**Exposure Draft**

***Issue Paper No. 1XX—LOAN-BACKED AND STRUCTURED SECURITIES***

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| **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](mailto:jgann@naic.org), Robin Marcotte at [rmarcotte@naic.org](mailto:rmarcotte@naic.org), Jim Pinegar at [jpinegar@naic.org](mailto:jpinegar@naic.org), Fatima Sediqzad at [fsediqzad@naic.org](mailto:fsediqzad@naic.org) and Jake Stultz at [jstultz@naic.org](mailto: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.

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## 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.**

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

1. Equipment Trust Certificates / Non-CFR Leased Back Securities (and other VOSTF-related items)
2. 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:
   1. 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.
   2. 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.
   3. 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.
   4. 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

1. 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

1. *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.
2. The original issue paper to SSAP No. 43 (Issue Paper No. 43) cited guidance originally contained in Chapter 1, *Bonds and Loaned Backed and Structured Securities*, from the *Accounting Practices and Procedures Manual of the Life and Accident and Health Insurance Companies*. The issue paper identified that the *Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies* contained similar guidance. In this Issue Paper No. 43, and the original SSAP No. 43, loan-backed securities were defined as “pass-through certificates, collateralized mortgage obligations (CMOs) and other securitized loans…” The reference to “securitized loans” was a key aspect of this original definition.
3. 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 trusteed assets or third parties such as insurers or guarantors) for repayment of the obligation. As a result, the sponsor and its other affiliates may have no financial obligation under the instrument, although one of those entities may retain the responsibility for servicing the underlying mortgage loans. Some sponsors do guarantee the performance of the underlying loans.

5. Loan-backed securities meet the definition of assets as defined in *SSAP No. 4—Assets and Nonadmitted Assets* and are admitted asset to the extent they conform to the requirements of this statement.

1. 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.
2. 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.”
3. 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.
   1. 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.*

1. 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.
2. 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.
3. Definition of loan-backed and structured securities in the “As of March 2020” AP&P Manual:
4. 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.
5. 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.
6. Loan-backed securities are issued by special-purpose corporations or trusts (issuer) established by a sponsoring organization. The assets securing the loan-backed obligation are acquired by the issuer and pledged to an independent trustee until the issuer’s obligation has been fully satisfied. The investor only has direct recourse to the issuer’s assets, but may have secondary recourse to third parties through insurance or guarantee for repayment of the obligation. As a result, the sponsor and its other affiliates may have no financial obligation under the instrument, although one of those entities may retain the responsibility for servicing the underlying assets. Some sponsors do guarantee the performance of the underlying assets.

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

1. Mortgage-referenced securities do not meet the definition of a loan-backed or structured security but are explicitly captured in scope of this statement. In order to qualify as a mortgage-referenced security, the security must be issued by a government sponsored enterprise[[2]](#footnote-2) in the form of a “credit risk transfer” in which the issued security is tied to a referenced pool of mortgages. These securities do not qualify as “loan-backed securities” as the pool of mortgages are not held in trust and the amounts due under the investment are not backed or secured by the mortgage loans. Rather, these items reflect instruments in which the payments received are linked to the credit and principal payment risk of the underlying mortgage loan borrowers captured in the referenced pool of mortgages. For these instruments, reporting entity holders may not receive a return of their full principal as principal repayment is contingent on repayment by the mortgage loan borrowers in the referenced pool of mortgages. Unless specifically noted, the provisions for loan-backed securities within this standard apply to mortgage-referenced securities.
2. Investments within the scope of this statement are also subject to the provisions and disclosure requirements of SSAP No. 25 if the SSAP No. 43R transaction is a related party arrangement[[3]](#footnote-3). Loan-backed and structured securities meet the definition of assets as defined in *SSAP No. 4—Assets and Nonadmitted Assets* and are admitted assets to the extent they conform to the requirements of this statement and SSAP No. 25.
3. The scope of this statement encompasses all types of loan-backed and structured securities, including, but not limited to, the following:
   1. Loan-backed and structured securities acquired at origination,
   2. 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,
   3. Loan-backed and structured securities for which it is probable, either known at acquisition or identified during the holding period[[4]](#footnote-4), that the reporting entity will be unable to collect all contractually required payments receivable, and
   4. Transferor’s beneficial interests in securitization transactions that are accounted for as sales under SSAP No. 103R and purchased beneficial interests in securitized financial assets[[5]](#footnote-5).

### Benefits of Reporting in Scope of SSAP No. 43R

1. 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:
   1. 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.”)
   2. 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.
      1. 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.)*
      2. 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.
      3. 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 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.)
   3. 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

1. With the existing guidance in SSAP No. 43R, there are no restrictions to the assets that can be placed in SPV/trust[[6]](#footnote-6) 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.
2. 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

1. 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 reference. Regardless of final revisions, this issue paper will document the proposals considered, and the resulting conclusions to provide historical reference.
2. In accordance with direction from the Working Group conference call on January 8, 2020:
   1. 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.
   2. 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.
   3. 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.)*
   4. 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)*
   5. 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.)*

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| **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

1. 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.*

1. 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.

1. 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. 78l).

**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.

1. 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.

1. 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…

1. 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.
2. 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.
3. 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.
4. 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.
5. 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.

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| **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

1. 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:
   1. 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.
   2. 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.
2. 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 note[[7]](#footnote-7)) is required to be bifurcated for accounting and reporting purposes with each ABS securitization tranche reported individually.
   1. 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.
   2. 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.
3. 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.
4. 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 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.*

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| **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)

1. 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.
2. 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:
   1. 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.
   2. 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).)
   3. 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 then what would be expected in a securitization of credit card receivables.)
   4. 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.)
3. 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.
4. 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.*

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| **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**

1. 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:
   1. Structures that issue securities from a trust / SPV with one underlying obligor.
   2. Structures that issue securities from a trust / SPV for which the contractual obligations collateralizing the security are not owed by many diverse payers.
   3. 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.)*
   4. 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.)
   5. 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.)
   6. 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.)

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| **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**

1. 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.
2. 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.*

1. 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:
   1. 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.
   2. 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.
2. 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.
3. 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.)*
   1. 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.
   2. 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.
4. 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.
5. If the investment with one underlying obligor is the result of a self-securitization, the guidance in paragraph \_\_\_ shall be followed. *(Staff Note – This guidance is still under development.)*

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| **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**

1. 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.
   1. 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 then 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.
2. 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:
   1. 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.
   2. 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.
3. 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.
4. 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:
   1. 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 \_\_\_.)
   2. 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.
5. 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.
6. 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:
   1. 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.
   2. 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.
   3. Section 5e: Structures that issue principal protected notes.
   4. 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.

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| **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**

1. 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.)
2. 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:
   1. 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.)*
   2. 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.
   3. 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.)
   4. 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.
3. 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.
4. 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:
   1. Accounting and reporting guidance in SSAP No. 48 (or a new SSAP).
   2. Proposed reporting in a new reporting line on Schedule BA.
   3. A fair value measurement method
   4. 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.***

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| **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**

1. 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.
2. 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.
3. 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.
   1. 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.
   2. 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.
   3. If the payment of interest or principal is contingent on the performance of an equity index, then the security is an equity instrument.
4. 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:
   1. Accounting and reporting guidance in SSAP No. 48 (or a new SSAP).
   2. Proposed reporting in a new reporting line on Schedule BA.
   3. A fair value measurement method
   4. 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.***

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| **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**

1. 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.
2. 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.

1. 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.
2. 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.
3. 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:
   1. 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.
   2. 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.
4. 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.
5. 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.
6. 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.
7. To provide a simple, general illustration of a PPN:
   1. 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.)*
   2. 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).
8. This issue paper proposes consideration of the following for these securities:
   1. 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.
   2. 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.

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| **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**

1. 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.
2. 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.
3. 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*.
4. 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.
5. 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.*

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| **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. |

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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. [↑](#footnote-ref-1)
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. [↑](#footnote-ref-2)
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. [↑](#footnote-ref-3)
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. [↑](#footnote-ref-4)
5. The accounting requirements related to these types of securities included in paragraphs 22-25 shall be determined at acquisition or initial transfer. [↑](#footnote-ref-5)
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. [↑](#footnote-ref-6)
7. Other examples could also include legacy collateralized debt obligations (CDOs) [↑](#footnote-ref-7)