Statutory Accounting Principles (E) Working Group
Comment Letters Received

TABLE OF CONTENTS

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July 15, 2021

Mr. Dale Bruggeman, Chairman
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National Association of Insurance Commissioners
1100 Walnut Street, Suite 1500
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RE: Ref #2019-21 – SSAP No. 43R, Proposed Bond Definition

Dear Mr. Bruggeman:

Interested parties would like to thank the Statutory Accounting Principles Working Group (SAPWG) for the opportunity to comment on the proposed bond definition in Reference #2019-21 – SSAP No. 43R, Proposed Bond Definition (the "Proposed Bond Definition" or "Exposure"). Interested parties would also like to thank SAPWG for the opportunity to regularly provide input to regulators and NAIC staff as the Proposed Bond Definition was being more fully developed; especially the collaborative environment where open and honest dialogue was encouraged so that the nuances of a very complicated project could be properly addressed.

Overall, interested parties are supportive of the proposed principles-based Proposed Bond Definition. We believe it is flexible enough to accommodate the continued evolution of the bond market, while having safeguards that help prevent potential regulatory abuses. The Proposed Bond Definition does come with a cost to industry though, which is primarily driven by the requirement to analyze and document that certain bonds meet specific thresholds ("meaningful" and "sufficient"). It may be necessary to have practical accommodations upon adoption (i.e., transition requirements for existing investments in an insurer's investment portfolio) as it is our understanding the Proposed Bond Definition will require such analysis and documentation "as if" it was done when the bonds were issued. It may be difficult to do this "as if" analysis and documentation with bonds that were issued many years previously and/or where documentation is not available to perform such an analysis.

Interested parties would also like to address several areas of the Proposed Bond Definition where greater clarity may be needed and/or where we believe the requirements are too stringent. Interested parties will limit our comments to those we believe are substantive and will address several editorial comments directly with the SAPWG Working Group.

One item that may have escaped our full attention during the development of the Proposed Bond Definition relates to interest only and principal only strips. While we believe such investments generally qualify under the Proposed Bond Definition, it is unclear if such investments are an Issuer Credit Obligation (US Treasury Strips?) or Asset Backed Security (Mortgage Backed Security Strips?) as well as how the sufficiency criteria would apply to the latter when there are, or are not, agency guarantees. We intend to work with the SAPWG Working Group to get proper clarity on such investments.

The interested parties believe the examples in the Proposed Bond Definition are integral to applying it as well as providing a principles-based way of preventing perceived regulatory abuses such as ensuring legal form bonds, with in-substance equity-like characteristics, are not reported as bonds. Interested parties would like to provide three comments on these examples.

1) Example 1 of Appendix I prevents a legal form debt investment, that is required to be purchased with a pro rata share of an equity interest, from being a bond where there is a restriction on selling, assigning or transferring the debt investment without also selling, assigning, or transferring the pro rata equity interest to the same party. While the debt investment would have legal priority of payment over the equity interest, both interests are contractually required to be held in the same proportion by the reporting entity and cannot be independently sold, assigned or transferred, which only gives the reporting entity priority of payment over itself. The structure does not alter the risk profile in a way that results in different performance relative to if an investor were to just directly invest in the underlying assets. Therefore, the debt investment does not represent a creditor relationship in substance. Interested parties agree with this assessment but would like to emphasize that such investments will need to find a reporting home, other than Schedule D, Bonds, where the proper accounting of both the debt and equity interest is addressed. For such a situation where the underlying fund predominantly holds debt securities, it may also be appropriate that such investment, in total, be applied a bond-like risk-based capital charge.

   Similarly, accounting and reporting will need to be addressed for any and all debt investments that do not meet the Proposed Bond Definition, but that are recognized as bonds in the financial markets. For example, 1) debt instruments issued by funds, that are treated as bonds in the capital markets, but would be excluded from the Proposed Bond Definition under Example III of Appendix I or 2) non-agency mortgage-backed securities that are treated as bonds in the capital markets but would be excluded from the Proposed Bond Definition under Example I of Appendix II, and therefore would not be reported as bonds on Schedule D. We understand the SAPWG Working Group intends to address the accounting and reporting, and potentially an appropriate risk-based capital charge for these investments, and any other bonds that do not meet the Proposed Bond Definition. Interested parties would like to emphasize the importance of addressing them appropriately and reaffirm that we stand ready to offer our assistance.

2) As mentioned previously, interested parties believe the examples in the Proposed Bond Definition are integral to applying the new proposed definition and generally find them helpful. However, the sufficiency examples in Appendix II do not include an example for a more traditional ABS, such as a collateralized loan obligation (CLO). Interested parties believe such an example would be beneficial to the Proposed Bond Definition and are currently working on developing one. We plan to share this with the SAPWG Working Group and are hopeful it can be added to the Proposed Bond Definition.

3) Interested parties believe Examples I and II of Appendix I do a good job of delineating a principle-based solution for preventing in-substance equity-like investments from being reported as bonds on Schedule D. Example III, however, we believe needs to be amended to ensure that it does not affect well-structured debt investments from being reported on Schedule D as bonds.

   First, real world collateralized fund obligation debt instruments (CFO Debt Instruments), that are treated as bonds in the marketplace, are much more complicated and nuanced than the simplified example and interested parties have been challenged in applying the example to investments they own. For example, many CFO Debt Instruments are self-amortizing (in full or in part) and it is unclear if the following provision applies to the anticipated bullet maturity or total principal balance.

> "*Additionally, a debt instrument for which repayment relies significantly upon the ability to refinance or sell the underlying equity interests at maturity subjects to a point-in-time equity valuation risk that is characteristic of the substance of the equity holder relationship rather than a creditor relationship. Therefore, such reliance would preclude the rebuttable presumption from being overcome"*

Notwithstanding this lack of perceived clarity, many may interpret the phrase "relies significantly", that limits refinancing or underlying assets sales for repayment, to mean only approximately 10 – 20% of such repayment is allowed from these sources. We do not believe this is appropriate nor that it makes the CFO Debt Instruments equity-like. We note that this is apparently independent of overcollateralization and would treat CFO Debt Instruments the same whether they are 10x overcollateralized or 1x overcollateralized. It also seems to contradict the factors on the previous page where it says a reporting entity should consider the overcollateralization. We believe overcollateralization (and the other factors listed) should be evaluated collectively when making an equity-like determination rather than the seemingly hard and fast rule noted above.

This hard and fast rule also makes it equity-like if repayment substantially relies on refinancing. Interested parties agree that refinancing risk is an important consideration, but it typically is a determining factor in assessing credit quality as opposed to a factor in determining whether it is a debt security or an equity-like one. Interested parties believe that the credit quality of an investment will decline as the refinancing risk increases, but also believe that it should be eligible for Schedule D treatment, assuming the refinancing risk is commensurate with that of other debt securities.

The vast majority of debt in the private and public capital markets is structured as bullet maturities and it is universally accepted that the source of repayment typically is going to be from a refinancing event occurring at or near the time of the debt maturity. For CFO Debt Instruments, interested parties believe that it can also be acceptable to expect to be refinanced at maturity, but only if the expectation that the level of overcollateralization will remain at prudent levels such that a reasonable investor would be willing to refinance the maturity with replacement debt. The assessment of the debt's ability to be refinanced needs to take into account the expectation for the initial, ongoing and "at maturity" overcollateralization, as well as the other structural enhancements that are likely to benefit the investor refinancing the debt. There is further little substantive difference between refinancing risk for debt issued by a CFO when compared to debt issued by an SEC '40 Act Fund.

Lastly, interested parties have also noted investments where the debt is issued from a feeder fund, which in turn invests in another fund, that invests directly in debt securities. While we do not believe Example III is intended to prohibit such investments, interested parties believe further clarity on these arrangements is warranted as they could be construed to be debt backed by equity interests.

Interested parties are hopeful we can re-assess Example III of Appendix I with the SAPWG working group to provide both greater clarity as well as additional flexibility on whether debt backed by equity should be eligible for reporting on Schedule D as bonds.

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Thank you for considering interested parties' comments. Interested parties are committed to working with NAIC staff and SAPWG on this very complicated and important topic. If you have any questions in the interim, please do not hesitate to contact us or Mike Reis at michaelreis@northwesternmutual.com or 414-241-8293.

Sincerely,

D. Keith Bell Rose Albrizio

cc: interested parties

The Lease-Backed Securities Working Group

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: Ref #2019-21 – SSAP No. 43R, Proposed Bond Definition

Dear Mr. Bruggeman:

Our group, the *Lease-Backed Securities Working Group*, would like to thank the Statutory Accounting Principles Working Group (SAPWG) for the opportunity to comment on the proposed bond definition in Reference #2019-21 – SSAP No. 43R, Proposed Bond Definition (the "Proposed Bond Definition" or "Exposure").

As you know, our group has been working closely for over a year now with members of SAPWG as well as the Valuation of Securities Task Force (VOSTF) and the Securities Valuation Office (SVO) to clarify the appropriate accounting and reporting treatment for the class of investments we are most concerned with: Lease-Backed Securities, Credit-Tenant Loans and Ground Lease Financings. We believe that together we have arrived at the correct outcome for these securities, and we are deeply appreciative of the consideration we received from all the regulators, as well as the time and effort that was put in by all parties to achieve that goal.

With regard to the broader effort to update the definition and classification of bonds and asset-backed securities which is the subject of the current exposure, we agree with many of the comments which have been submitted by other interested parties. However, we would like to offer the following additional comments:

1.) As a specific matter, paragraph 2 of the exposure lists various securities which would fall into the category of "issuer credit obligations". Among others, these include:

    g. ETCs, EETCs, and CTLs *for which repayment is fully supported by a lease to an operating entity* (emphasis added).

    With regard to CTLs, although it is not explicitly stated here, we assume that the phrase "fully-supported" would extend to CTLs which meet the newly-revised definition in the P&P Manual: that is "Credit Tenant Loans" with a residual balance no greater than 5%.

2.) From a broader perspective, the current language in SSAP 43R, "Loan-Backed and Structured Securities", draws a clear distinction between "structured securities" and "loan-backed securities" -- which are "not included in structured securities" -- and "for which the payment of interest and/or principal is directly proportional to the payments received by the issuer from the underlying assets".

    These loan-and-lease-backed "pass-through securities" have long been accepted insurance company investments, as codified in SSAP 43R for many years. We believe that it is important not to lose this distinction between "pass-through" and "structured" securities, and we worry that the division of the universe of bonds neatly into "issuer credit obligations" and "asset-backed securities" (a phrase which does not seem to appear at all in the current version of 43R) may be confusing to the market.

This is especially true, as the phrase "Asset-Backed Security" is commonly used to refer to pools of assets which have been carved-up, or "tranched" into multiple securities, and for which the cash flows received by investors are not "directly proportional" to the payments flowing from the underlying assets.

This confusion is made worse by the requirement in Paragraph 3.b of the Exposure that in order to qualify as an "asset-backed security" an investment must include "*sufficient credit enhancement through guarantees (or other similar forms of recourse) subordination and/or overcollateralization*" [Paragraph 3.b].

The examples in Appendix II of the exposure seek to clarify the "sufficiency criteria" for credit enhancement for various types of bonds. The principal used is that credit enhancement needs to be "*sufficient to absorb losses similar to other debt instruments of similar quality*".

We believe that when this language is exposed, it will be both very confusing to market participants and difficult to implement in practice. This is because it conflates two concepts: credit quality and accounting classification. Who would bear the responsibility for determining: a) which debt instruments were of "similar quality", and b) the amount of credit enhancement "sufficient" to achieve a certain credit quality? These are highly subjective judgments for which the answers could vary from deal to deal based on the specific characteristics of each individual transaction. How would disagreements be resolved?

This language also runs the risk of making it appear that all "asset-backed securities" must be "structured securities" with an equity tranche, or "first-loss" piece – or otherwise, they would not qualify as "bonds".

While this may not have been the intent of the regulators, the current language seems to point in that direction. We would hope that as the process moves forward these important issues could be further clarified. In order for markets to function in an orderly manner, there need to be clear "guardrails" for both regulators and investors, and a clear distinction between accounting rules and standards, and credit quality.

We look forward to continuing the dialog we have established over the past year with the regulator community in clarifying the treatment of "CTLs", Lease-backed Securities, and Ground-Lease Securities, and we are grateful for the opportunity to comment on the current exposure.

Thank you for considering our comments,

JMGarrison

John Garrison
On behalf of *The Lease-Backed Securities Working Group*

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July 12, 2021

Mr. Dale Bruggeman
Chair, Statutory Accounting Principles (E) Working Group
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Ms. Fatima Sediqzad at fsediqzad@naic.org
Mr. Jake Stultz at jstultz@naic.org

Re: Proposed Definition of "Bond," issued May 20, 2021 (last updated May 26, 2021)

Ladies and Gentlemen:

I serve as Vice President and Chief Investment Officer of Pinnacol Assurance ("Pinnacol"), Colorado's state workers' compensation insurance fund. This advice represents Pinnacol's Comment to the Proposed Bond Definition (the "Definition") issued by the Statutory Accounting Principles (E) Working Group on May 20, 2021.

As you know, many insurers have statutory limits on the amount of "other invested assets" they can own— Colorado limits an insurer's "other invested assets" to 5% of the portfolio. Any "other invested assets" in excess of the 5% limitation cannot be considered "admitted assets" comprising part of the insurer's surplus but instead, will reduce that surplus dollar for dollar.

The reason all this is important is that Pinnacol has invested around $85 million in five separate rated note structures which are comprised of two parts. The first part represents loans made by the manager of the investment to various borrowers (which would seem to be characterizable as a Bond and not an equity interest). The second part represents an equity interest in the vehicle issuing the notes. The ultimate underlying investments in these strategies are comprised of private debt, which generates the cash flows to pay Pinnacol's returns on both the notes and the equity components.

According to the examples set forth in the proposed definition of "Bond," it appears that the existence of the equity interest (which cannot be traded separately from the notes) in the rated notes programs in which Pinnacol has invested would disqualify these investments as "Bonds." This would mean that Pinnacol would suffer a reduction in its surplus by at least $85 million.

The proposed definition of "Bond" suggests that whether an investment qualifies as a "Bond" is an all or nothing proposition-- if a structured rated note investment contains certain equity like characteristics, it will not be characterizable as a Bond, even though a significant portion of the investment represents a creditor relationship which otherwise would qualify as a Bond. Pinnacol believes a more reasonable approach (and one which better reflects economic reality) would be to allow insurers to characterize that portion of their investment which

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represents a creditor relationship as a Bond (and therefore, categorizable as an admitted asset constituting part of the insurer's surplus) with only the equity portion of the investment not being characterized as a Bond (and if in excess of 5% of the portfolio, not qualifying as an admitted asset). In other words, we suggest that the definition of a Bond recognize that portions of an investment may be characterized as a Bond while other portions may not. This bifurcation will better reflect the economic reality of each investment and protect insurer surplus from the dramatic dilution that otherwise will be experienced by adopting an "all or nothing" definition of Bond.

In conclusion, we contend that the Working Group's "all or nothing" approach to characterization of an investment as a "Bond" poses great harm to the industry and is not reflective of the fact that a significant portion of rated note structured investments are creditor relationships properly characterized as Bonds. Instead, we urge the Working Group to adopt a definition of Bond which at the very least, permits those portions of an investment which truly reflect a creditor relationship to be treated as a Bond.

Sincerely,

PINNACOL ASSURANCE

David L. Bomberger

David L. Bomberger
Vice President, Chief Investment Officer

cc: Mr. Joel Hornbostel
Jon Atkins, Esq.
Mr. Francis Rooney
Marc Lieberman, Esq.