Attachment Two

ACLI
Financial Security for Life

RBC Principles for Bond Funds

December 2024

Background

- Operating under a regulatory regime where funds with slightly different structures but same economic risks receive different RBC treatment
- (9/27/2017) VOSTF directed NAIC staff to develop a comprehensive proposal to ensure consistent treatment for investments that involved funds that invest in bond portfolios (history included in Appendix)
- (5/10/2019) VOSTF requested that CATF consider formally integrating the comprehensive instructions for mutual funds recently adopted for the P&P Manual into the NAIC RBC framework
- ACLI has agreed with RBC IRE to begin looking at three types of bond funds that get different treatment in RBC calculation. ACLI has been looking at these to determine whether the risk profiles are similar or different to warrant different treatment for different types of bond funds. While this work focuses on these three types of bond funds, ACLI is identifying principles that can be used to expand treatment from these types of bond funds to other similar bond fund types.

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Focus on Bond Funds – Current State

	Bond Exchange Traded Funds (ETF)[1]	SEC Registered Bond Mutual Funds	Private Bond Funds[1]
Description	Portfolios of bonds held in a 1940 Act fund structure whose ownership interests trade on a centralized securities exchange	Open-end investment company registered with the SEC under 1940 Act that invests in a portfolio of bonds but does not trade on an exchange	Fund in LLC/LP form investing in bonds for benefit of investors
Accounting Standard	SSAP 26	SSAP 30	SSAP 48
Accounting Methodology	Fair Value unless Systematic Value elected	Fair Value	Equity Method Value of Accounting
RBC Charge	Bond RBC	Equity RBC	Bond RBC
RBC Charge Methodology	SVO WARF	30% equity charge (can file and SVO can apply WARF but cannot be used for RBC)	SVO WARF
RBC Asset Concentration Factors	Excluded[2]	Excluded[2]	Look through for inclusion
SIRI[3] Top 10 Exposure Disclosure	Excluded[2]	Excluded[2]	Look through for inclusion
Reporting Schedule	Schedule D-1	Schedule D-2-2	Schedule BA
AVR Treatment for Realized Capital Gains/Losses	Depends on NAIC rating changes	Entirely	Entirely

[1] *For funds meeting SVO criteria*
[2] *For funds that are diversified within the meaning of the Investment Company Act of 1940 [Section 5(b)(1)]*
[3] *Supplementary Investment Risks Interrogatories*

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Focus on Bond Funds – Future State after Applying Principles

	Bond Exchange Traded Funds (ETF)[1]	SEC Registered Bond Mutual Funds	Private Bond Funds[1]
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RBC Charge Methodology	SVO WARF	**SVO WARF**	SVO WARF
RBC Asset Concentration Factors	Excluded[2]	Excluded[2]	Look through for inclusion
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Assumptions / Constraints for Principles

- Develop principles for consistent RBC treatment for Bond ETFs, Bond Mutual Funds, and Bond Private Funds that bear substantially the same economic risks regardless of legal form.

- The accounting for the aforementioned Bond Funds will/should not be changed because each different fund type is governed by different SSAPs.

Application of Principles

- Candidate principles developed to evaluate and ensure consistent RBC treatment between various fund types where the underlying holdings are bonds and currently meet the criteria for the SVO WARF methodology.

- Candidate principles could be applied for substantially similar bond fund investments to Bond ETFs, Bond Mutual Funds, and Bond Private Funds (currently meet the criteria for SVO WARF methodology) that the SVO could also apply their WARF as they become known.

- Candidate principles are intended to focus on the C-1 factor exclusively (i.e., excludes concentration factors).

- Principles could be leveraged for addressing similar situations where industry or regulators note similar significantly inconsistent RBC treatment for substantially similar investments. While the principles can potentially be leveraged, they will need to be tailored, as other fund types are likely not subject to the SVO WARF methodology.

Candidate Principles

1. Meets qualifications for SVO to apply WARF methodology
2. RBC is based on underlying economic risk
   - Regardless of accounting method applied, fund risk depends on the collateral pool
   - Differences between fund types are considered immaterial where such differences are deemed not to contribute risks captured by RBC (e.g., illiquidity is not measured by C-1)
3. Economic risk of fund investment is materially similar to the collateral pool
   - There are no support tranches
   - All fund investors have equal ownership status (i.e., no fund investors are more senior nor junior than others)
4. Included within an SSAP in AP&P Manual

Focus on Bond Funds – Future State after Applying Principles

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Key Questions for Regulators

- Which candidate-principles do regulators support?
- Are there additional principles not outlined herein that also ought to be incorporated into RBC for funds?

Appendix: History of VOSTF Treatment of Funds Investing in Bonds

- 1991 – Money market mutual funds that hold short-term U.S. Treasuries - exempted from reserve
- 1992 – Funds holding U.S. direct and full faith and credit obligations - exempted from reserving
- 1992 – Funds holding high quality corporate bonds & U.S. Government obligations - reserve as NAIC 1 bonds
- 1995 – Short-term bond funds - holding high quality corporate & U.S./GSO obligations) - Schedule D; market value & reserved as bonds for AVR and RBC
- 2003 – Exchange Traded Funds that held bonds – report as bonds
- 2005 – BA assets with fixed income characteristics can be assigned NAIC Designations
- 2017 – SVO authorized to assign NAIC Designations to private Schedule BA funds, joint ventures or partnership interests if underlying investments are fixed-income like to align with Annual Reporting Instruction

Source: September 21, 2018 Referral to the Capital Adequacy Task Force – Comprehensive Fund Proposal from VOSTF