



STATE OF IOWA

KIM REYNOLDS
GOVERNORDOUG OMMEN
COMMISSIONER OF INSURANCEADAM GREGG
LT. GOVERNOR

October 6, 2020

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

RE: Ref #2019-21 – SSAP No. 43R, Loan-backed and Structured Securities

Dear Mr. Bruggeman:

The Iowa Insurance Division (the “Division”) would like to make comment regarding the ongoing discussions of Reference #2019-21 – SSAP No. 43R, Loan-backed and Structured Securities. The Working Group has exposed Issue Paper No. 1XX in regards to this topic which has received extensive commentary from interested parties.

The impetus for this project was to review the scope of SSAP 43R to determine whether certain types of investments with unique characteristics should be reported as loan-backed and structured securities within the scope of SSAP 43R. This was in response to the identification of such investments by regulators and the SVO and concerns raised that some may not be of the character that regulators would expect to be reported as bonds on Schedule D-1. When defining the project as a SSAP 43R scoping project, it was expected that all of the investments identified were being reported in scope of SSAP 43R.

It has since been identified that there is diversity in practice in how these investments are classified, and that some companies believe that many of the investments identified for evaluation in this project are within the scope of SSAP 26R. The appropriate classification between SSAP 26R and SSAP 43R is an important topic, and the Working Group should consider whether there are clarifications needed to address the differences in interpretation. However, this issue is secondary to the primary purpose of this project, which is to determine whether investments with certain unique characteristics should qualify as bonds for Schedule D-1 reporting.

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

In most cases, securitizations serve a bona fide economic purpose and can create high-quality bonds out of a pool of otherwise non-investable assets through overcollateralization and the prioritization of payments to debtholder classes. However, the current guidance is too broad to distinguish between those with economic substance and those without, leaving the reporting of these assets susceptible to abuse.

Therefore, the Division recommends that the Working Group focus its efforts on developing a principles-based definition for those assets that qualify for Schedule D-1 bond treatment as the initial step for this project. To facilitate this discussion, the Division has included as Appendix A of this letter, a draft definition that we believe serves as a good starting point for identifying those principles. This draft is intended to facilitate the discussions of the Working Group and industry and we look forward to hearing feedback on both the draft and the proposed direction of the project.

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

Sincerely,

Kevin Clark, Chief Accounting Specialist, Iowa Insurance Division

Carrie Mears, Chief Investment Specialist, Iowa Insurance Division

Introduction

The following draft definition provides a basis for distinguishing between the two types of bonds which have been identified through discussions to date. Those are issuer obligations and asset backed securities. It clarifies that issuer obligations are those backed by the credit of an operating entity. A debt security that is issued by an entity whose purpose is the pass-through of collateral cash flows is not an issuer obligation.

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

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

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

Principles-based Definition of a Bond to be Reported on Schedule D, Part 1: (New Elements in Red)

1. Bonds shall be defined as any securities representing a creditor relationship, whereby there is a fixed schedule for one or more future payments, and which qualify as Issuer Obligations or Asset Backed Securities.
2. Issuer Obligations represent the debt of operating entities, which have a purpose other than the pass through of investment proceeds. Examples of issuer obligations include (SSAP 26R examples):
 - a. U.S. Treasury securities;(INT 01-25)
 - b. U.S. government agency securities;
 - c. Municipal securities;
 - d. Corporate bonds, including Yankee bonds and zero-coupon bonds;
 - e. Convertible bonds, including mandatory convertible bonds as defined in paragraph 11.b;
 - f. 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 issued directly by a reporting entity or acquired through a participation, syndication or assignment;
 - iii. Hybrid securities, excluding: surplus notes, subordinated debt issues which have no coupon deferral features, and traditional preferred stocks.
 - iv. Debt instruments in a certified capital company (CAPCO) (INT 06-02)

3. Asset backed securities represent debt issued through the securitization of financial assets. There are two defining characteristics that must be present in order for a security to meet the definition of an asset backed security:
 - a. The financial assets collateralizing the debt issuance are expected to be the primary source of cash flows for repayment of the debt;
 - b. The securitization of the financial assets collateralizing the debt issuance redistributes the credit risk of the underlying financial assets, such that the creditor is in a different position than if the underlying collateral were held directly.

Asset backed securities are typically issued from 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.

4. Inherent in the definition of a bond, whether represented by an issuer obligation or asset backed security, is the notion that the creditor has a senior interest in the assets of the issuer. The most subordinated interest, sometimes referred to as the first-loss position, represents the interest of an equity holder, rather than a creditor. Therefore, in order to meet the definition of a bond, a more-than-insignificant subordinated interest must be present.

Exposure Draft

ISSUE PAPER NO. 1XX—LOAN-BACKED AND STRUCTURED SECURITIES

Hearing Date: 2020 Spring National Meeting

Location: 2020 Spring National Meeting

Deadline for Written Notice of Intent to Speak:

June 26, 2020

Deadline for Receipt of Written Comments:

June 26, 2020

Notice of Public Hearing and Request for Written Comments

Basis for hearings. The Statutory Accounting Principles Working Group (SAPWG) will hold a public hearing to obtain information from and views of interested individuals and organizations about the standards proposed in this Exposure Draft. The SAPWG will conduct the hearing in accordance with the National Association of Insurance Commissioners (NAIC) policy statement on open meetings. An individual or organization desiring to speak must notify the NAIC in writing **June 26, 2020**. Speakers will be notified as to the date, location, and other details of the hearings.

Oral presentation requirements. The intended speaker must submit a position paper, a detailed outline of a proposed presentation or comment letter addressing the standards proposed in the Exposure Draft by **June 26, 2020**. Individuals or organizations whose submission is not received by that date will only be granted permission to present at the discretion of the SAPWG chair. All submissions should be addressed to the NAIC staff at the address listed below.

Format of the hearings. Speakers will be allotted up to 10 minutes for their presentations to be followed by a period for answering questions from the SAPWG. Speakers should use their allotted time to provide information in addition to their already submitted written comments as those comments will have been read and analyzed by the SAPWG. Those submissions will be included in the public record and will be available at the hearings for inspection.

Copies. Exposure Drafts can be obtained on the Internet at the NAIC Home Page (<http://www.naic.org>). The documents can be downloaded using Microsoft Word.

Written comments. Participation at a public hearing is not a prerequisite to submitting written comments on this Exposure Draft. Written comments are given the same consideration as public hearing testimony.

The Statutory Accounting Principles Statement of Concepts was adopted by the Accounting Practices & Procedures (EX4) Task Force on September 20, 1994, in order to provide a foundation for the evaluation of alternative accounting treatments. All issues considered by the SAPWG will be evaluated in conjunction with the objectives of statutory reporting and the concepts set forth in the Statutory Accounting Principles Statement of Concepts. Whenever possible, establish a relationship between your comments and the principles defining statutory accounting.

The exposure period is not meant to measure support for, or opposition to, a particular accounting treatment but rather to accumulate an analysis of the issues from other perspectives and persuasive comments supporting them. Therefore, form letters and objections without valid support for their conclusions are not helpful in the deliberations of the working group. Comments should not simply register your agreement or disagreement without a detailed explanation, a description of the impact of the proposed guidelines, or possible alternative recommendations for accomplishing the regulatory objective.

Any individual or organization may send written comments addressed to the Working Group to the attention of Julie Gann at jgann@naic.org, Robin Marcotte at rmarcotte@naic.org, Jim Pinegar at jpinegar@naic.org, Fatima Sediqzad at fsediqzad@naic.org and Jake Stultz at jstultz@naic.org no later than **June 26, 2020**. Electronic submission is preferred. Julie Gann is the NAIC Staff that is the project lead for this topic.

National Association of Insurance Commissioners
1100 Walnut Street, Suite 1500, Kansas City, MO 64106-2197
(816) 842-3600

Statutory Issue Paper No. 1XX**Loan-Backed and Structured Securities****STATUS****Exposure Draft – March 18, 2020****Original SSAP: SSAP No. 43; Current Authoritative Guidance: SSAP No. 43R****Type of Issue:****Common Area**

Staff Note – This Issue Paper has been divided into key sections to allow for focused discussion. This issue paper being completed in phases and further development is required. Comments are welcome on all aspects, but are specifically requested on the discussion elements captured at each section.

SECTION / DISCUSSION TOPIC	PAGES
1) Summary of Issue (Includes History / Benefits / Concepts / Key Issues)	2-8
2) Defining Asset Backed Security	9-12
3) Accounting and Reporting for Asset Backed Securities	13-14
4) Accounting and Reporting for Non-CFR ABS (Traditional Securitizations)	15-16
5) Accounting and Reporting for Non-CFR ABS and Non-Traditional Securitizations	17
a. One Underlying Obligor	18-19
b. Collateral Not Owed by Many Payers	20-21
c. Security Partially Impacted by Equity Collateral	22-24
d. Security is Solely Impacted by Equity Collateral / Equity Index	25-26
e. Principal Protected Notes	27-29
f. Collateral is Not Cash Generating and Not Equity (e.g., artwork held in trust)	30

The issue paper does not currently address the following topics. These items are currently in development and will be the focus of subsequent exposures.

- a. Equipment Trust Certificates / Non-CFR Leased Back Securities (and other VOSTF-related items)
- b. Self-Securitizations / Retained Beneficial Interests

SECTION 1: SUMMARY OF ISSUE

1. The guidance within this issue paper introduces substantive revisions to *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 captured and reported in scope of the current SSAP No. 43R that were not contemplated at issuance. The Investment Classification Project is a comprehensive review to address a variety of issues pertaining to definitions, measurement and overall scope of the investment SSAPs.
2. The concepts discussed in this issue paper reflect the following:
 - a. Overall Scope of SSAP No. 43R: Current application of SSAP No. 43R by some reporting entities has extended beyond SEC and Federal Code “asset-backed securities,” with investments captured in scope designed to meet explicit structural scope requirements of the SSAP. This expansion has resulted in various securities, including securities with investment returns coupled with equity/asset performance, and the issuance of principal-protected notes, where the issued security does not fully reflect the resulting investments held in SPV/trust.
 - b. Use of NAIC Designations in Determining Measurement: Current application of SSAP No. 43R uses an NAIC designation in determining measurement method. With the expansion of investments reported in scope of this standard, for certain securities, alternative measurement approaches not driven by NAIC designation may be more appropriate.
 - c. Insurer Sponsored Securitizations: The ability to remove previously-owned assets through a “sale” with reacquisition as a securitization in scope of SSAP No. 43R (and reported on Schedule D-1) is not clear. Furthermore, with the exception of the “sale” guidance in *SSAP No. 103—Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, there are no safeguards or disclosures surrounding these transactions.
 - d. SVO Assessment of Securities: The current SSAP No. 43R intends to include certain items in scope that have passed a structural assessment by the NAIC SVO. However, the inclusion of these items is not currently detailed in the scope section and the generic references to these types of securities (in current paragraph 26.c) does not include any indication of compliance with the provisions in the *Purposes and Procedures Manual of the Investment Analysis Office* (P&P Manual). This has resulted in confusion, and likely inconsistent application, of the guidance.

DISCUSSION

3. This issue paper intends to provide information on discussions that occurred when considering substantive revisions to SSAP No. 43R.

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

4. *SSAP No. 43—Loan-backed and Structured Securities* was originally effective with the codification of statutory accounting principles (SAP) and resulted with separate guidance for “bonds” (in *SSAP No. 26—Bonds, excluding loan-backed and Structured Securities*) 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.) Although most of the guidance between the original SSAP No. 26 and SSAP No. 43 was the same, the guidance in SSAP No. 43 recognized the need to review (at least quarterly) the prepayment assumptions and resulting cash flows of the underlying loans, as changes in assumptions would necessitate a recalculation of the effective yield.

5. The original issue paper to SSAP No. 43 (Issue Paper No. 43) cited guidance originally contained in Chapter 1, *Bonds and Loan 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.

6. Original definition / scope guidance in 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 trustee 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.

7. 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.

8. In 2009, the Working Group adopted a substantively-revised SSAP No. 43R (effective September 30, 2009). The focus of the substantive revisions were 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.”

9. 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 Jan. 1, 2011.

- a. Although the agenda item 2010-12 identifies that this item was exposed in August 2010, and 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 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.

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

10. 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.

11. 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 RMBS/CMBS, clarification of disclosures, updating Q/A guidance, and guidance for prepayment fees.

12. 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 predominantly¹ 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 be 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 enterprise² 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 arrangement³. 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.

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,

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.

- c. Loan-backed and structured securities for which it is probable, either known at acquisition or identified during the holding period⁴, 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 assets⁵.

Benefits of Reporting in Scope of SSAP No. 43R

13. There are a variety of benefits for reporting investments in scope of SSAP No. 43R. Depending on the investment, reporting in scope of SSAP No. 43R may be more advantageous than reporting in scope of SSAP No. 26R—*Bonds*. These benefits include:

- a. Capturing an investment in scope of 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 (if designated as high quality), 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 SPV/trust has been particularly noted as providing “regulatory capital relief.”)
- b. Capturing an investment in scope of 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 SPV/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 other-than-temporary impairment (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 credit-related decline. *(This has been a key factor in the PPN design, as a high-quality bond is placed in SPV/trust (along with other assets), and the bond – over several years – will single-handedly satisfy the contractual requirements of the SSAP No. 43R issued security, preventing any recognition of OTTI or a reduction of NAIC designation even when the other securities held in SPV/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 credit-related loss. Under SSAP No. 26R, if there is any assessed OTTI (regardless if interest or credit related), a reporting entity must recognize an OTTI down to the then-current fair value for the security.
 - iii. Guidance in SSAP No. 43R does not currently differentiate between different types of tranches or payment streams for SSAP No. 43R 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

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.

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 43R securities, this tranche is the first-loss position and only receives payment after all other layers have been satisfied. Without specific guidance in SSAP No. 43R for this layer, if they are included in scope, with the same guidance as other non-equity tranche SSAP No. 43R investments. This process raises questions on the use of amortized cost for these tranches (if they have qualifying designations), as well as situations where these tranches are unrated. The guidance in SSAP No. 43R does not provide provisions for unrated securities and a designation is required for reporting on Schedule D-1. (Without guidance, if reported in scope of SSAP No. 43R, these would presumably default to insurer-assigned designations of 5GI or 6.)

- c. SSAP No. 43R permits admittance of a SSAP No. 43R security without any verification to the assets held in SPV/trust. As an example, if a reporting entity was to derecognize a joint venture or LLC from Schedule BA, and reacquire through the ownership of a 43R security, the reporting entity would be permitted to admit the security without any verification of the joint venture or LLC held in SPV/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

14. With the existing guidance in SSAP No. 43R, there are no restrictions to the assets that can be placed in SPV/trust⁶ used to collateralize securities issued from the SPV/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.

15. 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 that is not 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” in accordance with the CFR definition. This has caused questions as regulators have identified designations from NRSROs not SEC approved to provide “ABS” designations and have questioned the use of these ratings in determining the NAIC designation.

Concepts Considered to Revise SSAP No. 43R

16. The approach in drafting this issue paper is to principally discuss different types of investments based on their characteristics to determine appropriate investment classification and overall accounting and reporting. This approach will begin with an initial assessment of “asset backed securities” under the Code of Federal Regulations (CFR) and instruments that do not meet this definition. The issue paper intends to document discussions on differing investments and proposals considered to ensure documentation for future

⁶ References in the issue paper to “trust” are intended to reflect either an SPV or trust structure. Generally, these structures hold the underlying assets used to satisfy the interest or principal repayment of an investment issued from the SPV/trust structure.

reference. Regardless of final revisions, this issue paper will document the proposals considered, and the resulting conclusions to provide historical reference.

17. In accordance with direction from the Working Group conference call on January 8, 2020:
- a. This issue paper will consider dividing the SSAP No. 43R guidance between items considered “asset backed securities” under the Code of Federal Regulations (CFR) and items that do not meet this definition. It is anticipated that investments, with potential exceptions, that meet the ABS CFR definition will primarily continue the historical accounting and reporting guidance contained in SSAP No. 43R.
 - b. The issue paper will review differing investments that do not fit the ABS CFR definition and consider the appropriate accounting and reporting guidance. For these discussions, the issue paper may consider whether the investment shall be retained in SSAP No. 43R with accounting and reporting treatment consistent to ABS CFR securities, whether the investment shall be reported at the lower of amortized cost or fair value regardless of NAIC designation, whether the investment shall be permitted to be “filing exempt,” whether the investment shall be captured on a different reporting schedule, whether the investment shall be nonadmitted and/or whether any other differing accounting and reporting guidance should apply.
 - c. This issue paper will remove from the SSAP No. 43R scope investments in the form of a debt instrument where the investment provides that the amount of principal/interest to be returned to the holder is calculated solely with reference of the S&P 500 Index (or other market indicator, whether public or proprietary). (Presumably, such investments will be captured under the scope of SSAP No. 48 and reported on Schedule BA or be considered derivative instruments and captured in scope of *SSAP No. 86—Derivatives.*) (*Staff Note: This is not intended to capture normal creditor relationships with a borrowing rate that may be variable based on the change of LIBOR or other reference rate.*)
 - d. This issue paper will consider the inclusion of guidance, investment reporting provisions, and disclosures to clearly identify and assess “insurer sponsored securitizations.” These disclosures will require disclosure of the conditions in SSAP No. 103R, paragraph 8 and how an insurer sponsor concluded that the conditions were met to attain “sale” accounting treatment upon securitization. (*Staff Note: NAIC staff proposes to capture the various examples provided by interested parties into an exhibit or application guidance to assist in determining whether the insurer-sponsored securitization qualifies for sale treatment and resulting securitization. Only investments that qualified for sale treatment under SSAP No. 103R could be removed from their prior reporting classified and considered for SSAP No. 43R eligibility. If sale accounting treatment was met, the actual resulting security will need to be assessed to determine if it qualifies as a SSAP No. 43R security and in determining the appropriate accounting and reporting treatment. Additionally, discussion will occur on the interaction between SSAP No. 25 and SSAP No. 103*)
 - e. This issue paper will review and consider revisions to explicitly reference equipment trust certificates, credit tenant loans and lease-backed securities. This review will coordinate work with the SVO staff on the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (P&P Manual) provisions and discussions the SVO is having with industry representatives. Consideration is expected to subsequently occur on the accounting and reporting for these investments as well as identification on the investment schedules and whether additional disclosures are necessary. (*Note: The reference to lease-backed*

securities pertains to those that do not qualify as CFR ABS or traditional securitizations that are addressed in the structural assessments reflected in the P&P Manual assessment.)

Overview of Key Concepts:

- This section details the overall issue, history of development and key concepts and issues that provide the background for the overall discussion / project.

Questions / Comments:

- Is there additional information that should be captured to provide more information on the overall issue or discussion?

Section 2: Defining Asset-Backed Security

18. Pursuant to the initial Jan. 8, 2020 direction, this issue paper proposes that the term “asset-backed security” be clearly defined to be consistent with the definition pursuant to the Code of Federal Regulations as detailed in 17 CFR 229.1101(c). Securities referenced in this issue paper as “asset-backed securities” are specifically those that comply with the CFR definition.

NAIC Staff Note: By using the CFR definition, only NRSROs that are registered with the SEC to provide designations for ABS could be used if the security was permitted as filing exempt (FE) under the Purposes and Procedures Manual of the NAIC Investment Analysis Office. As of December 2018, of the 10 NRSROs, three were not registered for asset-backed securities. These three included Egan-Jones Rating Company, HR Ratings de Mexico, and the Japan Credit Rating Agency.

19. The definition of an “asset-backed security” pursuant to the Securities Exchange Act of 1934:

(79) ASSET-BACKED SECURITY.—The term “asset-backed security”— (A) means a fixed-income or other security collateralized by any type of self-liquidating financial asset (including a loan, a lease, a mortgage, or a secured or unsecured receivable) that allows the holder of the security to receive payments that depend primarily on cash flow from the asset, including— (i) a collateralized mortgage obligation; (ii) a collateralized debt obligation; (iii) a collateralized bond obligation; (iv) a collateralized debt obligation of asset-backed securities; (v) a collateralized debt obligation of collateralized debt obligations; and (vi) a security that the Commission, by rule, determines to be an asset-backed security for purposes of this section; and (B) does not include a security issued by a finance subsidiary held by the parent company or a company controlled by the parent company, if none of the securities issued by the finance subsidiary are held by an entity that is not controlled by the parent company.

20. The definition of an “asset-backed security” and an “asset-backed issuer” pursuant to the CFR:

17 CFR 229.1101 (b)

Asset-backed issuer means an issuer whose reporting obligation results from either the registration of an offering of asset-backed securities under the Securities Act, or the registration of a class of asset-backed securities under section 12 of the Exchange Act (15 U.S.C. 78I).

17 CFR 229.1101 (c)

(1) **Asset-backed security** means a security that is primarily serviced by the cash flows of a discrete pool of receivables or other financial assets, either fixed or revolving, that by their terms convert into cash within a finite time period, plus any rights or other assets designed to assure the servicing or timely distributions of proceeds to the security holders; provided that in the case of financial assets that are leases, those assets may convert to cash partially by the cash proceeds from the disposition of the physical property underlying such leases.

(2) The following additional conditions apply in order to be considered an asset-backed security:

- (i) Neither the depositor nor the issuing entity is an investment company under the Investment Company Act of 1940 (15 U.S.C. 80a-1 et seq.) nor will become an investment company as a result of the asset-backed securities transaction.
- (ii) The activities of the issuing entity for the asset-backed securities are limited to passively owning or holding the pool of assets, issuing the asset-backed securities supported or serviced by those assets, and other activities reasonably incidental thereto.
- (iii) No non-performing assets are part of the asset pool as of the measurement date.
- (iv) Delinquent assets do not constitute 50% or more, as measured by dollar volume, of the asset pool as of the measurement date.

- (v) With respect to securities that are backed by leases, the portion of the securitized pool balance attributable to the residual value of the physical property underlying the leases, as determined in accordance with the transaction agreements for the securities, does not constitute:
- (A) For motor vehicle leases, 65% or more, as measured by dollar volume, of the securitized pool balance as of the measurement date.
 - (B) For all other leases, 50% or more, as measured by dollar volume, of the securitized pool balance as of the measurement date.

(3) Notwithstanding the requirement in paragraph (c)(1) of this section that the asset pool be a discrete pool of assets, the following are considered to be a discrete pool of assets for purposes of being considered an asset-backed security:

- (i) Master trusts. The offering related to the securities contemplates adding additional assets to the pool that backs such securities in connection with future issuances of asset-backed securities backed by such pool. The offering related to the securities also may contemplate additions to the asset pool, to the extent consistent with paragraphs (c)(3)(ii) and (c)(3)(iii) of this section, in connection with maintaining minimum pool balances in accordance with the transaction agreements for master trusts with revolving periods or receivables or other financial assets that arise under revolving accounts.
- (ii) Prefunding periods. The offering related to the securities contemplates a prefunding account where a portion of the proceeds of that offering is to be used for the future acquisition of additional pool assets, if the duration of the prefunding period does not extend for more than one year from the date of issuance of the securities and the portion of the proceeds for such prefunding account does not involve in excess of:
 - (A) For master trusts, 25% of the aggregate principal balance of the total asset pool whose cash flows support the securities; and
 - (B) For other offerings, 25% of the proceeds of the offering.
- (iii) Revolving periods. The offering related to the securities contemplates a revolving period where cash flows from the pool assets may be used to acquire additional pool assets, provided, that, for securities backed by receivables or other financial assets that do not arise under revolving accounts, the revolving period does not extend for more than three years from the date of issuance of the securities and the additional pool assets are of the same general character as the original pool assets.

Instructions to Item 1101(c).

1. For purposes of determining non-performing, delinquency and residual value thresholds, the “measurement date” means either:
 - a. The designated cut-off date for the transaction (i.e., the date on and after which collections on the pool assets accrue for the benefit of asset-backed security holders), if applicable; or
 - b. In the case of master trusts, the date as of which delinquency and loss information or securitized pool balance information, as applicable, is presented in the prospectus for the asset-backed securities to be filed pursuant to §230.424(b) of this chapter.
2. Non-performing and delinquent assets that are not funded or purchased by proceeds from the securities and that are not considered in cash flow calculations for the securities need not be considered as part of the asset pool for purposes of determining non-performing and delinquency thresholds.

3. For purposes of determining non-performing, delinquency and residual value thresholds for master trusts, calculations are to be measured against the total asset pool whose cash flows support the securities.
21. The definition of an “asset-backed security” from Model 280:
- “Asset-backed security” means a security or other instrument, excluding a mutual fund, evidencing an interest in, or the right to receive payments from, or payable from distributions on, an asset, a pool of assets or specifically divisible cash flows which are legally transferred to a trust or another special purpose bankruptcy-remote business entity, on the following conditions:
- (1) The trust or other business entity is established solely for the purpose of acquiring specific types of assets or rights to cash flows, issuing securities and other instruments representing an interest in or right to receive cash flows from those assets or rights, and engaging in activities required to service the assets or rights and any credit enhancement or support features held by the trust or other business entity; and
 - (2) The assets of the trust or other business entity consist solely of interest bearing obligations or other contractual obligations representing the right to receive payment from the cash flows from the assets or rights. However, the existence of credit enhancements, such as letters of credit or guarantees, or support features such as swap agreements, shall not cause a security or other instrument to be ineligible as an asset-backed security.
22. In reviewing the definitions for ABS from the SEC, CFR and Model 280, all of the definitions are consistent in that the assets held in trust must have contractual components that generate cash flow as the primary source to satisfy the issued ABS security. This is explicit in the CFR definition:
- Asset-backed security means a security that is primarily serviced by the cash flows of a discrete pool of receivables or other financial assets, either fixed or revolving, that by their terms convert into cash within a finite time period...
23. Common examples of asset-backed securities include mortgage backed securities (both commercial and residential), auto loans, credit card receivables, equipment lease contracts and student loans. For these examples, traditionally, the securitization occurs by grouping like assets, with securitization issuances split into tranches with differing levels of subordination.
24. The category of “other” asset-backed securities captures a variety of differing structures that do not fit the main categories. Per SIFMA, common subcategories include, cell phone contracts, consumer lending, franchise lending, insurance, timeshares and utility/stranded costs. It is noted that the ABS market continues to evolve, and new securitization arrangements will continue to occur.
25. Although the common categories of ABS generally include the grouping of like assets, collateralized loan obligations (CLOs) are distinctly different because they reflect a bundling of diverse business leveraged loans (senior secured below investment grade bank loans). Another key difference with CLOs is that the portfolio is actively managed over a fixed tenure (“reinvestment period”) during which time the manager of the CLO can buy and sell individual bank loans for the underlying collateral pool to create trading gains and mitigate losses.
26. The different tranches of ABS provide different levels of risk exposure. In a typical structure, there is a senior class with various levels of subordinated tranches. The senior level has the first claim on cashflows, with the subordinated tranches only receiving principal repayments after the more senior classes have been repaid in full. If the underlying asset pool becomes insufficient to make payments on the securities (e.g., an underlying loan supporting the securitization has defaulted), the loss is first absorbed by the subordinated tranches, and the more senior tranches are unaffected unless the losses are so great that

they exceed the entire amount of the subordinated tranches. The most junior class (lowest level tranche), often referred to as the “equity class” or “residual tranche” is the most exposed to default risk. This class receives the residual cash flow (if any) after all other tranches have been fully paid for a given period. Equity level tranches often do not have credit ratings and do not have a stated coupon during the duration of the CLO. These equity / residual tranches do not have a principal balance that is subject to a contractual obligation for return.

27. A variation of ABS is the formation of the “combination (combo) notes.” A combo note packages parts of multiple tranches from a securitization to form a new security. Often, this includes combining a part of a rated (higher-level tranche) with parts of the equity / residual class. By combining different parts of the CLO, the overall security is able to obtain an investment-grade rating for the entire investment, whereas if holding the equity class separately, the security would not be rated and would not be considered investment grade. By holding a combo note, an investor may continue to receive periodic payments representing the cash flows from the higher-level tranche, and not be aware (or not recognize) that the part of the security representing the equity class has experienced a default.

Overview of Key Concepts:

- The issue paper proposes use of the CFR definition for asset-backed securities as a general principle concept for determining scope of SSAP No. 43R. Securities that do not meet the CFR ABS definition will be required to be separately discussed and scoped into the Statement (as applicable).
- Use of the CFR ABS definition clarifies that the general premise of an ABS security is one that is satisfied primarily through receivables and financial assets held in trust that, by the terms of those assets, convert to cash over a finite time period. This definition prevents use of this classification as a means to convert equity instruments into debt instruments, as equity instruments could not be captured in a trust and used as the primary source of repayment for an issued “debt” security as it would not meet the requirements of the ABS definition.

Questions / Comments:

- Are there concerns with the use of the CFR ABS definition as the general principle concept for SSAP No. 43?
- It is expected that PPNs, CFOs and other instruments where the cash flows used to pay the ABS security are not fully contingent on interest and principal payments on assets held in trust would not be considered CFR ABS securities. Comments are requested on whether this assessment is correct, or if these items could qualify as CFR ABS securities.
- Comments are requested on the securities that have historically been captured within scope of SSAP No. 43R that will not meet the CFR ABS definition that should be considered for inclusion in scope of SSAP No. 43R. (Principle concepts for these securities are requested.)

Section 3 - Accounting and Reporting for Asset-Backed Securities

28. This issue paper proposes that ABS, with the exception of tranches that are considered “equity class” or “residual tranches” (this is generally the most junior tranche) and structures combined to include the equity or residual class (e.g. combo notes), will follow historical accounting and reporting provisions reflected within SSAP No. 43R. Historical accounting guidance detailed below:

- a. For reporting entities that maintain an Asset Valuation Reserve (AVR), asset-backed securities shall be reported at amortized cost, except for those with an NAIC designation of 6, which shall be reported at the lower of amortized cost or fair value.
- b. For reporting entities that do not maintain an AVR, asset-backed securities designated highest quality and high quality (NAIC designations 1 and 2, respectively) shall be reported at amortized cost. ABS that are designated medium quality, low quality, lowest quality and in or near default (NAIC designations 3 to 6, respectively) shall be reported the lower of cost or fair value.

29. Although the historical accounting and reporting provisions are proposed, this issue paper clarifies that all ABS must be separately reported by tranche. As such, if an insurance reporting entity acquires more than one tranche from an ABS securitization, each tranche shall be separately reviewed for proper statutory accounting and reporting. Furthermore, acquisition of an ABS security that reflects the combination of different tranches from a single ABS securitization, or the combination of tranches from more than one ABS securitization (e.g., a combo note⁷) is required to be bifurcated for accounting and reporting purposes with each ABS securitization tranche reported individually.

- a. Separate tranche reporting is proposed as the combining of different ABS tranches into a new security does not impact the cash flows that would be received from the ABS. An insurer needs to know the cash flows received on each individual tranche to properly assess future cash flows under the provisions of SSAP No. 43R.
- b. In cases where a combo note (or other structure) reflects various rated (debt) tranche levels, each tranche shall be separately reported with the NAIC designation that is attributed to the rating for the specific tranche (not the rating for the overall combined instrument.) In cases in which the combo note includes a component of the non-rated equity class (residual tranche), after the separation of the tranches, the residual tranches shall be accounted and reported in accordance with the provisions of the SSAP for those specific tranches.

30. With the retention of the historical accounting and reporting provisions, this issue paper proposes to retain existing guidance requiring periodic (at least quarterly) assessments of cash flows, as well as guidance when cashflows are probable and the concept of accretable yield. As detailed within, this issue paper proposes revisions to ensure consistency in application when changes in case flows are expected and proposes to require use of the prospective method.

31. This issue paper proposes that equity class / residual tranches not be reported as a debt instruments on Schedule D-1. These tranches do not reflect debt instruments, as there are no contractual cash flows, and these instruments do not meet the definition of a “rated credit instrument” as these tranches of asset-backed securities are not rated instruments. This issue paper proposes the inclusion of new guidance in SSAP No. 43R to clarify that an insurer-holder of these instruments shall initially report them at acquisition cost, not to exceed fair value, in a new dedicated line on Schedule BA. Subsequent measurement would the lower of amortized cost or fair value. Admittance of these investments is proposed, but specific other-than-temporary impairment guidance is proposed to ensure timely realized loss recognition. In determining OTTI, as well

⁷ Other examples could also include legacy collateralized debt obligations (CDOs)

as guidance in the recognition of investment income or return on investment, this issue paper proposes to require quarterly review of trustee and payment reports to assess the cash flows payments for the entire ABS securitization.

NAIC Staff Note: Reporting non-rated equity / residual tranches on Schedule D-1 is problematic as an NAIC designation is required for instruments reported (except for mandatory convertibles) on that schedule. The issuance of combo notes, which are attributed a general rating to the entire security was a mechanism used to capture these securities on Schedule D-1, with an NAIC designation, although the equity class is not a rated security and does not reflect a contractual obligation. By reporting this class outside of Schedule D-1, the instrument is no longer improperly classified as a debt instrument, the reporting does not require an NAIC designation, and appropriate RBC charges would occur. NAIC staff has discussed the reporting of equity class / residual tranches with a handful of interested party / investment representatives and it seems there is currently inconsistent application of how these tranches are being reported. Some responses have indicated that these tranches are already reported on Schedule BA, whereas other responses have indicated that since these are captured in SSAP No. 43R they are reported on Schedule D-1 as debt instruments. In response to inquiries on how they are reported on Schedule D-1 since they are not rated securities and do not have NAIC designations, it has been shared that companies self-designate the securities as either 5GI or 6. For life entities, by self-designating as a "5" the entity is able to utilize an amortized cost measurement method. Use of an amortized cost measurement method is not appropriate for these securities, as they only receive funds after all other tranches have been fully satisfied.*

Overview of Key Concepts:

- All CFR ABS (as defined) will be addressed in SSAP No. 43R.
- Each ABS rated debt tranche shall be separately reported for accounting and RBC. (This requires bifurcation of combination notes or other structures where ABS tranches have been combined to form a new security.)
- Tranches reflecting residual tranches / equity classes will be addressed in SSAP No. 43R, but the guidance will require reporting of these tranches on Schedule BA at the lower of amortized cost or fair value. Guidance is proposed to clarify the subsequent reporting of this tranche, particularly for OTTI, investment income, and return of investment.

Questions / Comments:

- Are there concerns with including all CFR ABS (as defined) in scope of SSAP No. 43R and allowing for the rated debt tranches of these instruments to generally follow historical accounting / reporting guidance? This guidance determines measurement method based on CRP rating (as permitted by the P&P Manual) translated to the equivocal NAIC designation.
- Should there be guidance that provides differing accounting and reporting treatment based on whether the CFR ABS is a "common" or "broadly syndicated" structure? Is the current collateral codes sufficient to identify new categories of SSAP No. 43R securities?
- From preliminary information received, all insurer-holders of combination notes should have the information necessary to bifurcate and separately report individual tranches. (As this is necessary to properly assess cash flows under the existing requirements of SSAP No. 43R.) However, specific investments details are requested if this is a concerning element.
- Are there concerns with guidance specifying that the residual / equity tranches shall be reported on Schedule BA, on a dedicated reporting line, with a lower of amortized cost or fair value measurement method?

Section 4 - Accounting and Reporting for Non-Asset-Backed Securities (outside CFR ABS definition)

32. This issue paper proposes to review securities that may have been previously reported in scope of SSAP No. 43R, that do not meet the CFR ABS definition, and assess whether the securities shall be retained in scope of that Statement. If retained in scope of SSAP No. 43R, the issue paper will consider whether the securities shall be subject to different accounting and reporting treatment.

33. Although specific types of securities may be reviewed, the issue paper proposes four key concepts in determining whether a securitization structure is principally similar to a CFR ABS and shall be provided similar accounting and reporting treatment in scope of SSAP No. 43R:

- a. Principle 1: Securitization and issuance of debt securities are from a trust / SPV that is separate and distinct as well as bankruptcy remote from the sponsoring organization.
- b. Principle 2: In order to serve as collateral backing issued debt instruments, the assets held in the trust / SPV shall predominantly represent contractual obligation to make payments. Only contracts such as leases, mortgages, loans, and agreements that define payment obligations create the contractual cash flows necessary for securitization. (“Hard” assets shall not serve as the primary collateral for securitizations. Although hard assets (real estate, airplanes, etc.) may be ultimately available to repay the investor (if needed), these assets only provide secondary security.) For securities that are backed by leases, the repayment may be reliant on the residual value of the physical assets to the extent allowed under the CFR ABS definition. (This is currently detailed in 17 CFR 229.1101 (c)(2)(v).)
- c. Principle 3: The contractual obligations to make payments (assets held in trust / SPV) are owed by many diverse payers. (The term “many” is not defined, but is intended to reflect characteristics of traditional securitizations, in which a broad, diverse population safeguards the performance of the securitization. For this principle, the amount of cash flow generating assets and the payers should be commensurate with the type of securitization. For example, securitized airplane leases would likely meet the “many” requirements with fewer obligations and involved airlines than what would be expected in a securitization of credit card receivables.)
- d. Principle 4: Each securitization distributes periodic performance reports to investors that provide information about the underlying collateral composition, credit quality of obligors and payment performance. (Payment performance shall include the current cash flows and terms related to particular assets and whether payments terms change over time.)

34. If a securitization structure complies clearly with the four principles, it is proposed to be considered principally similar to a CFR ABS and the structure is proposed to be in scope of SSAP No. 43R. This issue paper proposes that the securities issued from the securitization follow the same accounting and reporting guidance as CFR ABS. This would include the specific guidance for tranches that reflect residual tranche / equity class securities and structures combined to include the equity or residual class (combo notes). This would also require that all securities be separately reported by tranche.

35. Securities issued from the securitization (excepting the residual / equity tranches and combo notes) are proposed to retain the ability for filing exempt, if permitted in accordance with the provisions of the P&P Manual, as long as the rating is issued from a CRP registered to provide designations for CFR ABS securities. If a tranche does not have a rating from a qualifying CRP, the security would be required to be filed with the NAIC SVO for a designation assessment.

Staff Note: As these securities are intended to be principally similar to CFR ABS securities, NAIC staff does not believe NRSROs/CRPs that are not SEC registered to provide ratings for ABS securities should be permitted to provide ratings for these securities for NAIC designation purposes.

Overview of Key Concepts:

- This proposes four principle concepts to identify securities that are principally similar to CFR ABS securities. If the four principles are met, this guidance proposes to have the securities treated in SSAP No. 43R as if they were CFR ABS.
- The proposed guidance suggests restricting CRP ratings to these securities to the NRSROs that are SEC registered for CFR ABS. *(This change would have to be addressed by the VOSTF and captured in the P&P Manual.)*
- Similar to the CFR ABS, each rated debt tranche shall be separately reported for accounting and RBC. (This requires bifurcation of combination notes or other structures where ABS tranches have been combined to form a new security.)
- Also, similar to CFR ABS, the residual tranche / equity class will be addressed in SSAP No. 43R, but the guidance will require reporting of this tranche on Schedule BA at the lower of amortized cost or fair value. Guidance will be drafted to clarify the subsequent reporting of this tranche, particularly in the recognition of OTTI, investment income, and return of investment.

Questions / Comments:

- Are there comments with the four proposed principles and whether they will successfully identify securitizations that are principally similar to CFR ABS?
- Will these principles capture a significant majority of the non-CFR ABS that reflect traditional securitizations? If not, what elements would disqualify those securities?
- Will these principles include securities that go beyond the intent for “traditional securitizations” and if so, what aspects would permit these securities?

Section 5 - Non-Traditional Securitizations

36. With the proposed guidance for CFR ABS and principally similar securitizations, the next item for review is the appropriate accounting and reporting guidance for structures that do not fit these distinctions. The following general structures have been initially identified for discussion:

- a. Structures that issue securities from a trust / SPV with one underlying obligor.
- b. Structures that issue securities from a trust / SPV for which the contractual obligations collateralizing the security are not owed by many diverse payers.
- c. Structures that issue securities from a trust / SPV where payments made on the issued security are partially impacted by the performance of equity assets held in trust. (For example, if the payment on the security reflects the interest from debt instruments (e.g., Treasury Strip), and the performance of equity investments (e.g., dividends, equity increase, appreciation, etc.) held in trust. (These structures may refer to the need to “harvest” or “liquidate” equity investments in order to access funds to make coupon payments or provide final payment at maturity.) *(This structure does not include PPNs as the debt instrument in trust will not satisfy the amounts owed under the issued security.)*
- d. Structures that issue securities from a trust / SPV in which the amount of principal or interest to be returned to the holder is solely impacted by equity or derivative collateral or by reference to an equity index (e.g., S&P 500). (The reference to “equity” includes any type of fund as well as joint venture, LLCs, partnership or SCA interests.)
- e. Structures that issue securities from a trust / SPV where a portion of the underlying assets is dedicated to ensuring the repayment of principal at maturity (principal protected notes.)
- f. Structures that issue securities from a trust / SPV where the underlying collateral is neither a cash-generating debt instrument nor an equity security. (For example, a structure in which “art” is included in trust as collateral for the issued security.)

Overview of Key Concepts:

- This section attempts to identify the types of structures that have been reported in scope of SSAP No. 43R.

Questions / Comments:

- Are there additional structures that are not captured in the noted categories?

NAIC Staff: General Comment on Certain Types of Investments:

From discussions on certain types of investments, concerns mostly arise due to the RBC charges that would be applied to the security if reported on Schedule BA. **Similar to past decisions, accounting and reporting that is not in line with the investment type is not proposed simply to obtain a more desirable RBC. Rather, the accounting and reporting shall be based on the type of investment. If the RBC is believed to be inappropriate for the underlying risks, the underlying issue should be identified with discussions / issues involving the Capital Adequacy (E) Task Force.** NAIC staff does not believe regulators expect equity-based investments to be reported as long-term bonds on Schedule D-1.

Section 5a - Structures with Issued Notes Collateralized from One Underlying Obligor

37. The general concept of a securitization is that the security is collateralized by cash flows generated from contractual obligations from many diverse payers. If the structure is one in which a note is issued from a trust / SPV, but the collateral has only one underlying obligor (and not many payers), then the structure does not fit the criteria for a traditional securitization.

38. For these situations, it is proposed that if the underlying obligation from the single obligor would qualify as a debt instrument in scope of SSAP No. 26R, and is not the result of a self-securitization, then the security issued from the trust structure shall also be captured as a debt instrument and retain historical accounting and reporting treatment from SSAP No. 43R. (Presumably, the structure has been captured in scope of SSAP No. 43R, and not SSAP No. 26R, as there is a trust / SPV that has issued the security.)

Staff Note: From info received, some entities may be classifying “equity-related” structures (captured in Sections 5c and/or 5d of this issue paper) as bonds in SSAP No. 26R even though the issued security is from a trust. NAIC staff suggests clarification that these items are excluded from SSAP No. 26R. If the Working Group ultimately concludes that these items can be reported as debt instruments, it is proposed that they be in scope SSAP No. 43R and not SSAP No. 26R. NAIC staff was initially under the impression that if a reporting entity had reported these instruments as debt items, then they would have been captured in SSAP No. 43R due to the presence of the trust structure, and the revisions adopted in 2009. However, it has been identified that this may not be the case and there is inconsistent application in industry.

39. In order to be captured within these provisions, the underlying instrument must fully comply with the requirements of a bond, as defined in SSAP No. 26R, and payments on the note must reflect principal and interest payments that are solely contingent on default risk of the one underlying payee. The following are examples (not all inclusive) of items that would not qualify within this guidance:

- a. Instruments that may resemble “notes” but for which payments of interest and principal are contingent on other factors other than default risk from the underlying payee. For example, structured notes, which are excluded from the scope of SSAP No. 26R, would not be permitted as a debt instrument under SSAP No. 43R simply because it was acquired from a SPV / trust structure.
- b. Instruments that do not meet the definition of a “security” pursuant to SSAP No. 26R. For example, a collateral loan that would be captured in scope of *SSAP No. 21R—Other Admitted Assets*, shall not be reported as a debt instrument simply due to the involvement of an SPV / trust structure.

40. If the trust / SPV issues more than one instrument (tranche), similar to the guidance for CFR ABS, this issue paper proposes to require separate reporting of each instrument acquired from the trust / SPV.

41. For the instruments that qualify within this section, this issue paper proposes continued use of historical SSAP No. 43R accounting and reporting concepts. Since the instruments in scope of this section are limited to one underlying obligor, it is anticipated that the reported NAIC designation will reflect the credit quality of the instrument from the obligor. The provisions from the NAIC P&P Manual shall be used in determining whether the underlying obligor and investment qualifies as filing exempt. (*Staff Note: Since this issuance is intended to reflect a bond issued through a trust / SPV, it is anticipated that the use of the trust / SPV shall not impact the determination of filing exempt or the accounting and reporting guidance.*)

- a. For reporting entities that maintain an Asset Valuation Reserve (AVR), asset-backed securities shall be reported at amortized cost, except for those with an NAIC designation of 6, which shall be reported at the lower of amortized cost or fair value.

- b. For reporting entities that do not maintain an AVR, asset-backed securities designated highest quality and high quality (NAIC designations 1 and 2, respectively) shall be reported at amortized cost. ABS that are designated medium quality, low quality, lowest quality and in or near default (NAIC designations 3 to 6, respectively) shall be reported the lower of cost or fair value.

42. If the investment with one underlying obligor would not separately qualify as a bond, it is proposed that the investment be captured in the applicable SSAP for the underlying investment. Pursuant to this guidance, if the investment from the trust / SPV was a structured note, the item would be in scope of *SSAP No. 86—Derivatives*. If the item acquired from the trust / SPV reflected an equity investment in a private equity fund or LLC, then the item would be in scope of *SSAP No. 48—Joint Ventures, Partnerships and Limited Liabilities Companies*. If captured in scope of another Statement, all elements of the applicable Statement shall be considered in determining measurement method and admissibility. (For example, investments in entities captured under SSAP No. 48 must have audited support for admittance. Acquiring an investment through a trust / SPV would not eliminate these admittance provisions.) It is proposed that the substance of the investment, and where it is reported if held individually, shall drive the accounting and reporting for items with one underlying obligor. The involvement of a trust / SPV and/or the presence of a CRP rating shall not be factors in making this determination.

43. If the investment with one underlying obligor is the result of a self-securitization, the guidance in paragraph [redacted] shall be followed. (*Staff Note – This guidance is still under development.*)

Overview of Key Concepts:

- This section addresses items that are issued through a trust / SPV but that are collateralized by a single obligor.
- If the underlying investment held in trust would qualify as a bond if held directly, the proposed guidance would retain historical accounting and reporting guidance.
- If the underlying investment would not qualify as a bond if held directly, the guidance proposes to require the underlying investment to be reported under the applicable SSAP. With this guidance, use of a trust / SPV could not be used to capture non-qualifying items on the bond schedule (such as structured notes or collateral loans).
- Pursuant to comments received, some entities may consider investments from trusts / SPV that would be captured in Section 5c or 5d of this issues paper (impacted by performance of equity investments held in trust) as bonds. These items are not intended to be captured within this “one obligor” guidance and shall be captured in Section 5c or 5d.

Questions / Comments:

- Are there comments with the proposed guidance / scope of section?
- Is the guidance in paragraph 39a sufficient to exclude investments that rely on the performance of underlying equity investments (e.g., CFOs and other structures) from the scope of the “one-obligor” provisions?

Section 5b - Structures with Issued Notes Not Collateralized by Many Payers

44. As previously noted, the general concept of a securitization is that a security is collateralized by cash flows generated from contractual obligations from many diverse payers. If the structure is one in which the trust / SPV issued security is not collateralized by many diverse payers, then the structure does not fit the criteria of a traditional securitization.

- a. As detailed in paragraph 33.c., the term “many” is not defined, but is intended to reflect characteristics of traditional securitizations, in which a broad, diverse population safeguards the performance of the securitization. For this “many” principle, the amount of expected cash flow generating assets and the payers should be commensurate with the type of securitization. (For example, securitized airplane leases would likely meet the “many” requirements with fewer obligations and involved airlines than what would be expected in a securitization of credit card receivables.) Structures captured in this section would have more than one underlying obligor, but the underlying obligors would not meet the “many” threshold of a traditional securitization.

45. Diversification (cash flow generating collateral from many payers) is a key element in traditional securitizations because a fundamental benefit in acquiring securities through these structures is the reduction of risk exposure. If a structure has limited (not many) payers, questions are raised as to why the investment was acquired through a trust / SPV structure rather than acquired individually. Specifically, the following dynamics have been noted as potentially concerning when there are limited payers in a SSAP No. 43R structure:

- a. Payers are predominantly affiliates of the insurer investor, but the trust / SPV is a separate, bankruptcy remote structure and is not considered an affiliated entity.
- b. Highly-rated payers are coupled with a lower-rated payers to obtain an overall CRP rating that is used for the issued “tranche,” resulting with an improved RBC than what would have been received if the investments captured in the tranche were held separately and reported individually.

46. As the component of many payers is paramount in a traditional securitization for the reduction of risk and in determining the ultimate credit risk used for measurement and RBC, when this characteristic is not met, there are concerns that the accounting and reporting concepts historically reflected in SSAP No. 43R no longer represent the appropriate guidance. For these scenarios, it may be considered inappropriate to permit continuous amortized cost reporting or delay other-than-temporary impairment recognition simply because investments have been collectively captured in a trust / SPV structure and bundled together.

47. If the investment qualifies as a debt instrument, with interest and principal payments fully contingent on cash flow generating assets held in trust (similar to a CFR ABS or traditional securitization), this issue paper proposes that the item be retained within scope of SSAP No. 43R and reported on Schedule D-1. However, in order to ensure that the accounting and reporting properly reflects the risk of the underlying investments, and to mitigate inappropriate use of the trust / SPV structure to combine securities for RBC or other accounting / reporting benefits, this issue paper proposes consideration of the following accounting and reporting guidance:

- a. Regardless of NAIC designation, investments issued from a trust / SPV in which there are limited underlying payers (it does not qualify as “many”) shall be reported at the lower of amortized cost or fair value. (This excludes investments that qualify as a “underlying one obligor” detailed in the previous section and self-securitizations addressed in paragraph [redacted].)

- b. It is proposed that the NAIC designation, which will be used for RBC, shall be determined by the NAIC SVO. (Meaning, these investments are proposed to not be filing exempt.) Or, as an alternative, the guidance could limit CRP ratings to the NRSROs that are approved by the SEC to provide designations on asset-backed securities.

48. Since guidance was already adopted in *SSAP No. 25—Affiliates and Other Related Parties* and *SSAP No. 43R* to clarify identification of affiliated investments, no further revisions on this aspect are considered necessary. This issue paper proposes to retain that recently adopted guidance, which clarifies that the inclusion of a non-affiliated intermediary (such as a trust / SPV) does not eliminate the identification of an affiliate investment.

49. The guidance in this section assumes that the investment is fully contingent on cash-flow generating assets held in trust (similar to CFR ABS or traditional securitization). If the security does not meet this criteria, then the investment shall follow the section that reflects the nature of the security:

- a. Section 5c: Structures that issue securities from a trust / SPV where payments made on the issued security are partially impacted by the performance of equity assets held in trust.
- b. Section 5d: Structures that issue securities from a trust / SPV in which the amount of principal or interest to be returned to the holder is solely impacted by equity or derivative collateral or by reference to an equity index.
- c. Section 5e: Structures that issue principal protected notes.
- d. Section 5e: Structures that issue securities from a trust / SPV where the underlying collateral is neither a cash-generating debt instrument nor an equity security.

Overview of Key Concepts:

- This section addresses items that do not qualify as a securitization due to the number of underlying payers. The key concern with these structures is that the use of a trust / SPV masks the underlying risk exposure. This is because the reduction of risk, which would generally be expected in a securitization with many payers, is not obtained.
- The proposed guidance would continue to permit the issued securities as debt instruments (if they qualify) in scope of *SSAP No. 43R*, but would require a lower of amortized cost or fair value measurement method regardless of the NAIC designation. Also, the guidance proposes to require the SVO involvement in determining the appropriate NAIC designation. (It also includes an alternative to permit only CRP ratings from NRSROs that are SEC approved to provide designations on asset-backed securities.)

Questions / Comments:

- The guidance proposed in this section is for all debt instrument securities that do not meet the “many” payee threshold. Are there securities that would not meet the “many” threshold, but would have more than a “limited” number of payees? Explicit examples of securities that would be characteristic of this dynamic are requested.
- Should amortized cost (and not LCOM) be permitted for certain investments that are captured in this section? Explicit examples and principle concepts to differentiate these securities are requested.

Section 5c - Structures with Issued Securities Where the Payment on the Issued Securities are Partially Impacted by the Performance of Equity Assets Held in Trust

50. The general concept of a securitization is that a security is collateralized by cash flows generated from contractual obligations from many diverse payers. If the structure is one in which a security is issued from a trust structure but the coupon payments, principal repayment and whether default occurs, is partially determined based on the performance of equity assets held in trust, then the structure does not fit the criteria for a traditional securitization. (As an example, the collateral within the trust includes a Treasury strip and equity instruments, and the trust-issued security includes a “coupon” to the holder that is greater than the amount that would be received from the Treasury instrument. By design, the coupon payments cannot be met if the underlying equity assets do not perform.)

51. The reporting within scope of SSAP No. 43R, reflected on Schedule D-1 as a long-term bond, is intended to reflect debt instruments. One of the key concerns of certain structures is that the issued security from the trust in substance “converts” an equity instrument into a debt instrument. Specifically, the following dynamics have been noted:

- a. Although the trust has issued a “note” with stated interest and principal, the issuer is expecting to meet their note obligations through the realization (“harvesting”) of performance results or through the liquidation of equity investments held in trust (joint venture, LLC, other equity instrument or group of such securities.) *(Note: The need to “harvest” equity returns to meet the trust/SPV issued security obligations is a key dynamic in considering whether these investments are characteristic of a debt instrument / bond.)*
- b. Although the trust has issued a “note” with a stated interest and principal, an event of default of the note does not reflect a default based on the credit-worthiness of an underlying asset payer. Rather, the act of default will depend on whether the underlying equity assets do not meet performance expectations that permit the trust to satisfy their obligation.
- c. It is identified that some existing structures have established “safeguards” to prevent or defer an event of default. For example, the structure may provide a third-party guarantee to safeguard coupon payments for a limited number of years after origination. Such provisions do not transform the underlying equity instrument into a debt structure, as once the guarantee timeframe has passed the ultimate payment will still be contingent on the equity performance. (If the guarantor provides funds to satisfy coupon payments, guarantor may also receive first payment rights ahead of the security holders when the equity investments are ultimately harvested / liquidated. As such, payment to the security holders at maturity may depend on the balance remaining after the guarantors have been repaid.)
- d. It has also been identified that these securities may be reviewed by CRPs and receive high-quality ratings. From what has been gathered, these ratings do not reflect the “credit-quality” of the underlying debt instruments, but rather whether the structure, by design, is likely to satisfy coupon payments. These assessments often focus on the strength of the liquidity facility (guarantor), the availability of a liquidity reserve as well as asset coverage ratios. It has been noted that the CRP ratings received may not come from an NRSRO that is SEC approved to provide ratings on asset-backed securities.

52. Although the instrument may be a “desirable” investment for insurers in terms of liquidity facility safeguards that protect initial coupon payments from equity instrument declines and with the potential equity returns to the insurer holders, the structure does not reflect a debt instrument holding. Although the issuance from the trust structure is a security in the form of a note, the actual investment and the underlying risk to the insurer holder, is contingent on equity holdings.

53. For instruments that meet these characteristics, this issue paper proposes alternative accounting and reporting treatment for these investment structures. Proposed accounting and reporting treatment alternatives are detailed below:

- a. Accounting and reporting guidance in SSAP No. 48 (or a new SSAP).
- b. Proposed reporting in a new reporting line on Schedule BA.
- c. A fair value measurement method
- d. Any reported NAIC designations, which would be used for RBC (and not measurement), be determined by the NAIC SVO. (Meaning, these investments are not proposed to be filing exempt.) The determination of any NAIC designation would be dependent on the SVO methodologies to review the instrument.

Staff Note: The issued security from the trust will always resemble a “debt instrument” as there would generally be a stated principal and coupon. However, if the assets held in trust do not provide principal and interest payments (or are not cash flow generating assets) to satisfy the obligation issued from the trust, the instrument issued from the trust is not an actual debt instrument. Rather, the use of the trust / SPV provides the appearance of a debt instrument although the return is contingent on equity instruments. Similar to existing SAP/VOSTF provisions, a CRP rating (whether public or private) does not impact the determination of the investment type or reporting schedule (e.g., a security does not become a “debt instrument” due to the issuance of an CRP rating).

NAIC staff notes (as detailed in the January 2020 interested parties’ response letter) that interested parties and rating agencies believe that, if structured properly (e.g., nonaffiliated and with sufficient overcollateralization), certain securities that are backed by equity assets are appropriate debt securities. As detailed in this issue paper, NAIC staff is currently obtaining a more thorough understanding of these types of securities, including SEC regulated 1940 Act Closed End Fund debt and is inviting further interested party comments on these types of securities.

If these structures are not considered debt instruments, there is no current SSAP guidance that would be applicable for these structures. Although we could point to SSAP No. 48, the structure is more of a commingling of a different equity investments (likely to include SSAP No. 48 entities) and not an explicit ownership interest in a single SSAP No. 48 entity. NAIC staff proposes the development of new guidance in SSAP No. 48 to explicitly include these structures, as well as other private equity fund structures within scope of the guidance. (The use of fair value as the measurement method is different from what would be captured under SSAP No. 48. However, as the underlying investments are a fund, or a commingling of different equity investments, the equity method (as it is based on ownership of a particular interest) would be difficult to apply.

As detailed earlier, some entities may be classifying these as bonds in SSAP No. 26R. NAIC staff would suggest revisions to clarify these items are excluded from SSAP No. 26R. If the Working Group ultimately concludes that these items shall be reported as debt instruments, it is proposed that they be in scope SSAP No. 43R and not SSAP No. 26R. NAIC staff was initially under the impression that if a reporting entity had reported such instruments as debt items, then they would have been captured in SSAP No. 43R due to the presence of the trust structure, and the revisions adopted in 2009, but it has been identified that this may not be the case and there is inconsistent application in industry.).

*From discussions on these types of investments, use of a fair value measurement method is not a key concern. **Rather, concerns arise due to the RBC charges that would be applied if reported on Schedule BA and not Schedule D-1.** Similar to past decisions, accounting and reporting that is not in line with the investment is not proposed simply to obtain a more desirable RBC. If captured on a new reporting line on*

Schedule BA, a referral could be submitted to the Capital Adequacy (E) Task Force to determine whether an “asset coverage ratio” (or other factors) could impact the RBC factor. (Other reporting options could also be considered.)

*NAIC staff recognizes that this bucket will likely be the focus of discussion, and it may be difficult to apply a straight-line test in assessing these structures as each of the different instruments have varying components and safeguards. To start the discussion, NAIC staff is recommending focus on instruments in which the principal/interest payment is contingent on the performance of the underlying equity instruments. **However, information on different structures, safeguards and aspects to consider are requested.***

Overview of Key Concepts:

- This section addresses items where the coupon payments, principal repayment and whether default occurs, is partially determined based on the performance of equity assets held in trust.
- Guidance identifies that these may be desirable investments, but are not debt instruments.
- The proposed guidance suggests alternative accounting and reporting treatment for these securities, suggesting new guidance in SSAP No. 48 or in a new SSAP.
- The information identifies that RBC may be the driving factor in reporting these investments on Schedule D-1.

Questions / Comments:

- Comments are requested on the different types of structures that would be captured within this category and if there are characteristics that are reflected in some structures that would support different accounting and reporting treatment from other structures in this category.
- Is there a different accounting / reporting approach that should be taken for these securities?
- If these items are excluded from Schedule D-1, what factors (e.g., asset coverage / over-collateralization, etc.) could be considered in determining an appropriate RBC?

Section 5d - Structures with Issued Securities Where the Payment on the Issued Securities are Solely Impacted by Equity or Derivative Collateral or by Reference to an Equity Index

54. This section addresses securities issued from a trust in the form of a debt instrument, where the payment of interest and principal is solely impacted by the performance of equity instruments or derivative instruments held as collateral and/or reference to an equity index. These securities, although designed to resemble a debt instrument, are in essence equity instruments and are proposed to be excluded from SSAP No. 43R.

55. The focus of this section is on equity or derivative instruments held as collateral and/or specific references to equity indices as the sole determinant in determining the interest / principal that is provided for the issued security. In these scenarios, there are no debt instruments held in trust and the “payment” on the note issued by the SVP is contingent on the performance of the underlying equity / derivative instruments held in trust.

56. For securities captured in scope of this section, if the underlying asset is a single equity instrument or derivative, it is proposed that the instrument follow the accounting and reporting guidance for the underlying collateral held in trust. As such, if the performance is contingent on derivative instruments, the security shall be reported as a derivative. If the performance is contingent on equity collateral or reference to an equity index, the security shall be on Schedule BA.

- a. If the underlying collateral would be reported as a derivative instrument in scope of *SSAP No. 86—Derivatives*, then the underlying is a derivative instrument and the security is a derivative instrument.
- b. If the underlying collateral would be reported as a common stock, preferred stock, or in scope of *SSAP No. 48—Joint Ventures, Partnerships and Limited Liability Companies*, then the underlying is an equity instrument and the security is an equity instrument.
- c. If the payment of interest or principal is contingent on the performance of an equity index, then the security is an equity instrument.

57. For other structures where the issued security is fully impacted by more than one equity instrument (e.g., a number of funds or LLC structures instead of a single fund / LLC), potentially with safeguards to prevent or defer an event of default, the structure is considered similar to Section 5c. Similar to the guidance in that section, instruments issued from these trust/SPV structures are not considered debt instruments as they are contingent on the “harvesting” of equity performance or the liquidation of equity investments in order to meet the trust/SPV’s issued note requirements. As detailed in Section 5c, this issue paper proposes alternative accounting and reporting treatment for these investment structures. Proposed accounting and reporting treatment alternatives include:

- a. Accounting and reporting guidance in SSAP No. 48 (or a new SSAP).
- b. Proposed reporting in a new reporting line on Schedule BA.
- c. A fair value measurement method
- d. Any reported NAIC designations, which would be used for RBC (and not measurement), be determined by the NAIC SVO. (Meaning, these investments are not proposed to be filing exempt.) The determination of any NAIC designation would be dependent on the SVO methodologies to review the instrument.

Staff Note: These scenarios are similar to the items discussed in 5.c, except there is no debt instrument held in trust. Similar to the discussion in 5.c, the issued security from the SPV/trust will always resemble a “debt

instrument” as there would generally be a stated principal and coupon. However, as the assets held in trust do not provide principal and interest payments (and are not cash flow generating assets) to satisfy the obligation issued from the trust, the instrument issued from the trust is not an actual debt instrument. Rather, the use of the trust / SPV has provides the appearance of a debt instrument although the return is contingent on equity instruments. NAIC staff does not believe that a CRP rating (whether public or private) should impact the determination of the whether the issued security is a “debt instrument” under this guidance.

Similar to the discussion in 5c, there is currently no SSAP guidance that would be applicable for these structures. Although we could point to SSAP No. 48, the structure is more of a commingling of a different equity investments (likely to include SSAP No. 48 entities) and not an explicit ownership interest in a single SSAP No. 48 entity. From information received, some entities may be classifying these as bonds in SSAP No. 26R. NAIC staff would suggest revisions to clarify these items are excluded from SSAP No. 26R. If the Working Group ultimately concludes that these items shall be reported as debt instruments, it is proposed that they be in scope SSAP No. 43R and not SSAP No. 26R. NAIC staff was initially under the impression that if a reporting entity had reported such instruments as debt items, then they would have been captured in SSAP No. 43R due to the presence of the trust structure, and the revisions adopted in 2009, but it has been identified that this may not be the case and there is inconsistent application in industry.

NAIC staff notes (as detailed in the January 2020 interested parties’ response letter) that interested parties and rating agencies believe that, if structured properly (e.g., nonaffiliated and with sufficient overcollateralization), certain securities that are backed equity assets are appropriate debt securities. As detailed in this issue paper, NAIC staff is currently obtaining a more thorough understanding of these types of securities, including SEC regulated 1940 Act Closed End Fund debt and is inviting further interested party comments on these types of securities.

Overview of Key Concepts:

- This section addresses those items that are solely contingent on derivative or equity collateral and references to equity index performance. The proposed guidance would exclude these securities fully from SSAP No. 43R.
- NAIC staff believes the treatment is in line with the interested parties’ comment letter, and clarification has been included to reflect what is considered an “equity” instrument.

Questions / Comments:

- Is the guidance clear as to what should be considered an equity instrument and excluded from the scope of SSAP No. 43R?
- Are there structures that would be captured within this guidance that would reflect an unintended consequence of what is intended?
- Comments are requested on whether these structures would include differing types of investments (combinations of equity / derivative instruments) and if specific guidance requiring bifurcation should be captured.

Section 5e – Principal Protected Notes

58. A principal-protected note (PPN) is a form of security in which a portion of the underlying assets (or a guarantee) is dedicated to ensuring the repayment of principal at maturity. With this design, other assets are captured in the trust structure, but those assets do not impact the assessment of the performance of the security (e.g., ability to pay interest / principal, OTTI, CRP rating, etc.). The design effectively permits an insurance entity to hold alternative investments in their portfolio without recognizing the insurer entity's exposure to those underlying assets.

59. It is anticipated that the final issue paper / SSAP guidance will reference the adopted definition of a principal protected note captured in the NAIC *Purposes and Procedures Manual of the NAIC Investment Analysis Office*. The following definition is being considered by the Valuation of Securities (E) Task Force:

Principal Protected Notes (PPNs) are a type of security that repackages one or more underlying investments and for which contractually promised payments according to a fixed schedule are satisfied by proceeds from an underlying bond(s) (including principal and, if applicable, interest, make whole payments and fees thereon) that if purchased by an insurance company on a stand-alone basis would be eligible for Filing Exemption, but for which: (i) a. the repackaged security structure enables potential returns from the underlying investments in addition to the contractually promised cash flows paid to such repackaged security according to a fixed schedule; OR b. the contractual interest rate paid by the PPN is zero, below market or, in any case, equal to or below the comparable risk-free rate; AND (ii) the insurer would obtain a more favorable Risk Based Capital charge or regulatory treatment for the PPN through Filing Exemption than it would were it to separately file the underlying investments in accordance with the policies in this Manual.

For the avoidance of doubt, PPNs shall not include defeased or pre-refunded securities which have separate instructions in this Manual; broadly syndicated securitizations, such as collateralized loan obligations (CLOs) (including middle market CLOs) and asset backed securities (ABS), except as described in the examples in this section; or CLO or ABS issuances held for purposes of risk retention as required by a governing law or regulation.

60. The Valuation of Securities (E) Task Force is currently proposing to not permit PPNs as filing exempt securities unless the SVO determines there are not any "Other Non-Payment Risks". As such, these securities are expected to file with the NAIC SVO for assessment.

61. Although the Task Force is already addressing PPNs in terms of NAIC designation, the concept of PPNs does not work well with certain provisions of SSAP No. 43R. Particularly, the existing guidance that uses currently estimated cash flows, allowing both prospective or retrospective adjustment methodologies, in revaluing loan-backed and structured securities, guidance for the assessment of "intent and ability to hold" in determining OTTI, and the guidance permitting an amortized cost measurement method.

62. With regards to adjustment methodologies, under existing guidance if the expected cash flows is greater than original projections, reporting entities recognize the change in one of the following two ways:

- a. **Prospective Method:** The entity utilizes their updated cash flow assessments to recalculate the effective yield for the anticipated future cash flows. For example, if the PPN security provides a 1% return, but the alternative investments held in trust provide greater returns, the reporting entity would recalculate their effective yield to reflect the higher anticipated cash flows. This approach revises the stated effective interest from origination.
- b. **Retrospective Method:** The entity utilizes their updated cash flow assessments to change both the yield and the asset balance so that the future cash flows produce a return on the investment equal to the return expected over the life of the investment as measured from the date of acquisition. Under this method, the recalculated effective yield will equate the present value of the actual and anticipated cash flows with the original cost of the

investment. The current balance is then increased or decreased to the amount that would have resulted had the revised yield been applied since inception and investment income is corresponding decreased or increased.

63. The use of the retrospective approach, as it permits an increase in the asset value is particularly concerning for PPNs. With this approach, if the asset is reported in scope of SSAP No. 43R, an entity is permitted to increase the reported value based on the well-performing underlying assets. However, if the underlying assets were to diminish in value, the reported asset value would never go below the original acquisition cost as the debt security held in trust will ultimately provide a return of principal. This dynamic essentially allows reporting entities to report the “upside” of the alternative investments held in trust, without recognition of any “downside” while excluding the exposure of the alternative investments from all risk-based capital charges.

64. In reviewing the two methodologies, it is identified that the ability to permit optionality is inconsistent with the Statutory Statement of Concepts, and would recommend that a single approach be required for all SSAP No. 43R securities. In considering the two options, this issue paper proposes that the prospective method – as it does not revise the asset balance – would be the more appropriate of the two methodologies to retain for statutory accounting. With the prospective method, the change in estimated cash flows will revise the effective yield of the security on a going forward basis.

65. Although the Task Force is already considering how an NAIC designation should be determined for PPNs, there is continued questions on whether use of an amortized cost approach is appropriate for these securities and whether the other-than-temporary impairment guidance for the insurer’s “intent and ability to hold” was intended to capture these securities.

66. To provide a simple, general illustration of a PPN:

- a. On day 1, the insurer provides \$50K in funds to the SPV / trust structure in exchange for a debt instrument that provides 1% interest with a stated maturity of 75 years. The trust holds collateral comprised of a \$25K AAA rated bond and \$25K in cash. A rating of the held collateral focuses on the AAA rated bond, resulting in a 1FE designation from a CRP. If held separately the \$25K bond would provide an 8% yield. However, over the time until maturity, the trust structure accumulates the excess bond interest so that at the time of maturity, the assets held in trust is guaranteed to return the acquisition cost (\$50K) and the required 1% interest. *(NAIC staff note, all numbers and years are for illustration purposes only and do not necessarily mathematically compute.)*
- b. On day 2, the trust uses the cash to acquire \$25K in alternative investments. Under the current approach, these investments are not used to update the initial rating from the CRP, and regardless of the performance of the investments, there will be no OTTI recognized or a change in measurement method, as the AAA bond, over a significant number of years, will guarantee performance (return of principal and 1% interest).

67. This issue paper proposes consideration of the following for these securities:

- a. PPNs shall always be reported at the lower of amortized cost or fair value. With this approach, the balance sheet will reflect the value of the underlying interests held in trust.
- b. PPNs shall not be permitted to utilize the “intent and ability to hold” guidance in determining whether an OTTI has occurred and in determining the amount of an OTTI to recognize. Rather, if fair value has dropped below amortized cost, and the impairment would be other than temporary if it was not for the “securing” bond, then a realized loss shall be recognized.

Overview of Key Concepts:

- This section addresses principal-protected notes (or similar structures), in which only a portion of the assets held in trust ensures the repayment of principal at maturity.
- As detailed, the Valuation of Securities (E) Task Force is currently proposing to exclude these instruments from filing exempt, and require submission to the NAIC SVO in determining NAIC designations.
- In addition to the filing exempt exclusion, the issue paper proposes consideration of a lower of amortized cost or fair value measurement method, as well as restrictions in using the “intent and ability to hold guidance” in determining OTTI.

Questions / Comments:

- In addition to the PPNs, are there other instances in which SSAP No. 43R securities are issued with stated interest rates that would be substantially lower than if the debt instruments were held individually?
- Is the proposed lower of amortized cost or fair value measurement method and the OTTI provisions appropriate for PPNs?
- Should there be additional disclosures for PPNs in the financial statements?

Section 5f - Structures with Issued Securities Where the Underlying Collateral is Neither a Cash-Generating Debt Instrument nor an Equity Security

68. This section addresses securities issued from a trust in the form of a debt instrument where the underlying collateral held in trust does not reflect cash-generating assets or an equity security. One example, which has been noted in an actual SVO filing, is the capturing of artwork as collateral. However, this category can include any type of asset that is not cash-generating or an equity instrument. Other examples could be the inclusion of real estate (if the real estate was not producing cash flows), company-owned software, and company-owned airplanes.

69. A key concern with this structure is that the use of the trust structure to issue a security in scope of SSAP No. 43R mitigates the accounting and reporting provisions of the SSAP that would be applicable if the instrument(s) had been held individually. For example, artwork, software and airplanes are all subject to admittance restrictions. Real estate can also be subject to appraisal requirements.

70. For securities captured in scope of this section, it is proposed that the instruments held in trust follow the accounting and reporting guidance that would be applicable if the collateral assets were held directly. For example, if the underlying collateral asset includes company-owned software, the software shall be assessed and reporting in accordance with *SSAP No. 16R—Electronic Data Processing, Equipment and Software*. If the underlying collateral asset is artwork or company owned airplanes, the assets shall be accounted for and reported in accordance with *SSAP No. 20—Nonadmitted Assets*.

71. If the insurer only holds a partial percentage (less than 100%) of the issued SPV / trust securities, the reporting entity shall only reflect their percentage of ownership of the underlying collateral assets when reporting the asset.

72. This guidance does not apply to self-securitizations in which the company assets are legally sold and re-acquired through securitizations that comply with the ABS CFR guidance or a traditional securitization. However, pursuant to the ABS and traditional securitization guidance, the collateral held in trust must reflect cash-generating assets.

NAIC Staff: Further discussion on self-securitizations is expected in subsequent issue paper drafts.

Overview of Key Concepts:

- This section addresses structures where the collateral held in trust is neither a cash-generating debt instrument nor an equity security.
- The guidance proposes to exclude these structures completely from SSAP No. 43R. It is identified that such structures may be designed to circumvent reporting if the underlying collateral had been held directly.

Questions / Comments:

- Is the guidance clear enough to ensure that this only captures non-cash generating assets and non-equity securities?
- Are there structures that would be captured within this guidance that would reflect an unintended consequence of what is intended?
- It is anticipated that these structures are not overly common, but information would be requested on the prevalence of these instances.

D. Keith Bell, CPA
 Senior Vice President
 Accounting Policy
 Corporate Finance
 The Travelers Companies, Inc.
 860-277-0537; FAX 860-954-3708
 Email: d.keith.bell@travelers.com

Rose Albrizio, CPA
 Lead Director
 Accounting Practices
 Equitable
 201-743-7221
 Email: rosemarie.albrizio@equitable.com

July 31, 2020

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

RE: Ref #2019-21, SSAP No. 43R

Dear Mr. Bruggeman:

Interested parties would like to thank the Statutory Accounting Principles Working Group (SAPWG) for the opportunity to comment on the exposed issue paper in Reference #2019-21 – SSAP No. 43R, Loan-Backed and Structured Securities (the “Issue Paper” or “Exposure”). Interested parties have been challenged by the complexity and difficulty of the issues involved. Investment professionals who are accustomed to thinking of asset-backed securities as a discrete set of investments, were also concerned to find proposed changes to underlying accounting definitions that have the potential for wide-ranging consequences affecting fixed income securities more generally.

Interested parties have provided comments directly on each question included within the various sections of the Issue Paper. However, because Interested parties were challenged by much of what was proposed in sections 5a through 5e and have struggled to unravel all of the disparate threads woven throughout the Issue Paper, we have also summarized many of those comments immediately following the below table of contents. The table of contents coincides with the various sections of the Exposure and helps facilitate navigation for the reader.

Preamble – Interested Party Summary Comments	2 – 9
Section 1 – Summary of Issue (Includes History / Benefits / Concepts / Key Issues)	10 – 12
Section 2 – Defining Asset Backed Security	13 – 17
Section 3 – Accounting and Reporting for Asset Backed Securities	18 – 20
Section 4 – Accounting and Reporting for Non-CFR ABS (Traditional Securitization)	21 – 23
Section 5 – Accounting and Reporting for Non-CFR ABS and Non-Traditional Securitizations	24 – 25
a. – One Underlying Obligor	26 – 29
b. – Collateral Not Owed by Many Payers	30 – 32
c. – Security Partially Impacted by Equity Collateral	33 – 37
d. – Security is Solely Impacted by Equity Collateral / Equity Index	38 – 40
e. – Principal Protected Notes	41 – 42
f. – Collateral is Not Cash Generating and Not Equity (e.g., artwork held in trust)	43 – 45
Appendix I – History of SEC and Congressional Definitions of Asset-Backed Securities	46 – 47
Appendix II – Asset Backed Security Definitional Review	48 – 65
Appendix III – Collateralized Fund Obligations (“CFOs”) Defined	66 – 67

Preamble – Interested Party Summary Comments

- 1) First and foremost, the proposed re-write of SSAP No. 43R with a new anchoring definition, is a very technical and nuanced process with the potential to drastically change the type of securities within the scope of both SSAP No. 26R and SSAP No. 43R that are currently afforded bond accounting treatment and reporting on Schedule D.

Since the proposed anchoring definition is generally only used from the perspective of an issuing entity, most insurance companies' accountants, attorneys or front office investment personnel are not familiar with the definition and supporting body of work. When insurance companies do utilize the definition, for example when sponsoring asset-backed securities (ABS), their interaction with the definition is very narrow and with assistance of outside legal counsel. This fact raised many questions; as a result, industry needed and sought assistance from outside legal counsel to inform our response to the Exposure.

After several Interested Party discussions with outside counsel, and analysis of both interested parties' investment portfolios and many areas of the Issue Paper, we became aware of some significant potential challenges associated with using the proposed anchoring definition. We question whether any benefits of using the proposed anchoring definition, outweigh the potential challenges, and expand upon those potential challenges below. Interested parties also believe developing independent principles beyond those included within the Issue Paper, and in lieu of the proposed anchoring definition, should strongly be considered.

In light of this, interested parties ask the SAPWG to take time to carefully and thoroughly consider the recommendations included in this letter. Our objective is to ensure both proper clarity and proper accounting for each security type currently or newly proposed as a bond under SSAP No. 43R. Arriving at the appropriate revisions takes precedence over timeliness of completion. It is in the best interest of both insurers and regulators, and ultimately policyholders, to not emplace statutory accounting principles that are detrimental to insurers engaging in sound investment principles.

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

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

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

Interested parties believe the 1934 Act Definition is the more appropriate starting point to define ABS for statutory accounting, as this definition was most recently evaluated and utilized by Congress to subject a wide range of instruments to risk retention rules. Even the 1934 Act Definition, however, does not cover many securities commonly viewed by the market as ABS. This is because the 1934 Act

Definition requires that the underlying assets of an ABS be self-liquidating, and thereby excludes a range of assets with predictable cash flows, but that are not self-liquidating (e.g., royalties and cell towers).

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

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

As a technical clarification¹ any NRSRO can assign a rating to any ABS, regardless of whether the ABS meets the 1933 Act Definition. Every NRSRO is registered with the SEC to rate at least one asset class. Registration indicates that the NRSRO has special expertise in rating securities of a certain type (such as ABS) or issued by certain entities (such insurance companies). The NRSRO must submit to annual SEC examinations to maintain such registration. At present, six of the nine NRSROs are registered to rate ABS (each, an “NRSRO Registered for ABS”).

It is entirely up to the NRSRO whether it wants to apply to be registered to rate multiple asset classes. For example, Japan Credit Rating Agency is registered for insurance company securities, but not for ABS. In those instances where federal law requires that securities held by federally regulated institutions be rated, only a rating from an NRSRO registered for securities of that type qualifies as a rating letter. Japan Credit Rating Agency is free to assign ratings to ABS as defined in the 1933 Act Definition, and the federally regulated institution is free to subscribe to or otherwise receive and review the Japan Credit Rating Agency rating; however, the rating is just another credit opinion and does not count toward the particular requirement of federal law.

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

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

If the 1934 Act Definition is adopted as the cornerstone of SSAP No. 43R, which interested parties believe is more appropriate than the 1933 Act Definition, interested parties are open to applying the

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

NRSRO Registered for ABS limitation to the 1934 Act Definition (i.e., if state regulators want to mirror what few remaining provisions of federal law do for ABS securities). Interested parties would also be open to discussing the extension of such concept to the Four Principles, when and if they are finalized.

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

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

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

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

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

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

Interested parties unequivocally believe that many of the securities issued from a Trust or SPV should continue to follow the regular amortized cost accounting within SSAP No. 26R, as they do not have prepayment or extension risk. Therefore the modified amortized cost within SSAP No. 43R is not appropriate, as there is no need to update prepayment and extension assumptions as required under SSAP No. 43R. Examples include but are not limited to 1) where there is a direct guarantee from a corporate or government entity (e.g., certain Issuer Obligation Municipal Bonds), even if the security

is issued from a Trust or SPV for legal or other reasons (i.e., an otherwise qualifying SSAP No. 26R security, with the exception of being issued from a Trust or SPV) or 2) project finance investments which are typically issued from an SPV. Many insurance companies currently report these securities as SSAP No. 26R investments. Interested parties and many others as well (industry, regulators, SVO, and NAIC staff) believe these are Schedule D bonds where regular amortized cost accounting is appropriate.

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

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

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

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

- 4) The NAIC Policy Statement on Coordination of the Accounting Practices and Procedures Manual and the Purposes and Procedures Manual of the NAIC Investment Analysis Office includes the following:

“The assessment of credit risk for an obligation or asset, as specified in the P&P Manual, is a separate and distinct process from the determination of statutory accounting or reporting under the AP&P Manual. The manner in which an NAIC designation is used within statutory accounting guidance is limited to that, if any, specified in a statement of statutory accounting principle (SSAP) and cannot be derived or implied by language in the P&P Manual. 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 the investment to be an admitted asset. There are limited instances in which a SSAP specifically identifies, within its scope, the inclusion of specific SVO-identified investments. The SVO review required for an investment to be included on a SVO listing is a separate evaluation process that focuses on the structure of the investment. This process is distinct from the SVO’s assessment of an investment’s credit risk, which results in a NAIC designation. As stated in the Statutory Hierarchy, Section V of the Preamble, the AP&P Manual is the highest level of authoritative guidance.”

Interested parties agree with the substance of this policy statement and believe SAPWG's effort should focus on the scope of bonds, and their appropriate accounting, and should not overlap with the SVO's mission of credit quality assessment of securities owned by insurance companies, in support of the Valuation of Securities Task Force (VOSTF) mission to establish and maintain the NAIC's credit assessment process. That is not to say interested parties believe NAIC staff and SAPWG should not work together with the SVO and VOSTF.

In fact, we encourage a high degree of interaction and cooperation between the two groups to ensure the overall framework is cohesive as the SVO works on Bespoke Securities (for example, certain Collateralized Fund Obligations "CFOs" or other bespoke transactions that the SVO believes to be abusive), which we understand is a main impetus of this project. Interested parties believe that each group's work product, SSAPs and Purposes and Procedures Manual (P&P Manual), respectively, should reflect only what is directly related to its specific mission and NAIC policy.

The SVO's mandate should continue to be limited to assessment of credit risk; scope determination should continue to be the mandate of SAPWG, unless a structural analysis has been delegated to the SVO where SAPWG has already determined scope (i.e., as with CTLs where the SVO determines if the security meets the SAPWG determined scope requirement). In this circumstance the SVO is enforcing a SAPWG decision as to scope but not determining scope. SAPWG should determine scope and the SVO should be limited to compliance with the defined scope.

An additional area where such interaction would be beneficial, and that interested parties would like to specifically address, is related to affiliated transactions. This seems to be an area of shared concern for regulators, the SVO, and NAIC staff. Interested parties agree that such concerns should be addressed. However, many sections of the Issue Paper, where scope requirements are proposed, instead appear to be addressing affiliated transaction concerns - i.e., 1) single obligor asset backed securities or whether it is "common" or "broadly syndicated" and 2) transactions where Schedule BA assets are converted to Schedule D Bonds, mostly in the context of certain CFO-type transactions, but do not meet sale criteria and could result in RBC arbitrage. This makes the proposed principles unworkable and appears to be inadvertently pejorative toward all CFO-type transactions (e.g., CEF Debt and similar structures) that interested parties believe, and we understand many regulators believe, are unequivocally investments that should be accounted for as bonds and reported on Schedule D.

Rather than commingling affiliated transaction concerns with scope, interested parties believe these concerns are already addressed (or will be addressed) as follows:

- a) Part III of Section 17 of the P&P Manual already requires the filing of all investments in Subsidiary, Controlled and Affiliated (SCA) entities – "SCA investments are transactions between insurance company affiliates (called related parties) that are subject to special regulatory considerations identified in *SSAP No. 25—Affiliates and Other Related Parties*. This Manual specifies that such transactions are not subject to filing exemption and can only be assigned an NAIC Designation if the SVO has first concluded that the transaction is like those the SVO typically assesses for credit risk." This determination should be (and is) being done with cooperation of the SVO, the insurance company, and the applicable regulator.

If this part of the P&P Manual does not include all types of affiliated transactions that are of concern (i.e., affiliated transactions are a subset of related parties), interested parties believe this should be addressed separately, rather than commingling the concern in SSAP No. 43R's scope determination. More specifically, interested parties note that the SVO's concurrently exposed project on Bespoke Securities also raises concerns on affiliated and related party transactions.

Interested parties also believe certain additional clarifications are warranted. For example, per the guidance in Reference No. 2019-03, many interested parties believe SCA transactions do not cover securities, where an insurer or one of its subsidiaries sponsors a securitization and the insurer purchases some of the tranches of that securitization, and where the securitized assets are non-affiliated assets. Interested parties agree with this interpretation but a definitive clarifying determination may be needed.

Lastly, both the 1933 Act Definition and the 1934 Act Definition include single obligor ABS within their scope, so there is no need to single them out in the exposure if the concerns are related to affiliated transactions as affiliated transactions already need to be filed with the SVO.

- b) As noted in Section 2 of this letter, interested parties have provided clarifying guidance in our October 2019 comment letter that prohibits moving assets from one schedule to another (e.g., from schedule BA to Schedule D), which could result in RBC arbitrage, if the transaction does not meet sale criteria. Our conversations with NAIC staff suggest they agreed with these clarifications and that they would eliminate such perceived abuses.
- c) Further, in response to “equity-related” structure concerns, we have suggested further safeguards to ensure only regulator supported CFOs such as CEF Debt, and similar CFO-type structures, are afforded bond accounting and Schedule D reporting. The full details can be found in Sections 5c and 5d of this letter.

If the above do not fully address the NAIC concerns, interested parties request such additional concerns be more fully articulated so interested parties can help address them. There are many valid reasons for affiliated transactions that benefit both insurance companies and policyholders and therefore regulators as well. That said, interested parties understand the unique nature of affiliation transactions and regulators’ concerns that they can be subject to abuse; so, interested parties welcome further transparency on affiliated transactions.

- 5) Similar to the assistance rendered by interested parties regarding Principal Protected Notes (“PPNs”), we again would like to help eliminate any potential statutory accounting abuses relative to SSAP 43R. However, to do so, there are some issues that interested parties need to more fully understand. For example, related to CFO-type investments, we agree that 1) instruments where the amount of principal or interest payable contractually varies based on the appreciation and/or depreciation of underlying equities warrant a different accounting treatment and therefore different reporting treatment than the bond section of Schedule D and 2) instruments that create RBC “arbitrage” (i.e., by moving Schedule BA assets to Schedule D without meeting sale criteria in SSAP No. 103R) should be prohibited.

However, any proposed scope clarifications should only address the perceived abuses and not have detrimental consequences to a broader range of CFO investments which are appropriate and beneficial for insurance companies’ investment portfolios. For example, there are many CFO-type investments with a fixed coupon and fixed principal, that have adequate structural features such as overcollateralization and/or liquidity facilities, such that equity appreciation is not required in order to service debt obligations, and in fact, the value of the underlying equity investments can fall substantially, without jeopardizing debt repayments as scheduled (e.g., CEF Debt and other similar structures). Interested parties believe these structures are bonds, appropriate for schedule D reporting, and should be eligible for filing exemption.

The Exposure states that NAIC staff believes regulators do not believe any equity-backed investments should be reported as bonds on Schedule D. This is not consistent with our discussion with some

regulators, who view that the aforementioned- types of securities with overcollateralization and fixed coupon rates and maturities are bonds and should be accounted for as bonds and reported on Schedule D. We would appreciate if regulators that share NAIC staffs' expressed view or have concerns would provide written comments on their specific concerns so we can help address them. We would welcome the opportunity to provide education on CEF Debt and other CFO structures that interested parties (and the SEC) unequivocally view as debt.

In general, we believe the Issue Paper too often wants to "look through" to the underlying assets to determine whether or not the security is a bond. We understand the rationale for this view is where the underlying collateral is a tangible asset not capable of generating cash flows, as is the case with certain collateral loans, defined in SSAP No. 21 (e.g., putting a piece of artwork or the "company airplane" in a Trust or SPV that issues debt). However, interested parties believe the Issue Paper conflates this concept with all other kinds of securities, including CFOs, that are generally recognized as bonds, by the SEC, the FASB and even certain members of the NAIC. The Internal Revenue Service also recognizes such securities as debt.

In addition to CFOs (see sections 5c & 5d), interested parties highlight many such instances throughout this letter where we believe solely "looking through" to the underlying assets is not appropriate, and that other characteristics of the specific investments should be considered. See also section 5f, where airplanes, rail cars or other physical assets, which are typically non-admitted assets, are cash generating through leases and are widely accepted as bonds even where there is re-leasing and/or related residual asset risk (i.e., reliance on the cash generating ability of the underlying asset). Similarly, royalty securitizations, municipal bonds contingent upon proceeds from tobacco settlements, etc. are also widely accepted as bonds. There are many more examples of such cash generating "non-admitted" assets where bond accounting is appropriate.

- 6) If the end product of this project results in significant changes to bond accounting and of Schedule D reporting, interested parties strongly believe any new scope requirements should be applied prospectively, so as to not penalize insurance companies who have complied with the rules prior to any such scope change. With that said, interested parties would agree to exceptions to this general principle if, as a result of the scope changes, transactions are identified that were deemed abusive by regulators.
- 7) Interested parties also believe it is imperative that any security-types where the scope or accounting is proposed to be changed, get adequate due process before SAPWG, and not get approved with a pass/fail vote on the broader proposed new standard. As noted above, this is a very complicated and technical area, and it serves both insurance companies and regulators to spend the requisite time to address affected asset classes individually. Further, drastic changes to scope of bonds could have a significant impact to certain areas of the capital markets or insurance company balance sheets. For example, even now, many insurance companies have stopped investing in CFO debt type securities given the regulatory uncertainty associated with their acceptability at the NAIC. Likewise, the CTL market is also challenged with regulatory uncertainty and their potential classification as Schedule BA assets. These are very good asset classes, with a track record of success, and such uncertainty is not healthy for insurance companies, regulators and ultimately policyholders, especially while already being challenged by the extended low interest rate environment.
- 8) Lastly, we appreciate NAIC staff's acknowledgement and support of industry's efforts to clarify the fundamentals that will help address some of the perceived abuses and develop a revised standard.

Quite possibly, the most important part of the interested parties' response to the Exposure, is the Appendix II included at the end of our letter as well as discussed in section 2 of this letter. Appendix II highlights a preliminary list of securities (e.g., any security issued from a Trust or SPV, inclusive of

existing SSAP No. 26R securities) many of which interested parties do not believe meet the scope of either the 1933 Act Definition or the 1934 Act Definition. It is important to note that this is only an initial attempt at identifying securities by interested parties after a “deep dive” into insurers’ investment portfolios. As this was a very significant effort, it illustrates how complex, time-consuming, and difficult it is to evaluate investments issued by a Trust or SPV to determine if they meet the 1933 Act Definition or the 1934 Act Definition. Much of the analysis involved an individual asset-by-asset assessment that took a significant amount of time for insurers to perform. Many more hours of analysis would be required to identify all investments issued by a Trust or SPV to determine classification in accordance with the Exposure. Even after interested parties’ efforts, there is still significant uncertainty about what asset classes qualify, and often the answer is “it depends.” In order to determine appropriate principles for ABS beyond those included within these definitions, it is imperative all the above issues be addressed. Interested parties attempted to summarize these points as follows:

- 1) Clarify whether regulators intend that any security issued from a Trust or SPV, fall in the scope of SSAP No. 43R, even those without prepayment/extension risk.
- 2) If any security, issued from a Trust or SPV, is desired to be within the scope of SSAP No. 43R, it is imperative to appropriately define the terms Trust and SPV to ensure an operational standard (i.e., provide sufficient clarity so that both industry and regulators apply the terms consistently) with no unintended consequences (e.g., the requirement to apply modified amortized cost accounting when there is no prepayment or extension risk).
- 3) Have regulators confirm that securities identified in Appendix II are appropriately accounted for as bonds and reported on Schedule D. As already mentioned, more work may be needed in this area, to ensure all security types are identified.
- 4) If the investments are not to be reported as bonds on Schedule D, determine an appropriate accounting home.
- 5) If the investments are to be accounted for as bonds and reported as Schedule D, determine whether those securities are going to be specifically referenced in SSAP No. 43R by definition (i.e., as is currently done today with CTLs, ETCs, EETCs) or expanded for other securities that would now be in the scope of SSAP No. 43R (e.g., project finance, CEF Debt and similar CFO-type securities, and issuer obligation municipal bonds, etc.) that regulators and interested parties all believe are appropriate to be accounted for as bonds and reported on Schedule D, but are not ABS.
- 6) Definitively determine the appropriate Securities Act Definition (or not) with the appropriate clarifications as to 1) whether the definition applies to 144A, private placements, and CLOs if the 1933 Act Definition is used and 2) in any case, whether the SEC’s interpretative guidance applies and, if not, how similar interpretative guidance will be developed.
- 7) Ensure that proper coordination with the SVO has occurred and appropriate determinations are made, for example, with regards to affiliated transactions.

Upon completion of the above, only then would it be appropriate to develop the principles to ensure they capture the intended ABS. For example, are they intended to capture royalty securitizations, or is that asset class going to be specifically defined within the scope of SSAP No. 43R and thus not needed to be captured under the principles?

We continue to stand ready to help NAIC staff and regulators in this effort.

Section 1 – Summary of Issue (Includes History / Benefits / Concepts / Key Issues)**Overview of Key Concepts:**

- This section details the overall issue, history of development and key concepts and issues that provide the background for the overall discussion / project.

Questions / Comments:

- Is there additional information that should be captured to provide more information on the overall issue or discussion?

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

For example, we note the following from paragraph 4:

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

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

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

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

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

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

- 1) Not all securities have prepayment/extension risk which renders the accounting of SSAP No. 43R moot,
- 2) Nowhere, as a result of the revisions adopted in 2010, did it change the scope of SSAP No. 43R to explicitly state all securities issued from a Trust or SPV are included,
- 3) Industry continues to hold multiple billions of dollars of securities issued from a Trust or SPV reported under SSAP No. 26 and neither regulators nor auditors have taken exception to this, and

- 4) Industry does not believe this was the intent of Matti Peltonen, at the time a member of the New York State Department of Financial Services, who was the impetus behind the 2010 changes. For example, after the 2010 changes were adopted, there were many open working calls with interested parties and Mr. Peltonen, where attempts were made to determine which securities within a Trust or SPV were ABS in accordance with SSAP No. 43R. Further, in a 2010 presentation to the North American Securities Valuation Association (NASVA), which we are happy to share with SAPWG, Mr. Peltonen concluded with the following observations:

“The preceding pages are not meant to be definite guidance on how to report municipal bonds: some are clearly Issuer Obligations, some are clearly LBaSS – and there are probably some that are clearly in between.”

“The definite determination on how to report, if in doubt, needs to be done by studying a security’s prospectus, and comparing the terms with the annual statement guidance, and SSAP26 and 43R.”

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

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

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

“When a municipal agency (that operates as a business) issues bonds they are issuer Obligations”

“When a municipal agency puts assets in a blind trust that are the sole collateral for the issued bonds, they are LBaSS”

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

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

Interested parties unequivocally believe that many of the securities issued from a Trust or SPV should continue to follow the regular amortized cost accounting within SSAP No. 26R, as they do not have prepayment or extension risk. Therefore, the modified amortized cost within SSAP No. 43R is not appropriate, as there is no need to update prepayment and extension assumptions as required under SSAP No. 43R. Examples include but are not limited to 1) where there is a direct guarantee from a corporate or

government entity (e.g., certain Issuer Obligation Municipal Bonds), even if the security is issued from a Trust or SPV for legal or other reasons (i.e., an otherwise qualifying SSAP No. 26R security, with the exception of being issued from a Trust or SPV) or 2) project finance investments which are typically issued from an SPV. Many insurance companies currently report these securities as SSAP No. 26R investments. Interested parties and many others as well (industry, regulators, SVO, and NAIC staff) believe these are Schedule D bonds where regular amortized cost accounting is appropriate.

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

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

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

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

Section 2 – Defining Asset Backed Security

Overview of Key Concepts:

- The issue paper proposes use of the CFR definition for asset-backed securities as a general principle concept for determining scope of SSAP No. 43R. Securities that do not meet the CFR ABS definition will be required to be separately discussed and scoped into the Statement (as applicable).
- Use of the CFR ABS definition clarifies that the general premise of an ABS security is one that is satisfied primarily through receivables and financial assets held in trust that, by the terms of those assets, convert to cash over a finite time period. This definition prevents use of this classification as a means to convert equity instruments into debt instruments, as equity instruments could not be captured in a trust and used as the primary source of repayment for an issued “debt” security as it would not meet the requirements of the ABS definition.

Questions / Comments:

- Are there concerns with the use of the CFR ABS definition as the general principle concept for SSAP No. 43?
- It is expected that PPNs, CFOs and other instruments where the cash flows used to pay the ABS security are not fully contingent on interest and principal payments on assets held in trust would not be considered CFR ABS securities. Comments are requested on whether this assessment is correct, or if these items could qualify as CFR ABS securities.
- Comments are requested on the securities that have historically been captured within scope of SSAP No. 43R that will not meet the CFR ABS definition that should be considered for inclusion in scope of SSAP No. 43R. (Principle concepts for these securities are requested.)

Interested parties’ comments on this section of the Exposure are as follows:

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

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

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

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

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

- 1) If an SEC definition is to be used as an anchor for ABS within SSAP No. 43R, we do not recommend that the 1933 Act Definition be used; rather, the 1934 Act Definition should be used. We believe this is a more appropriate definition for the following key reasons as also discussed in the preamble to this letter:
 - a. The intended use of the 1933 Act Definition was to determine the manner in which an ABS may be offered to potential investors and the amount of information provided to investors (e.g., registered through a more simplified S-3 registration form versus a longer S-1 registration). It was not intended to identify the entire population of investments that investors and the capital markets consider to be ABS.
 - b. The more widely used definition of an ABS is contained in the 1934 Act Definition and was relied upon by Congress for the Dodd-Frank Act to determine which ABS issuances must comply with the risk retention rules. That means the 1934 Act Definition was more recently evaluated, versus the 1933 Act Definition, and determined to be an appropriate definition of ABS.
 - c. The key types of ABS that are included in the 1934 Act Definition and not in the 1933 Act Definition include the following, which are considered by investors in the capital markets to be ABS securities:

issued by the NRSRO with the corresponding registration. An NRSRO without the registration is free to rate the deal, but for federal law purposes, the NRSRO's work product is just a credit opinion. In practice, NRSROs that are not registered with the SEC to rate ABS are typically not chosen by issuers to rate widely syndicated, publicly registered offerings of plain vanilla ABS. But issuers of any other ABS, such as ABS issued in 144A offerings, may well choose any NRSRO, particularly if the targeted purchasing base does not need any rating benefit under federal law.

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

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

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

Question 2 above: It is expected that PPNs, CFOs and other instruments where the cash flows used to pay the ABS security are not fully contingent on interest and principal payments on assets held in trust would not be considered CFR ABS securities. Comments are requested on whether this assessment is correct, or if these items could qualify as CFR ABS securities.

Interested parties have included in Section 5e of this letter, comments related to PPNs.

Regarding debt tranches of CFOs, Interested parties believe such investments should be reported on Schedule D as bonds and be afforded regular amortized cost under SSAP No. 26R accounting when the debt tranches issued from a CFO have adequate protection such as overcollateralization, significant diversification, reserves, liquidity facilities, etc. to ensure they perform like debt, as discussed in more detail in Sections 5c and 5d of this letter.

Some CFOs are originated through self-securitizations on the part of insurers (e.g., Schedule BA assets securitized with tranches from the securitization being sold to unrelated third parties and/or to affiliates of the insurer, including those affiliates that are not in the ownership stack of the insurer, and/or with some tranches retained by the insurer that initiated the securitization). As discussed in our 2019 interested parties comment letter, we believe if the sale criteria in SSAP No. 103R are met and the transaction is compliant with SSAP No 25, sale accounting should be applied. That is, the original Schedule BA assets would be removed from the insurer's financial statements and the debt tranches issued from the Trust or SPV would be reported and accounted for as Schedule D bonds by any debt tranche investor. Our 2019 interested parties comment letter also discussed that these types of transactions, and other self-securitizations, are used by insurers for important business reasons (e.g., provides the ability to change the risk profile, economics and cash flows in its insurance and non-insurance companies; prevents the need for insurers to sell assets to unrelated third parties in an inefficient private market; enhances liquidity for the underlying pool of assets, etc.). When an insurer purchases some of the tranches from a self-securitization, that insurer has

changed the risk profile and the expected cash flows significantly from the original Schedule BA assets. Therefore, the newly issued debt tranches from the self-securitization should be accounted for and reported as if the insurer purchased the tranches in the secondary markets (i.e., Schedule D reporting and bond accounting).

Interested parties note that the term “RBC arbitrage” has been used when referring to some self-securitization transactions, which some view as having a negative connotation. Interested parties believe that when sale accounting is achieved in compliance with SSAP No. 103R and the transaction is compliant with SSAP No. 25, the transaction should be considered acceptable and any change in the related RBC risk should be considered appropriate. As a result, we believe that though such acceptable transactions result in “RBC optimization” (i.e., compliant with SSAPs 103R and 25; the risk and cash flows have been changed from the original Schedule BA Assets), they are legitimate transactions for legitimate business purposes. Interested parties view RBC arbitrage to be a situation where the transaction is not compliant with SSAP No. 103R or SSAP No. 25, yet the insurer reports and accounts for the transaction as if it were compliant. We provide a more detailed explanation and examples of self-securitizations in our 2019 letter.

Interested parties have included in Appendix II a list of investments that have traditionally been included in either the scope of SSAP No. 26R or SSAP No. 43R that may or may not meet the definition of an ABS either under the 1933 Act Definition or the 1934 Act Definition. It is very important to note that, when working with the two law firms, we experienced first-hand how difficult it is to apply the 1933 Act Definition and the 1934 Act Definition and how time consuming both initially and on-going it would be to identify assets in or out of scope. In many cases, whether an asset meets either definitions involves a significant amount of judgment (no bright line tests exist) and detailed analysis of each asset’s own set of facts and circumstances. We found it not uncommon for one prominent law firm to conclude that a bond is in scope of one of the definitions, while another leading law firm concludes that the bond is not in scope (inconsistent conclusions). The 1933 Act Definition and 1934 Act Definition have been interpreted for many years by legal firms and the SEC, and there is significant judicial interpretation related to scope. We also found that the analysis required to determine if an asset is in scope would likely not be simple for an insurer to perform without the assistance of outside counsel. This list was the result of an initial deep dive we performed on our investment portfolios. In all cases, we believe the asset types listed should be reported and accounted for as bonds on Schedule D because they are considered bonds in the capital markets, by investors and by the FASB (under the Uniform Commercial Code definition). We believe more work would be needed to evaluate our investment portfolios to identify additional asset types, especially if any security issued from a Trust or SPV is to be included in SSAP No. 43R. We recommend SAPWG and industry work closely together to determine how simplified principles, if this path is chosen, may be developed to include such investments in Appendix II. Other investments will also need to be analyzed as appropriate decisions will need to be made on whether such securities get SSAP No. 43R accounting or SSAP No. 26R accounting if they do not have prepayment or extension risk. As noted in the first paragraph of this section of our letter, we believe an even more simplified approach to identify the scope of SSAP No. 43R assets could be used to accomplish the same key objectives in the Exposure

Question 3 above: Comments are requested on the securities that have historically been captured within scope of SSAP No. 43R that will not meet the CFR ABS definition that should be considered for inclusion in scope of SSAP No. 43R. (Principle concepts for these securities are requested.)

See comments already provided above.

Section 3 – Accounting and Reporting for Asset Backed Securities

Overview of Key Concepts:

- All CFR ABS (as defined) will be addressed in SSAP No. 43R.
- Each ABS rated debt tranche shall be separately reported for accounting and RBC. (This requires bifurcation of combination notes or other structures where ABS tranches have been combined to form a new security.)
- Tranches reflecting residual tranches / equity classes will be addressed in SSAP No. 43R, but the guidance will require reporting of these tranches on Schedule BA at the lower of amortized cost or fair value. Guidance is proposed to clarify the subsequent reporting of this tranche, particularly for OTTI, investment income, and return of investment.

Questions / Comments:

- Are there concerns with including all CFR ABS (as defined) in scope of SSAP No. 43R and allowing for the rated debt tranches of these instruments to generally follow historical accounting / reporting guidance? This guidance determines measurement method based on CRP rating (as permitted by the P&P Manual) translated to the equivocal NAIC designation.
- Should there be guidance that provides differing accounting and reporting treatment based on whether the CFR ABS is a “common” or “broadly syndicated” structure? Is the current collateral codes sufficient to identify new categories of SSAP No. 43R securities?
- From preliminary information received, all insurer-holders of combination notes should have the information necessary to bifurcate and separately report individual tranches. (As this is necessary to properly assess cash flows under the existing requirements of SSAP No. 43R.) However, specific investments details are requested if this is a concerning element.
- Are there concerns with guidance specifying that the residual / equity tranches shall be reported on Schedule BA, on a dedicated reporting line, with a lower of amortized cost or fair value measurement method?

Interested parties’ response to 19-14 Section 3 questions below:

Question: Are there concerns with including all CFR ABS (as defined) in scope of SSAP No. 43R and allowing for the rated debt tranches of these instruments to generally follow historical accounting / reporting guidance? This guidance determines measurement method based on CRP rating (as permitted by the P&P Manual) translated to the equivalent NAIC designation.

Yes. We agree that ABS meeting the 1933 Act Definition of ABS should be included in the scope of SSAP No. 43R. However, as detailed in our responses to the questions in Section 2, the definition of ABS used in the 1933 Act is very narrow and would only capture a subset of investments that should be included in the scope of SSAP No. 43R. Therefore, if SAPWG concludes that a securities law definition must be used, we recommend the 1934 Act Definition of ABS be used in place of the 1933 Act Definition. However, we believe broad principles that capture what the marketplace generally considers to be ABS to be more appropriate.

Question: Should there be guidance that provides differing accounting and reporting treatment based on whether the CFR ABS is a “common” or “broadly syndicated” structure? Is the current collateral codes sufficient to identify new categories of SSAP No. 43R securities?

Without clearly knowing the definition of “common” and “broadly syndicated,” it is difficult to completely answer this question. That is, are these terms referring to the underlying assets held in a Trust or SPV for the ABS or do they refer to the ABS itself (i.e., investors in the issued ABS)? In the context of this Exposure, we assume that it related to the underlying assets of an ABS. However, broadly syndicated usually means that the ABS itself has been marketed to a wide range of potential investors. We recommend these terms be clearly defined. Or, as mentioned in the preamble of this letter, are these terms being used to differentiate between affiliated and nonaffiliated transactions?

Assuming these terms relate to the underlying assets in the Trust or SPV of the ABS, if the structure meets the definition of an ABS, we do not believe the accounting and reporting treatment should be different. That is a look-through approach to the underlying assets in the ABS, as discussed in other sections of this letter, is generally not appropriate.

Assuming these terms relate to the ABS debt issued by a Trust or SPV, for securities that meet the relevant definition of ABS, we do not believe the accounting and reporting treatment should be different based on whether they are “common” or “broadly syndicated”. Interested parties note that accounting methods are not determined, in either U.S. GAAP or elsewhere in Statutory Accounting, based on whether an investment is “common” or “broadly syndicated”.

Regarding whether the current collateral codes are sufficient to identify new categories of SSAP No. 43R securities, we believe we are too early in this process to properly assess whether those collateral codes are sufficient. As we progress further through this process, we will be able to provide more clarity on our views as to whether additional collateral codes will be necessary.

Question: From preliminary information received, all insurer-holders of combination notes should have the information necessary to bifurcate and separately report individual tranches. (As this is necessary to properly assess cash flows under the existing requirements of SSAP No. 43R.) However, specific investments details are requested if this is a concerning element.

Paragraph 29 of the Exposure requires the various underlying tranches of a combo note (or other structure) to be separately reported with the NAIC designation that is attributed to the rating for the specific tranche (not the rating for the overall combined instrument). We have concerns with what may be included in the undefined “other structure.” Footnote 7 of this paragraph appears to suggest that combo notes and other ABS structures, like ABS squared, are similar. This is not true. A combo note combines various tranches of a one or more ABS and issues a single tranche. Whereas an ABS squared is an ABS that has underlying debt tranches of ABS as the underlying assets in the Trust or SPV, from which the Trust or SPV then issues multiple debt tranches.

While we do not think it would be difficult to obtain information necessary to bifurcate and separately report individual tranches of a combo note, it most likely would be a manual process, which creates unnecessary operational burden for insurers. However, for securitizations, such as collateralized debt obligations (CDOs), which utilize tranches of other ABS to create a new CDO (e.g., CDO squared), we believe it would be inappropriate for the CDO, or similar securitizations, to be bifurcated as the securitization is a new securitization for which it would be impossible to unwind.

Question: Are there concerns with guidance specifying that the residual / equity tranches shall be reported on Schedule BA, on a dedicated reporting line, with a lower of amortized cost or fair value measurement method?

Most reporting entities interpret the U.S. GAAP accounting guidance to require most residual interests of securitizations be reported as bonds. We would not want to create an unnecessary GAAP to Statutory difference by classifying residual debt tranches as equity. Currently there is diversity in practice how insurers report residual tranches. Some insurers report residual tranches on Schedule D, while others report these on Schedule BA. However, the general consensus is that residual tranches of an ABS are bonds and accounted for in accordance with SSAP No. 43R. Interested parties would not object to reporting the residual tranche of an ABS in a dedicated section of Schedule BA-Bonds provided that the accounting remains consistent with SSAP No. 43R, the assets are deemed admitted assets to the extent they conform to the requirements within the statement, and the RBC is the same as reporting the investments on Schedule D (for both Life and P&C companies). Additionally, availability of audited financial statements should not impact admissibility of residual tranches of an ABS.

Section 4 – Accounting and Reporting for Non-CFR ABS (Traditional Securitizations)

Overview of Key Concepts:

- This proposes four principle concepts to identify securities that are principally similar to CFR ABS securities. If the four principles are met, this guidance proposes to have the securities treated in SSAP No. 43R as if they were CFR ABS.
- The proposed guidance suggests restricting CRP ratings to these securities to the NRSROs that are SEC registered for CFR ABS. *(This change would have to be addressed by the VOSTF and captured in the P&P Manual.)*
- Similar to the CFR ABS, each rated debt tranche shall be separately reported for accounting and RBC. (This requires bifurcation of combination notes or other structures where ABS tranches have been combined to form a new security.)
- Also, similar to CFR ABS, the residual tranche / equity class will be addressed in SSAP No. 43R, but the guidance will require reporting of this tranche on Schedule BA at the lower of amortized cost or fair value. Guidance will be drafted to clarify the subsequent reporting of this tranche, particularly in the recognition of OTTI, investment income, and return of investment.

Questions / Comments:

- Are there comments with the four proposed principles and whether they will successfully identify securitizations that are principally similar to CFR ABS?
- Will these principles capture a significant majority of the non-CFR ABS that reflect traditional securitizations? If not, what elements would disqualify those securities?
- Will these principles include securities that go beyond the intent for “traditional securitizations” and if so, what aspects would permit these securities?

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

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

The Exposure sets forth the Principles that may be leveraged to identify investments in scope of SSAP No. 43R. Those Principles include investments issued by a bankruptcy remote entity, where the underlying collateral is self-liquidating (has contractual cash flows), the underlying collateral has more than a single obligor, and the securitization provides periodic performance reports to investors. The Exposure proposes that although some investments may not meet either the 1933 Act Definition or the 1934 Act Definition,

they would still be in scope of SSAP No. 43R and be filing exempt, if they meet the Principles. As noted above and in the following paragraph, we believe that the Principles should be revised, if they are used in a final SSAP, to include a broader range of assets with predictable cash flows.

Interested parties believe that the 1934 Act Definition is a better starting point than the 1933 Act Definition, although we note that some investments falling outside the 1934 Act Definition are widely and properly viewed as ABS (e.g., are considered ABS by investors and the capital markets). We believe the use of Principles to capture and identify such investments (paragraph 33 of the Exposure) may be a reasonable approach. However, as currently proposed, the Principles are too limiting in that they would unintentionally exclude various types of assets, which should be considered ABS, that are discussed below. We recommend SAPWG and interested parties work closely together to develop the appropriate Principles; however, we offer a few recommendations thus far (not necessarily all inclusive as more work is needed to appropriately define the Principles) to more closely align the Principles with the definition of an ABS as follows:

- a. Interested parties note that both the 1933 Act Definition and the 1934 Act Definition include securities whose underlying collateral is backed by a single obligor. As a result, interested parties recommend the Principle requiring more than one obligor be removed to align the Principles more closely with the 1933 Act Definition and the 1934 Act Definition. Interested parties note that at least half of all commercial mortgage-backed securities (“CMBS”) issued today have underlying collateral (a commercial mortgage loan) from only a single obligor. All of these single-asset CMBS deals are ABS that meet the 1933 Act Definition and 1934 Act Definition. To require more than one obligor in the Principles would be inconsistent with this. Interested parties also believe single obligor transactions in ABS markets may grow in the future (e.g., Property Assessed Clean Energy; PACE bonds).
- b. The 1934 Act Definition requires that the underlying assets be self-liquidating. Certain assets with variable future cash flows (i.e., future flow assets), such as royalties (e.g., where the cash flow generated is a function of volume and/or sales price) may be perpetual in nature and hence not self-liquidating. Our interested parties comment letter would recommend that these be considered ABS under SSAP No. 43R, because the capital markets consider them to be ABS, which are debt, and they are reported as debt for US GAAP. If they are not in scope of SSAP No. 43R (e.g., no prepayment/extension risk), then they should be in the scope of SSAP No. 26R bonds. They also provide various forms of protection (such as over collateralization ranging from 50-60%), resulting in them being debt-like.
- c. ETCs/EETCs were not considered when the SEC defined ABS under the 1933 Act Definition or when Congress defined ABS under the 1934 Act Definition. As a result, they do not fall in scope of either Act. Interested parties believe such investments should be reported as Schedule D bonds as discussed throughout our letter.
- d. Regarding debt tranches of CFOs, as mentioned in Section 2 of our letter, we believe they should be reported as Schedule D bonds and apply “regular” amortized cost accounting. They are debt in that they have fixed return of principal, are considered debt in US GAAP, and are considered debt by investors and capital markets.

- e. Both the 1933 Act Definition and the 1934 Act Definition include assets with re-leasing risk. As a result, we believe the Principles should be modified to clarify that this is permissible. This concept is more thoroughly explored in Section 5f of our letter.
- f. Regarding residual asset risk, also more thoroughly explored in Section 5f of our letter, we believe this should not be relevant when determining the classification of bonds.

Section 5 – Accounting and Reporting for Non-CFR ABS and Non-Traditional Securitizations

Overview of Key Concepts:

- This section attempts to identify the types of structures that have been reported in scope of SSAP No. 43R.

Questions / Comments:

- Are there additional structures that are not captured in the noted categories?

As noted in section 2, interested parties are currently in the process of identifying securities issued from a Trust or SPV that do not meet the definition of either the 1933 Act Definition or 1934 Act Definition. This is a daunting task as the volume of SSAP No. 43R securities that need to be analyzed is substantial. Further, because the Issue Paper implies that anything issued from a Trust or SPV is proposed to be within scope of SSAP No. 43R, this analysis needs to be extended to a substantial amount of securities currently accounted for and reported under SSAP No. 26R.

Further, whether the 1933 Act Definition or 1934 Act Definition is utilized as the cornerstone of a new SSAP No. 43R, each definition has hundreds of pages of judicial interpretations, etc. that need to be sorted through. With that said, while the identification of such securities is discussed in our response in Section 2, there are often differences in how companies report such securities. For example, most companies report project financing securities and CFO-like securities under SSAP No. 26R while some report under SSAP No. 43R.

Quite possibly, the most important part of the interested parties' response to the Exposure, is the Appendix II included at the end of our letter as well as discussed in section 2 of this letter. Appendix II highlights a preliminary list of securities (e.g., any security issued from a Trust or SPV, inclusive of existing SSAP No. 26R securities) many of which interested parties do not believe meet the scope of either the 1933 Act Definition or the 1934 Act Definition. It is important to note that this is only an initial attempt at identifying securities by interested parties after a deep dive into insurers' investment portfolios. As this was a very significant effort, it illustrates how complex, time-consuming, and difficult it is to evaluate investments issued by a Trust or SPV to determine if they meet the 1933 Act Definition or the 1934 Act Definition. Much of the analysis involved an individual asset-by-asset assessment that took a significant amount of time for insurers to perform. Many more hours of analysis would be required to identify all investments issued by a Trust or SPV to determine classification in accordance with the Exposure. Even after interested parties' efforts, there is still significant uncertainty about what asset classes qualify, and often the answer is "it depends."

In order to determine appropriate principles for ABS beyond those included within these definitions, it is imperative that many issues be addressed before attempting to develop principles to capture within scope any securities issued from a Trust or SPV. These issues and the necessary steps are summarized at the beginning of this letter.

With respect to using any SEC definition as a cornerstone, two other issues will need to be addressed.

First, does the definition used incorporate both existing and future SEC interpretations as to whether a security-type meets the definition? Without incorporating existing and future interpretations, additional clarification would be needed for statutory accounting purposes, even if further principles are developed. Regulators and industry would otherwise be left with significant uncertainty as to scope. At a minimum,

the NAIC would need to develop similar interpretative guidance which would likely be both voluminous and require continual update to keep pace with market evolution.

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

Section 5a – Accounting and Reporting for Non-CFR ABS and Non-Traditional Securitizations – One Underlying Obligor

Overview of Key Concepts:

- This section addresses items that are issued through a trust / SPV but that are collateralized by a single obligor.
- If the underlying investment held in trust would qualify as a bond if held directly, the proposed guidance would retain historical accounting and reporting guidance.
- If the underlying investment would not qualify as a bond if held directly, the guidance proposes to require the underlying investment to be reported under the applicable SSAP. With this guidance, use of a trust / SPV could not be used to capture non-qualifying items on the bond schedule (such as structured notes or collateral loans).
- Pursuant to comments received, some entities may consider investments from trusts / SPV that would be captured in Section 5c or 5d of this issues paper (impacted by performance of equity investments held in trust) as bonds. These items are not intended to be captured within this “one obligor” guidance and shall be captured in Section 5c or 5d.

Questions / Comments:

- Are there comments with the proposed guidance / scope of section?
- Is the guidance in paragraph 39a sufficient to exclude investments that rely on the performance of underlying equity investments (e.g., CFOs and other structures) from the scope of the “one-obligor” provisions?

Interested parties have the following comments and observations regarding single obligor transactions issued from a Trust or SPV:

- a) The beginning of Section 5a, paragraph 37 states that “the general concept of a securitization is that the security is collateralized by contractual obligations from many diverse payers. If the structure ... has only one underlying obligor ... then the structure does not fit the criteria for a traditional securitization.”

The original concept of securitization was the transformation of financial assets – not in themselves securities – into securities. The transformation was accomplished by transferring ownership of financial assets to a discrete entity, which would issue securities backed by the assets it owned. In this way receivables, loans, leases, mortgages and other financial assets with contractual cash flows were “securitized”.

Even in the early years of securitizations, however, there were deals involving single underlying obligors. There were also deals where a single asset (usually a receivable) was the subject of a securitization. These deals made sense because it was possible for the purchaser to perform its own underwriting on the credit of the underlying obligor.

SEC guidance on the 1933 Act Definition and the 1934 Act Definition indicates that each definition recognizes single obligor deals as ABS. A brief look at the current CMBS market illustrates this:

approximately half of recent issuance in the CMBS markets consists of deals with a single commercial mortgage as the underlying collateral.

Interested parties do not understand the apparent discomfort with single obligor ABS deals. In particular, we see no reason why these particular transactions merit the treatment indicated in paragraph 41, in which potential eligibility for Filing Exemption would be determined by reference to the P & P Manual.

- b) In addition to ABS transactions that involve a single underlying obligor, there are many other transactions involving both (i) issuance from a Trust or SPV and (ii) a single obligor.

Notable examples include ETCs, EETCs and conforming CTLs, where debt is serviced via a pass-through of contractual lease payments made by the lessee for use of either real property or equipment. In these structures, all debt service payments enjoy a contractual claim to a corporate payor (via a lease or similar obligation). Unlike traditional ABS structures, there is no uncertainty around the timing of debt cash flow repayment. Since there is no prepayment or extension risk associated with these structures, reporting requirements are usually just corporate financial reporting requirements with no “servicer reports” to track performance as typically provided in most ABS structures. Therefore, these transactions behave like corporate bonds that also have an additional benefit of being secured by valuable collateral (equipment and/or real property), and we believe they should be accounted for as such in SSAP No. 26. However, if SAPWG elects not to move these transactions back to SSAP No. 26R, then these securities will need to be addressed separately in SSAP No. 43R, as they do not necessarily meet either the 1933 Act Definition or the 1934 Act Definition; nor do they meet all of the Four Principles, as set forth in the Issue Paper.

In short, both ABS and non-ABS transactions often involve (i) issuance from a Trust or SPV and (ii) a single obligor (collectively, “Single-Payor Securitizations”). Interested parties do not believe that Single-Payor Securitizations need to be subject to special rules or guidance from the P&P Manual in order to be Filing Exempt. Rather, we believe the following types of asset classes, which have historically enjoyed Filing Exempt status, should continue to retain Filing Exempt status. Such Single-Payor Securitizations include, but are not limited to, ETCs, EETCs, Project Finance, and certain Issuer Obligation Municipal Securities, as well as ABS under both the 1933 Act Definition and the 1934 Act Definition.

While no explicit rationale was offered up in Section 5a on why Single-Payor Securitizations should not be filing exempt, other than a premise in paragraph 37 which interested parties believe is inaccurate, Interested parties understand that NAIC staff concerns potentially stem from affiliated transactions that fail to meet true sale criteria and could result in RBC arbitrage if the proper accounting is not followed, especially as they relate to “equity-related” structures. We believe these concerns are already addressed (or will be addressed) as follows:

1. Part III of Section 17 already requires the filing of all investments in SCA entities – “SCA investments are transactions between insurance company affiliates (called related parties) that are subject to special regulatory considerations identified in *SSAP No. 25—Affiliates and Other Related Parties*. This Manual specifies that such transactions are not subject to filing exemption and can only be assigned an NAIC Designation if the SVO has first concluded that the transaction is like those the SVO typically assesses for credit risk.” This determination should be (and is) being done with cooperation of the SVO, the insurance company, and the applicable regulator.

If this part of the P&P Manual does not include all types of affiliated transactions that are of concern (i.e., affiliated transactions are a subset of related parties), interested parties believe this should be addressed separately, rather than commingling the concern in SSAP No. 43R's scope determination. More specifically, interested parties note that the SVO's concurrently exposed project on Bespoke Securities also raises concerns on affiliated and related party transactions.

Interested parties also believe certain additional clarifications are warranted. For example, per the guidance in Reference No. 2019-03, many interested parties believe SCA transactions do not cover securities, where an insurer or one of its subsidiaries sponsors a securitization and the insurer purchases some of the tranches of that securitization, and where the securitized assets are non-affiliated assets. Interested parties agree with this interpretation but a definitive clarifying determination may be needed.

Lastly, both the 1933 Act Definition and the 1934 Act Definition include single obligor ABS within their scope, so there is no need to single them out in the exposure if the concerns are related to affiliated transactions as affiliated transactions already need to be filed with the SVO.

2. As noted in Section 2 of this letter, interested parties have provided clarifying guidance in our October 2019 comment letter that prohibits moving assets from one schedule to another (e.g., from Schedule BA to Schedule D), which could result in RBC arbitrage, if the transaction does not meet sale criteria. Our conversations with NAIC staff suggest they agreed with these clarifications and that they would eliminate such perceived abuses.
3. Further, in response to "equity-related" structure concerns, we have suggested further safeguards to ensure only regulator supported CFOs such as CEF Debt, and similar CFO-type structures, are afforded bond accounting and Schedule D reporting. The full details can be found in Sections 5c and 5d of this letter.

If the above do not fully address the NAIC concerns, interested parties request such additional concerns be more fully articulated so interested parties can help address them. There are many valid reasons for affiliated transactions that benefit both insurance companies and policyholders and therefore regulators as well. With that said, interested parties understand the unique nature of affiliated transactions and regulators' concerns that they can be subject to abuse; so, interested parties welcome further transparency on affiliated transactions.

- c) Interested parties agree with the principle that the mere presence of a Trust or SPV, as issuer of a security, should have no bearing on whether the security itself is classified as a bond. We acknowledge that regulators are trying to be helpful in suggesting that historical accounting policy would apply if "the underlying investment held in trust would qualify as a bond if held directly".

By its premise, this key concept jumps forward to a time when the type of assets used in ABS structures has expanded far beyond the original set of financial assets that were not themselves securities. Originally, the items in trust (credit card receivables, motor vehicle leases) often were not even commonly viewed as investments, let alone securities. The ABS markets were, however, quick to innovate and expand upon basic securitization structures. One of the earliest and most notable examples would be commercial mortgages, the securitization of which has evolved into its own industry. Putting aside CMBS, only a subset of today's ABS issuance features underlying assets that insurers would commonly acquire as investments. The most notable example is CLOs, which are backed by loans rather bonds.

The look-through concept, however, has limited usefulness. If one were to look through the entities that issue single asset CMBS, an insurer might be required to account for the underlying commercial mortgage on Schedule B. Another example is “whole business securitization,” a widespread new type of ABS in which the securities issued are backed by key operating assets of a business. If one were to look through the structure to the underlying assets, under what SSAP could those assets be reported? As a separate example, the power produced by hydroelectric plants is often sold on a merchant (not contracted) basis. If a project finance deal for a hydroelectric facility were subject to the “look-through” analysis proposed in the Issue Paper, where would that facility sit on the insurer’s schedules? Taken to extremes, one can see where this approach calls into question the reporting status of billions of dollars of insurer’s assets, much of which has been considered a mainstay of insurers’ investment portfolios for decades.

Interested parties also note that the FASB generally does not look through to the underlying assets of a security. For example, FASB does not look through to the underlying assets in ABS structures.

- d) In the Issue Paper, staff asked whether Section 39a is sufficient guidance to exclude investments that rely on performance from underlying equity investments from the single-payor category. Interested parties found the guidance to be confusing. Should staff wish to exclude CFOs and similar equity-supported structures from SSAP No. 43R, it would be better to reference such structures specifically, rather than referring to “the requirements of a bond” and thereby excluding ABS backed by contractual payment obligations, such as receivables of a single underlying obligor.

That said, interested parties believe that certain types of debt issued from a Trust or SPV that owns equity investments should, in fact, qualify as bonds, particularly those structures with significant overcollateralization. We would refer staff and SAPWG to Sections 5c and 5d of this response letter for more detail on that issue.

Section 5b – Accounting and Reporting for Non-CFR ABS and Non-Traditional Securitizations – Collateral Not Owed by Many Payers

Overview of Key Concepts:

- This section addresses items that do not qualify as a securitization due to the number of underlying payers. The key concern with these structures is that the use of a trust / SPV masks the underlying risk exposure. This is because the reduction of risk, which would generally be expected in a securitization with many payers, is not obtained.
- The proposed guidance would continue to permit the issued securities as debt instruments (if they qualify) in scope of SSAP No. 43R, but would require a lower of amortized cost or fair value measurement method regardless of the NAIC designation. Also, the guidance proposes to require the SVO involvement in determining the appropriate NAIC designation. (It also includes an alternative to permit only CRP ratings from NRSROs that are SEC approved to provide designations on asset-backed securities.)

Questions / Comments:

- The guidance proposed in this section is for all debt instrument securities that do not meet the “many” payee threshold. Are there securities that would not meet the “many” threshold, but would have more than a “limited” number of payees? Explicit examples of securities that would be characteristic of this dynamic are requested.
- Should amortized cost (and not LCOM) be permitted for certain investments that are captured in this section? Explicit examples and principle concepts to differentiate these securities are requested.

Interested parties share the following comments and observations regarding securitizations involving more than one, but fewer than many, payors:

- a) We do not agree that the use of a Trust or SPV structure “masks the underlying risk exposure” of a security. The Trust or SPV structures used in the early types of securitizations have evolved and have become widespread in the financial markets. Trusts and SPVs are used so widely in finance, and indeed in business generally, that SAPWG should not place much, if any, weight on the presence of these vehicles. A Trust or SPV format is often used, as the owner of assets and issuer of securities, solely to enable the issuer to grant a security interest in the assets to debt investors *on a bankruptcy-remote basis*. The bankruptcy remote position is viewed by debt investors as a benefit. This is the rationale behind the more recent iteration of “whole business securitizations”.

Nor do interested parties agree that structures with many payors are “preferred” for securitizations. As stated previously, the CMBS market demonstrates this. Approximately half of recent issuance in the CMBS markets consists of deals with a single commercial mortgage as collateral. These deals, often referred to as single asset CMBS, have the advantage (from an investor standpoint) of allowing the investor to scrutinize and assess the underlying asset in detail. The other half of CMBS issuance consists of diverse pools of commercial mortgages. These CMBS deals offer the benefits of asset diversification, offset in some cases by exposure to asset types that the purchaser of CMBS views as more of a detriment than a positive. Some investors invest in both types of CMBS; some

invest in neither; some invest in one type but not the other. It is not possible to conclude that either type is “preferred”.

- b) The Issue Paper specifically asks if there are types of securities (other than affiliated transactions or RBC-arbitraging transactions) that are issued from a Trust or SPV which have more than one, but fewer than many, payors. Interested parties are aware of such transactions, but for the most part they have been executed in the bank markets. The typical transaction features a company that is not a strong credit, but which sells products or services to highly rated customers. The receivables generated from the company’s sales of products or services are placed in a Trust or SPV structure, which in turn issues loans or securities. Only certain receivables are eligible. In practice, the bulk of the receivables might be payable by a small handful of key customers, often of higher credit quality. The structure gives the lender exposure to the better credits (the customers) while providing some insulation from a possible bankruptcy of the company. Our expectation is that only a subset of insurance companies will invest in these transactions; but we see no reason to exclude them in advance.

We are also aware of at least one EETC transaction that would fit this description. It was the Air 2 US transaction, sponsored by Airbus, which had a mix of aircraft collateral in the SPV, some on lease to United Airlines, and some on lease to American Airlines. Airbus had previously provided financing support to those airlines, in order to facilitate the purchase of Airbus aircraft, and the manufacturer decided to exit its financing interests using an EETC structure. For all practical purposes, that deal behaved like a traditional EETC; however, it happened to have aircraft with two different airline obligors as opposed to one. This deal was a market-clearing capital markets transaction that had nothing to do with affiliated transactions or with arbitraging RBC requirements.

Interested parties expect that transactions featuring just a few obligors will remain a relatively small universe going forward. We should note, however, that if the look-through approach is applied widely, many commonplace deals are subject to being recharacterized as having a few underlying obligors. For example, a deal issued by a sports league (which itself may be an unincorporated association) might have, as its primary underlying source of revenue, payments made under contracts with two national broadcasting networks.

- c) The Issue Paper specifically asks whether amortized cost accounting (and not lower of cost or fair value) should be permitted for certain investments captured in this section. Interested parties note that it is difficult to generalize about the investments captured in this section. For most of these investments, interested parties believe that amortized cost accounting is appropriate. Rather than using the number of obligors to determine accounting treatment, interested parties believe that the nature of the investment (specifically, whether there is extension/prepayment risk, and whether the debt cash flows are likely to be serviced as contractually promised) should determine accounting treatment.
- d) The Issue Paper proposes “to require the SVO involvement in determining the appropriate NAIC designation.” Interested parties see no reason to deny Filing Exemption to these investments. As stated in other contexts, eligibility for Filing Exemption should be presumed, so long as the transactions are non-affiliated and are not designed for the purpose of RBC arbitrage (i.e., where sale criteria in SSAP No. 103R has not been met). As a practical matter, it would be very difficult to craft a definition that provides clear boundaries for “more than one, but fewer than many”.

The Issue Paper also contemplates an alternative option, where these transactions could be Filing Exempt, if they are rated by a CRP that is an NRSRO Registered for ABS. Interested parties are open to this alternative approach. Indeed, interested parties advocate defining ABS in a manner reflective of the wide range of ABS transactions in the market, and are open to discussing the possibility of limiting eligibility for Filing Exemption to ABS rated by a CRP that is a NRSRO Registered for ABS.

Section 5c – Accounting and Reporting for Non-CFR ABS and Non-Traditional Securitizations – Security Partially Impacted by Equity Collateral

Overview of Key Concepts:

- This section addresses items where the coupon payments, principal repayment and whether default occurs, is partially determined based on the performance of equity assets held in trust.
- Guidance identifies that these may be desirable investments, but are not debt instruments.
- The proposed guidance suggests alternative accounting and reporting treatment for these securities, suggesting new guidance in SSAP No. 48 or in a new SSAP.
- The information identifies that RBC may be the driving factor in reporting these investments on Schedule D-1.

Questions / Comments:

- Comments are requested on the different types of structures that would be captured within this category and if there are characteristics that are reflected in some structures that would support different accounting and reporting treatment from other structures in this category.
- Is there a different accounting / reporting approach that should be taken for these securities?
- If these items are excluded from Schedule D-1, what factors (e.g., asset coverage / over-collateralization, etc.,) could be considered in determining an appropriate RBC?

Regarding the following bullet points, as they relate to CFOs and similar structures;

- Comments are requested on the different types of structures that would be captured within this category and if there are characteristics that are reflected in some structures that would support different accounting and reporting treatment from other structures in this category.

Is it the intent to have the rule relate only to assets “held in trust”, or is it more broadly related to debt backed by equity instruments? Interested parties do not understand why a definition of whether an instrument constitutes debt should depend on the type of business entity issuing the instrument. The staff note following paragraph 53 inadvertently highlights the pitfalls of this approach. There is a discussion of Closed-end Fund debt, some of which is issued by funds owning only equity securities. It is noted that some reporting entities classify these as bonds in SSAP No. 26R. Then a comment is made that NAIC Staff had expected such instruments to be captured in SSAP No. 43R “due to the presence of a trust structure”. However, there is no trust structure as most closed end funds are corporations.

The regulatory concerns stated in Section 5c and 5d seem to have migrated from an understandable concern over instruments where the investor’s contractual entitlement under the instrument directly depends on the performance of an equity security or index, to a much more sweeping concern over debt securities where the investor’s practical ability to collect principal and interest is impacted in some general way by the “performance” of equity assets held by the issuer of the instrument. Interested parties understand the concerns over the former category, in which the instrument resembles, in some ways, a variable annuity. The latter category, however, could encompass a wide array of securities, particularly if the aspect of a Trust is discarded, and the rule is written to apply to instruments issued by any type of business entity. The following paragraphs will attempt to illustrate this.

Debt securities whose repayment is dependent upon equity ownership interests are common and have trillions of dollars of issuance outstanding. Debt securities whose repayment is dependent upon equity ownership are viewed by the SEC, capital markets, rating agencies, and accounting standards organizations (FASB and IFRS) as bonds. Examples of debt issued by corporations, limited liability companies, partnerships, trusts and other business entities whose performance is wholly, or partially based on the performance of equity instruments include:

Holding Companies: Holding company debt is prevalent. There are thousands of holding company debt issuers worldwide, including well known corporations such as Berkshire Hathaway, Alphabet, utility holding companies (e.g. DTE Energy or Alinta) or banks (e.g. JP Morgan or Barclays). These holding companies do not have operating businesses, but instead have ownership interests in subsidiaries, which can take the form of equity shares or partnership interests.

Often, debt issued by a holding company is not guaranteed by the holding company's subsidiaries. Instead, holding companies look to the equity of their subsidiaries to meet all holding company obligations. Subsidiaries can pay dividends to the holding company so the holding company can service its debt, for example. Alternatively, a holding company can sell equity interests in its subsidiaries and use the proceeds from the sales to service holding company debt. The SEC, capital markets, rating agencies and accounting standards organizations (FASB and IFRS) all view obligations for borrowed money at holding companies as debt. The Internal Revenue Service also recognizes such obligations as debt. (Indeed, insurers who purchase such obligations are often required to furnish a Form W-9, which is designed to give the IRS the practical ability to double check whether the insurer is accurately reporting the receipt of interest income on its federal tax return.). The fact that the assets of the holding company are equity does not cause debt obligations to be recast as equity. Obligations for borrowed money are debt, notwithstanding the fact that dividends made by a subsidiary to a holding company can only be paid to the holding company if the subsidiary is solvent. Dividends from subsidiaries are further restricted by financial covenants imposed by lenders to the subsidiary and by corporate law limiting dividend payments to those payable out of surplus. Holding companies issue both amortizing debt and bullet maturity debt (where the holding company is taking refinancing risk). Debt is repaid from dividends, equity sales or refinancing.

Business Development Corporations ("BDCs"): BDCs are authorized by the 1940 Act. BDCs invest in the debt and the equity of underlying portfolio companies that they finance. BDCs rely upon income from, and the continued harvesting of, such investments to service debt issued by the BDC. Borrowed money issued by BDCs is considered debt by the SEC, capital markets, rating agencies and accounting standards organizations (FASB and IFRS). BDC obligations for borrowed money are not re-characterized as equity, even though the assets of the BDC are not operating assets, but instead financial instruments held by the BDC.

Real Estate Investment Trusts ("REITs") and Master Limited Partnerships ("MLPs"): Under U.S. Federal income tax law, a REIT is "any corporation, trust or association that acts as an investment agent specializing in real estate...". The early REITs focused on the ownership of mortgages. Today, most REITs focus on owning real estate equities.

The Omnibus Budget Reconciliation Act of 1987 (also known as the Revenue Act of 1987) delineated that an MLP must earn at least 90% of its gross income from qualifying sources, which were defined as the transportation, processing, storage, and production of natural resources and minerals. MLPs typically do not own the operating assets directly, but instead like REITs, they focus on owning the equity of entities that own assets that generate qualifying income.

The underlying REIT and MLP assets that generate earnings and cashflows are not owned directly, but rather in an array of subsidiaries that may be partnerships, limited liability companies or other vehicles. REITs and MLPs rely upon cash flow paid from equity interests, and often the sale of equities, to service debt issued by the MLP or REIT. In that sense, the practical ability of the holder of REIT or MLP debt to collect depends on the “performance” of the equities owned by the REIT or MLP. The SEC, capital markets, rating agencies and accounting standards organizations (FASB and IFRS) characterize obligations for borrowed money issued by MLPs or REITs as debt. These obligations are not recast as equity.

Closed-end Funds (“CEFs”): Debt issued by listed 1940 Act vehicles that invest in equity or debt securities are another example of debt securities that, in many instances, are backed by equity holdings. These funds often issue debt and/or preferred stock (both of which are regulated as leverage under the 1940 Act) to enhance the expected returns for shareholders in the funds. The debt issued by the CEFs is serviced from dividend and interest income generated by portfolio holdings. CEFs, in effect, use debt as a margin financing. Indeed, in some instance holders of CEF debt must make filing under margin lending rules. The 1940 Act reflects this reality with certain built in protections for lenders, and lenders to CEFs often impose additional limits on the use of leverage. For instance, covenants in debt instruments often require the CEF to repay its borrowed money, if the market value of its portfolio does not exceed the value of its debt by a specified coverage level. The SEC, capital markets, rating agencies and accounting standards organizations (FASB and IFRS) do not consider borrowed money issued by CEFs as anything but debt, even though the assets of many CEFs consist solely of equity shares whose market values change constantly. CEFs pay debt service through dividends received from equity shares held by the CEF, or by sale of shares owned by the CEF, as well as by refinancing.

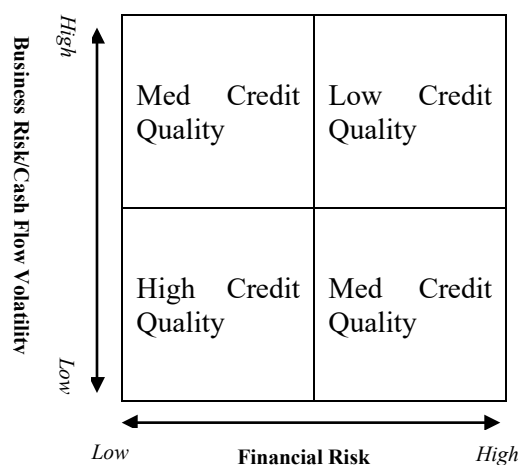
Collateralized Fund Obligations (“CFOs”): CFOs are similar to Closed-end Funds in that they typically invest in equity securities (main difference is the CFOs invest in partnership stakes in private equity funds or in privately held companies, while CEFs typically invest in public stock or debt). The underlying funds do not guarantee the debt issued by a CFO, but the debt issued by a CFO benefits from significant overcollateralization and, in some cases, reserve accounts and/or liquidity facilities that ensure the contractual debt payments can be made under a variety of market conditions. Private equity firms have accumulated business holdings that rival, and in some case exceed, the total amount of operating company assets controlled by major corporations. The portfolio holdings of private equity funds contain many individual companies and often are more diverse in their industry and economic cycle exposure than corporations that sell a single product or service. CFOs service their debt from dividends received from portfolio companies, sale of portfolio holdings or refinancing, and in that sense, are no different than debt issued by holding companies, BDCs, MLPs and REITs or CEFs.

CFOs are structured with protections for the investors who provide borrowed money or debt to the CFO. As with CEFs, lenders benefit from covenants that limit leverage, typically with respect to the market value of the assets in the CFO. The leverage limits for CFOs tend to have greater structural features than Closed-end Funds to protect lenders to CFOs, because CFOs invest in pools that hold illiquid assets lacking observable market values. Because CFOs own less liquid investments, the value of these investments often is not directly observable by a quotation on an exchange, but instead is determined by a valuation process that compares the less liquid valuation to liquid assets, adjusted for an illiquidity charge. Debt issued by CFOs is recognized by the SEC, capital markets, rating agencies and accounting standards organizations (FASB and IFRS) to be debt or borrowed money, just as borrowed money for holding companies, which rely upon ownership interests, have their borrowed money classified as debt.

Investors, lenders and rating agencies assess the risk of the debt issued by a CFO using the same fundamental principle used by a lender to a holding company, BDC, MLP and REIT, or CEF: evaluation of the stability/predictability of the cash flows received from the underlying assets, combined with the level of overcollateralization. In all cases, no matter the legal form of the borrower, be it a holding company or

otherwise, the amount of debt permitted for a given risk level, or rating of the probability of payment interruption, is sized based upon the certainty and predictability of the cash flow of, and/or salability of, the assets held. The more stable and predictable the cash flows, the greater leverage allowed. Sizing of debt backed by the equity interests in the investment grade markets is done to ensure that, under a variety of market conditions, the debt can be serviced by the cash flows received from the underlying investments.

If overcollateralization levels decline, the assigned ratings on the debt security decline as well. In addition, if the cashflows are insufficient to service the contractual debt payments, the debt security issued by the CFO will be impaired to reflect this.



Under Sections 5c and 5d, interested parties would like to note the descriptions that the exposure uses (namely, “partially” and “solely”) to separate the securities addressed between the two sections (in Section 5c “items where the coupon payments, principal repayment...is partially determined based on the performance of equity assets held in trust”, and in Section 5d “items that are solely contingent on derivative or equity collateral and references to equity index performance”). Because the word “partially” can refer to a wide range of variabilities, as currently worded in Section 5c of the Exposure, a wide array of securities may fall within the scope and securities whose repayment is partially determined by the performance of equity assets on one end of the spectrum would be treated the same as those securities on the other end of the spectrum. This may not appear to lead to improved accounting or reporting. Thus, interested parties would like to seek clarification of the Exposure’s intent in this regard. Please see comments under Section 5d for interested parties’ view on “solely”.

- Is there a different accounting / reporting approach that should be taken for these securities?

In analyzing debt securities backed by equity interests, rating agencies and investors attempt to understand the level of subordination, volatility of the cash flows and sensitivity to underlying asset price volatility. The ratings vary based on changes in these factors. These securities do not vary from the principle used in the insurance industry to capture investment risk for all Schedule D Assets: ratings issued by a CRP are accepted by the SVO, or if no CRP rating exists, a designation from the SVO is applied. SSAP No. 26R recognizes this fundamental accounting hierarchy in insurance regulation as applied by the P&P Manual of the SVO. In all cases, if the risk increases, the designation will decline to a higher capital charge designation, ensuring that the insurance company holds appropriate capital for the investment risk held. Industry acknowledges that the Regulators may want Schedule D to provide more disclosure as to the investment type and are willing to accommodate, if helpful. Industry also affirms that reporting

classification is independent of the fundamental principle of investment risk, which is, as risk increases, the designation is accordingly recognized with a higher SVO classification on the scale from 1-6. At the same time, industry strongly believes that these forms of borrowed money are debt, no different from any other debt instrument recognized by SSAP No. 26R. Therefore, industry believes regular amortized cost accounting is appropriate for these securities

- If these items are excluded from Schedule D-1, what factors (e.g., asset coverage / over-collateralization, etc.,) could be considered in determining an appropriate RBC?

Rating agencies have established criteria where they assign ratings that consider a variety of factors, including the volatility of cash flow, the degree of overcollateralization or excess of value of the assets relative to the debt outstanding, the liquidity of the entity that must service the debt relative to the frequency of scheduled debt payments, structural and legal protections including bankruptcy-remote entities that ring fence assets, and covenants giving the lender of the borrowed money rights to force asset liquidation and other remedies, if risk rises to trigger threshold metrics. The preceding is a fundamental process of assessing investment risk ratings. Interested parties believe that risk ratings assigned by either CRPs or the SVO (if filed for a designation) should drive RBC charges.

Section 5d – Accounting and Reporting for Non-CFR ABS and Non-Traditional Securitizations – Security is Solely Impacted by Equity Collateral / Equity Index

Overview of Key Concepts:

- This section addresses those items that are solely contingent on derivative or equity collateral and references to equity index performance. The proposed guidance would exclude these securities fully from SSAP No. 43R.
- NAIC staff believes the treatment is in line with the interested parties' comment letter, and clarification has been included to reflect what is considered an "equity" instrument.

Questions / Comments:

- Is the guidance clear as to what should be considered an equity instrument and excluded from the scope of SSAP No. 43R?
- Are there structures that would be captured within this guidance that would reflect an unintended consequence of what is intended?
- Comments are requested on whether these structures would include differing types of investments (combinations of equity / derivative instruments) and if specific guidance requiring bifurcation should be captured.

Regarding the following questions, as they relate to debt backed by equity or other risk assets, that is dependent on risk asset performance to service debt:

- Is the guidance clear as to what should be considered an equity instrument and excluded from the scope of SSAP No. 43R?

Interested parties agree that an instrument that is solely contingent upon derivative equity (a contingent right) or solely contingent upon equity index return has the characteristics of equity. However, interested parties do not agree that an instrument that is solely backed by equity can never be debt. Holding companies often own nothing but equity in subsidiaries. Loans made to holding companies are debt and recognized as such by the SEC, the IRS, commercial contract law, recognized accounting standards, and rating agencies, even though the entity that issues the debt solely owns equity interests. In addition to holding companies, there are other legal entities that issue debt, including limited liability companies, trusts, partnerships and other legal entities which also indirectly own assets, and whose form is chosen for tax treatment reasons. The problem with the above characterization in the "Overview of Key Concepts" is that the premise proposed for SSAP No. 43R conflates the form of an instrument to its risk and return characterization narrowly because the proposal appears to exclude considerations for the structural enhancements (e.g. requiring that equity value to exceed the debt, reserve accounts and other features designed to provide downside protection) that exist to make the security a marketable debt instrument. Debt results when an instrument has sufficient cash flow resources (including assets that can be converted to cash) and structure to reduce the payment risk to the point where the instrument can support a stated coupon and maturity. Debt is distinct from equity, but the element that makes a debt instrument is not the legal form, per se, of what backs that instrument. Instead, it is the elements where the debt instrument has sufficient cash flow, and assets that can be converted to cash, or refinanced based on their value, that allow that instrument to have sufficient certainty of payment. Debt repayment is less volatile than equity, and as

the certainty of debt repayment increases, the credit quality of the debt rises, but equity alone can still underpin a debt instrument.

- Are there structures that would be captured within this guidance that would reflect an unintended consequence of what is intended?

Interested parties would like to clarify the term “solely,” as there are debt securities that are backed by equity interests that have materially different risk profile than the equity assets backing the debt. This different risk profile is mainly due to significant overcollateralization and structural enhancements (e.g. covenants and reserve accounts) that work to preserve bond like characteristics under a variety of market conditions. Hence, while the “sole” assets backing the debt may be equities, the debt does have a materially different risk profile. The sole assets backing a REIT’s unsecured public bonds is typically equity interests in real estate, but that does not mean that the unsecured REIT debt is itself an equity. The unsecured REIT debt has a very different risk profile versus equity interests. Further, interested parties would like to state that corporations, partnerships and other entities all can own assets, but the type of entity used to own an asset or assets, and then issue a debt instrument, does not impact whether the borrowed money is debt.

The legal form of the issuer is, in some cases, selected to obtain specific tax treatment of income from the issuer, and in some other cases, to legally isolate the transferred financial assets, to give a few examples. But in of itself, the legal form of an issuer holds no bearing on what constitutes the core of borrowed money or debt.

- Comments are requested on whether these structures would include differing types of investments (combinations of equity / derivative instruments) and if specific guidance requiring bifurcation should be captured.

Look through treatment can be appropriate in narrowly defined circumstances as is the case with combo notes. In many other contexts, however, look through treatment can lead to philosophical abstractions that, in practical application, end up transforming a REITs debt “backed” by a real estate equity, into equity itself. Bifurcation may also be appropriate if the underlying assets are a combination of equity and debt securities and all returns are directly passed through to investors. Interested parties suggest that the look through concept or bifurcation approach be applied only on a case-by-case basis, as an aid to analysis rather than a binding rule.

In conclusion, related to CFO investments, we agree that 1) instruments where the amount of principal or interest payable contractually varies based on the appreciation and/or depreciation of underlying equities warrant a different accounting treatment and therefore different reporting treatment than the bond section of Schedule D and 2) instruments that create RBC “arbitrage” (i.e., by moving Schedule BA assets to Schedule D without meeting sale criteria in SSAP No. 103R) should be prohibited.

However, any proposed scope clarifications should only address the perceived abuses and not have detrimental consequences to a broader range of CFO investments which are appropriate and beneficial for insurance companies’ investment portfolios. For example, there are many CFO-type investments with a fixed coupon and fixed principal, that have adequate structural features such as overcollateralization and/or liquidity facilities, such that equity appreciation is not required in order to service debt obligations, and in fact, the value of the underlying equity investments can fall substantially, without jeopardizing debt repayments as scheduled (e.g., CEF Debt and other similar structures). Interested parties believe these structures are bonds, appropriate for schedule D reporting, and should be eligible for filing exemption.

The Exposure states that NAIC staff believes regulators do not believe any equity-backed investments should be reported as bonds on Schedule D. This is not consistent with our discussion with some regulators,

who view that the aforementioned- types of securities with overcollateralization and fixed coupon rates and maturities are bonds and should be accounted for as bonds and reported on Schedule D. We would appreciate if regulators that share NAIC staffs' expressed view or have concerns would provide written comments on their specific concerns so we can help address them. We would welcome the opportunity to provide education on CEF Debt and other CFO structures that interested parties (and the SEC) unequivocally view as debt.

For the benefit of NAIC staff and regulators, included in Appendix III of this letter, is an overview of typical non-abusive CFO issued debt, which interested parties believe should be accounted for as bonds and reported on Schedule D.

Section 5e – Accounting and Reporting for Non-CFR ABS and Non-Traditional Securitizations – Principal Protected Notes

Overview of Key Concepts:

- This section addresses principal-protected notes (or similar structures), in which only a portion of the assets held in trust ensures the repayment of principal at maturity.
- As detailed, the Valuation of Securities (E) Task Force is currently proposing to exclude these instruments from filing exempt, and require submission to the NAIC SVO in determining NAIC designations.
- In addition to the filing exempt exclusion, the issue paper proposes consideration of a lower of amortized cost or fair value measurement method, as well as restrictions in using the “intent and ability to hold guidance” in determining OTTI.

Questions / Comments:

- In addition to the PPNs, are there other instances in which SSAP No. 43R securities are issued with stated interest rates that would be substantially lower than if the debt instruments were held individually?
- Is the proposed lower of amortized cost or fair value measurement method and the OTTI provisions appropriate for PPNs?
- Should there be additional disclosures for PPNs in the financial statements?

PPNs, as described in the Issue Paper, present unique considerations due to structuring which creates a difference between the yield implied by the contractually promised fixed-schedule payments and the expected total yield at the time of investment. Contractually promised payments are satisfied by underlying bonds (which would, on a stand-alone basis, qualify as filing exempt debt instruments under SSAP Nos. 26R or 43R), but the structure offers other potential returns via the presence of other assets, a contractually promised yield well below market comparable credits, or a combination thereof. There is a substantial component to PPN structures that exhibits characteristics consistent with qualifying debt instruments (contractually promised fixed-schedule payments, contingent upon the credit risk of the underlying debt issuer(s)), but there is also a component that may either generate additional return on investment or alternatively erode the portion(s) of initial invested basis (acquisition price) associated with its unique expected future cash flow prospects.

PPNs are finite term investment vehicles with structured fixed-schedule payments covered by underlying monetary assets (by their terms converting to cash within a finite time period). Much of the specific performance measurement and valuation guidance already outlined within SSAP No. 43R, including the qualification of continuous monitoring of currently expected underlying cash flows, is already well suited to capturing the economic substance of PPN structures, including for impairment. Interested parties, however, would take no objection to restrictions in using the “intent and ability to hold guidance”, in determining impairment, due to the “lower than market” yield often associated with such investments.

Interested parties further note that the VOSTF has now adopted finalized guidance to exclude these instruments from the filing exempt universe thus requiring their submission to the SVO for determining an NAIC designation. The analysis of cash flows employed by the SVO in executing their Weighted Average

Ratings Factor (“WARF”) methodology for designating credit and other non-payment risk on PPNs is meant to address the real risk associated with these investment (i.e., to obtain the appropriate RBC charge), and with the more strict impairment requirements noted previously, interested parties do not believe lower of cost or market accounting is necessary. We are open to considering whether the inherent diversity of Schedule BA might ultimately serve as the best fit; particularly given that it already has a classification grouping for investments with underlying characteristics of fixed income attended by a data field for NAIC Designations. Interested parties further take no objection to further disclosures surrounding such investments, if regulators feel such disclosure would be beneficial.

Section 5f – Accounting and Reporting for Non-CFR ABS and Non-Traditional Securitizations – Collateral is Not Cash Generating and Not Equity (e.g., artwork held in trust)

Overview of Key Concepts:

- This section addresses structures where the collateral held in trust is neither a cash-generating debt instrument nor an equity security.
- The guidance proposes to exclude these structures completely from SSAP No. 43R. It is identified that such structures may be designed to circumvent reporting if the underlying collateral had been held directly.

Questions / Comments:

- Is the guidance clear enough to ensure that this only captures non-cash generating assets and non-equity securities?
- Are there structures that would be captured within this guidance that would reflect an unintended consequence of what is intended?
- It is anticipated that these structures are not overly common, but information would be requested on the prevalence of these instances.

Interested parties offer the following comments and observations regarding structures taking asset risk:

- a) First, it should be noted that the commentary in this section often strays far from most definitions of ABS, including the fairly narrow 1933 Act Definition. The 1933 Act Definition includes ABS backed by many types of underlying financial assets, not just ABS backed by debt instruments. It requires that the ABS be primarily serviced by the cash flows from the underlying financial assets, while allowing for some level of physical asset releasing/refinancing risk within the structure.
- b) The 1933 Act Definition goes on to provide some definition around the word primarily. For securities backed by leases, the portion of the pool balance attributable to the residual value of the physical property may be as high as 50%; in the case of motor vehicle leases, as high as 65%. In short, the securities are backed partly by a financial asset (a lease) and partly by a physical asset. The physical asset would fall between the bookends of “neither a cash generating debt instrument nor an equity security”.
- c) SAPWG rules should distinguish between (i) securities backed by non-admitted assets that, by their nature, are not cash generating (e.g., collector’s items or artwork) and (ii) securities backed by non-admitted assets that are capital assets, used and useful in commerce, such as ships, aircraft, railcars and power plants. An entity that owns capital assets can generate cash flow through the operation, lease or sale of the assets; and a lender to that entity can assess whether the cash flows likely to be generated will suffice to repay debt. Lease-backed debt instruments have been held by insurers since the nineteenth century. The most common type, for many decades, was debt instruments secured by locomotives and rail cars. Title to the rolling stock was held by an equipment trustee, and the rolling stock was on lease to a railroad. More recently, lease-backed debt instruments have been secured by ships and aircraft. From the standpoint of the insurer holding the debt instrument, it has always been of critical importance to have a valid security interest in the leased collateral,

and the ability to repossess such collateral in the event of a default by the lessee. The security interest also affords protections, should the lessee go directly into bankruptcy. In the event of an outright liquidation of the lessee, however, or the rejection of a lease in bankruptcy, the debtholder can become the owner of the collateral. Therefore, it is important to understand that the investor views the collateral as an extra form of protection and a benefit, above and beyond the contractual obligation of the underlying equipment operator to pay for such equipment's use.

- d) This has always been the case with lease-backed debt instruments. Investors need to understand that they might become the owners of the collateral, whether they want to or not. This is true, whether the collateral is motor vehicles, boats, aircraft, rail cars, industrial equipment, or otherwise. The taking of ownership occurs very infrequently, but it has happened in the past and will surely happen again. When lenders take ownership, the assets are almost never held directly. Entities are set up to hold the assets, in part to limit liability, and also to allow the issue of shares or other instruments reflecting percentage ownership where more than one lender is involved. Once a lender has become an owner, the lender's ownership interest may need to be impaired substantially, or even non-admitted. In fact, impairment would likely occur well before the lender becomes an actual owner. Notwithstanding these accounting consequences, insurers have been willing to take ownership of leased assets, in cases where the assets are still useful in commerce and capable of generating cash flows from potential unaffiliated users (unlike the examples cited in the Issue Paper). In contrast to bank regulators, who assign considerable positive value to collateral held by bank lenders, commentary in the Exposure seems intent on recognizing no benefit to insurance lenders for the potential to release, refinance or sell collateral in order to service or repay secured debt investments.
- e) Industry is very surprised to see the NAIC look to promote the policy that, if the leased asset would be non-admitted if eventually owned by the insurer (following a lessee event of default, or following an SPV's inability to refinance a balloon debt maturity at lease expiry), then the debt instrument backed by the leases of such assets must be non-admitted as well. What would the result if this concept were applied to ABS backed by motor vehicle leases where there is releasing risk or relatedly residual asset risk? Would the answer be, if the motor vehicles could not be held as admitted assets, neither can the ABS? Other examples could be provided of lease backed securities might suddenly become non-admitted just because of releasing risk. Is this best for insurance companies, regulators and ultimately policyholders? We understand the regulatory concern with debt securities backed by physical assets that are very unlikely ever to generate cash flows (e.g. corporate art). To adopt the concept broadly across all physical assets as suggested above, however, would be to undermine the concept of secured lending altogether.
- f) In addition, interested parties note that SAPWG's current concerns around releasing/refinancing risk for SSAP No. 43R structured securities directly conflicts with how debt is treated within SSAP No. 26R. A great many corporations and municipalities issue debt with bullet maturities. It is very often the case that such debt maturities are larger than the free cash flow expected to be generated by the underlying business or municipality in any given year. In such instances, investors in corporate and municipal debt are inherently taking refinancing risk. Should the corporation or municipality fail to refinance their debt maturities, debt investors pursue remedies. In the case of corporate debt, unsecured debt investors may convert their claims into equity of the insolvent corporation as part of a bankruptcy, and thereby gain control of the corporation's assets. A process identical in substance could take place with debt issued by a Trust or SPV that holds a leased asset,

where the debt has a balloon maturity payment obligation. If the borrower is unable to refinance its balloon maturity debt obligation, investors may foreclose on the underlying collateral within the Trust or SPV and sell or re-lease the collateral in order to recoup their investment. In essence, this is the same outcome that occurs with the corporation unable to refinance its debt obligations. The risks are inherently the same, regardless of whether a security sits within SSAP No. 43R or SSAP No. 26R. Therefore, interested parties do not understand why the Issue Paper contends that Single-Payor Securitizations with residual value/refinancing risk should not be accounted for as bonds.

- g) Refinancing risk is a fundamental part of any credit assessment process. The existence of refinancing risk should have no bearing on whether a security is classified as a bond. Instead, refinancing risk is one of many risks inherent in a security and is therefore relevant in determining the appropriate capital requirements for that security. Interested parties believe that SAPWG is better served to focus on the nature of the underlying collateral for SSAP No. 43R securities, rather than focusing on whether there is an element of refinancing risk. If the underlying collateral is used or useful in commerce and can be operated, re-leased or sold to generate cash flow (in the event that the debt cannot be refinanced at maturity), then the security should be granted bond accounting treatment. If the underlying collateral is, by its nature, not used or useful in commerce (for example, collectors' items), then debt backed by such assets is unlikely to merit bond accounting treatment.

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

Sincerely,

D. Keith Bell

Rose Albrizio

cc: Interested parties

Appendix I

History of SEC and Congressional Definitions of Asset-Backed Securities

In the early 1980s, Congress strongly supported enhanced liquidity in the mortgage loan markets to facilitate home ownership, and the government sponsored entities, Fannie Mae and Freddie Mac, along with Ginnie Mae, were key participants in developing residential mortgage-backed securities (RMBS). In 1984, Congress adopted the Secondary Mortgage Market Enhancement Act (SMMEA), which added a definition of “mortgage-related security” to the 1934 Act and preempted state law to allow insurance companies to purchase mortgage-related securities. When the SEC modified its procedures to facilitate quicker public securities issuance by large companies with an established reporting history, it added mortgage-related securities to the issuances that could use those procedures. The SEC—which has dual missions of investor protection and supporting capital formation—had recently adopted Rule 415, allowing securities to be issued on a delayed or continuous basis through shelf registration on Form S-3. Rule 415 was expanded to permit mortgage-related securities to use shelf registration, even without the reporting history.

In 1992, the SEC decided to expand shelf registration under Rule 415 to asset-backed securities, which had developed in the mid-1980s as the techniques used for RMBS created funding opportunities for other assets, like credit card receivables and equipment leases. In 1992, the SEC also adopted a rule under the Investment Company Act of 1940, Rule 3a-7, to clarify that the issuers of asset-backed were not investment companies required to register under the '40 Act. Both rules used the same definition for asset-backed securities, with the key principle being that shelf registration and the '40 Act exemption would be limited to offerings of securities backed by “a discrete pool of financial assets that by their terms convert into cash within a finite time period.” There were a few goals here:

1. Limit the use of shelf registration for issuers without a reporting history to structures with an asset pool that investors could assess quickly
2. Maintain clear lines between an “asset-backed security” and an investment company that should be registered (in this case by requiring that the issuing entity not be actively managed, that it have a discrete pool of assets, and that the assets be self-liquidating (i.e., no equity securities))
3. Provide a safe harbor for sponsors of asset-backed securities under the '40 Act
4. Ensure that the securities offered were high quality by requiring them to be rated by a nationally recognized statistical rating organization (NRSRO)

ABS disclosure was a square peg in a round hole. The SEC issued a variety of no-action letters that explained to issuers which parts of the SEC disclosure requirements applied to ABS and which parts did not, and established an alternative reporting regime that relied on knowledge of guidance and lore more than formal rules. In 2004, the SEC consolidated its guidance into Regulation AB and adopted new, formal disclosure requirements focused on pool characteristics, parties and deal structure, while specifically exempting ABS prospectuses from requirements for audited financial statements, MD&A and other requirements that were relevant to operating companies but not to asset pools. Regulation AB moved the definition of “asset-backed security” into a rule, but did not change it significantly from that used to determine eligibility for Form S-3.

In 2007-08, the financial crisis hit, and Congressional focus turned to mortgage-backed securities—in particular, the assertion was that subprime mortgages were originated without adequate underwriting because the lenders knew they could offload all of the risk of the assets by securitizing them. The proposed solution was risk retention—requiring sponsors of securitizations (and in some cases loan originators) to retain a portion of the risk of securitized assets so that they would be more careful in their originations. Because there was concern that similar issues could arise from “originate to distribute”

models in other asset classes, Congress decided to apply risk retention requirements to all securitizations of assets with credit risk—loans, leases, mortgages and receivables—to improve credit underwriting. The SEC had tried to have a narrow focus with its definition of ABS to restrict the securities that could achieve shelf eligibility and use different disclosure rules. Congress was much more concerned about capturing the portion of the securitization market that securitized debt, and Article IX of the Dodd-Frank Act imposes risk retention obligations on the sponsors of securities that depend primarily on the cash flows from self-liquidating financial assets—in other words, those that by their terms convert into cash in a finite time period. It does not try to capture all ABS.

Appendix II

Asset-Backed Security Definitional Review

Both transaction structure and asset pool composition may determine whether an investment is in scope of the definition of “asset backed security” under the 1934 Act or under the 1933 Act (Regulation AB). Key considerations include whether any securities are issued, whether such securities “depend primarily on the cash flow” from the asset pool, the type of financial assets comprising the pool, and the underlying collateral, if any, supporting the financial assets. Accordingly, interests in one structure may be in scope of the definitions, but interests in a different structure supported by the same asset type may be out of scope. Each issuance requires nuanced analysis, and different counsel (and different regulators) may reach different conclusions about a single structure and asset pool. Moreover, the characterization of any transaction depends on the time at which it is evaluated and the characteristics of the asset pool existing at that time. This document is intended to provide some general considerations in determining whether a transaction could be considered in scope of the 1934 Act Definition or the 1933 Act (Regulation AB) Definition, but a thorough analysis should be conducted with respect to any particular transaction to determine whether it would be in scope of the 1934 Act Definition or the 1933 Act (Regulation AB) Definition. We note that many of the securities that fall outside of both definitions are considered by the market to be asset-backed securities, especially those that have predictable cash flows and that legally isolate the assets.

Asset Class	Description	1933 Act (Regulation AB) analysis	1934 Act analysis
Residential Mortgage Backed Securities	Securities issued by a special purpose entity (SPE) that owns a pool of underlying residential mortgages (mortgage pass through security or collateralized mortgage obligation or CMO). The underlying mortgages can be prime (high credit quality) or subprime, they can be guaranteed by a federal agency or government-sponsored entity (collectively Agency RMBS) or not (non-Agency RMBS). The mortgage cash flows (and, if applicable, servicer advances and guarantee payments) are the source of repayments of interest and principal on the securities, and the security holders have a security interest and/or fractional undivided interest in the mortgages themselves. Investors in non-Agency RMBS typically benefit from various forms of credit enhancement such as (i) credit and prepayment tranching; (ii) shifting interest mechanism - whereby payment to junior classes of debt holders can be skipped for a period of time to prevent the level of credit enhancement from deteriorating over time; (iii) over collateralization; and (iv) reserve accounts.	Typically, yes, subject to compliance with the restrictions on pool and structure set forth in the Regulation AB definition	For non-agency RMBS, typically yes. For agency RMBS, a question remains as to whether payments on the securities depend primarily on the cash flows from the mortgage-loan pool or whether they depend primarily on the GSE payment obligation under the guarantee. This has not been tested, because agency RMBS is exempt from risk retention.
Commercial Mortgage	Securities issued by an SPE that owns one or more commercial mortgages on income	Depends on type of structure. Typically,	Depends on type of structure. Typically, yes

Backed Securities	producing properties (e.g., multi-family properties, office buildings, industrial properties, shopping centers, hotels and healthcare facilities). The cashflows from the income-generating properties service and repay the securities, while security holders have a security interest and/or fractional undivided interest in the mortgages themselves. The debt is typically tranching into multiple categories of debt, with junior securities and equity supporting the senior class. Prepayment risk may be eliminated through call protection, but investors are typically exposed to extension risk due to balloon structures in the underlying collateral pool.	yes, subject to compliance with the restrictions on pool and structure set forth in the Regulation AB definition	as the mortgages are thought to be self-liquidating financial assets, assuming the underlying assets consist of mortgages rather than leases.
Asset Backed Securities—Credit Card Receivables	Securities issued by an SPE that owns a revolving pool of assets generating contractual cash flows, which can be paid at a required minimum level or in higher amounts, up to repayment in full, on any month, and typically have an open line of credit that permits additional borrowing. The cash flows from the underlying assets in the pool are used to reinvest in new receivables and to service and repay the securities. Credit card securitizations assume that there will be some level of defaults and are structured to have the ability to cover those defaults—typically through the yield on the assets, which is expected to cover interest, servicing and anticipated defaults with a cushion (excess spread) remaining. Prepayment risk largely only relates to a decline in the excess spread below zero and does not typically depend on principal repayment rate. Subordinated tranches and cash reserves often provide credit enhancement to more senior tranches.	Typically, yes, subject to compliance with the restrictions on pool and structure set forth in the Regulation AB definition	Typically, yes
Asset Backed Securities—Other (Student Loans, Auto Loans, Home Improvement Loans, RV Loans, Mobile Home Loans)	Securities issued by an SPE that typically owns a static pool of assets generating contractual cash flows. The cash flows from the underlying assets in the pool are used to service and repay the securities. Through the use of partitioning, the risk of default in the underlying collateral as well as prepayment risk is shared differently across different groups of debt holders (tranches) but uniformly within a tranche. Often early losses are reallocated to a junior tranche, which then serves as a form of credit protection for the senior tranche. Transactions typically have credit enhancement, which may be in the form of overcollateralization, subordinated securities, cash collateral or reserve accounts and/or priorities of payment that suspend payments to	Typically, yes, subject to compliance with the restrictions on pool and structure set forth in the Regulation AB definition	Typically, yes. If the loan pool is not static (i.e., the deal is more of a future flow transaction), there could be an argument that it is not 1934 Act ABS.

	holders of subordinate interests if certain tests are not satisfied.		
Asset Backed Security— Structured Settlement	Securities issued by an SPE. The SPE owns a pool of court-approved structured settlements and/or annuities issued by insurance companies and may hold other assets to address early termination of annuities linked to the life of the original holder. Through the use of partitioning, the risk of defaults in the underlying collateral as well as prepayment risk is shared differently across different groups of debt holders (tranches) but uniformly within a tranche. Transactions typically have credit enhancement, which may be in the form of overcollateralization, subordinated securities, cash collateral or reserve accounts and/or priorities of payment that suspend payments to holders of subordinate interests if certain tests are not satisfied.	Depends on assets and structure. The court-approved structured settlements are likely to convert into cash in a finite time period. Depending on the terms of the annuities, those assets may or may not convert into cash in a finite time period. Whether a transaction qualifies as an asset-backed security under Regulation AB will depend on the particular asset pool.	Depends on assets and structure. The court-approved structured settlements are likely to be considered self-liquidating assets. Depending on the terms of the annuities, those assets may or may not be considered self-liquidating financial assets. Whether a transaction qualifies as an asset-backed security under the 1934 Act definition will depend on the particular asset pool.
Asset Backed Security— Consumer loans	Securities issued by an SPE that owns a pool of consumer loans (other than credit card, auto or student loans), either fixed or revolving, that generate contractual cash flows used to service and repay the securities.	Typically, yes, as the loans by their terms typically convert into cash within a finite time period, and serve as the primary cash flow to the holders of the securities, e.g., a pool of consumer loans, subject to compliance with the restrictions on pool and structure set forth in the Regulation AB definition.	Typically, yes, as the loans are typically self-liquidating financial assets that serve as the primary cash flow to the holders of the securities, e.g., a pool of consumer loans. If the loan pool is not static (i.e., the deal is more of a future flow transaction), there could be an argument that it is not 1934 Act ABS. Securitizations that permit new borrowings under existing lines of credit are not considered future flow.
Asset Backed Security— Home equity loans and lines of credit	Securities issued by an SPE that owns a pool of home equity loans (static) or a pool of home equity lines of credit (revolving, sometimes using master trust technology) that generate contractual cash flows used to service and repay the securities.	Typically, yes, as the loans by their terms typically convert into cash within a finite time period and serve as the primary cash flow to the holders of the securities, e.g., a pool of home equity loans subject to compliance with the restrictions on pool and structure set forth in the	Typically, yes, as the loans are typically self-liquidating financial assets that serve as the primary cash flow to the holders of the securities, e.g., a pool of home equity loans.

		Regulation AB definition.	
Asset Backed Security— Venture Capital Backed Loans	Securities issued by an SPE that owns a pool of venture capital loans.	Typically, yes, assuming the loans by their terms convert into cash, as opposed to equity interests (e.g., warrants or convertible debt), subject to compliance with the restrictions on pool and structure set forth in the Regulation AB definition.	Typically, yes, assuming the loans are self-liquidating financial assets that by their terms convert into cash, as opposed to equity interests (e.g., warrants or convertible debt).
Asset Backed Security— Timeshare securitizations	Securities issued by an SPE that holds promissory notes secured by mortgages that generate contractual cash flows used to service and repay the securities. The mortgages represent the purchase price of a timeshare interest in vacation properties.	Depends on type of structure, typically yes assuming the underlying assets are promissory notes secured by mortgages, which typically by their terms convert into cash within a finite time period.	Depends on type of structure, typically yes assuming the underlying assets are promissory notes secured by mortgages, which are typically self-liquidating financial assets.
Collateralized Loan Obligations (CLOs)	Debt securities issued by an SPE that holds a pool of bank loans. The capital structure of a CLO typically consists of a highly rated senior class, multiple subordinated classes (many of them still with an investment grade rating) and a junior class that receives all residual cash flow on the assets. The cash flows from the loans, as well as sale proceeds to the extent not reinvested in new assets, are allocated to investors based on tranche seniority. CLOs are typically actively managed by an investment manager (loans are actively purchased and sold during investment period).	Typically, no, unless the securities are backed by a static pool of loans (balance sheet CLOs). The active management of the asset pool in open market CLOs generally is inconsistent with the “discrete pool” requirement of Regulation AB.	Typically, yes, but depends on structure. If a CLO structure does not issue securities but instead enters into a credit agreement in which it borrows loans, then the loans may not constitute ABS under the 1934 Act definition.
Lease-Backed Securities— Auto Leases, Equipment Leases (health care, industrial/manufacturing, computers/tech),	Securities issued by an SPE that owns a pool of leases on multiple assets. The cash flows from the underlying leases in the pool are used to service and repay the securities. Through the use of partitioning, the risk of defaults in the underlying collateral as well as prepayment risk is shared differently across different groups of debt holders (tranches) but uniformly within a tranche. Often early losses are reallocated to a junior tranche, which then serves as a form of credit protection for the senior tranche. Transactions typically have credit enhancement, which may be in the form of	Depends on whether the residual value for automobiles exceeds the 65% threshold under the Regulation AB definition, and whether the residual value for other assets exceeds the 50% threshold (as well as satisfying the other pool and structuring	Depends on whether the leases serve as the primary cash flow to the holders of the securities, rather than the re-leasing, selling or otherwise disposing of the automobiles or other equipment.

	overcollateralization, subordinated securities, cash collateral or reserve accounts and/or priorities of payment that suspend payments to holders of subordinate interests if certain tests are not satisfied.	characteristics required under Regulation AB)	
Lease-Backed Securities - Residential and commercial solar	Debt issued by an SPE that owns an equity interest in a number (usually 5-10 in each transaction) of limited liability company subsidiaries (the “LLCs”) which own and lease solar panels on residential properties as well commercial industrial. Although the insurer's investment is directly in the SPE that owns the equity interest, the cash flows are still contractual since the residential property owners/commercial borrower make lease payments on the solar payments based on contractual agreements. The underlying limited liability companies are typically established with shared ownership with a tax equity investor but are managed by an affiliate of the Issuer. The LLCs each have provisions in their organizational documents setting out application of expenses and sharing of revenue with the tax equity investor such that, effectively, the SPE issues debt directly backed by cash flows (and indirectly backed by solar panels and related customer agreements) that represent the profits of the LLCs. These transactions are typically tranching with different waterfall priorities.	Depends on structure. Although the leases convert to cash in a finite time period, the interposition of the LLCs may make Regulation AB unavailable.	Depends on structure. The leases are typically self-liquidating financial assets, and for purposes of satisfying the regulatory intention of the 1934 Act definition to require risk retention, regulators may look through intervening LLC structures. The market treats them as subject to risk retention.
Lease-Backed Securities - Aircraft	Securities issued from an SPE which typically owns some combination of aircraft, leases, loans, or equity interests in wholly owned subsidiaries that own such aircraft, leases or loans. Assets may be held in a variety of non-US entities to satisfy foreign licensing requirements or because retitling them in the US is cost prohibitive. The equipment is typically leased to multiple entities and is subject to significant re-leasing risk. The cash flows from the underlying leases and assets in the pool are used to service and repay the debt. Through the use of partitioning, the risk of defaults in the underlying collateral as well as prepayment risk is shared differently across different groups of debt holders (tranches) but uniformly within a tranche. Often early losses are reallocated to a junior tranche, which then serves as a form of credit protection for the senior tranche. Transactions typically have credit enhancement, which may be in the form of	Depends on type of structure. Securitization of loans (SPV holds a portfolio of loans): Typically, yes, as the loans by their terms typically convert into cash within a finite time period and serve as the primary cash flow to the holders of the securities, subject to compliance with the restrictions on pool and structure set forth in the Regulation AB definition. Securitization of aircraft and leases (SPV holds a portfolio of aircraft and related leases): it	Depends on type of structure. Securitization of loans (SPV holds a portfolio of loans): Typically, yes, as the loans are typically self-liquidating financial assets that serve as the primary cash flow to the holders of the securities. Securitization of aircraft and leases (SPV holds a portfolio of aircraft and related leases): it depends on the structure. If the leases are short-term and do not serve as the primary cash flow to the holders of the securities, but rather the cash flow primarily

	<p>overcollateralization, subordinated securities, cash collateral or reserve accounts and/or priorities of payment that suspend payments to holders of subordinate interests if certain tests are not satisfied.</p>	<p>depends on the structure. If the leases are short-term and do not serve as the primary cash flow to the holders of the securities, but rather the cash flow primarily depends on re-leasing, selling or otherwise disposing of the underlying aircraft, and the residual value of the aircrafts exceeds the 50% threshold under Regulation AB, and other aspects of the structure are inconsistent with Regulation AB, then typically no.</p>	<p>depends on re-leasing, selling or otherwise disposing of the underlying aircraft, typically no.</p> <p>We note that aircraft securitizations backed by the full faith and credit of the United States may be less likely to be 1934 Act asset-backed securities, because they are less likely to depend for payment primarily on the cash flow from self-liquidating financial assets.</p>
<p>Lease-Backed Securities - Railcars</p>	<p>Securities issued from a special purpose entity which typically owns some combination of railcars and leases on such railcars. The equipment is leased to multiple entities and is subject to significant re-leasing risk. The cash flows from the underlying leases and assets in the pool are used to service and repay the debt.</p> <p>Through the use of partitioning, the risk of defaults in the underlying collateral as well as prepayment risk is shared differently across different groups of debt holders (tranches) but uniformly within a tranche. Often early losses are reallocated to a junior tranche, which then serves as a form of credit protection for the senior tranche. Transactions typically have credit enhancement, which may be in the form of overcollateralization, subordinated securities, cash collateral or reserve accounts and/or priorities of payment that suspend payments to holders of subordinate interests if certain tests are not satisfied. Securities may also be issued as a single tranche on a pass-through basis.</p>	<p>Depends on the terms of the leases and the maturity of the securities. Typically, yes, if the payments on the securities are tied to the expected cash flows on the existing lease portfolio at the time of securitization, subject to compliance with the restrictions on pool and structure set forth in the Regulation AB definition.</p> <p>Typically, no, if the leases are short-term and do not serve as the primary cash flow to the holders of the securities, but rather the cash flow primarily depends on re-leasing, selling or otherwise disposing of the rail cars.</p>	<p>Depends on the terms of the leases and the maturity of the securities.</p> <p>Typically, yes, if the payments on the securities are tied to the expected cash flows on the existing lease portfolio at the time of securitization.</p> <p>Typically, no, if the leases are short-term and do not serve as the primary cash flow to the holders of the securities, but rather the cash flow primarily depends on re-leasing, selling or otherwise disposing of the rail cars.</p>
<p>Lease-Backed Securities- Containers</p>	<p>Securities issued from a special purpose entity which typically owns some combination of containers, leases on such containers and equity interests in wholly owned subsidiaries that own</p>	<p>It depends. If the leases are short-term and do not serve as the primary cash flow to the holders</p>	<p>It depends. If the leases are short-term and do not serve as the primary cash flow to the holders of the</p>

	<p>such containers. The equipment is leased to multiple entities and is subject to significant releasing risk. The cash flows from the underlying leases and assets in the pool are used to service and repay the debt.</p> <p>Through the use of partitioning, the risk of defaults in the underlying collateral as well as prepayment risk is shared differently across different groups of debt holders (tranches) but uniformly within a tranche. Often early losses are reallocated to a junior tranche, which then serves as a form of credit protection for the senior tranche. Transactions typically have credit enhancement, which may be in the form of overcollateralization, subordinated securities, cash collateral or reserve accounts and/or priorities of payment that suspend payments to holders of subordinate interests if certain tests are not satisfied.</p>	<p>of the securities, but rather the cash flow primarily depends on re-leasing, selling or otherwise disposing of the containers, typically no. If the residual value of the physical assets does not exceed the 50% threshold of the Regulation AB definition, then may be in scope.</p>	<p>securities, but rather the cash flow primarily depends on re-leasing, selling or otherwise disposing of the containers, typically no.</p>
<p>Lease-Backed Securities - Triple net leases</p>	<p>Securities are issued by an SPE that holds property interests and a pool of triple net leases. Similar to CMBS, but with leases, rather than a mortgage loan, on the property constituting the primary financial asset.</p>	<p>Depends on the transaction. Transactions may have long-term leases that serve as the primary cash flow to the holders of the securities, rather than the cash flow depending primarily on re-leasing, selling or otherwise disposing of the underlying real estate, so may be considered in scope. If the transaction has short-term leases that do not serve as the primary cash flow, then it may not be considered in scope. In addition, depends on whether the residual value of the underlying real estate exceeds the 50% threshold under the Regulation AB definition and other collateral and structural conditions are satisfied.</p> <p>Securitization of leases only and not the underlying real estate:</p>	<p>Depends on the transaction. Transactions may have long-term leases that serve as the primary cash flow to the holders of the securities, rather than the cash flow depending primarily on re-leasing, selling or otherwise disposing of the underlying real estate, so may be considered in scope. If the transaction has short-term leases that do not serve as the primary cash flow, then it may not be considered in scope.</p> <p>Securitization of leases only and not the underlying real estate: Yes, assuming the leases serve as the primary cash flow to the holders of the securities.</p>

		Yes, assuming the leases serve as the primary cash flow to the holders of the securities, subject to compliance with the restrictions on pool and structure set forth in the Regulation AB definition.	
Lease-Backed Securities - Single family rental	Securities issued from an SPE that typically owns mortgage loan receivables from owners of single family residential rental properties which are, in turn, secured by an assignment of rents. This asset class combines certain aspects of RMBS (underlying asset is mortgage loans on residential properties) with certain aspects of CMBS (small number of obligors and income-generating property). The cash flows from the underlying leases in the pool are used to service and repay the debt.	Typically, yes, subject to compliance with the restrictions on pool and structure set forth in the Regulation AB definition	Typically, yes
Lease-Backed Securities -Cell towers, data centers	Securities issued by a special purpose entity that holds a portfolio of cell towers or data centers and related leases. The cash flows from the underlying leases and assets in the pool are used to service and repay the debt.	<p>Depends on type of structure and assets.</p> <p>If the leases are short-term and do not serve as the primary cash flow to the holders of the securities, but rather the cash flow primarily depends on re-leasing, selling or otherwise disposing of the cell towers (i.e., the residual value of the property exceeds the 50% threshold), then these are unlikely to be Regulation AB asset-backed securities.</p> <p>If the transaction has long-term leases that serve as the primary source of cash flow, then it may be considered in scope, subject to compliance with the restrictions on pool and structure set forth in the</p>	<p>Depends on type of structure and assets.</p> <p>If the leases are short-term and do not serve as the primary cash flow to the holders of the securities, but rather the cash flow primarily depends on re-leasing, selling or otherwise disposing of the cell towers, then these are unlikely to be securities the payments on which depend primarily on the cash flow from self-liquidating financial assets.</p> <p>If the transaction has long-term leases that serve as the primary source of cash flow, then it may be considered in scope.</p>

		Regulation AB definition	
Lease-Backed Securities - Rental cars	Vehicles are transferred to a special purpose subsidiary (the “SPV”) that issues debt in various series, typically on a shared collateral basis, to both capital markets investors in term note transactions and bank lenders in variable funding note transactions. The SPV leases the entire pool of vehicles to the operating company pursuant to a single operating lease. The rental payments under the operating lease are sized to meet the debt service obligations of the SPV together with a profit component. The vehicles are titled in the name of the SPV and pledged to the noteholders through a collateral agency arrangement. In some transactions, a two-tier structure exists (originally intended to facilitate like-kind exchanges) whereby one SPV owns the vehicles and leases to the operating company and finances the vehicles through an intercompany loan to a second SPV. The second SPV issues third party debt secured by the intercompany loan and, indirectly, the vehicles. Rental car structures typically also have credit support in the form of reserve of letters of credit covering interest payment obligations and certain other amounts.	Typically, no. Because of the shared collateral pool, these are unlikely to be viewed as supported by a discrete pool of assets.	Typically, yes.
Other Lease Backed Securities— Equipment Based (aircraft, ships, etc.)	Debt issued by a pass-through trust ("Trust") that either owns equipment on long-term lease to a Credit Entity or holds a debt instrument secured by a mortgage against equipment owned by a Credit Entity. The Trust issues certificates representing an undivided interest in the assets of the Trust. The lease or debt payments from the Credit Entity are passed through to the holders of the certificates and represent the right to obtain interest and principal calculated based on the face amount of the certificates. The structures, however, are not fully contractually obligated to a Credit Entity; either because the lease expires before the associated debt matures, or because there is a balloon payment due at maturity that is not part of the lease obligation. This refinancing and residual asset risk is mitigated by low leverage at maturity or point of refinancing.	Depends on type of structure. Securitization of loans (SPV holds a portfolio of loans): Typically, yes, as the loans by their terms typically convert into cash within a finite time period and serve as the primary cash flow to the holders of the securities, subject to compliance with the restrictions on pool and structure set forth in the Regulation AB definition. Securitization of equipment and leases (SPV holds a portfolio of equipment and related leases): it depends on the structure. If the leases	Depends on type of structure. Securitization of loans (SPV holds a portfolio of loans): Typically, yes, as the loans are typically self-liquidating financial assets that serve as the primary cash flow to the holders of the securities. Securitization of equipment and leases (SPV holds a portfolio of equipment and related leases): it depends on the structure. If the leases are short-term and do not serve as the primary cash flow to the holders of the securities, but rather the cash flow primarily depends on re-leasing,

		are short-term and do not serve as the primary cash flow to the holders of the securities, but rather the cash flow primarily depends on releasing, selling or otherwise disposing of the underlying equipment, and the residual value of the equipment exceeds the 50% threshold under Regulation AB, and other aspects of the structure are inconsistent with Regulation AB, then typically no.	selling or otherwise disposing of the underlying equipment, typically no.
Equipment Trust Certificate ("ETC")—backed by equipment, aircraft, aircraft engines, rail cars, rail locomotives, ships	Debt issued by a pass-through trust ("Trust") that either owns equipment on lease to a Credit Entity or holds a debt instrument secured by a mortgage against equipment owned by a Credit Entity. The Trust issues certificates representing an undivided interest in the assets of the Trust. The lease or debt payments from the Credit Entity are passed through to the holders of the certificates and represent the right to obtain interest and principal calculated based on the face amount of the certificates. This differs from the item above under Other Lease-Backed Security - Equipment Based) as this type does not have refinancing/residual risk with the balloon payment at the end of the debt. The certificate holders (through their interest in the assets held by the Trust) also enjoy the benefits of an unsecured claim to the corporation in a bankruptcy scenario, in addition to hard asset collateral. Therefore, if the underlying obligor defaults on its lease or debt obligations, investors can foreclose (or direct the Trust to foreclose) on the underlying equipment as an additional protection to the claim on the Credit Entity in the bankruptcy. Equipment could be a range of collateral types.	An ETC is effectively a security structure to provide financing for a specific piece or pieces of equipment. These deals are typically not considered asset-backed securities under these regulations, but they are considered debt securities.	An ETC is effectively a security structure to provide financing for a specific piece or pieces of equipment. These deals are typically not considered asset-backed securities under these regulations, but they are considered debt securities.
Enhanced Equipment Trust Certificate ("EETC")	An ETC that has been "enhanced" through division into multiple tranches, each representing a different claim in priority within the SPE's capital structure (1st Loss, 2nd Loss, Last Loss, etc.) and also some additional enhanced features. As with an ETC, investors enjoy an unsecured	The securities are viewed as direct obligations of the sponsor and not as asset-backed securities under these regulations, but	The securities are viewed as direct obligations of the sponsor and not as asset-backed securities under these regulations, but they

	<p>claim to a credit entity plus the benefits of collateral. Since EETC's relate to aircraft equipment owned by airlines, investors have the benefit of Section 1110 of the bankruptcy code and because EETCs typically are cross-collateralized and cross-defaulted to the lease or mortgage, the related underlying obligor is strongly incentivized to perform under Section 1110 for the entire pool of equipment securing the certificates with respect to a transaction. EETCs also typically contain either a liquidity facility to service interest payments, or a Paid-in-Kind feature to accrue additional principal, in the event of a bankruptcy/payment</p>	<p>they are considered debt securities.</p>	<p>are considered debt securities.</p>
<p>Credit Tenant Loan ("CTL")</p>	<p>Debt issued from an SPE which owns real property net leased to a single credit tenant (a Credit Entity). Lease payments are used to pay debt service on the transaction, which is an obligation of the SPE that owns the property. Collateral consists of a first lien priority assignment of the lease, including all rent due thereunder which is paid directly to the CTL debt investors, and a mortgage on the property. The debt issued by the SPE is either nearly fully amortizing, or amortizing down to a 5% maximum principal balloon due at maturity (as permitted under the CTL guidelines in Statutory accounting) or, amortizes down to an amount which is fully insured with RVI insurance, or amortizes down to a payment obligation of the Credit Entity tenant or other credit enhancement. Therefore, the holders of the debt are not subject to any repayment risk in excess of 5% of the original principal amount and are fully secured. CTLs are not rated by a CRP and are not FE.</p>	<p>CTLs do not meet the definition of "ABS" as set forth in the 1933 Act. CTLs are viewed as debt securities that are obligations of a Credit Entity (the tenant).</p>	<p>CTLs do not meet the definition of "ABS" as set forth in the 1933 Act. CTLs are viewed as debt securities that are obligations of a Credit Entity (the tenant).</p>
<p>Ground Lease Financing ("GLF")</p>	<p>Debt issued from an SPE that owns and leases (as Ground Lessor) the underlying land of a property where ownership and financing of the land and improvements are bifurcated. The deal is structured exactly like a CTL, except that the owner of the improvement (the Ground Lessee) which leases the land from the Ground Lessor is not an operating company like CVS or IBM, but instead is an SPE that owns and operates the improvements (which can be either single or multi-tenanted) under a long-term Ground Lease (typically 99 years) entered into with the Ground Lessor. The rent from the Ground Lessee is paid directly to the GLF debt investors as debt service - like in a CTL - with the same collateral (first</p>	<p>GLFs do not meet the definition of "ABS" as set forth in the 1933 Act. GLFs are viewed as debt securities that are obligations of an SPE owned by a sponsor.</p>	<p>GLFs do not meet the definition of "ABS" as set forth in the 1933 Act. GLFs are viewed as debt securities that are obligations of an SPE owned by a sponsor.</p>

	<p>priority assignment of lease and all rent due thereunder, and a mortgage on land and on the Ground Lessor’s reversionary interest in the improvements). The Ground Lease payments are sufficient to service debt over the term of the financing, which is typically 30-35 years, and is fully amortizing or with a 5% balloon due at maturity (as permitted under the CTL guidelines in Statutory accounting). Given the foregoing structure, investors in Ground Leases are in a “last loss” position and have a reversionary interest in the improvements should a default occur. Like a CTL, there is no refinancing or residual risk. Ground lease transactions are typically rated by a CRP but are not FE.</p>		
<p>Other Rated Lease-Backed Financings (“ORLB”)</p>	<p>Same structure as a CTL, except an ORLB does not fully comply with CTL guidelines in either one or both of the following areas: 1) a balloon payment due at maturity is in excess of 5% (as permitted under CTL guidelines in Statutory accounting) and is not insured with RVI or other credit enhancement; 2) the primary term of the lease expires on or before the maturity date so investors are relying on lease renewal by Credit Entity tenant. Therefore, the structure is subject to an element of refinancing or residual asset value risk, which is mitigated by low leverage at maturity, and a strong likelihood of lease renewal by the Credit Entity tenant. ORLBs are rated by a CRP but are not expected to be FE.</p>	<p>ORLBs do not meet the definition of “ABS” as set forth in the 1933 Act. Similar to GLFs, ORLBs are viewed as debt securities that are direct obligations of an SPE owned by a sponsor.</p>	<p>ORLBs do not meet the definition of “ABS” as set forth in the 1933 Act. Similar to GLFs, ORLBs are viewed as debt securities that are direct obligations of an SPE owned by a sponsor.</p>
<p>Royalty Payment Streams— intellectual property, movie rights, drug rights</p>	<p>Occurs when a corporation or individual wishes to monetize future fixed payment streams that are usually already legally set forth in the contract. An SPE is established, and debt issued to buyout the original recipient of future royalty payments. The right to receive royalty payments is then assigned to the SPE; and cash flows received from the royalty payments are usually sufficient to fully cover debt service.</p>	<p>No, these generally do not convert into cash in a finite time period. However, royalty securitizations are viewed as asset backed securities in the financial markets due to use of bankruptcy remote entities and predictable cash flows.</p>	<p>No, these generally are not self-liquidating financial assets. However, royalty securitizations are viewed as asset backed securities in the financial markets due to use of bankruptcy remote entities and predictable cash flows.</p>
<p>Future Flow Receivables</p>	<p>Future flow securitizations are those where at the time of the securitization, the pre-set receivables backing the securitization are not of equivalent or higher value than the debt that was issued by the SPV. For example, the receivables may increase or decrease due to volume or usage (e.g. tollway usage). Other examples are whole business securitizations of franchises where the franchisor securitizes its right to receive fees from</p>	<p>Typically, no. However, future flow receivable securitizations are viewed as asset backed securities in the financial markets due to use of bankruptcy remote</p>	<p>Typically, no. Some future flow receivables transactions may be 1934 Act asset-backed securities if (i) the amount of receivables at issuance is high enough that payments on the securities depend primarily on the cash</p>

	franchisees for providing contractual services to the franchisee.	entities and predictable cash flows.	flows on the existing receivables, rather than on the generation of new receivables, (ii) the contract under which new receivables arise is itself a self-liquidating financial asset, or (iii) the securitization includes additional self-liquidating assets in the pool, such as a sponsor note secured by existing and future receivables. Future flow receivables deals are viewed as asset backed securities in the financial markets due to use of bankruptcy remote entities and predictable cash flows.
Collateralized Fund Obligation with Firm Schedule of CF Repayment	Debt is issued from an SPE that owns a seasoned pool of LP interests in PE funds diversified across vintage, strategy and manager. Cash distributions from the underlying funds over time are used to pay interest and principal of the notes, with the remainder going to the equity. The debt is tranching into one or more categories, with junior debt and equity supporting the senior class. Prepayment risk is addressed through call protection, although investors are exposed to extension risk due to the distribution characteristics of the underlying PE funds holdings. Most have liquidity facility to cover cash flow timing differences.	Typically, no. PE funds generally do not convert into cash in a finite time period. Although probably not asset backed securities under these regulations, these are debt securities similar to corporate debt.	Typically, no. PE funds generally are not self-liquidating financial assets. Although probably not asset backed securities under these regulations, these are debt securities similar to corporate debt.
Other examples of debt issued by CFO-like structures but are not viewed as SPVs. Most are Closed-end Funds (“CEFs”), Holding Companies (e.g. Utilities, Berkshire Hathaway), Business	CEFs are listed 1940 Act vehicles that invest in equity or debt securities, are another example of securities that in many instances are backed by equity holdings. These funds often use borrowed money, or debt to enhance the expected returns for shareholders in the funds. The debt issued by the CEFs is serviced from dividend and interest income generated by portfolio holdings. CEFs in effect use debt as margin financing. The 1940 Act reflects this reality with certain built in protections for lenders, and lenders to CEFs often impose additional limits on the use of leverage, such as debt covenants. The other examples such as Holding companies	Typically, no. Although probably not asset backed securities, these are debt securities similar to corporate debt.	Typically, no. Although probably not asset backed securities, these are debt securities similar to corporate debt.

Development Corporations	and business development corporations, which own equity interest in other entities.		
Project Finance Debt	Long term debt issued by an SPE or limited liability corp. to fund a stand-alone capital investment. The SPE/LLC will own the project assets, and the cash flows generated from operating the project are the source of debt repayment. In this sense, the project can be viewed as a small, standalone Credit Entity. Debtholders have a pledge of collateral in the project cash flows, any contingency reserve accounts and often the project asset itself (often through step-in or cure rights).	No, the project assets are not assets that by their terms convert into cash in a finite time period. Although probably not asset backed securities, these are debt securities similar to corporate debt.	No, the project assets are not self-liquidating financial assets. Although probably not asset backed securities, these are debt securities similar to corporate debt.
Special Revenue Municipal Bonds	Issuer Obligation - Backed by "special" revenue generating activity of the municipality AND operates as a business - Toll Roads and Bridges, Water and Wastewater, Airports, Seaports, and Transportation Hubs, Power Plants and Electrical Generation Facilities. The bond is issued by a division of the municipality and may or may not be issued by an SPV.	Depends on type of structure, typically not considered to convert by their terms into cash within a finite time period if the fee requires some future action, such as performing a service, which typically would not be considered a financial asset that converts by its terms into cash. If the fees are already earned due to prior service and the fee is simply deferred, then it may be considered a financial asset that converts by its terms into cash.	Depends on type of structure, typically not considered self-liquidating financial assets if the fee requires some future action, such as performing a service, which typically would not be considered self-liquidating financial assets. If the fees are already earned due to prior service and the fee is simply deferred, then it may be considered self-liquidating financial assets.
Special Revenue Municipal Bonds	LBASS - Backed by "special" revenue generating activity of the municipality AND does not operate as a business and assets in blind trust - Student loan bonds, Tobacco Settlement Bonds (based on contractually set cash flows either for legal fees or payments to be received by states), some Housing bonds.	Depends on the underlying asset and the rights conveyed. Tobacco settlement bonds are typically comparable to other structured settlement securitizations; other special revenue municipal bonds are unlikely to be supported by self-liquidating financial assets or assets that by their terms convert into cash in a finite time period.	Depends on the underlying asset and the rights conveyed. Tobacco settlement bonds are typically comparable to other structured settlement securitizations; other special revenue municipal bonds are unlikely to be supported by self-liquidating financial assets or assets that by their terms convert into cash in a finite time period.

<p>NFL/NBA/MLB/NHL Bonds</p>	<p>An almost infinite variety of deals [League Deals Backed By Media Revenue, League Deals Backed By General Revenue, Team Deals, Stadium Deals] held by a majority of life insurance companies. There is usually a separate SPV that pledges revenue (from the different sources listed under Collateral Type) to the entity to service the debt issued.</p> <p>Debt obligations can be serviced by sources of revenue (often contractual in nature) such as:</p> <ul style="list-style-type: none"> -Television revenues, -Team franchise rights, - Member Club Assessments, -Ticket Sales/ticketing fees - Participating Club Assets, - Naming rights - Sponsorships/advertising - Suite fees and premiums - Concessions - Parking -Non-TeamCo events -Team rent payments -Premium seat licenses 	<p>Depends on the nature of the underlying assets. If the issuing entity holds secured debt from the club or league, that is likely an asset that converts to cash in a finite time period. Media rights do not so convert, whereas a committed payment stream under an advertising contract might, depending on the contingencies affecting payments. The right to ticket sale proceeds likely does not qualify. Stadium bonds probably do not qualify, in the same way that other project finance does not. For the types of structures that may not fit in the scope of this regulation, they would typically be viewed as debt securities similar to corporate debt.</p>	<p>Depends on the nature of the underlying assets. If the issuing entity holds secured debt from the club or league, that is likely a self-liquidating financial asset. Media rights are not self-liquidating, whereas a committed payment stream under an advertising contract might be, depending on the contingencies affecting payments. The right to ticket sale proceeds likely does not qualify. Stadium bonds probably do not qualify, in the same way that other project finance does not. For the types of structures that may not fit in the scope of this regulation, they would typically be viewed as debt securities similar to corporate debt.</p>
<p>Global Funding Investments</p>	<p>An insurance company creates a special purpose vehicle to issue a single series of notes. The insurance company enters into a funding agreement with the special purpose vehicle. Cash flows from the funding agreement are used to make principal and interest payments on the notes. The transaction has the following characteristics:</p> <p>The funding agreement is an insurance product and the direct liability of the insurance company. Payments on the funding agreement are backed by the general account of the insurance company.</p> <p>The terms of the notes exactly match the terms of the underlying funding agreement. There are no other credit enhancements for the notes, and only a nominal residual interest in the special purpose vehicle is created for purposes of complying with formation requirements of local law.</p>	<p>No. The SEC says that it would look through the funding agreement to the general account of the insurance company. Therefore, these are usually treated as corporate debt of an insurance company.</p>	<p>No. The SEC says that it would look through the funding agreement to the general account of the insurance company. Therefore, these are usually treated as corporate debt of an insurance company.</p>

	Only one series of notes is created with the backing of a particular funding agreement. While the special purpose vehicle may issue multiple series of notes, each series will be backed by one distinct funding agreement.		
Stranded Cost Utility Securitizations	Stranded costs are the costs of obsolete assets or system restoration by energy companies, and the right to recover such costs through rates charged to specified customers are created by action of state legislatures. Such rights to charge customers are transferred to an SPE that issue bonds backed by such future charges.	Typically, no. Although probably not asset backed securities, these are debt securities similar to corporate debt.	Typically, no. Although probably not asset backed securities, these are debt securities similar to corporate debt.
Real Estate Investment Trusts ("REITs") and Master Limited Partnerships ("MLPs")	Under U.S. Federal income tax law, a REIT is “any corporation, trust or association that acts as an investment agent specializing in real estate...”. The early REITs focused on the ownership of mortgages. Today, most REITs focus on owning real estate equities. The 1987 Tax Act delineated that an MLP must earn at least 90% of its gross income from qualifying sources, which were strictly defined as the transportation, processing, storage, and production of natural resources and minerals. MLPs typically do not own the operating assets directly, but instead like REITs, they focus on owning the equity of entities that own assets that generate qualifying income. These equities held by REITs and MLPs are not owned directly, but rather in an array of subsidiaries that may be partnerships, limited liability companies or other vehicles. REITs and MLPs rely upon cash flow paid from equity interests, and often the sale of equities, to service debt issued. In that sense the practical ability of the holder of REIT/MLP debt to collect does depend on the “performance” of the equities owned by the REIT/MLP. The SEC, capital markets, rating agencies and accounting standards organizations (FASB and IFRS) characterize obligations for borrowed money issued by REITs/MLPs as debt. These obligations are not recast as equity.	Securities issued by REITs and MLPs would not be viewed as asset-backed securities for purposes of the Regulation AB definition. They do not hold a discrete pool of assets that by their terms convert into cash into a finite time period. REITs do sponsor securitizations—typically RMBS and CMBS—but the REIT itself is not the issuer of those securities.	Typically, no. Securities issued by REITs and MLPs would not be viewed as asset backed securities for purposes of 1934 Act definition. The securities do not typically depend for payment primarily on the cash flows from self-liquidating financial assets. REITs do sponsor securitizations—typically RMBS and CMBS—but the REIT itself is not the issuer of those securities.
STACR	STACR REMIC or STACR Debt -Bonds issued directly by Fannie Mae and Freddie Mac or issued from a trust set up by Fannie and Freddie whose principal and interest payments are linked to a referenced set of mortgages STACR Trust - issues notes out of a third-party trust. Freddie Mac pays a credit premium payment to the trust and benefits from the credit	The credit risk transfer securities that were issued directly by Fannie Mae and Freddie Mac would not meet the Regulation AB definition for asset-backed security, since those securities are	The credit risk transfer securities that were issued directly by Fannie Mae and Freddie Mac would not meet the 1934 Act definition for asset-backed security, since those securities are unsecured debt of the GSEs—there is

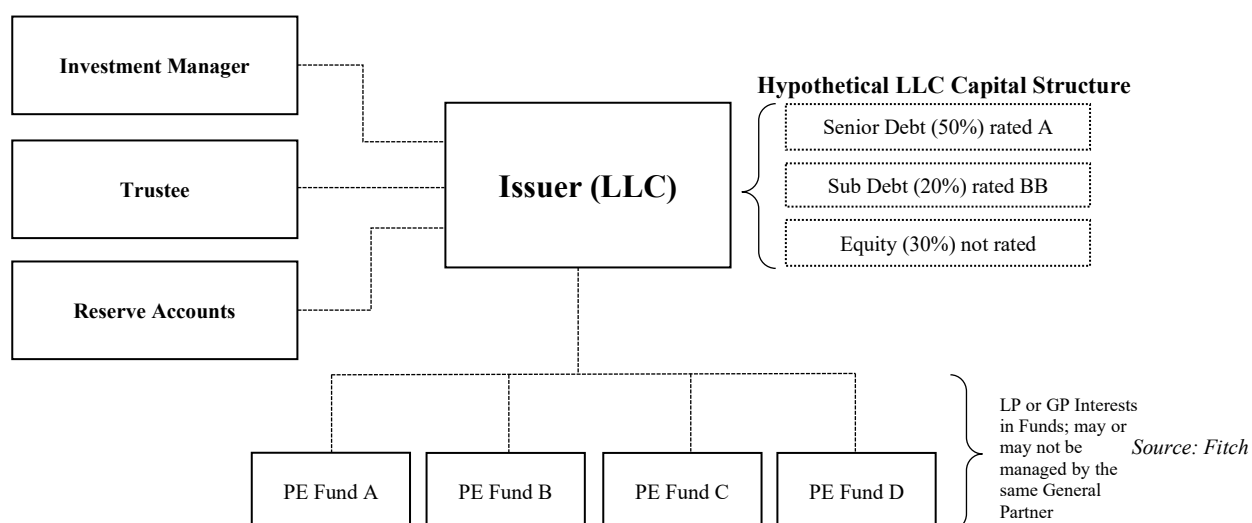
	<p>risk transfer through a reduction in note balances for defined credit events on the reference pool. The trust makes periodic payments of interest and principal to noteholders. Freddie Mac receives payments from the trust that otherwise would have been made to the noteholders to the extent there are certain defined credit events on the mortgages in the related reference pool. Note, there are similar structures by FNMA & mortgage insurers</p>	<p>unsecured debt of the GSEs—there is a reference pool, but no genuine pool of assets. Note that credit risk transfer securities issued directly by Fannie and Freddie do not use a trust or SPV.</p> <p>Similarly, STACR Trusts and STACR REMICs are unlikely to be considered asset-backed securities, even though they hold a pool of assets, because the payments on the securities do not depend on the performance of the assets. In its Regulation AB adopting release, the SEC stated that “Payments on ABS must be based primarily on the performance of the financial assets in the pool.” Moreover, the GSEs take the position that the risk retention rules do not apply to the STACR Trusts or STACR REMICs because the securities issued by them are not asset-backed securities under the 1934 Act or under Regulation AB.</p>	<p>a reference pool, but no genuine pool of assets.</p> <p>The GSEs take the position that the risk retention rules do not apply to the STACR Trusts or STACR REMICs because the securities issued by them are not asset-backed securities under the 1934 Act or under Regulation AB.</p>
ReRemic	<p>REMICs (created by the Tax Reform Act of 1986) are essentially the securitization of mortgage pass through securities. A Re-REMIC takes one or more than one tranche of a REMIC and issues tranches (e.g. BRE issues tranches backed by tranches issued by a REMIC)</p>	<p>Typically, yes.</p>	<p>Typically, yes.</p>
Structured Repos	<p>SPV enters into a reverse repo (buys a security under agreement to resell); SPE issues bond backed by reverse repo.</p>	<p>This is unlikely to be considered ABS under Regulation AB. The SPV holds two assets—the reverse repo agreement itself and the</p>	<p>Probably not. A structured repo is more likely to be viewed as a self-liquidating financial asset under the '34 Act than under the '33 Act, but that</p>

		<p>securities sold under it. The repayment to security holders does not depend on the cash flows on the securities subject to the repo; it depends on payment being made under the repo. So the repo itself would have to be the financial asset that by its terms converts into cash in a finite time period. Although possible, it's unlikely the SEC would view it that way.</p>	<p>requires the repurchase agreement to be treated as a self-liquidating financial asset. We have not seen a federal regulator give a definitive answer on this point, but industry participants have argued against the view that a repurchase agreement is a self-liquidating financing asset.</p>
--	--	---	--

Appendix III

Collateralized Fund Obligations (“CFOs”) Defined:

Summary Definition	Key Credit Variables/Considerations
<p>Typically represents the financing of private equity partnership interests transferred to a Limited Liability Company (“LLC”).</p> <p>The LLC issues debt and equity securities that are sold to investors. Most often, the General Partner (“GP”) of the underlying funds retains the equity tranche, but CFOs have been issued by Limited Partners (“LPs”) to monetize or to alter the risk and return of their existing exposure by selling debt or equity/subordinated tranches.</p> <p>Creditors do not have direct recourse to the sponsor and are secured by the underlying limited partnership interests.</p> <p>The equity tranche (subordination) is sized to ensure that the LLC’s solvency and contractual cashflows are maintained under a variety of market conditions. The LLC also establishes reserve accounts to support creditors in extreme market conditions.</p> <p>If cashflow coverage and overcollateralization requirements are not maintained, the equity holders of the structure are restricted from extracting economics from the LLC.</p>	<ul style="list-style-type: none"> • Initial and ongoing required overcollateralization (or LTV) • Expected volatility of the value and cashflows of the underlying partnership interests • Nature of underlying risk (equity, debt, or combination) • Size of reserve accounts • Debt service coverage covenants • Ability for equity investors to receive excess cashflows • Performance track record of sponsor • Investment phase of underlying interests • Static or dynamic pool of underlying assets • Ratings based covenants/”triggers” • Integrity of asset valuations • Ability to add incremental debt • Sponsor obligations (e.g. keep well provisions) • Source of payment for future capital calls • Fee structure on partnership interests • Operational and other counterparty related risks

Basic Example:**Ratings Framework:**

The primary focus for evaluating the credit risk of CFO issued debt securities is the level of equity (or subordination) and the expected volatility of the underlying assets. The level of subordination to achieve an investment grade rating is typically at least the size of the gross expected losses of the underlying assets (i.e. 15% expected gross losses require a 15% level of equity support). The size also varies based on expected volatility of the expected gross losses – a guiding principle used in almost all debt markets (i.e. more equity support is needed to support debt issued by entities with more volatility or underlying risk).

The expected cashflows generated by the underlying assets are also evaluated to: 1) assess risk, 2) ensure timely payment of interest and principal, and 3) establish the size of the reserve accounts.

Valuation, Covenants and Ongoing Ratings Assessment:

The values of the underlying partnership interests are established by the General Partner’s pricing policies, which are agreed to in advance by the Limited Partners. They typically use an independent internal

valuation committee and/or external advisers to review methodologies, inputs, and fair value estimates for reasonableness. These valuations and valuation procedures are also reviewed by the fund's auditors.

These valuations form the basis for the Loan to Value ("LTV") covenants and ongoing assessment of risk. The initial and ongoing expectation for a well-structured debt security issued by a CFO is that, at all times, the value of the underlying assets will exceed the value of the debt issued by the structure. In fact, most debt securities issued by CFOs benefit from covenants that require substantial excess cushion in the LTV, such that risk of principal loss is low. For an example, if the initial LTV of a CFO is 65%, the covenants will typically restrict the ability for the equity tranche to receive economics from the structure if the LTV exceeds 80% - this may also trigger rapid debt amortization or require additional reserves to be established. The credit rating on debt issued by CFOs allows for some variation in the LTV; however, if persistently above the initial LTV (i.e. if initially set at 65% and it is persistently is above 70%), the credit rating on the CFO issued debt will likely be lowered. In addition, if the amount of subordination is smaller than the gross expected loss rate of the underlying assets, the credit rating will likely be lowered materially.

Sponsor Obligations:

While debt investors do not have direct recourse to the sponsor, in some GP sponsored CFOs, the GP is required to fund and contribute related capital calls into the LLC. If the LTV exceeds the initial LTV at the time of the capital call, the GP may be required to contribute the additional partnership interests into the LLC without incurring additional debt at the LLC level. Some CFOs also require the GP's stake in successor funds to be contributed as well. This requirement effectively provides a "keepwell" from the GP to ensure that the LTV does not increase above the LTV when the structure was established.

Key Risk Differential Between Debt Issued by CFOs and Principal Protected Notes ("PPNs"):

A PPN typically involves an issuance by an LLC that holds a combination of risk assets (e.g. private equity limited partnership interests) and assets with no credit risk (e.g. long dated zero-coupon Treasury bonds). The LLC will issue one security: a single PPN with no subordination. The amount of riskless assets in the structure is sized so that if an investor holds the PPN to maturity, the value accretion of the zero-coupon bond will ensure that the PPN's principal will be repaid with no dependence on the performance of the risk assets.

For the PPN, returns vary with asset performance, but if held to maturity, there is no risk of loss. However, the structure still holds a sizable amount of risk assets and assets with duration, such that at any given point in time, the value of the assets in the LLC may not exceed the value of the PPN.

While CFOs and PPNs both expose investors to risk assets, the CFO issued debt benefits from a sizable amount of subordination with contractual returns not expected to vary with asset performance. This subordination ensures that if the assets in the LLC were to be liquidated, at any time, the debt could be repaid with no risk of principal loss. This concept of continuous asset coverage only exists at issuance and at the stated maturity for a PPN.

CFO Issued Debt Within Scope of SSAP 26R:

Debt backed by equity instruments is common in the capital markets and universally viewed as having bond-like characteristics. Other examples of debt issued by CFO-like structures (or equity-reliant) include debt issued by Holding Companies (e.g. Utilities, Berkshire Hathaway), Business Development Corporations, Closed-end Funds, Master Limited Partnerships and Real Estate Investment Trusts.

For CFO issued debt to be within scope of SSAP 26r (or to get similar accounting and RBC treatment), there must be a fixed maturity, fixed coupon rate (not varying with asset performance), and a minimum level of asset overcollateralization of 133% (or inversely, an LTV of not more than 75%). The structure should also include covenants that work to maintain continuous asset coverage and have established reserve accounts to support the timely payment of interest and principal.

Reference Materials:

SSAP 43R IP Comment Letter 10/11/19; Fitch Special Report: *PE CFOs: Securitizing Private Equity Fund Interests* 10/10/19