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

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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.

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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).

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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.

<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 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.

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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.

B. **Consideration of Maintenance Agenda – Active Listing**

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.

ANY OTHER MATTERS

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.

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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
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 - PROPOSED BOND DEFINITION

Ref #	Title	Attachment #	Agreement with Exposed Document?	Comment Letter Page Number
2019-24 SSAP No. 26R & 43R (Julie)	**Proposed Bond Definition**	**3 – Agenda Item**	**Comments Received**	**IP – 1 LBSWG – 7 Pinnacol - 9**

Summary:
Pursuant to the direction from the Statutory Accounting Principles (E) Working Group in October 2020, a small group of regulators and industry met regularly to draft a bond definition for consideration. The intent of this project is to clarify what should be considered a bond (whether captured in *SSAP No. 26R—Bonds* or *SSAP No. 43R—Loan-Backed and Structured Securities*) and reported on Schedule D-1: Long-Term Bonds.

On May 20, 2021, the Working Group exposed a principles-based bond definition, along with a glossary and appendices with examples for application purposes. The exposure requested comments on the proposed bond definition but identified that comments on future developments (such as reporting changes, accounting and reporting guidance for items that do not qualify as bonds, transition guidance, etc.) could be submitted to assist in the development of those items.

In response to the May 20 exposure, the Working Group received three comment letters (interested parties, Industry Lease-Backed Securities Working Group and Pinnacol Assurance) as detailed within. The purpose of the August 26 public discussion is to consider those comments, but to also consider the future development of this project and whether the principles-based bond proposal provides the general framework that should be used to proceed with development of an issue paper and SSAP revisions. If electing to make this direction, it should be highlighted that all elements in the bond proposal are subject to continuous discussion and revision throughout the process but providing direction that the exposure reflects the intent of principle-based concepts that should be used as the basis for determining whether an investment is a bond, then NAIC staff will begin the next steps to incorporate these concepts into statutory accounting guidance. If the Working Group is not prepared to make that direction, consideration should occur for how to go forward with the overall project. (For example, should more exposure/review occur or should a different approach be considered.)

Expected Next Steps:
If the Working Group affirms the overall intent of the principles-based bond proposal, the next steps are expected to occur:

- Development of an issue paper and proposed SSAP revisions to incorporate the bond concepts.
- Development of SAP guidance that specifically details accounting and reporting for items that may fall out of Schedule D-1 reporting. (For example, this would specifically address equity tranches that are part of securitizations that should not be reported on Schedule D-1. This would also address structures that may in legal form appear to be bonds, but not in substance, and the SSAP that would capture these structures.)
- Development of reporting revisions to incorporate more granularity in Schedule D-1 reporting. This is expected to be a significant change to the existing Schedule D-1 reporting categories, as well as encompass a reconsideration of certain reporting fields (such as the code columns).

In terms of timeline, it is projected that the **earliest** that the entire package could be effective is January 1, 2024. (This would require adoption in May 2023 of the reporting changes through the Blanks (E) Working Group.) An earlier effective date (of Jan. 1, 2023) would require adoption in May 2022 (next year) of reporting changes, and that timeline is not viewed to be realistic due to the extent of revisions needed and discussions expected to occur.

Comment Letters Received:

Interested Parties' Comments:
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

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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.

Industry Lease-Backed Securities Working Group

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.

Pinnacol Assurance
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 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.

Recommended Action:

NAIC staff recommends that the Working Group explicitly affirm the direction of the exposed principle-based bond concepts and direct NAIC staff to utilize those concepts to develop an issue paper and proposed SSAP revisions.

With this direction, it is recommended that the Working Group repurpose the "43R small group" as a "43R study group" and request that additional regulators volunteer to participate as regular members. This group is anticipated to continue discussions and proposed guidance within the issue paper and SSAP. (If considering participation, this group is anticipated to likely meet for one hour on a weekly basis to discuss overall concepts, review proposed language and consider investment designs.)

With this explicit direction, it is noted that all elements of the principles-based bond proposal, and the reflection of those concepts in statutory accounting guidance, is subject to continued discussion and deliberation. Revised guidance for Schedule D-1 investment classification will not be considered authoritative statutory guidance until the specific effective date detailed in adopted authoritative SSAPs.

To address reporting entity questions on the classification of investments, the following is recommended:

- Until revised guidance is adopted and effective, reporting entities can continue reporting as they have been for items currently in scope of SSAP No. 26R or SSAP No. 43R.

- With regards to equity tranches of securitizations: If reporting on Schedule D, unrated equity tranches should be self-reported as NAIC 6 with a measurement method of lower of cost or fair value. If an entity prefers, can move the equity tranches to Schedule BA as an "Any Other Class of Asset" and report at fair value. Tranches from securitization structures are considered in scope of SSAP No. 43R, therefore qualify as admitted assets. It is anticipated that these equity tranches will not be eligible to be reported as bonds on Schedule D-1 under the bond project, and entities that have previously reported as bonds may wish to proceed with reporting on Schedule BA.

The comment letters are included in Attachment 4 (12 pages).

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