination on request.

Report in Column 23 the estimated amount of anticipated salvage and subrogation that has been taken as credit (netted) in the reserves for **unpaid losses and loss adjustment expenses** reported in Column 24. (Note: Column 23 is a memo column only as the amounts contained therein have already been taken into consideration in Columns 13 through 20.)

The Life and Health Annual Statement Instructions for Note 36 (matches SSAP No. 55, paragraph 17h disclosure.)

36. Loss/Claim Adjustment Expenses

Instruction:

The financial statement shall include the following disclosures for each year full financial statements are presented. Life and annuity contracts are not subject to this disclosure requirement:

- The balance in the liabilities for unpaid loss/claim adjustment expense reserves at the beginning and end of each year presented.

- Incurred loss/claim adjustment expenses with separate disclosures of the provision for insured or covered events of the current year and increases or decreases in the provision for insured or covered events of prior years.

- Payments of loss/claim adjustment expenses with separate disclosure of payment of loss/claim adjustment expenses attributable to insured or covered events of the current year and insured or covered events of prior years.

- **Estimates of anticipated salvage and subrogation (including amounts recoverable from second injury funds, other governmental agencies, or quasi-governmental agencies, where applicable), deducted from the liability for unpaid claims or losses.**

Illustration:

The balance in the **liability for unpaid accident and health claim adjustment expenses** as of and_____ was $_______ and $_______, respectively.

The Company incurred $_______ and paid $_______ of **claim adjustment expenses** in the current year, of which
$_______ of the paid amount was attributable to insured or covered events of prior years. The Company did not increase or decrease the provision for insured events of prior years.

The Company took into account estimated anticipated salvage and subrogation of the liability for unpaid claims/losses and reduced such liability by $________.

The Health Annual Statement Instructions for note 31 matches SSAP No. 55, paragraph 17h disclosure.

31. Anticipated Salvage and Subrogation
Instruction:
Estimates of anticipated salvage and subrogation (including amounts recoverable from second injury funds, other governmental agencies, or quasi-governmental agencies, where applicable), deducted from the liability for unpaid claims or losses. Refer to *SSAP No. 55—Unpaid Claims, Losses and Loss Adjustment Expenses* for accounting guidance.

Illustration:
The Company took into account estimated anticipated salvage and subrogation in its determination of the liability for unpaid claims/losses and reduced such liability by $______________.

Activity to Date (issues previously addressed by the Working Group, Emerging Accounting Issues (E) Working Group, SEC, FASB, other State Departments of Insurance or other NAIC groups): None

Information or issues (included in *Description of Issue*) not previously contemplated by the Working Group: None

Convergence with International Financial Reporting Standards (IFRS):Not applicable.

Staff Review Completed by:
Robin Marcotte
NAIC Staff
August 2021

Staff Recommendation:
NAIC staff recommends that the Working Group move this agenda item to the active listing, categorized as nonsubstantive, and expose revisions to SSAP No. 55, which clarify that subrogation recoveries should be reported as a reduction of losses and/or loss adjusting expense LAE reserves, depending on the nature of the costs being recovered. In addition, updates to the disclosure in paragraph 17h are recommended. In conjunction, with the agenda item, NAIC staff should be directed to coordinate develop conforming revisions to the annual statement instructions. While NAIC staff believes the proposed clarification is consistent with the current practice of most entities, the Working Group should notify the Casualty Actuarial and Statistical (C) Task Force, the Life Actuarial (A) Task Force and the Health Actuarial (B) Task Force of the exposure.

SSAP No. 55—Unpaid Claims, Losses and Loss Adjustment Expenses proposed revisions

General

11. The liability for claim reserves and claim liabilities, unpaid losses, and loss/claim adjustment expenses shall be based upon the estimated ultimate cost of settling the claims (including the effects of inflation and other societal and economic factors), using past experience adjusted for current trends, and any other factors that would modify past experience. These liabilities shall not be discounted unless authorized for specific types of claims by specific SSAPs, including SSAP No. 54R and SSAP No. 65—Property and Casualty Contracts.

12. Various analytical techniques can be used to estimate the liability for IBNR claims, future development on reported losses/claims, and loss/claim adjustment expenses. These techniques generally consist of statistical analysis of historical experience and are commonly referred to as loss reserve projections. The estimation process is generally performed by line of business, grouping contracts with like characteristics and policy provisions. The decision to use a particular projection method and the results obtained from that method shall be evaluated by considering the inherent assumptions underlying the

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method and the appropriateness of those assumptions to the circumstances. No single projection method is inherently better than any other in all circumstances. The results of more than one method should be considered.

13. For each line of business and for all lines of business in the aggregate, management shall record its best estimate of its liabilities for unpaid claims, unpaid losses, and loss/claim adjustment expenses. Because the ultimate settlement of claims (including IBNR for death claims and accident and health claims) is subject to future events, no single claim or loss and loss/claim adjustment expense reserve can be considered accurate with certainty. Management's analysis of the reasonableness of claim or loss and loss/claim adjustment expense reserve estimates shall include an analysis of the amount of variability in the estimate. If, for a particular line of business, management develops its estimate considering a range of claim or loss and loss/claim adjustment expense reserve estimates bounded by a high and a low estimate, management's best estimate of the liability within that range shall be recorded. The high and low ends of the range shall not correspond to an absolute best-and-worst case scenario of ultimate settlements because such estimates may be the result of unlikely assumptions. Management's range shall be realistic and therefore, shall not include the set of all possible outcomes but only those outcomes that are considered reasonable. Management shall also follow the concept of conservatism included in the Preamble when determining estimates for ~~claims~~ claim and loss and loss/claim adjustment expense reserves. However, there is not a specific requirement to include a provision for adverse deviation in claims.

14. In the rare instances when, for a particular line of business, after considering the relative probability of the points within management's estimated range, it is determined that no point within management's estimate of the range is a better estimate than any other point, the midpoint within management's estimate of the range shall be accrued. It is anticipated that using the midpoint in a range will be applicable only when there is a continuous range of possible values, and no amount within that range is any more probable than any other. For purposes of this statement, it is assumed that management can quantify the high end of the range. If management determines that the high end of the range cannot be quantified, then a range does not exist, and management's best estimate shall be accrued. This guidance is not applicable when there are several point estimates which have been determined as equally possible values, but those point estimates do not constitute a range. If there are several point estimates with equal probabilities, management should determine its best estimate of the liability.

15. If a reporting entity chooses to anticipate salvage and subrogation recoverables (including amounts recoverable from second injury funds, other governmental agencies, or quasi-governmental agencies, where applicable), the recoverables shall be estimated in a manner consistent with paragraphs 10-12 of this statement. Estimated salvage and subrogation recoveries (net of associated recovery expenses) shall be deducted from the liability for unpaid claims, unpaid losses, and unpaid loss/claim adjustment expenses, depending on the whether the subrogation represents a recovery of claims/losses or loss/claims adjustment expenses ~~or losses~~. If a reporting entity chooses to anticipate coordination of benefits (COB) recoverables of Individual and Group Accident and Health Contracts, the recoverables shall be estimated in a manner consistent with paragraphs 11-13 of this statement and shall be deducted from the liability for unpaid claims or losses. A separate receivable shall not be established for these recoverables. In addition, all of these recoverables are also subject to the impairment guidelines established in *SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets* (SSAP No. 5R) and an entity shall not reduce its reserves for any recoverables deemed to be impaired. Salvage and subrogation recoveries received (net of associated recovery expenses) are reported as a reduction to paid losses/claims and/or paid loss/claim adjustment expenses. Coordination of benefits (COB) recoveries received of Individual and Group Accident and Health Contracts (net of associated recovery expenses) are reported as a reduction to paid claims.

Disclosures

17. The financial statements shall include the following disclosures for each year full financial statements are presented. The disclosure requirement in paragraph 17.d. is also applicable to the interim financial statements if there is a material change from the amounts reported in the annual filing. Life and annuity contracts are not subject to this disclosure requirement.

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a. The balance in the liabilities for unpaid claims and unpaid losses and loss/claim adjustment expense reserves at the beginning and end of each year presented;

b. Incurred claims, losses, and loss/claim adjustment expenses with separate disclosures of the provision for insured or covered events of the current year and increases or decreases in the provision for insured or covered events of prior years;

c. Payments of claims, losses, and loss/claim adjustment expenses with separate disclosures of payments of losses and loss/claim adjustment expenses attributable to insured or covered events of the current year and insured or covered events of prior years;

d. The reasons for the change in the provision for incurred claims, losses, and loss/claim adjustment expenses attributable to insured or covered events of prior years. The disclosure should indicate whether additional premiums or return premiums have been accrued as a result of the prior-year effects. (For Title reporting entities, “provision” refers to the known claims reserve included in Line 1 of the Liabilities page, and “prior years” refers to prior report years);

e. Information about significant changes in methodologies and assumptions used in calculating the liability for unpaid claims and claim adjustment expenses, including reasons for the change and the effects on the financial statements for the most recent reporting period presented;

f. A summary of management’s policies and methodologies for estimating the liabilities for losses and loss/claim adjustment expenses, including discussion of claims for toxic waste cleanup, asbestos-related illnesses, or other environmental remediation exposures;

g. Disclosure of the amount paid and reserved for losses and loss/claim adjustment expenses for asbestos and/or environmental claims, on a direct, assumed and net of reinsurance basis (the reserves required to be disclosed in this section shall exclude amounts relating to policies specifically written to cover asbestos and environmental exposures). Each company should report only its share of a group amount (after applying its respective pooling percentage) if the company is a member of an intercompany pooling agreement; and

h. Estimates of anticipated salvage and subrogation (including amounts recoverable from second injury funds, other governmental agencies, or quasi-governmental agencies, where applicable), deducted from the liability for unpaid claims, ~~or~~ losses or their associated adjusting expenses.

https://naiconline.sharepoint.com/teams/FRSStatutoryAccounting/National Meetings/A. National Meeting Materials/2021/9. August 26/C - 21-13 Salvage legal fees.docx

Statutory Accounting Principles (E) Working Group
Maintenance Agenda Submission Form
Form A

Issue: Policy Statement Terminology Change – Substantive & Nonsubstantive

Check (applicable entity):

	P/C	Life	Health
Modification of Existing SSAP	☒	☒	☒
New Issue or SSAP	☐	☐	☐
Interpretation	☐	☐	☐

Description of Issue: Pursuant to the Aug. 14, 2021 referral from the Financial Condition (E) Committee, the discussion involving *SSAP No. 71—Policy Acquisition Costs and Commissions*, has highlighted that the statutory accounting terminology of "substantive" and "nonsubstantive" to describe statutory accounting revisions being considered by the Statutory Accounting Principles (E) Working Group to the *Accounting Practices and Procedures Manual* (AP&P Manual) could be misunderstood by users that are not familiar with the specific definitions and intended application of those terms. To avoid the incorrect perception that these terms may reflect the degree of financial impact to companies based on their common usage, the Financial Condition (E) Committee requests that the Statutory Accounting Principles consider updating these terms to prevent future misunderstandings.

Additional Referral Excerpts:

> The Financial Condition (E) Committee understands the terms "substantive" and "nonsubstantive" were crafted as part of the statutory accounting principles (SAP) codification, which was finalized in 1998, and were intended to be simple, concise terms to differentiate whether proposed revisions reflect new SAP concepts (substantive) or clarification of existing SAP concepts (nonsubstantive). The source location for the definitions and classification criteria of these terms is the NAIC Policy Statement on Maintenance of Statutory Accounting Principles, but it is noted that the terms and definitions are referred to throughout SAP guidance, other policy statements, issue papers, and agenda items.
>
> The Working Group should consider eliminating "substantive" and "nonsubstantive" and instead refer to the type of revisions in accordance with the general nature in which those terms were intended to reflect. As such a revision that would have previously been considered "substantive" could be referred to as a "New SAP Concept" and a revision that would have previously been considered as "nonsubstantive" could be referred to as a "SAP Clarification." The Committee is not proposing that the Working Group reassess the classification criteria but is simply requesting terminology changes to prevent future misinterpretations or assessments by others. As such, unless the Working Group believes further revisions are necessary, statutory revisions that would have been previously classified as "nonsubstantive" are anticipated to continue to fall within that definition and be captured under the new terminology as a "SAP Clarification."

The referral also includes proposed revisions to the *NAIC Policy Statement on Maintenance of Statutory Accounting Principles* as potential suggestions to incorporate the proposed guidance change. (These proposed edits are shown in the Aug. 26, 2021, proposed edits for exposure.)

Existing Authoritative Literature:

Although the terms "substantive" and "nonsubstantive" are used throughout the AP&P Manual, the source location for the definitions of these terms is the *NAIC Policy Statement on Maintenance of Statutory Accounting Principles*:

NAIC Policy Statement on Maintenance of Statutory Accounting Principles

1. Statutory accounting principles (SAP) provide the basis for insurers to prepare financial statements to be filed with and utilized by state insurance departments for financial regulation purposes. Accuracy and completeness of such filings are critical to meaningful solvency monitoring. Accordingly, maintenance of SAP guidance for changes in the industry and changes in regulatory concerns is vital to preserving the usefulness of SAP financial statements.

2. The promulgation of new or revised SAP guidance by the NAIC ultimately requires action of the entire NAIC membership. Responsibility for proposing new or revised SAP guidance will be delegated through the NAIC committee structure to the Accounting Practices and Procedures (E) Task Force (Task Force). The Task Force will charge the Statutory Accounting Principles (E) Working Group (Working Group) with the exclusive responsibility to develop and propose new statements of statutory accounting principles (SSAPs), to revise existing SSAPs, and to issue interpretations.

Composition of the Statutory Accounting Principles (E) Working Group

3. The chair of the Task Force shall determine membership of the Working Group subject to approval by the Financial Condition (E) Committee. The Working Group shall be limited in size to no more than 15 members and will include representation from the four zones of the NAIC. Membership shall be vested in the state (until such time as the membership may be changed) but continuity of individuals, to the extent possible, is extremely desirable.

Development of New or Substantively Revised SSAPs

4. New SSAPs will be developed to address, but will not be limited to: 1) concepts not previously addressed by a SSAP and that do not fit within the scope of an existing SSAP; 2) concepts that fit within the scope of an existing SSAP, but the Working Group elects to supersede existing SSAPs and 3) existing concepts that warrant significant revisions. Substantively-revised SSAPs will be developed to address, but will not be limited to: 1) concepts that fit within the accounting topic of an existing SSAP, but have not been addressed by the Working Group; 2) changes to the valuation and/or measurement of an existing SSAP; and 3) modifications to the overall application of existing SSAPs. The decision to undertake development of a new or substantively revised SSAP will rest with the Working Group. New or substantively revised SSAPs will have a specified effective date.

5. Research and drafting of new or substantially revised SSAPs will be performed by NAIC staff under the direction and supervision of the Working Group which may enlist the assistance of interested parties and/or consultants with requisite technical expertise as needed or desired. The first step in developing new and substantively revised SSAPs will commonly be the drafting of an issue paper, which will contain a summary of the issue, a summary conclusion, discussion, and a relevant literature section. Public comments will be solicited on an issue paper (at least one exposure period), and at least one public hearing will be held before the issue paper is converted to a SSAP. Upon approval by the Working Group, all proposed SSAPs will be exposed for public comment for a period commensurate with the length of the draft and the complexities of the issue(s). After a hearing of comments, adoption of new or substantively revised SSAPs (including any amendments from exposure) may be made by simple majority. If no comments are received during the public comment period, the Working Group may adopt the proposal collectively (one motion/vote) with other non-contested positions after the opportunity is given during the hearing to separately discuss the proposal. All new and substantively revised SSAPs must be on the agenda for at least one public hearing before presentation to the Task Force for consideration. Adoption by the Task Force, its parent and the NAIC membership shall be governed by the NAIC bylaws.

6. The Working Group may, by a super majority vote (7 out of 10 members, 8 out of 11 or 12, 9 out of 13, 10 out of 14, and 11 out of 15) elect to: 1) combine the IP and SSAP process, resulting in concurrent exposure of the

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two documents; 2) expose and adopt revisions to a SSAP prior to the drafting/adoption of the related IP; and/or 3) forego completion of an IP and only proceed with revisions to a substantively revised SSAP.

7. If accounting guidance, reserving standards, asset valuation standards, or any other standards or rules affecting accounting practices and procedures are first developed by other NAIC working groups, task forces, subcommittees, or committees, such proposed guidance, standards or rules shall be presented to the Working Group for consideration. In cases where such guidance has already been subjected to substantial due process (e.g., public comment periods and/or public hearings), the Working Group may elect to shorten comment periods and/or eliminate public hearings, and in such cases, will notify the Task Force of these actions.

Development of Nonsubstantive Revisions to SSAPs

8. Nonsubstantive revisions to SAP will be developed to address, but will not be limited to: 1) clarification of the intent or application of existing SSAPs; 2) new disclosures and modification of existing disclosures; 3) revisions that do not change the intent of existing guidance; and 4) revisions to *Appendix A—Excerpts of NAIC Model Laws* to reflect amendments to NAIC adopted model laws and regulations. Research and drafting of nonsubstantive revisions will be performed by NAIC staff under the direction and supervision of the Working Group. Public comment will be solicited on nonsubstantive revisions, and the item will be included on the agenda for at least one public hearing before the Working Group adopts nonsubstantive revisions. Nonsubstantive revisions are considered effective immediately after adoption by the Working Group, unless the Working Group incorporates a specific effective date. If comments are not received during the public comment period, the Working Group may adopt the proposal collectively (one motion/vote) with other "non-contested" positions after opportunity is given during the hearing to separately discuss the proposal. At its discretion, the Working Group may request that an issue paper be drafted for nonsubstantive revisions in order to capture historical discussion and adopted revisions. Adoption of nonsubstantive revisions by the Task Force, its parent and the NAIC membership shall be governed by the NAIC bylaws.

Development of Interpretations to SSAPs and Referencing Interpretations Within SSAPs

Interpretations Which DO NOT Amend, Supersede or Conflict with Existing SSAPs

9. Interpretations may be developed to address issues requiring timely application or clarification of existing SAP, which shall not amend, supersede or conflict with effective SSAPs. Issues being considered as an interpretation must be discussed at no less than two open meetings. (Original introduction of the issue when the Working Group identifies the intent to address the issue as an "interpretation" during a public discussion is considered the first open meeting discussion.) The process must allow opportunity for interested parties to provide comments, but as interpretations are intended to provide timely responses to questions of application or interpretation and clarification of guidance, no minimum exposure timeframe is required.

10. As these interpretations do not amend, supersede or conflict with existing SSAP guidance, the interpretation is effective upon Working Group adoption unless specifically stated otherwise. The voting requirement to adopt an interpretation of this type is a simple majority. The Working Group shall report the adopted interpretation to the Accounting Practices and Procedures (E) Task Force as part of its public report during the next NAIC national meeting (or earlier if applicable). Interpretations can be overturned, amended or deferred by a two-thirds majority of the Task Force membership. For clarification, a two-thirds majority of the Task Force requires two-thirds of the entire Task Force membership, not just those electing to vote. Additionally, interpretations can be overturned, amended, deferred, or referred to either the Task Force and/or the Working Group by a simple majority of the Financial Condition (E) Committee.

Interpretations Which Amend, Supersede or Conflict with Existing SSAPs

11. In certain circumstances such as catastrophes and other time-sensitive issues requiring immediate, temporary statutory accounting guidance, the Working Group may adopt an interpretation which creates new SAP or conflicts with existing SSAPs. Historically, these interpretations temporarily modified statutory accounting principles and/or specific disclosures were developed in response to nationally significant events (e.g., Hurricane Sandy, September 11, 2001). (Examples of time-sensitive issues that have previously provided INT exceptions to SAP include the transition from LIBOR and special situations such as the federal TALF program.) Interpretations

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that conflict with existing SSAPs shall be temporary and restricted to circumstances arising from the need to issue guidance for circumstances requiring immediate guidance. In order to adopt an interpretation that creates new SAP or conflicts with existing SSAPs, the Working Group must have 67% of its members voting (10 out of 15 members) with a super majority (7 out of 10, 8 out of 11 or 12, 9 out of 13, 10 out of 14, or 11 out of 15) supporting adoption.

a. These interpretations are effective upon Working Group adoption, unless stated otherwise, and shall be reported to the Accounting Practices and Procedures (E) Task Force as part of its public report during the next NAIC national meeting (or earlier if applicable). In circumstances where the Working Group adopts an interpretation (which creates new SAP or conflicts with existing SSAPs) that is controversial in nature (i.e., due to regulator or industry feedback or could have a policy level impact), the Working Group may elect to postpone the effective date until the item has been discussed by the Task Force and the Financial Condition (E) Committee and both have had an opportunity to review the interpretation.

b. These interpretations can be overturned, amended or deferred by a two-thirds majority of the Task Force membership. For clarification, a two-thirds majority of the Task Force requires two-thirds of the entire Task Force membership, not just those electing to vote. Additionally, interpretations can be overturned, amended, deferred, or referred to either the Task Force and/or the Working Group by a simple majority of the Financial Condition (E) Committee.

12. As new SSAPs are developed, it is essential to review and, if necessary, update the status of interpretations related to SSAPs that are being replaced and/or new SSAPs being developed. The following options are available to the Working Group when a SSAP with existing interpretations is replaced:

a. **Interpretation of the new SSAP -** If the Working Group would like to maintain the interpretation, the new SSAP can be added to the list of statements interpreted by the interpretation. In addition, the status section of the new SSAP will list the interpretation number next to the heading "Interpreted by."

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c. **Incorporation** - When an interpretation is incorporated into a new SSAP, the Working Group can choose from the following two options:

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ii. If the interpretation references additional SSAPs, and the Working Group intends to maintain the guidance, the interpretation is unchanged (no nullification). The new SSAP (Summary of Issue section) reflects that the interpretation issue has been incorporated into the new statement.

Activity to Date (issues previously addressed by the Working Group, Emerging Accounting Issues (E) Working Group, SEC, FASB, other State Departments of Insurance or other NAIC groups): None

Information or issues (included in *Description of Issue*) not previously contemplated by the Working Group: None

Convergence with International Financial Reporting Standards (IFRS): N/A

Staff Recommendation:
NAIC staff recommends that the Working Group move this item to the active listing and expose revisions to the *NAIC Policy Statement on Maintenance of Statutory Accounting Principles,* as suggested by the Financial Condition (E) Committee in their Aug. 14, 2021, referral, to alter the terminology used when discussing types of statutory accounting revisions.

Due to the extent that these terms are currently used throughout the AP&P Manual, upon adoption of this terminology change, NAIC staff will utilize the new terminology on a go-forward basis. These updates will be limited to the guidance that describes the use of these terms and will not capture previously adopted SSAPs, issue papers or agenda items. The terms used in previously adopted guidance will remain, with the new terms being used prospectively when considering future revisions to statutory accounting.

Aug. 26, 2021 - Proposed Revisions from Aug. 14, 2021 Financial Condition (E) Committee Referral:

NAIC Policy Statement on Maintenance of Statutory Accounting Principles

1. Statutory accounting principles (SAP) provide the basis for insurers to prepare financial statements to be filed with and utilized by state insurance departments for financial regulation purposes. Accuracy and completeness of such filings are critical to meaningful solvency monitoring. Accordingly, maintenance of SAP guidance for changes in the industry and changes in regulatory concerns is vital to preserving the usefulness of SAP financial statements.

2. The promulgation of new or revised SAP guidance by the NAIC ultimately requires action of the entire NAIC membership. Responsibility for proposing new or revised SAP guidance will be delegated through the NAIC committee structure to the Accounting Practices and Procedures (E) Task Force (Task Force). The Task Force will charge the Statutory Accounting Principles (E) Working Group (Working Group) with the exclusive responsibility to develop and propose new statements of statutory accounting principles (SSAPs), to revise existing SSAPs, and to issue interpretations.

Composition of the Statutory Accounting Principles (E) Working Group

3. The chair of the Task Force shall determine membership of the Working Group subject to approval by the Financial Condition (E) Committee. The Working Group shall be limited in size to no more than 15 members and will include representation from the four zones of the NAIC. Membership shall be vested in the state (until such time as the membership may be changed) but continuity of individuals, to the extent possible, is extremely desirable.

Development of New SSAPs or New SAP Concepts[1] in an Existing SSAP~~Substantively Revised SSAPs~~

4. New SSAPs will be developed to address, but will not be limited to: 1) concepts not previously addressed by a SSAP and that do not fit within the scope of an existing SSAP; 2) concepts that fit within the scope of an existing SSAP, but the Working Group elects to supersede existing SSAPs and 3) existing concepts that warrant significant revisions. ~~Substantively-revised~~ New SAP concepts to existing SSAPs will be developed to address, but will not be limited to: 1) concepts that fit within the accounting topic of an existing SSAP, but have not been addressed by the Working Group; 2) changes to the valuation and/or measurement of an existing SSAP; and 3) modifications to the overall application of existing SSAPs. The decision to undertake development of a new SSAP or ~~substantively~~ a new SAP concept in an existing~~revised~~ SSAP will rest with the Working Group. New SSAPs or ~~substantively~~ new SAP concept in an existing~~revised~~ SSAP~~s~~ will have a specified effective date.

5. Research and drafting of new SSAP or ~~substantially~~ a new SAP concept in an existing~~revised~~ SSAP~~s~~ will be performed by NAIC staff under the direction and supervision of the Working Group which may enlist the assistance of interested parties and/or consultants with requisite technical expertise as needed or desired. The first step in developing new SSAPs and ~~substantively~~ new SAP concepts in existing~~revised~~ SSAPs will commonly be the drafting of an issue paper, which will contain a summary of

the issue, a summary conclusion, discussion, and a relevant literature section. Public comments will be solicited on an issue paper (at least one exposure period), and at least one public hearing will be held before the issue paper is converted to a SSAP. Upon approval by the Working Group, all proposed SSAPs will be exposed for public comment for a period commensurate with the length of the draft and the complexities of the issue(s). After a hearing of comments, adoption of new SSAPs or new SAP concepts in existing~~substantively revised~~ SSAPs (including any amendments from exposure) may be made by simple majority. If no comments are received during the public comment period, the Working Group may adopt the proposal collectively (one motion/vote) with other non-contested positions after the opportunity is given during the hearing to separately discuss the proposal. All new SSAPs and ~~substantively revised~~new SAP concepts in existing SSAPs must be on the agenda for at least one public hearing before presentation to the Task Force for consideration. Adoption by the Task Force, its parent and the NAIC membership shall be governed by the NAIC bylaws.

6. The Working Group may, by a super majority vote (7 out of 10 members, 8 out of 11 or 12, 9 out of 13, 10 out of 14, and 11 out of 15) elect to: 1) combine the IP and SSAP process, resulting in concurrent exposure of the two documents; 2) expose and adopt revisions to a SSAP prior to the drafting/adoption of the related IP; and/or 3) forego completion of an IP and only proceed with a new SSAP or new SAP concepts in an existing ~~revisions to a substantively revised~~ SSAP.

7. If accounting guidance, reserving standards, asset valuation standards, or any other standards or rules affecting accounting practices and procedures are first developed by other NAIC working groups, task forces, subcommittees, or committees, such proposed guidance, standards or rules shall be presented to the Working Group for consideration. In cases where such guidance has already been subjected to substantial due process (e.g., public comment periods and/or public hearings), the Working Group may elect to shorten comment periods and/or eliminate public hearings, and in such cases, will notify the Task Force of these actions.

Development of SAP Clarifications[1] ~~Nonsubstantive Revisions to SSAPs~~

8. SAP clarifications ~~Nonsubstantive revisions to SAP~~ will be developed to address, but will not be limited to: 1) clarification of the intent or application of existing SSAPs; 2) new disclosures and modification of existing disclosures; 3) revisions that do not change the intent of existing guidance; and 4) revisions to *Appendix A—Excerpts of NAIC Model Laws* to reflect amendments to NAIC adopted model laws and regulations. Research and drafting of SAP clarification ~~nonsubstantive~~ revisions will be performed by NAIC staff under the direction and supervision of the Working Group. Public comment will be solicited on ~~nonsubstantive~~ these revisions, and the item will be included on the agenda for at least one public hearing before the Working Group adopts ~~nonsubstantive~~ revisions. ~~Nonsubstantive~~ SAP clarification revisions are considered effective immediately after adoption by the Working Group, unless the Working Group incorporates a specific effective date. If comments are not received during the public comment period, the Working Group may adopt the proposal collectively (one motion/vote) with other "non-contested" positions after opportunity is given during the hearing to separately discuss the proposal. At its discretion, the Working Group may request that an issue paper be drafted for ~~nonsubstantive~~ SAP clarification revisions in order to capture historical discussion and adopted revisions. Adoption of ~~nonsubstantive~~ these revisions by the Task Force, its parent and the NAIC membership shall be governed by the NAIC bylaws.

New Footnote 1: Prior to (adoption date), the term used to describe a new SAP concept was "substantive" and the term used to describe a SAP clarification was "nonsubstantive." The new terms will be reflected in materials to describe revisions to statutory accounting principles on a prospective basis and historical documents will not be updated to reflect the revised terms.

Development of Interpretations to SSAPs and Referencing Interpretations Within SSAPs

Interpretations Which DO NOT Amend, Supersede or Conflict with Existing SSAPs

9. Interpretations may be developed to address issues requiring timely application or clarification of existing SAP, which shall not amend, supersede or conflict with effective SSAPs. Issues being considered as an interpretation must be discussed at no less than two open meetings. (Original introduction of the issue when the Working Group identifies the intent to address the issue as an "interpretation" during a

public discussion is considered the first open meeting discussion.) The process must allow opportunity for interested parties to provide comments, but as interpretations are intended to provide timely responses to questions of application or interpretation and clarification of guidance, no minimum exposure timeframe is required.

10. As these interpretations do not amend, supersede or conflict with existing SSAP guidance, the interpretation is effective upon Working Group adoption unless specifically stated otherwise. The voting requirement to adopt an interpretation of this type is a simple majority. The Working Group shall report the adopted interpretation to the Accounting Practices and Procedures (E) Task Force as part of its public report during the next NAIC national meeting (or earlier if applicable). Interpretations can be overturned, amended or deferred by a two-thirds majority of the Task Force membership. For clarification, a two-thirds majority of the Task Force requires two-thirds of the entire Task Force membership, not just those electing to vote. Additionally, interpretations can be overturned, amended, deferred, or referred to either the Task Force and/or the Working Group by a simple majority of the Financial Condition (E) Committee.

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Staff Review Completed by: Julie Gann, NAIC Staff – August 2021

https://naiconline.sharepoint.com/teams/FRSStatutoryAccounting/National Meetings/A. National Meeting Materials/2021/9. August 26/D - 2021-14 - SAP Terminology.docx

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NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

MEMORANDUM

TO: Dale Bruggeman (OH), Chair, Statutory Accounting Principles (E) Working Group
Carrie Mears (IA), Vice-Chair, Statutory Accounting Principles (E) Working Group

FROM: Commissioner Scott A. White (VA), Chair, Financial Condition (E) Committee

DATE: July 22, 2021

RE: Terminology Change – Substantive and Nonsubstantive

In response to the discussion on *SSAP No. 71—Policy Acquisition Costs and Commissions*, it has been highlighted that the statutory accounting terminology of "substantive" and "nonsubstantive" to describe statutory accounting revisions being considered by the Statutory Accounting Principles (E) Working Group to the *Accounting Practices and Procedures Manual* (AP&P Manual) could be misunderstood by those who are not familiar with the specific definitions and intended application of those terms. To avoid the incorrect perception that these terms may reflect the degree of financial impact to companies based on their common usage, the Financial Condition (E) Committee requests that the Statutory Accounting Principles consider updating these terms to prevent future misunderstandings.

The Financial Condition (E) Committee understands the terms "substantive" and "nonsubstantive" were crafted as part of the statutory accounting principles (SAP) codification, which was finalized in 1998, and were intended to be simple, concise terms to differentiate whether proposed revisions reflect new SAP concepts (substantive) or clarification of existing SAP concepts (nonsubstantive). The source location for the definitions and classification criteria of these terms is the *NAIC Policy Statement on Maintenance of Statutory Accounting Principles*, but it is noted that the terms and definitions are referred to throughout SAP guidance, other policy statements, issue papers, and agenda items.

Pursuant to this Committee request, the Working Group should consider eliminating "substantive" and "nonsubstantive" and instead refer to the type of revisions in accordance with the general nature in which those terms were intended to reflect. As such, a revision that would have previously been considered "substantive" could be referred to as a "New SAP Concept" and a revision that would have previously been considered as "nonsubstantive" could be referred to as a "SAP Clarification." The Committee is not proposing that the Working Group reassess the classification criteria but is simply requesting terminology changes to prevent future misinterpretations or assessments by others. As such, unless the Working Group believes further revisions are necessary, statutory revisions that would have been previously classified as "nonsubstantive" are anticipated to continue to fall within that definition and be captured under the new terminology as a "SAP Clarification."

To illustrate the intent of this request, draft revisions are presented for Working Group consideration. The Working Group should feel welcome to modify these draft revisions as deemed appropriate to best reflect this requested change.

If you have any questions on this request, please contact Commissioner Scott A. White, Chair of the Financial Condition (E) Committee or Dan Daveline, NAIC staff.

c: Julie Gann, Robin Marcotte, Jim Pinegar, Jake Stultz, Fatima Sediqzad

https://naiconline.sharepoint.com/teams/FRSStatutoryAccounting/Stat Acctg_Statutory_Referrals/2021/E to SAPWG - Terminology.docx

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Potential Revisions to the Policy Statement:

NAIC Policy Statement on Maintenance of Statutory Accounting Principles

1. Statutory accounting principles (SAP) provide the basis for insurers to prepare financial statements to be filed with and utilized by state insurance departments for financial regulation purposes. Accuracy and completeness of such filings are critical to meaningful solvency monitoring. Accordingly, maintenance of SAP guidance for changes in the industry and changes in regulatory concerns is vital to preserving the usefulness of SAP financial statements.

2. The promulgation of new or revised SAP guidance by the NAIC ultimately requires action of the entire NAIC membership. Responsibility for proposing new or revised SAP guidance will be delegated through the NAIC committee structure to the Accounting Practices and Procedures (E) Task Force (Task Force). The Task Force will charge the Statutory Accounting Principles (E) Working Group (Working Group) with the exclusive responsibility to develop and propose new statements of statutory accounting principles (SSAPs), to revise existing SSAPs, and to issue interpretations.

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3. The chair of the Task Force shall determine membership of the Working Group subject to approval by the Financial Condition (E) Committee. The Working Group shall be limited in size to no more than 15 members and will include representation from the four zones of the NAIC. Membership shall be vested in the state (until such time as the membership may be changed) but continuity of individuals, to the extent possible, is extremely desirable.

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terms will be reflected in materials to describe revisions to statutory accounting principles on a prospective basis and historical documents will not be updated to reflect the revised terms.

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Statutory Issue Paper No. 16x

Levelized Commission

STATUS
August 26, 2021 - Proposed Exposure Draft

Original SSAP: 71; Current Authoritative Guidance: SSAP No. 71

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. This issue paper documents for historical purposes the discussion of nonsubstantive revisions to *SSAP No. 71—Policy Acquisition Costs and Commissions.* The intent of these nonsubstantive revisions is to provide clarifying guidance to existing accounting requirements regarding levelized commission arrangements. The statutory accounting guidance in SSAP No. 71 has been in place since 1998 and is based on pre-codification guidance.

SUMMARY CONCLUSION

2. The nonsubstantive revisions to SSAP No. 71 adopted by the Statutory Accounting Principles (E) Working Group on March 15, 2021, the Accounting Practices and Procedures (E) Task Force on March 23, 2021, and the Financial Condition (E) Committee on April 13, 2021 (illustrated in Exhibit A), reflect the following:

a. Provides additional descriptive guidance to assist with identifying levelized commission arrangements.

b. Emphasizes the requirements noted in the original SSAP No. 71 guidance that levelized commission arrangements require full recognition of the liability amount. In addition, interest and or fees incurred to date are accrued.

c. Specifies an effective December 31, 2021, for contracts in effect as of that date.

Policy Acquisition Costs Overview

3. Acquisition costs are those costs that are incurred in the acquisition of new and renewal insurance contracts and include costs that vary with and are primarily related to the acquisition of insurance contracts (e.g., agent and broker commissions, certain underwriting and policy issue costs, and medical and inspection fees). Pursuant to SSAP No. 71, as originally effective January 1, 2001, for the initial SAP Codification, specifically states that acquisition costs and commissions are expensed as incurred. This provision is a fundamental difference from U.S. generally accepted accounting principles (U.S. GAAP) and reflects a statutory concept that was employed prior to codification, as detailed in *Issue Paper No. 71—Policy Acquisition Costs and Commissions.*

a. Under U.S. GAAP, paid or accrued acquisition costs, which include commission costs, are capitalized and reported as a deferred asset and expensed over time to match the recognition of revenue. Note that under U.S. GAAP and SAP, the liabilities associated with acquisition costs are the same. However, U.S. GAAP allows capitalization of certain acquisition costs where SAP requires immediate expense recognition. From information received on the basis of U.S. GAAP, commission obligations from the writing of an insurance policy would be recognized as a deferred acquisition cost regardless of a third-party arrangement.

b. The departure from U.S. GAAP is consistent with original and ongoing SAP concepts that focus on the solvency of reporting entities for the protection of policyholders and not the matching of revenue to expenses. As detailed in the Preamble, the ultimate objective of solvency regulation is to ensure that policyholder, contract holder and other legal obligations are met when they come due and that companies maintain capital and surplus at all times and in such forms as required by statute to provide a margin of safety.

c. As detailed in the Statutory Accounting Recognition Concept, accounting treatments that defer expense recognition do not generally represent acceptable SAP treatment. Even if consideration had occurred to mirror U.S. GAAP and allow the capitalization of expenses as "deferred assets," such assets would not be considered admitted assets for statutory accounting. This is because such items do not reflect assets with economic value available for policyholder claims. Nonadmitted assets are required to be charged to surplus in the period in which they arise. As such, in either scenario under SAP, the financial statements of the reporting entity would reflect a reduction of available surplus (either through the recognition of expense or through a direct surplus charge for nonadmitted assets) for acquisition costs and commissions.

Levelized Commission - Background

4. Agenda item 2019-24 on levelized and persistency commission was drafted and presented to the Statutory Accounting Principles (E) Working Group at the request of a state department of insurance after the practice was identified on a financial examination. The issues received by the Working Group related to the use of levelized commission arrangements and the amount to be recorded as a liability in accordance with SSAP No. 71 and *SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets*.

5. Both SSAP No. 71 and SSAP No. 5R have relevant guidance on this topic:

a. SSAP No. 71 describes levelized commission arrangements as follows:

> 4. Levelized commissions occur in situations where agents receive normal (non-level) commissions with payments made by a third party. It is intended, but not necessarily guaranteed, that the amounts paid to the agents by the third party would ultimately be repaid (with interest explicit or implied) to the third party by levelized payments (which are less than the normal first year commissions but exceed the normal renewal commissions) from the reporting entity. These transactions are, in fact, funding agreements between a reporting entity and a third party. The continuance of the stream of payments specified in the levelized commission contract is a mechanism to bypass recognition of those expenses which are ordinarily charged to expense in the first year of the contract. Consequently, the normal link between the persistency of the policy, the continuance of the premium payment or the maintenance of the agent's license with the reporting entity is not maintained with respect to the payment stream.

b. SSAP No. 5R defines liabilities as follows:

> **Liabilities**
>
> 2. A liability is defined as certain or probable[1] future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or to provide services to other entities in the future as a result of a past transaction(s) or event(s).

[1] *FASB Statement of Financial Accounting Concepts No. 6, Elements of Financial Statements*, states: Probable is used with its usual general meaning, rather than in a specific accounting or technical sense (such as that in *FASB Statement 5, Accounting for*

3. A liability has three essential characteristics: (a) it embodies a present duty or responsibility to one or more other entities that entails settlement by probable[1] future transfer or use of assets at a specified or determinable date, on occurrence of a specified event, or on demand, (b) the duty or responsibility obligates a particular entity, leaving it little or no discretion to avoid the future sacrifice, and (c) the transaction or other event obligating the entity has already happened. This includes, but is not limited to, liabilities arising from policyholder obligations (e.g., policyholder benefits, reported claims and reserves for incurred but not reported claims). Liabilities shall be recorded on a reporting entity's financial statements when incurred.

4. Estimates (e.g., loss reserves) are required in financial statements for many ongoing and recurring activities of a reporting entity. The mere fact that an estimate is involved does not of itself constitute a loss contingency. For example, estimates of losses utilizing appropriate actuarial methodologies meet the definition of liabilities as outlined above and are not loss contingencies.

Levelized Commission Funding Agreement

6. The levelized commission arrangements identified for agenda item 2019-24 had the following key elements:

a. A third party (referred to as a "funding-agent") paid selling agents commission amounts for business directly written on behalf of the reporting entity. These payments typically occurred in the first year of policy issuance and were consistent with normal initial sales commissions considered policy acquisition costs.

b. The reporting entity repaid the funding-agent through a levelized commission arrangement that spread out the commission repayment over multiple years (e.g., 3-6 years). The yearly commission repayments to the funding agent also included additional fees and explicit or implicit interest charged to the reporting entity. Consistent with the guidance in SSAP No. 71, paragraph 4, this levelized commission arrangement is repaying the funding-agent amounts "which are less than the normal first year commissions but exceed the normal renewal commissions." As noted, SSAP No. 71 characterizes such agreements as in substance, a funding agreement (i.e. loan).

c. The example agreement between the reporting entity and the funding agent specified that the funding agent will not be reimbursed by the reporting entity if the policies that generate the commission are cancelled prior to the policy anniversary date. This reduction in commission payment for policy cancellation is not materially different than direct agreements with agents that have commission "claw back" features. However, regardless of claw back features, commission is fully accrued and expensed upfront. In the event there is a policy cancellation / lapse, then the liability accrued and recognized expense is adjusted for the amount of the commission that will not be paid.

7. The regulator noted that the reporting entity was not accruing all of the commission liability to the third-party funding agent. The insurance reporting entity employing the disputed practice asserted that the payments to the funding agent were theoretically avoidable until the policy had passed the anniversary date. The reporting entity did not accrue the full amount of initial sales commission that had already been paid on its behalf by the funding agent, which should have been recognized at the time the policy was sold. Although the entity should have recognized the full initial sales commission per SSAP No. 71, the reporting entity also did not accrue the next total expected payment to the third-party. The reporting entity only

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Contingencies, paragraph 3), and refers to that which can reasonably be expected or believed on the basis of available evidence or logic but is neither certain nor proved.

accrued the next payment when they viewed it as "earned" by the third-party agent. This "earned" date was typically the next policy anniversary when the payment to the funding agent became unavoidable. With this approach, the reporting entity was essentially incorporating a 100% lapse assumption in their process to recognize commission expense, as they would only recognize the commission expense when the policy continued passed a specific lapse date. This assumption is not permitted in statutory accounting, and therefore not reflected in other aspects of their financial statements such as policy reserves.

8. The reporting entities employing the disputed practice asserted that even though commission has been paid by the funding-agent to the sub agent, that no commission should be accrued by the reporting entity until after the end of each policy year when the policy has persisted past its anniversary. The reporting entity was asserting that inserting a persistency clause into a funding agreement allowed them to avoid the liability accrual and expense recognition for the initial acquisition costs for the issued policy at the time the policy was issued.

9. The assertion from the reporting entity is not consistent with SSAP No. 71, paragraph 5:

> 5. The use of an arrangement where commission payments are not linked to traditional elements such as premium payments and policy persistency, but rather are linked to the repayment of an advance amount requires the establishment of a liability for the full amount of the unpaid principal and accrued interest which is payable to a third party related to levelized commissions.

10. The regulator viewed the disputed practice as a misapplication of the levelized commission guidance in SSAP No. 71 and that the reporting entity was underreporting its sales commission expense incurred and the related commission expense liability.

DISCUSSION

11. The accounting issue is whether levelized commission funding arrangements require the establishment of a liability for the full amount of the unpaid principal and accrued interest which is payable to a third party. The agenda item and the proposed revisions assert that guidance in SSAP No. 71, which has existed since prior to codification, requires accrual of the full amount that is repayable to the funding agent under the levelized commission agreement. It is important to highlight that the guidance in SSAP No. 71, nor the proposed clarifying edits, do not seek to prohibit funding agreements. The long-standing guidance simply requires full liability recognition to ensure continued consistent reporting across reporting entities of commission obligations.

12. During the discussion of the agenda item, it was identified that this disputed practice of not accruing the full liability for the commission expense was only employed by a small number of reporting entities that employ similar operational practices. It was identified that these limited number of insurers entered into third-party arrangements with the intent to defer the recognition of commission costs for surplus relief. This goes against long-standing statutory accounting guidance and results in those insurers presenting a better financial position than other reporting entities that applied the guidance in SSAP No. 71 when using third-parties to pay commission as well as reporting entities that pay commission directly to agents. The application of this approach by the small number of reporting entities employing the practice resulted in significant differences impacting consistency and comparability in statutory financial statements. From information obtained, it is believed that a vast majority of companies are following the guidance in SSAP No. 71 as originally intended.

13. Research identified that some capital-funding companies were facilitating the practice, with marketing efforts to promote the surplus relief provided by using their structure as a third-party payer. These capital-funding companies were also active commenters in response to the proposed edits to clarify the guidance in SSAP No. 71. Throughout the Working Group discussion, it was identified that if the guidance is not clarified, then all reporting entities would need to contract with third-party agents to pay commissions to prevent competitive disadvantages in reporting financial results in the statutory financial statements. For the small number of companies that have engaged in this practice, these entities have benefited from lower

expense recognition. It also results with a decrease in liabilities, resulting with a calculation that fewer assets are needed to meet obligations and improving overall RBC calculations. These results were identified as concerning as the financial statements do not accurately represent the obligations of the reporting entity from issued in-force policies and could hinder the proper assessment of whether there are appropriate assets available to satisfy policyholder claims and other contractual requirements of the reporting entity.

Development of Statutory Accounting Guidance

14. SSAP No. 71 was adopted in 1998 as part of base codification, which went into effect in 2001.

15. *Issue Paper No. 71—Policy Acquisition Costs and Commission*s, paragraph 10 identifies the pre-codification statutory accounting guidance that is the basis for the existing SSAP No. 71 guidance. The pre-codification guidance also notes the same concerns (reiterated in the agenda item 2019-24) if reporting entities use levelized commission arrangements which operate as funding agreements to inappropriately enhance surplus. *Issue Paper No. 71—Policy Acquisition Costs and Commissions*:

> 10. Chapter 17, Other Liabilities, of the Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies contains the following guidance on levelized commissions:
>
> Levelized Commission
>
> The accounting treatment for certain transactions, characterized as levelized commissions, which results in enhancement of surplus, has been determined to be inappropriate for statutory reporting.
>
> These transactions are, in fact, funding agreements between an insurer and a third party. Agents receive normal (non-level) commissions with payments made by the third party. It is intended, but not necessarily guaranteed, that the amounts paid to the agents would ultimately be repaid (with interest explicit or implied) to the third party by "levelized" payments (which are less than the normal first year commissions but exceed the normal renewal commissions) from the insurer. The continuance of the stream of payments specified in the levelized commission contract is a mechanism to bypass recognition of those expenses which are ordinarily charged to expense in the first year of the contract. Consequently, the normal link between the persistency of the policy, the continuance of premium payment or the maintenance of the agents license with the insurer is not maintained with respect to the payment stream.
>
> The use of an arrangement where commission payments are not linked to traditional elements such as premium payments and policy persistency but rather are linked to the repayment of an advanced amount requires the establishment of a liability in the full amount of the unpaid principal and accrued interest.

16. The intent of SSAP No. 71 for levelized commissions is that repayment of an advance (by having a third party pay on the insurer's behalf), requires the establishment of a liability for the full amount of unpaid principal and accrued interest.

Contingent Commission versus Funding Agreement

17. SSAP No. 71, paragraphs 3-5, which are excerpted in the relevant statutory accounting section of this issue paper, describes both contingent commission and levelized commission agreements.

18. Contingent commission: SSAP No. 71, paragraph 3 provides the following key points:

a. Contingent Commission liabilities are to be determined in accordance with the terms of each individual commission agreement.

b. Commission liabilities determined on the basis of a formula that relates to loss experience shall be established for the earned portion.

c. Assumptions used to calculate the contingent commission liability shall be consistent with the terms of the policy contract and with the assumptions made in recording other assets and liabilities necessary to reflect underwriting results of the reporting entity, such as retrospective premium adjustments and loss reserves, including incurred but not reported.

19. Levelized commission: SSAP No. 71, paragraphs 4 and 5 discuss levelized commission with the following key points:

a. Such transactions are noted as in substance to be a funding agreement or a loan between a reporting entity and a third party.

b. Selling agents receive their normal commission from a third party and repayment of the commission amounts to the third party by the reporting entity are intended, but repayment (with interest explicit or implied) to the third party is not necessarily guaranteed.

c. Commission repayment to the third party by the reporting entity is over time. The levelized commission payments are lower than normal first year (sales) commission, but higher than normal renewal commission.

d. The levelized commission arrangements are described as an attempt to bypass the recognition of expenses, which are normally charged to expense in the first year of the insurance contract.

e. This guidance also notes that the use of a levelized commission arrangement is an attempt to break the normal link between underlying policies and the expense recognition, by changing the timing of the payment stream.

f. SSAP No. 71, paragraph 5 provides:

> 5. The use of an arrangement where commission payments are not linked to traditional elements such as premium payments and policy persistency, but rather are linked to the repayment of an advance amount requires the establishment of a liability for the full amount of the unpaid principal and accrued interest which is payable to a third party related to levelized commissions.

20. The key differences between traditional contingent commission paid directly to the selling agent and a levelized commission funding agreement that uses a third-party funding agent were a major component of the discussion prior to adopting the clarifying edits. The example brought to the Working Group was identified, by the regulator as a levelized commission funding agreement. Key levelized commission features of this example were: 1) the direct selling agents were paid their sales commission for policies written on behalf of the insurance reporting entity for year one commission by the third party; 2) the third-party funding agent was being repaid over time with some contingency elements in the third party levelized commission contract; and 3) the third party had typically advanced the funds to the selling agents in the same year that the policies were written (however some direct selling agents could choose different payment patterns).

21. Rather than accruing the total expected payments to the third party who had made commission payments to the direct selling agents, the reporting entity was only accruing commission expense based on when the next annual payment was due to the third-party. This levelized commission arrangement attempts to de-link the timing of recognition for the initial sales commission by inserting a third party.

22. As recognition of commission expenses is driven by policy events (such as the issuing or renewing of an insurance policy), the commission expenses had already been incurred, therefore, the reporting entities employing the disputed practice were viewed as underreporting their incurred commission expense and commission liabilities. This was not viewed as consistent with the principle of expensing acquisition costs when incurred or with the treatment of levelized commission funding agreements in SSAP No. 71.

23. In addition, it was identified that waiting to accrue the subsequent expected payments because the underlying polices might lapse in the future reflects a 100% lapse assumption. Using a 100% lapse assumption was noted as being inconsistent with the other financial statement assumptions regarding the underlying policies used for reserving, incurred but not reported claims, etc.

Contingent Commission versus Loan with Contingency Element

24. Comments received often characterized the third-party funding agreements as a persistency commission as support for why the full commission expense should not be required. The use of the term "persistency" in these instances is not in line with the traditional use of this term as it pertains to insurance contracts. Fundamentally, a persistency commission is commission that is earned over time as a policy is renewed or remains in force. A persistency commission occurs subsequent to an initial sales commission, where the triggering event is either the continuation or renewal of a policy. With these terms, an additional commission (beyond what was earned from the initial sales commission) is owed once the policy 'persists' overtime. Persistency commissions are generally much smaller payments than initial sales commission.

25. The third-party funding agreements reference to persistency commission in their contracts is not referring to additional commission owed with the continuation or renewal of a policy. Rather, they have taken the position that deferring the initial sales commission overtime and requiring portions of that initial sales commission to be paid to the third-party as the contract remains in force is akin to a persistency commission. This is not an appropriate comparison. As detailed, commission liabilities and the recognition of commission expenses shall occur in accordance with policy events. As such, with the issuance of an initial policy, the initial sales commission shall be recognized, with a liability accrual until paid, and with the recognition of the commission expense. If a policy remains in force over time, the terms of the contract may require additional commission to be paid to the selling agent. These additional commission amounts are considered "persistency" commissions and are only recognized when the policy event occurs that triggers the commission to be owed.

26. The following examples are included to assist with illustrating these concepts:

a. Single Premium Immediate Annuity (SPIA): On January 1, 2020, agent sells a SPIA insurance policy and is owed $1,000 in initial sales commission. Over the next 10 years, if the policy continues to be in force, on January 1, the selling agent is awarded a persistency commission of $10, per year. This is a reward to the agent for the policy not being churned / terminated.

b. Direct Agent Arrangement: On January 1, 2020, the reporting entity recognizes the $1,000 as commission expense. On January 1, 2021 (and subsequent years) as the policy continues in force, reporting entity recognizes the $10 persistency commission as incurred.

c. Funding Agreement Arrangement: Rather than the reporting entity paying the $1,000 initial sales commission directly to the agent upfront, the funding agent pays the initial $1,000 commission to the selling agent. The insurer and the funding agent have an expectation that the reporting entity will repay the funding agent this amount over time. Under SSAP No. 71, an insurer is not permitted to insert a third-party to delay commission expense recognition. As such, under this arrangement the reporting entity insurer shall also recognize the full $1,000 as commission expense on January 1, 2020. Additionally, the

insurer should recognize the $10 persistency commission on January 1, 2021 (and each year subsequent) if the policy continues to be in force. (This example does not reflect the recognition of the fees / interest of the funding agreement arrangement, which would also be required to be recognized.)

27. To be overly clear, the key concepts within these illustrations are as follows:

a. The initial obligating event is the selling of the insurance contract. Commission expense for initial sales commission shall be recognized consistently by each insurer, regardless of third-party arrangements where a funding agent pays this on behalf of the insurer.

b. The second obligation event is the persistency threshold in which additional commission is owed to the selling agent (policy did not lapse). This is also required to be recognized consistently by insurer regardless of any third-party arrangement.

c. The small number of companies that have delayed recognition of initial commission expense due to the insertion of a funding agent have noted that their agreement allows them to avoid payment in the future even of policy cancellation (lapse). The proper accounting for commission in the event of policy lapse is to decrease the payable to the funding agent when the lapse occurs, not prior to the lapse.

d. In addition to not altering the triggering event (initial issuance of policy), this dynamic does not reflect a traditional "persistency" commission. This funding agreement and use of a finance agent is simply a financing mechanism that the insurer has paid additional fees and interest to obtain. The proper accounting is to recognize the obligation for the full commission expense at the time of policy issuance, and then derecognize the obligation if, and only if, the insurer is no longer obligated to the funding agent. It is also noted that a third party would not pay large sums of money on an insurer's behalf in an arm's length transaction without an expectation of repayment.

Actions of the Statutory Accounting Principles (E) Working Group

28. On August 3, 2019, the Working Group moved this agenda item to the active listing, categorized as nonsubstantive, and exposed revisions to *SSAP No. 71—Policy Acquisition Costs and Commissions* to clarify levelized commissions guidance and provide additional direction regarding commissions that are based on policy persistency. The Working Group exposed initial revisions to paragraphs 2, 3, 4 and 5 which were intended to clarify both levelized and persistency commission because it was identified that some entities were trying to characterize their funding agreements as persistency commission. Key points in the exposed guidance were that:

a. A levelized commission arrangement (whether linked to traditional or nontraditional elements) require the establishment of a liability for the full amount of the unpaid principal and accrued interest payable to a third party at the time the policy is issued.

b. The persistency commission is accrued proportionately over the policy period in which the commission relates to and is not deferred until fully earned.

29. The exposed revisions were consistent with the original intent of SSAP No. 71 as well as the Statutory Statement of Concepts focusing on Recognition (excerpts from Preamble, paragraphs 37 and 38).

a. Liabilities require recognition as they are incurred.

b. Accounting treatments which tend to defer expense recognition do not generally represent acceptable SAP treatment.

30. On December 7, 2019, the Working Group exposed nonsubstantive revisions to SSAP No. 71 to provide clarifications to the long-standing levelized commissions guidance and provide additional guidance regarding commission that is based on policy persistency. The revisions proposed to clarify that a levelized commission arrangement (whether linked to traditional or nontraditional elements) requires the establishment of a liability for unpaid principal and accrued interest payable, regardless of the timing of payments made to a third party. Additionally, the exposed guidance required accrual of persistency commission over the associated policy period.

31. The December 7, 2019, revisions were to address some of the comments received from interested parties and two capital funding companies. It was affirmed that the levelized commission repayment amount is owed to the funding agent who made the advance on the insurer's behalf unless the policy has lapsed. It was noted that delaying payment to a third-party does not delay expense recognition. After this discussion, the guidance was exposed with the following revisions from the prior exposure:

a. Paragraph 2 - Removed previously exposed revisions regarding persistency commission. These provisions were initially included because the levelized commission example included contingency features regarding repayment. Commenters expressed concern that the exposed revisions could have an inadvertent impact on traditional renewal commissions, which was unrelated to a levelized commission arrangement.

b. Paragraph 3 - Added clarifying phrases regarding persistency commission accrual. The concept is that normal persistency commission is accrued for the period it relates to unless the policy is cancelled. This language was also added to address the industry comments regarding inadvertent impacts to traditional renewal commission.

c. Paragraph 4 - Added two clarifying phrases to assist with identifying levelized commission funding agreements.

d. Paragraph 5 - Added clarifying phrases regarding funding agreements.

e. Footnote 1 - Redrafted to remove double negative wording.

32. The December 7, 2019, exposed nonsubstantive revisions were again intended to be consistent with the original intent of SSAP No. 71 as well as the Statutory Statement of Concepts focusing on Recognition (noted in the Preamble, paragraphs 37 and 38) stating that liabilities require recognition as they are incurred and accounting treatments which tend to defer expense recognition do not generally represent acceptable SAP treatment.

33. Notice of the December 7, 2019, exposure was also sent to the Life Actuarial (A) Task Force. The Working Group forwarded comments received at the 2019 Fall National Meeting inquiring whether there is specific *Valuation Manual* language in *VM-20, Requirements for Principle-Based Reserves for Life Products*, and *VM 21, Requirements for Principle-Based Reserves for Variable Annuities*, that needs to be addressed in the coordination process as part of this agenda item. It was noted that the Principles-Based Reserving (PBR) methodology takes commission into account when projecting the present value of future cash flows. However, the projected future cash flows would not be accrued in duplicative if there is an existing liability.

34. On March 18, 2020, the Working Group, deferred discussion of this item for a subsequent call or meeting. This deferral occurred as the 2020 Spring National Meeting was cancelled for COVID-19, and the interim call held by the Working Group was limited in the topics to address.

35. During the July 30, 2020, meeting, the Working Group reviewed comments from interested parties and on behalf of two capital funding companies.

a. The proposed language from interested parties and one of the capital funding entities, as detailed in the following subparagraphs, was rejected by the Working Group as not viable and inconsistent with existing principles.

i. Interested parties' proposed language recommended deleting most of the exposed revisions and adding guidance that would redefine a funding arrangement to only include those items where repayment is guaranteed. This proposal was noted as being in conflict with the long-standing guidance in SSAP No. 71, paragraph 4 which notes that "It is intended, but not necessarily guaranteed, that the amounts paid to the agents by the third party would ultimately be repaid…" It was also noted that the existing language in SSAP No. 71 seeks to look at the substance of the levelized commission arrangement noting that a third party would not prepay an entity's commission expenses without an expectation of repayment.

ii. One of the capital funding companies sent comments through a legal firm. Their comments proposed only requiring levelized commission liability recognition if the third party, which prepays the commission, is under the control or has common control with the insurance reporting entity. The perception of that comment was that if an unrelated party were the third-party funding agent that paid the upfront sales commission expense, no liability recognition would be required by the insurance reporting entity. This recommendation was also rejected as the substance of the transaction is a loan and the accrual of a liability for a loan is the same under SSAP No. 5R for related and unrelated parties.

b. The Working Group also noted a concern with the capital funding company's comments regarding assumption of lapse risk by noninsurance entities such as brokers and other third parties. The capital funding company's comment letter (via the legal firm) asserted that the third-party broker, by virtue of their agreement, has assumed "lapse risk, mortality risk and the commission expense obligation." The Working Group noted that some of the identified items which were noted as being transferred to the broker are insurance risks that can only be transferable to an insurance entity through a reinsurance agreement.

c. The comments from the other capital funding company focused on unintended consequences and potential impacts to various entities. It asserted that the clarifying edits to the existing language are a substantive change. The Working Group noted that the proposed revisions are trying to emphasize existing language that has been in effect prior to codification that is being ignored by some reporting entities in an attempt to defer expense recognition. The Working Group affirmed that expensing acquisition costs when incurred is a long-standing principle in statutory accounting.

d. While commenters agreed that the commission obligations are ultimately liabilities/expenses, they noted that the issue is when to record the liability/expense. The discussion noted that the accrual of sales commission liabilities and the corresponding recognition of expenses are incurred when the insurance contract is written, not when the payment is due. It also noted that an insurer is responsible for the policy acquisition costs of its directly written policies.

36. After the discussion on July 30, 2020, the Working Group exposed additional nonsubstantive revisions to SSAP No. 71 to clarify the original levelized commission guidance and provide additional direction regarding commissions that are based on policy persistency. The exposed edits would require reporting entities that have not complied with the original intent of SSAP No. 71 to reflect the change as a correction of an error (as a mistake in the application of an accounting principle) pursuant to *SSAP No. 3—Accounting Changes and Corrections of Errors* in the December 31, 2020, financial statements. In accordance with SSAP No. 3, correction of accounting errors in previously issued financial statements, for which an amended financial statement was not filed, are to be reported as an adjustment to unassigned funds (surplus) in the period in which the error was detected. This guidance also requires disclosure in accordance

with SSAP No 3. Part of the reason the exposure included correction of error guidance, as opposed to change in accounting principle, is that the Working Group identified that the practice was employed by a small number of reporting entities purposely for surplus relief and it was viewed as inconsistent with the long-standing guidance in SSAP No. 71. Further, it was identified that some funding companies were actively promoting the use of these third-party arrangements as a way to increase surplus by avoiding the recognition of commission expense when incurred.

37. On October 15, 2020, the Working Group held a hearing to receive comments from interested parties and from the American Institute of Certified Public Accountants' NAIC Task Force (AICPA Task Force).

38. Both interested parties and the AICPA disagreed with the correction of an error treatment and stated a preference to have the classification as a change in accounting principle. It was noted that referring as a correction in error could result with issues in previously filed financial statements, prior exams, and previously issued audit opinions. The Working Group agreed to remove the previously exposed correction of error guidance in paragraph 7 and to revert to the change in accounting principle guidance. When making this decision, it was noted that the resulting financial statements would ultimately have a similar result. Under the change in accounting principle guidance, a reporting entity reflects the cumulative effect of the change as an adjustment to unassigned funds (surplus) in the period of change of the accounting principle. This guidance provides that the cumulative effect is the difference between the amount of capital and surplus at the beginning of the year and the amount of capital and surplus that would have been reported at that date as if the accounting principle had been applied retroactively to all prior periods. For a correction of error, domiciliary states may require entities to file corrected financial statements for all prior periods that reflected the error. If this direction does not occur, the change is required as an adjustment to unassigned funds in the period the error is detected. As such, by permitting this correction to be reported as a change in accounting principle, the impacted reported entities will not be subject to different treatment by domiciliary states with the resubmission of previously filed financial statements to correct the error. Rather, all impacted entities will have a consistent approach to update their financial statements accordingly.

39. The Working Group discussed the other comments and proposed revisions from interested parties regarding contingency commission. The Working Group did remove more of the contingent commission guidance that was previously exposed in paragraph 3 to address concerns regarding potential impacts on traditional commission and renewals. This was viewed as addressing the remaining concerns about unintended impacts from the majority of industry that is not using funding agreements.

40. The Working Group also agreed to move the proposed effective date to January 1, 2021, to allow the small number of entities that are employing the practice the opportunity to consult with their domiciliary regulators.

41. With this discussion the Working Group again highlighted that the revisions are a nonsubstantive clarification of existing longstanding provisions of SSAP No. 71 which have been in place before 1998 and are only not being applied by a small number of reporting entities. As some commenters noted the materiality impact to the small number of entities that engaged in this practice, it was noted that under the *NAIC Policy Statement on Maintenance of Statutory Accounting Principles*, it is not the impact of a change on an individual entity that determines whether a change is substantive or nonsubstantive, but rather if the change alters original intent.

Excerpt from Policy Statement on Maintenance of Statutory Accounting Principles:

Nonsubstantive revisions to SAP will be developed to address, but will not be limited to: 1) clarification of the intent or application of existing SSAPs; 2) new disclosures and modification of existing disclosures; 3) revisions that do not change the intent of existing guidance; and 4) revisions

to Appendix A—Excerpts of NAIC Model Laws to reflect amendments to NAIC adopted model laws and regulations.

42. After the discussion on October 15, 2020, the Working Group exposed updated revisions to SSAP No. 71 to clarify existing levelized commissions guidance, which requires full recognition of funding agreement liabilities incurred for commission expenses obligated when an insurance policy is written. (This guidance clarifies that writing the insurance policy is the obligating event for initial sales commission.) The exposed revisions have the following key changes from the prior exposure:

a. Improved description of the funding agreements in paragraphs 4 and 5.

b. Deletes the previously proposed revisions in paragraph 3 regarding other types of commission to address the comments received regarding unintended impacts on traditional renewal commission.

c. Modifies the revisions in paragraph 7 to remove the language on correction of an error.

d. Proposes the nonsubstantive revisions apply to contracts in effect on January 1, 2021.

43. On November 12, 2020, the Working Group held a hearing to receive comments on the October exposure. Comments were received from interested parties, the Mississippi Department of Insurance and a former New York state regulator. Key points from the review of comments were as follows:

a. Given the year-end timing and the material impact to what is believed to be a very limited number of companies, the Working Group discussed having another exposure, with minor edits, to clarify that that the revisions would apply to contracts in effect as of the effective date to later be specified by the Working Group. While the Working Group did not want to have the guidance in effect on January 1, 2021, a few members stated a preference to having the guidance effective upon adoption sometime in 2021.

b. The Working Group discussed the comments from the Mississippi Department of Insurance, interested parties and a former New York regulator that the changes appear to be substantive.

   i. It was identified that the revisions have already had the due process required for either a substantive or a nonsubstantive change since it has had multiple exposures and public discussions.

   ii. The Working Group affirmed that the proposed revisions are a nonsubstantive clarification of existing longstanding provisions of SSAP No. 71 which have been in place since prior to 1998. It was noted that under the *NAIC Policy Statement on Maintenance of Statutory Accounting Principles*, it is not the impact of a change on an individual entity that determines whether a change is substantive or nonsubstantive , but rather if the change alters original intent.

   iii. It was also noted that the *NAIC Policy Statement on Maintenance of Statutory Accounting Principles* allows for drafting of an issue paper subsequent to the adoption of revisions. An issue paper can be drafted for either substantive or nonsubstantive revisions.

c. The former New York regulator generally opposed all of the revisions. He noted that the total commission paid will not change under this guidance, but rather only the timing of commission expense recognition will change. In response to these comments, Working

Group members noted that the total commission expense is actually higher using these third-party arrangements because the funding agents charge interest and/or fees.

44. The Working Group also discussed and rejected the following revisions proposed by interested parties:

a. The proposed interested parties' revisions would have allowed both a reduction in commission expense recognition and the delay in commission expense timing. The parties employing the disputed practice are trying to use persistency features in a funding agreement to defer and decrease the funding agreement liability. Interested parties' comments advocated that the funding-agent fronting commission does not require recognition because of the insertion of a persistency contingency provision into the funding agreement. They noted that this persistency contingency provision might allow the reporting entity to avoid repayment of the past advance if the policy is subsequently cancelled. These proposed revisions were not incorporated as they are not in line with the original intent of the guidance and because it is not permissible to assume 100% lapse risk in recognition commission expense. It is only if a policy has been cancelled can a reporting entity derecognize the accrued liability/ commission expenses.

b. Interested parties' proposed revisions that commission funding agreements should only be accrued when repayment is guaranteed. This position has been previously rejected by the Working Group as it is in direct conflict with the existing guidance in SSAP No. 71, paragraph 4 which requires accrual of the full amount of a levelized commission agreement even when repayment is not guaranteed. It was noted that the purpose of the levelized commission guidance is to identify that the substance of the levelized commission is a funding arrangement. It identifies that a third party in an arm's length transaction would not pay acquisition costs on behalf of an insurer without expectation of repayment and expectation of profit. The guidance requires recognition of the full amount of the funding agreement liability even if repayment is not guaranteed. The funding agreement is an attempt to de-link the relationship to the underlying policy from the normal day one accrual of sales commission. The funding agreement advance made by the third party is made with an expectation of repayment. Thus, the liability for amounts already advanced by the funding agent is not extinguished as a liability (under SSAP No. 5R or SSAP No. 103—*Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*) until it has either been repaid or the policy is cancelled.

c. The interested parties recommended revisions to recognize a reduced and delayed liability for the funding amount. They recommended ignoring the funding agreement nature of the advances and only recognizing the next payment because the policy might be cancelled in the future. It was again noted that this is the equivalent of assuming a 100% lapse rate on the policies. This position is similar to setting up the liability for a single payment on a loan instead of the entire principal balance. This proposed revision was rejected as inconsistent with the existing guidance in SSAP No. 71 which requires full accrual of the funding agreement liability.

d. Interested parties' recommended revisions to add a new reference to *SSAP No. 52—Deposit Type Contracts* for the recognition of funding agreement liabilities. This was possibly an attempt to allow the funding agreement liability to be calculated using actuarial assumptions in the calculation of the liability. This would be inconsistent with SSAP No. 71 which does not allow discounting of such a liability.

e. Interested parties commented that "SSAP No. 71 is consistent in the application of persistency being part of the transfer of the risk (liability) to another party. If the lapse risk (persistency) is transferred to another party, the liability that the insurance company may

have is also transferred to that party and the insurance company has no liability." However, it was noted that guidance in Appendix A-791 on Life and Health Reinsurance identifies that lapse risk, which is an insurance risk, can only be transferred via reinsurance. The Working Group disagreed that insurance risk liabilities can be extinguished with a commission agreement with a noninsurance entity, which seems to be the position of interested parties.

f. It was also noted that because of the persistency feature in the funding agreement, interested parties' commenters were advocating to not recognize any commission expense in these arrangements until it is due to the third-party agent. Similar to other positions, this is the equivalent of a 100% lapse assumption. This assertion is not consistent with any other assertions reflected in the recognition of these insurance policies in their financial statements.

g. The Working Group did not support the comment by interested parties that under a levelized commission agreement another party is responsible for an insurer's acquisition costs. It was noted that statutory accounting requires acquisition costs to be expensed as incurred, not shifted to a non-insurance entity. Interested parties were asserting that even though a third party prepaid their acquisition costs that they do not have to recognize an accrual for the levelized commission funding agreement. This position was rejected by the Working Group. The Working Group affirmed that a funding agreement is not the same as traditional persistency commission. The Working Group affirmed the original SSAP No. 71 guidance that the substance of a levelized commission agreement is a loan.

45. The Working Group discussed the overall statutory accounting concepts of conservatism and consistency which require that statutory financial statements reflect assets available for policyholder claims with comparable financial information. It was noted that allowing delayed expense recognition of initial policy commission expenses will contradict both statutory accounting concepts, as assets will be included that are not available for policyholder claims (as they are needed for non-recognized commission expenses) and will result with financial statements that are not comparable to other insurance entities. Working Group members also expressed concerns with the competitive advantages that were occurring with companies that were employing these practices and stated a preference to have the guidance in effect in 2021.

46. After the discussion on November 12, 2020, the Working Group took the following actions:

a. The proposed effective date of January 1, 2021 was changed to be effective upon adoption, and revised text was added to explicitly state that the proposed revisions will apply to contracts in effect as of the date of adoption.

b. Determined that the revisions to SSAP No. 71 had met the due process for either a substantive or a nonsubstantive revision but concluded to keep the revision classified as nonsubstantive as the edits are in line with the original intent of SSAP No. 71. The Working Group reiterated that it is not the impact of a change on an individual entity that determines whether a change is substantive or nonsubstantive, but whether the revision is in line with the original intent of the SSAP. The Working Group noted that the proposed revisions to SSAP No. 71 are clarifications to the existing guidance consistent with original intent. Commissioner Donelon (LA) noted an objection to the classification as nonsubstantive.

c. Directed NAIC Staff to draft an Issue Paper to document the discussion on this topic for historical purposes.

47. On March 15, 2021, the Working Group discussed written comments received from six parties including the 1) Montana Commissioner (now U.S. Representative) Matthew M. Rosendale, Sr., 2) a former North Carolina Commissioner 3) National Council of Insurance Legislators (NCOIL), 4) Interested parties, 5) one capital management company, and 6) a national conglomerate insurer. The key points from comments were summarized and draft responses were provided in the hearing materials for the meeting.

a. Comments that there is no reason to change as current programs have been around for decades, been subject to external audits and insurance examinations and have not previously been noted of concern. (Montana commissioner, former North Carolina commissioner, capital company and the national conglomerate insurer).

i. Materials response **-** It was noted that identifying levelized commission transactions is difficult, without an in-depth review. When this was identified on a 2017 state examination, the reporting entity refused to recognize the full liability, which is why this issue was brought to the Working Group. The guidance to recognize the full liability amount for a levelized commission transaction has been a statutory accounting requirement since before 1998. This guidance is in place to recognize that the substance of an arrangement that has a third party pay an insurer's sales commission costs, is a loan. This is because a third party would not pay out large amounts of costs on another's behalf without an expectation of repayment.

b. Comments that the change is substantive based on impact and needs more study and review for unintended consequences. (Montana, former North Carolina commissioner, NCOIL, interested parties, the capital company and the national conglomerate insurer)

i. Materials response **-** As noted in earlier meetings, under the *NAIC Policy Statement on Maintenance of Statutory Accounting Principles*, it is not the impact of a change on an individual entity that determines whether a change is substantive or nonsubstantive. To the extent this is a clarification of existing guidance, the revisions are consistent with the nonsubstantive classification.

ii. Materials response **-** Agenda item 2019-24 has been under discussion since August 2019, and the March 2021 meeting will be the sixth public discussion of this item. This item has been discussed: 1) August 2019; 2) December 2019; 3) July 2020; 4) October 2020; 5) November 2020 and 6) March 2021. It was noted that the underreporting of commission liabilities appears to be a practice employed by only a very small number of reporting entities.

c. Comments that there can be a negative RBC impact. The former North Carolina Commissioner, NCOIL, and the capital company all noted concern with the potential negative impact to risk-based capital which will result with the revisions requiring companies employing the disputed practice to recognize the full funding agreement.

i. Materials response **-** Reporting previously unrecognized liabilities can have negative RBC impacts; this is why the adoption of the agenda item was delayed from year-end 2020. The delay was to allow the small number of reporting entities which are employing the disputed practice to have an opportunity to have discussions with their regulators. However, it is highlighted that the unrecognized liability also resulted with improved financial statements (and better RBC) than what should have been recognized based on actual operations.

d. Possible consumer rate increases on guaranteed renewable long-term care were noted by the former NC commissioner and the capital company.

i. Materials response **-** The disputed practice is underreporting incurred commission expense and the obligation to repay it to a funding agent. This financing activity is being used to delay / under report incurred commissions. However, the total commission cost is typically slightly higher as the funding agents charge a fee and

or interest (implicit or explicit) for their services. As such, the full financial statement impact is not as clear cut as implied in this comment.

e. Effective date comments were varied. NCOIL was against a 2020 effective date, however that comment appeared to be related to the prior October exposure. NCOIL also requested a delay for the issue paper and recommended a five-year phase-in. The interested parties and the national insurance conglomerate advocated for an effective date no sooner than December 31, 2021, to allow time to work with regulators, auditors etc.

i. Materials response **-** Effective Date - The Working Group discussed proposed language which allows a December 31, 2021, effective date.

ii. Materials response **-** Phase-in - This is viewed as a practice employed by a small minority of reporting entities, but the potential impact is material. Some Working Group members and some members of industry have noted the unfair competitive advantage that entities which employ this practice are receiving, because it underrepresents the incurred liabilities. Prior Working Group discussions have indicated that a phase-in would need to be a permitted practice granted by the domiciliary regulator.

f. Interested parties' comments asserted that lapse risk under the contracts had been transferred to a noninsurance entity, with the following comments "The existing SSAP No. 71 guidance is consistent in the application of persistency being part of the transfer of the risk (liability) to another party. If the lapse risk (persistency) is transferred to another party, the liability that the insurance company may have is also transferred to that party and the insurance company has no liability. Removing persistency as a factor in the accrual of commissions is a dangerous precedent. The differentiation between commissions based on real insurance risks versus payments based solely upon the passage of time in SSAP No. 71 goes directly to the risk transfer issue of one type of level commissions versus another. The proposed additional language eliminates this differentiation."

i. Materials response **-** Statutory accounting guidance in Appendix A-791 on Life and Health Reinsurance identifies that lapse risk can be transferred via reinsurance. Transferring lapse related liabilities with a commission agreement with a noninsurance entity, was not viewed as a viable option under statutory accounting. The long-standing guidance in SSAP No. 71 requires full accrual of the funding agreement liability even if repayment is not guaranteed.

ii. Materials response **-** Because of the persistency feature in the funding agreement, interested parties' commenters are advocating to not recognize any commission expense in these arrangements until it is due to the third-party agent. This is the equivalent of a 100% lapse assumption. This assumption would be inconsistent with any other assertions reflected in the recognition of these insurance policies in their financial statements. The overall statutory accounting concepts of conservatism and consistency require that financial statements reflect assets available for policyholder claims with comparable financial information. Allowing delayed expense recognition of initial policy commission expenses will contradict both statutory accounting concepts, as assets will be included that are not actually available for policyholder claims (as they are needed for non-recognized commission expenses) and will result with financial statements that are not comparable to other insurance entities.

g. Interested parties resubmitted some of the previously rejected proposed paragraph 4 revisions which seek to codify the industry position that funding agreements, which

incorporate contingencies linked to traditional elements, should not be treated as a funding agreement (i.e. excluded from liability recognition).

i. Materials response **-** The proposed revisions were not incorporated as proposed language seeks to codify the treatment which has previously been rejected as inconsistent with the guidance in SSAP No. 71.

h. Interested parties resubmitted some of the previously rejected proposed paragraph 5 revisions to replace most of the exposed paragraph with language that is less detailed and which seeks to codify the industry position that funding agreements which incorporate contingencies linked to traditional elements should not be treated as a funding agreement (i.e. excluded from liability recognition).

i. Materials response **-** The proposed revisions were not incorporated as proposed language seeks to codify the treatment which has previously been rejected as inconsistent with the guidance in SSAP No. 71.

i. Interested parties commented that the exposed language which describes funding agreements, is too broad. Notes a concern that interim pay downs are not mentioned.

i. Materials response **-** Additional guidance regarding interim payments to paragraph 5, were not added because liabilities are always reduced when paid. This is detailed in SSAP No. 5R and SSAP No. 103R.

48. Interested parties commented that, "The current revisions require the accrual of a liability in situations that are inconsistent with the guidance SSAP No. 5R. Under a levelized commission program a third party has the obligation for the full initial sales commission. The insurer's obligation under a levelized commission program that incorporates persistency should be accrued to the extent of legally contracted amounts owed. We do not believe the original intent of the SSAP required accruing for amounts that are not yet due and that may never be due. We strongly feel that the recognition of an obligation based on persistency is in accordance with the principles of SSAP 5R."

a. Materials response **-** The comment by interested parties indicates that under a levelized commission agreement another party is responsible for an insurer's acquisition costs. This is not appropriate as statutory accounting requires acquisition costs are expensed as incurred, not shifted to a non-insurance entity. The position of interested parties is that even though a third party prepaid an insurer's acquisition costs that the insurer does not have to recognize an accrual for the levelized commission funding agreement because in some situations such as future policy cancellation, the insurer might not have to pay. This is rejected as inconsistent with SSAP No. 71 guidance and inconsistent with SSAP No. 5R.

b. Materials response **-** SSAP No. 5R incorporates an obligation to recognize contingent amounts that are probable and can be reasonably estimated. The difference is that a levelized commission arrangement is repaying a loan where in most cases the advance of the loan amount has already been made. The loan has contingency elements that may allow the loan repayment to be reduced in the future. Until the policy is cancelled there is a presumption that the amounts will be repaid. This is different from making a future commission payment on commission that has not yet been earned which occurs under traditional persistency commission. The elements of a liability under SSAP No. 5R:

i. Current obligation to pay for a past transaction - the insurer has a contract to repay the funding agent (current obligation). The service that is being paid for is the selling agent's sale of the insurance contract (past transaction). The guidance in SSAP No. 71 provides that related interest payments for the financing charges do

not meet the definition of a liability until the passage of time for the interest has occurred. The insertion of a persistency element to the funding-agent funding agreement does not extinguish the entire pending liability. Such a liability would only be extinguished by payment or other legal release such as policy cancellation. The advance liability to the third party is for a past transaction- that is, the funding agent has paid commission to the direct agents for the sale of the policy.

ii. Payment probable of occurring - Payment of the obligation has to be probable of occurring. The only difference between the "persistency linked" funding arrangement and one where payment is guaranteed, is obviously the potential that principal will not be repaid due to lapse. However, the funding agents are not taking this risk without being compensated. The funding agreements are using a conservative estimate of expected lapses and factoring in a profit for the funding agent, hence the existing wording in SSAP No. 71 regarding interest explicit or implied. Therefore, a third-party funding agent would not be willing to provide financing if they did not think it was probable that they would have their full investment, plus a return on investment repaid. As such, the probable element of SSAP No. 5R is also met. The payment is probable and can be estimated and therefore meets the accrual requirements of SSAP No. 5R.

49. On March 15, 2021, the Working Group discussion included the following key points:

a. Mr. Bruggeman (OH) and Ms. Marcotte (NAIC) introduced agenda item 2019-24: Levelized and Persistency Commissions. The Working Group has been discussing this topic since August 2019 with this being the sixth public discussion. This agenda item was drafted in response to a specific state insurance regulator request to address an accounting practice identified during a financial examination. It was noted that a few insurers are utilizing a disputed practice by using third parties to pay policy acquisition costs, and they are not recognizing the full liability to repay those third parties. Not recognizing the full liability to repay the parties who are paying acquisition costs on an insurer's behalf is inconsistent with the guidance in *SSAP No. 71—Policy Acquisition Costs and Commissions.* SSAP No. 71, which has been in place prior to 1998, provides statutory accounting guidance and identifies such agreements as funding agreements, which require full liability recognition. Mr. Bruggeman stated that NAIC staff have provided a summary of comments received, which includes a response to each position. Accordingly, NAIC staff are not recommending additional modifications.

b. Commissioner Mulready (OK) inquired as to whether actions taken by the Working Group regarding this project would go through the complete NAIC committee process, including reporting to the Accounting Practices and Procedures (E) Task Force and the Financial Condition (E) Committee and review by the Executive (EX) Committee and Plenary. Mr. Bruggeman stated that due to the controversial nature of this topic, this agenda item will be specifically considered through all levels of the committee process.

c. Commissioner Mulready further inquired regarding the expense recognition and payment of cashflows for using a third party to pay policy acquisition costs compared to insurers who directly pay commission expense. Mr. Bruggeman stated that traditional life insurance policies typically have a larger commission in the first year the policy is written. Through the use of a third party, some insurers have used a levelized repayment plan, so the first-year commission is repaid over several years. Additionally, the immediate expense recognition for this first-year commission, as required under SSAP No. 71, is not being properly recognized by some insurers in the year of acquisition. As a third party has remitted funds on behalf of an insurer, the insurer needs to properly recognize the loan as a liability.

d. Commissioner Mulready inquired about lapse risk, which is a common element built into these financing agreements. Mr. Bruggeman commented that lapse risk cannot be transferred to a noninsurance entity; and SSAP No. 71 still requires the liability to be recognized, even if repayment to the third party is not guaranteed. Mr. Bruggeman further stated that by not recognizing the full commission financing liability, an insurance company is asserting a 100% lapse rate, which is not an appropriate assumption and not consistent with the reserving methodology used for these products.

e. Ms. Nettleton (Guggenheim) stated that levelized commissions are not a new concept. She noted that a 2010 U.S. Securities and Exchange Commission (SEC) complaint against another carrier notes that levelized commissions were common practice. She stated that the concept of persistency remains a concern, as Guggenheim believes expense recognition will occur earlier than has traditionally been required. She stated that Guggenheim feels it is a dangerous practice to remove persistency in the treatment of levelized commission. Mr. Bruggeman stated that the concepts regarding traditional persistency commission are not a part of the proposed edits, as this agenda item is to clarify that initial acquisition costs should not be deferred through the use of a funding agreement.

f. Mr. Stolte (VA) stated that in 1991, Virginia had an insolvency in which the company participated in a structure where it utilized a levelized commission financing arrangement and did not properly recognize a liability for the amounts paid by the third party. However, as the insurer was liquidated, the third-party financier sought reimbursement for commission amounts previously forwarded on behalf of the insurer. Mr. Stolte stated that the insurer had not recorded the full amount of the liability, and this overstated surplus. He stated that if these amounts due are not recorded, they are in essence off book, unrecorded liabilities. He stated that the concept of recognizing commission expenses when incurred has been a long-standing concept of statutory accounting, which was noted even prior to codification. He noted that acquisition costs are expensed as incurred upfront.

g. Commissioner Donelon responded that the insurer referenced by Mr. Stolte did a levelized commission practice; however, he perceived the accounting practice was fully transparent, and the $16 million amount of the off-balance sheet liability only represented a fraction of the $120 million insolvency. He stated that earlier exposures of this item, involved other large life insurers; however their earlier concerns appear to have been accommodated. He inquired regarding the nature of this accommodation. Mr. Bruggeman stated that this comment pertains to clarification involving true persistency commissions—i.e., subsequent year commissions—were not intended to be captured in the scope of levelized commissions revisions in SSAP No. 71. He said the initial revisions were perceived by the broader insurance industry as affecting traditional persistency commission and the Working Group subsequently clarified that that was not the intent of the revisions. Ms. Gann (NAIC) stated that SSAP No. 71 is a common area SSAP, so it is applicable to all insurer and product types. She stated that the intent of the SSAP No. 71 revisions is to capture initial acquisition costs and commissions from the issuance of a policy, not traditional persistency commissions that arise subsequent to initial commissions which are common in many insurance products.

h. Thomas B. Considine (National Council of Insurance Legislators—NCOIL) stated that NCOIL believes that the changes proposed are substantive in nature and the timing of an adoption is less than prudent, especially in light of the current economic environment. He noted that the revisions will have adverse capital consequences on some companies. Companies utilizing levelized commission structures have done so for decades, and in

conjunction with this requiring a significant financial impact, NCOIL would recommend a four or five-year phase-in of expense recognition. Mr. Stolte stated that in response to a multi-year phase-in request, insurers affected could request a permitted practice from their state of domicile. In doing so, a multi-year phase-in could be granted; however, the financial and capital impact could be appropriately disclosed. Mr. Considine stated that permitted practices are not viewed as favorably as uniform treatment, and this would not be a preferred solution.

i. Lynn Kelley (Delaware Life), on behalf of interested parties, stated that they do not agree with the proposed edits, and they believe the edits are substantive in nature. She stated that interested parties believe that their accounting practices have been in compliance with SSAP No. 71 and have been subject to numerous insurance exams and independent financial audits. If adopted by the Working Group, an effective date no earlier than December 31, 2021, is requested. She stated her support also for a multi-year phase-in.

j. Mr. Bridgeland (Center for Insurance Research—CIR), NAIC consumer representative, stated that the most important function of statutory accounting is to ensure solvency and a level playing field among similar insurers. He stated that an insurer’s financial statements should reflect capital available to pay policyholder claims and not permit off-balance sheet liabilities. Despite this requiring material adjustments to a few insurers, he stated that adoption was recommended to ensure that financial statements appropriately reflect an insurer’s financial position. He stated that if deferring the recognition of commissions is what is maintaining a company in the appropriate risk-based capital (RBC) range, then the company may warrant additional scrutiny for other areas as well.

k. Mr. Bruggeman stated that as the edits proposed do not change the original intent of SSAP No. 71, he views the edits as nonsubstantive in nature. He stated that the concept of requiring immediate expense recognition of initial acquisition costs meets the spirit of statutory accounting concepts, as well as the concept of conservatism as referenced in the preamble. Commissioner Donelon stated that he believes this issue to be substantive in nature, even if it is not in the technical accounting sense. He indicated that the reporting entity that contacted him indicated that it will not have a materially adverse impact on them. However, he has been told that there are reporting entities that will have a significant financial impact on some small companies, and it will jeopardize members of the ACLI and the National Alliance of Life Companies (NALC). He stated recommendation for grandfathering of existing practices or a multi-year phase-in of any recognition requirements. He stated his agreement with Mr. Considine that a permitted practice is not preferred. Mr. Smith stated that when referencing the definitions of substantive versus nonsubstantive in the *Accounting Practices and Procedures Manual* (AP&P Manual), the exposed edits are nonsubstantive in nature.

l. Commissioner Mulready stated that this practice has been in place for decades, and to classify this as nonsubstantive signifies to him that all prior insurance exams and independent audits are incorrect. Ms. Andersen (IL) stated that the proposed edits are only clarifying in nature, as they do not change the intent of SSAP No. 71. She stated that this practice has only been employed by a small number of insurance entities, and it results in liabilities that are not recorded in the financial statements. Mr. Stolte stated that commission financial arrangements are difficult to discover; in the prior insolvency example referenced, it was not until the company was in receivership that the issue was discovered. He noted that such arrangements create illusory surplus and violate the concepts of statutory accounting and audits do not review every single contract.

m. Mr. Bruggeman stated that nonsubstantive agenda items are generally effective immediately; however, due to the nature of this topic, it will need to be approved by the Accounting Practices and Procedures (E) Task Force, the Financial Condition (E) Committee, and the Executive (EX) Committee and Plenary. With the Executive (EX) Committee and Plenary not meeting until the Summer National Meeting, the earliest this adoption could take effect is likely the third quarter of 2021. Mr. Smith (VA) stated that due to the length that this agenda item has been discussed, they would support an immediate effective date. Ms. Belfi (CT), Mr. Fry (IL), Mr. Clark (IA) and Mr. Kim Hudson (CA) recommended a December 31, 2021, effective date. due to the likelihood of a significant financial impact combined with the requirement for adoption by the Executive (EX) Committee and Plenary. In an inquiry from Mr. Bruggeman, no Working Group member was opposed to a December 31, 2021, effective date, which is the effective date suggested by Delaware Life per the comments from Ms. Kelley.

n. As this agenda item directs that any adjustments be accounted for as a change in accounting principle under *SSAP No. 3—Accounting Changes and Corrections of Errors*, the effective date will not have a material impact, as any required cumulative adjustments calculated as of January 1, 2021, will impact unassigned funds (surplus). Mr. Bruggeman stated that upon adoption, insurers will be required to record a liability for outstanding amounts due to a third-party funding agent as a cumulative effect adjustment to surplus as of January 1. He noted that activities throughout the year after January 1 are recorded through income.

50. On March 15, 2021, the Working Group took the following actions with Louisiana voting in opposition.

a. Directed NAIC staff to update this Issue paper for March 2021 and subsequent actions to allow for future exposure. It was noted that the non-authoritative issue paper does not need to be adopted prior to implementation of the SSAP No. 71 revisions.

b. Supported an annual statement blanks proposal to provide a new general interrogatory to identify the use of a third party for the payment of commission expenses, which will be concurrently exposed with the Blanks (E) Working Group.

c. Adopted the exposed revisions to SSAP No. 71 with a December 31, 2021, effective date. The Working Group affirmed the nonsubstantive classification of these revisions as consistent with the original intent of SSAP No. 71.

51. On March 23, 2021, the Accounting Practice and Procedures (E) Task Force adopted the report of the Working Group. The Task Force conducted a separate vote on the SSAP No. 71 revisions. The motion passed with 41 in favor and the states of Louisiana and Oklahoma opposed.

52. Key aspects of the March 23, 2021, Task Force discussion are provided below.

a. Mr. Bruggeman provided an overview of agenda item 2019-24 regarding levelized commission, which affects *SSAP No. 71—Policy Acquisition Costs and Commissions*. He stated that the Working Group has been discussing this item since August 2019, when it was brought to the Working Group by a domiciliary state. Mr. Bruggeman stated that after six public discussions, the nonsubstantive revisions that clarify the guidance in SSAP No. 71 regarding levelized commissions were adopted on March 15, 2021, with a December 31, 2021, effective date. Thirteen Working Group members voted in favor of adoption, and one member was opposed.

b. Mr. Bruggeman stated that both U.S. GAAP and SAP would calculate acquisition costs in a similar manner. However, one of the major financial reporting differences between SAP

and GAAP is that GAAP capitalizes acquisition costs and expenses them over time to match revenue and expenses while SAP expenses policy acquisitions costs as incurred. Mr. Bruggeman stated that at the heart of this issue is that a small number of reporting entities are using third parties to pay their sales commission costs and not recognizing the full liability of what is in essence a loan to repay the third parties as required under SSAP No. 71. He said that the Working Group has had extensive discussion on this topic and has noted that the revisions clarify the long-standing principles in SSAP No. 71, which have existed since even prior to codification. He stated that the revisions were classified as nonsubstantive because the revisions emphasize the original principles regarding funding agreements and the impact to a minor number of companies do not determine the classification of the revisions.

c. Mr. Bruggeman noted that state insurance regulators and consumer representatives also voiced concerns about the illusory surplus and unlevel playing field such arrangements create. He stated that because of the unfair competitive advantages that are perceived, the Working Group was not in favor of grandfathering the practices. He noted that the Working Group did discuss that companies could have discussions with their domiciliary states regarding obtaining a permitted practice for phasing in the financial impact. because the impact to the affected companies may vary.

d. Louisiana staff stated that Commissioner James J. Donelon could not attend the meeting, but he wanted his comments that this is a substantive change noted and also that he is in favor of a phase-in period. Oklahoma staff also noted that Oklahoma also supports the comments from Louisiana.

e. Ms. Kelley (Delaware Life) stated that their position is also that the revisions are substantive and that they appreciate the time that the Working Group has spent discussing this issue even if not all of the edits they submitted were incorporated. She also stated support for an effective date at least as late as December 31, 2021.

f. Elly Nettleton (Guggenheim Life and Annuity) highlighted two points from their prior comment letters: 1) levelized commissions are not a new concept and date back several decades. She noted that a 2010 U.S. Securities and Exchange Commission (SEC) complaint against another carrier identified levelized commissions as a common practice in the industry. She said Guggenheim is not aware that the accounting treatment was determined not to be in accordance with statutory accounting principles; and 2) traditional commissions such as those tied to policy persistency are carved out of the proposals. Ms. Nettleton said Guggenheim believes it is a dangerous precedent to remove persistency as a factor in the accrual of commissions as it is a key insurance element. Mr. Bruggeman noted that similar comments as Ms. Nettleton's were made at the Working Group. He stated that the Working Group did hear the comments but did not agree with them.

g. Thomas Considine (National Council of Insurance Legislators—NCOIL) stated that NCOIL members feel strongly that the revisions are substantive but are willing to put that aside and do not feel the need to debate that classification again at this time. He stated that this is a practice that has been going on for decades. He stated that to implement this change during a period of great economic turmoil seems not only short-sighted, but also it is dangerous to require entities to make such a change in a period of a year. He stated that NCOIL recommends a significant phase-in period with a proposed effective date of December 31, 2025. He stated that a permitted practice does not reflect positively on the state granting the practice or the reporting entity receiving the practice. He stated that accreditation reviews note the permitted practices granted by a jurisdiction. He stated that

the most fair and equitable solution and a way to avoid the debate of change classification is to add a four- or five-year phase-in.

h. Mr. Bruggeman stated that funding agreements to levelized commission costs are not prohibited. He said the issue is that the full liability for the funding agreement must be recognized for the inherent loan. In other words, it is a financing arrangement; it does not delay the timing of recognition of the acquisition costs. He stated that a permitted practice may not have a positive perception. However, permitted practice disclosure requirements allow state insurance regulators to understand the surplus impact of the arrangement. He stated that a permitted practice provides transparency and noted that if there were any decisions to extend the effective date beyond December 31, 2021, there would need to be a disclosure of the impact. Ms. Walker (TX) agreed, noting that consistency, meaning the ability to compare reporting entities' financial positions, is a fundamental concept that statutory accounting is based on. She noted its importance for solvency regulation.

i. Mr. Considine noted that to address Mr. Bruggeman's point about state insurance regulators' information needs, he is confident that if there were a four- or five-year phase-in, legislators would be supportive of a reasonably tailored data call. Mr. Rehagen (MO) asked if Mr. Considine envisioned a confidential data call or one that would be publicly produced. Mr. Considine indicated he assumed if it were for the state insurance regulators, then such a data call would be confidential. However, he said NCOIL would be open to discussion. Mr. Bruggeman stated his intent was for a disclosure to be part of the public statutory accounting filing.

j. Mr. Stolte stated that the Task Force is discussing noncompliant statutory accounting by a handful of companies. He stated that in 1991, Virginia had an insurance receivership of a large life insurance company that had a deferred commission funding arrangement. He said that the insurer had not booked the liability, but when the company was put into receivership, the funding entity/financier filed with the receivership a request for payment of $16 million. He said that the reporting entity prior to the receivership was reporting $120 million in surplus, but true surplus ended up being approximately $4 million. He said he disagreed with the statement that what the handful of companies are doing is an acceptable SAP practice. He said it is noncompliance with statutory accounting in SSAP No. 71, and also with the statutory accounting guidance that existed even prior to codification. He said from a level playing field perspective, he does not want to be forced to approve such agreements for his companies to be able to compete with reporting entities employing this practice. He stated that not recording the full liability for the funding agreements creates illusory surplus. He stated that if a reporting entity needs more time to implement the revisions, a permitted practice is what should be employed. He noted that he received notification of more than 100 permitted practices in an average year. He stated that the permitted practices are designed to provide transparent disclosure for all state insurance regulators.

k. Mr. Considine stated that what Mr. Stolte is terming "noncompliance" has been accepted in the regulatory community for 20 years. He said if reporting entities have been doing so for 20 years, it seems unreasonable to require a change in one year. Mr. Stole said that in Virginia, they have not accepted such practices. He noted that there may be some that they were unaware of, but they do not view it as an acceptable practice. He stated that this has been noted as problematic in a formal examination report, and he respectfully disagrees with Mr. Considine's statement that it was an acceptable practice. Ms. Walker also noted that she has been a Texas state insurance regulator for 20 years and is not aware of any entities that are using funding agreements to defer the recognition of acquisition costs. She

noted that she would also take exception to doing so if it were identified in an examination or other regulatory review.

l. Mr. Bridgeland (Center for Insurance Research—CIR) stated support for the proposal as adopted by the Working Group. He stated that one of the top priorities for state insurance regulators was ensuring that the insurers are solvent. He stated that part of that is also ensuring that there is a level playing field. He stated that in this case, there are a handful of companies using a technique that, by their own admission, is enhancing surplus. He noted that as a consumer advocate, he does not want to see insurers have illusory surplus.

53. On April 13, 2021, the Financial Condition (E) Committee, adopted the revisions with 11 in favor and the three states of Mississippi, New Mexico, and South Carolina dissenting. The following key comments were part of the discussion:

a. Commissioner White stated that the last item on the agenda is an issue that has received a considerable amount of discussion within the Statutory Accounting Principles (E) Working Group over the last couple years. He stated that unlike the premium refund issue from 2020, where the Committee overturned the adoption of a position and suggested that the issue be redrafted, he does not believe that should occur for this particular issue. He stated that the reason for this was that it was his understanding that the vast majority of the life insurance industry is very much opposed to the practice that has apparently been used by what we think is a handful of companies. The reason being is they believe it gives those handful of companies an unfair competitive advantage over the rest of the industry that has been abiding by Statement of Statutory Accounting Principles (SSAP) No. 71—*Policy Acquisition Costs and Commissions* ever since its inception, as well as even dating back before at least the 1990s. He suggested that if the Committee does not adopt this item, his understanding is that it would force the Working Group to change the entire SSAP No. 71 to allow all commissions and related acquisition costs to be deferred and amortized over time. The reason this would be required is that is essentially what the handful of companies are doing today, while the rest of the industry expenses these costs at the inception of the contract in accordance with statutory accounting principles (SAP). Commissioner White summarized that this would require the Working Group to go back and basically adopt U.S. Generally Accepted Accounting Principles (GAAP) for this particular issue, even though this is one of the biggest differences between SAP and U.S. GAAP. He noted that even if the Committee adopts the issue, it still needs to be adopted by the Executive (EX) Committee and Plenary. He also noted that he already recommended that the Executive (EX) Committee and Plenary consider taking it up either at the Summer National Meeting or during an interim call of the Executive (EX) Committee and Plenary.

b. Ms. Walker noted that included in the materials is a document that provides an overview of the levelized commission agenda item 2019-24 from the Working Group, which modifies SSAP No. 71 through a clarification. She discussed how the Working Group began discussion on the issue in August 2019, and on March 15, 2021, the Working Group adopted nonsubstantive revisions illustrated at the end of the attachment, with an effective date of December 31, 2021. The Working Group vote was 13 states in favor and one state opposed. On March 23, 2021, the Accounting Practices and Procedures (E) Task Force adopted the Working Group’s revisions without modification. The vote was 41 members in favor and two opposed (Louisiana and Oklahoma).

c. Ms. Walker discussed that although U.S. GAAP and SAP calculate acquisition costs in a similar manner, one major financial reporting difference between the two is that U.S. GAAP capitalizes acquisition costs and expenses them over time to match revenues and expenses while SAP expenses policy acquisitions costs as incurred. This accounting treatment is in line with the SAP Statement of Concepts, particularly the recognition

concept. This concept specifically identifies that accounting treatments that defer expense recognition are not generally acceptable under SAP.

d. Ms. Walker noted that this agenda item was initiated because some reporting entities are using third parties to pay their sales commission costs without recognizing the full liability to repay the third parties, as required under SSAP No. 71. These entities have taken the position that their agreements are not funding agreements, as they pass on lapse risk to the third party. Ms. Walker discussed how the Working Group has noted that the revisions clarify the long-standing principles in SSAP No. 71, which have existed since even prior to codification. The nonsubstantive revisions emphasize the original principles that require full liability recognition for the commission paid on an insurer's behalf and any interest and fees incurred to date. Ms. Walker described how the Working Group noted that it is not permissible to pass insurance lapse risk to a non-insurance entity. Furthermore, as the commission is owed with the issuance of an insurance contract, the proper recognition shall continue to require recognition at the time the insurance contract is issued. Ms. Walker indicated that the Working Group confirmed that it is not permissible to utilize a third-party payer of sales commission as a means to defer recognition of commission expenses.

e. Ms. Walker described how if the agenda item is adopted, a small number of companies will have a material financial impact. She emphasized that because of the unfair competitive advantages that are perceived, and as the guidance is in line with the original intent of SSAP No. 71, the Working Group did not adopt grandfathering or transition provisions. She discussed how the Working Group has recommended that affected companies speak to their domiciliary states regarding potential permitted practices, as needed, for phasing in the financial impact. This approach was favored because the impact to the affected companies may vary, and it provides disclosure in Note 1 to ensure the comparability of all insurers with SAP. Ms. Walker noted that it is her understanding that most companies are not employing this practice and will not be affected by the agenda item's adoption.

f. Superintendent Toal (NM) suggested that the Committee should consider modifying the effective date from the current proposed year-end 2021 to year-end 2022. Ms. Walker stated that the Working Group had already delayed the effective date from its usual practice of effective upon adoption for nonsubstantive items such as this, but the Working Group wanted to allow time for domestic states to work with any of their companies affected. She also described how a further delay was considered, but since the vast majority of the industry is complying, such a suggestion was rejected by the Working Group. Superintendent Toal questioned whether having less than six months allows enough time for companies to make the changes necessary. Commissioner Donelon repeated a comment that he indicated he has made in the past, which was that even though this was not a substantive change, the real-world impact to some companies was to the tune of hundreds of millions of dollars; therefore, grandfathering of the old contracts, perhaps on a phased-in approach, should be allowed. He described that he had been directed to some communication from the U.S. Securities and Exchange Commission (SEC) where this practice was identified as far back as 30 years ago. He described how such companies therefore may have been using this practice in good faith, or at least one they believed was appropriate, and they are being asked to record hundreds of millions of changes in surplus from this practice. He stated that for this reason, he and other commissioners have interceded in this process. Mr. Slape (TX) stated that the reference to SEC action may not be accurate, as he believes the facts indicate that the company was in worse financial condition after entering into these transactions. In essence, these companies are borrowing money, paying interest on that borrowed money, then competing against other companies that are following the current accounting requirements. Mr. Slape noted that this is not a

new issue; this is the first thing that a state insurance regulator learns about regarding the differences between SAP and U.S. GAAP.

g. Commissioner White indicated that everything he has been told is that this may have been taking place within a handful of companies, but that does not mean the state insurance regulators of those companies were aware of its existence in those companies. He described how this is not readable or identified in the financial statements since it is an unrecorded liability. He described how expensing these costs as incurred has been a bedrock principle within statutory accounting for years, even before SSAP No. 71 was adopted in 2001. He noted that he understands the argument for phasing in the impact, given that it could be material for some companies; however, the other side of that is the argument about the level playing field. He emphasized what Ms. Walker said earlier about affected companies working with their domestic regulator about a permitted practice, which is disclosed in Note 1 of the financial statements. Commissioner Donelon stated that he believes from his experience as a commissioner for so many years that the term "permitted practice" certainly comes with a negative connotation. He stated that for the companies he has heard from, the affected companies are unwilling to pursue a permitted practice. However, he stated his appreciation for the time that the Committee and its subsidiary task forces and working groups have given to this issue.

h. Mr. Galbraith (AR) asked if it is possible to determine definitively if there were just a handful of companies and also whether the practice will definitively cease with all companies going forward on the same level playing field if the proposed changes are adopted. Commissioner White stated that he has heard no evidence to the contrary that it was anything more than a handful of companies since he believes state insurance regulators would have heard from those companies that are affected, and he noted that he is aware of companies in only three states where this is an issue. He described how this is a difficult practice to identify since it is not recorded in the financial statements. He also stated that with the significant discussion, the industry appears to be very aware of the issue, and the vast majority of the industry is supportive of the clarification to have a level playing field.

i. Commissioner Mulready stated his support for the comments made by Commissioner Donelon, noting that his concerns have never been about the issue but rather the implementation. He stated his understanding that grandfathering may be difficult, but a delayed effective date, as suggested by Superintendent Toal, should be considered. Commissioner White responded that he believes that point was debated at the Working Group and the Accounting Practices and Procedures (E) Task Force. Commissioner Mulready noted that as a result of these discussions, Oklahoma had sent communication to all of its domestics to determine if other insurers are affected, and he suggested that he is sure other states are likely doing the same thing. Commissioner White stated his support for that practice, noting that it allows the domestic regulator to determine what is best for any affected companies. Wayne Goodwin, former North Carolina Insurance Commissioner, stated that he had previously submitted comments on this issue, noting slippery slope concerns with what could happen if it is implemented as quickly as is suggested since those concerns affect consumers. He stated his support for comments from Commissioner Donelon, Commissioner Mulready and Mr. Galbraith, and he noted concern about the potential impact on smaller carriers.

j. Superintendent Toal stated that he wants to be clear in the idea of moving to a level playing field, and he is not objecting to the policy, rather his objection was with the limited time to implement, particularly given that state insurance regulators do not know the number of companies affected. Commissioner White responded that his deputy refers to the issue that arises from this practice as illusory surplus, and if in fact there are millions in unrecorded

liabilities, that indicates information should be available to solvency regulators and indicates a level of concern. Ms. Walker stated that she believes this is a consumer protection issue, and her highest responsibility is ensuring that carriers can pay policyholder claims as they come due. She stated that when she hears some of the concerns that are being stated, as the domiciliary regulator, she needs the companies to come speak to her so that the two can work out a practice that takes care of consumers while considering the concerns of the company. She stated that the Accounting Practices and Procedures Task Force is trying to adopt some disclosures to gather information on companies, but that depends upon accurate completion by the company, something that may not occur given this particular accounting practice of expensing commissions as they are incurred, which is a fundamental bedrock of statutory accounting that differs from other standards. She noted that there was discussion of trying to obtain more data on the companies using this practice, but the companies did not come forward to their state insurance regulator even though that was requested. So, while a complete scope is not known, the Working Group and the Task Force did not receive information from state insurance regulators that are on the Task Force or follow it. Ms. Walker also noted that the current proposed effective date of year-end 2021 is already a delay. Mr. Slape suggested that if this is going to have hundreds of millions of impacts on a handful of companies, that is illusory surplus, and that raises questions about the solvency of such insurers using this practice. Therefore, it could have an impact on this small number of companies.

k. Ms. Kelley (Delaware Life Insurance Company), on behalf of interested parties, stated that this is an issue that has been discussed for some time, and she appreciates the ongoing discussions of the Committee and NAIC staff that have worked with Delaware Life. She strongly advocated for additional time to work through this implementation because Delaware Life still believes there are unanswered questions with regard to the calculations. She stated that Delaware Life has advocated all along for an extended effective date. She stated that Delaware Life maintains that this is a substantive change and believes that it has applied SSAP No. 71 in good faith, with all prior financial statements subject to examination and audit. Mr. Corbett (Guggenheim Life and Annuity Company) stated that the accounting for levelized commissions has been presented as a solvency issue, whereby companies have unrecorded liabilities for future commission payments. If this is the case, the liability is deemed necessary for policyholder protection, so how would the Committee be comfortable with any persistency commissions being recorded over time when all insurers have policy experience to be used as a basis for estimating the liability for these future expected commission payments. Therefore, the obligating event, which is defined by one of three essential characteristics in *SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets*, has not occurred until the policy anniversary date. Mr. Corbett noted that paragraph 2 of SSAP No. 71, which contains no proposed modifications to the definition of a liability, determine when that liability has been incurred. The proposed changes to levelized commissions with a link to persistency are contradictory to paragraph 2. Commissions that are paid and earned according to persistency, which is a long-standing insurance element, should be treated in a consistent manner to ensure comparability among reporting entities. Guggenheim believes the proposed changes to SSAP No. 71 sets a dangerous precedence for the need to accrue for other liabilities for other predictable future expenses. Ms. Walker noted that the expense is incurred for the first year when the policy is written. So, even if the funding agreement allows the company to pay the sales agent in the future, that does not allow the company to defer expenses the first year of the policy. She stated that by deferring, and not recording the liability, and making the statement that it is not due until after the period is contrary and has a different assumption. The assumption that one does not have to book the liability until the policy is still in effect ignores the fact that the policy is currently in effect. As long as the policy is in effect, that amount will be

owed. Therefore, you are not to adjust the liability down until the policy lapses or is cancelled. Using a funding agreement simply changes the timing of when the payment is due and does not affect if there should be an expense. Mr. Slape said these are not persistency commissions because in those situations the agent is paid a commission in future years for when that policy stays in force. These are referred to as renewal commissions, and they are reported on the future anniversary date, but the first-year commission must be expensed immediately up front regardless of the existence of a funding agreement since that is a loan. Mr. Slape stated that he takes issue with the statement that these funding agreements provide for a persistency commission.

l. Roger Sevigny (Sevigny Consulting), as a former state insurance regulator, stated that what he keeps hearing is a lack of information, and he asked that the work be slowed down. Commissioner Donelon stated that with respect to the companies referred to, they are owned by wealthy owners and some of the largest insurers in the world . Commissioner White stated that the debate has been vigorous, and he reminded everyone that even if the Committee votes to adopt the proposal, it will still need to be considered by the Executive (EX) Committee and Plenary. at the Summer National Meeting or during an interim meeting before that date.

54. The revisions were adopted by the Executive (EX) Committee and Plenary on August 17, 2021, with 10 jurisdictions voting as opposed. The discussion primarily centered around whether to allow a one-year deferral of the effective date to December 31, 2022. The December 31, 2021, effective date was maintained.

RELEVANT STATUTORY ACCOUNTING

55. Existing guidance in *SSAP No. 71—Policy Acquisition Costs and Commissions.*

> 3. Contingent commission liabilities shall be determined in accordance with the terms of each individual commission agreement. Commission liabilities determined on the basis of a formula that relates to loss experience shall be established for the earned portion. Assumptions used to calculate the contingent commission liability shall be consistent with the terms of the policy contract and with the assumptions made in recording other assets and liabilities necessary to reflect underwriting results of the reporting entity such as retrospective premium adjustments and loss reserves, including incurred but not reported.
>
> 4. Levelized commissions occur in situations where agents receive normal (non-level) commissions with payments made by a third party. It is intended, but not necessarily guaranteed, that the amounts paid to the agents by the third party would ultimately be repaid (with interest explicit or implied) to the third party by levelized payments (which are less than the normal first year commissions but exceed the normal renewal commissions) from the reporting entity. These transactions are, in fact, funding agreements between a reporting entity and a third party. The continuance of the stream of payments specified in the levelized commission contract is a mechanism to bypass recognition of those expenses which are ordinarily charged to expense in the first year of the contract. Consequently, the normal link between the persistency of the policy, the continuance of the premium payment or the maintenance of the agent's license with the reporting entity is not maintained with respect to the payment stream.
>
> 5. The use of an arrangement where commission payments are not linked to traditional elements such as premium payments and policy persistency, but rather are linked to the repayment of an advance amount requires the establishment of a liability for the full amount of the unpaid principal and accrued interest which is payable to a third party related to levelized commissions.

Effective Date

56. As issue papers are not represented in the Statutory Hierarchy (see Section IV of the Preamble), the subsequent consideration and adoption of this issue paper will not have any impact of the December 31, 2021, effective date of the nonsubstantive revisions adopted to SSAP No. 71 by the Working Group on March .

EXHIBIT A – Nonsubstantive Revisions to *SSAP No. 71—Policy Acquisition Costs and Commissions*

Statement of Statutory Accounting Principles No. 71

Policy Acquisition Costs and Commissions

SCOPE OF STATEMENT

1. This statement establishes statutory accounting principles for policy acquisition costs and commissions.

SUMMARY CONCLUSION

2. Acquisition costs are those costs that are incurred in the acquisition of new and renewal insurance contracts and include those costs that vary with and are primarily related to the acquisition of insurance contracts (e.g., agent and broker commissions, certain underwriting and policy issue costs, and medical and inspection fees). Acquisition costs and commissions shall be expensed as incurred. Determination of when acquisition costs and commissions have been incurred shall be made in accordance with *SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets*.

3. Contingent commission liabilities shall be determined in accordance with the terms of each individual commission agreement. Commission liabilities determined on the basis of a formula that relates to loss experience shall be established for the earned portion. Assumptions used to calculate the contingent commission liability shall be consistent with the terms of the policy contract and with the assumptions made in recording other assets and liabilities necessary to reflect underwriting results of the reporting entity such as retrospective premium adjustments and loss reserves, including incurred but not reported.

4. Levelized commissions occur in situations where agents receive normal (non-level) commissions with payments made by a third party. It is intended, but not necessarily guaranteed, that the amounts paid to the agents by the third party would ultimately be repaid (with interest explicit or implied) to the third party by levelized payments (which are less than the normal first year commissions but exceed the normal renewal commissions) from the reporting entity. These transactions are, in fact, funding agreements between a reporting entity and a third party regardless of how the payment to the third party is characterized. The continuance of the stream of payments specified in the levelized commission contract is a mechanism which attempts to bypass recognition of those expenses which are ordinarily charged to expense in the first year of the contract. Consequently, the normal link between the persistency of the policy, the continuance of the premium payment or the maintenance of the agent's license with the reporting entity is not maintained with respect to the payment stream.

5. The use of an arrangement such as a levelized commission arrangement where commission payments are not linked to traditional elements such as premium payments and policy persistency, but rather are linked to the repayment of an advance amount paid by a third party to the direct selling agents requires the establishment of a liability by the reporting entity for the full amount of the unpaid principal and accrued interest which is payable to a third party related to levelized commissions. Arrangements that use a third party to pay agents who write policies for the reporting entity and the insured can be an attempt to de-link the relationship between the insurer and those agents and defer or levelize the acquisition commissions. The insurance reporting entity is required to recognize the full amount of earned commission costs to the direct policy writing agents even if those costs are paid indirectly to the agents by a third party through the use of levelized commission, or similar arrangement, which is in substance a funding arrangement. Having a third party pay commission costs to the selling agent is strong evidence of a potential funding arrangement which shall be recognized as a liability because the substance of the arrangement indicates that repayment

is reasonable and probable, even if a contingency has been incorporated into the funding arrangement, until the underlying policy has been cancelled. A third-party structure cannot recharacterize (e.g. by referencing policy persistency) and delay recognition of liabilities for initial sales commission owed from the writing of policies regardless of how a third-party arrangement is structured with regards to the timing of payment from the insurer. The amount owed for full initial sales commission shall be recognized immediately as the writing of an insurance contract is the event that obligates the insurer, and such action shall occur consistently among insurers. As such, this recognition is required regardless of if the insurer owes a selling agent directly or if a third-party has been contracted to provide payment to the selling agent.

Relevant Literature

6. This statement rejects *ASU 2018-12, Targeted Improvements to the Accounting for Long-Duration Contracts*, *ASU 2010-26, Accounting for Costs Associated with Acquiring or Renewing Insurance Contracts, FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises, FASB Statement No. 97, Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*, and *Statement of Position 05-1, Accounting by Insurance Enterprises for Deferred Acquisition Costs in Connection with Modifications or Exchanges of Insurance Contracts..*

Effective Date and Transition

7. This statement is effective for years beginning January 1, 2001. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with *SSAP No. 3—Accounting Changes and Corrections of Errors*. The nonsubstantive revisions adopted March 15, 2021, regarding levelized commission are to clarify the original intent of this statement and apply to existing contracts in effect as of December 31, 2021, and new contracts thereafter.

REFERENCES

Relevant Issue Papers

- *Issue Paper No. 71—Policy Acquisition Costs and Commissions*
- *Issue Paper No. 16X—Levelized Commissions*

https://naiconline.sharepoint.com/teams/FRSStatutoryAccounting/Maintenance/Active Form A's/2021/IP No. 16x -19-24 Levelized comn DD Aug 26.docx

NAIC NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

150 1871 2021

Date: July 20, 2021

To: Dale Bruggeman, Chair, Statutory Accounting Principles (E) Working Group

From: Kevin Fry, Chair, Valuation of Securities (E) Task Force

CC: Carrie Mears, Vice-Chair, Valuation of Securities (E) Task Force
Charles A. Therriault, Director, NAIC Securities Valuation Office (SVO)
Marc Perlman, Managing Investment Counsel, NAIC Securities Valuation Office (SVO)
Julie Gann, Assistant Director, NAIC Financial Regulatory Services
James Pinegar, Manager II, NAIC Financial Regulatory Services

RE: Referral to the Statutory Accounting Principles (E) Working Group Requesting Comment on a Proposed Amendment to the P&P Manual to Direct the SVO to Rely on the Parent Entity Rating for Unrated Subsidiary Obligors in WCFI transactions

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1. **Summary -** The Valuation of Securities (E) Task Force is considering a policy change that would, in Part One of the *Purposes and Procedures Manual of the NAIC Investment Analysis Office*, direct the SVO, in regards to Working Capital Finance Investment (WCFI) transactions with unrated obligors, to rely upon the NAIC designation or the NAIC designation equivalent of a credit rating provider (CRP) rating of the obligor's parent entity, without notching for the subsidiary. However, under the policy, the SVO would expressly retains its right, in its sole analytic discretion, to notch the designation or choose not to assign a designation to a WCFI program for reasons unrelated to the relationship between the obligor and its parent. In Part Three the definition of WCFI "Obligor" would be revised to permit the SVO to follow this Task Force policy directive in Part One. I believe there is strong implied support from these high-quality parental entities for their unrated, non-guaranteed subsidiaries as obligors on these short-term WCFI transactions and such support should be recognized in NAIC designations. If the Task Force agrees and deems it essential that the SVO be able assign designations to WCFI transactions with unrated, non-guaranteed obligors, then this policy change will be adopted and impact how NAIC Designations are assigned to WCFI transactions.

2. **Referral** – Because NAIC Designations on WCFI program obligors may be impacted by this proposed policy change, the Task Force wanted to make the Working Group aware of the change and provide it with an opportunity to provide comments to Task Force members when they consider the proposal.

   Attached is the memorandum and the exposed amendment prepared by the SVO staff. Please direct any questions or responses to Charles Therriault and Marc Perlman of the SVO.

MEMORANDUM

TO: Kevin Fry, Chair, Valuation of Securities (E) Task Force
Members of the Valuation of Securities (E) Task Force

FROM: Charles A. Therriault, Director, NAIC Securities Valuation Office (SVO)
Marc Perlman, Investment Counsel, NAIC Securities Valuation Office (SVO)

CC: Eric Kolchinsky, Director, NAIC Structured Securities Group (SSG) and Capital Markets Bureau

RE: Proposed Amendment to the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (P&P Manual) regarding a possible Valuation of Securities (E) Task Force directive to the SVO to rely on unrated subsidiaries in WCFI transactions.

DATE: October 16, 2020 (Updated June 14, 2021)

1. **Summary** – The SVO has received comments by some insurers and other industry participants that it should assign NAIC Designations to issues of non-guaranteed, unrated subsidiaries of NAIC Credit Rating Provider (CRP) rated parent entities, based on implied support from the parent to the subsidiary. This topic is most relevant to Working Capital Finance Investments (WCFI) with unrated obligors which are wholly owned, but not guaranteed, by CRP rated parent entities. Without legally-binding support, such as a guarantee, parental support of a subsidiary is entirely discretionary and ultimately reliant on the best interest of the parent. The SVO contends that no generally accepted analytical technique or methodology supports the assumption that a parent entity will necessarily support its subsidiary in times of financial distress. The SVO has reached this conclusion based on its previous legal study of support obligations and on its examination of CRP methodologies and examples of parents not supporting subsidiaries.

2. **CRP and NAIC Methodologies** – Rating agencies are generally consistent in their approach to rating parents and subsidiaries. To give credit to one entity's relationship with another it is necessary to first determine the stand-alone credit profile of both entities and then to notch up or down based on various factors explained in the various rating agency methodologies[1]. These factors include, among others, determinations of the parent's willingness and ability to support its subsidiary (Moodys[2]), strategic importance and core versus non-core businesses (S&P[3]), and

[1] Fitch Ratings provides one exception to this general approach. Pursuant to Fitch Ratings methodology it is possible to rate a subsidiary issuer without standalone financial information or a parent guarantee when an issuer (subsidiary) had long-term public bonds outstanding at the time it was acquired by an acquiring company (parent). Fitch clarifies that this exception is not meant to be an alternative to its general parent-subsidiary linkage methodology, nor does it apply to new debt issues. ("Parent and Subsidiary Linkage Rating Criteria," Fitch Ratings, 26 August 2020.)

[2] "Rating Non-Guaranteed Subsidiaries: Credit Considerations In Assigning Subsidiary Ratings In The Absence of Legally Binding Parent Support," Moody's Investors Service, December 2003. Though originally published in 2003, Moody's maintains this article on its website.

[3] "Parent and Subsidiary Ratings," S&P Global, August 29, 2000. Though originally published in 2000, S&P Global maintains this article on its website.

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legal, operational and strategic ties between the parent and its subsidiary (Fitch[4]). Neither S&P nor Fitch directly addresses the question of whether an unrated, non-guaranteed subsidiary should or should not be assigned a rating based on implied support from its parent. Rather, they make the determination of stand-alone rating a key starting point for determining parent and subsidiary ratings, meaning a subsidiary for which they cannot determine a stand-alone rating would receive no benefit from its parent. Moody's, however, provides a persuasive explanation of the problems with implying a parent's support for its subsidiary in the absence of a legally-binding support agreement:

> During 2002, there were four instances[5] in which highly rated parent companies opted to maximize shareholder value by curtailing investment in wholly or partially owned subsidiaries that failed to produce or show any prospects of generating satisfactory returns on investment. As a consequence, the subsidiaries ultimately defaulted on their debt despite, in several cases, public assurances by the parent of continuing support given the ongoing strategic importance of the underlying subsidiary to its parent. While the subsidiaries ultimately defaulted, it should be noted that the cessation of funding weak non-return producing subsidiaries was ultimately a positive credit event at the parent level[6].

In its methodology Moody's draws on the empirical evidence of four examples of parents letting their respective subsidiaries fail, to demonstrate that non-legally binding promises of support are entirely discretionary and should not be the basis for a rating. Moody's further adds that in each of the four examples, "the parent company elected to discontinue support notwithstanding having: (1) made sizable initial and, in some cases, certain follow-on investments and (2) publicly articulated the 'strategic' nature and ongoing support for their subsidiary issuers."

Reliance on implied support of a parent for its subsidiary also conflicts with the "Credit Substitution" guidelines in Part Three of the Purposes and Procedures Manual of the NAIC Investment Analysis Office (the "Purposes and Procedures Manual") which were developed from a legal study of the enforceability of various types of support obligations. These guidelines plainly state that for the SVO to rely on the creditworthiness of an entity other than the issuer, a credit substitution instrument, such as a guarantee or letter of credit must be in place. The Credit Substitution guideline further align with Moody's methodology in that both distinguish between guarantees and non-legally binding support, such as comfort letters, keep-well agreements or other such statements of intended support. While guarantees, when consistent with the Purposes and Procedures Manual guidance, can allow for full credit substitution, comfort letters, by which an entity promises support of a limited kind to an affiliate or subsidiary, only allows the SVO to notch-up from the stand-alone NAIC designation of the issuer, and even then, only in limited circumstances. Moody's writes, ". . . the fact that some parent companies decided to discontinue investment in their subsidiaries after determining that such funding would fail to produce satisfactory return illustrates the low intrinsic value of non-legally binding support such as comfort letters, keep-well agreements, letters of moral intent, or verbal support."

The general rule among rating agencies that the strength of a parent can, at best, be used to *notch up the subsidiary's stand-alone rating* supports the similar approach found in the Purposes and Procedures Manual's credit substitution guidelines. This rule precludes the SVO from analytically deriving a designation for a subsidiary from its parent when the subsidiary has no stand-alone CRP rating or NAIC designation or for which the SVO cannot derive one.

3. Examples -

The following are examples provided by Moody's to support its determination not to imply a rated parent's support for its unrated, non-guaranteed subsidiary.

Decisions by the parents to cease support were based on the following:

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[4] "Parent and Subsidiary Linkage Rating Criteria" Fitch Ratings, 26 August 2020.

[5] BCE Inc.; AT&T Corp.; Verizon Communications, Inc.; and TXU Corp.

[6] Rating Non-Guaranteed Subsidiaries: Credit Considerations In Assigning Subsidiary Ratings In The Absence of Legally Binding Parent Support," Moody's Investors Service, December 2003

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• BCE Inc. decided after a review of strategic alternatives that the incremental investment required to support its subsidiary, Teleglobe Inc., to a self-sustaining status in the deteriorating long-haul telecommunications sector was very unclear, and therefore so was the likelihood of earning an adequate return on its marginal investment.

• AT&T Corp. decided not to make further marginal investments in its partly owned subsidiary, AT&T Canada Inc., (ATTC) likely because the facilities based competitive local exchange carrier (CLEC) business was unable to support existing debt levels. Moreover, regulatory pricing changes in 2002 did not make economic the reselling of the incumbent telcos' own networks by ATTC.

• Verizon Communications, Inc. made a decision to curtail further investment in Genuity Inc., a leading provider of enterprise IP networking services. Verizon opted not to exercise its option to acquire and reintegrate Genuity after reevaluating Genuity's growth prospects in light of the significant slowdown in IT spending and order rates.

• TXU Corp. discontinued financial support for its subsidiary, TXU Europe Ltd., despite publicly stating its willingness to do so, after determining that further funding of TXU Europe would not maximize shareholder value and recognizing that TXU Europe Ltd. was putting the ratings of its other subsidiaries at tremendous risk. TXU Europe's operations were hampered by the effects of increasing competition following deregulation of UK power markets, declining wholesale power prices, and contracts to purchase power at prices above market[7].

4. **Recommendation and proposed amendment** – The SVO is aware that some industry participants and certain regulators have a different opinion than the SVO on the likelihood of parental support for their unrated, non-guaranteed subsidiaries and think such implied support exists and should be recognized in NAIC designations. Therefore, if the Task Force deems it essential that the SVO be able assign designations to WCFI transactions with unrated, non-guaranteed obligors, the SVO offers the following proposed amendments to Part One and Part Three of the Purposes and Procedures Manual. Pursuant to the amendment the Task Force would, in Part One, direct the SVO, in regards to WCFI transactions with unrated obligors, to rely upon the NAIC designation or the NAIC designation equivalent of a CRP rating of the obligor's parent entity but authorizes the SVO, based on its analytical judgement and in its sole discretion, to notch such NAIC designation. In Part Three the definition of WCFI "Obligor" would be revised to permit the SVO to follow the directive in Part One. The following text in red shows the proposed revisions in Part One and Part Three.

[7] Rating Non-Guaranteed Subsidiaries: Credit Considerations In Assigning Subsidiary Ratings In The Absence of Legally Binding Parent Support," Moody's Investors Service, December 2003

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PART ONE

POLICIES OF THE NAIC VALUATION OF SECURITIES (E) TASK FORCE

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WORKING CAPITAL FINANCE INVESTMENTS (WCFI)

Description

116. As described in *SSAP No. 105R - Working Capital Finance Investment*s, WCFI represents a confirmed short-term obligation to pay a specified amount owed by one party (the obligor) to another (typically a supplier of goods), generated as a part of a working capital finance investment program for which an NAIC Designation is assigned by the SVO. Pursuant to the working capital finance investment program, this short-term obligation has been transferred by the entity entitled to payment (typically a supplier of goods) to a third-party investor.

Obligor

117. The Obligor for WCFI transactions is the party that purchases the goods or services that generates the original supplier receivable (which is the payable for that Obligor). The obligor must have an NAIC Designation of "1" or "2" or an ~~Eligible~~ NAIC Credit Rating Provider (CRP) Rating equivalent.

Unrated Subsidiaries

118. Many WCFI programs are structured in a way whereby unrated subsidiaries of a rated parent entity are involved as transaction participants, including as the Obligor. Such programs may have strong operational and strategic linkages between the rated parent entity and its unrated subsidiaries.

119. Given (i) the short-term (less than one year) payment terms of each of the underlying receivables arising from the sale of goods or services, (ii) WCFI investors' option to stop funding a working capital finance program, and (iii) the necessity of working capital finance programs to obligors due to obligors' reliance on their suppliers, the Task Force has concluded there is a low probability of default of WCFI investments. Accordingly, the Task Force deems it reasonable to establish a principle to direct the SVO, in its assessment of WCFI programs, to rely upon a parent entity's rating for purposes of determining the NAIC Designation of the overall WCFI program.

120. Solely for purposes of WCFI transactions, the Task Force directs the SVO to rely upon the NAIC Designation or ~~Eligible~~ NAIC CRP Rating equivalent of the obligor, subsidiary or affiliate's parent entity if~~:~~

~~a)~~ the obligor, subsidiary or affiliate does not have an ~~Eligible~~ NAIC CRP Rating and the SVO cannot assign an NAIC Designation to it~~, and~~

b) ~~each relevant obligor, subsidiary or affiliate constitutes a substantial portion of its parent entity's operations representing at least twenty-five percent (25%) or greater of the parent entity's assets, revenue and net income~~.

~~121. The Task Force authorizes the SVO, based on its analytical judgement and in its sole discretion, to notch such NAIC Designation based on factors including, but not limited to, whether:~~

~~a) the unrated subsidiaries or affiliates that serve as key transaction participants can reasonably perform the functions expected of them; and/or~~

~~b) the rated entity has documented operational control over the performance of the unrated subsidiaries or affiliates that also serve as obligors in the program; and/or~~

~~c) there is documentary evidence in the program documents or appended thereto that sufficiently demonstrates the importance of the inter-relationship between the rated entity and the unrated subsidiaries or affiliates.~~

122. For the avoidance of doubt, ~~while~~ though the Task Force directs the SVO to use the NAIC Designation or ~~Eligible~~ NAIC CRP rating equivalent of the obligor's parent entity, due to the SVO's authority to notch such NAIC Designation or rating, the SVO, based on its analytical judgement and in its sole discretion, may assign an NAIC Designation to the obligor which differs from the correlated ~~Eligible~~ NAIC CRP rating equivalent of the obligor's parent entity or choose not to assign any NAIC Designation to the working capital finance program, based on aspects of the working capital finance program which are unrelated to the relationship between the obligor, subsidiary or affiliate and its parent entity. ~~Also, for the avoidance of doubt, the SVO may, based on its analytical judgement and in its sole discretion, choose not to assign any NAIC Designation to the working capital finance program, based on other attributes of the working capital finance program which are unrelated to the obligor or its parent entity.~~

123. The Task Force acknowledges that reliance upon the NAIC Designation or ~~Eligible~~ NAIC CRP rating equivalent of the obligor's parent entity in the absence of a binding legal obligation for the parent to assume the financial obligations of the obligor, such as a guarantee, is not a generally accepted technique or methodology (as explained in "Use of Generally Accepted Techniques or Methodologies" in Part One of this Manual) and is inconsistent with the credit substitution guidelines detailed in "Credit Substitution" in Part Three of this manual, but it is directing the SVO to so rely.

NOTE: See "Working Capital Finance Investments" in Part Three for filing instructions, documentation requirements, definitions and methodology applicable to Working Capital Finance Investments.

PART THREE

SVO PROCEDURES AND METHODOLOGY FOR PRODUCTION OF NAIC DESIGNATIONS

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110. **Obligor** – An entity that purchases the goods or services from the Supplier and thereby generates the original supplier receivable—and which Obligor has, or can be designated, **NAIC 1** or **NAIC 2** by the SVO or has been assigned an equivalent credit rating by a NAIC CRP or, if not so designated, the SVO can imply such designation, as directed by the VOS/TF pursuant to the "Working Capital Finance Investments (WCFI)" section in Part One of this Manual.

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NAIC NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

150 1871 2021

Date: August 26, 2021

To: Kevin Fry, Chair, Valuation of Securities (E) Task Force

From: Dale Bruggeman, Chair, Statutory Accounting Principles (E) Working Group

RE: Referral Response: Unrated Subsidiary Obligors in WCFI transactions

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Summary – Pursuant to the referral received July 28, 2021, the Valuation of Securities (E) Task Force exposed a policy change that would direct the SVO to rely upon the NAIC designation of an unrated subsidiary obligor's parent entity for Working Capital Finance Investments (WCFI), without notching for the subsidiary. A referral was provided to the Statutory Accounting Principles (E) Working Group, as a qualifying NAIC designation of the obligor is a required element for admittance of WCFI receivables under *SSAP No. 105R—Working Capital Financial Investments.*

The Working Group has considered this exposure and acknowledges that establishment of NAIC designations is within the purview of the Task Force. However, the provisions within SSAP No. 105R were established in accordance with the historical approaches utilized in determining NAIC designations which allowed the SVO to apply its credit substitution methodology as it does for other asset classes. The proposed policy would require the SVO to imply an NAIC designation to an unrated entity based on the parent entity's credit quality without guarantees or other legally-binding provisions that provide assurance that the parent will be legally or contractually obligated to financially cover the obligations of the unrated entity. Although, for a given program, and not related to the parent/sub relationship, the SVO may notch or otherwise not give a rating to that program.

If the Task Force chooses to move away from the historical application of financial analysis and use of the credit substitution methodology in determining NAIC designations for WCFI programs, the Working Group may deem it necessary to incorporate additional guardrail provisions to SSAP No. 105R as the NAIC designation of the obligor may no longer provide the intended safeguard for WCFI programs. As WCFI are complex arrangements, the credit quality of the obligor – who is ultimately responsible for satisfying the debt owed to the insurance reporting entity – is of paramount importance. Furthermore, the referral and exposure documentation memo seem to understand this dilemma, as it specifically identifies that "no generally accepted analytical technique or methodology supports the assumption that a parent entity will necessarily support its subsidiary in times of financial distress." Consideration of changes that the Working Group would deem necessary, if any, would be expected to occur after any such edits to the P&P manual are adopted.

If the Task Force chooses to move forward with the issuance of "implied" NAIC designations to unrated entities for WCFI programs, the Working Group offers the following two components for additional consideration:

1. The exposed P&P Manual language seems to contradict with SSAP No. 105R, paragraph 7. Specifically, the Task Force language identifies that the implied approach is an alternative method to obtaining an NAIC designation. If the Task Force is going to permit an implied approach to an unrated sub, then to avoid conflicts with SSAP No. 105R, this implied designation would need to be considered an "NAIC Designation." If the guidance is adopted with the inconsistency, the guidance in SSAP No. 105R requiring an NAIC designation would be the authoritative guidance. Therefore, the Working Group would recommend coordination to address any inconsistencies.

2. Although the implied designation would need to be considered an "NAIC Designation" to satisfy the requirements of SSAP No. 105R, the Working Group recommends that NAIC designations determined under the implied methodology have a specific identifier so that WCFI programs with rated obligors and unrated obligors can be separately identifiable by state insurance regulators. This is considered necessary as without this identification, regulators could erroneously conclude that an unrated obligor has been individually determined to be of high-credit quality, or that the parent entity has guaranteed or is otherwise legally obligated to pay the obligations of the unrated entity.

The Working Group appreciates the referral from the Task Force and opportunity to provide comments. Please direct any questions or responses to the Chair of the Working Group, or NAIC SAPWG Staff.

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https://naiconline.sharepoint.com/teams/FRSStatutoryAccounting/National Meetings/A. National Meeting Materials/2021/8. August 10 - Reg Only/SAPWG response to VOSTF on WCFI - Unrated Subs (8-10-21DRAFT).docx