Statutory Accounting Principles (E) Working Group

**Maintenance Agenda Submission Form**

**Form A**

## **Issue: Residuals in SSAP No. 48 Investments**

**Check (applicable entity):**

 P/C Life Health

Modification of Existing SSAP [ ]  [x]  [ ]

New Issue or SSAP [ ]  [ ]  [ ]

Interpretation [ ]  [ ]  [ ]

**Description of Issue:**

This agenda item proposes revisions to clarify the scope and reporting for investment structures that represent residual interests or a residual security tranche (collectively referred to as residuals) within statutory accounting principles. Previously, revisions have been incorporated in *SSAP No. 43R—Loan-Backed and Structured Securities* to address the reporting of residual interests within securitization structures. With these revisions, residual interests, as defined within SSAP No. 43R, were required to be reported on Schedule BA on designated reporting lines beginning year-end 2022. After reviewing the 2022 reporting results, it was identified that the information for residuals may be underrepresented as a result of the various legal forms that residual investments can take. For example, a reporting entity could hold investments that have the substance of residual interests in the form of limited partnerships, joint ventures, or other equity fund investments. To ensure collective and consistent reporting of all residual interests, this agenda item proposes guidance to clarify the reporting of in-substance residuals regardless of the structure of the investment vehicle.

The discussion of residual interests often compares those securities to equity interests. These two investment structures are not synonymous, and it should not be perceived that all equity interests reflect residuals. A residual interest or a residual security tranche exists in investment structures that are backed by a discrete pool of collateral assets. These designs could be backed directly or indirectly through a feeder fund. These collateral assets generate cash flows that provide interest and principal payments to debt holders, and once those contractual requirements are met, the resulting excess funds generated by (or with the sale of) the collateral assets are provided to the holder of the residual interest. When an asset within the discrete pool of assets does not perform as expected, it impacts the extent cash flows will be generated and distributed. The residual interest holder absorbs these losses (as it reduces what they could receive as a residual holder) while the holders of the debt securities continue to receive interest and principal, so long as there are enough collateral cash flows to cover them. The residual holder may ultimately receive nothing, a reduced amount from original projection, or large returns, based on how the underlying collateral assets perform.

The structural design of a residual interest or residual security tranche can vary, but the overall concept is that they receive ‘residual’ cash flows after all debt holders receive contractual interest and principal payments. The list below provides common characteristics in residuals, but with varying (and often changing structures), this list should not be used as rules governing whether a security reflects a residual interest. Determining whether a security reflects a residual interest or tranche for reporting purposes shall be based on the substance of the investment held rather than its legal form.

Common Characteristics of Residual Interests / Residual Security Tranches:

* Residuals often do not have contractual principal or interest.
* Residuals may have stated principal or interest, but with terms that result in receiving the residual cash flows of the underlying collateral. The terms allow for significant variation in the timing and amount of cash flows without triggering a default of the structure.
* Residuals do not have credit ratings or NAIC assigned designations. Rather, they provide the subordination to support the credit quality of the typically rated debt tranches.
* Residuals may provide payment throughout the investment duration (and not just at maturity), but the payments received continue to reflect the residual amount permitted after other tranche holders receive contractual principal and interest payments.
* Frequently, there are contractual triggers that divert cash flows from the residual tranche to the debt tranches if the structure becomes stressed.

**Existing Authoritative Literature:**

***SSAP No. 43R—Loan-Backed and Structured Securities*** defines residuals specific to securitizations or beneficial interests and requires these securities to be reported on dedicated Schedule BA reporting lines. (This guidance was effective for year-end 2022 and detailed in agenda item 2022-15.)

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* (P&P Manual), 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:
2. For reporting entities that maintain an Asset Valuation Reserve (AVR), loan-backed and structured securities, excluding 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.
3. 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 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.
4. For residual tranches or interestsFN captured in scope of this statement, all reporting entities shall report the item on Schedule BA: Other Long-Term Invested Assets at the lower of amortized cost or fair value. Changes in the reported value from the prior period shall be recorded as unrealized gains or losses. For reporting entities that maintain an AVR, the accounting for unrealized gains and losses shall be in accordance with *SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve*.

Footnote: Reference to “residual tranches or interests” intends to capture securitization tranches and beneficial interests as well as other structures captured in scope of this statement that reflect loss layers without any contractual payments, whether principal or interest, or both. 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.

**Annual Statement Instructions** also detail specific reporting lines for residuals with instructions for reporting in Schedule BA:

Residual Tranches or Interests with Underlying Assets Having Characteristics of:

Fixed Income Instruments

Unaffiliated 4699999

Affiliated 4799999

Common Stock

Unaffiliated 4899999

Affiliated 4999999

Preferred Stock

Unaffiliated 5099999

Affiliated 5199999

Real Estate

Unaffiliated 5299999

Affiliated 5399999

Mortgage Loans

Unaffiliated 5499999

Affiliated 5599999

Other

Unaffiliated 5699999

Affiliated 5799999

**Residual Tranches or Interests with Underlying Assets Having Characteristics of:**

Investment in Residual Tranches or Interests should be assigned to the subcategory with the highest underlying asset concentration. There shouldn’t be any bifurcation of the underlying assets among the subcategories.

Include: Residual tranches or interests captures securitization tranches and beneficial interests as well as other structures captured in scope of *SSAP No. 43R – Loan-Backed and Structured Securities*, that reflect loss layers without any contractual payments, whether interest or principal, or both. 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. See SSAP No. 43R for accounting guidance.

**Fixed Income Instruments**

Include: Investments with underlying collateral which, if held individually, would be reported on *Schedule D – Part 1 – Long-Term Bonds*

**Common Stocks**

Include: Investments with underlying collateral which, if held individually, would be reported on *Schedule D – Part 2 – Section 2 – Common Stocks*

**Preferred Stocks**

Include: Investments with underlying collateral which, if held individually, would be reported on *Schedule D – Part 2 – Section 1 – Preferred Stocks*

**Real Estate**

Include: Investments with underlying collateral which, if held individually, would be reported on *Schedule A – Real Estate Owned*

**Mortgage Loans**

Include: Investments with underlying collateral which, if held individually, would be reported on *Schedule B – Mortgage Loans*

**Other**

Include: Items that do not qualify for inclusion in the above subcategories.

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):

* Under the principles-based bond project, revisions have been proposed to incorporate guidance for residuals in *SSAP No. 21R—Other Admitted Assets*. With the Spring 2023 National Meeting exposure, information was requested from industry on how amortized cost for residuals was determined as well as how other-then-temporary assessments were completed.
* The Investment Risk and Evaluation (IRE) Risk Based-Capital (E) Working Group is considering a structural change and a potential factor change for residuals reported on Schedule BA. The year-end 2022 data was reviewed and was noted to underrepresent the full scope of residual tranche securities held by insurance reporting entities as the current guidance in SSAP No. 43R is specific to securitizations or beneficial interests.
* A March 31, 2023, Valuation of Securities (E) Task Force referral to the Statutory Accounting Principles (E) Working Group identified other structures that could contains residual tranche securities that may not be captured within the year-end 2022 Schedule BA dedicated residual reporting lines.

**Information or issues (included in *Description of Issue*) not previously contemplated by the Working Group:**

None

**Convergence with International Financial Reporting Standards (IFRS):** NA

Recommendation:

NAIC staff recommend that the Working Group move this item to the active listing, as a SAP clarification, and expose revisions to clarify that investments structures captured in scope of *SSAP No. 48—Joint Ventures, Partnerships, and Limited Liability Companies*, that represent residual interests or that predominantly hold residual interests, shall be reported on the dedicated residual reporting line on Schedule BA. As these investments are already reported on Schedule BA, this revision results in a reporting classification change within the same schedule. These investments are still considered to be in scope of SSAP No. 48 and they are only permitted to be admitted if they qualify as admitted assets pursuant to requirements of SSAP No. 48. (Under SSAP No. 48, investments in scope must be supported by an audit to qualify for admittance.)

Proposed revisions to *SSAP No. 48—Joint Ventures, Partnerships and Limited Liability Companies*:

New header and paragraphs 18-20. All other paragraphs will be renumbered accordingly.

### Residual Interests and Reporting

18. Investments in scope of this statement are reported on *Schedule BA: Other Long-Term Assets*. Schedule BA includes dedicated reporting categories for joint ventures, partnerships, and limited liability company investments as well as for residual interests, both with reporting lines in accordance with underlying asset characteristics. Investments within scope of this standard shall be divided within these reporting categories, with investments that reflect residual interests, or that predominantly hold residual interests, captured in the residual interest reporting category.

19. A residual interest or a residual security tranche (collectively referred to as residuals) exists in investment structures that are backed by a discrete pool of collateral assets. These designs could be backed directly or indirectly through a feeder fund. These collateral assets generate cash flows that provide interest and principal payments to debt holders, and once those contractual requirements are met, the resulting funds generated by (or with the sale of) the collateral assets are provided to the holder of the residual security / residual interest holder. When an asset within the discrete pool of assets does not perform as expected, it impacts the extent to which cash flows will be generated and distributed. The residual security holder absorbs these losses first (as it reduces what they could receive as a residual holder) while the holders of the debt securities continue to receive interest and principal so long as there are enough collateral cash flows to cover them. The residual holder may ultimately receive nothing, a reduced amount from original projection, or large returns, based on how the underlying collateral assets perform.

20. The structural design of a residual interest or residual security tranche can vary, but the overall concept is that they receive ‘residual’ cash flows after all debt holders receive contractual interest and principal payments. Determining whether a security reflects a residual interest or tranche shall be based on the substance of the investment held rather than its legal form. Common characteristics of residual interests / residual security tranches include the items noted below, but the presence of absence of any of these factors should not be definitive in determination. Classification as a residual should be based on the substance of the investment and how cash flows to the holder are determined.

1. Residuals often do not have contractual principal or interest.
2. Residuals may have stated principal or interest, but with terms that result in receiving the residual cash flows of the underlying collateral. The terms allow for significant variation in the timing and amount of cash flows without triggering a default of the structure.
3. Residuals do not have credit ratings or NAIC assigned designations. Rather, they provide the subordination to support the credit quality of the typically rated debt tranches.
4. Residuals may provide payment throughout the investment duration (and not just at maturity), but the payments received continue to reflect the residual amount permitted after other tranche holders receive contractual principal and interest payments.
5. Frequently, there are contractual triggers that divert cash flows from the residual tranche to the debt tranches if the structure becomes stressed.

**Corresponding revisions are also proposed to SSAP No. 43R—Loan-Backed and Structured Securities:**

Revisions are proposed to pull the residual guidance into a new section, after paragraph 26, rather than a footnote. Remaining paragraphs will be renumbered accordingly.

### 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 (P&P Manual), 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:

1. For reporting entities that maintain an Asset Valuation Reserve (AVR), loan-backed and structured securities, excluding 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.
2. 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 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.
3. For residual tranches or interests captured in scope of this statement, all reporting entities shall report the item on Schedule BA: Other Long-Term Invested Assets at the lower of amortized cost or fair value. Changes in the reported value from the prior period shall be recorded as unrealized gains or losses. For reporting entities that maintain an AVR, the accounting for unrealized gains and losses shall be in accordance with *SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve*.

### Residual Tranches or Interests

27. A residual interest or a residual security tranche (collectively referred to as residuals) exists in investment structures (including securitizations, beneficial interests and other structures captured in scope of this statement) that are backed by a discrete pool of collateral assets. These collateral assets generate cash flows that provide interest and principal payments to debt holders, and once those contractual requirements are met, the resulting funds generated by (or with the sale of) the collateral assets are provided to the holder of the residual security / residual interest holder. When an asset within the discrete pool of assets does not perform as expected, it impacts the extent to which cash flows will be generated and distributed. The residual security holder absorbs these losses first (as it reduces what they could receive as a residual holder) while the holders of the debt securities continue to receive interest and principal so long as there are enough collateral cash flows to cover them. The residual holder may ultimately receive nothing, a reduced amount from original projection, or large returns, based on how the underlying collateral assets perform.

28. The structural design of a residual interest or residual security tranche can vary, but the overall concept is that they receive ‘residual’ cash flows after all debt holders receive contractual interest and principal payments. Determining whether a security reflects a residual interest or tranche for reporting purposes shall be based on the substance of the investment held rather than its legal form. Common characteristics of residual interests / residual security tranches include the items noted below, but the presence of absence of any of these factors should not be definitive in determination. Classification as a residual should be based on the substance of the investment and how cash flows to the holder are determined.

1. Residuals often do not have contractual principal or interest.
2. Residuals may have stated principal or interest, but with terms that result in receiving the residual cash flows of the underlying collateral. The terms allow for significant variation in the timing and amount of cash flows without triggering a default of the structure.
3. Residuals do not have credit ratings or NAIC assigned designations. Rather, they provide the subordination to support the credit quality of the typically rated debt tranches.
4. Residuals may provide payment throughout the investment duration (and not just at maturity), but the payments received continue to reflect the residual amount permitted after other tranche holders receive contractual principal and interest payments.
5. Frequently, there are contractual triggers that divert cash flows from the residual tranche to the debt tranches if the structure becomes stressed.

**Proposed revisions to Annual Statement Instructions:**

**Residual Tranches or Interests with Underlying Assets Having Characteristics of:**

Investment in Residual Tranches or Interests should be assigned to the subcategory with the highest underlying asset concentration. There shouldn’t be any bifurcation of the underlying assets among the subcategories.

Include: Residual tranches or interests from securitization tranches and beneficial interests as well as other structures captured in scope of *SSAP No. 43R – Loan-Backed and Structured Securities.*

 Investments in joint ventures, partnerships and limited liability companies captured in scope of *SSAP No. 48—Joint Ventures, Partnerships and Limited Liability Companies* that represent residual interests, or that predominantly hold residual interests.

 This category shall also include residual interests or residual security tranches within investment structures that are not captured in scope of SSAP No. 43R or SSAP No. 48 but that reflect, in substance, residual interests or residual security tranches.

The structural design of a residual interest or residual security tranche can vary, but the overall concept is that they receive ‘residual’ cash flows after all debt holders receive contractual interest and principal payments. Determining whether a security reflects a residual interest or tranche shall be based on the substance of the investment held rather than its legal form. Common characteristics of residual interests / residual security tranches include the items noted below, but the presence of absence of any of these factors should not be definitive in determination. Classification as a residual should be based on the substance of the investment and how cash flows to the holder are determined.

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4. Residuals may provide payment throughout the investment duration (and not just at maturity), but the payments received continue to reflect the residual amount permitted after other tranche holders receive contractual principal and interest payments.
5. Frequently, there are contractual triggers that divert cash flows from the residual tranche to the debt tranches if the structure becomes stressed.

Staff Note: With adoption of guidance to define a residual, corresponding revisions will also be proposed to the SSAPs proposed to be updated under the principles-based bond definition (e.g., *SSAP No. 43R—Asset-Backed Securities* and *SSAP No. 21R—Other Admitted Assets*.)

Staff Review Completed by: Julie Gann - NAIC Staff, April 2023

Status:

On May 16, 2023, the Statutory Accounting Principles (E) Working Group moved this agenda item to the active listing, categorized as a SAP clarification, and exposed revisions to SSAP No. 48 which clarify that investments structures captured in scope of SSAP No. 48 that represent residual interests or that predominantly hold residual interests, shall be reported on the dedicated residual reporting line on Schedule BA. Corresponding edits to ensure consistent language in SSAP No. 43R and revisions to the Schedule BA Annual Statement Instructions were also exposed.

https://naiconline.sharepoint.com/teams/FRSStatutoryAccounting/National Meetings/A. National Meeting Materials/2023/05-16-23/Exposures/C 23-12 - Residuals.docx