Statutory Accounting Principles (E) Working Group

**Maintenance Agenda Submission Form**

**Form A**

## **Issue:** SSAP No. 43R – Equity Instruments

**Check (applicable entity):**

 P/C Life Health

Modification of existing SSAP [x]  [x]  [x]

New Issue or SSAP [ ]  [ ]  [ ]

Interpretation [ ]  [ ]  [ ]

Description of Issue:

This agenda item has been drafted to consider clarifications to the scope of *SSAP No. 43R—Loan-Backed and Structured Securities*, particularly with regards to collateralized fund obligations (CFOs) and similar structures that reflect underlying equity interests but are issued in the form of bonds / debt instruments.

Overview: A collateralized fund obligation (CFO) is a form of [securitization](https://en.wikipedia.org/wiki/Securitization) involving [private equity fund](https://en.wikipedia.org/wiki/Private_equity_fund) or [hedge fund](https://en.wikipedia.org/wiki/Hedge_fund) assets, similar to [collateralized debt obligations](https://en.wikipedia.org/wiki/Collateralized_debt_obligation) (CDOs). A CDO uses loans as the collateral backing the security, whereas a CFO is backed by interests in funds, often private equity or hedge funds. (A CFO can also be backed by other equity interests, such as a limited liability partnership.) Although the CFO appears to have a “debt instrument” cash flow and may receive a credit rating from an NRSRO, the backing of the issued security is based on the equity performance of the underlying funds or equity interest. From a Bloomberg article from Oct. 2018, it was noted that CFOs have been noted as allowing an opportunity for “regulatory capital relief.” This article cited a statement that entities “can exchange their equity interests into CFOs, maintain the same level of exposure, without having to hold as much capital against the investments because regulators treat CFOs as bonds, not the private equity-linked investments that they are.”

NAIC staff was contacted by a rating provider with a request for information on how CFOs are considered for statutory accounting. The rating provider noted that this information would assist them in determining their methodology for reviewing CFOs under their credit policy and providing credit ratings. As part of that discussion, the rating provider provided the following information regarding their knowledge of CFOs:

* CFOs were first issued prior to the financial crisis in the early 2000’s.
* The early CFOs were packages of hedge funds assets, not private equity funds.
* CFOs did not perform well in the financial crisis and the development / issuance was halted.
* CFOs have now returned to the market, with the majority of holders identified as insurance companies.
* Although CFOs have returned, it was noted they have not seen many issuances.
* CFOs have been formed through repackaging of existing owned assets. (For example, if an insurance company held private equity on Schedule BA, they can package these assets in a CFO and report on Schedule D under SSAP No. 43R.) The rating agency noted that they do not formally receive information on the source of the CFO assets, but they receive source information informally through company inquiries.
* CFOs can be acquired individually (not through the repackaging of existing assets).
* CFOs can include both debt and equity components. Per the rating agency, in the situations seen, the insurance company either keeps the entire structure (both debt and equity pieces), or they sell the debt component and retain the equity component. They identified that in the situations they have seen, insurance companies have always retained the equity portion.

As identified in *SSAP No. 26R—Bonds*, loan-backed and structured securities (LBSS), although they may meet the definition of a bond, are excluded from SSAP No. 26R and follow the accounting and reporting guidance within SSAP No. 43R. The accounting and reporting of LBSS is similar to the reporting of bonds, with the measurement method (amortized cost or the lower of amortized cost or fair value) determined in accordance with the credit risk of the security (NAIC designation). Securities in scope of SSAP No. 43R are reported on Schedule D-1 as long-term bonds consistent with securities captured in scope of SSAP No. 26R.

Pursuant to the *NAIC Purposes and Procedures Manual of the NAIC Investment Analysis Office* (P&P Manual) NAIC designations are used to determine the category of credit risk and are security specific based on the position of a specific security in the issuer’s capital structure.

Existing Authoritative Literature:

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

## SCOPE OF STATEMENT

1. This statement establishes statutory accounting principles for investments in loan-backed securities, structured securities and mortgage-referenced securities. In accordance with *SSAP No. 103R—Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, retained beneficial interests from the sale of loan-backed securities and structured securities are accounted for in accordance with this statement. Items captured in scope of this statement are collectively referred to as loan-backed securities.

## SUMMARY CONCLUSION

1. 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.
2. 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.
3. 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.
4. 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[[1]](#footnote-1) 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.
5. 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.
6. 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[[2]](#footnote-2), 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[[3]](#footnote-3).

### Reporting Guidance for All Loan-Backed and Structured Securities

1. Loan-backed and structured securities shall be valued and reported in accordance with this statement, the *Purposes and Procedures Manual of the NAIC Investment Analysis Office*, and the designation assigned in the *NAIC Valuations of Securities* product prepared by the NAIC Securities Valuation Office or equivalent specified procedure. The carrying value method shall be determined as follows:

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

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

Activity to Date (issues previously addressed by the Working Group, SEC, FASB, other State Departments of Insurance or other NAIC groups): None

**Information or issues (included in *Description of Issue*) not previously contemplated by the Working Group:** None

**Convergence with International Financial Reporting Standards (IFRS) and U.S. GAAP:** None

Staff Recommendation: NAIC staff recommends that the Working Group move this item to the active listing, categorized as nonsubstantive, and expose revisions to *SSAP No. 43R—Loan-Backed and Structured* Securities to clarify that CFOs (or similarly structured instruments), and other structures with underlying equity exposure, are excluded from the scope of SSAP No. 43R. Additionally, the revisions prevent existing assets from being repackaged as “securitizations” for reporting in scope of SSAP No. 43R. Key elements noted in the revisions include:

* The intent for SSAP No. 43R securities to have “bond-like cash flows.”
* Exclusion of equity instruments, investments with underlying assets that include equity instruments, or structures representing an equity interest (e.g., joint venture, LLCs, partnerships)
* Exclusion of assets that were previously reported as standalone assets by the reporting entity to change the investment schedule / reporting value / RBC charge.
* Clarification that the lease-backed securities and equipment trust certificates are in scope when eligible per the *P&P Manual of the NAIC Investment Analysis Office.*

Proposed Revisions to SSAP No. 43R—Loan-Backed and Structured Securities:

## SCOPE OF STATEMENT

1. This statement establishes statutory accounting principles for investments in loan-backed securities, structured securities and mortgage-referenced securities. The intent of SSAP No. 43R is to capture investments that have bond-like cash flows. In accordance with *SSAP No. 103R—Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, retained beneficial interests from the sale of loan-backed securities and structured securities are accounted for in accordance with this statement. Items captured in scope of this statement are collectively referred to as loan-backed securities.
2. Pursuant to the intent of to capture investments with bond-like cash flows, the scope of SSAP No. 43R does not include equity instruments, investments with underlying assets that include equity instruments or any structures representing an equity interest (e.g., joint ventures, limited liability companies, partnerships) in which the cash flow payments (return of principle or interest) are partially or fully contingent on the equity performance of an underlying assetFN. For example, Collateralized Fund Obligations (CFO) are not captured in scope of SSAP No. 43R. In these structures, investors gain exposure to a collection of funds (or equity interests) with the established interest and principle payments based on the issuer’s expected performance of the underlying funds. These are equity investments and shall not be captured as debt instruments in scope of SSAP No. 43R.

New Footnote: As examples, the assumed performance of a fund, a fund of funds, joint venture or limited liability partnership cannot be the basis for a securitization with a resulting investment that indicates a contractual interest and/or principle repayment.

1. The scope of SSAP No. 43R shall not include any securitization of assets that were previously reported as standalone assets by the insurance reporting entity. In other words, an insurance reporting entity is not permitted to repackage existing assets as “securitizations” to move the reporting of the existing assets within scope of SSAP No. 43R. For example, investments in joint ventures held by a reporting entity and reported on Schedule BA shall not be repackaged as a securitization (with the joint ventures as the underlying assets) for reporting on Schedule D-1: Long-Term Bonds. This guidance is applicable regardless if the reporting entity retains less than 100% of the securitized assets. In these situations, the reporting entity shall continue to report the underlying assets (with any reduction of ownership) as if they had not been repackaged into a securitization.

## SUMMARY CONCLUSION

1. Loan-backed securities are defined as securitized assets not included in structured securities, as defined below, for which the contractual 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 certificatesFN. Pursuant to paragraph 2, the underlying assets supporting payment of interest and/or principal shall not reflect equity interests.

New Footnote: Lease-backed securities and equipment trust certificates are in scope when meeting structural requirements per the *Purposes and Procedures Manual of the NAIC Investment Analysis Office*.

1. Structured securities are defined as loan-backed securities which have been divided into two or more classes for which the contractual 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. Pursuant to paragraph 2, the underlying assets supporting payment of interest and/or principal shall not reflect equity interests.
2. 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.
3. 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[[4]](#footnote-4) 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.
4. 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.

Staff Review Completed by: Julie Gann – May 2019

Status:

On August 3, 2019, the Statutory Accounting Principles (E) Working Group moved this item to the active listing, categorized as nonsubstantive, and exposed revisions to *SSAP No. 43R—Loan-Backed and Structured Securities*, as illustrated above, to exclude collateralized fund obligations, and similar structures that reflect underlying equity interests, from the scope of the statement, as well as prevent existing equity assets from being repackaged as securitizations and reported as long-term bonds.

On March 18, 2020, the Statutory Accounting Principles (E) Working Group exposed a preliminary issue paper for initial assessment. Comments and information are requested on the items detailed within the issue paper. This item was exposed with an extended comment deadline ending June 26, 2020. Comments are requested throughout the exposure process, to the extent possible, as NAIC staff will continue working with industry in discussing SSAP No. 43R investments. *(Note: This comment letter deadline was extended to July 31, 2020 in response to industry request due to the focus on the impacts from COVID-19.)*

On October 13, 2020, the Statutory Accounting Principles (E) Working Group conducted a hearing to receive industry comments on two key items detailed within the interested parties’ comment letter on SSAP No. 43R: 1) Classification as *SSAP No. 26R—Bonds* or *SSAP No. 43R—Loan-Backed and Structured Securities* and 2) Definition of Asset-Backed Security. In response to the review of comments on these issues, the Iowa Insurance Division submitted a proposal to first identify principles that should govern whether an investment is reported on *Schedule D-1: Long-Term Bonds*. With this submission, it was identified that some structures reported on Schedule D-1 that cause concerns may be captured in scope of SSAP No. 26R, although they may be issued through a SPV/trust structure. As such, the comprehensive project on SSAP No. 43R would not encompass the full extent of regulator concerns due to the broad SSAP No. 26R bond definition. The Iowa proposal intends to first identify whether an investment should be considered a Schedule D-1 investment, with a subsequent secondary focus of whether the investment shall be captured in scope of SSAP No. 26R or SSAP No. 43R. With this exposure, it was specifically noted that the proposal is not suggesting edits to SSAP No. 26R with the reference to “bonds” but is focused on what is captured on the Schedule D-1 reporting schedule as a “long-term bond,” as that schedule encompasses investments in scope of both SSAP No. 26R and SSAP No. 43R. After this discussion, the Working Group exposed the Iowa Insurance Division Proposal for a comment period ending Dec. 4, 2020. It was requested that industry work with NAIC staff and key regulators throughout the exposure process.

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1. 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-1)
2. 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-2)
3. The accounting requirements related to these types of securities included in paragraphs 22-25 shall be determined at acquisition or initial transfer. [↑](#footnote-ref-3)
4. 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-4)