

**Statutory Accounting Principles (E) Working Group
Maintenance Agenda Submission Form
Form A**

Issue: SSAP No. 43R – Residual Tranches

Check (applicable entity):

	P/C	Life	Health
Modification of Existing SSAP	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>
New Issue or SSAP	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Interpretation	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>

Description of Issue: Although the broad principles-based bond proposal project is establishing principles for reporting investments on Schedule D-1: Long-Term Bonds, it has been identified that there is current inconsistency in practice for the reporting of non-rated residual tranches for structures captured in scope of *SSAP No. 43R—Loan-Backed and Structured Securities*. To address this current inconsistency, it has been requested that revisions occur as an interim step to provide specific accounting and reporting for these items.

As background information, SSAP No. 43R provides guidance for investments in loan-backed and structured securities, as well as purchased and retained beneficial interests in securitized financial assets. The guidance presumes that the investments within scope reflect fixed-income instruments, particularly with the Schedule D-1: Long-Term Bond reporting as well as the amortized cost measurement method, but it has been identified that non-rated, first loss layers without contractual principal or interest (known as residual tranches or interests) are technically captured within the legal-form structure currently permitted within scope of the guidance.

As part of the principles-based bond project discussions, it has been identified that some entities report these residual investments on Schedule BA: Other Long-Term Investments. However, it has been noted that other entities report these residual tranches on Schedule D-1, as in scope of SSAP No. 43R. Since items on Schedule D-1 are required to have NAIC designations, and these tranches are not (and cannot be) rated from a CRP or receive an NAIC designation, some entities have applied the “NAIC 5GI” process to self-assign an NAIC 5 designation. For life entities, an NAIC 5 permits an amortized cost valuation and for all lines of business a NAIC 5 receives a lower RBC charge than what is received if reporting on Schedule BA.

The NAIC 5GI process permits entities to self-assign an NAIC 5 when they can certify to the following three components:

1. Documentation necessary to permit a full credit analysis of the security does not exist or an NAIC CRP ratings for an FE or PL security is not available.
2. The issuer or obligor is current on all contracted interest and principal payments.
3. The insurer has an actual expectation of ultimate payment of all contracted interest and principal payments.

Use of the NAIC 5GI process for non-rated residual investments is an incorrect application of the guidance as 1) there are no contracted interest and principal payments to certify as current and 2) the insurer cannot have an actual expectation of receiving all contractual principal and interest of the underlying collateral as these tranches absorb the losses first for the securitization structure. Although cash flows may pass through to these holders at periodic intervals in the waterfall, ultimate returns depend on continued performance, therefore, there can be no actual expectation that future payments will be received.

From the discussions that have occurred on the principles-based bond project, there is general agreement that these non-rated residual tranches do not belong on Schedule D-1 as long-term bonds. This agenda item proposes minor revisions to SSAP No. 43R, as an interim action in advance of the adoption of the principles-based bond project, to

prescribe the accounting and reporting for these non-rated residual investments to ensure consistent reporting. As detailed, it is proposed that these items remain in scope of SSAP No. 43R, as they are a component of a securitization, with specific guidance to report on Schedule BA with a lower of cost or fair value measurement.

Existing Authoritative Literature:

Reporting Guidance for All Loan-Backed and Structured Securities

26. 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, Emerging Accounting Issues (E) Working Group, SEC, FASB, other State Departments of Insurance or other NAIC groups): The Statutory Accounting Principles (E) Working Group has a comprehensive project to establish principles-based concepts for the definition for bond investments for reporting on Schedule D-1: Long-Term Bonds. This separate agenda item was directed as an interim action on Aug. 26, 2021, as it was identified that there is inconsistent reporting for non-rated residual tranches, with some entities reporting these non-rated loss-layer investments on D-1 with a self-assigned NAIC 5GI designation.

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

Convergence with International Financial Reporting Standards (IFRS): N/A

Staff Recommendation:

NAIC staff recommends that the Working Group move this item to the active listing, categorized as a new SAP concept, and expose revisions to SSAP No. 43R to establish specific accounting and reporting guidance for non-rated residual tranches or interests. Additionally, it is recommended that the Working Group sponsor a blanks proposal to capture a new reporting line specific for these items on Schedule BA and send a referral to the Valuation of Securities (E) Task Force to identify that the NAIC 5GI process shall not be used to self-assign an NAIC designation to non-rated residual investments.

Proposed edits to SSAP No. 43R:

Reporting Guidance for All Loan-Backed and Structured Securities

26. 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, excluding non-rated residual tranches or interests, 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), excluding non-rated residual tranches or interests, 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.
- c. For non-rated residual tranches or interests^{FN} captured in scope of this statement, all reporting entities (regardless of AVR) shall report the item on Schedule BA: Other Long-Term Invested Assets at the lower of cost or fair value. Changes in the reported value from the prior period shall be recorded as unrealized gains or losses.

New Footnote: Reference to “non-rated residual tranches or interests” intends to capture securitization tranches, beneficial interests, interests of structured finance investments, as well as other structures captured in scope of this statement, that reflect loss layers without contractual interest or principal payments. Payments to holders of these investments occur after contractual interest and principal payments have been made to other tranches or interests and are based on the remaining available funds. Although payments to holders can occur throughout an investment’s duration (and not just at maturity), such instances still reflect the residual amount permitted to be distributed after other holders have received contractual interest and principal payments.

Staff Review Completed by: Julie Gann, NAIC Staff – September 2021

Status:

On September 9, 2021, in response to an e-vote to expose, the Statutory Accounting Principles (E) Working Group moved this agenda item to the active listing, categorized as nonsubstantive, and exposed revisions to *SSAP No. 43R—Loan-Backed and Structured Securities* to clarify that non-rated residual tranches shall be reported on Schedule BA – Other Long-Term Investments and valued at the lower of cost or fair value.

<https://naiconline.sharepoint.com/teams/FRSStatutoryAccounting/NationalMeetings/A.NationalMeetingMaterials/2021/10.Sept9e-vote/21-15-SSAPNo.43R-ResidualTranches.docx>