Statutory Accounting Principles (E) Working Group
Hearing Agenda
July 18, 2022
10:00 a.m. – Noon (Central)

ROLL CALL

Dale Bruggeman, Chair	Ohio	Judy Weaver	Michigan
Kevin Clark/Carrie Mears, Co-Vice Chairs	Iowa	Doug Bartlett	New Hampshire
Sheila Travis	Alabama	Bob Kasinow	New York
Kim Hudson	California	Melissa Greiner/Matt Milford	Pennsylvania
William Arfanis/Michael Estabrook	Connecticut	Jamie Walker	Texas
Rylynn Brown	Delaware	Doug Stolte/David Smith	Virginia
Eric Moser	Illinois	Amy Malm/Elena Vetrina	Wisconsin
Stewart Guerin/Melissa Gibson	Louisiana		

NAIC Support Staff: Julie Gann, Robin Marcotte, Jim Pinegar, Jake Stultz, Jason Farr

Note: This meeting will be recorded for subsequent use.

REVIEW of COMMENTS on EXPOSED ITEMS

The following items received comments during the exposure period that are open for discussion.

1. Principles-Based Bond Definition and Draft Issue Paper

Ref #	Title	Attachment #	Agreement with Exposed Document?	Comment Letter Page Number
2019-21 (Julie)	**Principles-Based Bond Definition and Issue Paper**	**1 – Bond Definition 2 – Issue Paper**	**Comments Received**	**1 – Interested Parties 9 – Industry LBSWG**

Summary:
On March 2, 2022, the Working Group exposed an updated principles-based bond definition along with an initial draft issue paper to document discussions and decisions for a public comment period ending May 6, 2022.

Comments on the exposed documents were received from interested parties and the industry 'Lease-Backed Securities Working Group' (LBSWG). In summary, the interested parties' comments provided specific elements to consider for focused areas of the bond definition. While NAIC staff agrees with most of the overall comments, the proposed resolution may be different than the recommendation proposed by interested parties. For the LBSWG, the comment letter requests a fundamental reconsideration of key aspects of the principles-based bond definition. Their comments reflect positions previously communicated by this small industry group considered and were deemed not in line with the intent of the bond definition. Further discussion on both sets of comments is detailed within.

Interested Parties' Comments:
Interested parties appreciate the opportunity to comment on the exposed Principles-Based Bond Definition (the Proposed Bond Definition) and Draft Issue Paper that were released for comment by the NAIC Statutory Accounting Principles (E) Working Group (the Working Group).

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Interested parties believe this effort is resulting in a workable and high-quality bond definition and we look forward to our continued collaborative effort as the project proceeds toward finalization. Interested parties also would like to commend NAIC staff for a well thought out and documented Draft Issue Paper.

The interested parties' comments are organized in two sections – 1) Comments on the Proposed Bond Definition and Draft Issue Paper and 2) Comments on the Specific Questions Posed in the Draft Issue Paper.

Comments on the Proposed Bond Definition and Draft Issue Paper

1) Interested parties suggest a slight modification to paragraph 2a, on page 2, of the Proposed Bond Definition. While interested parties are supportive of proposed edits to include U.S. Treasury Inflation-Indexed Securities in paragraph 2a, we do not believe the following subscript is appropriate or warranted.

   > *The inclusion of U.S. Treasury Inflation-Indexed Securities identifies these securities as an explicit exception to the principles-based bond definition that prohibits securities from being reported on Schedule D-1 that have variable principal or interest due to the underlying equity appreciation or depreciation, or an equity-based derivative.*

   Interested parties believe U.S. Treasury Inflation-Indexed Securities are more accurately adjusted for inflation rather than adjusted for "underlying equity appreciation or depreciation, or an equity-based derivative."

2) Interested parties believe a small change is need on Page 2, paragraph 2g of the Proposed Bond Definition, to be consistent with both regulator intent, and current practice, related to loan form CTLs, that would otherwise be reported on Schedule B, Mortgage Loans, under SSAP No. 37. Paragraph 2g, as written, is only inclusive of security form CTLs which excludes certain loan form CTLs currently permitted to be reported on Schedule D in guidance adopted by the NAIC during 2021. Specifically, interested parties propose the following changes (underlined) to paragraph 2g:

   > Investments in the form of securities for which repayment is fully supported by an underlying contractual obligation of a single operating entity (e.g., Credit Tenant Loans (CTLs), Equipment Trust Certificates (ETCs), other lease backed securities, Funding Agreement Backed Notes (FABNs), etc.). For purposes of applying this principle-based concept, repayment is fully supported by the underlying operating entity obligation if it provides cash flows for the repayment of all interest and at least 95% of the principal of the security. In addition, mortgage loans in scope of SSAP No. 37 that qualify under a SVO structural assessment are in scope of this statement as CTLs.

3) Interested parties note there is new language included within paragraph 3b, on page 3, of the Proposed Bond Definition. Interested parties agree with what we believe to be the intent (i.e., close a potential "loophole" related to equity backed securities). We therefore propose the following technical edit (underlined) to ensure it is not potentially interpreted more broadly:

   > For clarification purposes, all returns from an equity backed ABS in excess of principal repayment are required to be considered as interest. Therefore, investments with "stated" interest and then "additional returns" to which the holder of the debt instrument is entitled are collectively considered as interest and shall be assessed together in determining whether the investment has variable principal or interest due to underlying equity interests.

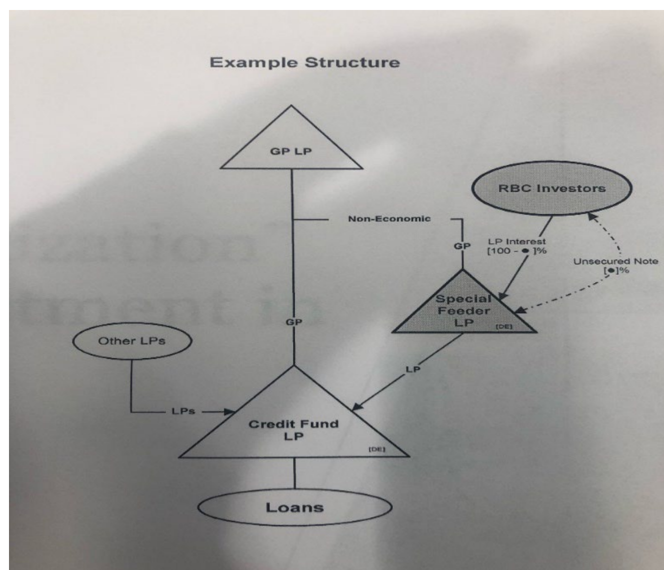
4) Interested parties propose the following changes (underlined) to the Substantive Credit Enhancement Language included within the glossary of the Proposed Bond Definition. The proposed changes are meant to clarify that there could be a first loss tranche, owned by an insurer, where there is a substantial credit enhancement that still qualifies the first loss tranche for Schedule D reporting (e.g., a Single Asset Single Borrower (SASB) CMBS security with substantial overcollateralization). For example, a SASB could be collateralized by a single real estate asset (e.g., $100 collateral value) where the loan being collateralized is only a fraction of the collateral value (e.g., $60). In such an instance, the first loss tranche security may be owned by an insurance company, but the first loss position is borne by the sponsor (i.e., the first $40 of losses). Interested parties believe the below proposed edits will help provide clarity for such a security, or other similar securities, and is consistent with the spirit of the proposed principles included therein.

   The first loss ~~tranche~~ position ~~(or tranches if the first tranche is not itself substantive)~~ may be issued as part of the securitization in the form of debt or equity interest, or it may be retained by the sponsor and not issued as part of the securitization. If the first loss ~~tranche~~ position (or a more senior position(s), if the first loss position(s) lack a substantive credit enhancement) is issued as part of the securitization, and does not have a substantive credit enhancement and is held by a reporting entity, the accounting should follow the guidance applicable to the type of instrument (i.e., debt vs. equity); however, regardless of the type of instrument, it does not qualify as a Schedule D bond and should be reported on Schedule BA.

   Additionally, interested parties question whether the accounting (highlighted above) for Schedule BA Assets should be codified within the Substantive Criteria of the Bond Definition. In principle it doesn't seem appropriate there and it may also conflict with, or add confusion around, any accounting guidance determined to be appropriate for such assets (see interested party comments in section 2 of this letter).

5) Interested parties note that "feeder funds" were a focal point of discussions during development of the Proposed Bond Definition. In large part, this was in the context of the "stapling" concern, which was de-escalated, as residual tranches have been moved to Schedule BA with the desire of regulators to assess appropriate capital charges. The below is a representative structure of a feeder fund, structured for various legal reasons, which we understand is not viewed as problematic. To ensure the Draft Issue Paper is wholly inclusive of discussions held on feeder funds, and further clarify the principle-based approach, we suggest the following language, and example structure, be included in the Draft Issue Paper. An appropriate spot might be right after paragraph 26.

   The assessment of equity backed securities should be looked at, not only in form, but in substance. For example, a feeder fund arrangement where the debt is issued from the feeder fund, that has an equity interest in another fund that holds debt instruments, should not be viewed as holding one equity interest (i.e., in this case a pass-through entity) if the substance is the debt is backed by debt instruments. Similarly, if the "credit" fund were an "equity" fund, backed by equity interests, the debt of the feeder fund would have to meet the requirements of paragraph 26 while looking at the substance of equity interests supporting the debt. Of course, such an arrangement would have to meet the other relevant parts of the standard (e.g., have a substantive credit enhancement, etc.). Substance over form should be the determining factor in these and similar situations.



6) Interested parties note that examples 1 & 2 of Appendix I are less explicit, as they have evolved over time, than the examples in Appendix II. For example, example 2 has many variables and really doesn't address a specific debt instrument, rather it lays out principles. Using a specific security in the example would not be particularly helpful as there are too many variables and any one example would therefore be of limited use. Interested parties therefore suggest the standard might have better flow if examples 1 & 2 become codified as part of the standard itself, with potentially minor edits for purposes of flow only. Instead of referencing Appendix 1, in paragraph 1, it might make sense to codify these examples at the end of paragraph 1. The end of paragraph 3 would potentially be another area to embed these principles within the standard itself. If regulators agree that there is value in this suggestion, interested parties would be more than willing to work with regulators and NAIC staff in that regards.

7) Interested parties note that paragraph 67 of the Draft Issue Paper includes a concept that is not in the Proposed Bond Definition, and which interested parties do not recall being discussed in any meaningful way. Therefore, interested parties question the appropriateness of its inclusion in the Draft Issue Paper. The stated concern appears to be "to allow for full assessment of the extent of ABS by regulators." The proposed solution is to remove all such investments from within the Scope of SSAP No. 2R, *Cash, Cash Equivalents, Drafts and Short-Term Investments*. Interested parties believe a less disruptive solution would be to just disclose, or have a separate reporting line, of any ABS short-term investments (e.g., ABS Commercial Paper) on the Short-Term investment schedules. If there is a broader concern that regulators feel needs to be addressed, interested parties believe that should be a separate project, as it appears outside of the Proposed Bond Definition Project, and should be addressed separately and therefore not included in the Draft Issue Paper for the Proposed Bond Definition.

Comments on the Specific Questions Posed in the Draft Issue Paper

Paragraph 105 of the Draft Issue Paper notes that it is anticipated that guidance will be drafted to recommend the use of Schedule BA for most investments that do not qualify as bonds under the Proposed Bond Definition, with comments requested in three areas. Interested parties' comments are immediately following each of the three questions asked and enumerated below:

1) Are there investments that will not qualify as bonds that should be considered for reporting on a different schedule other than Schedule BA? Comments on key investment characteristics that would appropriately distinguish these investments are requested.

   Interested parties have not identified anything to date, that will not qualify as a bond under the Proposed Bond Definition, for which we have identified an alternative reporting schedule to Schedule BA.

2) For investments that are captured on Schedule BA, should consideration occur to permit an amortized cost approach rather than a lower of cost or fair value measurement? For investments in which an amortized cost approach is supported, what characteristics can be used to identify / support this measurement method? Should use of NAIC designations be permitted to drive the Schedule BA measurement method for these securities?

   Interested parties note that there are likely investments that do not qualify as Schedule D, Bonds (e.g., non-agency guaranteed pass-through mortgage-back securities) that are not considered bad investments (i.e., they are considered good investments, by both interested parties and regulators, just not appropriate as bonds on Schedule D). Further, in the case of non-agency guaranteed pass-through mortgage-backed securities, the securities are not considered bonds because they have no substantive credit enhancement, which therefore are akin to mortgages that have a designated reporting schedule. While this example, in theory, could be reported on the Schedule B – Mortgage Loans, it may not be practical to report them on Schedule B because Schedule B RBC formulas would need to substantially be revised. Further, revisions to SSAP No. 37 would be necessary since securities are not permitted as mortgage loans. The question implies that the default measurement method on Schedule BA would be lower of cost or fair value, which itself seems to imply they are "bad" investments. Interested parties therefore recommends taking a close look at this assumption for all investments that may have to be reported on Schedule BA simply because they do not meet the definition of a bond under the Proposed Bond Definition. For example, specifically related to non-agency guaranteed pass-through mortgage-backed securities, like mortgages, amortized cost seems to be the appropriate accounting.

   In addition to amortized cost, fair value or lower of cost or fair value may be appropriate in other situations. For example, fair value may be appropriate for equity-linked bonds as they exhibit equity like characteristics. Lower of cost or fair value may be appropriate for Principal Protected Notes, if regulators believe lower of cost of fair value appropriately captures the non-payment risk they have identified as a concern.

   Also, as noted in the "feeder fund example", and previously discussed in this letter, the "residual tranche" is in a limited partnership form. In general, limited partnership interests are accounted for under the equity method of accounting, and subject to impairment. It may be that such accounting is determined to be appropriate in this instance. If not, interested parties would like to discuss with regulators and NAIC staff any distinctions which may need to be made when a limited partnership interest is a residual tranche or the equity component of a SSAP No. 48/97 investment that issues debt.

   Lastly, interested parties are very supportive of the SVO's outstanding exposure, and shared (with interested parties) objective, on designating additional Schedule BA assets, that exhibit fixed income characteristics, with the goal of obtaining commensurate risk-based-capital charges. With that said, interested parties do not necessarily see the connection for having NAIC designations drive the measurement method (accounting) of investments on Schedule BA.

   SSAP No. 26R *Bonds* includes in its scope debt instruments issued by Certified Capital Companies (CAPCOs). As defined in INT 06-02 *Accounting and Reporting for Investments in a Certified Capital Company*, CAPCOs are state legislated venture capital firms for which investors who invest cash to acquire an equity interest or qualified debt instrument receive state premium tax credit or income tax credit.

As currently exposed, the Proposed Bond Definition will continue to include debt investments in CAPCOs in the scope of SSAP No. 26R. Therefore, it is expected that these investments will continue to be reported on Schedule D as bonds.

This question has also raised a question on debt investments whose returns are earned solely through federal tax credits – should they be reported on Schedule D since these investments are similar to debt investments in CAPCOs?

For example, there is a program referred to as the New Markets Tax Credit (NMTC) program whose goal is to stimulate regeneration of low-income and impoverished communities across the United States. Capital raised by NMTC programs is used to drive expansion of investment, job creation and economic opportunities in distressed communities. The NMTC program provides federal tax credits to reporting entities that invest in the development entities which make direct investments in these communities. An investor is required to make a debt and equity investment into the development entity. We believe that debt investments in this program are akin to debt investments in CAPCOs. The only differences of which we are aware is that CAPCOs benefit from state tax credits whereas NMTC programs benefit from federal tax credits and CAPCOs do not require investors to also make an equity investment. Some of the similarities between CAPCOs and NMTC programs are as follows:

1. **Fixed schedule for one or more future payments** – The schedule and timing of tax credits to be earned is fixed from day 1. In addition, the par amount of the notes is paid back in cash upon maturity of the deal.

2. **Return is based on tax credits** – The return on NMTC investments is earned solely through tax credits. Similar to CAPCOs, where there is usually no cash interest earned on the debt investment, NMTC deals do not pay cash interest.

3. **Significant premiums** – These investments are purchased at significant premiums. Premiums are amortized pro-rata throughout the life of the deal in proportion to the tax credits earned.

4. **Operating entity guarantee** – It is common for debt investments in these deals to have a guarantee by an operating entity such as a financial institution. The guarantee would ensure that if the tax credits do not emerge, the investor gets its investment back.

Based on these similarities, we believe that debt investments in NMTC programs and other similar programs should also qualify for Schedule D reporting. Interested parties would like to discuss these investments with regulators and NAIC staff as to whether they qualify for Schedule D reporting and/or if specific language should be added to paragraph 2.k.iii with CAPCOs.

3) Revisions are also expected to SSAP No. 2R, to address the ABS restrictions, as well as SSAP No. 103R, to clarify that only beneficial interests that qualify as ABS will be accounted for under SSAP No. 43R. Comments are requested on whether other SSAPs will also be impacted and need to be revised.

Please see our comments above related to SSAP No. 2R on ABS restrictions. In relation to any changes to SSAP No. 103R, interested parties think this potentially relates to proposed changes being drafted in SSAP No. 43R, which are not part of the Draft Issue Paper, and believe it is appropriate to see such proposed changes prior to commenting. It may be appropriate to develop the accounting guidance for securities discussed in question 2 above and/or securities not meeting the substantive criteria of the Proposed Bond Definition (see also the interested party response 4 in section I of this comment letter). It may be appropriate to include this guidance in another SSAP such as SSAP No. 21, *Other Admitted Assets*.

One further comment relates to adoption of the standard, specifically as it relates to the meaningful and/or substantive credit enhancement requirements, which require stepping back in time "as if" one was looking forward at that time. Upon adoption, this could require looking back for a considerable period, perhaps decades. It may be

necessary, for example, to allow an insurance entity to use hindsight in instances in which assumptions in a prior period are unobservable or otherwise unavailable and cannot be independently substantiated. Interested parties would like to continue discussions with regulators on this topic which, while discussed, the issue of a "practical expedient" was never fully discussed through to full resolution.

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 exposure Reference #2019-24 – SSAP No. 26R & 43R, Proposed Bond Definition (the "Proposed Bond Definition" or "Exposure") as well the attached Statutory Issue Paper No. 1XX (the "Issue Paper").

We fully support the attempt to clarify the accounting standards for bonds and structured assets, and we appreciate the immense effort that has gone into this project by both the regulators and various industry groups. While we believe much work remains to be done, our group looks forward to assisting in any way we can as this project continues to evolve. We also anticipate the opportunity to comment on the draft revisions to the two SSAPs when the language is submitted for exposure later this year. At this point, we are limiting our comments to several 'high-level' observations:

In particular, we worry that the designation of *some* simple unstructured single-borrower securities backed by secured loans as 26R "issuer credit obligations" and *others* as 43R "asset-backed securities" will cause confusion in the markets and will result in inconsistent filing by insurance company investors.

Our group was involved over twelve years ago when investments were originally separated between 26R and 43R. At that time, a decision was made -- which we did not agree with -- that even simple un-structured single-borrower securities should be included in 43R, along with "structured securities", if they had been issued by a trust or SPV. For that reason, it was determined that 43R would include "Loan-Backed *and* Structured Securities" ("LBASS"). However, as the Issue Paper notes, that decision led to confusion in the markets as "many insurers had different interpretations of the adopted 2010 revisions."

This is because market participants distinguish between two basic types of transactions, based on the source of the credit:

1.) Simple unstructured debt transactions where the credit depends primarily on the contractual obligation of *a single rated-credit payor*. These transactions may either be "unsecured" or "secured" by a lien on an asset. If issued in security form by a Trust or special-purpose issuer, the cash flows from the underlying loan are simply "passed-through" unaltered to investor, and the credit risk of the securities is identical to that of the underlying loan.

    and

2.) "Asset-Backed" or "Structured Securities" where the credit of each security is not based fundamentally on the credit characteristics of the underlying collateral -- which is typically unrated -- but instead is determined by the "structure" that has been imposed on the transaction, & which fundamentally alters the cash-flows to investors. In these transactions, determining the "credit" of each security depends on a detailed analysis of the structure.

For this reason, the 2010 revisions were confusing to market participants, and many, assuming that 43R was meant to be for "structured securities", continued to file simple single credit-based transactions under SSAP 26R. Other investors filed anything issued by an SPE Trust -- even if backed by a single loan to a single borrower -- under 43R. This led to inconsistent filing of transactions.

Seeking to address this confusion, the current Proposed Bond Definition seeks once again to clarify for investors which types of transactions should be reported in scope of 26R (now to be designated as "issuer credit obligations")

and which fall more properly into 43R, (now labeled as "asset-backed securities") -- or even potentially what types of investments would not be admitted as "bonds" under either Schedule and would be have to be reported on Schedule BA, "Other Admitted Assets".

This determination would be made first based on whether the issuer was considered to be an 'operating entity' or an SPE "ABS Issuer". If the transaction was determined to be issued by an "ABS Issuer", there would be a second distinction based on the degree of "asset risk" implicit in the transaction. Those with very little "asset risk" could still qualify as an "issuer credit obligations"; while those with higher exposures, would be either designated as "asset-backed securities" -- or even potentially was as "non-bond" BA assets. For simple secured loans, "asset risk" would be measured by the size of the unamortized residual or final "balloon" payment supported by a lien on the asset -- as a proportion of the original principal balance.

The implied concept behind this framework seems to be that being secured by a lien on an asset implies a level of "equity risk" for the lender. We disagree, for several reasons:

> As every lender knows, having a lien on an asset does not convey an "equity" or ownership interest in that asset.
>
> The lien securing the loan is in almost all cases represents a "first priority" claim on the asset, and the final payment secured by that lien is typically only a fraction of the total estimated value of the asset at the maturity of the loan. The correct metric for assessing the risk of that priority claim is the size of the claim relative to the value of the asset (and the predictability of that value), not the size of the final payment as a proportion of the total loan. Determining this risk is an essential part of the credit analysis that all secured lenders -- and rating agencies -- undertake, and is definitely not equivalent to the risk associated with owning the asset outright.
>
> From an accounting standpoint, the only proper time to assign "equity risk" to a lender is when the lender becomes the owner of the asset, via foreclosure or otherwise depending on the terms of the credit agreement.

The result of applying this framework is that *some* simple secured single-borrower loans such as those listed in 1.) above -- even if issued by an SPV Trust or "ABS Issuer" -- would now be designated to be "issuer credit obligations" while *others* would be "asset-backed securities" -- or, depending on the degree of "asset risk", even potentially BA assets:

> *Some* simple secured transactions supported by cash flows from a non-financial asset via a lease or other form of contract with the credit payor -- for example, project finance loans or municipal lease-revenue bonds -- even if they were issued as securities through a "trust" or "SPV" by an "ABS Issuer" -- would now be re-classified as "issuer credit obligations" *regardless of the size of the residual asset exposure in the transaction.*
>
> *Other* identical structures, i.e. loans secured by leases to corporate entities, equipment trust certificates, funding agreement notes, etc. would ***either*** be classified as "issuer credit obligations" ***or*** "asset backed securities" depending on the amount of residual "asset risk" in the transaction. Those with minimal residual asset exposure (less than 5%) would now qualify as "issuer credit obligations". Those with higher exposures would be designated as either "asset backed securities" or even, depending on the size of the exposure, potentially as Schedule BA assets. (That determination would depend on the specifics of each individual transaction.)

Those secured loans designated as "asset backed securities" would have additional credit requirements regarding "credit enhancement" and the demonstration of a "meaningful" level of cash flows to service the debt (if supported by "non-financial assets" - see below) -- requirements which would not apply to those designated as issuer credit obligations.

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This framework is bound to create confusion for investors and lead once again to inconsistencies and errors in reporting. The confusion is made worse by the two additional requirements for a transaction to qualify as a Schedule D-1 asset backed security:

The first requirement is that in order to qualify as an asset-backed security, a transaction must benefit from "Substantive Credit Enhancement" sufficient to place the holder of the debt "*in a different position than if the holder owned the ABS Issuer's assets directly*". (Paragraph 41 of the Issue Paper states that "To qualify as a bond under this standard, there is a requirement that there are *substantive credit enhancements* <u>*within the structure*</u> *that absorb losses before the debt instrument being evaluated would be expected to absorb losse*s.) [emphases added]

To begin with, the determination of "expected losses" is a subjective determination which is an essential part of credit analysis, not an accounting distinction.

More fundamentally, there are many simple secured loan transactions where the issuer of the securities (the ABS Issuer) has no equity or ownership interest in the asset being financed. In these transactions the "asset" held by the issuer is the loan itself, a financial instrument that unambiguously represents a "creditor relationship" with the borrower, not an equity interest. In these simple "pass-through securities", there is no intervening structure and the cashflows from the underlying loan are simply passed-through *unaltered* to the holders of the securities. In other words, the holder of the securities is in *exactly* the same position "as if it owned the ABS Issuer's assets (underlying loan) directly". While this may not be the intent of the drafters, interpreted literally, it would disqualify all simple pass-through secured loans as ABS securities -- and implicitly, as bonds.

The second requirement to qualify as an "asset backed security" is that those deals secured by "cash-generating non-financial assets" must demonstrate a "meaningful" source of cash flows for the repayment of the bond (i.e.: other than through the sale or re-financing of the assets). However, as the exposure itself admits, determining what constitutes a "meaningful" source of cash flows is once again subjective, depending largely on the specifics of each individual transaction, requiring numerous "examples" to serve as guidance, but no firm metrics.

<u>**Industry LBSWG Conclusion:**</u>

Secured lending is as old as lending itself, and does not represent a new or exotic innovation. Simple secured loans, even if issued in security form by a trust or SPV -- allowing investors to participate *pari-passu* in the underlying loan -- have long been accepted insurance company investments, as codified in SSAP 43R for many years -- and indeed before that, as 26R "bonds".

While in one sense every secured loan issued in security form can be considered an "asset-backed security", this not the common understanding in the market. The term "Asset-Backed Security" is broadly used by market participants (including the SEC and organizations such as SIFMA) to refer to "structured securities": pools of assets which have been carved-up, or "tranched" into multiple securities, and for which the payments received by investors are not "directly proportional" to the payments flowing from the underlying assets.

The current version of 43R states clearly that it covers both "loan-backed" and "structured" securities. (It appears that the term "asset-backed security is not used in the current 43R.) If the current terminology is dropped, and some simple secured loans are now to be designated as "asset-backed securities", we feel it is important that additional language be added to the standard making it clear that they are not subject to the same requirements as "structured securities" -- the most common use of the term "asset-backed securities".

Our group continues to believe that a much clearer division between the two SSAPs, 26R and 43R – one which would avoid much of the ambiguity in the current Exposure – would be to assign *all* single-credit payor/single obligor transactions – whether secured or unsecured – to be in scope of SSAP 26R as "issuer credit obligations". This would allow for SSAP 43R to be used exclusively for true *structured securities*, where the credit is not based

on the underlying loans or assets – which are frequently not rated entities – but instead credit is determined by the structure of the transaction.

This reflects the common understanding in the market, which draws a fundamental distinction between simple (i.e.: unstructured) debt relying primarily on the creditworthiness of a single rated-credit payor, and "structured securities", where the credit has been modified through the introduction of multiple classes of securities, each with its own credit characteristics, and where the underlying cash flows have been altered by the structure, thus putting investors in a different economic position from having direct credit exposure to the underlying loans or assets backing the transaction (the most common use of the term "Asset-Backed Securities").

If the current framework is adopted, we would suggest that additional language needs be supplied to 43R making it clear -- as does the current version of 43R -- that it covers simple secured loan-backed transactions as well as "structured securities".

We thank you for the opportunity to offer these comments, and are happy to answer any questions or discuss our comments further with the regulator community.

NAIC Staff Review of Industry Comments:

1) *Interested Parties – US TIPs:*
   Interested parties propose to remove the footnote that details the inclusion of U.S. TIPs as an explicit exception to the variable return guidance. The interested parties' comments indicate that U.S. TIPs are adjusted for inflation and not "underlying equity appreciation or depreciation, or an equity-based derivative."

   > *The inclusion of U.S. Treasury Inflation-Indexed Securities identifies these securities as an explicit exception to the principles-based bond definition that prohibits securities from being reported on Schedule D-1 that have variable principal or interest due to the underlying equity appreciation or depreciation, or an equity-based derivative.*

   Interested parties believe U.S. Treasury Inflation-Indexed Securities are more accurately adjusted for inflation rather than adjusted for "underlying equity appreciation or depreciation, or an equity-based derivative."

   In reviewing these comments, NAIC staff does not oppose deletion of the footnote, but highlights that reference to U.S. TIPs is explicitly included in the discussion of structured notes currently captured in SSAP No. 26R, paragraph 2c. In that current reference, U.S. TIPs are excluded from being considered a structured note because even though they can be impacted by an underlying linked variable, they are protected from a risk of principal loss. (Although returns can be increased with inflation adjustments, they do not have a risk of original investment / principal loss.) **Rather than delete the footnote as recommended by interested parties, it is recommended that a revised footnote clarify the distinction of why TIPs (which are adjusted by inflation) are included in scope of SSAP No. 26R.** U.S. TIPs have previously been captured within industry disclosures for structured notes (as the investment incorporates a risk of an underlying variable), and as structured notes are not anticipated to be captured within scope of SSAP No. 26R, the explicit exception language was intended to clarify that TIPs are in scope of SSAP No. 26R.

   The comments have assisted with identifying that the depreciation and appreciation of referenced non-equity assets (such as real estate or artwork) could be used as mechanisms to adjust contractual principal and interest for debt instruments, as the definition only has an explicit reference to "equity interests." This could inadvertently open the door to structures that were not intended to be captured as bonds. To ensure the principle concepts of the bond definition are maintained, revisions have been proposed to revise the US TIPs footnote,

as well as to clarify that bond definition for variable contractual principal and interest payments also includes referenced non-equity assets. The language intends to continue to permit variable interest, which is common in debt instruments.

Item 1 - NAIC Staff Recommendation: Revise the U.S. TIPs footnote and clarify the bond definition:

Proposed Revisions to Footnote 2

The inclusion of U.S. Treasury Inflation-Indexed Securities ~~identifies~~ clarifies that securities with plain-vanilla inflation adjustment mechanisms are not intended to be captured within the provisions that restrict bond classification to securities that have principal and interest payments that vary based on appreciation or depreciation of an underlying referenced variable. Inflation adjustment mechanisms are considered plain-vanilla if it is based on a widely recognized measure of inflation and excludes those that involve either leverage (such as a multiplier) or an inverse adjustment relationship. As detailed in paragraph 3b, securities that have principal and interest payment variations due to valuation changes of a referenced variable (such as the appreciation of equity or real estate cause variations of changes in the principle or interest of a security structure) are intended to be precluded from bond treatment under the principles-based bond definition. ~~these securities as an explicit exception to the principles-based bond definition that prohibits securities from being reported on Schedule D-1 that have variable principal or interest due to underlying equity appreciation or depreciation, or an equity-based derivative.~~

Proposed Revisions to Bond Definition paragraph 3b:

The holder of a debt instrument issued by an ABS Issuer is in a different economic position than if the holder owned the ABS Issuer's assets directly. The holder of the debt instrument is in a different economic position if such debt instrument benefits from substantive[1] credit enhancement through guarantees (or other similar forms of recourse), subordination and/or overcollateralization. ~~In instances where the assets owned by the ABS Issuer are equity interests, t~~The debt instrument must have pre-determined principal and interest payments (whether fixed interest or variable interest) with contractual amounts that do not vary based on the appreciation or depreciation of any underlying collateral value or other variable~~the equity interests~~. For example, an issued security that has varying principal and interest payments based on the appreciation of referenced equity, real estate or other variable is precluded from bond treatment. Plain-vanilla inflation adjustments (such as with U.S. TIPs) are not captured within these appreciation or depreciation adjustment exclusions and therefore are not excluded from bond classification. (For clarification purposes, all returns from an ABS in excess of principal repayment are required to be considered as interest. Therefore, investments with "stated" interest and then "additional returns" to which the holder of the debt instrument is entitled are collectively considered as interest and shall be assessed together in determining whether the investment has variable principal or interest due to underlying ~~equity interests~~ referenced variables.) See Appendix II for examples illustrating the evaluation of the sufficient criteria.

2) *Interested Parties – SVO-Identified Credit Tenant Loans*

Interested parties have recommended a minor change to the proposed bond definition to include reference to SVO-Identified Credit Tenant Loans (CTLs) as bonds. Although it is correct that SVO-Identified CTLs are explicit inclusions to Schedule D-1, SVO-Identified CTLs are not bonds. These investments are mortgage loans, and specifically do not qualify as a security structure.

Although there is explicit guidance proposed to capture SVO-Identified CTLs in scope of SSAP No. 26R, these items will be additions to the investments that qualify under the bond definition. These investments will be

[1] The term "substantive credit enhancement" is defined in the Glossary.

referenced similarly to SVO-Identified Bond ETFs and certificates of deposit that exceed 1 year to be specifically scoped into Schedule D-1 reporting. The draft language proposed for SSAP No. 26R includes the following:

> In addition to security investments that qualify under the principles-based definition as issuer credit obligations, certain specific instruments are also captured in scope of this statement:
>
> a. Certificates of deposit that have a fixed schedule of payments and a maturity date in excess of one year from the date of acquisition;
>
> b. Bank loans that are obligations of operating entities issued directly by a reporting entity or acquired through a participation, syndication or assignment;
>
> c. Debt instruments in a certified capital company (CAPCO) (INT 06-02)
>
> d. Exchange Traded Funds (ETFs) that qualify for bond treatment as identified in the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* and included in the 'SVO-Identified Bond ETF List' published on the SVO's webpage. (These instruments are referred to as SVO-Identified Bond ETFs.)
>
> e. Mortgage loans in scope of *SSAP No. 37—Mortgage* Loans that qualify under an SVO structural assessment and are identified as SVO-Identified Credit Tenant Loans.

Item 2 - NAIC Staff Recommendation: Although the SVO-Identified CTLs are proposed to be captured in SSAP No. 26R and Schedule D-1, these items are specifically scoped in rather than qualifying under the principles-based bond definition, which only applies to investments meeting the definition of a security. The proposed language from interested parties will not be incorporated, however the language in paragraph e shown above is anticipated to be retained and reflect that qualifying CTLS will be in the scope of SSAP No. 26R, which should address the concern raised.

3) *Interested Parties – Additional Returns*

Interested parties have proposed to restrict the clarification that "all returns" in excess of principal repayments are required to be considered interest to only items that reflect equity-backed Asset-Backed Securities. Although equity-backed ABS are anticipated to be impacted, as discussed in item 2, non-equity referenced assets should also be captured to prevent inadvertent structures that have variable contractual principal and interest payments based on the appreciation or depreciation of referenced non-equity assets (real estate, artwork, etc.).

A key driver for the 'all returns shall be considered interest" guidance was for principle-protected notes, as those notes can have a stated interest rate (often a small percentage) with the potential for significant additional returns from the alternative investment components captured in the structure. If only the stated interest was considered in the bond assessment, there could be a conclusion that principal-protected notes qualify as bonds, as they are likely perceived to not be 'equity backed ABS". However, by looking at the substance of the full structure, and the 'additional returns' expected, the structure would not qualify as a bond under the principles-based bond definition.

It has been identified that there are potential structures – that some industry may believe should be captured as bonds – that could have the possibility of equity returns. One example was a CLO structure in which the residual is distributed to the debt tranche holders as additional interest based on the overall performance of the CLO. If a residual tranche was held directly, the residual would not qualify for bond reporting. However, if the investment held was in substance a debt tranche **and** had the benefit of additional returns based on overall

performance, there may be a question on whether these investments shall be captured as bonds on Schedule D-1 or as residuals on Schedule BA. Pursuant to the principal intent of the bond definition, these assessments should come down to the substance of the investment. If a reporting entity is holding an instrument with limited principle or interest payments to satisfy the legal form of a bond, with the intent to receive equity-based returns, this structure should not qualify for reporting on Schedule D-1. **However, if the instrument is in substance as a debt instrument, and there is a limited benefit for additional returns based on overall performance, consideration could be given to report that investments on Schedule D-1 as it is in-substance a debt instrument.** NAIC staff has contacted the NAIC SVO/CMB to inquire on these potential investments, and information was received to identify that although these investments have been identified in concept, but there has been no submission of documents to detail the logistics of these potential investments. It was also noted that there is a potential concern that such structures could be orchestrated as a workaround for the SVO Combo Note guidance that was established a few years or so ago.

Ultimately, with the intent of the guidance to avoid application based on "naming conventions" or broad security classifications, NAIC staff does not support the proposed industry edit to only consider "all returns" as interest if the item is considered "equity-backed." This "all-return" guidance should be considered for all investments that are being considered for bond reporting. If there are additional returns, other than the stated interest rate, then all returns shall be considered to determine the substance of the investment in accordance with the principles-based bond definition. Only investments that qualify as in-substance bonds shall be reported on Schedule D-1.

Item 3 - NAIC Staff Recommendation: Do not incorporate the interested parties' proposed change to restrict consideration of "all returns" to only equity-backed items. Further, as detailed in item 1, NAIC staff has proposed revisions to clarify that the restrictions for variations in principal or interest payments due to the appreciation and depreciation of equity interests is not limited to equity interests. A structure that has variable principal or interest contractual cash flows based on the appreciation or depreciation of referenced equity, real estate or other variable is precluded from bond treatment. Ultimately, if a structure includes stated interest and the potential for 'additional returns," the collective structure of the entire investment shall be assessed under the bond definition.

4) *Interested Parties – First Loss Tranche*
Interested parties have proposed revisions that would potentially allow first loss tranches to be captured on Schedule D-1 if they have substantive credit enhancements. In the example provided, if the amount of the debt ($60) was less than the value of the collateral ($100), then the overcollateralization would provide support for a substantive credit enhancement, and the investment could qualify for Schedule D-1 reporting.

NAIC staff has concerns with the proposed recommendation, predominantly with regards to potential confusion with the residual tranche guidance previously adopted. Residual tranches, which do not have contractual principal or interest payments, are not permitted to be captured on Schedule D-1 and are required to be reported on Schedule BA. This residual tranche reporting is required regardless of potential overcollateralization of the collateral assets to the total debt issuance. Pursuant to guidance previously adopted, residual tranches provide payments to holders after debt service payments have been made to other tranches or interests and are based on remaining available funds. These tranches of securitizations are not permitted to be reported on Schedule D-1.

NAIC staff believes the intent of the interested parties' proposed guidance was to clarify that the 'first loss tranche' being referenced was the first *debt* tranche after the residual tranche. Meaning, the sponsor / creator of the securitization retained the residual tranche, and the insurer holds a debt security that would be subject to losses after the residual tranche protection has been exhausted.

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NAIC staff agrees that all debt tranches with contractual principal and interest payments that have substantive credit enhancement and meaningful cash flows (as required) under the principles-based bond definition are eligible for reporting on Schedule D-1. However, structures without contractual interest or principal payments or that otherwise do not comply with the definition (e.g., they lack substantive credit enhancement) are not permitted on Schedule D-1. Tranches that meet the residual definition shall be reported on Schedule BA regardless of the ultimate value (or differential) of the collateral and issued debt.

Item 4 - NAIC Staff Recommendation: Consider revisions to clarify guidance and mitigate confusion or inconsistent interpretations on the guidance with residual tranches. Although the edits are similar to the interested parties proposed edits, the guidance continues to require contractual principal and interest payments and substantive credit enhancements to qualify for bond reporting. As noted above, residual tranches shall always be reported on Schedule BA regardless of potential overcollateralization / substantive credit enhancement. (NAIC staff has agreed that the shaded area specific to measurement guidance does not fit within this paragraph and will address measurement of Schedule BA assets in a different location.)

Interested parties' proposed edits:

The first loss ~~tranche~~ position ~~(or tranches if the first tranche is not itself substantive)~~ may be issued as part of the securitization in the form of debt or equity interest, or it may be retained by the sponsor and not issued as part of the securitization. If the first loss ~~tranche~~ position (or a more senior position(s), if the first loss position(s) lack a substantive credit enhancement) is issued as part of the securitization, and does not have a substantive credit enhancement and is held by a reporting entity, the accounting should follow the guidance applicable to the type of instrument (i.e., debt vs. equity); however, regardless of the type of instrument, it does not qualify as a Schedule D bond and should be reported on Schedule BA.

NAIC staff proposed edits:

The first loss ~~tranche~~ position ~~(or tranches if the first tranche is not itself substantive)~~ may be issued as part of the securitization in the form of debt or equity interest, or it may be retained by the sponsor and not issued as part of the securitization. If the first loss ~~tranche~~ position (or a more senior position(s), if the first loss position(s) lacks contractual payments along with a substantive credit enhancement) is issued as part of the securitization, and does not have contractual principal and interest payments along with substantive credit enhancement and is held by a reporting entity, ~~the accounting should follow the guidance applicable to the type of instrument (i.e., debt vs. equity); however, regardless of the type of instrument, it~~the structure does not qualify as a Schedule D bond and should be reported on Schedule BA.

5) *Interested Parties – Feeder Funds*

Interested parties have recommended guidance to specifically address feeder funds. A feeder fund is an arrangement where the debt is issued from the feeder fund, but the feeder fund has an equity interest in another fund (secondary fund). The proposed language would be explicit that reporting entities should look beyond the equity interest to the secondary fund and determine what is held, in-substance, by the secondary fund. If the secondary fund holds debt instruments, then the issuance from the feeder fund would in-substance be considered debt and not equity-backed instruments. However, if the secondary fund was backed by equity interests, the reporting entity would have to 1) consider the substance of equity interests in the secondary fund in supporting the debt from the feeder fund, 2) assess whether the creditor-relationship criteria was met, and 3) conclude that the investment did not reflect an in-substance equity relationship. (Ultimately, the presence of an equity interest

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between the feeder fund and secondary fund would not automatically result with an underlying equity assessment and it would be based on the actual holdings of the secondary fund.)

NAIC staff agrees with the conclusions of the interested parties' and the focus on what an investment reflects in substance over form. NAIC staff agrees with including language like what was proposed by interested parties to specifically address feeder funds.

Item 5 - NAIC Staff Recommendation: Incorporate guidance similar to the concepts proposed by interested parties to clarify how feeder funds shall be assessed under the principles-based bond definition.

Interested Parties' Proposed Edits:

The assessment of equity backed securities should be looked at, not only in form, but in substance. For example, a feeder fund arrangement where the debt is issued from the feeder fund, that has an equity interest in another fund that holds debt instruments, should not be viewed as holding one equity interest (i.e., in this case a pass-through entity) if the substance is the debt is backed by debt instruments. Similarly, if the "credit" fund were an "equity" fund, backed by equity interests, the debt of the feeder fund would have to meet the requirements of paragraph 26 while looking at the substance of equity interests supporting the debt. Of course, such an arrangement would have to meet the other relevant parts of the standard (e.g., have a substantive credit enhancement, etc.). Substance over form should be the determining factor in these and similar situations.

NAIC Staff Proposed Edits (tracked changes from interested parties' proposal – new paragraph):

The assessment of equity backed securities should be looked at, not only in form, but in substance. For example, an ~~feeder fund~~ arrangement where the debt is issued from ~~the~~ a feeder fund, and the feeder fund~~,~~ ~~that~~ has an equity interest in another fund, which only holds debt instruments and passes those fixed income cash flows through the structure to the ultimate debt holder, **may** have substance aligned with a debt investment rather than a single equity investment. This conclusion would be supported if the terms of the structure ensure that underlying fixed income cash flows are passed through. Factors that create uncertainty as to the timing and/or amount of the pass through of the underlying cash flows would call into question a conclusion that a feeder fund structure is a debt-backed structure in substance. For example, discretion of an underlying fund manager to withhold distribution of the underlying cash flows may create uncertainties as to the timing and/or amount of cash flows in such a manner that is more characteristic of an equity investment. Likewise, a feeder fund structure that is not expected to provide for regular cash interest payments would call into question the substance as a debt-backed investment. ~~that holds debt instruments, should not be viewed as holding one equity interest (i.e., in this case a pass-through entity) if the substance is the debt is backed by debt instruments.~~

Similarly, if the ~~"credit"~~ structure was ultimately backed by equity interests (the final fund holds equity interests that generate the pass-through cash flows)~~fund were an "equity" fund, backed by equity interests~~, the held debt instrument from ~~of~~ the feeder fund would have to meet the requirements of paragraph 26 while looking at the substance of equity interests supporting the debt. ~~Of course, such~~

Regardless of the underlying collateral, such ~~an~~ feeder fund arrangements would have to meet the other relevant parts of the standard (e.g., have a substantive credit enhancement, etc.) to qualify for bond reporting. Investments that resemble feeder fund structures will require entity review to determine the underlying source of cash flows and identify the uncertainties or vulnerabilities that could impact the cash

flows that will be passed through to the reporting entity holder. Ultimately, the conclusion that a structure represents a feeder fund shall not automatically qualify the structure for bond classification but shall not automatically preclude bond classification. Substance over form should be the determining factor in these and similar situations.

6) *Interested Parties – Appendix I Examples*

Interested parties have recommended that Appendix I, which has been reduced to two examples that do not reflect in-substance creditor relationships, be codified within the guidance instead of the Appendix. Although NAIC staff does not disagree with this suggestion, at this stage, it is recommended that the proposed revisions be first captured within the proposed edits to the SSAPs and issue paper. Although NAIC staff does not oppose edits to move the guidance in the principles-based bond definition if also desired, it will ultimately be the inclusion of the guidance within the SSAPs that will reflect the authoritative guidance.

Item 6 - NAIC Staff Recommendation: Request interested parties to work with NAIC staff in proposing revisions to capture the information in Appendix I within the bond definition, SSAPs and issue paper.

7) *Interested Parties – ABS as Short-Term Investments*

Interested parties have provided comments on the guidance restricting the reporting of ABS securities as short-term or cash equivalent investments. These comments have suggested separate breakouts on Schedule DA or E2 rather than restricting the ABS from those schedules.

NAIC staff highlights that the components of the bond definition are designed to ensure that only investments that qualify are reported as bonds on Schedule D-1. For ABS, determination of bond classification requires assessment of substantive credit enhancement and meaningful cash flows (non-financial ABS).

The granular reporting lines being developed on Schedule D-1 are intended to ensure that regulators have complete transparency as to the types of investments that are held. NAIC staff notes that ABS structures are often specifically designed, and it would be unfortunate to have situations in which ABS securities are designed with shortened maturity dates (less than one-year) to permit reporting that does not provide the transparency intended as part of this project. Furthermore, as identified a few years ago, it is not uncommon for short-term investments to be "rolled" and the SSAP provisions permit these transactions to continue on Schedule DA and Schedule E2 when certain conditions exist. If ABS structures are permitted to be reported as short-term or cash equivalents, it is not unrealistic to assume that structures could be designed to utilize this reporting, particularly if those structures would warrant further scrutiny if reported on the specific new granular reporting lines on Schedule D-1.

NAIC staff highlights that those investments reported as short-term or cash equivalents receive favorable treatment in that they all have the same minimal RBC factor and there is no need to obtain an NAIC designation or CRP rating. This favorable treatment is generally supported as short-term / cash equivalents are intended to have insignificant changes or risk from the date of acquisition until maturity. Due to the components of ABS securities, particularly if there are elements that require performance factors (e.g., leasing or royalty fees) or have elements of principal repayment contingent on sale or refinancing at maturity, these securities should not be permitted to be reported as short-term or cash equivalent investments regardless of how close the maturity date is after the reporting entity acquires the investment. These ABS investments have risks that go beyond what is expected for short-term or cash equivalent securities.

Lastly, there has been little information shared as to the extent ABS securities are actually acquired within 1-year to maturity. It is perceived that these securities are not prevalent. The only example provided so far is "Asset-Backed Commercial Paper" (ABCP). Although these designs have 'commercial paper' in the name, it would be erroneous to assume that these ABS resemble 'commercial paper' investments. From information on the description of these assets, ABCP structures are very different and represent a short-term vehicle issued by a bank or other financial institution that is **backed by the company's physical assets** and issued on a discount or interest-bearing basis. For these structures, **the collateral often consists of the corporation's expected future payments or receivables. These receivables might include payments the corporation expects to collect from loans it has made, such as auto loans, credit card debt, student loans or residential mortgages. It should be noted that a company can create an ABCP from any type of asset-backed security, including subprime mortgages, which are high-risk mortgages**. The use of assets, including high-risk assets, to back ABCP is a key difference from actual commercial paper. Actual commercial paper is not backed by assets but represents a short-term note backed only by the high credit quality of the issuing company.

With information on ACBP, and that they can be collateralized by any type of high-risk asset, NAIC staff strongly supports retaining the proposed guidance that excludes all ABS from reporting as a cash equivalent or short-term asset. NAIC strongly supports that all ABS, even if referred to as "Asset-Backed Commercial Paper," be reported on Schedule D-1 in the appropriate reporting line that reflects the actual substance of the ABS investment consistent with all other ABS structures. Meaning, regardless of the maturity date after acquisition, all ABS shall be reported on Schedule D-1 and categorized based on the substance of the transaction that allows identification of whether the ABS is backed by financial assets, backed by non-financial assets and whether or not the meaningful cash flow practical expedient has been satisfied. In addition to reporting based on the substance of the structure, by capturing on the ABS schedule (and not DA or E2), the reporting columns specific to ABS structures (such as balloon payment percentage, overcollateralization, etc.) will be completed.

Furthermore, NAIC staff believes an NAIC designation or CRP rating is appropriate for all ABS structures. (Such designations would not be required if captured as a short-term or cash equivalent on Schedule DA/E2.) If the requirement for an NAIC designation is a key motivator for industry's request to classify ABS as short-term, a referral could be considered to the Valuation of Securities (E) Task Force to permit FE for short-term ABS. With this change, ABS that were rated by a qualifying CRP could use the CRP rating for reporting on Schedule D-1, even though the insurer acquired the ABS with a limited time until maturity. If the ABS structure was unrated, then it would follow the same rules as Schedule D bonds. Under these rules, securities that do not have a CRP rating and do not have a designation from the NAIC SVO shall be reported with an NAIC 6.

Item 7 - NAIC Staff Recommendation: Retain guidance to require all ABS to be reported on Schedule D-1, and not permit as short-term or cash equivalent securities on Schedule DA or E2 regardless of acquisition date to the scheduled maturity date.

Review of Industry Lease-Backed Working Group Comments:

The comments within the industry Lease-Backed Securities Working Group (LBSWG) letter are consistent with their July 15, 2021, comment letter. Although the letter is fairly detailed, the ultimate ask is to allow all "simple secured loans" issued in security form to be in scope of SSAP No. 26R as issuer credit obligations. This would permit all such designs, regardless of structure, contingent factors, or residual/balloon payments to be permitted bond treatment without further analysis. Although the letter does not include examples, if revisions were incorporated as requested by the LBSWG, the following investment structures would be permitted in scope of SSAP No. 26R (as issuer credit obligations) and reported on Schedule D-1 without any further assessment:

- Any scenario in which a non-cash generating (potentially non-admitted) asset is moved to an SPV/Trust structure to collateralize a security issued by the trust / SPV. This would codify the approach to permit non-admitted artwork (or any such asset) to be "transformed" into a bond structure through use of an SPV and be reported on Schedule D-1 and admitted within the financial statements.

- Any lease-backed structure regardless of the term of the debt issuance in comparison to the lease term. For example, a ten-year debt issuance backed by a 5-year lease would be permitted as a bond without detailed analysis. Such structures require re-leasing after the 5-year initial least term – at whatever market conditions exist at that time - to ensure cash flows will continue to be generated to satisfy the debt instrument.

- Any lease-backed structure regardless of the size of future balloon or residual payment. For example, this would permit, without further analysis, structures with significant balloon payments – including 100% of the principal balance at maturity. (These are the sort of structures that were noted as concerning during the CTL discussion that occurred in 2020. Although the prior discussion resulted with a focus on mortgage loan structures (and not securities) it was noted that the provisions of the bond definition would likely ensure appropriate analysis of "CTL security structures" to ensure properly structuring for bond reporting.)

- Any lease-backed structure regardless of the number of payors (lease arrangements) within the structure that passes on the cash flows generated under the leases to the security holders.

All of these examples conflict with the existing bond definition that require issuer credit obligations (SSAP No. 26R structures) to be primarily supported by the general creditworthiness of an operating entity. Furthermore, if reported as issuer credit obligations, there is no further assessment required on substantive credit enhancement or whether there will meaningful cash flows throughout the duration of the security. The LBSWG comment letter is even explicit that a characteristic of these "simple secured loans" is that the creation of the structure intends to just pass-through cash flows unaltered, meaning that the holder of the securities is in exactly the same position as if it owned the underlying assets directly. Although the LBSWG seems to think that this dynamic supports bond reporting, in actuality, preventing the recharacterization of non-bond assets, particularly items that would be reported with high RBC charges or nonadmitted if held directly, as "bonds" because they are moved to an SPV, with an SPV issuing a debt instrument without any change to the underlying risk, is an initiative of the bond project.

With the proposal of the LBSWG, it seems that any ABS dynamic that did not qualify with substantive credit enhancement and permitted for ABS Schedule D-1 reporting could be presented as a 'simple secured security" and be captured – with less scrutiny and oversight – as an issuer credit obligation. If the change from the LBSWG is supported, it would explicitly permit a number of investment structures on Schedule D-1 that have already been identified as not representing 'bond risk' or that have already been identified as warranting specific identification so that regulators understand the underlying risks within Schedule D-1 structures. For example, although the lease-backed examples provided by staff above may qualify as a non-financial asset-backed security, if they do not qualify under the practical expedient for meaningful cash flows, they would be reported on specific lines to highlight to regulators that the satisfaction of the debt obligation is contingent on aspects other than what will be predominantly generated through the normal debt term. Having transparent information on these future risks is key in understanding the underlying investment risks and security of assets reported as bonds.

Ultimately, it seems that the LBSWG has a concern with perceived inequities between municipal-revenue bonds and non-municipal project finance bonds issued by operating entities which are permitted in scope of SSAP No. 26R vs lease-backed securities which are treated as asset backed securities if not fully supported by a lease to an operating entity. The small group had significant discussions on the conclusion to include project finance bonds issued by operating entities in scope. A key aspect of this inclusion is that the project finance bond must be issued by an operating entity. Entities issuing project finance bonds may themselves have the characteristics of operating

entities while also having similarities to special purpose entities used in securitizations or lease-backed securities. Because these entities sit in the center of the spectrum between operating entities and ABS issuers, guidance was drafted through small group discussions with industry to help provide some direction regarding these entities. The following is currently captured within the issue paper to detail this discussion / conclusion:

> 30. Whether an issuer of debt represents an operating entity or ABS Issuer is expected to be clear in most instances, but certain instances may be less clear. Ultimately, for an issuer credit obligation, it comes down to whether support for repayment consists of direct or indirect recourse to an operating entity or entities. In addition to "traditional bond" structures previously included in SSAP No. 26R, examples of issuer credit obligations include:
>
> d. Project finance debt issued by operating entities. These investments reflect financing of a single asset or "operation" (such as a toll road or power generation facility) that collateralizes a debt issuance and the cash flows produced by the asset/operation service the debt, where the issuer may also represent an operating entity. These designs have characteristics of both issuer credit operations, as the operation constitutes a stand-alone business, as well as characteristics of ABS, as they are formed for the purpose of raising debt capital backed by the cash flows from collateral held by a bankruptcy-remote entity. When viewed holistically, these issuing entities are typically used to facilitate the financing of an operating component of a project sponsor or municipality. Although the use of a bankruptcy-remote entity (e.g., SPV) facilitates the efficient raising of debt as a source of financing, the primary purpose is to finance an operating project. Therefore, when the issuing entity represents a stand-alone business producing its own operating revenues and expenses, where the primary purpose is to finance an operating project, the issuing entity shall be considered an operating entity despite certain characteristics that resemble ABS issuances.
>
> i. It is important to highlight that the guidance for project finance is strictly for instruments issued by operating entities, similar to other instruments that qualify as issuer credit obligations under the principles-based bond definition. Consistent with other concepts, the naming convention (e.g., referring to an instrument as project finance) or the presence or absence of an SPV/trust structure are not definitive components in determining whether an investment qualifies for reporting on Schedule D-1, or is classified as an issuer credit obligation or ABS. Instruments (even if identified as "project finance") that do not qualify as issuer credit obligations as they not issued by operating entities, shall be assessed for qualification for reporting on Schedule D-1 as ABS. If the instruments do not qualify for reporting as ABS, they shall not be reported on Schedule D-1.

If the Working Group agrees that project finance bonds issued by operating entities and lease-backed securities with balloon payments are too similar to warrant classification differences between issuer credit obligations and ABS, then it would be staff's recommendation to identify that project finance bonds are not considered to be issued by operating entities. If the structure is not considered to be an issued by an operating entity, then the structure would be required to follow the guidance for an asset-backed security classification. As detailed in the issue paper, it was already acknowledged that project finance bonds issued by operating entities have characteristics of both issuer credit obligations and ABS. The decision to classify as issuer obligations was due to the issuing entity representing a stand-alone business producing its own operating revenues and expenses where the primary purpose is to finance its own operating project. (This description for project finance items is perceived to be different from the proposed LBSWG structure, which is a non-financial asset backing a debt instrument.) Ultimately, NAIC staff does not recommend moving more lease-backed structures (or "simple secured loans") to an issuer credit obligation classification. As stated previously, classifying 'simple secured investments' as issuer credit obligations, as requested by LBSWG contradicts fundamental components of the overall bond project.

Input is requested from regulators on whether it would be appropriate to specify that project finance bonds are not considered to be issued by operating entities to address the perceived inequity that the LBSWG believes to exist. However, NAIC staff does not believe this is necessary for the guidance of the bond definition to be understood.

Recommended Action:

NAIC staff recommends that the Working Group retain the existing guidance – which permits project finance bonds issued by operating entities to qualify as issuer credit obligations.

However, if there is concern that these items would be captured as issuer credit obligations in comparison to other structures, it would be recommended to revise the guidance to specify that project finance bonds are not considered to be issued by operating entities. By identifying that project finance bonds are not issued by operating entities, the guidance would require them to be captured as ABS. Regardless, NAIC staff does not recommend that other lease-backed securities or "simple secured loans" be explicitly identified as issuer credit obligations. Investments shall be reported as issuer credit obligations only if they qualify with the principles detailed in the principles-based bond definition. As discussed, lease-backed (and other such structures) are already permitted as issuer credit obligations if they are fully backed by a single obligor.

Review of Other Interested Parties' Comments – Questions in the Issue Paper

The interested parties' comment letter also provided comments in response to questions asked about classification of non-bond investments to BA and the appropriate measurement method for those investments. The following recommendation is included in response to these comments:

- NAIC staff appreciates the information on the proper measurement method for investments that may move from Schedule D-1 to Schedule BA. NAIC staff requests direction from the Working Group to develop SSAP revisions to incorporate principal guidance for the different types of investments and how measurement should be determined. For example, equity-backed investments that do not qualify as bonds may be more appropriately reflected at fair value. Investments with pass through cash flows (but do not qualify as Schedule D-1 as they do not have substantive credit enhancement) or investments that have substantive credit enhancement, but lack meaningful cash flows, may warrant amortized cost measurement.

- NAIC staff does highlight that there needs to be consideration on providing a wide-spread provision for admittance for investments reported on Schedule BA. Pursuant to SSAP No. 4, only investments that are explicitly identified as admitted assets are permitted to be admitted in the statutory financial statements. Consideration of parameters to support admittance (types of investments, etc.) will be captured as part of the SSAP revisions.

- NAIC staff also recognizes the interested parties' comments on New Market Tax Credits and the establishment of statutory accounting guidance for these investments. NAIC staff has already been reviewing these structures and does not recommend bringing them within the scope of the principal-based bond definition project. Rather, it is recommended that these investments be considered in a separate agenda item. If the conclusion is reached that they should be captured on Schedule D-1, then corresponding revisions to the appropriate SSAP will be proposed to bring them in scope.

Recommended Action:

NAIC staff recommends that the Working Group direct NAIC staff to proceed with drafting SSAP revisions to consider measurement guidance for investments that will move from Schedule D-1 to Schedule BA, as well as whether specific admittance criteria for investments should be established. NAIC staff also recommends that the Working Group direct NAIC staff to consider New Market Tax Credits in a separate agenda item.

<u>Summary of Recommended Actions – Hearing Agenda</u>

The following summarizes the NAIC staff recommendations to revise the bond definition or issue paper:

1. Item 1 – **<u>Revise</u>** the U.S. TIPs footnote and paragraph 3b of the bond definition to clarify the guidance regarding variable contractual principal and interest payments. (Proposed language on page 11.) (Corresponding revisions will also be reflected in the issue paper and proposed SSAP edits.)

2. Item 2 – No revisions recommended as SVO-Credit Tenant Loans are not securities and cannot qualify as bonds under the definition. They will be specific scope inclusions to SSAP No. 26R.

3. Item 3 – No revisions recommended as all returns over principal repayment from all structures (and not just equity backed ABS) shall be considered interest.

4. Item 4 – **<u>Revise</u>** the guidance describing a substantive credit enhancement in the bond definition glossary. This guidance is specific to the first loss tranche. (Proposed language on page 14.) (Corresponding revisions will also be reflected in the issue paper and the proposed SSAP edits.)

5. Item 5 – **<u>Add a new paragraph</u>** to the issue paper (at or around paragraph 27) to provide discussion on feeder funds. (Proposed language on page 15.) This is not planned for inclusion in the bond definition, but consideration could occur to include concepts in the proposed edits to SSAP No. 43R.

6. Item 6 – Request interested parties to work with NAIC staff in proposing revisions to capture information from Appendix I into the bond of the bond definition. (No revisions proposed at this time.)

7. Item 7 – No revisions recommended as all ABS shall be captured on Schedule D-1-2 and not Schedule DA or E2.

8. LBSWG – No revisions recommended. (An option is provided on page 20 if the Working Group would want to exclude project finance bonds from being considered issuer obligations.)

9. Next Steps – Direct NAIC staff to consider measurement guidance for investments that will move from Schedule D-1 to Schedule BA, as well as to consider admittance criteria. Also, direct NAIC staff to consider New Market Tax Credit Investments in a separate agenda item.

<u>Overall Recommendation</u> – NAIC staff recommends that the Working Group direct NAIC staff to incorporate the revisions proposed within this agenda item (items 1, 4 & 5) into the bond definition, issue paper and draft SSAP edits (as identified in the discussion) for subsequent exposure at the Summer National Meeting. It is also recommended that the Working Group direct NAIC staff to work with interested parties to propose edits to integrate the Appendix I content into the bond definition. Lastly, it is recommended that the Working Group direct NAIC staff to consider measurement guidance for investments that will move from Schedule D-1 to Schedule BA, as well as consider admittance criteria, and to consider New Market Tax Credit Investments in a separate agenda item.

The comment letters are included as Attachment 3 (12 pages).

Meeting Agenda

Ref #	Title	Attachment #
2019-21 (Julie)	**Bond Proposal Reporting Revisions**	**A – General Instructions** **B – Schedule D Instructions**

Summary:
A key element of the bond proposal project is improved transparency and granularity to the regulators on the actual investment types held by industry. There has been a number of discussions on improving the reporting structure to provide enhanced information. NAIC staff, with initial discussions / commentary from a small group of regulators and industry, have drafted preliminary proposals to significantly revise the Schedule D-1 reporting. Although initial feedback has been received, these are considered staff drafts as detailed discussion has yet to occur. (Broad exposure for comments was suggested rather than detailed discussion in the small group.)

Although there is detail below to summarize the changes, the recommendation is to expose two documents with a public comment deadline of October 7, 2022, A blanks proposal is not suggested at this time, but NAIC SAPWG staff will continue to inform the blanks support staff (as well as other NAIC staff within the FRS division) of the exposure and the potential for reporting changes. After considering comments from the initial exposure, the Working Group may want to consider formal referrals / blanks proposals. Also, it should be noted that the proposed documents only reflect edits to Schedule D-1. If these edits are supported, it is recognized that additional revisions would be necessary to other schedules. A full proposal of all necessary revisions would be subsequently exposed.

Summary of documents proposed for exposure:

- Proposed Reporting Lines - This document proposes annual statement general instructions (reporting line descriptions) for suggested reporting lines to capture issuer credit obligations and asset-backed securities on Schedule D-1. As detailed within, the general classifications that currently exist are proposed to be deleted and new granular reporting lines are suggested. This document shows tracked changes to the current "Annual Statement General Instructions," however, the document only includes revisions related to Schedule D-1. As noted above, other schedules are likely to be impacted by these new reporting lines, and those revisions will be drafted after considering the comments from this initial exposure.

- Schedule D-1 A/S Instructions – This document details the overall approach to add a new Schedule D-1 schedule specific to asset-backed securities. D-1-1 would reflect issuer credit obligations (items captured in scope of SSAP No. 26R) and D-1-2 would reflect asset backed securities (items captured in scope of SSAP No. 43R). This separation of the schedules is supported to enable different reporting columns based on the type of security. Columns that are proposed to be specific to issuer obligations and ABS are noted within the document. In addition to creating new columns, this document also details revisions to existing columns and instructions. There are instances in which columns are proposed to move to electronic only and situations in which the instructions are significantly revised as to what is included.

Recommendation:
NAIC staff recommends that the Working Group expose the proposed reporting changes until October 7, 2022. The SAPWG support staff has informed the Blanks Working Group staff of these discussions and potential reporting changes. Additionally, the blanks industry liaison has been working with the SAPWG staff. At this time, a formal blanks proposal is not suggested. It is recommended that the SAPWG expose the initial reporting proposal documents for broad comments. After assessing the comments from this initial exposure, consideration can occur as to whether this approach is generally supported, and a blanks proposal could be considered at that time.

ANY OTHER MATTERS

a. **Memorandum of Support from the Financial Condition (E) Committee – Attachment C - (Julie)**
Receive and discuss a memorandum of support from the Financial Condition (E) Committee regarding the principal-based bond definition project and ongoing efforts related to reviewing risk-based capital charges of certain structured securities.

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Statutory Accounting Principles (E) Working Group
Proposed Bond Definition
~~May 20, 2021~~March 2, 2022

Introduction: Pursuant to the direction from the Statutory Accounting Principles (E) Working Group in October 2020, a small group of regulators and industry have been meeting 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. **This exposure reflects consideration of comments received as well as clarifications of intent by the regulator and industry study group after the initial exposure in May 2021. This exposure is accompanied by a proposed issue paper that details the discussions in developing the principle-based bond definition. Proposed revisions to the SSAPs or reporting changes are not included with the current exposure.** Items shown as tracked changes are revisions from the previously exposed definition. (Revisions to reflect the "substantive credit enhancement" are not shown as tracked as those edits were previously exposed.)

Below is the proposed principles-based definition of a bond eligible for reporting on Schedule D, Part 1.

1. A bond shall be defined as any security[1] representing a creditor relationship, whereby there is a fixed schedule for one or more future payments, and which qualifies as either an issuer credit obligation or an asset backed security.

   [Need to incorporate concepts of paragraph 2 of current SSAP No. 26R but not recast here for brevity]

   Determining whether a security represents a creditor relationship should consider its substance, rather than solely the legal form of the instrument. The analysis of whether a security represents a creditor relationship should consider all other investments the reporting entity owns in the investee as well as any other contractual arrangements. A security that in substance possesses equity-like characteristics or represents an ownership interest in the issuer does not represent a creditor relationship. See Appendix I for examples of securities that, despite their legal form, do not represent a creditor relationship in substance.

2. An issuer credit obligation is a bond, the repayment of which is supported primarily by the general creditworthiness of an operating entity or entities. Support consists of direct or indirect recourse to an operating entity or entities, which includes holding companies with operating entity subsidiaries where the holding company has the ability to access the operating subsidiaries' cash flows through its ownership rights. An operating entity may be any sort of business entity, not-for-profit organization,

[1] This statement adopts the GAAP definition of a security as it is used in FASB Accounting Standards Codification Topics 320 and 860. Evaluation of an investment under this definition should consider the substance of the instrument rather than solely its legal form.

Security: A share, participation, or other interest in property or in an entity of the issuer or an obligation of the issuer that has all of the following characteristics:

a. It is either represented by an instrument issued in bearer or registered form or, if not represented by an instrument, is registered in books maintained to record transfers by or on behalf of the issuer.
b. It is of a type commonly dealt in on securities exchanges or markets or, when represented by an instrument, is commonly recognized in any area in which it is issued or dealt in as a medium for investment.
c. It is either one of a class or series or by its terms is divisible into a class or series of shares, participations, interests or obligations.

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governmental unit, or other provider of goods or services, but not a natural person or ABS Issuer (defined below). Examples of issuer credit obligations include, but are not limited to:

a. U.S. Treasury securities, including U.S. Treasury Inflation-Indexed Securities[2]; (INT 01-25)
b. U.S. government agency securities;
c. Municipal securities issued by the municipality or supported by cash flows generated by a municipally-owned asset or entity that provides goods or services (e.g., airport, toll roads etc.);
d. Corporate bonds issued by operating entities, including Yankee bonds and zero-coupon bonds;
e. Corporate bonds issued by holding companies that own operating entities;
f. Project finance bonds issued by operating entities;
g. Investments in the form of securities for which repayment is fully supported by an underlying contractual obligation of a single operating entity. (e.g., Credit Tenant Loans (CTLs), Equipment Trust Certificates (ETCs), other lease backed securities, Funding Agreement Backed Notes (FABNs), etc.). For purposes of applying this principle concept, repayment is fully-supported by the underlying operating entity obligation if it provides cash flows for the repayment of all interest and at least 95% of the principal of the security.
g. ~~ETCs, EETCs, and CTLs for which repayment is fully supported by a lease to an operating entity;~~
h. Bonds issued by real estate investment trusts (REITS) or similar property trusts;
i. Bonds issued by business development corporations, closed-end funds, or similar operating entities, in each case registered under the 1940 Act;
j. Convertible bonds issued by operating entities, including mandatory convertible bonds as defined in paragraph 11.b;
k. Fixed-income instruments specifically identified:
    i. Certifications of deposit that have a fixed schedule of payments and a maturity date in excess of one year from the date of acquisition;
    ii. Bank loans that are obligations of operating entities, issued directly by a reporting entity or acquired through a participation, syndication or assignment;
    ~~iii. Hybrid securities issued by operating entities, excluding surplus notes, subordinated debt issues which have no coupon deferral features, and traditional preferred stocks;~~
    iii. Debt instruments in a certified capital company (CAPCO). (INT 06-02)
    iv. Exchange Traded Funds (ETFs) that qualify for bond treatment as identified in the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* and published on the SVO's webpage. (These instruments are referred to as SVO-Identified ETFs.)

~~*[Need to incorporate concepts in paragraph 4 of SSAP No. 26R but not recast here for brevity.]*~~

[2] The inclusion of U.S. Treasury Inflation-Indexed Securities identifies these securities as an explicit exception to the principles-based bond definition that prohibits securities from being reported on Schedule D-1 that have variable principal or interest due to underlying equity appreciation or depreciation, or an equity-based derivative.

3. An asset[3] backed security is a bond issued by an entity (an "ABS Issuer") created for the primary purpose of raising debt capital backed by financial assets[4] or cash generating non-financial assets owned by the ABS Issuer, whereby repayment is primarily derived from the cash flows associated with the underlying defined collateral rather than the cash flows of an operating entity[5]. In most instances, the ABS Issuer is not expected to continue functioning beyond the final maturity of the debt initially raised by the ABS Issuer. Also, many ABS Issuers are in the form of a trust or special purpose vehicle ("SPV"), though the presence or lack of a trust or SPV is not a definitive criterion for determining that a security meets the definition of an asset backed security.

   There are two defining characteristics that must be present for a security to meet the definition of an asset backed security:

   a. The assets owned by the ABS Issuer are either financial assets or cash-generating non-financial assets. Cash-generating non-financial assets are defined as assets that are expected to generate a meaningful[6] level of cash flows toward repayment of the bond through use, licensing, leasing, servicing or management fees, or other similar cash flow generation (for the avoidance of doubt, there must be a meaningful level of cash flows to service the debt, other than through the sale or refinancing of the assets). Reliance on cash flows from the sale or refinancing of cash generating non-financial assets does not preclude a bond from being classified as an asset backed security so long as the condition in the preceding sentence is met. See Appendix II for examples (2, 3 and 4) illustrating the evaluation of the meaningful criteria.

   b. The holder of a debt instrument issued by an ABS Issuer is in a different economic position than if the holder owned the ABS Issuer's assets directly. The holder of the debt instrument is in a different economic position if such debt instrument benefits from substantive[7] credit enhancement through guarantees (or other similar forms of recourse), subordination and/or overcollateralization. In instances where the assets owned by the ABS Issuer are equity interests, the debt instrument must have pre-determined principal and interest payments (whether fixed interest or variable interest) with contractual amounts that do not vary based on the appreciation or depreciation of the equity interests. (For clarification purposes, all returns from an ABS in

[3] The underlying collateral supporting an asset backed security shall meet the definition of an asset by the ABS Issuer. Certain forms of collateral, such as rights to future cash flows, may not be recognized as assets by the selling entity but may be recognized as assets when sold to an ABS Issuer. These assets are permitted as the collateral supporting an asset backed security, although they may not represent an asset that can be liquidated to provide payment toward the issued debt obligations (i.e., if the future cash flows do not materialize). The limited ability to liquidate the underlying collateral supporting an asset backed security does not impact the structural determination of whether an issued security meets the definition of an asset backed security but may impact the recoverability of the investment, as well as the consideration of whether there is substantive credit enhancement.

[4] SSAP No. 103R defines a financial asset as cash, evidence of an ownership interest in an entity, or a contract that conveys to one entity a right (a) to receive cash or another financial instrument from a second entity or (b) to exchange other financial instruments on potentially favorable terms with the second entity. As a point of clarity, for the purposes of this standard, financial assets do not include assets for which the realization of the benefits conveyed by the above rights depends on the completion of a performance obligation (e.g., leases, mortgage servicing rights, royalty rights, etc.). These assets represent non-financial assets, or a means through which non-financial assets produce cash flows, until the performance obligation has been satisfied.

[5] Dedicated cash flows from an operating entity can form the underlying defined collateral in an asset backed security. This dynamic, perhaps noted in a whole-business securitization, still reflects an asset backed security and not an issuer credit obligation.

[6] The term "meaningful" is defined in the Glossary.
[7] The term "substantive credit enhancement" is defined in the Glossary.

excess of principal repayment are required to be considered as interest. Therefore, investments with "stated" interest and then "additional returns" to which the holder of the debt instrument is entitled are collectively considered as interest and shall be assessed together in determining whether the investment has variable principal or interest due to underlying equity interests.) See Appendix II for examples illustrating the evaluation of the sufficient criteria.

4. Whether an issuer of debt represents an operating entity or ABS Issuer is unambiguous in most instances, but certain instances may be less clear. For example, an entity may operate a single asset such as a toll road or power generation facility (e.g., project finance) which serves to collateralize a debt issuance, and the cash flows produced by the operation of the assets are pledged to service the debt. In many such instances, the entity is structured as a bankruptcy-remote entity that is separate from the municipality or project sponsor. Such entities have characteristics of operating entities as the operation of the asset constitutes a stand-alone business. They also have many common characteristics of ABS Issuers as they are formed for the purpose of raising debt capital backed by the cash flows from collateral held by a bankruptcy-remote entity. When viewed more holistically, these issuing entities are typically being used to facilitate the financing of an operating component of a project sponsor or municipality. The use of a bankruptcy-remote entity facilitates the efficient raising of debt to finance the operating project, but the primary purpose is to finance an operating project. Therefore, structures in which the issuing entity represents a stand-alone business producing its own operating revenues and expenses, where the primary purpose is to finance an operating project, shall be considered operating entities despite certain characteristics they may share with ABS Issuers.

Note: The elements captured below are not components of the core bond definition. However, comments are requested on the proposal to separately identify on Schedule D-1 or a subschedule of D-1, those ABS that qualify as bonds under the definition and have certain characteristics noted below. The purpose of separate identification would be to improve transparency and provide more specific disclosures applicable to bonds with such characteristics.

A separate reporting section on Schedule D, Bonds is being contemplated, for the purpose of capturing additional disclosures for regulators, for the following:

Any asset backed securities where:

1) the underlying collateral comprises cash generating non-financial assets and does not meet the practical expedient for evaluating the meaningful criteria defined in paragraph 3a and the glossary, or

2) the underlying collateral comprises financial assets that are not self-liquidating.

Glossary

Meaningful – What constitutes a "meaningful" level of cash flows generated to service the debt from sources other than the sale or refinancing of the underlying collateral is specific to each transaction, determined at origination, and should consider the following factors:

1. The price volatility in the principal market for the underlying collateral;
2. The liquidity in the principal market for the underlying collateral;
3. The diversification characteristics of the underlying collateral (i.e., types of collateral, geographic location(s), source(s) of cash flows within the structure, etc.);
4. The overcollateralization of the underlying collateral relative to the debt obligation; and
5. The variability of cash flows, from sources other than sale or refinancing, expected to be generated from the underlying collateral.

Factors #1 and #5 are directly related to the "meaningful" requirement. That is, as price volatility or variability of cash flows increase, the required percentage of cash flows generated to service the debt from sources other than the sale or refinancing of the underlying collateral must also increase. Factors #2, #3 and #4 are inversely related to the "meaningful" concept. That is, as liquidity, diversification or overcollateralization increase, the required percentage of cash flows generated to service the debt from sources other than the sale or refinancing of the underlying collateral may decrease.

As a practical expedient to determining whether a cash generating non-financial asset is expected to produce meaningful cash flows, a reporting entity may consider an asset for which less than 50% of the original principal relies on sale or refinancing to meet the meaningful criteria. In applying this practical expedient, only contractual cash flows of the non-financial asset may be considered. This practical expedient should not be construed to mean that assets cannot meet the meaningful criteria if they rely on sale or refinancing to service greater than 50% of the original principal or if they rely on cash flows that are not contracted at origination. Rather, such instances would require a complete analysis of the considerations described above.

Substantive Credit Enhancement – The intent of the criteria requiring the holder to be in a different economic position is to distinguish qualifying bonds from instruments with equity-like characteristics or where the substance of the transaction is more closely aligned with that of the underlying collateral. To qualify as a bond under this standard, there is a requirement that there are substantive credit enhancements within the structure that absorb losses before the debt instrument being evaluated would be expected to absorb losses. This is inherent in the context of an Issuer Credit Obligation as the owners of the equity in the operating entity are the first to absorb any variability in performance of the operating entity. The same concept applies to asset-backed securities. If substantive credit enhancement did not exist, the substance of the debt instrument being evaluated would be more closely aligned with that of the underlying collateral than that of a bond. Credit enhancement that is merely nominal or lacks economic substance does not put a holder in a different economic position.

The substantive credit enhancement required to be in a different economic position is specific to each transaction; determined at origination; and refers to the level of credit enhancement a market participant (i.e., knowledgeable investor transacting at arm's length) would conclude is substantive.

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The first loss tranche (or tranches if the first tranche is not itself substantive) may be issued as part of the securitization in the form of a debt or equity interest, or it may be retained by the sponsor and not issued as part of the securitization. If the first loss tranche is issued as part of the securitization, and held by a reporting entity, the accounting should follow the guidance applicable to the type of instrument (i.e., debt vs. equity); however, regardless of the type of instrument, it does not qualify as a Schedule D bond and should be reported on Schedule BA.

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Appendix I

<u>Examples of securities that, despite their legal form, do not represent creditor relationships in substance:</u>

~~Example I:~~

~~A reporting entity invests in a private equity fund, whereby each investor is required to make 75% of its investment in the form of an unsecured debt investment and 25% in the form of an equity interest. Additionally, each investor owns a pro rata share of the unsecured debt investments and equity interests outstanding, and is restricted from selling, assigning or transferring the unsecured debt investment without also selling, assigning, or transferring the equity interest to the same party.~~

~~Rationale:~~

~~Although the unsecured debt investment appears to represent a creditor relationship in legal form, consideration of the substance of its terms in conjunction with the reporting entity's other interests in the fund, reflects that of an equity investment in substance. While the unsecured 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. As such, the reporting entity is in the same economic position as if it held its entire investment in the form of an equity interest in the fund. Therefore, the unsecured debt investment does not represent a creditor relationship in substance. It would also be inappropriate to conclude that a component of a similar investment, but not exact replica of this transaction, represents a creditor relationship if it in substance does not put the holder collectively in a materially different economic position than holding an equity interest (e.g., the required equity interest was not exactly pro-rata). However, requirements to hold both debt and equity interests as a result of regulatory restrictions, such as regulatory risk retention rules, should not influence the conclusion that a debt investment represents a creditor relationship in substance.~~

<u>Example ~~2~~1:</u>

A reporting entity invests in a debt instrument issued by a SPV that holds a large number of diversified equity interests with characteristics that support the production of predictable cash flows. The structure contains sufficient overcollateralization and liquidity provisions to ensure the production of adequate cash flows to service both principal and interest payments without significant reliance on refinancing or sale of the underlying equity investments. The debt instrument's periodic principal or interest payments, or both, contractually vary based on the appreciation or depreciation of the equity interests held in the SPV.

Rationale:

Because the instrument's principal or interest payments, or both, contractually vary with the appreciation or depreciation of the underlying equity interests, it contains an equity-like characteristic that is not representative of a creditor relationship. It would be inappropriate to conclude that a security with any

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variation in principal or interest payments, or both, due to underlying equity appreciation or depreciation, or an equity-based derivative, is a bond under this standard as such security would contain equity-like characteristics. A bond under this standard is required to have pre-determined principal and interest payments (whether fixed interest or variable interest) and comply with the structured note guidance within paragraph XXX.

Example ~~3~~2:

A reporting entity invests in a debt instrument issued from a SPV that owns a portfolio of ~~one or few~~ equity interests, and the debt instrument does not meet the definition of an issuer credit obligation. ~~The debt instrument benefits from sufficient credit enhancement as defined in paragraph 3b, but the timing, amount and likelihood of cash distributions from the underlying equity interests is highly uncertain. Additionally, the capital structure of the SPV does not contain adequate diversification or liquidity provisions to ensure the production of adequate cash flows to service the contractual principal and interest payments, and repayment relies primarily on the ability to refinance or sell the underlying equity interests at maturity.~~

Rationale:

~~The debt instrument does not qualify as a bond because the timing, amount, and likelihood of cash distributions from the underlying equity interests is highly uncertain, and because the capital structure of the SPV does not contain adequate diversification or liquidity provisions to ensure the production of adequate cash flows to service both principal and interest payments. Furthermore, the anticipated repayment significantly relies on the ability to refinance or sell the underlying equity interests at maturity.~~

Determining ~~of~~ whether ~~a~~ debt instruments collateralized by equity interests qualify as bonds ~~represents a creditor relationship~~ under this statement ~~in substance when the source of cash flows for repayment is derived from underlying equity interests~~ inherently requires significant judgment and analysis. Unlike ~~a~~ debt instruments collateralized by assets with contractual cash flows, or debt instruments collateralized by cash-generating non-financial assets, debt instruments collateralized by equity interests may be ~~are~~ dependent on cash flow distributions that are not contractually required to be made and/or may ~~are~~ not be controlled by the issuer of the debt. In some instances, sale or refinancing of the underlying equity interests may be the only means of generating cash flows to service the debt instruments. As a result of these factors, there is a rebuttable presumption that a debt instrument collateralized by equity interests does not qualify as a bond. ~~As a result, there is a rebuttable presumption that a debt instrument collateralized by equity interests does not represent a creditor relationship in substance.~~ Notwithstanding this rebuttable presumption, it is possible for such ~~a~~ debt instruments to qualify as bonds, ~~to represent a creditor relationship~~ if the characteristics of the underlying equity interests lend themselves to the production of predictable cash flows and the underlying equity risks have been sufficiently redistributed through the capital structure of the issuer. Factors to consider in making this determination include but are not limited to:

- Number and diversification of the underlying equity interests
- Characteristics of the underlying equity interests (vintage, asset-types, etc.)

- Liquidity facilities
- Overcollateralization
- Waiting period for distributions/paydowns to begin
- Capitalization of interest
- Covenants (e.g., loan-to-value trigger provisions)
- Reliance on ongoing sponsor commitments
- Source(s) of expected cash flows to service the debt (i.e., dividend distributions from the underlying collateral vs. sale of the underlying collateral)

Additionally, a debt instrument for which repayment relies significantly upon the ability to refinance or sell the underlying equity interests at maturity subjects the holder to a point-in-time equity valuation risk that is characteristic of the substance of an equity holder relationship rather than a creditor relationship. Therefore, such reliance would preclude the rebuttable presumption from being overcome.
While reliance of the debt instrument on sale of underlying equity interests or refinancing at maturity does not preclude the rebuttable presumption from being overcome, it does require that the other characteristics mitigate the inherent reliance on equity valuation risk to support the transformation of underlying equity risk to bond risk. As reliance on sale or refinancing increases, the more compelling the other factors needed to overcome the rebuttable presumption become.

Furthermore, this analysis The analysis of whether a debt instrument that relies on cash flows from underlying equity interests for repayment represents a creditor relationship in substance should be conducted and documented by a reporting entity at the time such an investment is acquired. The level of documentation and analysis required to demonstrate that the rebuttable presumption has been overcome willmay vary based on the characteristics of the individual debt instrument, as well as the level of third-party and/or non-insuranceer company market validation to which the issuance has been subjected. For example, a debt instrument backed collateralized by fewer, less diversified equity interestsfunds would require more extensive and persuasive documented analysis than one backed collateralized by a larger with a larger number of diversified portfolio of equity interestsfunds. Likewise, a debt instrument that has been successfully marketed to unrelated and/or non-insuranceer company investors, may provide enhanced market validation of the structure compared to one held only by related party and/or insuranceer company investors where capital relief may be the primary motivation for the securitization.

Appendix II

Examples of analysis of asset backed securities under the criteria as defined in paragraphs 3a and 3b:

Example 1:

A reporting entity invests in debt instruments issued from a SPV sponsored by the Government National Mortgage Association (GNMA), the Federal National Mortgage Association (FNMA) and the Federal Home Loan Mortgage Corporation (Freddie Mac) (collectively, "Agency or Agencies"). These debt instruments pass through principal and interest payments received from underlying mortgage loans held by the SPV to the debtholders proportionally, with principal and interest guaranteed by the Agencies. While there is prepayment and extension risk associated with the repayment of the underlying mortgage loans, the credit risk associated with the mortgage loans is assumed by the Agencies.

Rationale:

Although the reporting entity participates on a proportional basis in the cash flows from the underlying mortgage loans held by the SPV, the reporting entity is in a different economic position than if it owned the underlying mortgage loans directly because the credit risk has been redistributed and assumed by the Agencies. This is a substantive credit enhancement because a market participant (i.e., a knowledgeable investor transacting at arm's length) would conclude the Agency guarantee is expected to absorb all losses before the debt instrument being evaluated. Therefore, the holder of the debt instrument is in a substantively different economic position than if the holder owned the ABS Issuer's unguaranteed assets directly, in accordance with the requirements in paragraph 3b. When guarantees do not cover 100% of principal and interest as the Agency guarantees do in this example, it is still appropriate to determine if the guarantee is substantive in accordance with the requirements in paragraph 3.b., to determine if the holder is in a substantively different economic position that if the holder held the ABS Issuer's assets directly.

Example 2:

A reporting entity invested in a debt instrument issued by a SPV that owns equipment which is leased to an equipment operator. The equipment operator makes lease payments to the SPV, which are passed through to service the SPV's debt obligation. While the debt is outstanding, the equipment and lease are held in trust and pledged as collateral for the debtholders. Should a default occur, the debtholders can foreclose on and liquidate the equipment as well as submit an unsecured lease claim in the lessee's bankruptcy for any defaulted lease payments. The loan-to-value at origination is 70%.

The existing lease payments are sufficient to cover all interest payments and all scheduled debt amortization payments over the life of the debt instrument. However, at debt maturity, there is a balloon payment due, totaling 50% of the original outstanding debt principal amount. The corresponding lease has no balloon payment due at lease maturity, so the SPV will either need to refinance the debt or sell the underlying equipment to service the final debt balloon payment. The loan-to-value at maturity is expected to decline to 40% considering the scheduled principal amortization payments net of the expected

economic depreciation in the equipment value over the term of the debt. The equipment is expected to be subject to some market value volatility and periods of lower liquidity at certain points in time but has a predictable value range and ready market over a longer period of time, such that the equipment could be liquidated over a reasonable period of time, if necessary.

Rationale:

The equipment is a cash generating non-financial asset which is expected to generate a meaningful level of cash flows for the repayment of the bonds via the existing lease that covers all interest payments and 50% of the principal payments. In reaching this determination, the reporting entity considered the predictable nature of the cash flows, which are contractually fixed for the life of the debt instrument, as well as the ability of the collateral value to provide for the balloon payment through sale or refinancing in light of its characteristics. While the equipment may have some market value volatility and periods of lower liquidity at points in time, the cash flows produced by the lease were concluded to reduce the loan balance to a level (40% loan-to-value) that would be able to be recovered by sale or refinancing even if it were to mature at such point in time.

The reporting entity also determined that the structure provides substantive credit enhancement in the form of overcollateralization to conclude that investors are in a different economic position than holding the equipment directly, in accordance with the requirements in paragraph 3.b. In reaching this conclusion, the reporting entity noted that the debt instrument starts with a 70% loan-to-value, which continues to improve over the life of the debt as the loan balance amortizes more quickly than the expected economic depreciation on the underlying equipment. In the context of the predictable nature of the cash flows and collateral value range over time, the reporting entity concluded that a market participant (i.e., knowledgeable investor transacting at arm's length) would consider this level of overcollateralization to put the investor in a substantively different economic position than owning the underlying equipment directly.

For the purposes of determining whether there is substantive overcollateralization, it is appropriate to consider any expected economic depreciation, if it is reasonably expected, but it is not appropriate to consider any expected economic appreciation. Note that a debt instrument with a loan-to- value that is expected to decrease over time is not necessarily deemed to have substantive overcollateralization.

Example 3:

A reporting entity invested in a debt instrument with the same characteristics as described in Example 2, except that the existing equipment lease at the time of origination has a contractual term that is shorter than that of the debt instrument. It is expected with a high degree of probability that the lease will be renewed, and a substantial leasing market exists to replace the lessee should they not renew. However, in the unlikely circumstance that the equipment cannot be re-leased, there would not be enough cash flows to service the scheduled principal and interest payments, and the equipment would have to be liquidated to pay off the debt upon default.

Rationale:

All details of Example 3, including the expected collateral cash flows, are consistent with those in Example 2, except that the cash flows in Example 2 are contractually fixed for the duration of the debt while the cash flows in Example 3 are subject to re-leasing risk. Notwithstanding the involvement of re-leasing risk, the reporting entity concluded that the ability to re-lease the equipment was highly predictable and supported the conclusion that the equipment was expected to produce meaningful cash flows to service the debt.

This distinction is to highlight that the expected cash flows of a cash-generating non-financial asset may or may not be contractually fixed for the term of the bond. Certain securitized cash flow streams may not by their nature lend themselves to long-term contracts (e.g., single-family home rentals), but may nevertheless lend themselves to the production of predictable cash flows. While the non-contractual nature of the cash flows is an important consideration in determining whether a non-financial asset is expected to produce meaningful cash flows to service the debt, it does not, in and of itself, preclude a reporting entity from concluding that the assets are expected to produce meaningful cash flows.

Example 4:

A reporting entity invested in a debt instrument issued by a SPV that owns equipment which is leased to an equipment operator. The equipment operator makes lease payments to the SPV, which are passed through to service the SPV's debt obligation. While the debt is outstanding, the equipment and lease are held in trust and pledged as collateral for the debtholders. Should a default occur, the debtholders can foreclose on and liquidate the equipment as well as submit an unsecured lease claim in the lessee's bankruptcy for any defaulted lease payments. The loan-to-value at origination is 70%.

The existing lease payments are sufficient to cover all interest payments and all scheduled debt amortization payments over the life of the debt instrument. However, at maturity, there is a balloon payment due, totaling 80% of the original outstanding principal amount. The corresponding lease has no balloon payment due at lease maturity, so the SPV will either need to refinance the debt or sell the underlying equipment to service the final debt balloon payment. The loan-to-value at maturity is expected to increase to 95% considering the scheduled principal amortization payments net of the expected economic depreciation in the equipment value over the term of the debt. The equipment is expected to be subject to some market value volatility and periods of lower liquidity at certain points in time, but has a predictable value range and ready market over a longer period of time, such that the equipment could be liquidated over a reasonable period of time, if necessary.

Rationale:

The equipment is a cash generating non-financial asset which is not expected to generate a meaningful level of cash flows for the repayment of the bonds via the existing lease that covers all interest payments and 20% of principal payments. In reaching this determination, the reporting entity considered that, while the cash flows being produced are predictable, the ability to recover the principal of the debt investment is almost entirely reliant on the equipment retaining sufficient value to sell or refinance to satisfy the debt.

The reporting entity also determined that the structure lacks substantive credit enhancement to conclude that investors are in a different economic position than holding the equipment directly, in accordance with the requirements in paragraph 3.b. In reaching this conclusion, the reporting entity noted that the debt starts with a 70% loan-to-value, but the overcollateralization is expected to deteriorate over the term of the debt as the equipment economically depreciates more quickly than the debt amortizes. This results in a high loan-to-value (i.e., 95%) at maturity, relative to the market value volatility of the underlying collateral. Despite the predictable nature of the cash flows, the reporting entity concluded that the debt instrument lacked a substantive level of overcollateralization to conclude that the investor is in a different economic position than owning the underlying equipment directly. It was determined that the level of overcollateralization , as determined by a market participant (i.e., a knowledgeable investor transacting at arm's length), is nominal. Therefore, the reporting entity concluded that it was in a substantively similar position as if it owned the equipment directly.

For the purposes of determining whether there is substantive overcollateralization, it is appropriate to consider any expected economic depreciation, if it is reasonably expected, but it is not appropriate to factor in any expected economic appreciation. Note that a debt instrument with a loan-to- value that is expected to increase over time is not necessarily deemed to have nominal overcollateralization.

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Statutory Issue Paper No. 1XX

Principles-Based Bond Definition

STATUS
Exposure Document – Comments Due May 6, 2022

Original SSAP: SSAP No. 26 and SSAP No. 43
Current Authoritative Guidance: SSAP No. 26R and SSAP No. 43R

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. The guidance within this issue paper introduces new statutory accounting concept revisions to *SSAP No. 26R—Bonds* (SSAP No. 26R) and *SSAP No. 43R—Loan-backed and Structured Securities* (SSAP No. 43R) pursuant to the Statutory Accounting Principles (E) Working Group's (Working Group) Investment Classification Project as well as in response to expanding investment structures that have been reported on Schedule D-1: Long-Term Bonds. The Investment Classification Project reflects a comprehensive review to address a variety of issues pertaining to definitions, measurement and overall scope of the investment SSAPs. Although SSAP No. 26R was previously revised pursuant to the Investment Classification Project in 2017, it was identified that some entities were classifying securities issued from special purpose vehicles (SPVs) in scope of SSAP No. 26R instead of SSAP No. 43R. As the focus of this current project is on the substance of investments, regardless of whether they include an SPV for issuance, this project includes both SSAP No. 26R and SSAP No. 43R.

SUMMARY CONCLUSION

2. Investments eligible for reporting on Schedule D-1 shall comply with the principles-based definition of a bond or be specifically noted in scope of SSAP No. 26R or SSAP No. 43R. Revisions to reflect the principles-based bond definition will be incorporated to SSAP No. 26R and SSAP No. 43R. Tracked changes to reflect this guidance are shown in Exhibit A & B.

DISCUSSION

3. The discussion of this issue originally began in August 2019 with agenda item 2019-21: SSAP No. 43R – Equity Investments. This agenda item was drafted to consider clarification to SSAP No. 43R particularly with regards to collateralized fund obligations and similar structures that reflect underlying equity interests. In response to the discussion of comment letters in January 2020, this project was expanded to include a comprehensive review of SSAP No. 43R under the Working Group's Investment Classification Project, with NAIC staff directed to prepare a discussion document for subsequent review.

4. A preliminary discussion document was exposed for comment on March 18, 2020. Although there were no proposed recommendations in that exposed document, it captured the following:

   a. History of the definition / scope development of SSAP No. 43R. (This history has been retained in Exhibit ___ of this Issue Paper.)

   b. Definitions of asset backed securities (ABS) from the Code of Federal Regulations (CFR), the Securities Exchange Act of 1934 and NAIC Model 280, Investments of Insurers Model Act (Defined Limits Version).

c. Potential options for the accounting and reporting of ABS based on whether they were considered traditional securitizations in accordance with the Code of Federal Regulations (CFR) (17 CFR 229.1101(c)) definition of an ABS or non-traditional securitizations that did not comply with the CFR definition.

5. In response to this initial exposure, a detailed comment letter dated July 31, 2020, was received from interested parties. Although a variety of elements were noted, two key issues were the primary focus:

a. Separation between SSAP No. 26R and SSAP No. 43R: Pursuant to the comments received, it was identified that many insurers had different interpretations of the adopted 2010 revisions that separated investments between SSAP No. 26R and SSAP No. 43R due to the presence of a "trust" or an "SPV" structure. As such, investment designs that had been identified as concerning due to the underlying investments in the SPV (e.g., equity-driven investments) believed by some to be limited to SSAP No. 43R were, under some interpretations, eligible to be captured in scope of SSAP No. 26R.

b. Defining an asset backed security: The comments received focused heavily on whether the 17 CFR definition captured securities within the 1933 or 1934 Securities Act. The proposed use of the 17 CFR definition, which is the ABS definition used by the SEC as a nationally recognized statistical ratings organization (NRSRO) registered for asset-backed securities, was intended to allow consistency in ABS items permitted for NRSRO designations. Furthermore, it was only the first "broad brush" in determining whether an investment would be initially captured in scope of SSAP No. 43R. Regardless, based on the comments received, which noted variations between the 1933 and 1934 Securities Act, differences of assessments based on whether an entity is the issuer or acquirer, the legal scrutiny that may be required in determining whether an investment complies with the definition, as well as a recommendation for independent principles for determining an investment as an asset backed security, it was identified that further discussion should occur before utilizing the CFR definition of an asset-backed security.

6. After considering the interested parties' July 31, 2020, comments, the Working Group directed that a small group of industry work with Iowa representatives and NAIC staff to first define what should be considered a bond for reporting on Schedule D-1. It was identified that some investment designs, which have been previously captured on Schedule D-1 or are proposed for inclusion on that schedule, may be well-performing assets, but are not bonds and should not be captured on Schedule D-1. It was also noted that regulators are not anticipating these sorts of investment structures when reviewing D-1 and assessing investment risk. These small group discussions began December 1, 2020 and continued until the bond proposal was exposed for public comment on May 20, 2021.

7. After considering the comment letters from the May 2021 exposure, on August 26, 2021, the Working Group affirmed the direction of the principle-based bond concepts and directed NAIC staff to utilize those concepts in proposing statutory accounting revisions. With this explicit direction, it was 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 the adopted authoritative SSAP. With the direction to proceed with the development of statutory guidance to reflect the principle-based concepts, the Working Group directed that NAIC staff continue to work with the small group of regulators and industry to discuss concepts, review proposed language and consider innovating investment designs. (During this meeting, the small group was repurposed and referred to as the "study" group with additional regulators participating.)

8. From September 2021 through January 2022, the study group of regulators and industry met to continue discussions on the bond proposal definition. Key elements discussed during this timeframe included 1) the requirement for a credit enhancement that puts the holder of an ABS in a different economic

position from holding the underlying collateral directly, 2) the contractual stapling restriction, and 3) guidance for when a debt instrument is issued from an SPV that owns a portfolio of equity interests. Revisions from these discussions, as well as other aspects to clarify the definition and an initial issue paper were presented to the Statutory Accounting Principles (E) Working Group on March 2, 2022 with a request for exposure.

9. This issue paper intends to provide information on discussions that occurred when considering the principles-based bond definition and the needed statutory accounting revisions to specify the types of investments that shall be reported on Schedule D-1: Long-Term Bonds. (JMG continue expansion of timeline throughout discussion.)

Discussion of Principles-Based Bond Concepts

10. Pursuant to the "small group" discussions comprised of industry, Iowa representatives and NAIC staff, the broad principle-based bond concepts discussed on August 26, 2021 reflected the following key concepts:

a. Definition of a bond requires a security structure, representing a creditor relationship, that is considered an Issuer Credit Obligation or an Asset Backed Security (ABS).

b. The assessment of whether a security represents a creditor relationship requires consideration of the substance, rather than the legal form of the document, as well as consideration of other investments owned in the investee and other contractual arrangements. A security that possesses equity-like characteristics or that represents an ownership interest in the issuer in substance does not represent a creditor relationship.

c. An ABS is a bond issued by an entity created for the primary purpose of raising debt capital backed by financial assets or cash generating non-financial assets owned by the ABS Issuer, whereby repayment is primarily derived from the cash flows associated with the underlying defined collateral rather than the cash flows of an operating entity.

d. There are two defining characteristics that must be present for a security to meet the definition of an asset backed security: 1) The holder of a debt instrument issued by an ABS issuer is in a different economic position than if the holder owned the ABS Issuer's assets directly, and 2) When the assets owned by the ABS are non-financial assets, the assets are expected to generate a meaningful level of cash flows towards repayment of the bond other than through the sale or refinancing of the non-financial assets.

11. Various discussions and components were addressed in the establishment of these broad concepts. Specific elements and discussion points are detailed within.

Security Structure Representing a Creditor Relationship

12. Similar to long-standing guidance in defining a bond, the principles-based bond concepts only permit security structures to be considered eligible for Schedule D-1 reporting. Although the concepts continue reference to the adopted security definition from U.S. GAAP, the guidance is expanded to require that the evaluation of the structure under the security definition considers the substance of the instrument rather than solely its legal form.

13. The consideration of whether a structure reflects a "security" is a key factor in determining the appropriate SSAP for accounting and reporting. A structure with one or more future payments that qualifies as a security has historically been captured as a bond, with measurement and risk-based capital (RBC) charges based on the NAIC designation. Under the prior SSAP guidance, bond securities did not require additional provisions for admittance and would likely only be subject to nonadmittance based on state

investment limits. This treatment is distinctly different than a "non-security' structure considered to be a loan under SSAP No. *20—Nonadmitted Assets* or *SSAP No. 21—Other Admitted Assets*. For these structures, the ability to admit the loan under the SSAP provisions is contingent on the nature of the loan and qualifying collateral or related party assessments. (State investment limits may have additional loan to value requirements that impact admittance.) Loans (other than mortgage loans) are captured on Schedule BA: Other Long-Term Invested Assets and are likely limited by state investment limits along with other invested assets reported on Schedule BA. Although the RBC charge for admitted collateral loans is lower than other Schedule BA investments, the RBC charge is still higher than Schedule D-1 investments with most NAIC designations.

14. Over time, since the codification of statutory accounting principles, various industry comments have been received questioning the difference between loans and securities (e.g., bonds), particularly with the different reporting outcomes. This discussion was also revisited as part of the principles-based bond proposal, and it was concluded that structures must meet the security definition to be captured on Schedule D-1. Although industry requested "loans with recourse" to be added to the bond scope paragraph as well as an explicit reference to "loans" as a type of investment captured in the bond definition, these proposals were not supported for inclusion. This discussion highlighted that the security definition is not a high threshold to meet, and direct loans should not be reflected as bonds if they do not qualify as securities. With this discussion it was noted that an investment could meet the definition of a bond regardless of the legal form (paper) it was written on and/or how it was described (such as a bond, note, obligation, etc.) Although an instrument could be described as a "loan," if it meets the security definition requirements and other principle concepts, it shall be captured as a bond. The same concept would be true for instruments named as a "bond" but that do not meet the security or other principle requirements, as they would not be permitted for Schedule D-1 reporting.

15. The statutory accounting guidance in SSAP No. 26R and *SSAP No. 37—Mortgage Loans* adopts the U.S. GAAP definition of a security as it is used in FASB Codification Topic 320 and 860:

a. Security: A share, participation, or other interest in property or in an entity of the issuer or an obligation of the issuer that has all of the following characteristics:

   i. It is either represented by an instrument issued in bearer or registered form or, if not represented by an instrument, is registered in books maintained to record transfers by or on behalf of the issuer.

   ii. It is of a type commonly dealt in on securities exchanges or markets or, when represented by an instrument, is commonly recognized in any area in which it is issued or dealt in as a medium for investment.

   iii. It either is one of a class or series or by its terms is divisible into a class or series of shares, participations, interests or obligations.

16. The "security/non-security" discussion highlighted that the naming convention of an investment (as a "note," "bond," "obligation," "loan," or other such term) does not determine the correct underlying SSAP or reporting location. Non-security structures (other than mortgage loans) shall be captured as collateral or non-collateral loans pursuant to *SSAP No. 20—Nonadmitted Assets* or *SSAP No. 21—Other Admitted Assets* as applicable. To prevent incorrect assumptions that all loans could be captured as issuer credit obligations, the group agreed not to include explicit reference to loan structures within the principles-based bond concepts and instead refer to the substance of the investment structure. Additionally, the following existing guidance was noted as support for this conclusion and to further highlight that the naming convention does not override the structural design of an investment when it comes to reporting or the application of statutory accounting principles.

a. Existing guidance in SSAP No. 21 states that if an instrument meets the definition of a bond, but has supporting collateral, then the investment is not classified as a collateral loan. This concept was affirmed as part of the principles-based bond discussion, noting that such arrangements that qualify for Schedule D-1 shall not be classified as collateral loans regardless of whether there is collateral backing the investment.

b. Guidance in *SSAP No. 25—Affiliates and Other Related Parties* applies to all transactions, regardless of the SSAP that governs the underlying accounting and reporting. As such, the provisions in SSAP No. 25 that require assessment of "loans or advances (including debt, public or private)" is intended to apply to all forms of lending from a reporting entity to a related party. As such, this guidance applies regardless of the naming convention of the agreement (e.g., loan, bond, note, obligation, etc.,). Structures reported on Schedule D-1 that reflect related party transactions shall only be admitted if the requirements in SSAP No. 25 are met. In addition to having a specific due date and written agreements, these requirements include specific assessments based on whether the arrangement is with a parent or principal owner or to other related parties.

17. After determining whether a structure represents a security, the next component for the principle-based bond definition is assessing whether the security represents a creditor relationship. Although the reference to a "creditor relationship" may seem very similar to prior guidance in SSAP No. 26R, that prior guidance did not explicitly detail the intended meaning of a "creditor relationship" but simply identified that such structures have a fixed schedule for one or more future payments. This prior guidance resulted with interpretations that structures qualified as "bonds" strictly on legal form. With the focus of the principles-based definition, it is explicit that the assessment of a whether a security represents a creditor relationship requires consideration of the substance, rather just the legal form, along with consideration of other investments owned in the investee and other contractual arrangements.

18. Original regulator concerns with the current guidance and reporting were in part due to the identification of investments with underlying equity interests that were structured to resemble bond instruments. This discussion identified that there is a significant incentive for insurers to characterize equity exposures, which would traditionally be captured on Schedule BA, as bonds due to the favorable capital treatment. Transferring or acquiring them as debt issued by an SPV (such as through a collateralized fund obligation (CFO) type structure) is a mechanism to reclassify these equity instruments and characterize them as bonds. The lack of current safeguards in existing SSAPs also provides significant opportunity for these reclassifications.

19. Equity investments differ from other types of financial assets in that they generally do not have contractual payments. Distributions are typically at the discretion of whichever decision maker has control of the entity. However, certain types of entities have greater likelihood and predictability of cash flows than others. For example, private equity and debt funds are often designed to have finite lives that begin with a capital raising and investment phase, and once the portfolio is built and seasoned, investments are monetized, returns realized, and distributed to investors. Therefore, while there can be variability in timing and amounts of cash flows, distributions can be expected with some level of predictability compared to other types of equity investments (e.g., publicly traded companies). Private debt funds are more predictable still given that the underlying investments of the fund have contractual cash flows. If a large, diversified pool of such types of seasoned funds are securitized, referred to as a CFO, there can be a level of predictable cash flows that is suited to support a bond, when coupled with the overcollateralization, liquidity facilities, and other protections that are built into the structure.

20. A regulator concern arises when features that facilitate the production of predictable cash flows are not present. In such a case, when there are not predictable cash flows equipped to service the debt, repayment may rely on sale or refinancing of the underlying equity investments at maturity in order to satisfy the debt. In that case, equity valuation risk may be the primary risk for the non-payment of the SPV-

issued debt. If repayment predominantly relies on a point-in-time equity valuation (such as at maturity), then the substance of the risk is not consistent with what is expected of a bond on Schedule D-1.

21. Although the full disallowance of equity-backed debt would prevent these concerns, there is a position that there are CFO securitizations (or other investments) of well-diversified, seasoned funds for which there is compelling evidence that there will be sufficient cash distributions to amortize the debt and structure protections that minimize the residual equity exposure. The approach to allow such CFO securitizations/investments only works when there are appropriate safeguarding principles established, which require a relatively high standard of proof.

22. An investment for which the primary risk for non-payment is equity devaluation is not consistent with the substance-intent for what is expected to be on Schedule D-1 under the principles-based definition. Allowing these items to be reported on Schedule D-1 could result with the regulatory arbitrage that regulators are concerned about without any real mitigants. This could ultimately result in a situation where industry has taken on significantly more equity risk that they have historically, all while characterizing the investment as a bond exposure. As such, it was noted as critical that appropriate safeguards be incorporated to address this concern, which is why the small group supported a rebuttable presumption that equity-backed ABS do not qualify to be reported on Schedule D-1 unless a documented analysis supporting the predictability of cash flows is completed to overcome that presumption.

23. The principles-based definition is clear that a security that possesses equity-like characteristics or that represents an ownership interest in the issuer in substance does not represent a creditor relationship. Examples of equity investments, equity holdings and equity-like interests include any security ultimately reflecting an ownership or membership interest in an entity (such as common stock, preferred stock, private equity holdings, investments in joint ventures, partnerships, and LLCs) as well as any structure that reflects the performance of an entity (such as dividends or capital gains). Furthermore, examples of equity instruments also include any debt instrument where the risk/reward profile is substantially similar to an equity interest.

24. With the prohibition of equity-like structures or items that represent ownership interests, there is a rebuttable presumption that debt instruments collateralized by equity interests do not qualify as bonds because they do not reflect a creditor relationship in substance. Notwithstanding this rebuttable presumption, it is possible for such a debt instrument to represent a creditor relationship if the characteristics of the underlying equity interests lend themselves to the production of predictable cash flows and the underlying equity risks have been sufficiently redistributed through the capital structure of the issuer.

25. With the establishment of the principles-based bond definition, this rebuttable presumption was specifically discussed, and it was concluded that the determination of whether debt instruments collateralized by equity interests qualify as bonds inherently requires significant judgment and analysis. Unlike debt instruments collateralized with contractual cash flows, or debt instruments collateralized by cash-generating non-financial assets, debt instruments collateralized by equity interests may be dependent on cash flow distributions that are not contractually required to be made and/or may not be controlled by the issuer of the debt. In some instances, sale or refinancing of the underlying equity interests may be the only means of generating cash flows to service the debt instruments. If this is the situation, then it is expected that compensating factors from other characteristics will be present to qualify. For example, if the source of cash flows is driven from the sale or refinancing, then an appropriate, compensating level of overcollateralization would be required to overcome the presumption that the structure does not qualify as a bond.

26. For debt instruments that are collateralized by equity interests, various factors should be considered in determining whether debt collateralized by equity interests qualify as bonds. Additionally, to overcome the presumption that the structure does not qualify as a bond, it is presumed that reporting entities will have sufficient documentation supporting this conclusion. Factors to consider include, but are not limited to, the following:

a. Number and diversification of the underlying equity interests

b. Characteristics of the equity interests

c. Liquidity facilities

d. Overcollateralization

e. Waiting period for the distributions / paydowns to begin

f. Capitalization of interest

g. Covenants (e.g., loan-to-value trigger provisions)

h. Reliance on ongoing sponsor commitments

i. Source(s) of expected cash flows to service the debt (i.e., dividend distributions from the underlying collateral vs. sale of the underlying collateral)

Determination of Issuer Credit Obligation or Asset Backed Security (ABS)

27. Security structures that qualify as creditor relationship are divided between issuer credit obligations and ABS. The initial distinction between an issuer credit obligation and an ABS is a key factor with the principle-based bond concepts. Given their differing characteristics, investments that qualify as issuer credit obligations are not required to complete assessments for qualifying credit enhancements or meaningful cash flow generation. As such, it is critical to ensure that structures which should be considered ABS or that reflect non-qualifying Schedule D-1 structures, are not classified as issuer obligations to avoid those detailed assessments.

28. Determining whether an investment reflects an issuer credit obligation or an ABS focuses on the issuer and the primary source of repayment of the instrument. An issuer credit obligation represents a bond structure where the repayment is supported primarily by the general creditworthiness of an operating entity or entities. The support for this structure consists of direct or indirect recourse to an operating entity or entities. An "operating entity" can be any sort of business entity, not-for-profit organization, or other provider of goods or services, but cannot be a natural person or an Asset Backed Security (ABS) issuer. An ABS is a bond issued by an entity (an ABS Issuer) created for the primary purpose of raising debt capital backed by financial assets or cash generating non-financial assets owed by the ABS Issuer, whereby repayment is primarily derived from the cash flows associated with the underlying defined collateral rather than the cash flows of an operating entity.

29. The prior assessments to divide structures between SSAP No. 26R and SSAP No. 43R seemed to focus primarily on legal form (issued by trust/SPV that held pledged assets) or on the basis of prepayment risk within the structure (meaning, that the expected timing of cash flows may vary, impacting the effective interest rate). Under the principle-based bond definition, neither of these components shall be used as a determinant in concluding whether a structure represents an issuer credit obligation or an ABS.

a. The prior guidance which focused on the use of an SPV relied more on legal form than the substance of the transaction. Although it is common that many ABS Issuers are in the form of a trust or SPV, the presence or lack of a trust or SPV is not a definitive criterion in determining that a security meets the definition of a Schedule D-1 investment, or that it is limited to a classification as an ABS. A key component of the principles-based bond definition is that it will not be possible to recognize a non-qualifying investment as a bond simply by moving it to a debt-issuing SPV to resemble a creditor relationship with a future payment obligation. Furthermore, the guidance does not preclude the use of SPVs in issuer credit obligations. Such structures are commonly utilized in project finance arrangements to separate business operations that support specific debt instruments, or to facilitate

efficient marketing of an issuer credit obligation (e.g. funding agreement backed notes). Although packaging investments together in an SPV, with an SPV-issued note may currently result with better RBC charges, such structures that simply reflect a pass-through of cash flows or performance from the underlying collateral and provide no economic difference than if holding the underlying collateral items directly should not be characterized as bonds.

b. With regards to the prior interpretation that SSAP classification was based on the presence of prepayment risk, which was not an interpretation based on any explicit guidance to that effect, the presence or absence of prepayment risk will continue to play no role in SSAP classification. Classification is based on whether the investment has the substance of an issuer obligation or asset backed security. This distinction aligns the accounting and measurement with the characteristics of the bond. As asset backed securities rely on the cash flows of underlying collateral, the measurement method described in SSAP No. 43R, which requires a quarterly review of underlying cash flow assumptions, is appropriate regardless of whether variations in timing of cash flows impact the effective yield. This methodology captures variations in **both** timing and **amount** of the underlying cash flows.

30. Whether an issuer of debt represents an operating entity or ABS Issuer is expected to be clear in most instances, but certain instances may be less clear. Ultimately, for an issuer credit obligation, it comes down to whether support for repayment consists of direct or indirect recourse to an operating entity or entities. In addition to "traditional bond" structures previously included in SSAP No. 26R, examples of issuer credit obligations include:

a. Investments in the form of securities for which repayment is fully supported by an underlying contractual obligation of a single operating entity. (e.g., CTLs, ETCs, other lease backed securities, Funding Agreement Backed Notes (FABNs), etc.). For purposes of applying this principle concept, repayment is fully-supported by the underlying operating entity obligation if it provides cash flows for the repayment of all interest and at least 95% of the principal of the security.

b. Bonds issued by real estate investment trusts (REITS) or similar property trusts.

c. Bonds issued by business development corporations, closed-end funds or similar operating entities, in each case registered under the 1940 Act. With this inclusion, it is important to highlight that the intent is specific to bonds issued from SEC-registered entities. The reference to "similar entities" is not intended to capture items issued from collateralized fund obligations (CFOs) or other such structures. Although some may consider CFOs to be similar to closed-end funds, that assessment is not supported for classification as an issuer credit obligation. Instruments considered to reflect CFOs (and other like structures) are required to be assessed as asset-backed securities for inclusion on Schedule D-1.

d. Project finance debt issued by operating entities. These investments reflect financing of a single asset or "operation" (such as a toll road or power generation facility) that collateralizes a debt issuance and the cash flows produced by the asset/operation service the debt, where the issuer may also represent an operating entity. These designs have characteristics of both issuer credit operations, as the operation constitutes a stand-alone business, as well as characteristics of ABS, as they are formed for the purpose of raising debt capital backed by the cash flows from collateral held by a bankruptcy-remote entity. When viewed holistically, these issuing entities are typically used to facilitate the financing of an operating component of a project sponsor or municipality. Although the use of a bankruptcy-remote entity (e.g., SPV) facilitates the efficient raising of debt as a source of financing, the primary purpose is to finance an operating project. Therefore, when the

issuing entity represents a stand-alone business producing its own operating revenues and expenses, where the primary purpose is to finance an operating project, the issuing entity shall be considered an operating entity despite certain characteristics that resemble ABS issuances.

i. It is important to highlight that the guidance for project finance is strictly for instruments issued by operating entities, similar to other instruments that qualify as issuer credit obligations under the principles-based bond definition. Consistent with other concepts, the naming convention (e.g., referring to an instrument as project finance) or the presence or absence of an SPV/trust structure are not definitive components in determining whether an investment qualifies for reporting on Schedule D-1, or is classified as an issuer credit obligation or ABS. Instruments (even if identified as "project finance") that do not qualify as issuer credit obligations as they not issued by operating entities, shall be assessed for qualification for reporting on Schedule D-1 as ABS. If the instruments do not qualify for reporting as ABS, they shall not be reported on Schedule D-1.

e. U.S. Treasury Inflation-Protected Securities (TIPs): The inclusion of U.S. TIPs specifically as an issuer credit obligation intends to highlight a specific exception to the determination as a creditor relationship. Under the definition, securities with principal or interest payments that vary based on the appreciation or depreciation of equity interests do not reflect creditor relationships. Although US TIPS are indexed to the consumer price index and grows with inflation, these securities shall be captured as issuer credit obligations on Schedule D-1.

31. This Schedule D-1 project is not expected to reconsider certain investments previously considered by the Working Group and explicitly permitted for Schedule D-1 reporting. As such, unless subsequently addressed within this project, the following investment types are expected to continue to qualify as Schedule D-1 investments and be classified as issuer credit obligations. (By including these investments as issuer credit obligations, these investments are not subject to the assessments of sufficiency or meaningful cash flow generation required for ABS securities.)

a. Certificates of deposit that have a fixed schedule of payments and a maturity date in excess of one year from the date of acquisition.

b. Bank loans that are obligations of operating entities, issued directly by a reporting entity or acquired through a participation, syndication or assignment.

c. Debt instruments in a certified capital company (CAPCO).

d. SVO-Identified Bond ETFs.

32. The investment structures explicitly permitted for Schedule D-1 reporting no longer includes a generic reference to "hybrid securities". Under prior guidance in SSAP No. 26R, hybrid securities, defined in the Annual Statement Instructions as securities with characteristics of both debt and equity securities, were included and captured on a specific Schedule D-1 reporting line. Examples in the Annual Statement Instructions included Trust Preferred Securities and Yankee Tier 1 bonds, however, both types of securities are no longer overly prevalent, although some insurers may continue to have them in their portfolios. Pursuant to the intent of the principle-based bond proposal, a broad exception for securities that have characteristics of both debt and equity is not viable. Rather, to ensure that securities are classified and reported based on the substance of the investments, securities with characteristics of both debt and equity

shall be assessed for inclusion on Schedule D-1 in accordance with the principal-based bond definition. If the securities qualify as issuer credit obligations or ABS, then they can be reported on Schedule D-1.

a. Trust Preferred Securities – With these securities, there is a trust funded by debt where shares of the trust are then sold to investors in the form of preferred stock. The shares held are referred to as "trust preferred" securities. These securities have characteristics of both stock and debt. While the trust is funded with debt, the shares are considered to be preferred stocks and pay dividends like preferred stock. However, since the trust holds the bank's debt as the funding vehicle, the payments received by investors are considered interest payments. These securities are considered equities under U.S. GAAP, but are taxed as debt obligations by the IRS. With the Dodd-Frank reforms, the incentives for banks to issue trust-preferred securities decreased, resulting with a significant reduction in the issuance of these securities. If these securities continue to be held by insurers, they should be assessed for reporting on Schedule D-1 under the principal-based bond proposal. If these securities do not qualify for Schedule D-1, presumably, these securities would be reported as preferred stock on Schedule D-2-1.

b. Yankee Bond – A Yankee bond is one issued by a foreign bank or company but that is traded in the U.S and priced in U.S. dollars. Yankee bonds are normally issued in tranches, with a large debt structure financing arrangement, with each tranche having different levels of risk, interest rates and maturities. The non-U.S. issuers have to register Yankee bonds with the SEC before offering the bond for sale. If these securities are held by insurers, they should be assessed for reporting on Schedule D-1 under the principal-based bond proposal.

c. Other Hybrid Securities – From information received, it was noted that some reporting entities have previously reported securities on Schedule D-1 as hybrids due to a code in Bloomberg that identified the security as having characteristics of both debt and equity. Such securities shall be reviewed in accordance with the principles-based bond definition and reported on Schedule D-1 only if they qualify.

33. For securities that represent principal-protected notes (or principal-protected securities) and structured notes that have been previously captured within SSAP No. 26R or SSAP No. 43R, the principles-based bond definition will no longer permit these security structures to be reported on Schedule D-1. Fundamentally, these structures have the potential for variable principal or interest / returns, or both, due to the underlying equity appreciation or depreciation, or an equity-based derivative. This structural characteristic precludes these investments from being captured as issuer credit obligations or ABS as the investment does not represent a creditor relationship in substance. It should be clear that the principles-based bond definition is intended to require a structural assessment inclusive of all investment components, therefore it is not permissible to segregate components within a structure, such as bond collateral supporting principal and interest payments to determine Schedule D-1 reporting when the structure also includes other collateral with the potential to generate additional interest or returns. Such structures must be viewed wholistically within the principles-based bond definition, with all potential returns considered in determining whether the structure qualifies as a creditor relationship.

a. A principal-protected note / security generally includes a high-quality traditional bond (such as a U.S. Treasury) that is used to safeguard principal repayment at the structure's maturity, but the structure also incorporates other investments, at origination or over the life of the structure, that are intended to generate returns or other assets to the reporting entity note holder. These returns, often based on underlying equity factors, prevents these

structures from qualifying as a creditor relationship. In addition to the traditional design of principal-protected notes, other designs have been identified that may provide "interest" payments in the form of tax-credits based on underlying equity exposures. (So, a high-quality bond still safeguards principal returns, but the structure acquires equity elements that provide tax credits to the note holder as a form of interest.) Although the classification of a creditor-relationship may not be as clear in this example, such designs would further be disqualified from Schedule D-1 reporting as they would not qualify as issuer credit obligations due to the different forms of collateral within the structure (considering both the bond and equity items) and such structures would not qualify as ABS as there is generally no credit enhancement.

b. A structured note is an instrument in which the terms make it possible that the reporting entity holder could lose all or a portion of its original investment amount for a reason other than failure of the issuer to pay the contractual amounts due. These instruments incorporate both the credit risk of the issuer, as well as the risk of an underlying variable/interest, such as the performance of an equity index or the performance of an unrelated security. Due to the underlying variable that determines principal repayment, these structures (regardless of if in a trust/SPV) do not qualify as creditor relationships and do not qualify for Schedule D-1 reporting. Existing guidance identifies that structured notes shall be captured in *SSAP No. 86—Derivatives*

34. The guidance in the principles-based bond proposal requires "assessment at origination" in determining whether a security complies for Schedule D-1 reporting. This provision intends to reflect the reporting entity's understanding of the intent and ultimate structure of the security at origination, not simply what a structure holds on the day of origination. It is not permissible to conclude that a principal-protected note is an issuer credit obligation at origination (when the structure includes only a US Treasury and cash) and disregard the intended use of the cash in the structure to subsequently acquire other investments to generate additional returns. The determination of whether an investment qualifies as a creditor-relationship, and then as an issuer creditor obligation or ABS (as applicable) requires an assessment of the full structure as it is ultimately intended by the reporting entity at the time of acquisition.

35. Consistent with prior guidance in SSAP No. 26R, mortgage loans and other real estate lending activities, which are not securities, made in the ordinary course of business are excluded from Schedule D-1. Those investments shall follow the application statutory accounting guidance in *SSAP No. 37—Mortgage Loans* and *SSAP No. 39—Reverse Mortgages*.

<u>Asset Backed Securities and Required Components</u>

36. An Asset Backed Security (ABS) is a bond issued by an entity (an ABS Issuer) created for the primary purpose of raising debt capital backed by financial assets or cash generating non-financial assets owed by the ABS issuer, whereby repayment is primarily derived from the cash flows associated with the underlying defined collateral rather than the cash flows of an operating entity. In most instances, the ABS issuer is not expected to continue functioning beyond the final maturity of the debt initially raised by the ABS Issuer. As previously noted, ABS Issuers are often in the form of a trust or special purpose vehicle, though the presence or lack of a trust or special purpose vehicle is not a definitive criterion for determining that a security meets the definition of an asset backed security.

37. To qualify on Schedule D-1 as an ABS, there are two defining characteristics that must be present. If the structure is a not an issuer credit obligation or identified for specific inclusion on Schedule D-1, and

does not meet these ABS requirements, the instrument is not permitted to be reported as a bond. Assessment on these aspects is investment specific, with determination at origination by the reporting entity based on the overall intent and ultimate expected holdings of the structure:

a. Substantive Credit Enhancement: The holder of the debt obligation issued by the ABS Issuer is in a different economic position than if the holder owned the ABS Issuer's assets directly.

b. Collateral Assets: The assets owed by the ABS issuer are either financial assets or cash-generating non-financial assets. Cash-generating non-financial assets are defined as assets that are expected to generate a meaningful source of cash flows for repayment of the bond through use, licensing leasing, servicing or management fees, or other similar cash flow generation. other than through the sale or refinancing of the assets.

38. Substantive Credit Enhancement: The component for substantive credit enhancement is required for all ABS structures. There are no practical expedients or thresholds that can be applied in determining whether a structure reflects substantive credit enhancement. Although certain structures may only require a limited analysis (such as agency-backed MBS), and insurers may benefit from prior analysis when acquiring similar subsequent structures, an automatic assessment is not permitted for this requirement.

39. To qualify as an ABS, the holder of the debt obligation is required to be in a different economic position than if the holder owned the ABS issuer's assets directly. For purposes of this assessment, the holder of the instrument is considered to be in a different economic position if the instrument benefits from substantive credit enhancement through guarantees (or other similar forms of recourse), subordination and/or overcollateralization. This element is required for all ABS designs, regardless of the collateral that is backing the ABS.

40. The requirement for substantive credit enhancement is intended to address investment designs crafted to appear as a debt / bond structure for reporting and RBC purposes, but for which the holder does not have a "more than nominal" change to the risk or reward profile than if they held the underlying investment directly. This guidance prevents using a specifically designed legal form (such as transferring assets to an SPV and acquiring an SPV-issued note), but which lacks any economic substance, to obtain favorable measurement and RBC impact or to avoid nonadmittance that would occur if the assets were directly held by the reporting entity.

41. The intent of the "substantive" threshold requiring the holder to be in a different economic position is to distinguish qualifying bonds from instruments with equity-like characteristics or where the substance of the transaction is more closely aligned with that of the underlying collateral. To qualify as a bond under this standard, there is a requirement that there are substantive credit enhancements within the structure that absorb losses before the debt instrument being evaluated would be expected to absorb losses. This is inherent in the context of an Issuer Credit Obligation as the owners of the equity in the operating entity are the first to absorb any variability in performance of the operating entity. The same concept applies to asset-backed securities. If substantive credit enhancement did not exist, the substance of the investment would be more closely aligned with that of the underlying collateral than that of a bond. Credit enhancement that is merely nominal or lacks economic substance does not put a holder in a different economic position.

42. The original exposure (May 2021) detailed this ABS requirement as a "sufficient" credit enhancement and detailed the provision as the level of credit enhancement a market participant (i.e., reasonable investor) would conclude is expected to absorb losses (or decreases in cash flows) to the same degree as other debt instruments of similar quality, under a range of stress scenarios (i.e., scenarios are similar to stress scenarios performed for other debt instruments of the same quality). This original proposal noted that losses are those a market participant would estimate with consideration of historical losses (including loss recoveries) on similar collateral, current market conditions, reasonable and supportable

forecasts, and prepayment assumptions associated with the collateral. Excluded from the estimate of expected losses are historical gains on similar collateral and expected market appreciation on the collateral. After further discussion of this concept, it was identified that the term sufficient and its proposed definition implies a quantitative assessment of credit quality is required. As a result, the proposed concept could be interpreted to mean that a reperformance of the credit underwriting process would be needed to support accounting classification, which is not the intent and could be seen to violate the policy that credit ratings not determine accounting classification, as well as introduce an administrative reporting burden that is both duplicative and lacking any added value. Further, a misinterpretation could occur that would permit satisfaction of this component if a credit rating or NAIC designation was obtained. The intent of the concept is not to address credit quality. Rather, the intent is to require that there must be economic substance to support the transformation of the underlying collateral risk, to bond risk. As a result of these discussions, revisions were incorporated to revise the terminology and related definition to reflect a “substantive credit enhancement.” In addition to eliminating a perception that reporting entities could use credit ratings to support this distinction, this guidance incorporates principle concepts to ensure that the provision cannot be satisfied with structural elements that are merely nominal or lack economic substance.

43. Substantive credit enhancement can come in various forms, including but not limited to, subordination/overcollateralization, guarantees, or other forms of recourse. In whatever form the credit enhancement comes in, it must be of a level of significance that the holder of the debt instrument is in a substantively different position than owning the underlying collateral directly. Evaluation of whether a credit enhancement has substance may involve an evaluation of the level of overcollateralization (LTV) or the capacity of whatever form of subordination, guarantee or recourse to absorb collateral losses. As noted, the guidance intends to be specific that an NAIC designation, obtained from either the NAIC Securities Valuation Office (SVO) or from a Credit Rating Provider (CRP) does not provide standalone evidence to support a conclusion that the structure includes a substantive credit enhancement. Although the presence of independent market validation may provide evidence supporting the substance of a credit enhancement, that provision shall not be interpreted to indicate that the presence of an NRSRO rating is automatic validation that the substantive threshold has been met.

44. The following elements were specifically discussed with regards to the requirement for a substantive credit enhancement:

a. Agency-Backed Pass-Through Structures (e.g., RMBS/CMBS): These structures, when they have an agency guarantee, are expected to meet the substantive credit enhancement requirement with little analysis. Although the reporting entity participates on a proportional basis in the cash flows from the underlying mortgage loans held by the SPV, the reporting entity is in a different economic position than if it owned the underlying mortgages directly because the credit risk has been redistributed and assumed by the agencies.

b. Non-Agency Backed Pass-Through Structures: Unlike the above agency-backed example, a pass-through MBS without a credit enhancement, if one were to exist, would not put the holder in a different economic position as owning the mortgage loans directly as they would participate proportionally in the first dollar of losses on the underlying loans. Pursuant to the intent of the overall Schedule D-1 project and required substantive credit enhancement, the guidance does not permit use of an SPV to recharacterize an asset to qualify for Schedule D-1 reporting if the holder is in the same economic position as holding the underlying investments directly. This would apply to any type of underlying asset. In contrast, if the holder of the debt instrument held a senior interest in the pool of loans, through existence of a subordinated tranche for example, the holder may conclude that it is in a different economic position, provided the subordination is determined to be substantive.

c. Loan-To-Value (LTV) Assessments: An assessment of LTV at origination may provide evidence of substantive credit enhancement through overcollateralization. The review should be a holistic assessment, evaluating the expected LTV over the life of the transaction, in conjunction with the liquidity and market value volatility of the underlying collateral, particularly in points in time when the underlying equipment is expected to be off-lease or at the time of maturity if refinancing or sale is required. It is appropriate to consider any expected economic depreciation, but it is not appropriate to factor in any expected economic appreciation. Although an expected decline in the LTV ratio may support the presence of a credit enhancement, a declining LTV is not required, and an increasing LTV is not prohibited, as long as the structure continues to provide a substantive credit enhancement. An expected high LTV at maturity, relative to the market value volatility of the underlying collateral, is considered to lack substantive overcollateralization and would require other forms of credit enhancement in order to meet the substantive credit enhancement criteria.

45. Meaningful Level of Cash Flows to Service Debt: The element for meaningful cash flow generation is only a requirement for ABS that are backed by non-financial assets. ABS designs backed by financial assets, when there is no future performance obligation outside of default risk that could impact the ability to generate cash flows to service the debt, are not required to be assessed under the meaningful cash flow requirement.

46. To qualify as an ABS, there must be a meaningful level of cash flows generated from non-financial assets backing an ABS to service the debt, other than through the sale or refinancing of the assets. The evaluation is specific to each transaction and should consider the market volatility and remarketing potential of the underlying collateral, the variability of the cash flows produced, as well as the diversification of the source of cash flows within the structure. The main intent of this guidance is to ensure that non-financial assets supporting structures reported as bonds on Schedule D-1 encompass a level of "cash generation" that is conducive to servicing traditional bond-like cash flows.

47. Consistent with the substance theme of the principles-based bond proposal, this guidance intends to prohibit situations in which the legal form of an investment is utilized to receive favorable accounting and reporting treatment, while the primary non-payment risk is the point-in-time valuation of an underlying asset. The prior guidance in SSAP No. 43R that focused on placing collateral assets in trust, with the SPV issuing a debt instrument, enabled situations in which non-cash generating structures could be reported as bonds on Schedule D-1. As a simple example, this guidance prevents artwork from being captured as the collateral backing a debt instrument issued by an SPV, with the reporting entity then reporting the SPV-issued note as a bond investment that reflects the expected future value that will be received upon the ultimate sale of the artwork.

48. The guidance requires meaningful cash generation to satisfy the debt instrument throughout the duration of the debt term. The timing of the cash generation, at points prior to maturity of the investment, is a key element as it intends to specifically exclude transactions in which the underlying assets must be sold or refinanced at maturity to produce cash to meet the meaningful requirement. However, this restriction is not intended to automatically exclude all structures that may incorporate collateral asset sales or refinancing throughout the debt duration as part of the expected cash generation. An example could be the securitization of short-term rental car receivables. Such a design could encompass both the rental car lease payments as well as periodic sales of the rental cars as the means to generate meaningful cash flows to service the debt. This design, with planned periodic sales of the non-financial collateral assets over the debt term, is distinctly different than a structure in which cash flows are not meaningfully generated over the course of the debt term and would rely predominantly on the sale or refinancing of the underlying collateral at maturity to satisfy the debt obligation. This restriction also does not exclude all structures that have any amount of sales or refinancing at the end of the debt term. Such investments can qualify for Schedule D-1

reporting if they meet the meaningful cash generation criteria throughout the term of the instrument other than through the sale/refinancing at maturity.

49. The assessment of meaningful cash flows may require detailed evaluations as it is not permissible to conclude that the presence of any cash flows generated within the structure will result with the investment reaching the "meaningful" threshold. It is also not expected to commonly see asset-backed securities that include both financial and non-financial collateral. Such designs shall be reviewed to determine that the structure is in line with the principle intent of the bond definition and has not been developed to circumvent separate assessment or reporting of non-financial asset components. As a simplistic example, including mortgage-backed securities and artwork in a single structure, and identifying that the cash flows of the MBS satisfies the meaningful threshold, with the artwork representing a minimal residual element, so that the full structure qualifies for Schedule D-1 reporting is not reflective of the intent of the principles-based standard. If there are instances in which financial asset and non-financial asset collateral are combined in a single asset-backed structure, consideration should occur on the intent of commingling these collateral elements pursuant to the intent of the principles-based bond definition and in assessing the meaningful cash flow requirements. Structures identified that have been developed to circumvent the provisions of the principle-based bond definition are not permitted to be reported on Schedule D-1 and shall be reported on Schedule BA at the lower of amortized cost or fair value.

50. The assessment of meaningful cash flows is specific to each transaction, determined at origination, and should consider various factors collectively in determining if the meaningful threshold is met. For this assessment, it is noted that an increase in price volatility or variability of cash flows requires a greater percentage of cash flows generated to service the debt from sources other than the sale or refinancing of the underlying collateral. On the flip side, as liquidity, diversification or overcollateralization increase, the required percentage of cash flows generated to service the debt from sources other than the sale or refinancing of the underlying collateral is permitted to decrease. The following factors should be considered with the assessment of meaningful cash flows:

a. Price volatility in the principal market in the underlying collateral.

b. Liquidity in the principal market for the underlying collateral.

c. Diversification characteristics of the underlying collateral (i.e., types of collateral, geographic locations, sources of cash flows within the structure, etc.,)

d. Overcollateralization of the underlying collateral relative to the debt obligation.

e. Variability of cash flows, from sources other than sale or refinancing, expected to be generated from the underlying collateral.

51. The assessment of meaningful cash flows does permit a practical expedient under the principles-based bond definition. A reporting entity may consider an asset for which less than 50% of the original principal relies on sale or refinancing to meet the meaningful criteria. In applying this practical expedient, only contractual cash flows of the non-financial asset may be considered. This practical expedient should not be construed to mean that assets cannot meet the meaningful criteria if they rely on the sale or refinancing to service greater than 50% of the original principal or if they rely on cash flows that are not contracted at origination. Rather, such instances do not qualify under the practical expedient and would require a complete analysis of the noted factors.

Additional Elements for Asset Backed Securities

52. When establishing the ABS definition and required components, various aspects were discussed to improve clarity on the application of the guidance.

53. <u>Determination of "Assets" Backing Securities</u>: Although the definition of an asset detailed in SSAP No. 4 is applied throughout the statutory accounting principles, the question was raised as to where the asset definition would be applied in determining a qualifying ABS. For example, an entity that expects to have subsequent receivables from future operations does not have recognized "assets" from those expectations as the requirements of the asset definition have not been met. However, if that entity were to sell the rights to future cash flows from expected operations, the selling entity would receive cash (a qualifying asset), and the acquiring entity would also have a recognized asset from the acquired right to future cash flows.

54. For purposes of qualifying as an "asset" permitted in an ABS structure, the definition of an asset must be met by the ABS issuer. In some situations, particularly when the asset represents a right to future cash flows, the asset may not be in a form that could be liquidated to provide payment towards the debt obligations. (For example, if the asset represents acquired rights to future royalties, those royalty rights would have to materialize to have liquid assets available toward the debt obligations.) The ability to liquidate the backing collateral asset at a single point in time does not impact the structural determination of whether the issued security meets the definition of an ABS provided that the assets are expected to produce meaningful cash flows to service the debt terms. Additionally, the inability to liquidate the assets backing the instrument may impact the assessment of what constitutes substantive credit enhancement. Failure of cash flows to materialize may impact recoverability and require impairment of an ABS.

55. There is no requirement for a collateral asset backing an ABS structure to qualify as an admitted asset under statutory accounting. Assessing whether the underlying asset qualifies for admittance is not necessary as non-financial assets backing ABS must meet the meaningful cash-generating criteria. If the structure fails to meet the meaningful cash-generating requirement, the instrument does not qualify for reporting on Schedule D-1. Note that statutory accounting has not historically restricted bonds backed by inadmissible assets from being admissible either, nor has it included any kind of evaluation of the cash flow producing ability of underlying assets. The proposed bond definition adds a requirement to evaluate the cash flow producing ability of the underlying collateral, but continues to recognize that assets that may not be admissible if held individually on an insurer's balance sheet, may be well suited to support bond-like cash flows when securitized in large numbers with appropriate structuring (e.g. prioritization of cash flows).

56. <u>Determining Whether the Structure Reflects "Financial" or "Non-Financial" Assets</u>: – The definition of a "financial asset" has previously been adopted from U.S. GAAP and is reflected in *SSAP No. 103R—Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* as cash, evidence of an ownership interest in an entity, or a contract that conveys to one entity a right 1) to receive cash or another financial instrument from a second entity or 2) to exchange other financial instruments on potentially favorable terms with the second entity.

57. For purposes of excluding financial assets from the ABS meaningful cash generation criteria, the financial asset definition was clarified, for the avoidance of doubt, to not include assets for which the realization of benefits conveyed by the rights to receive or exchange financial assets depends on the completion of a performance obligation such as with a lease, mortgage servicing right, royalty rights, etc. For purposes of applying the ABS guidance, when there is a performance obligation required before the cash flows are generated, the assets represent non-financial assets, or a means through which non-financial assets produce cash flows, until the performance obligation has been satisfied. As another way to assess this clarification, if the assets backing the ABS are only subject to default risk (meaning the risk of nonpayment is solely based on failure of the underlying payer to satisfy its unconditional promise to pay), then the asset is a financial asset. If the asset is subject to any other risk in addition to default risk, then the assets represent non-financial assets. As simple illustrative examples:

a. A mortgage-backed security (MBS), where the underlying mortgages have been securitized into a structure, the mortgage receivables represent unconditional promises to pay, with no further performance obligation of the lender or any other party. This structure is considered to be backed by financial assets. Although this structure is excluded from the

meaningful cash flow assessment, it must still comply with the substantive credit enhancement requirement

b. A structure that represents the securitization of rental car leases is contingent on the lessor performing its side of the transaction (providing the car for use) before the lessee is obligated to pay. Therefore, a lease is a non-financial asset due to the performance obligation that must be satisfied in order for payment to become unconditional. Additionally, as is the case with short-term car rentals, the lease (rental agreement) may not themselves be in place and the structure may represent a securitization of the rights to future rental payments, which adds an additional performance condition. This structure combines performance risk with default risk, resulting with the structure not qualifying for classification as being backed by financial assets. For this structure, the reporting entity would have to complete assessments that 1) the structure results with substantive credit enhancement and 2) the structure produces meaningful cash flows over the term of the instrument to satisfy the debt obligation other than through the sale or refinancing at maturity. If at origination, the cash flows from the underlying collateral (rental cars) are expected to generate at least 50% of the original principal, then the meaningful criteria would be met through the practical expedient.

58. Whole-Business Securitizations: In most ABS structures, the assets backing the cash flows are specified and limited to a distinct collateral pool. For example, dedicated cash flows from specific lease arrangements, or specific receivables from credit cards or mortgages. However, ABS structures can exist that represent an entire range of operating revenues or cash flows generated by the business. These structures are often referred to as “whole business” or “operating asset” securitizations.” These structures (which could only include cash flows from certain operating segments, and not necessarily the entire business of a company’s operations) transfer the cash flows from the dedicated operations first to the investment holders, with the operating entity receiving their “operation proceeds” after the investment holders have been paid. This is different from a traditional bond structure where the operating entity first receives the proceeds from their operations, and has discretion for how it uses those proceeds to continue operations and pay expenses and then ultimately pay the bond holders according to the debt terms. Further, debt holders in a whole-business securitization generally only have recourse to the cash flow streams pledged to support the debt, unlike a general credit obligation of the operating entity.

59. For the principles-based bond definition, structures that refer to whole-business securitizations, or that refer to operation proceeds as the collateral for the source of debt repayment still meet the definition as an ABS and do not reflect issuer credit obligations. For these structures, the dedicated operational cash flows represent the defined collateral pool and should not be classified as issuer credit obligations based on an interpretation that the proceeds represent the cash flows of an operating entity as they are not supported by the general creditworthiness of an operating entity, but rather only on referenced cash flow streams from operations.

60. Residual Tranches / “Equity” Components of Schedule D-1 Qualifying Structures: The assessment of qualifying Schedule D-1 investments has to consider the overall investment structure but focuses primarily on the specific instrument held by the reporting entity. Structures, particularly ABS, may include residual tranches that do not have contractual principal or interest payments, but rather provide payment after contractual principal and interest payments have been made to other tranches or interests based on remaining available funds. Although payments to residual note holders could occur throughout an investment’s duration, and not just at maturity, such instances still reflect the residual amount permitted to be distributed after other holders have received contractual interest and principal payments. In all instances, despite whether other tranches of the investment structure qualify for Schedule D-1 reporting, residual tranches do not qualify for reporting on Schedule D-1.

61. Under prior guidance in SSAP No. 43R, there was no exclusion that restricted residual tranches of qualifying securitizations from being captured in scope and being reported as bonds. From the outreach performed in developing the principles-based bond definition, it was identified that several insurers have previously reported these residual tranches on Schedule BA: Other Long-Term Invested Assets. However, it was noted that some reporting entities have reported these tranches on Schedule D-1 as a component of the securitization or as a beneficial interest in scope of SSAP No. 43R. Although residual tranches (first loss tranches) are not rated, when reported on Schedule D-1, an NAIC designation would be required. From information obtained, entities reporting residual tranches on Schedule D-1 have either been reporting as self-assigned 6* or applied the NAIC 5GI concept to self-designate these securities. Under the 5GI concept, the P&P Manual permits self-designation as an NAIC 5 if the documentation necessary for a full SVO credit analysis does not exist, the issuer is current on all principal and interest payments, and the reporting entity has an expectation that they will receive all contracted interest and principal. The use of the NAIC 5GI concept to self-designate residual tranches on Schedule D-1 is a misapplication of this guidance. It is faulty to conclude that an investment is current and will provide all contractual interest and principal payments when the investment has no contractual interest or principal payments. Furthermore, the 5GI provision was intended to prevent an NAIC 6 designation simply because the documentation for a full credit analysis could not be provided or reviewed, such as situations involving foreign securities when the supporting documents may be in a foreign language. The NAIC 5GI provision was not intended to permit self-assignment of an NAIC 5 designation to securities that would not qualify as a fixed-income instrument eligible for an NAIC designation under the P&P Manual.

62. With the identification that residual tranches are inconsistently reported, with some entities reporting on D-1 and others reporting on Schedule BA, the Working Group drafted and exposed agenda item 2021-15: SSAP No. 43R – Residual Tranches in September 2021 as an interim action prior to the conclusion of the bond proposal project. The guidance within this agenda item clarifies that residual tranches shall be reported on Schedule BA at lower of amortized cost or fair value. The guidance also clarifies that the reference to residual tranches intends to capture securitization tranches and beneficial interests, as well as other structures captured in scope of SSAP No. 43R that reflect loss layers without contractual interest or principal payments. Payments to holders of these items occur after contractual interest and principal payments have been made to holders of other tranches or interests and are based on the remaining available funds. Although payments can occur throughout an investment's duration, such instances still reflect the residual amount permitted to be distributed after other holders have received contracted interest and principal payments.

63. On November 10, 2021, the Statutory Accounting Principles (E) Working Group adopted the agenda item, clarifying that residual tranches are required to be reporting on Schedule BA: Other Long-Term Assets beginning December 31, 2022, with early adoption permitted. The effective date of this action allows time for reporting entities to implement this change and corresponds with a Blanks (E) Working Group proposal to incorporate separate reporting lines for residuals, based on underlying characteristics, on Schedule BA. With the adoption of this guidance, the Working Group noted that reporting entities may elect to reclassify residual tranches or interests to Schedule BA in advance of the effective date. As of the effective date, residual tranches or interests previously reported on Schedule BA shall be reclassified to the appropriate residual tranche Schedule BA reporting line based on the underlying characteristics of the investment structure.

64. Along with the action to specify the Schedule BA reporting for residuals, the Working Group and the Valuation of Securities (E) Task Force provided a joint memorandum to the Blanks (E) Working Group to specifically identify that application of the NAIC 5GI process is an inaccurate application. Residual tranches or interests reported on Schedule D-1 for year-end 2021 shall be reported with an NAIC 6. The Working Group also provided the Task Force a referral requesting clarification of the NAIC 5GI process so future misapplications could be mitigated. The Task Force considered specific changes to address residuals and adopted those revisions during the 2021 Fall National Meeting.

65. Stapling of investments: The original exposure of the principles-based bond definition (May 2021) included an initial example (originally referred to as Appendix I – Example I) detailing a situation where "equity interests" from a tranche (such as residuals) were required to be held by a reporting entity when holding debt tranches. (That language identified situations where the reporting entity would be restricted from selling, assigning, or transferring the unsecured debt investment without also selling, assigning or transferring the equity interest to the same party. This restriction is often referred to as the "stapling" of investments.) Pursuant to the guidance in the original example, although the debt instrument would separately qualify as a creditor relationship for bond reporting, when considering the entirety of the holdings (both the equity interests and debt tranches combined), the investment would be considered an equity instrument in substance. Although the debt instrument would appear to have a higher priority of payment, that priority would be supported by the equity interest the reporting entity has to hold. (Ultimately, the reporting entity would be subordinate to themselves as they would recognize a loss on the equity tranche to safeguard payment under the debt tranche.) Under that initial proposed guidance, all holdings under such situations, including the debt tranches, would not qualify as creditor relationships and would not qualify for bond reporting.

66. After considering comments from the first exposure period, as well as discussing within the small group of industry and regulators, this example was eliminated from the principles-based bond definition. These discussions ultimately concluded that tranches that separately qualify as bonds should be reported as bonds even if other tranches from a structure that do not qualify as bonds are also held by the reporting entity. Elements noted as part of the decision to remove the stapling restriction include:

a. A key element in the initial proposal to require the entire holdings as equity was to ensure that the risk of the holdings was properly captured. It was noted that recent developments to tranche investments that were previously reported as investments in LLCs or joint ventures could result in RBC arbitrage. This is because the risk of the investment would be concentrated in a specific tranche intended to absorb losses, and only that limited tranche would be reported on BA with higher RBC charges. This would allow the debt tranches (as they are subordinated by the equity tranche) to likely qualify as bonds with Schedule D-1 reporting and lower RBC charges. However, because risk has been concentrated into the smaller equity tranche as a result of leverage, and because Schedule BA RBC charges are fixed and insensitive to leverage, there is a lowering of risk-based capital in total despite no change in risk. The subsequent discussions highlighted that this is an RBC issue for the equity tranche and is not an accounting classification issue. As consideration on appropriate risk charges for residual tranches has been requested to the Financial Condition (E) Committee and is a discussion item for the RBC Investment Risk and Evaluation (E) Working Group, this issue is not within the focus of the Statutory Accounting Principles (E) Working Group. It was also noted that consideration of statutory accounting provisions (such as nonadmittance) to achieve a desired risk assessment would be an inappropriate use of the accounting guidance. It was also noted that the investments within scope of these discussions are likely permitted for admittance under state law, and differing SAP guidance would only result with identification of prescribed practices as domiciliary state laws and statutes are the ultimate authority for the application of SAP.

b. It was also identified that the initial exposed example was specific to investments that were "stapled" under contractual terms. This guidance would have only been applicable to dynamics in which there was an explicit restriction in the sale, assignment, or transfer of the equity tranche separately from a debt tranche. It was identified that without an active market for equity tranches (which is common) the explicit restrictions would not be necessary to achieve a similar result. Structures would only need to be designed to require initial acquisition of equity tranches when acquiring debt tranches (with removal of the explicit disposal restrictions) to avoid the proposed stapling guidance. Since the proposed guidance could be easily avoided, the guidance would not address the underlying concern.

c. This discussion noted that it is quite common for acquisitions to require purchases of a vertical slice of a structure and for investments to be stapled for a short duration of time. These provisions are generally done for easier marketing and for easier compliance with conflict-of interest provisions. The short-term aspect of some stapled investments raised concerns as to how bond-qualifying debt tranches would be reported if stapling provisions to an equity tranche were subsequently eliminated. This was identified as likely requiring a schedule move (from BA to D-1) with potential other accounting and reporting impacts (such as with NAIC designations and measurement method). This discussion noted that an issuer's stapling of investments may reflect a legitimate business purpose, and not intend for RBC arbitrage, and the elimination of such components after the stated timeframe could cause confusion or unnecessary noise in the financial statements from the reclassification of investments. This discussion further supported that the acquisition of different tranches, even if explicitly stapled, should not prevent separate debt (bond) and equity recognition based on the characteristics of the specific tranche.

67. ABS as Short-Term or Cash Equivalents: With the required focus and requirements to be met for asset-backed securities, as well as dedicated reporting based on the underlying collateral assets, ABS will no longer be permitted to be reported as short-term or cash equivalents. All qualifying ABS will be required to be reported on Schedule D-1, even if acquired within one year or less from the maturity date, to allow for full assessment of the extent of ABS by the regulators. Investments captured in scope of *SSAP No. 2R—Cash, Cash Equivalents, Drafts and Short-Term Investments* are intended to reflect situations in which limited risk remains, either from changes in credit-quality or interest rates, due to the short-duration until maturity. As ultimate cash flows from asset-backed securities may have other risks beyond default risk or interest rate risk (such as performance factors, balloon payments, collateral quality), reporting as a cash equivalent or short-term investment is not permitted to prevent inappropriate assumptions of the investment's remaining potential risk. (Drafting Note – Corresponding edits will be needed to SSAP No. 2R.)

Key Discussions / Aspects in Developing the Definition:

68. Refinancing Risk / Residual Risk Exposure: Discussion of refinancing risk (where there is outstanding debt owed at maturity that will need to be refinanced for the remaining principal to be received by the note holder) was a key element discussed in accordance with the meaningful cash flows requirement for non-financial asset backed securities. This discussion highlighted that traditional refinancing risk is accepted in the context of corporate debt but is viewed differently when assessing the cash flows of non-financial assets in an ABS structure. This differentiation was confirmed, with identification that there are concerns unique to non-financial asset-backed securities.

69. The requirement for a non-financial asset backed security to produce meaningful cash flows to service the debt other than through the sale or refinancing of the collateral assets ensures that structures captured on Schedule D-1 actually reflect bond-like cash flows. Structures that rely on the sale or refinancing at maturity to generate cash flows to repay debt obligations ultimately reflect a point-in-time reliance on the underlying collateral asset values that does not reflect the intent of Schedule D-1 reporting of bond-like cash flows. These structures are more reflective of the underlying collateral risk, ultimately contingent on the market at a future point in time and whether the underlying assets can be sold or refinanced in accordance with original expectations at the time of the structure origination.

70. A key comment raised by industry with regards to the meaningful cash flow requirement, and the restriction against relying on the sale/refinancing at maturity to produce meaningful cash flows, is that consideration should be given to the level of overcollateralization that exists in a structure if the meaningful requirement will not be met without sale or refinancing. These industry comments take the position that as the level of overcollateralization to the debt obligation increases, then there is a greater likelihood that the debt issuer will be successful in refinancing or selling the assets and generate the means to repay the debt

obligation. Although overcollateralization is a factor in securities for bond classification, allowing overcollateralization to override the requirement for meaningful cash flows other than the refinancing / sale at maturity is not permitted for the following reasons:

a. The intent of the principles-based bond proposal is to clarify what shall be reported as long-term bonds on Schedule D-1. Non-financial asset backed securities that do not generate meaningful cash flows and rely on the refinancing or sale of the underlying assets do not reflect bond-like cash flows and are not characteristic of bond investments. These structures ultimately reflect equity (point-in-time) valuation risks of the assets held as collateral.

b. The industry position that overcollateralization safeguards the asset performance is an argument that supports the quality of the structure, but not the substance of the investment design. The principles-based bond proposal does not factor in investment or credit quality within the determination of whether a structure qualifies for reporting on Schedule D-1. Permitting an assessment based on overcollateralization would introduce a concept that credit quality determines Schedule D-1 reporting, and that is not an accurate conclusion in line with the principle concepts of bond classification.

71. Consistent with prior conclusions, reporting on Schedule D-1 is not indicative of the quality of the investment, but rather reflects securities expected to generate bond-like cash flows. Securities reporting on Schedule D-1 may be of high-quality or low-quality, but the reporting is based on the substance of the structure, which ultimately requires bond-like cash flows for all investments. This includes a requirement that non-financial asset backed securities must produce meaningful cash flows through the use of the underlying collateral assets other than through the sale or refinancing of the assets.

72. Additionally, through the small group discussions around the refinancing restriction noted above, it was noted that even if a debt instrument meets all of the criteria to be reported as a bond on Schedule D-1, there will still be a potential for unintentional RBC arbitrage related to securitizations, because the residual tranches absorb all of the redistributed risk of the underlying collateral, but receives a fixed RBC charge that is not in any way risk-rated. While this could be the case in any type of securitization, it is particularly pronounced if the underlying collateral is equity investments. Equity investments generally receive a 30% RBC charge for life companies. If equity investments are securitized, the bond tranches will get low bond charges (<2%), while the residual tranche will continue to receive a flat 30% charge. This will have the effect of bringing the overall weighted-average capital charge on the underlying investments from 30% to approximately 10-15%, as an example. This will occur even if the bond tranches have all of the substance associated with a bond. Following these discussions, it was identified that this regulatory concern may not be able or appropriate to address through the accounting standards but may warrant discussion for the Capital Adequacy (E) Task Force. Subsequent discussions from the Financial Condition (E) Committee directed the new RBC working group (the RBC Investment Risk and Evaluation (E) Working Group) to evaluate this and any other investment-related RBC items.

73. Use of NAIC Designation / SVO Review in Determining Schedule D-1 Reporting: The accuracy of the financial statements, and compliance with statutory accounting provisions, is the responsibility of the reporting entity. Assessment and compliance with key concepts, such as the "meaningful" and "substantive credit enhancement" concepts for ABS are also the responsibility of the reporting entity, along with appropriate documentation of these assessments for regulator review when requested. As such, consistent with the existing *NAIC Policy Statement on Coordination of the Accounting Practices and Procedures Manual and the Purposes and Procedures Manual of the NAIC Investment Analysis Office*, a reporting entity cannot obtain an NAIC designation to conclude on the substance of an investment or the resulting reporting schedule. Pursuant to the policy statement, obtaining an NAIC designation does not change an investment's applicable SSAP, annual or quarterly statement reporting schedule, or override other SSAP guidance required for an investment to be an admitted asset.

74. Questions have been received whether an NAIC designation in the AVS+ product or an assessment of an investment from an RTAS submission can be utilized as support that an investment qualifies for Schedule D-1 reporting. These are inaccurate interpretations on the use of NAIC designations within those products. The assignment of an NAIC designation (either from the SVO or CRP) reflects the credit quality of an investment. An assessment of credit quality does not provide assurances that the investment qualifies for reporting on Schedule D-1 as an issuer credit obligation or an ABS. As part of this project, consideration is planned to expand the ability to report and use NAIC designations on Schedule BA (or other schedules) so that investments that do not qualify as bonds can have appropriate risk assessments that factor in the credit quality of the investment. This capability would ultimately depend on action by the Capital Adequacy (E) Task Force.

75. Although the NAIC designation and RTAS processes cannot be used in determining Schedule D-1 compliance, it is envisioned that a small group of regulators and NAIC staff could be formed to review specific investment structures under the principle-based concepts to assist in assessments of complex new investment designs. It is anticipated that NAIC staff on the statutory accounting side and within the SVO would assist this small group.

76. Interest Only / Principal Only Strips: Discussion occurred on whether specific guidance should direct the reporting of interest only (IO) and principal only (PO) strips. The resulting conclusion from this discussion was that the principle concepts from the bond definition should continue to be applied for these investments. If the strips qualify within the definition as issuer credit obligations, they would be captured in scope of that guidance. If the strips qualified as asset-backed securities, they would be captured in scope of that guidance. It was noted that interest only strips shall also be assessed in accordance with the residual guidance. If the interest only strip reflects excess interest (e.g., remaining differential spread from interest collected from interest paid), these investments would be akin to a residual investment without contractual interest or principal payments and shall be captured in scope of that guidance. (Residuals are required to be reported on Schedule BA and not permitted to be reported on Schedule D-1.)

77. The discussion of IO/PO strips with industry representatives identified that they are not overly prevalent investments with insurance reporting entities. It was also noted that IO/PO based on RMBS are relatively rare due to the prepayment risk, however those based on CMBS generally have contractual provisions that prohibit prepayments, thus ensuring that they act more akin to typical bonds. This discussion further highlighted that changes to the principal-based bond definition are not justified for IO/PO investments, and insurers should document their accounting policies for these investments to demonstrate compliance with the bond definition.

78. The discussion of IO/PO strips focused on U.S. Treasury strips and mortgage-backed securities as likely investments, but it was noted that the application of the overall bond definition concepts should be applied to any future design of these investments. Specific elements noted for the two general designs:

a. U.S. Treasury Strips: Treasury Strips are created when a bond's coupons are separated from the bond. The coupons separated from the bond are also sold individually (IO), becoming separate securities from the principal payments due at maturity (PO). U.S. Treasury Strips are backed by the U.S. government. U.S. Treasury strips (IO/PO) were noted to be considered U.S. government issues and would be captured with other securities backed by the U.S. government as issuer obligations. Specific identification of U.S. Treasury strips as specific elements as issuer credit obligations, captured within the U.S. government category, was noted to be repetitive and not necessary.

b. Mortgage-Backed Securities and Other Non-Treasury Strips: Other IO and PO strips are required to be assessed in accordance with the principle concepts of the bond definition. It is anticipated that non-U.S. strips (including mortgage-backed security strips) would not qualify as issuer credit obligations and shall be reviewed in accordance with the asset-backed security concepts to determine whether the strip qualifies for reporting on Schedule

D-1. The separation of the principal and interest components into separate securities does not change the application of the principle concepts for determining whether a security qualifies as a bond. It was noted that IO strips could be high in the capital structure (supported by subordination) or could represent residual interests (reflecting the spread between proceeds collected and contractual interest). The specific details of the individual IO/PO security shall determine the appropriate accounting and reporting.

79. The discussion of IO/PO strips identified that there is likely no current need to have separate reporting lines to identify these items within the investment schedules. However, it was identified that the ability to identify these investments with a code (or other feature) would allow for future aggregation and assessment. This was requested to be considered as part of the reporting revisions.

Investment Examples – Securities That Do Not Represent Creditor Relationship Despite Legal Form

80. As detailed in paragraph 1 of the principles-based bond definition, an initial determinant in the principles-based bond definition is whether the investment is a security that represents a creditor relationship in substance. Examples included intend to identify scenarios that do not reflect an in-substance creditor relationship.

81. Example 1: Debt Instrument from SPV with Large Number of Diversified Equity Interests: A reporting entity invests in a debt instrument issued by a SPV that holds a large number of diversified equity interests with characteristics that support the production of predictable cash flows. The structure contains sufficient overcollateralization and liquidity provisions to ensure the production of adequate cash flows to service both principal and interest payments without significant reliance on refinancing or sale of the underlying equity investments. The debt instrument's periodic principal or interest payments, or both, contractually vary based on the appreciation or depreciation of the equity interests held in the SPV.

82. Example 1 Rationale: Because the instrument's principal or interest payments, or both, contractually vary with the appreciation or depreciation of the underlying equity interests, it contains an equity-like characteristic that is not representative of a creditor relationship. It would be inappropriate to conclude that a security with any variation in principal or interest payments, or both, due to underlying equity appreciation or depreciation, or an equity-based derivative, is a bond under this standard as such security would contain equity-like characteristics.

83. Example 2: Debt Instrument from SPV with Few Equity Interests, Not an Issuer Credit Obligation: A reporting entity invests in a debt instrument issued from a SPV that owns a portfolio of equity interests, and the debt instrument does not meet the definition of an issuer credit obligation.

84. Example 2 Rationale: Determining whether debt instruments collateralized by equity interests qualify as bonds under this statement inherently requires significant judgment and analysis. Unlike debt instruments collateralized by assets with contractual cash flows, or debt instruments collateralized by cash-generating non-financial assets, debt instruments collateralized by equity interests may be dependent on cash flow distributions that are not contractually required to be made and/or may not be controlled by the issuer of the debt. In some instances, sale or refinancing of the underlying equity interests may be the only means of generating cash flows to service the debt instruments. As a result, there is a rebuttable presumption that a debt instrument collateralized by equity interests does not qualify as a bond. Notwithstanding this rebuttable presumption, it is possible for such debt instruments to qualify as bonds, if the characteristics of the underlying equity interests lend themselves to the production of predictable cash flows and the underlying equity risks have been sufficiently redistributed through the capital structure of the issuer. Factors to consider in making this determination include but are not limited to:

a. Number and diversification of the underlying equity interests

b. Characteristics of the underlying equity interests (vintage, asset-types, etc.)

c. Liquidity facilities

d. Overcollateralization

e. Waiting period for distributions/paydowns to begin

f. Capitalization of interest

g. Covenants (e.g., loan-to-value trigger provisions)

h. Reliance on ongoing sponsor commitments

i. Source(s) of expected cash flows to service the debt (i.e., dividend distributions from the underlying collateral vs. sale or refinancing of the underlying collateral)

85. While reliance of the debt instrument on sale of underlying equity interests or refinancing at maturity does not preclude the rebuttable presumption from being overcome, it does require that the other characteristics mitigate the inherent reliance on equity valuation risk to support the transformation of underlying equity risk to bond risk. As reliance on sale or refinancing increases, the more compelling the other factors needed to overcome the rebuttable presumption become.

86. Furthermore, this analysis should be conducted and documented by a reporting entity at the time such an investment is acquired. The level of documentation and analysis required will vary based on the characteristics of the individual debt instrument, as well as the level of third-party and/or non-insurance company market validation to which the issuance has been subjected. For example, a debt instrument collateralized by fewer, less diversified equity interests would require more extensive and persuasive documented analysis than one collateralized by a large and diversified portfolio of equity interests. Likewise, a debt instrument that has been successfully marketed to unrelated and/or non-insurance company investors, may provide enhanced market validation of the structure compared to one held only by related party and/or insurance company investors where capital relief may be the primary motivation for the securitization.

Investment Examples – Analysis of ABS Under the Meaningful and Credit-Enhancement Concepts

87. As detailed in paragraph 3b of the principles-based bond definition, all asset-backed security structures are required to provide substantive credit enhancement to qualify for Schedule D-1 reporting. Furthermore, asset-backed security structures that are backed by non-financial assets must generate meaningful cash flows to service the debt without reliance on the sale or refinancing at the maturity of the investment. Examples 4-7 provide examples of analysis under these criteria:

88. Example 4 – Agency Mortgage-Backed Securities: A reporting entity invests in debt instruments issued from a SPV sponsored by the Government National Mortgage Association (GNMA), the Federal National Mortgage Association (FNMA) and the Federal Home Loan Mortgage Corporation (Freddie Mac) (collectively, "Agency or Agencies"). These debt instruments pass through principal and interest payments received from underlying mortgage loans held by the SPV to the debtholders proportionally, with principal and interest guaranteed by the Agencies. While there is prepayment and extension risk associated with the repayment of the underlying mortgage loans, the credit risk associated with the mortgage loans is assumed by the Agencies.

89. Example 4 Rationale: Although the reporting entity participates on a proportional basis in the cash flows from the underlying mortgage loans held by the SPV, the reporting entity is in a different economic position than if it owned the underlying mortgage loans directly because the credit risk has been redistributed and assumed by the Agencies. This is a substantive credit enhancement because a market participant (i.e., knowledgeable investor transacting at arm's length) would conclude the Agency guarantee is expected to absorb all losses before the debt instrument being evaluated. Therefore, the holder of the debt instrument is in a substantively different economic position than if the holder owned the ABS Issuer's unguaranteed assets directly, in accordance with the requirements of paragraph 3b of the principles-based bond definition. When guarantees do not cover 100% of principal and interest as the Agency guarantees do in this example, it is still appropriate to determine if the guarantee is substantive in accordance with the requirements in paragraph 3b of the principles-based bond definition to determine if the holder is in a substantively different economic position than if the holder held the ABS Issuer's assets directly.

90. Example 5 - Lease in SPV with 50% Balloon Payment: A reporting entity invested in a debt instrument issued by a SPV that owns equipment which is leased to an equipment operator. The equipment operator makes lease payments to the SPV, which are passed through to service the SPV's debt obligation. While the debt is outstanding, the equipment and lease are held in trust and pledged as collateral for the debtholders. Should a default occur, the debtholders can foreclose on and liquidate the equipment as well as submit an unsecured lease claim in the lessee's bankruptcy for any defaulted lease payments. The loan-to-value at origination is 70%.

91. The existing lease payments are sufficient to cover all interest payments and all scheduled debt amortization payments over the life of the debt instrument. However, at debt maturity, there is a balloon payment due, totaling 50% of the original outstanding debt principal amount. The corresponding lease has no balloon payment due at lease maturity, so the SPV will either need to refinance the debt or sell the underlying equipment to service the final debt balloon payment. The loan-to-value at maturity is expected to decline to 40% considering the scheduled principal amortization payments net of the expected economic depreciation in the equipment value over the term of the debt. The equipment is expected to be subject to some market value volatility and periods of lower liquidity at certain points in time but has a predictable value range and ready market over a longer period of time, such that the equipment could be liquidated over a reasonable period of time, if necessary.

92. Example 5 Rationale: The equipment is a cash generating non-financial asset which is expected to generate a meaningful level of cash flows for the repayment of the bonds via the existing lease that covers all interest payments and 50% of the principal payments. In reaching this determination, the reporting entity considered the predictable nature of the cash flows, which are contractually fixed for the life of the debt instrument, as well as the ability of the collateral value to provide for the balloon payment through sale or refinancing in light of its characteristics. While the equipment may have some market value volatility and periods of lower liquidity at points in time, the cash flows produced by the lease were concluded to reduce the loan balance to a level (40% loan-to-value) that would be able to be recovered by sale or refinancing even if it were to mature at such point in time.

93. The reporting entity also determined that the structure provides substantive credit enhancement in the form of overcollateralization to conclude that investors are in a different economic position than holding the equipment directly, in accordance with the requirements of paragraph 3.b of the principles-based bond definition. In reaching this conclusion, the reporting entity noted that the debt instrument starts with a 70% loan-to-value, which continues to improve over the life of the debt as the loan balance amortizes more quickly than the expected economic depreciation on the underlying equipment. In the context of the predictable nature of the cash flows and collateral value range over time, the reporting entity concluded that a market participant (i.e., a knowledgeable investor transacting at arm's length) would consider this level of overcollateralization to put the investor in a substantially different economic position than owning the underlying equipment directly.

94. For the purposes of determining whether there is substantive overcollateralization, it is appropriate to consider any expected economic depreciation, if it is reasonably expected, but it is not appropriate to consider any expected economic appreciation. Note that a debt instrument with a loan-to-value that is expected to decrease over time is not necessarily deemed to have substantive overcollateralization.

95. Example 6 – Lease in SPV With Lease Term Less than Debt Instrument: A reporting entity invested in a debt instrument with the same characteristics as described in Example 5, except that the existing equipment lease at the time of origination has a contractual term that is shorter than that of the debt instrument. It is expected with a high degree of probability that the lease will be renewed, and a substantial leasing market exists to replace the lessee should they not renew. However, in the unlikely circumstance that the equipment cannot be re-leased, there would not be enough cash flows to service the scheduled

principal and interest payments, and the equipment would have to be liquidated to pay off the debt upon default.

96. Example 6 – Rationale: All details of this example, including the expected collateral cash flows, are consistent with those in Example 5, except that the cash flows in Example 5 are contractually fixed for the duration of the debt while the cash flows in this example are subject to re-leasing risk. Notwithstanding the involvement of re-leasing risk, the reporting entity concluded that the ability to re-lease the equipment was highly predictable and supported the conclusion that the equipment was expected to produce meaningful cash flows to service the debt.

97. This distinction is to highlight that the expected cash flows of a cash-generating non-financial asset may or may not be contractually fixed for the term of the bond. Certain securitized cash flow streams may not by their nature lend themselves to long-term contracts (e.g., single-family home rentals), but may nevertheless lend themselves to the production of predictable cash flows. While the non-contractual nature of the cash flows is an important consideration in determining whether a non-financial asset is expected to produce meaningful cash flows to service the debt, it does not, in and of itself, preclude a reporting entity from concluding that the assets are expected to produce meaningful cash flows.

98. Example 7 - Lease in SPV with 80% Balloon Payment: A reporting entity invested in a debt instrument issued by a SPV that owns equipment which is leased to an equipment operator. The equipment operator makes lease payments to the SPV, which are passed through to service the SPV's debt obligation. While the debt is outstanding, the equipment and lease are held in trust and pledged as collateral for the debtholders. Should a default occur, the debtholders can foreclose on and liquidate the equipment as well as submit an unsecured lease claim in the lessee's bankruptcy for any defaulted lease payments. The loan-to-value at origination is 70%.

99. The existing lease payments are sufficient to cover all interest payments and all scheduled debt amortization payments over the life of the debt instrument. However, at maturity, there is a balloon payment due, totaling 80% of the original outstanding principal amount. The corresponding lease has no balloon payment due at lease maturity, so the SPV will either need to refinance the debt or sell the underlying equipment to service the final debt balloon payment. The loan-to-value at maturity is expected to increase to 95% considering the scheduled principal amortization payments net of the expected economic depreciation in the equipment value over the term of the debt. The equipment is expected to be subject to some market value volatility and periods of lower liquidity at certain points in time, but has a predictable value range and ready market over a longer period of time, such that the equipment could be liquidated over a reasonable period of time, if necessary.

100. Example 7 Rationale: The equipment is a cash generating non-financial asset which is not expected to generate a meaningful level of cash flows for the repayment of the bonds via the existing lease that covers all interest payments and 20% of principal payments. In reaching this determination, the reporting entity considered that, while the cash flows being produced are predictable, the ability to recover the principal of the debt investment is almost entirely reliant on the equipment retaining sufficient value to sell or refinance to satisfy the debt

101. The reporting entity also determined that the structure lacks a substantive credit enhancement to conclude that investors are in a different economic position than holding the equipment directly, in accordance with the requirements of paragraph 3.b of the principles-based bond definition. In reaching this conclusion, the reporting entity noted that the debt starts with a 70% loan-to-value, but the overcollateralization is expected to deteriorate over the term of the debt as the equipment economically depreciates more quickly than the debt amortizes. This results in a high loan-to-value (i.e., 95%) at maturity, relative to the market value volatility of the underlying collateral. Despite the predictable nature of the cash

flows, the reporting entity concluded that the debt instrument lacked a substantive level of overcollateralization to conclude that the investor is in a different economic position than owning the underlying equipment directly. It was determined that the level of overcollateralization, as determined by a market participant (i.e., a knowledgeable investor transacting at arm's length), is nominal. Therefore, the reporting entity concluded that it was in a substantively similar position as if it owned the equipment directly.

102. For the purposes of determining whether there is substantive overcollateralization, it is appropriate to consider any expected economic depreciation, if it is reasonably expected, but it is not appropriate to factor in any expected economic appreciation. Note that a debt instrument with a loan-to-value that is expected to increase over time is not necessarily deemed to have nominal overcollateralization.

Reflecting the Principles-Based Bond Proposal in SSAP

103. This issue paper proposes that statutory accounting principles reflect the principles-based bond concepts and the specific accounting guidance for bonds (issuer obligations) and asset backed securities be captured as substantive revisions to two existing SSAPs:

a. SSAP No. 26R--Bonds

b. SSAP No. 43R—Loan-Backed and Structured Securities

104. Although there will be new statutory accounting concepts added to these SSAPs, certain aspects of the SSAPs will be retained and unchanged. With this approach, all of the relevant guidance will be in the original SSAPs for these investment types, which will allow the continuation of prior references when discussing these investment structures.

105. In addition to the revisions to SSAP No. 26R and SSAP No. 43R, additional new statutory accounting concepts are expected to detail the accounting and reporting for structures that do not qualify as bonds.

Issue Paper Drafting Note:

Proposed revisions to SSAP No. 26R and SSAP No. 43R are being drafted outside of the issue paper and will be exposed as separate documents to allow for focused attention. The revised guidance will be ultimately incorporated in the issue paper for historical retention purposes.

In addition to the revisions to SSAP No. 26R and 43R, it is anticipated that guidance will be drafted to recommend the use of Schedule BA for most investments that do not qualify as bonds within the principle-based bond definition. With exposure of the issue paper, comments are requested on the following:

- Are there investments that will not qualify as bonds that should be considered for reporting on a different schedule than Schedule BA? Comments on key investment characteristics that would appropriately distinguish these investments are requested.

- For investments that are captured on Schedule BA, should consideration occur to permit an amortized cost approach rather than a lower of cost or fair value measurement method? For investments in which an amortized cost approach is supported, what characteristics can be used to identify / support this measurement method? Should use of NAIC designations be permitted to drive the Schedule BA measurement method for these securities?

Furthermore, revisions are also expected to SSAP No. 2R, to address the ABS restriction, as well as SSAP No. 103R, to clarify that only beneficial interests that qualify as ABS will be accounted for under SSAP No. 43R. Comments are requested on whether other SSAPs will also be impacted and need to be revised.

History of the Definition / Scope Development of SSAP No. 43R

The following section details the historical development of SSAP No. 43R. Due to various revisions that have been reflected since its original adoption, this information is retained for historical reference on the SSAP No. 43R guidance prior to the reflection of the principles-based bond proposal.

106. *SSAP No. 43—Loan-backed and Structured Securities* was originally effective with the SAP codification and resulted with separate guidance for "bonds" (in SSAP No. 26) and "loan-backed and structured securities" (in SSAP No. 43). (The initial guidance indicated that investments in scope of SSAP No. 43 met the definition of a bond in *SSAP No. 26—Bonds, excluding Loan-backed and Structured Securities*.) Although most of the guidance between the original SSAP No. 26 and SSAP No. 43 was the same, the guidance in SSAP No. 43 recognized the need to review (at least quarterly) the assumptions and resulting cash flows of the underlying loans, as changes in assumptions could necessitate a recalculation of the effective yield or other-than-temporary impairment.

107. The original issue paper to SSAP No. 43 (Issue Paper No. 43) cited guidance originally contained in Chapter 1, *Bonds and Loaned Backed and Structured Securities*, from the *Accounting Practices and Procedures Manual of the Life and Accident and Health Insurance Companies*. The issue paper identified that the *Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies* contained similar guidance. In this Issue Paper No. 43, and the original SSAP No. 43, loan-backed securities were defined as "pass-through certificates, collateralized mortgage obligations (CMOs) and other securitized loans…" The reference to "securitized loans" was a key aspect of this original definition.

108. Original definition / scope guidance for SSAP No. 43:

> 2. Loan-backed securities are defined as pass-through certificates, collateralized mortgage obligations (CMOs), and other securitized loans not included in structured securities, as defined below, for which the payment of interest and/or principal is directly proportional to the interest and/or principal received by the issuer from the mortgage pool or other underlying securities.
>
> 3. Structured securities are defined as loan-backed securities which have been divided into two or more classes for which the payment of interest and/or principal of any class of securities has been allocated in a manner which is not proportional to interest and/or principal received by the issuer from the mortgage pool or other underlying securities.
>
> 4. Loan-backed securities are issued by special-purpose trusts (issuer) established by a sponsoring parent organization. Mortgage loans or other securities securing the loan-backed obligation are acquired by the issuer and pledged to an independent trustee under the issuer's obligation has been fully satisfied. The investor can only look to the issuer's assets (primarily the trusteed assets or third parties such as insurers or guarantors) for repayment of the obligation. As a result, the sponsor and its other affiliates may have no financial obligation under the instrument, although one of those entities may retain the responsibility for servicing the underlying mortgage loans. Some sponsors do guarantee the performance of the underlying loans.
>
> 5. Loan-backed securities meet the definition of assets as defined in *SSAP No. 4—Assets and Nonadmitted Assets* and are admitted asset to the extent they conform to the requirements of this statement.

109. In agenda item 2007-26, *FAS 156: Accounting for Servicing of Financial Assets an amendment of FASB Statement No. 140,* the Working Group adopted with modification FAS 156 in *SSAP No. 91R—Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, revising the terminology for "retained interests" to "interests that continue to be held by the transferor." This action also clarified that beneficial interests from the sale of loan-backed and structured securities shall be accounted for in accordance with SSAP No. 43. This initial adoption identified that the holder of a beneficial interest in securitized financial assets should recognize the excess of all cash flows attributed to the beneficial

interest estimated at the acquisition date over the initial investment as interest income over the life of the beneficial interest using the effective yield method.

110. In 2009, the Working Group adopted a substantively-revised SSAP No. 43R (effective September 30, 2009). The focus of the substantive revisions was to revise the valuation and impairment requirements based on the cash flows expected to be collected for the securities, rather than fair value. Although the focus of the revisions was inclusion of impairment guidance based on whether an entity has an intent to sell, whether an entity does not have the intent and ability to hold a security, and when there is a non-interest related decline if there is no intent to sell and the entity has the intent and ability to hold, the revisions resulted in a significant rewrite of the guidance in SSAP No. 43R, including the guidance for beneficial interests. This guidance expanded the prior scope inclusion from "beneficial interests from the sale of LBSS," to include "purchased beneficial interests in securitized financial assets."

111. In agenda item 2010-12, Clarify Definitions of Loan-Backed and Structured Securities, the Working Group received a regulator-sponsored, nonsubstantive Form A with a proposal to revise the definitions of a loan-backed and structured security (LBSS). As a result of this proposal, the definition was revised to eliminate the reference to "securitized loans" and instead refer to "securitized assets." These revisions were adopted with an effective date of January 1, 2011.

a. Although the agenda item simply identifies that this item was exposed in August 2010, and then adopted after a single exposure in October 2010, with an effective date of January 1, 2011, there were significant comments received during the exposure period. In short summary, these comments highlighted that the scope of the changes were intended to move fixed-income assets that had been accounted for as bonds under SSAP No. 26 to SSAP No. 43R as LBSS. Particularly, the comments noted concerns with the movement of equipment trust certificates and credit tenant loans from the accounting provisions of SSAP No. 26 to the accounting rules of SSAP No. 43R. These comments stated that "instruments with radically different sources of cash flows and risk characteristics utilize trust structures, and not all should be classified as loan-backed." There were no changes incorporated to the proposed guidance as a result of these comments, and the revisions were adopted as exposed.

112. In 2019, revisions to the definition and scope section were also adopted to clarify the identification of affiliate/related party transactions (agenda Item 2019-03) as well as to explicitly capture mortgage-referenced securities issued from a government sponsored enterprise in scope of SSAP No. 43R (Agenda Item 2018-17). The inclusion of mortgage-referenced securities was a distinct departure from the "trust" structure required in determining inclusion within scope of SSAP No. 43R, but was incorporated as the securities (with the referenced pool of assets), functions similarly to the securities held in trust and the referenced pool of assets can be assessed for the underlying credit risk

113. Between the adoption of agenda item 2010-12 and the items adopted in 2019, there were several revisions to SSAP No. 43R, but those revisions did not impact the definition / scope of the statement. Those revisions included changes to incorporate price-point NAIC designations, guidance for interim financials for RMBC/CMBS, clarification of disclosures, updating Q/A guidance, and guidance for prepayment fees.

114. Definition of loan-backed and structured securities in the "As of March 2020" AP&P Manual:

> 2. Loan-backed securities are defined as securitized assets not included in structured securities, as defined below, for which the payment of interest and/or principal is directly proportional to the payments received by the issuer from the underlying assets, including but not limited to pass-through securities, lease-backed securities, and equipment trust certificates.
>
> 3. Structured securities are defined as loan-backed securities which have been divided into two or more classes for which the payment of interest and/or principal of any class of securities has

been allocated in a manner which is not proportional to payments received by the issuer from the underlying assets.

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

a. In determining whether a loan-backed structure is a related party investment, consideration shall be given to the substance of the transaction, and the parties whose action or performance materially impacts the insurance reporting entity holding the security. For example, although a loan-backed security may be acquired from a non-related issuer, if the assets held in trust predominantly[1] reflect assets issued by affiliates of the insurance reporting entity, and the insurance reporting entity only has direct recourse to the assets held in trust, the transaction shall be considered an affiliated investment, and the transaction shall also subject to the accounting and reporting provisions in *SSAP No. 25—Affiliates and Other Related Parties*.

5. Mortgage-referenced securities do not meet the definition of a loan-backed or structured security but are explicitly captured in scope of this statement. In order to qualify as a mortgage-referenced security, the security must be issued by a government sponsored enterprise[2] in the form of a "credit risk transfer" in which the issued security is tied to a referenced pool of mortgages. These securities do not qualify as "loan-backed securities" as the pool of mortgages are not held in trust and the amounts due under the investment are not backed or secured by the mortgage loans. Rather, these items reflect instruments in which the payments received are linked to the credit and principal payment risk of the underlying mortgage loan borrowers captured in the referenced pool of mortgages. For these instruments, reporting entity holders may not receive a return of their full principal as principal repayment is contingent on repayment by the mortgage loan borrowers in the referenced pool of mortgages. Unless specifically noted, the provisions for loan-backed securities within this standard apply to mortgage-referenced securities.

6. Investments within the scope of this statement are also subject to the provisions and disclosure requirements of SSAP No. 25 if the SSAP No. 43R transaction is a related party arrangement[3]. Loan-backed and structured securities meet the definition of assets as defined in *SSAP No. 4—Assets and Nonadmitted Assets* and are admitted assets to the extent they conform to the requirements of this statement and SSAP No. 25.

[1] In applying this guidance, a reporting entity is not required to complete a detailed review of the assets held in trust to determine the extent, if any, the assets were issued by related parties. Rather, this guidance is a principle concept intended to prevent situations in which related party transactions (particularly those involving affiliates) is knowingly captured in a SSAP No. 43R structure and not identified as a related party transaction (or not reported as an affiliated investment on the investment schedule) because of the involvement of a non-related trustee or SSAP No. 43R security issuer. As identified in *SSAP No. 25—Affiliates and Other Related Parties*, it is erroneous to conclude that the inclusion of a non-related intermediary, or the presence of non-related assets in a structure predominantly comprised of related party investments, eliminates the requirement to identify and assess the investment transaction as a related party arrangement.

[2] Currently, only Fannie Mae and Freddie Mac are the government sponsored entities that issue qualifying mortgage-referenced securities. However, this guidance would apply to mortgage-referenced securities issued by any other government sponsored entity that subsequently engages in the transfer of residential mortgage credit risk.

[3] As discussed in paragraph 4.a. of this statement, a SSAP No. 43R security may still be considered a related party transaction even if the asset trustee or security issuer is a non-related party.

7. The scope of this statement encompasses all types of loan-backed and structured securities, including, but not limited to, the following:

a. Loan-backed and structured securities acquired at origination,

b. Loan-backed and structured securities acquired subsequent to origination for which it is probable, at acquisition, that the reporting entity will be able to collect all contractually required payments receivable, and are accounted for at acquisition under SSAP No. 103R,

c. Loan-backed and structured securities for which it is probable, either known at acquisition or identified during the holding period[4], that the reporting entity will be unable to collect all contractually required payments receivable, and

d. Transferor's beneficial interests in securitization transactions that are accounted for as sales under SSAP No. 103R and purchased beneficial interests in securitized financial assets[5].

Benefits of Reporting in Scope of SSAP No. 43R

115. There are a variety of benefits for reporting investments as bonds on Schedule D-1. Also, with regards to bifurcated impairment, capturing an investment in scope of SSAP No. 43R may be more advantageous than capturing in scope of *SSAP No. 26R—Bonds*. These benefits include:

a. Capturing an investment in scope of SSAP No. 26R or SSAP No. 43R results with reporting the investment on Schedule D-1, Long-Term Bonds. By reporting on this bond schedule, the investment is generally not subject to investment limitations, the asset is admitted and the investment has the benefit of lower risk-based capital (RBC) charges based on NAIC designation. (Moving held equity instruments from Schedule BA into a SSAP No. 43R trust has been particularly noted as providing "regulatory capital relief.")

b. Capturing an investment in scope of SSAP No. 26R or SSAP No. 43R may result in amortized cost reporting and a delay in recognizing decreases in value or other-than-temporary impairments than if the assets held in trust were reported separately on the statutory financial statements.

i. Under the SSAP No. 43R bifurcated impairment model, an entity is not required to recognize an OTTI or deviate from an amortized cost measurement as long as the entity can assert that they have the intent and ability to hold the 43R security to recover the amortized cost basis and there is no non-interest related decline. (This has been a key factor in the PPN design, as a high-quality bond is placed in trust (along with other assets), and the bond – over several years – will single-handedly satisfy the contractual requirements of the 43R issued security, preventing any recognition of OTTI or a reduction of NAIC designation even when the other securities held in trust could completely default to zero.)

ii. The SSAP No. 43R bifurcated impairment can be considered an advantage over SSAP No. 26R as under SSAP No. 43R, if there is an intent and ability to hold the asset, a reporting entity only has to recognize an OTTI for the portion of the non-

[4] Securities classified within the type of paragraph 7.a. or 7.b. may be required to change classification to type 6.c. when it becomes probable that the reporting entity will be unable to collect all contractually required payments receivable.

[5] The accounting requirements related to these types of securities included in paragraphs 22-25 shall be determined at acquisition or initial transfer.

interest related loss. Under SSAP No. 26R, if there is any assessed OTTI (despite if interest or credit related), a reporting entity must recognize an OTTI down to the then-current fair value for the security.

iii. Prior to the principles-based bond project, guidance in SSAP No. 43R did not differentiate between different types of tranches or payment streams for the issued securities. This is easiest to illustrate through the "equity" tranche of a SSAP No. 43R investment but could be a factor if payments are provided sequentially. (Sequential payments are used to pay the senior notes first, until paid in full, before payments are allocated to junior notes.) For the "equity" tranche, which is a term that refers to the junior-most layer of issued SSAP No. 43R securities, this tranche is the first-loss position and only receives payment after all other layers have been satisfied. Without prior guidance in SSAP No. 43R for this layer, entities were able to classify these residual tranches as "bonds" on Schedule D-1, which did not properly reflect the nature of those investments.

c. SSAP No. 43R permits admittance of the security without any verification to the assets held in trust. As such, if a reporting entity was to derecognize a joint venture or LLC from Schedule BA, and reacquire through the ownership of a SSAP No. 43R security, the reporting entity would be permitted to admit the security without any verification of the joint venture or LLC held in trust. Under *SSAP No. 48—Joint Ventures, Partnerships and Limited Liability Companies*, assets must have audited support (audited U.S. GAAP financials, audited reconciliation to U.S. GAAP, audited IFRS financials or audited U.S. tax basis equity) in order to be admitted in the statutory financial statements.

Key Issues with the Current Scope / Definition Application of SSAP No. 43R

116. With the existing guidance in SSAP No. 43R, there are no restrictions to the assets that can be placed in trust and used to support securities issued from the trust structure. Although these structural designs are referred to as "securitizations" and reported as debt instruments, these investment structures may not reflect actual securitizations in which cash flows from multiple contractual debt obligations held in trust are used to pay principal and interest payments on the trust-issued security. The assets being securitized may include assets that are not cash flow producing, creating reliance on an underlying collateral valuation risk. Or, there may be no economic substance to the use of the securitization structure, such that the insurer is in the same economic position as owning the underlying assets directly. As a result, there is a regulatory concern that assets being represented as bonds may contain unidentifiable risks that regulators would not traditionally associate with bond risk.

117. As an additional issue of the existing guidance, questions have been raised on whether securities captured in scope of SSAP No. 43R would be "asset-backed securities" as defined by the Code of Federal Regulations (17 CFR 229.1101(c)). These questions have arisen as an SEC identified nationally recognized statistical rating organization (NRSRO) must be specifically approved to provide ratings of "asset-backed securities." Since the CFR definition is different than what is permitted in scope of SSAP No. 43R, a rating from an NRSRO approved as a credit rating provider (CRP) that may not be approved by the SEC for "asset-backed securities" could provide a valid rating for a SSAP No. 43R instrument permitted as "filing exempt" if that asset was not an "asset-backed security." This has caused questions as regulators have identified designations given by CRPs not SEC approved to provide "ABS" designations and have questioned the use of these CRP ratings in determining the NAIC designation.

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May 6, 2022

Mr. Dale Bruggeman, Chairman
Statutory Accounting Principles Working Group
National Association of Insurance Commissioners
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RE: Principles-Based Bond Definition and Draft Issue Paper – Comments Due May 6, 2022

Dear Mr. Bruggeman:

Interested parties appreciate the opportunity to comment on the exposed Principles-Based Bond Definition (the Proposed Bond Definition) and Draft Issue Paper that were released for comment by the NAIC Statutory Accounting Principles (E) Working Group (the Working Group).

Interested parties believe this effort is resulting in a workable and high-quality bond definition and we look forward to our continued collaborative effort as the project proceeds toward finalization. Interested parties also would like to commend NAIC staff for a well thought out and documented Draft Issue Paper.

The interested parties' comments are organized in two sections – 1) Comments on the Proposed Bond Definition and Draft Issue Paper and 2) Comments on the Specific Questions Posed in the Draft Issue Paper.

Comments on the Proposed Bond Definition and Draft Issue Paper

1) Interested parties suggest a slight modification to paragraph 2a, on page 2, of the Proposed Bond Definition. While interested parties are supportive of proposed edits to include U.S. Treasury Inflation-Indexed Securities in paragraph 2a, we do not believe the following subscript is appropriate or warranted.

   The inclusion of U.S. Treasury Inflation-Indexed Securities identifies these securities as an explicit exception to the principles-based bond definition that prohibits securities from

being reported on Schedule D-1 that have variable principal or interest due to the underlying equity appreciation or depreciation, or an equity-based derivative.

Interested parties believe U.S. Treasury Inflation-Indexed Securities are more accurately adjusted for inflation rather than adjusted for "underlying equity appreciation or depreciation, or an equity-based derivative."

2) Interested parties believe a small change is need on Page 2, paragraph 2g of the Proposed Bond Definition, to be consistent with both regulator intent, and current practice, related to loan form CTLs, that would otherwise be reported on Schedule B, Mortgage Loans, under SSAP No. 37. Paragraph 2g, as written, is only inclusive of security form CTLs which excludes certain loan form CTLs currently permitted to be reported on Schedule D in guidance adopted by the NAIC during 2021. Specifically, interested parties propose the following changes (underlined) to paragraph 2g:

    Investments in the form of securities for which repayment is fully supported by an underlying contractual obligation of a single operating entity (e.g., Credit Tenant Loans (CTLs), Equipment Trust Certificates (ETCs), other lease backed securities, Funding Agreement Backed Notes (FABNs), etc.). For purposes of applying this principle-based concept, repayment is fully supported by the underlying operating entity obligation if it provides cash flows for the repayment of all interest and at least 95% of the principal of the security. In addition, mortgage loans in scope of SSAP No. 37 that qualify under a SVO structural assessment are in scope of this statement as CTLs.

3) Interested parties note there is new language included within paragraph 3b, on page 3, of the Proposed Bond Definition. Interested parties agree with what we believe to be the intent (i.e., close a potential "loophole" related to equity backed securities). We therefore propose the following technical edit (underlined) to ensure it is not potentially interpreted more broadly:

    For clarification purposes, all returns from an equity backed ABS in excess of principal repayment are required to be considered as interest. Therefore, investments with "stated" interest and then "additional returns" to which the holder of the debt instrument is entitled are collectively considered as interest and shall be assessed together in determining whether the investment has variable principal or interest due to underlying equity interests.

4) Interested parties propose the following changes (underlined) to the Substantive Credit Enhancement Language included within the glossary of the Proposed Bond Definition. The proposed changes are meant to clarify that there could be a first loss tranche, owned by an insurer, where there is a substantial credit enhancement that still qualifies the first loss tranche for Schedule D reporting (e.g., a Single Asset Single Borrower (SASB) CMBS

security with substantial overcollateralization). For example, a SASB could be collateralized by a single real estate asset (e.g., $100 collateral value) where the loan being collateralized is only a fraction of the collateral value (e.g., $60). In such an instance, the first loss tranche security may be owned by an insurance company, but the first loss position is borne by the sponsor (i.e., the first $40 of losses). Interested parties believe the below proposed edits will help provide clarity for such a security, or other similar securities, and is consistent with the spirit of the proposed principles included therein.

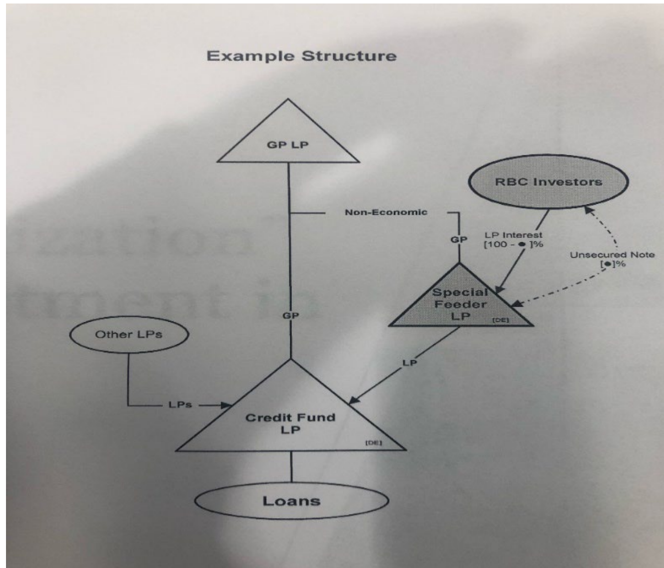
> The first loss ~~tranche~~ position ~~(or tranches if the first tranche is not itself substantive)~~ may be issued as part of the securitization in the form of debt or equity interest, or it may be retained by the sponsor and not issued as part of the securitization. If the first loss ~~tranche~~ position (or a more senior position(s), if the first loss position(s) lack a substantive credit enhancement) is issued as part of the securitization, and does not have a substantive credit enhancement and is held by a reporting entity, the accounting should follow the guidance applicable to the type of instrument (i.e., debt vs. equity); however, regardless of the type of instrument, it does not qualify as a Schedule D bond and should be reported on Schedule BA.

Additionally, interested parties question whether the accounting (highlighted above) for Schedule BA Assets should be codified within the Substantive Criteria of the Bond Definition. In principle it doesn't seem appropriate there and it may also conflict with, or add confusion around, any accounting guidance determined to be appropriate for such assets (see interested party comments in section 2 of this letter).

5) Interested parties note that "feeder funds" were a focal point of discussions during development of the Proposed Bond Definition. In large part, this was in the context of the "stapling" concern, which was de-escalated, as residual tranches have been moved to Schedule BA with the desire of regulators to assess appropriate capital charges. The below is a representative structure of a feeder fund, structured for various legal reasons, which we understand is not viewed as problematic. To ensure the Draft Issue Paper is wholly inclusive of discussions held on feeder funds, and further clarify the principle-based approach, we suggest the following language, and example structure, be included in the Draft Issue Paper. An appropriate spot might be right after paragraph 26.

> The assessment of equity backed securities should be looked at, not only in form, but in substance. For example, a feeder fund arrangement where the debt is issued from the feeder fund, that has an equity interest in another fund that holds debt instruments, should not be viewed as holding one equity interest (i.e., in this case a pass-through entity) if the substance is the debt is backed by debt instruments. Similarly, if the "credit" fund were an "equity" fund, backed by equity interests, the debt of the feeder fund would have to meet the requirements of paragraph 26 while looking at the substance of equity interests supporting the debt. Of course, such an arrangement would have to meet the other

relevant parts of the standard (e.g., have a substantive credit enhancement, etc.). Substance over form should be the determining factor in these and similar situations.



6) Interested parties note that examples 1 & 2 of Appendix I are less explicit, as they have evolved over time, than the examples in Appendix II. For example, example 2 has many variables and really doesn't address a specific debt instrument, rather it lays out principles. Using a specific security in the example would not be particularly helpful as there are too many variables and any one example would therefore be of limited use. Interested parties therefore suggest the standard might have better flow if examples 1 & 2 become codified as part of the standard itself, with potentially minor edits for purposes of flow only. Instead of referencing Appendix 1, in paragraph 1, it might make sense to codify these examples at the end of paragraph 1. The end of paragraph 3 would potentially be another area to embed these principles within the standard itself. If regulators agree that there is value in this suggestion, interested parties would be more than willing to work with regulators and NAIC staff in that regards.

7) Interested parties note that paragraph 67 of the Draft Issue Paper includes a concept that is not in the Proposed Bond Definition, and which interested parties do not recall being discussed in any meaningful way. Therefore, interested parties question the appropriateness of its inclusion in the Draft Issue Paper. The stated concern appears to be "to allow for full assessment of the extent of ABS by regulators." The proposed solution is to remove all such investments from within the Scope of SSAP No. 2R, *Cash, Cash Equivalents, Drafts and Short-Term Investments*. Interested parties believe a less disruptive solution would be to just disclose, or have a separate reporting line, of any ABS short-term investments (e.g., ABS Commercial Paper) on the Short-Term investment schedules. If there is a broader concern that regulators feel needs to be addressed, interested parties believe that should be a separate project, as it appears outside of the Proposed Bond Definition Project, and should be

addressed separately and therefore not included in the Draft Issue Paper for the Proposed Bond Definition.

Comments on the Specific Questions Posed in the Draft Issue Paper

Paragraph 105 of the Draft Issue Paper notes that it is anticipated that guidance will be drafted to recommend the use of Schedule BA for most investments that do not qualify as bonds under the Proposed Bond Definition, with comments requested in three areas. Interested parties' comments are immediately following each of the three questions asked and enumerated below:

1) Are there investments that will not qualify as bonds that should be considered for reporting on a different schedule other than Schedule BA? Comments on key investment characteristics that would appropriately distinguish these investments are requested.

   Interested parties have not identified anything to date, that will not qualify as a bond under the Proposed Bond Definition, for which we have identified an alternative reporting schedule to Schedule BA.

2) For investments that are captured on Schedule BA, should consideration occur to permit an amortized cost approach rather than a lower of cost or fair value measurement? For investments in which an amortized cost approach is supported, what characteristics can be used to identify / support this measurement method? Should use of NAIC designations be permitted to drive the Schedule BA measurement method for these securities?

   Interested parties note that there are likely investments that do not qualify as Schedule D, Bonds (e.g., non-agency guaranteed pass-through mortgage-back securities) that are not considered bad investments (i.e., they are considered good investments, by both interested parties and regulators, just not appropriate as bonds on Schedule D). Further, in the case of non-agency guaranteed pass-through mortgage-backed securities, the securities are not considered bonds because they have no substantive credit enhancement, which therefore are akin to mortgages that have a designated reporting schedule. While this example, in theory, could be reported on the Schedule B – Mortgage Loans, it may not be practical to report them on Schedule B because Schedule B RBC formulas would need to substantially be revised. Further, revisions to SSAP No. 37 would be necessary since securities are not permitted as mortgage loans. The question implies that the default measurement method on Schedule BA would be lower of cost or fair value, which itself seems to imply they are "bad" investments. Interested parties therefore recommends taking a close look at this assumption for all investments that may have to be reported on Schedule BA simply because they do not meet the definition of a bond under the Proposed Bond Definition. For example, specifically related to non-agency guaranteed pass-through mortgage-backed securities, like mortgages, amortized cost seems to be the appropriate accounting.

In addition to amortized cost, fair value or lower of cost or fair value may be appropriate in other situations. For example, fair value may be appropriate for equity-linked bonds as they exhibit equity like characteristics. Lower of cost or fair value may be appropriate for Principal Protected Notes, if regulators believe lower of cost of fair value appropriately captures the non-payment risk they have identified as a concern.

Also, as noted in the "feeder fund example", and previously discussed in this letter, the "residual tranche" is in a limited partnership form. In general, limited partnership interests are accounted for under the equity method of accounting, and subject to impairment. It may be that such accounting is determined to be appropriate in this instance. If not, interested parties would like to discuss with regulators and NAIC staff any distinctions which may need to be made when a limited partnership interest is a residual tranche or the equity component of a SSAP No. 48/97 investment that issues debt.

Lastly, interested parties are very supportive of the SVO's outstanding exposure, and shared (with interested parties) objective, on designating additional Schedule BA assets, that exhibit fixed income characteristics, with the goal of obtaining commensurate risk-based-capital charges. With that said, interested parties do not necessarily see the connection for having NAIC designations drive the measurement method (accounting) of investments on Schedule BA.

SSAP No. 26R *Bonds* includes in its scope debt instruments issued by Certified Capital Companies (CAPCOs). As defined in INT 06-02 *Accounting and Reporting for Investments in a Certified Capital Company*, CAPCOs are state legislated venture capital firms for which investors who invest cash to acquire an equity interest or qualified debt instrument receive state premium tax credit or income tax credit.

As currently exposed, the Proposed Bond Definition will continue to include debt investments in CAPCOs in the scope of SSAP No. 26R. Therefore, it is expected that these investments will continue to be reported on Schedule D as bonds.

This question has also raised a question on debt investments whose returns are earned solely through federal tax credits – should they be reported on Schedule D since these investments are similar to debt investments in CAPCOs?

For example, there is a program referred to as the New Markets Tax Credit (NMTC) program whose goal is to stimulate regeneration of low-income and impoverished communities across the United States. Capital raised by NMTC programs is used to drive expansion of investment, job creation and economic opportunities in distressed communities. The NMTC program provides federal tax credits to reporting entities that invest in the development entities which make direct investments in these communities. An investor is required to make a debt and equity investment into the development entity. We believe that debt investments in this program are akin to debt investments in CAPCOs. The only differences of which we are aware is that CAPCOs benefit from state tax credits whereas NMTC programs benefit from federal tax credits and CAPCOs do not require investors to also make

an equity investment. Some of the similarities between CAPCOs and NMTC programs are as follows:

1. **Fixed schedule for one or more future payments** – The schedule and timing of tax credits to be earned is fixed from day 1. In addition, the par amount of the notes is paid back in cash upon maturity of the deal.

2. **Return is based on tax credits** – The return on NMTC investments is earned solely through tax credits. Similar to CAPCOs, where there is usually no cash interest earned on the debt investment, NMTC deals do not pay cash interest.

3. **Significant premiums** – These investments are purchased at significant premiums. Premiums are amortized pro-rata throughout the life of the deal in proportion to the tax credits earned.

4. **Operating entity guarantee** – It is common for debt investments in these deals to have a guarantee by an operating entity such as a financial institution. The guarantee would ensure that if the tax credits do not emerge, the investor gets its investment back.

Based on these similarities, we believe that debt investments in NMTC programs and other similar programs should also qualify for Schedule D reporting. Interested parties would like to discuss these investments with regulators and NAIC staff as to whether they qualify for Schedule D reporting and/or if specific language should be added to paragraph 2.k.iii with CAPCOs.

3) Revisions are also expected to SSAP No. 2R, to address the ABS restrictions, as well as SSAP No. 103R, to clarify that only beneficial interests that qualify as ABS will be accounted for under SSAP No. 43R. Comments are requested on whether other SSAPs will also be impacted and need to be revised.

   Please see our comments above related to SSAP No. 2R on ABS restrictions. In relation to any changes to SSAP No. 103R, interested parties think this potentially relates to proposed changes being drafted in SSAP No. 43R, which are not part of the Draft Issue Paper, and believe it is appropriate to see such proposed changes prior to commenting. It may be appropriate to develop the accounting guidance for securities discussed in question 2 above and/or securities not meeting the substantive criteria of the Proposed Bond Definition (see also the interested party response 4 in section I of this comment letter). It may be appropriate to include this guidance in another SSAP such as SSAP No. 21, *Other Admitted Assets*.

One further comment relates to adoption of the standard, specifically as it relates to the meaningful and/or substantive credit enhancement requirements, which require stepping back in time "as if" one was looking forward at that time. Upon adoption, this could require looking back for a considerable period, perhaps decades. It may be necessary, for example, to allow an insurance entity to use hindsight in instances in which assumptions in a prior period are unobservable or otherwise unavailable and cannot be independently substantiated. Interested parties would like to continue discussions with regulators on this topic which, while discussed,

the issue of a "practical expedient" was never fully discussed through to full resolution.

*   *   *

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

Sincerely,

D. Keith Bell   Rose Albrizio

cc: NAIC staff
Interested parties

The Lease-Backed Securities Working Group

May 5, 2022

Mr. Dale Bruggeman, Chairman
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RE: Ref #2019-24 – SSAP No. 26R & 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 exposure Reference #2019-24 – SSAP No. 26R & 43R, Proposed Bond Definition (the "Proposed Bond Definition" or "Exposure") as well the attached Statutory Issue Paper No. 1XX (the "Issue Paper").

We fully support the attempt to clarify the accounting standards for bonds and structured assets, and we appreciate the immense effort that has gone into this project by both the regulators and various industry groups. While we believe much work remains to be done, our group looks forward to assisting in any way we can as this project continues to evolve. We also anticipate the opportunity to comment on the draft revisions to the two SSAPs when the language is submitted for exposure later this year. At this point, we are limiting our comments to several 'high-level' observations:

In particular, we worry that the designation of *some* simple unstructured single-borrower securities backed by secured loans as 26R "issuer credit obligations" and *others* as 43R "asset-backed securities" will cause confusion in the markets and will result in inconsistent filing by insurance company investors.

Our group was involved over twelve years ago when investments were originally separated between 26R and 43R. At that time, a decision was made -- which we did not agree with -- that even simple un-structured single-borrower securities should be included in 43R, along with "structured securities", if they had been issued by a trust or SPV. For that reason, it was determined that 43R would include "Loan-Backed *and* Structured Securities" ("LBASS"). However, as the Issue Paper notes, that decision led to confusion in the markets as "many insurers had different interpretations of the adopted 2010 revisions."

This is because market participants distinguish between two basic types of transactions, based on the source of the credit:

1.) Simple unstructured debt transactions where the credit depends primarily on the contractual obligation of *a single rated-credit payor*. These transactions may either be "unsecured" or "secured" by a lien on an asset. If issued in security form by a Trust or special-purpose issuer, the cash flows from the underlying loan are simply "passed-through" unaltered to investor, and the credit risk of the securities is identical to that of the underlying loan.

    and

2.) "Asset-Backed" or "Structured Securities" where the credit of each security is not based fundamentally on the credit characteristics of the underlying collateral -- which is typically unrated -- but instead is determined by the "structure" that has been imposed on the transaction, & which fundamentally alters the cash-flows to investors. In these transactions, determining the "credit" of each security depends on a detailed analysis of the structure.

For this reason, the 2010 revisions were confusing to market participants, and many, assuming that 43R was meant to be for "structured securities", continued to file simple single credit-based transactions under

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SSAP 26R. Other investors filed anything issued by an SPE Trust -- even if backed by a single loan to a single borrower -- under 43R. This led to inconsistent filing of transactions.

Seeking to address this confusion, the current Proposed Bond Definition seeks once again to clarify for investors which types of transactions should be reported in scope of 26R (now to be designated as "issuer credit obligations") and which fall more properly into 43R, (now labeled as "asset-backed securities") -- or even potentially what types of investments would not be admitted as "bonds" under either Schedule and would be have to be reported on Schedule BA, "Other Admitted Assets".

This determination would be made first based on whether the issuer was considered to be an 'operating entity' or an SPE "ABS Issuer". If the transaction was determined to be issued by an "ABS Issuer", there would be a second distinction based on the degree of "asset risk" implicit in the transaction. Those with very little "asset risk" could still qualify as an "issuer credit obligations"; while those with higher exposures, would be either designated as "asset-backed securities" -- or even potentially was as "non-bond" BA assets. For simple secured loans, "asset risk" would be measured by the size of the unamortized residual or final "balloon" payment supported by a lien on the asset -- as a proportion of the original principal balance.

The implied concept behind this framework seems to be that being secured by a lien on an asset implies a level of "equity risk" for the lender. We disagree, for several reasons:

> As every lender knows, having a lien on an asset does not convey an "equity" or ownership interest in that asset.
>
> The lien securing the loan is in almost all cases represents a "first priority" claim on the asset, and the final payment secured by that lien is typically only a fraction of the total estimated value of the asset at the maturity of the loan. The correct metric for assessing the risk of that priority claim is the size of the claim relative to the value of the asset (and the predictability of that value), not the size of the final payment as a proportion of the total loan. Determining this risk is an essential part of the credit analysis that all secured lenders -- and rating agencies -- undertake, and is definitely not equivalent to the risk associated with owning the asset outright.
>
> From an accounting standpoint, the only proper time to assign "equity risk" to a lender is when the lender becomes the owner of the asset, via foreclosure or otherwise depending on the terms of the credit agreement.

The result of applying this framework is that *some* simple secured single-borrower loans such as those listed in 1.) above -- even if issued by an SPV Trust or "ABS Issuer" -- would now be designated to be "issuer credit obligations" while *others* would be "asset-backed securities" -- or, depending on the degree of "asset risk", even potentially BA assets:

> *Some* simple secured transactions supported by cash flows from a non-financial asset via a lease or other form of contract with the credit payor -- for example, project finance loans or municipal lease-revenue bonds -- even if they were issued as securities through a "trust" or "SPV" by an "ABS Issuer" -- would now be re-classified as "issuer credit obligations" *regardless of the size of the residual asset exposure in the transaction.*
>
> *Other* identical structures, i.e. loans secured by leases to corporate entities, equipment trust certificates, funding agreement notes, etc. would ***either*** be classified as "issuer credit obligations" ***or*** "asset backed securities" depending on the amount of residual "asset risk" in the transaction. Those with minimal residual asset exposure (less than 5%) would now qualify as "issuer credit obligations". Those with higher exposures would be designated as either "asset backed securities" or even, depending on the size of the exposure, potentially as Schedule BA assets. (That determination would depend on the specifics of each individual transaction.)

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Those secured loans designated as "asset backed securities" would have additional credit requirements regarding "credit enhancement" and the demonstration of a "meaningful" level of cash flows to service the debt (if supported by "non-financial assets" - see below) -- requirements which would not apply to those designated as issuer credit obligations.

This framework is bound to create confusion for investors and lead once again to inconsistencies and errors in reporting. The confusion is made worse by the two additional requirements for a transaction to qualify as a Schedule D-1 asset backed security:

The first requirement is that in order to qualify as an asset-backed security, a transaction must benefit from "Substantive Credit Enhancement" sufficient to place the holder of the debt "*in a different position than if the holder owned the ABS Issuer's assets directly*". (Paragraph 41 of the Issue Paper states that "To qualify as a bond under this standard, there is a requirement that there are *substantive credit enhancements* <u>*within the structure*</u> *that absorb losses before the debt instrument being evaluated would be expected to absorb losse*s.) [emphases added]

To begin with, the determination of "expected losses" is a subjective determination which is an essential part of credit analysis, not an accounting distinction.

More fundamentally, there are many simple secured loan transactions where the issuer of the securities (the ABS Issuer) has no equity or ownership interest in the asset being financed. In these transactions the "asset" held by the issuer is the loan itself, a financial instrument that unambiguously represents a "creditor relationship" with the borrower, not an equity interest. In these simple "pass-through securities", there is no intervening structure and the cashflows from the underlying loan are simply passed-through *unaltered* to the holders of the securities. In other words, the holder of the securities is in *exactly* the same position "as if it owned the ABS Issuer's assets (underlying loan) directly". While this may not be the intent of the drafters, interpreted literally, it would disqualify all simple pass-through secured loans as ABS securities -- and implicitly, as bonds.

The second requirement to qualify as an "asset backed security" is that those deals secured by "cash-generating non-financial assets" must demonstrate a "meaningful" source of cash flows for the repayment of the bond (i.e.: other than through the sale or re-financing of the assets). However, as the exposure itself admits, determining what constitutes a "meaningful" source of cash flows is once again subjective, depending largely on the specifics of each individual transaction, requiring numerous "examples" to serve as guidance, but no firm metrics.

<u>Conclusion:</u>

Secured lending is as old as lending itself, and does not represent a new or exotic innovation. Simple secured loans, even if issued in security form by a trust or SPV -- allowing investors to participate *pari-passu* in the underlying loan -- have long been accepted insurance company investments, as codified in SSAP 43R for many years -- and indeed before that, as 26R "bonds".

While in one sense every secured loan issued in security form can be considered an "asset-backed security", this not the common understanding in the market. The term "Asset-Backed Security" is broadly used by market participants (including the SEC and organizations such as SIFMA) to refer to "structured securities": pools of assets which have been carved-up, or "tranched" into multiple securities, and for which the payments received by investors are not "directly proportional" to the payments flowing from the underlying assets.

The current version of 43R states clearly that it covers both "loan-backed" and "structured" securities. (It appears that the term "asset-backed security is not used in the current 43R.) If the current terminology is dropped, and some simple secured loans are now to be designated as "asset-backed securities", we feel it is

important that additional language be added to the standard making it clear that they are not subject to the same requirements as "structured securities" -- the most common use of the term "asset-backed securities".

Our group continues to believe that a much clearer division between the two SSAPs, 26R and 43R – one which would avoid much of the ambiguity in the current Exposure – would be to assign *all* single-credit payor/single obligor transactions – whether secured or unsecured – to be in scope of SSAP 26R as "issuer credit obligations". This would allow for SSAP 43R to be used exclusively for true *structured securities*, where the credit is not based on the underlying loans or assets – which are frequently not rated entities – but instead credit is determined by the structure of the transaction.

This reflects the common understanding in the market, which draws a fundamental distinction between simple (i.e.: unstructured) debt relying primarily on the creditworthiness of a single rated-credit payor, and "structured securities", where the credit has been modified through the introduction of multiple classes of securities, each with its own credit characteristics, and where the underlying cash flows have been altered by the structure, thus putting investors in a different economic position from having direct credit exposure to the underlying loans or assets backing the transaction (the most common use of the term "Asset-Backed Securities").

If the current framework is adopted, we would suggest that additional language needs be supplied to 43R making it clear -- as does the current version of 43R -- that it covers simple secured loan-backed transactions as well as "structured securities".

We thank you for the opportunity to offer these comments, and are happy to answer any questions or discuss our comments further with the regulator community.

Thank you for considering our comments,

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

Bond Definition
Proposed Reporting Lines

This document proposes annual statement general instructions (reporting line descriptions) for suggested reporting lines for investments reported ad issuer credit obligations or asset-backed securities on Schedule D, Part 1. As detailed within, the general classifications that currently exist are proposed to be deleted and new reporting lines divided between issuer credit obligations and asset-backed securities are suggested.

Comments are requested on all aspects of this document – including whether reporting lines should be added or deleted as well as the suggested instructions to clarify what should be captured in each location.

Although this document is the "Investment Schedule General Instructions" the revisions have been limited to Schedule D, Part 1. (Other sections have been deleted from this draft.) It is recognized that corresponding revisions will be required to a variety of other schedules. Although it is perceived that the new reporting lines will be carried over into applicable schedules, comments are also welcome on whether variations should occur. Once initial consideration occurs on Schedule D, Part 1, then impact to other schedules will be subsequently detailed so a complete picture can be considered prior to incorporation.

The proposed reporting lines are detailed below. These lines are not part of this page in the Annual Statement Instructions but are included for reference purposes.

Comments on the proposed lines, as well as the ordering of the proposed lines are welcome. **The categories for which both unaffiliated and affiliated holdings are proposed to be captured are identified**. This is simply to identify the categories in which affiliated holdings will be reported and does not represent the actual structure for reporting in the blanks. Comments are requested on these categories and whether additional categories shall report affiliated investments.

Issuer Credit Obligations:

U.S. Government Obligations ....
Other U.S. Government Securities ....
Non-U.S. Sovereign Jurisdiction Securities ....
Municipal Bonds – General Obligations ....
Municipal Bonds – Special Revenue..........

Project Finance Bonds Issued by Operating Entities (Unaffiliated / Affiliated) ....
Corporate Bonds (Unaffiliated / Affiliated) ....
Mandatory Convertible Bonds (Unaffiliated / Affiliated)..........
Single Entity Backed Obligations (Unaffiliated / Affiliated)..........
SVO-Identified Bond Exchange Traded Funds – Fair Value..........
SVO-Identified Bond Exchange Traded Funds – Systematic Value ....
Bonds Issued from SEC-Registered Business Development Corps, Closed End Funds & REITS (Unaffiliated / Affiliated).

Bank Loans – Issued (Unaffiliated / Affiliated)
Bank Loans – Acquired (Unaffiliated / Affiliated)..........

Mortgages Loans that Qualify as SVO-Identified Credit Tenant Loans (Unaffiliated / Affiliated)..........
Certificates of Deposit..........
Other Issuer Credit Obligations (Unaffiliated / Affiliated) ....

Total Issuer Credit Obligations (Unaffiliated & Affiliated) ....
Total Affiliated Issuer Credit Obligations..........

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Financial Asset-Backed Securities – Self-Liquidating

Agency Residential Mortgage-Backed Securities - Guaranteed ....

Agency Commercial Mortgage-Backed Securities - Guaranteed ....

Agency Residential Mortgage-Backed Securities – Not Guaranteed ....

Agency Commercial Mortgage-Backed Securities – Not Guaranteed ....

Non-Agency Residential Mortgage-Backed Securities (Unaffiliated / Affiliated) ....

Non-Agency Commercial Mortgage-Backed Securities (Unaffiliated / Affiliated) ....

Non-Agency – CLOs / CBOs / CDOs (Unaffiliated / Affiliated) ....

Other Financial Asset-Backed Securities - Self-Liquidating (Unaffiliated / Affiliated) ....

Total Financial Asset-Backed Securities - Self-Liquidating **(Unaffiliated / Affiliated) ....**

Financial Asset-Backed Securities – Not Self-Liquidating

Equity Backed Securities (Unaffiliated / Affiliated) ....

Other Financial Asset Backed Securities – Not Self-Liquidating (Unaffiliated / Affiliated) ....

Total Financial Asset-Backed Securities – Not Self Liquidating (Unaffiliated / Affiliated) ....

Non-Financial Asset Backed Securities - Practical Expedient ....

Lease-Backed Securities – Practical Expedient (Unaffiliated / Affiliated) ....

Other Non-Financial Asset-Backed Securities – Practical Expedient (Unaffiliated / Affiliated) ....

Total Non-Financial Asset-Backed Securities – Practical Expedient (Unaffiliated / Affiliated) ....

Non-Financial Asset-Backed – Full Analysis ....

Lease-Backed Securities – Full Analysis (Unaffiliated / Affiliated) ....

Other Non-Financial Asset-Backed Securities – Full Analysis (Unaffiliated / Affiliated) ....

Total Non-Financial Asset-Backed Securities – Full Analysis (Unaffiliated / Affiliated) ....

Total Asset-Backed Securities ....

Total Affiliated Asset-Backed Securities ....

Total Long-Term Bonds (Issuer Credit Obligations & Asset Backed Securities) ....

Total Affiliated Long-Term Bonds (Issuer Credit Obligations & Asset Backed Securities)

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Attachment A

INVESTMENT SCHEDULES GENERAL INSTRUCTIONS
(Applies to all investment schedules)

The following definitions apply to the investment schedules.

SAP Book Value (Defined in Glossary of *Accounting Practices and Procedures Manual*):

Original Cost, including capitalized acquisition costs and accumulated depreciation, unamortized premium and discount, deferred origination and commitment fees, direct write-downs, and increase/decrease by adjustment.

SAP Carrying Value (Defined in Glossary of *Accounting Practices and Procedures Manual)*:

The SAP Book Value plus accrued interest and reduced by any valuation allowance (IF APPLICABLE) and any nonadmitted adjustment applied to the individual investment. Carrying Value is used in the determination of impairment.

Adjusted Carrying Value:

Carrying Value amount adjusted to remove any accrued interest and to add back any of the following amounts: individual nonadmitted amounts, individual valuation allowances (IF APPLICABLE), and aggregate valuation allowance (IF APPLICABLE). In effect, this is equivalent to the definition of SAP Book Value (not to be confused with the old "Book Value" reported in the annual statement blanks for data years 2000 and prior).

Recorded Investment:

The SAP Book Value (Adjusted Carrying Value) plus accrued interest.

The information included in the investment schedules shall be broken down to the level of detail as required when all columns and rows are considered together unless otherwise addressed in specific instructions. For example, on Schedule D Part 4, a reporting entity is required to list the CUSIP book/adjusted carrying value, among other things. The reporting entity would only be required to break this information down to a lower level of detail if the information was inaccurate if reported in the aggregate. Thus, the reporting entity would not be required to break the information down by lot (information for each individual purchase) and could utilize the information for book/adjusted carrying value using an average cost basis, or some other method, provided the underlying data reported in that cell was calculated in accordance with the *Accounting Practices and Procedures Manual*. However, reporting entities are not precluded from reporting the information at a more detailed level (by lot) if not opposed by their domiciliary commissioner.

"To Be Announced" securities (commonly referred to as TBAs) are to be reported in Schedule D unless the structure of the security more closely resembles a derivative, as defined within *SSAP No. 86—Derivatives*, in which case the security should be reported on Schedule DB. The exact placement of TBAs in the investment schedules depends upon how a company uses TBA. (For example, if a reporting entity was to acquire a TBA with the intent to take possession of a Schedule D, Part 1 qualifying mortgage-backed security, the TBA shall be reported on Schedule D, Part 1 at acquisition. If a reporting entity was to an acquire a TBA, with the intent to roll the TBA, this acquisition is more characteristic of a forward derivative and shall be captured on Schedule DB.)

For Rabbi Trusts, refer to *SSAP No. 104R—Share-Based Payments* for accounting guidance.

For the Foreign Code columns in Schedules D and DA, the following codes should be used:

"A" For Canadian securities issued in Canada and denominated in U.S. dollars.

"B" For those securities that meet the definition of foreign provided in the Supplement Investment Risk Interrogatories and pay in a currency OTHER THAN U.S. dollars.

"C" For foreign securities issued in the U.S. and denominated in U.S. dollars.

"D" For those securities that meet the definition of a foreign as provided in the Supplement Investment Risk Interrogatories and denominated in U.S. dollars (e.g., Yankee Bonds or Eurodollar bonds).

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Leave blank for those securities that do not meet the criteria for the use of "A", "B", "C" or "D."

Derivatives (Schedule DB); repurchase and reverse repurchase agreements (Schedule DA); and securities borrowing and securities lending transactions (Schedule DL) shall be shown gross when reported in the investment schedules. If these transactions are permitted to be reported net in accordance with *SSAP No. 64—Offsetting and Netting of Assets and Liabilities*, the investment schedule shall continue to provide detail of all transactions (gross), with the net amount from the valid right to offset reflected in the financial statements (pages 2 and 3 of the statutory financial statements). Disclosures for items reported net when a valid right to offset exists including the gross amount, the amount offset and the net amount reported in the financial statements are required per *SSAP No. 64—Offsetting and Netting of Assets and Liabilities*.

For the columns that disclose information regarding investments that are not under the exclusive control of the reporting entity, and also including assets loaned to others, the following codes should be used:

LS	–	Loaned or leased to others
RA	–	Subject to repurchase agreement
RR	–	Subject to reverse repurchase agreement
DR	–	Subject to dollar repurchase agreement
DRR	–	Subject to dollar reverse repurchase agreement
C	–	Pledged as collateral – excluding collateral pledged to FHLB
CF	–	Pledged as collateral to FHLB (including assets backing funding agreements)
DB	–	Pledged under an option agreement
DBP	–	Pledged under an option agreement involving "asset transfers with put options"
R	–	Letter stock or otherwise restricted as to sale – excluding FHLB capital stock
		(Note: Private placements are not to be included unless specific restrictions as to sale are included as part of the security agreement.)
RF	–	FHLB capital stock
SD	–	Pledged on deposit with state or other regulatory body
M	–	Not under the exclusive control of the reporting entity for multiple reasons
SS	–	Short sale of a security
O	–	Other

The following is the description of the ~~General and Specific Classifications used for reporting the~~ detailed lines for bonds and stocks.

~~General~~ Classifications ~~Bonds~~ Schedule D, Part 1 Only:

All investments shall qualify for reporting on Schedule D, Part 1. Investments that may fit within the classifications below are not permitted on Schedule D, Part 1 if they do not qualify under the bond definition detailed within *SSAP No. 26R—Bonds* and *SSAP No. 43R—Asset-Backed Securities* or are otherwise named in scope within those statements.

(Note: Schedule D-1 references will be updated to reflect D-1-1 (ISC) and D-1-2 (ABS) if that approach is supported.)

Refer to *SSAP No. 26R—Bonds, SSAP No. 43R—~~Loan-Backed and Structured~~Asset-Backed Securities* and *SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities* for additional guidance.

Issuer Credit Obligations – Investments that qualify for reporting on Schedule D, Part 1 in scope of SSAP No. 26R:

U.S. Government Obligations:

~~U.S. Government shall be defined as~~ U.S. Government Obligations, as defined per the *Purposes and Procedures Manual of the NAIC Investment Analysis Office*, includes direct claims (including securities, loans

and leases) on, and the portions of claims that are directly and unconditionally issued, guaranteed or insured by the U.S. Government or its agencies. U.S Government obligations captured within this category include obligations issued by U.S. Government agencies that are fully guaranteed or insured as to the timely payment of principal and interest by the full faith and credit of the U.S. Government.

Note: Although not planned as part of the A/S instructions, pursuant to the.2022 P&P Manual, investments from the following agencies would be included in this reporting line:

- Army and Air Force Exchange Service (AAFES)
- Commodity Credit Corporation (CCC)
- Export–Import Bank of the United States (EXIM Bank)
- Farmers Home Administration (FmHA) – Certificates of Beneficial Ownership
- Federal Deposit Insurance Corporation (FDIC)
- Federal Housing Administration (FHA)
- General Services Administration (GSA)
- Government National Mortgage Association (GNMA)
- National Credit Union Administration (NCUA)
- Overseas Private Investment Corp (OPIC)
- Small Business Administration (SBA)
- U.S. Agency for International Development (USAID)
- U.S. Department of Agriculture (USDA)
- U.S. Department of Health and Human Services (HHS)
- U.S. Department of Housing and Urban Development (HUD)
- U.S. Department of the Treasury
- U.S. Department of Veterans Affairs (VA)
- U.S. International Development Finance Corporation (DFC)
- U.S. Maritime Administration (MARAD)
- Washington Metropolitan Area Transit Authority

~~All~~ Other U.S. Government Securitie~~s~~s:

Securities issued by U.S. Government agencies or government-sponsored enterprises that are not backed by the full faith and credit of the U.S. Government.

This category includes securities issued from agencies that are not backed by the full faith and credit of the U.S. Government but have a filing exemption detailed in the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* based on analytical judgement.

Note: Although not planned as part of the A/S instructions, pursuant to the 2022 P&P Manual, investments from the following agencies would be included in this reporting line:

- Federal Agricultural Mortgage Corporation (Farmer Mac)
- Federal Farm Credit Banks (FFCB)
- Federal Financing Bank (FFB)
- Federal Home Loan Banks (FHLB)
- Federal Home Loan Mortgage Corporation (Freddie Mac)
- Federal National Mortgage Association (Fannie Mae)
- Financing Corporation (FICO)
- Resolution Funding Corporation (REFCorp)
- Tennessee Valley Authority (TVA)

Non-U.S. Sovereign Jurisdiction Securities

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This includes ~~bond~~ investments issued by non-U.S. sovereign governments, including bonds of political subdivisions and special revenue. This also includes bonds issued by utilities owned by non-U.S. governments and bonds fully guaranteed by non-U.S. governments.

~~U.S. States, Territories and Possessions~~Municipal Bonds – General Obligation (Direct and Guaranteed):

Include securities issued by states, cities, counties and other governmental entities to fund day-to-day obligations and to finance capital projects that are not secured by specific assets, but are backed by the "full faith and credit" (taxing power) of the issuer. ~~General obligations of these entities (NAIC members), as well as bonds issued by utility companies owned by these entities. NAIC membership is composed of the 50 states, the District of Columbia, American Samoa, Guam, Northern Marianna Islands, Puerto Rico, and the U.S. Virgin Islands.~~

Municipal Bonds – Special Revenue

Include securities issued by states, cities, counties, and other governmental entities to finance projects not backed by the taxing power of the issuer, but by revenues from the specific project or source (e.g., highway tolls). Also include other municipal securities that do not qualify as general obligation (e.g., pre-refunded bonds and insured bonds).

Project Finance Bonds Issued by Operating Entities

Include non-municipal securities issued by an operating entity as defined in SSAP No. 26R, that finances a single asset or operation (such as a toll road or power generation facility). For these investments, the asset or operation collateralizes the issuance and the cash flows produced satisfy the debt payments. The use of a bankruptcy remote entity (e.g., Special Purpose Vehicle) does not preclude reporting in this category when the entity is determined to represent an operating entity and the ~~entity is determined to represent an operating entity and the~~ primary purpose of the debt issuance is to finance a specific operating project for the operating entity.

~~U.S. Political Subdivisions of States, Territories and Possessions (Direct and Guaranteed):~~

~~General obligations of cities, counties, townships, etc., as well as bonds issued by utility companies owned by these entities.~~

~~U.S. Special Revenue and Special Assessment Obligations and All Non-Guaranteed Obligations of Agencies and Authorities of Governments and Their Political Subdivisions:~~

~~Those U.S. government issues not listed as "Securities That Are Considered "Exempt Obligations" For Purposes of Determining The Asset Valuation Reserve And The Risk-Based Capital Calculation" in the *Purposes and Procedures Manual of the NAIC Investment Analysis Office*, yet included as "Filing Exemptions for Other U.S. Government Obligations". This category also includes bonds that are issued by states, territories, possessions and other political subdivisions that are issued for a specific financing project rather than as general obligation bonds. Also include mortgage reference securities that are within the scope of *SSAP No. 43R—Loan-Backed and Structured Securities*.~~

~~Industrial and Miscellaneous (Unaffiliated)~~Corporate Bonds:

~~This category includes all non-governmental issues that do not qualify for some other category in Schedule D, Part 1, including privatized (non-government ownership) utility companies. Include Public Utilities.~~Issuer credit obligation issued by a company to raise capital and support company operations.

Mandatory Convertible Bonds

A type of convertible bond that has a required conversion or redemption feature. Either on or before a contractual conversion date, the holder must convert the mandatory convertible into underlying common stock.

Single-Entity Backed Obligations

Investments for which repayment is fully supported by an underlying contractual obligation of a single operating entity. This does not include corporate bonds or project finance structures. Examples of structures that could qualify for reporting within this category, if payment is fully supported by a single operating entity, include but are not limited to, equipment trust certificates, enhanced equipment trust certificates, single-tenant lease-backed securities and funding agreement backed notes. Repayment is considered fully supported by the underlying operating entity if the structure in place at origination provides cash flows to satisfy all interest and at least 95% of the principal of the security. (For example, a 5-year lease-backed security that has all cash flows for interest and principal repayment generated from one existing tenant who is under a matching 5-year lease term on the building qualifies for reporting as a single-entity backed obligation.)

SVO Identified Funds – Fair Value:

This category includes allInclude SVO-Identified Bond Exchange Traded Funds included on the "List of Exchange Traded Funds Eligible for Reporting as a Schedule D Bond (the ETF Bond List)" as found on the Securities Valuation Office Web page (*https://www.naic.org/svo.htm*) that do not quality for, or for which the reporting entity has elected not to report, at systematic value.

SVO Identified Funds – Systematic Value:

Include SVO-Identified Bond Exchange Traded Funds included on the "List of Exchange Traded Funds Eligible for Reporting as a Schedule D Bond (the ETF Bond List)" as found on the Securities Valuation Office Web page (*https://www.naic.org/svo.htm)* that qualify for, and that the reporting entity has elected to report, at systematic value. Use of systematic value is an irrevocable election as long as the qualifying investment is held by the reporting entity and qualifies for systematic value within the parameters of SSAP No. 26R.

Bonds Issued From SEC-Registered Business Development Corps, Closed-End Funds & REITs

Bonds issued by SEC-registered business development corporates, closed-end funds or similar operating entities registered under the 1940 Act.

Bank Loans – Issued

Fixed-income instruments, representing indebtedness of a borrower, made by a financial institution. Bank loans in this category shall be obligations of operating entities acquired directly at issuance by a reporting entity.

Bank Loans - Acquired

Fixed-income instruments, representing indebtedness of a borrower, made by a financial institution. Bank loans in this category shall be obligations of operating entities acquired through an assignment, participation or syndication.
See *SSAP No. 26R—Bonds* for guidance.

Mortgage Loans that Qualify as SVO-Identified Credit Tenant Loans

Mortgage loans, in scope of *SSAP No. 37—Mortgage Loans*, that have been filed with the SVO and included on the SVO Identified Credit-Tenant Loan listing. Investments in the form of security structures shall not be captured on this reporting line. Security structures supported by a credit tenant lease shall be reported as single-entity back obligations (if qualifying) or captured in the appropriate reporting line for Asset-Backed Securities.

Certificates of Deposit

Certificates of deposit that have a fixed schedule of payments and a maturity date in excess of one year from the date of acquisition.

Other Issuer Credit Obligations

Report investment structures that qualify as issuer credit obligations pursuant to SSAP No. 26R that do not fit within a specific reporting line. (Specific reporting lines shall be utilized when applicable.) Debt instruments in a CAPCO permitted under SSAP No. 26R shall also be captured within this category.

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~~Hybrid Securities:~~

~~Securities whose proceeds are accorded some degree of equity treatment by one or more of the nationally recognized statistical rating organizations and/or which are recognized as regulatory capital by the issuer's primary regulatory authority. Hybrid securities are designed with characteristics of debt and of equity and are intended to provide protection to the issuer's senior note holders. Hybrid securities products are sometimes referred to as capital securities. Examples of hybrid securities include Trust Preferreds, Yankee Tier 1s (with and without coupon step-ups) and debt-equity hybrids (with and without mandatory triggers).~~

~~This specifically excludes surplus notes, which are reported in Schedule BA; subordinated debt issues, which have no coupon deferral features; and "Traditional" preferred stocks, which are reported in Schedule D, Part 2, Section 1. With respect to preferred stock, traditional preferred stocks include, but are not limited to a) U.S. issuers that do not allow tax deductibility for dividends; and b) those issued as preferred stock of the entity or an operating subsidiary, not through a trust or a special purpose vehicle.~~

~~Parent, Subsidiaries and Affiliates~~Affiliated Reporting Lines:

Each reporting category other than those specific to government jurisdictions shall have affiliated investments separately reported within the affiliate reporting line. The definition of affiliates is pursuant to ~~Defined by~~ *SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities*.

Asset-Backed Securities – Investments that qualify for Schedule D, Part 1 pursuant to SSAP No. 43R:

Financial Asset-Backed Securities - Self-Liquidating – A self-liquidating security is a design where the terms of the underlying collateral has contractual principal and interest that results with a conversion into cash over a period of time (e.g., receivables or other such assets). (For example, a mortgage loan backing a mortgage-backed security, where the loan balance is reduced as payments are made and is ultimately fully paid off by the borrower, or a collateralized loan obligation (CLO) backed by bank loans that reduces as the loan is paid.) A financial asset is defined within SSAP No. 103R as cash, evidence of an ownership interest in an entity, or a contract that conveys to one entity a right (a) to receive cash or another financial instrument from a second entity or (b) to exchange other financial instruments on potentially favorable terms with the second entity. As a point of clarity, for the purposes of the bond definition and reporting on Schedule D, Part 1, financial assets do not include assets for which the realization of the benefits conveyed by the above rights depends on the completion of a performance obligation (e.g., leases, mortgage servicing rights, royalty rights, etc.). These assets represent non-financial assets, or a means through which non-financial assets produce cash flows, until the performance obligation has been satisfied.

Agency Residential Mortgage-Backed Securities - Guaranteed

Include 'agency' residential mortgage-backed securities where the mortgages or bonds are guaranteed as to principal and interest by federal and federally sponsored agencies such as the Government National Mortgage Association (GNMA), Federal National Mortgage Association (FNMA) or Federal Home Loan Mortgage Corporation (FHLMC). Also include loans guaranteed by the U.S. Department of Veteran Affairs or the U.S. Department of Agriculture's Rural Development Housing and Community Facilities Programs. Government Sponsored Mortgage Reference Securities shall not be captured within this category.

Agency Commercial Mortgage-Backed Securities - Guaranteed

Include 'agency' commercial mortgage-backed securities where the mortgages or bonds are guaranteed as to principal and interest by federal and federally sponsored agencies such as the Government National Mortgage Association (GNMA), Federal National Mortgage Association (FNMA) or Federal Home Loan Mortgage Corporation (FHLMC). Also include loans guaranteed by the U.S. Department of Veteran Affairs or the U.S. Department of Agriculture's Rural Development Housing and Community Facilities Programs. Government Sponsored Mortgage Reference Securities shall not be captured within this category.

Agency Residential Mortgage-Backed Securities – Not Guaranteed

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Include residential mortgage-backed securities issued by an agency that is not guaranteed by federal or federally sponsored agencies. This category shall include mortgage-referenced securities issued by a government-sponsored enterprise (e.g., Fannie Mae or Freddie Mac) in the form of a credit-risk-transfer in which the security is tied to a pool of residential mortgages. These items reflect instruments in which the payments received are linked to the credit and principal payment risk of the underlying mortgage loan borrowers captured in the referenced pool of mortgages. For these instruments, the holder may not receive a return of their full principal as repayment is contingent on repayment by the mortgage loan borrowers in the referenced pool of mortgages.

Agency Commercial Mortgage-Backed Securities – Not Guaranteed

Include commercial mortgage-backed securities issued by an agency that is not guaranteed by federal or federally sponsored agencies. This category shall include mortgage-referenced securities issued by a government-sponsored enterprise (e.g., Fannie Mae or Freddie Mac) in the form of a credit-risk-transfer in which the security is tied to a pool of commercial mortgages. These items reflect instruments in which the payments received are linked to the credit and principal payment risk of the underlying mortgage loan borrowers captured in the referenced pool of mortgages. For these instruments, the holder may not receive a return of their full principal as repayment is contingent on repayment by the mortgage loan borrowers in the referenced pool of mortgages.

Non-Agency Residential Mortgage-Backed Securities

Include residential mortgage-backed securities not issued by a government agency.

Non-Agency Commercial Mortgage-Backed Securities

Include commercial mortgage-backed securities not issued by a government agency.

Non-Agency - CLOs/ CBOs /CDOs

Include self-liquidating collateralized loan obligations, collateralized bond obligations and collateralized debt obligations. (Note: NAIC staff has requested the NAIC Capital Markets Bureau to provide suggestions to define CLOs for inclusion.)

Other Financial Asset Backed Securities - Self-Liquidating

Include self-liquidating financial asset-backed securities not issued by a government agency that are not backed by commercial or residential mortgage loans and that are not considered CLOs / CBOs / CDOs.

Affiliated Reporting Lines:

Each reporting category other than those specific to government (agency) issuances shall have affiliated investments separately reported within the affiliate reporting line. The definition of affiliates is pursuant to *SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities*.

Financial Asset-Backed Securities – Not Self-Liquidating – Include all financial-asset backed securities where the structure does not represent a design where the underlying collateral converts into cash over a period of time.

Equity-Backed Securities

Include structures where the financial assets backing the structure reflect equity. These securities must overcome the rebuttable presumption that equity-like structures do not inherently possess the characteristics to be reported on Schedule D, Part 1 and have appropriate reporting entity documentation supporting a conclusion that the underlying equity interests lend themselves to the production of predictable cash flows and the underlying equity risks have been sufficiently redistributed through the capital structure of the issuer. This category should include securitized collateralized fund obligations (CFOs) and other such structures, that qualify within Schedule D, Part 1. (Securitized equity-backed structures, including CFO structures, that do not qualify for Schedule D, Part 1 reporting shall be captured on Schedule BA.)

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Other Financial Asset Backed – Not Self-Liquidating

Include non-self-liquidating financial asset-backed securities that are not backed by equity.

Non-Financial Asset Backed Securities (Practical Expedient) – A non-financial ABS is defined as a bond backed by assets that are expected to generate a meaningful level of cash flows toward repayment of the bond through use, licensing, leasing, servicing or management fees, or other similar cash flow generation. For the avoidance of doubt, there must be a meaningful level of cash flows to service the debt, other than through the sale or refinancing of the assets. As a practical expedient, if less than 50% of the original principal relies on the sale or refinancing of the underlying assets, the meaningful criteria is considered to be met. In applying this practical expedient, only contractual cash flows of the non-financial asset may be considered.

Lease-Backed Transactions (Practical Expedient)

Include structures where the generation of cash flows to use towards repayment of the asset-backed security are predominantly driven from underlying lease transactions.

Other Non-Financial Asset Backed Securities (Practical Expedient)

Include structures where the generation of cash flows to use towards repayment of the asset-backed security are predominantly driven from underlying cash-flow streams that do not predominantly reflect lease arrangements.

Non-Financial Asset-Backed Securities (Full Analysis) – Include non-financial asset backed securities that qualify for reporting on Schedule D, Part 1 pursuant to *SSAP No. 43R—Asset-Backed Securities*, but that do not qualify within the practical expedient for meaningful cash flows.

Lease-Backed Transactions (Full Analysis)

Include structures where the generation of cash flows to use towards repayment of the asset-backed security are predominantly driven from underlying lease transactions.

Other Non-Financial Asset Backed Securities (Full Analysis)

Include structures where the generation of cash flows to use towards repayment of the asset-backed security are predominantly driven from underlying cash-flow streams that do not predominantly reflect lease arrangements.

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REPORTING PROPOSAL – July 18, 2022
Issuer Credit Obligations and Asset Backed Securities

Under this reporting option, there are two separate schedules, with Schedule D-1, Section 1 detailing issuer credit obligation (items captured in scope of SSAP No. 26R) and with Schedule D-1, Section 2 detailing asset-backed securities (items captured in scope of SSAP No. 43R). With this approach, separate columns and instructions can be considered for the different broad investment classifications. A variety of schedule and instruction changes are proposed for each schedule.

For Schedule D-1-1 – Issuer Credit Obligations, proposed reporting lines:

(Note: Lines for which affiliated investments are proposed to be captured are identified as "unaffiliated / affiliated." Comments are requested on these lines for affiliate reporting.)

Issuer Credit Obligations:

U.S. Government Obligations ....
Other U.S. Government Securities ....
Non-U.S. Sovereign Jurisdiction Securities ....
Municipal Bonds – General Obligations ....
Municipal Bonds – Special Revenue..

Project Finance Bonds Issued by Operating Entities (Unaffiliated / Affiliated) ....
Corporate Bonds (Unaffiliated / Affiliated) ....
Mandatory Convertible Bonds (Unaffiliated / Affiliated) ....
Single Entity Backed Obligations (Unaffiliated / Affiliated) ....
SVO-Identified Bond Exchange Traded Funds – Fair Value ....
SVO-Identified Bond Exchange Traded Funds – Systematic Value ....
Bonds Issued from SEC-Registered Business Development Corps, Closed End Funds & REITS (Unaffiliated / Affiliated).

Bank Loans – Issued (Unaffiliated / Affiliated)
Bank Loans – Acquired (Unaffiliated / Affiliated)..

Mortgages Loans that Qualify as SVO-Identified Credit Tenant Loans (Unaffiliated / Affiliated) ....
Certificates of Deposit..
Other Issuer Credit Obligations (Unaffiliated / Affiliated) ....

Total Issuer Credit Obligations (Unaffiliated & Affiliated) ....
Total Affiliated Issuer Credit Obligations..

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For Schedule D-1-2 – Asset Backed Securities, proposed reporting lines:

Financial Asset-Backed Securities – Self-Liquidating

Agency Residential Mortgage-Backed Securities - Guaranteed ....

Agency Commercial Mortgage-Backed Securities - Guaranteed ....

Agency Residential Mortgage-Backed Securities – Not Guaranteed ....

Agency Commercial Mortgage-Backed Securities – Not Guaranteed ....

Non-Agency Residential Mortgage-Backed Securities (Unaffiliated / Affiliated) ....

Non-Agency Commercial Mortgage-Backed Securities (Unaffiliated / Affiliated) ....

Non-Agency – CLOs / CBOs / CDOs (Unaffiliated / Affiliated) ....

Other Financial Asset-Backed Securities - Self-Liquidating (Unaffiliated / Affiliated) ....

Total Financial Asset-Backed Securities - Self-Liquidating **(Unaffiliated / Affiliated) ....**

Financial Asset-Backed Securities – Not Self-Liquidating

Equity Backed Securities (Unaffiliated / Affiliated) ....

Other Financial Asset Backed Securities – Not Self-Liquidating (Unaffiliated / Affiliated) ....

Total Financial Asset-Backed Securities – Not Self Liquidating (Unaffiliated / Affiliated) ....

Non-Financial Asset Backed Securities - Practical Expedient ....

Lease-Backed Securities – Practical Expedient (Unaffiliated / Affiliated) ....

Other Non-Financial Asset-Backed Securities – Practical Expedient (Unaffiliated / Affiliated) ....

Total Non-Financial Asset-Backed Securities – Practical Expedient (Unaffiliated / Affiliated) ....

Non-Financial Asset-Backed – Full Analysis ....

Lease-Backed Securities – Full Analysis (Unaffiliated / Affiliated) ....

Other Non-Financial Asset-Backed Securities – Full Analysis (Unaffiliated / Affiliated) ....

Total Non-Financial Asset-Backed Securities – Full Analysis (Unaffiliated / Affiliated) ....

Total Asset-Backed Securities ....

Total Affiliated Asset-Backed Securities ....

Total Long-Term Bonds (Issuer Credit Obligations & Asset Backed Securities) ....

Total Affiliated Long-Term Bonds (Issuer Credit Obligations & Asset Backed Securities)

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Schedule D-1 Proposed Columns:
For both proposed schedules, the foreign code and the characteristic code are proposed to move to electronic only. The 'code' column is proposed to be 'restricted asset code.' The column for 'rate used to obtain fair value' is proposed to be deleted. Also, par value and fair value are proposed to switch locations for easier comparisons of fair value and BACV. LEI is proposed to be deleted, but regulator discussion is requested. Lastly, various changes to instructions are suggested. (Call date, call price and effective date of maturity are in blue to identify them limited to issuer credit obligations.)

For ABS, new columns on the pdf reflect payment due at maturity and balloon payment percentage determined at acquisition. New electronic only columns include original & current overcollateralization, current expected payoff date, aggregate deferred interest, PIK interest due and accrued and payoff date determined at acquisition. Information on call dates / prices are proposed to be deleted for ABS.

	Issuer Credit Obligations		**Asset-Backed Securities**
	PDF Columns		*PDF Columns*
1	CUSIP Identification	1	CUSIP Identification
2	Description	2	Description
3	Restricted Asset Code	3	Restricted Asset Code
4	NAIC Designation, Modifier and Symbol	4	NAIC Designation, Modifier and Symbol
5	Actual Cost	5	Actual Cost
	~~Rate Used to Obtain Fair Value~~		~~Rate Used to Obtain Fair Value~~
6	Par Value	6	Par Value
7	Fair Value (Moved after par value)	7	Fair Value (Moved after par value)
8	Book / Adjusted Carrying Value	8	Book / Adjusted Carrying Value
9	Unrealized Valuation Increase / (Decrease)	9	Unrealized Valuation Increase / (Decrease)
10	Current Year's (Amortization) / Accretion	10	Current Year's (Amortization) / Accretion
11	Current Year Realized OTTI	11	Current Year Realized OTTI
12	Total Foreign Exchange in BACV	12	Total Foreign Exchange in BACV
13	Stated Rate of Interest	13	Stated Rate of Interest
14	Effective Rate of Interest	14	Effective Rate of Interest
15	When Interest is Paid	15	When Interest is Paid
16	Interest Due & Accrued	16	Interest Due & Accrued
17	Interest Received During Year	17	Interest Received During Year
18	Date Acquired	18	Date Acquired
19	Stated Contractual Maturity Date	19	Stated Contractual Maturity Date
20	Payment Due at Maturity	20	Payment Due at Maturity
		21	Acquisition Balloon Payment %
	Electronic-Only Columns		*Electronic-Only Columns*
	Investment Involves Related Party		Investment Involves Related Party
	Investment Characteristic Code (Moved to Electronic)		Investment Characteristic Code (Moved to Electronic)
	Foreign Code (Moved to Electronic)		Foreign Code (Moved to Electronic)
	Agency, Sovereign Jurisdiction or State Abbreviation		Agency, Sovereign Jurisdiction or State Abbreviation
	Fair Value Hierarchy and Method to Obtain Fair Value		Fair Value Hierarchy and Method to Obtain
	Source Used to Obtain Fair Value		Source Used to Obtain Fair Value
	Collateral Type		Collateral Type
	Call Date		Current Overcollateralization
	Call Price		Current Expected Payoff Date
	Effective Date of Maturity		Acquisition Overcollateralization
	Aggregate Deferred Interest		Acquisition Expected Payoff Date
	PIK Interest Due and Accrued		Aggregate Deferred Interest
	~~Legal Entity Identifier (LEI)~~		PIK Interest Due and Accrued
	Issuer		~~Legal Entity Identifier (LEI)~~
	Issue		Issuer
	ISIN Identification		Issue
	Capital Structure Code		ISIN Identification
			Capital Structure Code

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Only investments that qualify in scope of SSAP No. 26R (or SSAP No. 43R for D-1-2) are permitted to be reported on this schedule. Bonds are to be grouped as listed below and each category arranged alphabetically (securities included in U.S. States, Territories and Possessions; U.S. Political Subdivisions of States, Territories and Possessions; and U.S. Special Revenue and Special Assessment Obligations and all Non-Guaranteed Obligations of Agencies and Authorities of Governments and Their Political Subdivisions should be listed with a state abbreviation in the column provided for electronic data capture).

Refer to *SSAP No. 23—Foreign Currency Transactions and Translations* for accounting guidance related to foreign currency transactions and translations.

Short Sales:

> Selling a security short is an action by a reporting entity that results with the reporting entity recognizing proceeds from the sale and an obligation to deliver the sold security. For statutory accounting purposes, obligations to deliver securities resulting from short sales shall be reported as contra-assets (negative assets) in the investment schedule, with an investment code in the code column detailing the item as a short sale. The obligation (negative asset) shall be initially reflected at fair value, with changes in fair value recognized as unrealized gains and losses. These unrealized gains and losses shall be realized upon settlement of the short sale obligation. Interest on short sale positions shall be accrued periodically and reported as interest expense.

If a reporting entity has any detail lines reported for any of the following required **categories or subcategories described in the Investment Schedules General Instructions**, it shall report the subtotal amount of the corresponding category or subcategory, with the specified subtotal line number appearing in the same manner and location as the pre-printed total or grand total line and number:

NOTE: See the Investment Schedules General Instructions for the following:

- **Category definitions for bonds and stocks.**
- **Foreign column code list.**
- **Code column list of codes and definitions for securities not under the exclusive control of the reporting entity.**
- **List of stock exchange names and abbreviations.**

List all securities in scope of SSAP No. 26R in Schedule D, Part 1, Section 1 bonds and certificates of deposit owned December 31, of current year, except securities in scope of SSAP No. 26R bonds and certificates of deposit in banks or other similar financial institutions with maturity dates or repurchase dates under repurchase agreements of one year or less from the acquisition date. Exclude cash equivalents as described inthat qualify as cash equivalents or short-term investments pursuant to *SSAP No. 2R—Cash, Cash Equivalents, Drafts, and Short-Term Investments* with original maturities of three months or less.

For Schedule D-1-2: List all asset-backed securities in scope of SSAP No. 43R in Schedule D, Part 1, Section 2 owned December 31, of current year. Securities in scope of SSAP No. 43R are not permitted to be reported as cash equivalents or short-term investments.

The security identifier reported (Column 1 for CUSIP, CINS, PPN or Column 33 for ISIN) must be the same as the identifier used when filing securities with the NAIC pursuant to the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* instructions.

Column 1 – CUSIP Identification

> CUSIP numbers for all purchased publicly issued securities are available from the broker's confirmation or the certificate. For private placement securities, the NAIC has created a special number called a PPN to be assigned by the Standard & Poor's CUSIP Bureau. For foreign securities, use a CINS that is assigned by the Standard & Poor's CUSIP Bureau: *www.cusip.com/cusip/index.htm*.
>
> If no valid CUSIP, CINS or PPN number exists, then the CUSIP field should be zero-filled and a valid ISIN security number should be reported in Column 33.

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Column 2 – Description

Give a description of all ~~bonds~~ investments owned. As appropriate, the reporting entity is encouraged to include data consistent with that reported in Column 31, Issuer and Column 32, Issue. This does not preclude the company from including additional detail to provide a complete and accurate description. Abbreviations may be used as needed.

For SVO-Identified Bond ~~Bond Mutual Funds – as Identified by the SVO and~~ Exchange Traded Funds ~~– as Identified by the SVO~~, enter the name of the fund as it appears on the NAIC SVO-Identified Bonds ETF listing as of Dec. 31 of the current year~~complete name of the fund~~. ETFs not included on the NAIC list as of Dec. 31 of the current year are required to be reported on Schedule D-2, Part 2. ~~As appropriate, the reporting entity is encouraged to include data consistent with that reported.~~

For Certificate of Deposit Account Registry Service (CDARs) or other similar services that have a maturity of greater than one year, individually list the various banking institutions that are financially responsible for honoring certificates of deposit. As appropriate, the name ~~of the name~~ of the banking institutions should follow from the registry of the Federal Financial Institutions Examination Council (FFIEC) (*www.ffiec.gov/nicpubweb/nicweb/SearchForm.aspx*).

For ABS reported as CLOs (Collateralized Loan Obligations), ~~For~~ CDOs (Collateralized Debt Obligations) or C~~L~~BOs (Collateralized ~~Loan~~ Bond Obligations), indicate what the CLO/CDO/CB~~L~~O collateral is, such as high-yield bonds, corporate loans, etc. If the collateral is of mixed type, indicate "Mix," in addition to the largest type of collateral in the mix. If the collateral is derived synthetically, indicate "synthetic."

Column 3 – Restricted Asset Code

~~Enter "*" in this column for all SVO Identified Funds designated for systematic value.~~

~~Enter "@" in this column for all Principal STRIP Bonds or other zero-coupon bonds.~~

~~Enter "$" in this column for Certificates of Deposit under the FDIC limit.~~

~~Enter "&" in this column for TBA (To Be Announced) securities.~~

~~Enter "^" in this column for all assets that are bifurcated between the insulated separate account filing and the non-insulated separate account filing.~~

If bonds are not under the exclusive control of the company as shown in the General Interrogatories, they are to be identified by placing one of the codes **identified in the Investment Schedules General Instructions** in this column.

~~If the security is an SVO Identified Fund designated for systematic value, Principal STRIP bond or other zero coupon bond, Certificates of Deposit under the FDIC limit or a TBA (To Be Announced) security and is not under the exclusive control of the company, the "*", "@", "$" or "&" should appear first, immediately followed by the appropriate code (**identified in the Investment Schedules General Instructions**).~~

~~**Separate Account Filing Only:**~~

~~If the asset is a bifurcated asset between the insulated separate account filing and the non-insulated separate account filing, the "^" should appear first and may be used simultaneously with the"*", "@", "$" or "&" with the "^" preceding the other characters ("*", "@", "$" or "&") depending on the asset being reported, immediately followed by the appropriate code (**identified in the Investment Schedules General Instructions**).~~

~~Column 4 – Foreign~~

~~Insert the appropriate code in the column based on the list provided in the Investment Schedules General Instructions.~~

~~Column 5 – Bond Characteristics~~

~~If bonds have one or more of the following characteristics, then list the appropriate number(s) separated by commas. If none of the characteristics apply, then leave the column blank.~~

~~1. Bonds that are callable at the discretion of the issuer, provided that in no instance will the call price be below par, based on a specified formula for the payoff amount (generally discounting future cash flows at then current interest rates which is generally referred to as a "make whole call provision").~~

~~2. Bonds that are callable at the discretion of the issuer, provided that in no instance will the call price be below par with a specified payoff amount based on a fixed schedule.~~

~~3. Bonds that are callable at the discretion of the issuer at a price that can be less than par.~~

~~4. Terms in which the timing of payments of principal, as well as the amounts and timing of payments of interest, can vary based on a pool of underlying assets or an index. This characteristic code is restricted to items captured in scope of *SSAP No. 43R—Loan-Backed and Structured Securities* and should include agency and non-agency residential mortgage-backed securities (RMBS), some commercial mortgage-backed securities (CMBS), and similar loan-backed or structured securities. This excludes those flagged with #1, #2 or #3.~~

~~5. Variable coupon bonds where the interest payments vary during the life of the transaction, but NOT as is typical based on a fixed spread over a well-established interest rate index (such as LIBOR, prime rate or a government bond yield). (This includes coupons that vary based on the performance of indices that are not interest rate related, such as equity indices, commodity prices or foreign exchange rates. This also includes coupons where the spread to the index is not fixed for the entire life of the transaction. This excludes basic floating rate and adjustable-rate notes with fixed spread over an interest rate index. This characteristic code is strictly limited to variable interest payments.)~~

~~6. Terms that may result in principal (or initial investment) not being repaid in full for reasons other than a payment default by the issuer or defaults within a pool of assets underlying a loan-backed or structured security. (This intends to capture to Mortgage Reference Securities reported in scope of SSAP No. 43R. Other structured notes (securities structured as debt instruments when the contractual amount of the instrument to be paid at maturity is at risk for other than the failure of the borrower to pay the contractual amount due) and whether derivatives shall not be reported on Schedule D, Part 1. These structures are captured in scope of *SSAP No. 86—Derivatives* and shall be reported on Schedule DB.)~~

~~7. Bonds where the issuer's obligation to make payments is determined by the performance of a different credit other than that of the issuer, which could be either affiliated or unaffiliated. (These securities are often referred to as credit-linked notes. This does not include loan-backed or structured securities.)~~

~~8. Mandatory convertible bonds. Bonds that are mandatorily convertible into equity, or, at the option of issuer, convertible into equity, or whose terms provide for payment in the form of equity instead of cash.~~

~~9. Other types of options solely at the discretion of the issuer that could affect the timing or amount of payments of principal or interest, not otherwise reported in 1-8.~~

Column ~~6~~4 – NAIC Designation, NAIC Designation Modifier and SVO Administrative Symbol

Provide the appropriate NAIC Designation (1 through 6), NAIC Designation Modifier (A through G) and SVO Administrative Symbol combination for each security. The list of valid SVO Administrative Symbols is shown below.

The listing of valid NAIC Designation, NAIC Designation Modifier and SVO Administrative Symbol combinations can be found on the NAIC's website for the Securities Valuation Office (*www.naic.org/svo.htm*).

The NAIC Designation, NAIC Designation Modifier and SVO Administrative Symbol will be shown as one column on the printed schedule but will be three sub-columns in the data table.

- NAIC Designation Column 6A

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- NAIC Designation Modifier Column 6B
- SVO Administrative Symbol Column 6C

On the printed page the sub-columns should be displayed with a "." between the NAIC Designation and the NAIC Designation Modifier with a space between the NAIC Designation Modifier and the SVO Administrative Symbol (e.g., "1.A YE").

NAIC Designation Modifier:

The NAIC Designation Modifier should only be used for bonds eligible to receive one, as defined in the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (P&P Manual), otherwise, the field should be left blank.

As defined in the P&P Manual, there is not an NAIC Designation Modifier for investments reporting an NAIC Designation 6, therefore, the NAIC Designation Modifier field should be left blank.

Refer to the P&P Manual for the application of these modifiers.

SVO Administrative Symbol:

Following are valid SVO Administrative Symbols for bonds. Refer to the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* for the application of these symbols.

S	Additional or other non-payment risk
SYE	Additional or other non-payment risk - Year-end carry over
FE	Filing Exempt
FM	Financially Modeled RMBS/CMBS subject to SSAP 43R
YE	Year-end carry over
IF	Initial filing
PL	Private Letter Rating
PLGI	Private Letter Rating – reported on General Interrogatory
RT	Regulatory Transaction
RTS	Regulatory Transaction - SVO Reviewed
RTIF	Regulatory Transaction - Initial Filing Submitted to SVO
RTSYE	Regulatory Transaction - SVO Reviewed - Year-end carry over
GI	General Interrogatory
F	Sub-paragraph D Company – insurer self-designated
Z	Insurer self-designated
*	Limited to NAIC Designation 6
Z*	Regulatory review initiated by either the SVO Director, Financial Condition (E) Committee, Executive (EX) Committee or VOSTF.
ND*	Regulatory review for an assessment of regulatory policy for the investment or regulatory reporting instructions to implement applicable policy.

The NAIC Designation Category is the combination of NAIC Designation and NAIC Designation Modifier. Valid combinations of NAIC Designation and NAIC Designation Modifier for NAIC Designation Category are shown below:

NAIC Designation	NAIC Designation Modifier	NAIC Designation Category
1	A	1A
	B	1B

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	C	1C
	D	1D
	E	1E
	F	1F
	G	1G
2	A	2A
	B	2B
	C	2C
3	A	3A
	B	3B
	C	3C
4	A	4A
	B	4B
	C	4C
5	A	5A
	B	5B
	C	5C
6		6

Column ~~7~~5 – Actual Cost

This column should contain the actual consideration paid to purchase the security. The Actual Cost column amount should be adjusted for: pay downs and partial sales (both reported in Schedule D, Part 4) and subsequent acquisitions of the same issue (reported in Schedule D, Part 3). Actual cost will need to be adjusted due to "other-than-temporary impairments" recognized, for use when determining realized gain/(loss) at disposition.

Include: Brokerage and other related fees, to the extent they do not exceed the fair value at the date of acquisition.

Cost of acquiring the bond or stock including broker's commission and incidental expenses of effecting delivery, transaction fees on re-pooling of securities, and reductions for origination fees intended to compensate the reporting entity for interest rate risks (i.e., points).

Exclude: Accrued interest.

All other costs, including internal costs or costs paid to an affiliated reporting entity related to origination, purchase or commitment to purchase bonds, are charged to expense when incurred.

For SVO Identified Bond ~~Funds (Bond Mutual Funds and~~ Exchange Traded Funds), enter the original cost of the shares purchased, including brokerage and other related fees.

For a bond received as a property dividend or capital contribution, enter the initial recognized value. See *SSAP No. 26R—Bonds* for guidance.

~~Column 8 Rate Used to Obtain Fair Value~~

~~Report rate used for determining fair value.~~

~~For SVO Identified Funds (Bond Mutual Funds and Exchange Traded Funds), enter the per share fair value or net asset value as of the reporting date.~~

~~For U.S. Treasury Inflation-Indexed Securities enter the VOS rate (provided in the *Valuation of Securities*) multiplied by the inflation ratio.~~

~~Column 9 Fair Value~~

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~~The fair value should be the price which, when multiplied by the notional amount (Column 10, Par Value) results in the dollar amount that would be received (excluding accrued interest) if the security was sold at fair value.~~

~~The fair value included in this column (calculated from the Rate Used to Obtain Fair Value column) should be the amount used in any comparison of fair value to another valuation method (e.g., book value or amortized cost) that is prescribed by the accounting/valuation rules.~~
~~For loan-backed securities, the prospective or retrospective methods are used in determining amortized value.~~
~~Exclude: Accrued interest.~~
~~For SVO Identified Funds (Bond Mutual Funds and Exchange Traded Funds), enter the amount representing the number of shares owned at year-end times the rate specified in Column 8.~~
~~For U.S. Treasury Inflation Indexed Securities, Fair Value should utilize the VOS rate multiplied by the inflation ratio.~~

Column ~~10~~6 – Par Value

Enter the par value of the ~~bonds~~ issuer credit obligations owned adjusted for repayment of principal.

For ~~mortgage-backed/loan~~asset-backed ~~and structured~~ securities, enter the par amount of principal to which the reporting entity has a claim.

For interest only ~~bonds~~ investments without a principal amount on which the reporting entity has a claim, use a zero value. ~~Enter the statement date par value for bonds with adjustable principal. An interest only bond with a small par amount of principal would use that amount~~.

For SVO Identified Bond ~~Funds (Bond Mutual Funds and~~ Exchange Traded Funds), enter Zero (0).

Column 7 – Fair Value

Fair value shall be determined pursuant to *SSAP No. 100R—Fair Value.*

Column ~~11~~8 – Book/Adjusted Carrying Value

Securities excluding SVO Identified Bond Exchange Traded Funds ~~fund~~ and mandatory convertible bonds:

This should be the amortized value or the lower of amortized value or fair value, depending upon the NAIC designation of the bond (and adjusted for any other-than-temporary impairment), as of the end of the current reporting year.

Include: The original cost of acquiring the bond, including brokerage and other related fees.

Amortization of premium or accrual of discount, but not including any accrued interest paid thereon.

Amortization of deferred origination and commitment fees.

For asset-backed securities, a reporting entity's use of the retrospective method to reflect changes in expected cash flows adjusts the amortized cost basis.

Deduct: A direct write-down for a decline in the fair value of an ~~bond~~ investment that is other-than-temporary or to reflect fair value when the investment is reported at lower of amortized cost or fair value.

Exclude: All other costs, including internal costs or costs paid to an affiliated reporting entity related to origination, purchase or commitment to purchase bonds, are

charged to expense when incurred. Cost should also be reduced by payments attributed to the recovery of cost.

Accrued interest.

The amount reported in this column should equal:

Book/Adjusted Carrying Value reported in the Prior Year statement (or Actual Cost for newly acquired securities)
plus "Current Year's (Amortization)/Accretion"
plus "Unrealized Valuation Increase/(Decrease)Total in Book/Adjusted Carrying Value"
minus "Current Year's Other-Than-Temporary Impairment Recognized"
plus "Total Foreign Exchange Change in Book/Adjusted Carrying Value"
plus Changes due to amounts reported in Schedule D, Parts 3, 4 and 5

Refer to *SSAP No. 26R—Bonds* and *SSAP No. 43R—Asset-Backed Securities*.

For reporting entities maintaining an AVR:

NAIC Designation 1 – 5* Enter amortized cost
NAIC Designation 6 Enter the lower of fair value or amortized cost

For reporting entities not maintaining an AVR:

NAIC Designations 1 – 2* Enter amortized cost
NAIC Designations 3 – 6 Enter the lower of fair value or amortized cost

*NOTE: An exception exists for Treasury Inflation Adjusted Securities ~~under INT 01-25,~~ where the book/adjusted carrying value may include an unrealized gain. See *INT 01-25, Accounting for U.S. Treasury Inflation-Indexed Securities*, for accounting guidance.

Mandatory Convertible Bonds:

The amount should be the lower of amortized cost or fair value during the period prior to conversion.

SVO Identified Funds:

The amount should be fair value unless the reporting entity has designated a qualifying security for systematic value. The election of using systematic value is irrevocable. Guidance in *SSAP No. 26R—Bonds* details the requirements for use of systematic value.

~~**NOTE: Use of systematic value is effective Dec. 31, 2017.** This effective date requires entities to either report SVO-Identified investments at fair value on the effective date, or to identify the SVO-Identified investments with a code to identify use of systematic value. If the investment is coded for systematic value, the investment will be reported in the 2017 annual financial statements using the measurement method utilized throughout 2017. For these investments, beginning Jan. 1, 2018, the reporting entity shall report the investment using the calculated systematic value method detailed in *SSAP No. 26R—Bonds*.~~

~~Refer to *SSAP No. 26R—Bonds*.~~

~~For reporting entities maintaining an AVR:~~

~~NAIC Designation 1 – 5 Enter fair value or systematic value~~
~~NAIC Designation 6 Enter fair value~~

~~For reporting entities not maintaining an AVR:~~

~~NAIC Designations 1 – 2 Enter fair value or systematic value~~
~~NAIC Designations 3 – 6 Enter fair value~~

~~The amount reported in this column should equal:~~

~~Book/Adjusted Carrying Value reported in the Prior Year statement~~
~~(or Actual Cost for newly acquired securities)~~
~~plus "Unrealized Valuation Increase/(Decrease)Total in Book/Adjusted Carrying Value"~~
~~plus "Current Year's (Amortization)/Accretion"~~
~~minus "Current Year's Other-Than-Temporary Impairment Recognized"~~
~~plus "Total Foreign Exchange Change in Book/Adjusted Carrying Value"~~
~~plus Changes due to amounts reported in Schedule D, Parts 3, 4 and 5~~

Column ~~12~~9 – Unrealized Valuation Increase/(Decrease)

The total unrealized valuation increase/(decrease) for a specific security will be the change in Book/Adjusted Carrying Value that is due to carrying or having carried (in the previous year) the security at Fair Value. Thus, this amount could be:

The difference due to changing from Amortized Cost in the previous year to Fair Value in the current year's Book/Adjusted Carrying Value column (calculated as **current year** Fair Value minus **current year** Amortized Value);

The difference of moving from Fair Value in the previous year to Amortized Cost in the current year's Book/Adjusted Carrying Value column (calculate as **prior year** Amortized Value minus **prior year** Fair Value); or

The difference between the Fair Value in the previous year and the Fair Value in the current year's Book/Adjusted Carrying Value column (calculate as **current year** Fair Value minus **prior year** Fair Value minus **current year** Accrual of Discount/(Amortization of Premium)).

Include: For SVO-identified Bond Exchange Traded Funds~~funds~~, the change from the prior reported BACV to fair value/net asset value. If an SVO-identified Bond Exchange Traded Fund ~~fund~~ no longer qualifies for systematic value, the difference from systematic value in prior year to fair value/net asset value in current year.

These amounts are to be reported as unrealized capital gains or (losses) in the Exhibit of Capital Gains/(Losses) and in the Capital and Surplus Account (Page 4).

Column 10~~3~~ – Current Year's (Amortization)/Accretion

This amount should equal the current reporting year's amortization of premium or accrual of discount (regardless of whether or not the security is currently carried at Amortized Cost). The accrual of discount amounts in this column are to be reported as increases to investment income in the Exhibit of Net Investment Income, while the amortization of premium amounts are to be reported as decreases to investment income. (For investments reported at the lower of amortized cost or fair value, the amortization/accretion occurs first, and then any unrealized valuation change necessary to reflect the lower fair value is reflected. This results with recognition of both investment income and an unrealized capital loss.)

Include: The (Amortization)/Accretion of SVO Identified Bond Exchange Traded Funds ~~Funds~~ designated for reporting at systematic value.

Column 11~~4~~ – Current Year's Other-Than-Temporary Impairment Recognized

If the security has ~~suffered~~ been identified with an "other-than-temporary impairment," ~~this column should contain~~report the amount of the direct write-down recognized. The amounts in this column are

to be reported as realized capital losses in the Exhibit of Capital Gains/(Losses) and in the calculation of Net Income.

Column 12~~5~~ – Total Foreign Exchange Change in Book/Adjusted Carrying Value

This is a positive or negative amount that is defined as the portion of the total change in Book/Adjusted Carrying Value for the year that is attributable to foreign exchange differences for a particular security. The amounts reported in this column should be included as net unrealized foreign exchange capital gain/(loss) in the Capital and Surplus Account (Page 4).

Column 13~~6~~ – Stated Rate of Interest ~~Rate~~

Show rate of interest as stated on the face of the bond. Where the original stated rate has been renegotiated, show the latest modified rate. For ~~long-term~~ bonds and asset-backed securities with a variable rate of interest, use the last rate of interest. ~~For short-term bonds with various issues of the same issuer, use the last rate of interest.~~ All information reported in this field must be a numeric value.

For SVO Identified Bond ~~Funds (Bond Mutual Funds~~ Exchange Traded Funds), ~~and~~ Principal STRIP Bonds or other zero-coupon bonds, enter numeric zero (0).

Column 14~~7~~ – Effective Rate of Interest

For issuer credit obligations, include the effective rate at which the purchase was made.

For ~~mortgage-backed/loan-backed and structured~~asset-backed securities, report the effective yield as of Dec. 31 of the current year. ~~used to value the security at the reporting date.~~ The Effective Yield calculation should be ~~modified~~updated pursuant to SSAP No. 43R:

- Prospective Method: Updated expectations of cash flows that are not attributable to an other-than-temporary impairment, results in a recalculation of the effective yield used to accrue income in future periods. The recalculated effective yield equates the carrying amount of the investment to the present value of the anticipated future cash flows.

- Retrospective Method: Updated expectations of cash flows results in a recalculation of both the effective yield and the amortized cost basis so that expected future cash flows produce a return equal to the return now expected over the life of the investment as measured from the date of acquisition. The recalculated effective yield will equate the present value of the actual and anticipated cash flows with the original cost of the investment. Use of the retrospective method is limited to NAIC 1 securities.

For SVO Identified Bond ~~Funds (Bond Mutual Funds and~~ Exchange Traded Funds), enter Zero (0).

Column 15~~8~~ – Interest – When Paid

For securities that pay interest annually, provide the first 3 letters of the month in which the interest is paid (e.g., JUN for June). For securities that pay interest semi-annually or quarterly, provide the first letter of each month in which interest is received (e.g., JD for June and December, and MJSD for March, June, September and December). For securities that pay interest on a monthly basis, include "MON" for monthly. Finally, for securities that pay interest at maturity, include "MAT" for maturity.

For SVO Identified Bond~~Funds (Bond Mutual Funds~~ Exchange Traded Funds) and Principal STRIP Bonds or other zero-coupon bonds, enter N/A.

Column 16~~9~~ – ~~Admitted Interest Due and Accrued~~Interest Income Due and Accrued

Report interest income earned and legally due to be paid to the reporting entity as of the reporting date (interest due) plus interest income earned as of the reporting date but not legally due to be paid to the reporting entity until subsequent to the reporting date (interest accrued). Refer to *SSAP No. 34—Investment Income Due and Accrued*. ~~This should equal the admitted amount of due and accrued~~

interest for a specific security, based upon the assessment of collectability required by *SSAP No. 34 – Investment Income Due and Accrued* and any other requirements for nonadmitting investment income due and accrued. The amount reported in this column should be the collectible amount of the interest income due and accrued regardless of admitted/nonadmitted determination. Items probable of collection, but nonadmitted pursuant to SSAP No. 34, shall be captured in this reporting column, with the nonadmittance shown in column 2 of the balance sheet and detailed in the notes to the financial statements.

With revisions to the reporting schedule, consideration could be given to the disclosure in Note 34. That disclosure is not currently data captured.

Column 2017 – Interest Amount Received During Year

Report actual amount of cash interest received. For paid-in-kind (PIK) interest received, report the fair value of the asset at the time the asset was received. Amount reported should reflect the combined total of al interest (cash and PIK) received for each reported investment during the year.

For SVO Identified Bond Funds (Bond Mutual Funds and Exchange Traded Funds) enter the amount of distributions received in cash or reinvested in additional shares.

Include: The proportionate share of interest directly related to the securities reported in this schedule.

Report amounts net of foreign withholding tax.

Column 2118 – Acquired Date

For public placements use trade date, not settlement date. For private placements, use funding date. Each issue of bonds issuer credit obligations or stocks acquired at public offerings on more than one date may be totaled on one line and the date of last acquisition inserted. All asset-backed securities shall be separately reported (no aggregation of separate acquisitions).

For SVO Identified Bond Funds (Bond Mutual Funds and Exchange Traded Funds), enter date of last purchase.

Column 2219 – Stated Contractual Maturity Date

For SVO Identified Bonds Funds (Bond Mutual Funds and Exchange Traded Funds), leave blank.

For perpetual bonds, enter 01/01/9999.

For mandatory convertible bonds use the conversion date.

Column 20 – Payment Due at Maturity

Report payment due at maturity. Include the final principal payment (including balloon payments) as well as interest to be paid at maturity.

Column 21 – Acquisition Balloon Payment %

For ABS, include the percentage of balloon payment due at maturity based on the original outstanding principal amount. For example, if the original security had principal repayment of $100 and $80 is scheduled to be paid at maturity, the balloon payment percentage at acquisition is 80%. The balloon percentage shall not be adjusted subsequent to acquisition regardless of principal reduction or payments in advance of maturity that reduce the outstanding balloon.

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**** Columns 23 through 34 will be electronic only. ****

(Note – All Columns will be Renumbered Accordingly. Prior references have been retained. Column numbers will be different between ICO and ABS)

Column 4 – Foreign

Insert the appropriate code in the column based on the list provided in the Investment Schedules General Instructions.

Column 5 – Investment Characteristics (Note –Proposed to be substantially different from current info.)

If an investment has one or more of the following characteristics, then list the appropriate number(s) separated by commas. If none of the characteristics apply, then leave the column blank.

1. Investment terms permit interest to be received in a form other than cash.

2. Investment terms permit payment of interest to be deferred without being considered past due.

3. Interest due and accrued has been written off as uncollectible and/or nonadmitted.

4. Investment has a current year or prior year recognized other than temporary impairment.

5. Investment is an interest-only strip

6. Investment is a principal-only strip

7. Investment reflects a To-Be-Announced (TBA) security that will qualify as an issuer credit obligation or ABS at the time the reporting entity takes possession of the issued security.

Separate Account Filing Only:

8. The asset is a bifurcated asset between the insulated separate account filing and the non-insulated separate account filing. (Note – This has been a long-standing element. Discuss with industry.)

Column 23 – Agency, Sovereign Jurisdiction or State Abbreviation

Applies to:

Issuer Credit Obligations:

U.S. Government Obligations ....

Other U.S. Government Securities ....

Non-U.S. Sovereign Jurisdiction Securities ....

Municipal Bonds – General Obligations ....

Municipal Bonds – Special Revenue..

For items captured as U.S. government or Other U.S. government, report "US" for treasury-issued items and for non-treasury items, report the abbreviation for the agency issuer captured within these categories. (Agency abbreviations are detailed in the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* in the listing of agencies approved for these categories.)

For Non-US, report the country abbreviation detailed in the Annual Statement Instructions Appendix.

For Municipal bonds, Include the abbreviation for the state where the security is issued (e.g., "MO" for Missouri). For federal issuances, report the abbreviation for the agency issuer.

Asset-Backed Securities:

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Agency Residential Mortgage-Backed Securities - Guaranteed ....
Agency Commercial Mortgage-Backed Securities - Guaranteed..
Agency Residential Mortgage-Backed Securities – Not Guaranteed..
Agency Commercial Mortgage-Backed Securities – Not Guaranteed ....

For agency ABS, report the abbreviation for the agency issuing the ABS.

~~U.S. States, Territories and Possessions~~

~~Include the appropriate state abbreviation for the state where the security is issued (e.g., "MO" for Missouri).~~

~~U.S. Political Subdivisions of States, Territories and Possessions~~

~~Include the appropriate state abbreviation for the state where the security is issued.~~

~~U.S. Special Revenue, Special Assessments Obligations and all Non-Guaranteed Obligations of Agencies and Authorities of Governments and Their Political Subdivisions~~

~~Include the appropriate state abbreviation for the state where the security is issued. Use "US" for federal agency issues.~~

Column 24 – Fair Value Hierarchy Level and Method Used to Obtain Fair Value Code

Report the fair value level that represents the inputs used to determine fair value. Whenever possible, the reported fair value shall reflect level 1 (quoted prices in active market), followed by level 2 (other observable inputs that do not qualify as level 1), and then level 3 (unobservable inputs). In all situations fair value shall be determined in accordance with *SSAP No. 100R—Fair Value*. ~~fair value should represent the price at which the security could be sold, based on market information. Fair value should only be determined analytically when the market-based value cannot be obtained.~~

The following is a listing of valid fair value level indicators to show the fair value hierarchy level.

"1" for Level 1

"2" for Level 2

"3" for Level 3

The following is a listing of the valid method indicators for bonds to show the method used by the reporting entity to determine the Rate Used to Obtain Fair Value.

"a" for securities where the rate is determined by a pricing service.

"b" for securities where the rate is determined by a stock exchange.

"c" for securities where the rate is determined by a broker or custodian. The reporting entity should obtain and maintain the pricing policy for any broker or custodian used as a pricing source. In addition, the broker must either be approved by the reporting entity as a counterparty for buying and selling securities or be an underwriter of the security being valued.

"d" for securities where the rate is determined by the reporting entity. The reporting entity is required to maintain a record of the pricing methodology used.

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"e" for securities where the rate is determined by the unit price published in the NAIC *Valuation of Securities*.

Enter a combination of hierarchy and method indicator. The fair value hierarchy level indicator would be listed first and the method used to determine fair value indicator would be listed next. For example, use "1b" to report Level 1 for the fair value hierarchy level and stock exchange for the method used to determine fair value.

The guidance in *SSAP No. 100R—Fair Value* allows the use of net asset value per share (NAV) instead of fair value for certain investments. If NAV is used instead of fair value, leave blank.

Column 25 – Source Used to Obtain Fair Value

For Method Code "a," identify the specific pricing service used.

For Method Code "b," identify the specific stock exchange used.

The listing of most **stock exchange codes can be found in the Investment Schedules General Instructions.**

For Method Code "c," identify the specific broker or custodian used.

For Method Code "d," leave blank.

For Method Code "e," leave blank.

If net asset value (NAV) is used instead of fair value, the reporting entity should use "NAV" to indicate net asset value used instead of fair value.

Column 26 – Collateral Type (Discuss applicable lines and desired categories)

Use only for securities included in the following subtotal lines.

Issuer Credit Obligations:

Single Entity Backed Obligations

Affiliated Single Entity Backed Obligations

Asset-Backed Securities:

Other Financial Asset-Backed Securities - Self-Liquidating

Affiliated Other Financial Asset-Backed Securities - Self-Liquidating

Other Financial Asset Backed Securities – Not Self-Liquidating

Affiliated Other Financial Asset Backed Securities – Not Self-Liquidating

Lease-Backed Transactions – Practical Expedient

Affiliated Lease-Backed Transactions – Practical Expedient

Other Non-Financial Asset-Backed Securities – Practical Expedient

Affiliated Other Non-Financial ABS – Practical Expedient

Lease-Backed Transactions – Full Analysis

Affiliated Lease-Backed Transactions – Full Analysis

Other Non-Financial ABS – Full Analysis

Affiliated Other Non-Financial ABS – Full Analysis

~~Residential Mortgage-Backed Securities 0299999~~

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Commercial Mortgage-Backed Securities 0399999
Other Loan-Backed and Structured Securities 0499999

All Other Governments

Residential Mortgage-Backed Securities 0799999
Commercial Mortgage-Backed Securities 0899999
Other Loan-Backed and Structured Securities 0999999

U.S. States, Territories and Possessions (Direct and Guaranteed)

Residential Mortgage-Backed Securities 1299999
Commercial Mortgage-Backed Securities 1399999
Other Loan-Backed and Structured Securities 1499999

U.S. Political Subdivisions of States, Territories and Possessions (Direct and Guaranteed)

Residential Mortgage-Backed Securities 1999999
Commercial Mortgage-Backed Securities 2099999
Other Loan-Backed and Structured Securities 2199999

U.S. Special Revenue and Special Assessment Obligations and all Non-Guaranteed Obligations of Agencies and Authorities of Governments and Their Political Subdivisions

Residential Mortgage-Backed Securities 2699999
Commercial Mortgage-Backed Securities 2799999
Other Loan-Backed and Structured Securities 2899999

Industrial and Miscellaneous (Unaffiliated)

Residential Mortgage-Backed/ Securities 3399999
Commercial Mortgage-Backed Securities 3499999
Other Loan-Backed and Structured Securities 3599999

Hybrid Securities

Residential Mortgage-Backed Securities 4399999
Commercial Mortgage-Backed Securities 4499999
Other Loan-Backed and Structured Securities 4599999

Parent, Subsidiaries and Affiliates

Residential Mortgage-Backed Securities 5099999
Commercial Mortgage-Backed Securities 5199999
Other Loan-Backed and Structured Securities 5299999

For issuer credit obligations reported as single entity backed obligations, report one of the following codes that most appropriately reflects the structure:

- ETC – Equipment Trust Certificate
- EETC – Enhanced Equipment Trust Certificate
- GLF – Ground Lease Financing
- CTL – Credit Tenant Loan (security structure)
- FABN – Funding Agreement Backed Note
- Other – Other Single Entity Backed

For asset-backed securities on the noted reporting lines, Eenter one of the following codes to indicate collateral type. Pick exactly one collateral type for each reported security. For securities that fit in more than one type, pick the predominant one. Judgment may need to be used when making selections involving prime, Alt-A and subprime, as there are no uniform definitions for these collateral types. In the description field, use abbreviations like ABS, CDO or CLO to disclose the type of the loan-backed/structured security.

Note: Various investments below require SVO review and approval, please refer to the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (P&P Manual) for further description.

1 Residential Mortgage Loans/RMBS

~~Include all types of residential first lien mortgage loans as collateral (e.g., prime, subprime, Alt-A).~~

~~2 Commercial Mortgage Loans/CMBS~~

~~Include all types of commercial mortgage loans as collateral (e.g., conduits, single name, etc.)~~

~~.~~1.~~3~~ Non-Standard Home Loan Equity

Include all home equity loans and/or home equity lines of credit as collateral. These are not first liens and are deemed loans to individuals. ~~Bonds~~ Asset-backed securities that are collateralized by home equity loans/lines of credit are considered asset-backed securities (ABS) rather than RMBS. This also includes manufactured housing loans and mobile home loans as collateral. These are not typical residential mortgage loans, and when they ~~securitize~~are securitized ~~bonds~~, they are considered ABS rather than RMBS.

2~~4~~ Individual Obligations – Credit Card, Auto, Personal Loans, Student Loans and Recreational Vehicles, etc

Include ~~bonds~~ asset-backed securities collateralized by individual obligations. Do not include individual obligations that reflect a security interest in real estate ~~have a real estate aspect~~.

~~5~~3 Corporate/Industrial Obligations – Tax Receivables, Utility Receivables, Trade Receivables, Small Business Loans, Commercial Paper, etc

Include ~~bonds~~ asset-backed securities collateralized by corporate or industrial obligations (sometimes referred to as commercial obligations). This category shall only be used for ABS that meet the definition of financial assets where there is no further performance obligation. ABS that are collateralized by rights to future revenue streams shall be captured as "cash flows rights" detailed in code 6.

~~6 Lease Transactions – Aircraft Leases, Equipment Leases and Equipment Trust Certificates~~

~~Include bonds collateralized by leases. Equipment leases are loans on heavy equipment. Equipment trust certificates are certificates that entitle the holder to the lease payments on the underlying assets.~~

~~7 CLO/CBO/CDO~~

~~Include bank loans, which securitize CLOs; investment grade and high-yield corporate bonds, which securitize CBOs; and corporate bonds and structured securities, which securitize CDOs.~~

~~8 Manufactured Housing and Mobile Home Loans~~

~~Include manufactured housing loans and mobile home loans as collateral. These are not typical residential mortgage loans, and when they securitize bonds, they are considered ABS~~.

~~9 Credit Tenant Loans~~

~~Real estate loans secured by the obligation of a single (usually investment grade) company to pay debt service by means of rental payments under a lease, where real estate is pledged as collateral also referred to as credit tenant lease, sale-leaseback or CTL.~~

~~10 Ground Lease Financing~~

~~Real estate loans secured by the obligation to pay debt service by means of rental payments of subleased property; where a long-term ground lease was issued in which the lessee intends significant land development and the subleasing of such property to other long-term tenants.~~

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4. Real Estate Leases

Include all lease structures backed by real estate, including investments that resemble credit tenant loans, ground lease finance, and project finance real estate structures that do not represent issuer credit obligations.

5. Other Leases

Include all lease-backed structures not backed by real estate that do not represent issuer credit obligations. This includes auto, aircraft, equipment, etc.

6. Cash Flow Rights

Include all ABS structures that securitize rights to future cash flows. Examples of collateral to include in this category includes royalties, licensing fees, servicing rights, mineral rights, other revenue rights such as those common in whole business securitizations.

~~11~~7 Other

Include other collateral types that do not fit into ~~categories 1 through 910~~the above categories.

~~**For Columns 27 through 29, make whole call information is not required.**~~

Column 27 – Call Date (ICO)

Report the next call date ~~used to calculate the Effective Date of Maturity. If call date does not affect the Effective Date of Maturity field but exists, report the next call date~~. If there is no call date, leave blank.

If the item is subject to a make whole call provision and it is not known that the issuer is expected to invoke the provision enter "MW". If information is known that the issuer expects to invoke the make whole provision, then the expected call date of the make whole call provision shall be reported.

Column 28 – Call Price (ICO)

Report the call price used to calculate the Effective Date of Maturity. If call price does not affect the Effective Date of Maturity field but exists, report the next call price. If there is no call price, leave blank.

If the item is subject to a make whole call provisions and it is known that the issuer expects to invokve the provision, enter the expected call price. Otherwise, for make whole call provisions, leave blank.

Column 29 – Effective Date of Maturity

On bonds purchased at a premium, the maturity date producing the lowest amortized value should be used. See *SSAP No. 26R—Bonds*. For loaned-backed and structured securities, include the effective date of maturity that results from the estimated cash flows, incorporating appropriate prepayment assumptions. If call data does not affect the Effective Date of Maturity field, leave blank. For ABS, include the date determined at security acquisition that the reporting entity expected to receive final payment of all amounts due, including both principal and interest.

Column XX – Current Overcollateralization Percentage (ABS)

For ABS, report the overcollateralization ratio that reflects the value of the assets backing the debt issuance in comparison to the tranche held and all tranches senior as of the reporting date.

The ratio shall reflect the total unimpaired assets backing the debt issuance over the specific tranche held and all the tranches senior to the held tranche. For example, if the assets / expected cash flows

supporting the debt issuance has declined to $88, and there is still $75 in issued senior debt and $15 in issued mezzanine debt, a reporting entity holding senior tranche would report 117% (88/75) and a reporting entity holding the mezzanine debt shall report 98% (88/90).

The original overcollateralization ratio shall be based on supporting investment documentation.

Column XX – Current Expected Payoff Date (ABS)

For ABS, report the current expected pay-off date resulting from estimated cash flows and prepayment assumptions.

Column XX – Acquisition Overcollateralization Percentage (ABS)

For ABS, report the overcollateralization ratio that reflects the value of the assets backing the debt issuance in comparison to the tranche held and all tranches senior at the time of acquisition.

The ratio shall reflect the total unimpaired assets backing the debt issuance over the specific tranche held and all the tranches senior to the held tranche. For example, with $100 in assets backing the debt issuance and $75 in issued senior debt, $15 in issued mezzanine debt, and $10 in residual assets, a reporting entity holding senior tranche would report 133% (100/75) and a reporting entity holding the mezzanine debt shall report 111% (100/90).

The original overcollateralization ratio shall be based on supporting investment documentation.

Column XX – Acquisition Expected Payoff Date (ABS)

For ABS, report the expected pay-off date at the time of original acquisition. (This field should remain unchanged for as long as the security is held.)

Column XX – Aggregate Deferred Interest

Some investments allow for interest payments to be deferred past the originally scheduled payment date without being considered past due under the agreement terms. Include the amount of interest reported as due and accrued for which the reporting entity has not received within 90 days of the originally scheduled payment date, that has not been nonadmitted under SSAP No. 34. For the avoidance of doubt, this should also include all accrued interest for investments that pay interest in full less frequently than annually per the agreement terms.

Column XX – PIK Interest Due and Accrued

Include the amount of reported interest due and accrued in which the terms of the investment permit payment "in kind" instead of cash.

The amount captured shall include the total amount of non-cash interest that can be provided to satisfy reported interest due and accrued.

~~Column 30 – Legal Entity Identifier (LEI)~~

~~Provide the 20-character Legal Entity Identifier (LEI) for any issuer as assigned by a designated Local Operating Unit. If no LEI number has been assigned, leave blank.~~

From data obtained, only a limited number of investments captured on Schedule D-1 have LEIs. Capturing LEI for other investments (e.g., derivatives) may still be appropriate.

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Column 31 – Issuer

Issuer Definition:

> The name of the legal entity that develops, registers and sells securities for the purpose of financing its operations and may be domestic or foreign governments, corporations or investment trusts. The issuer is legally responsible for the obligations of the issue and for reporting financial conditions, material developments and any other operational activities as required by the regulations of their jurisdictions.

The reporting entity is encouraged to use the following sources:

- Bloomberg
- Interactive Data Corporation (IDC)
- Thomson Reuters
- S&P/CUSIP
- Name used in either the relevant SEC filing or legal documentation for the transaction. Issuer is the name of the legal entity that can be found on documents such as SEC Form 424B2, Note Agreements, Prospectuses and Indentures, as appropriate. The name used should be as complete and detailed as possible to enable others to differentiate the legal entity issuing the security from another legal entity with a similar name.

Do not report ticker symbols, either internal or otherwise.

Column 32 – Issue

Issue information provides detailed data as to the type of security being reported (e.g., coupon, description of security, etc.). Below are examples of what could be provided, but additional information should be provided as appropriate for the security.

> 6% Senior 2018
> 7% Subordinated Debenture 03/15/2022
> 3% NY Housing Authority Debenture 2035

The reporting entity is encouraged to use the following sources:

- Bloomberg
- Interactive Data Corporation (IDC)
- Thomson Reuters
- S&P/CUSIP
- Descriptions used in either the relevant SEC filing or legal documentation for the transaction.

Do not report ticker symbols, either internal or otherwise. Include tranche information.

Column 33 – ISIN Identification

The International Securities Identification Numbering (ISIN) system is an international standard set up by the International Organization for Standardization (ISO). It is used for numbering specific securities, such as stocks, bonds, options and futures. ISIN numbers are administered by a National Numbering Agency (NNA) in each of their respective countries, and they work just like serial numbers for those securities. Record the ISIN number only if no valid CUSIP, CINS or PPN exists to report in Column 1.

Column 34 – Capital Structure Code

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Please identify the capital structure of the security using the following codes consistent with the SVO Notching Guidelines in the *Purposes and Procedures Manual of the NAIC Investment Analysis Office*:

Capital structure is sometimes referred to as rank or payment priority and can be found in feeds from the sources listed in the Issue and Issuer column.

As a general rule, a security is senior unsecured debt unless legal terms of the security indicate another position in the capital structure. Securities are senior or subordinated and are secured or unsecured. Municipal bonds, Federal National Mortgage Association securities (FNMA or Fannie Mae) and Federal Home Loan Mortgage Corporation securities (FHLMC or Freddie Mac) generally are senior debt, though there are examples of subordinated debt issued by Fannie and Freddie. 1st Lien is a type of security interest and not capital structure but could be used to determine which capital structure designation the security should be reported under. The capital structure of "Other" should rarely be used.

Capital structure includes securities subject to *SSAP No. 26R—Bonds* and *SSAP No. 43R—Loan-Backed and Structured Securities*.

1. Senior Secured Debt

   Senior secured is paid first in the event of a default and also has a priority above other senior debt with respect to pledged assets.

2. Senior Unsecured Debt

   Senior unsecured securities have priority ahead of subordinated debt for payment in the event of default.

3. Subordinated Debt

   Subordinated is secondary in its rights to receive its principal and interest payments from the borrower to the rights of the holders of senior debt (e.g., for loan-backed and structured securities, this would include mezzanine tranches).

   (Subordinated means noting or designating a debt obligation whose holder is placed in precedence below secured and general unsecured creditors e.g., another debtholder could block payments to that holder or prevent that holder of that subordinated debt from taking any action.)

4. Not Applicable

   Securities where the capital structure 1 through 3 above do not apply (e.g., Line 6099999 Exchange Traded Funds – as Identified by the SVO).

NAIC Designation Category Footnote:

Provide the total book/adjusted carrying value amount by NAIC Designation Category that represents the amount reported in Column 11.

The sum of the amounts reported for each NAIC Designation Category in the footnote should equal Line 8399999.

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NAIC NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

MEMORANDUM

TO: Interested Parties of the Financial Condition (E) Committee

FROM: Financial Condition (E) Committee

DATE: May 23, 2022

RE: Memorandum of Support

Since the great financial crisis, interest rates have generally been in a downward trend for nearly 15 years, resulting in reduced spreads for life insurers and otherwise putting pressure on many members of the industry that depend upon longer-dated, lower risk debt instruments. In addition, recent inflationary pressures and increasing uncertainty resulting from the Russia/Ukraine crisis are exacerbating other challenges for the industry. Members of the Committee remain particularly concerned that macro-economic trends are likely to continue to drive an increase in asset risk for at least some members of the industry.

This memorandum is being issued by the Committee to express its support for several current, interrelated initiatives focused on asset risk or spread risk within the task forces and working groups of the Committee as well as other related work within the task forces and working groups of other Committees, including the Life Insurance and Annuities (A) Committee. The Committee recognizes the range of risk management practices within the industry and the critical importance of maintaining a fair and competitive marketplace by establishing standards if necessary to address issues that could translate into material risks if not properly and timely considered within the NAIC solvency framework.

Although the Committee has not yet reviewed specific proposals from these various groups, it is aware of the underlying objectives of many of the proposals under discussion, including, without limitation:

- A more risk-sensitive Life Risk Based Capital (RBC) charge for certain structured securities and other asset-backed securities that carry a greater tail risk;
- Clarification of investments permitted to be reported on Schedule D-1: Long-Term Bonds, particularly focused on improved transparent accounting and RBC reporting for certain loan-backed and structured securities to capture the more risk-sensitive features of these types of assets;
- Consideration of changes to the current policies of the Valuation of Securities (E) Task Force as they pertain to possible use of or reduction of reliance on rating agencies, where deemed appropriate, and possible use of other risk identifiers such as market data;
- A modified economic scenario generator that more appropriately captures the low interest rates experienced during the past few years; and
- Consideration of certain "high-yielding" assets within the annual asset adequacy analysis testing.

The Committee is grateful to all the States and staff members that are currently participating in the important work of these groups and welcomes the input of industry and other stakeholders in the development of proposals. Although this work is ongoing, the Committee encourages all States and the Securities Valuation Office (SVO) to continue to take all appropriate actions under existing rules and standards.