October 6, 2020

Mr. Dale Bruggeman, Chairman
Statutory Accounting Principles Working Group
National Association of Insurance Commissioners
1100 Walnut Street, Suite 1500 Kansas City, MO 64106-2197

RE: Ref #2019-21 – SSAP No. 43R, Loan-backed and Structured Securities

Dear Mr. Bruggeman:

The Iowa Insurance Division (the "Division") would like to make comment regarding the ongoing discussions of Reference #2019-21 – SSAP No. 43R, Loan-backed and Structured Securities. The Working Group has exposed Issue Paper No. 1XX in regards to this topic which has received extensive commentary from interested parties.

The impetus for this project was to review the scope of SSAP 43R to determine whether certain types of investments with unique characteristics should be reported as loan-backed and structured securities within the scope of SSAP 43R. This was in response to the identification of such investments by regulators and the SVO and concerns raised that some may not be of the character that regulators would expect to be reported as bonds on Schedule D-1. When defining the project as a SSAP 43R scoping project, it was expected that all of the investments identified were being reported in scope of SSAP 43R.

It has since been identified that there is diversity in practice in how these investments are classified, and that some companies believe that many of the investments identified for evaluation in this project are within the scope of SSAP 26R. The appropriate classification between SSAP 26R and SSAP 43R is an important topic, and the Working Group should consider whether there are clarifications needed to address the differences in interpretation. However, this issue is secondary to the primary purpose of this project, which is to determine whether investments with certain unique characteristics should qualify as bonds for Schedule D-1 reporting.

It has been identified that the definition of a bond under current statutory accounting principles is broad and includes, "any securities representing a creditor relationship, whereby there is a fixed schedule for one or more future payments." Given the broad definition, it is possible for an insurer to acquire any asset through a debt-issuing trust or special purpose vehicle and report it as a Schedule D-1 bond, even if that asset would be otherwise inadmissible if held directly, and even if there is no economic substance to the trust. In other words, the insurer could be in an identical economic position to holding the inadmissible asset directly and still qualify for Schedule D-1 reporting.

In most cases, securitizations serve a bona fide economic purpose and can create high-quality bonds out of a pool of otherwise non-investable assets through overcollateralization and the prioritization of payments to debtholder classes. However, the current guidance is too broad to distinguish between those with economic substance and those without, leaving the reporting of these assets susceptible to abuse.

Therefore, the Division recommends that the Working Group focus its efforts on developing a principles-based definition for those assets that qualify for Schedule D-1 bond treatment as the initial step for this project. To facilitate this discussion, the Division has included as Appendix A of this letter, a draft definition that we believe serves as a good starting point for identifying those principles. This draft is intended to facilitate the discussions of the Working Group and industry and we look forward to hearing feedback on both the draft and the proposed direction of the project.

Once the Working Group has reached consensus regarding those assets that qualify for Schedule D-1 bond reporting, there may be certain characteristics that, while they do not impair qualification as a bond, may warrant separate identification on Schedule D-1. This, along with clarification of the classification between SSAP 26R and SSAP 43R and review of the accounting and measurement methodologies will be important secondary objectives of the project. But it is first necessary to answer the question of what qualifies as a bond, before these secondary objectives can be fully addressed.

Sincerely,

Kevin Clark, Chief Accounting Specialist, Iowa Insurance Division

Carrie Mears, Chief Investment Specialist, Iowa Insurance Division

Introduction

The following draft definition provides a basis for distinguishing between the two types of bonds which have been identified through discussions to date. Those are issuer obligations and asset backed securities. It clarifies that issuer obligations are those backed by the credit of an operating entity. A debt security that is issued by an entity whose purpose is the pass-through of collateral cash flows is not an issuer obligation.

The definition of asset backed securities specifies that they involve the securitization of **financial assets**. When an insurer invests in a securitization of assets, it is important that the nature of those assets lend themselves to the production of cash flows. Therefore, the securitization of non-financial assets should receive bond treatment only in instances where the nature of the assets lends itself to the production of cash flows. Those specific instances should be separately identified for Schedule D-1 qualification, as is currently the case with lease-backed securities and equipment trust certificates.

The definition of asset backed securities also stipulates that an asset backed security redistributes the risk of the underlying collateral such that the investor is in a different position than if the underlying collateral were held directly. Under this definition, an entity that simply passes through the proceeds of the underlying collateral has done nothing to alter the nature of the investment, has no economic substance, and should therefore be looked through to determine the appropriate accounting.

Finally, it introduces the concept that a key characteristic of a bond and what makes it a debt investment, rather than an equity-like investment, is that it represents a senior or priority interest in the assets of the issuer. This is true for issuer obligations as well as asset backed securities. Therefore, in order for something to meet the definition of a bond, there must be a more-than-insignificant subordinated interest present, or said another way, overcollateralization. The residual position is akin to an equity investment, and should not qualify for Schedule D-1 reporting.

Principles-based Definition of a Bond to be Reported on Schedule D, Part 1: (New Elements in Red)

1. Bonds shall be defined as any securities representing a creditor relationship, whereby there is a fixed schedule for one or more future payments, and which qualify as Issuer Obligations or Asset Backed Securities.

2. Issuer Obligations represent the debt of operating entities, which have a purpose other than the pass through of investment proceeds. Examples of issuer obligations include (SSAP 26R examples):

    a. U.S. Treasury securities;(INT 01-25)

    b. U.S. government agency securities;

    c. Municipal securities;

    d. Corporate bonds, including Yankee bonds and zero-coupon bonds;

    e. Convertible bonds, including mandatory convertible bonds as defined in paragraph 11.b;

    f. Fixed-income instruments specifically identified:

        i. Certifications of deposit that have a fixed schedule of payments and a maturity date in excess of one year from the date of acquisition;

        ii. Bank loans issued directly by a reporting entity or acquired through a participation, syndication or assignment;

        iii. Hybrid securities, excluding: surplus notes, subordinated debt issues which have no coupon deferral features, and traditional preferred stocks.

        iv. Debt instruments in a certified capital company (CAPCO) (INT 06-02)

3. Asset backed securities represent debt issued through the securitization of financial assets. There are two defining characteristics that must be present in order for a security to meet the definition of an asset backed security:

    a. The financial assets collateralizing the debt issuance are expected to be the primary source of cash flows for repayment of the debt;

    b. The securitization of the financial assets collateralizing the debt issuance redistributes the credit risk of the underlying financial assets, such that the creditor is in a different position than if the underlying collateral were held directly.

    Asset backed securities are typically issued from a trust or special purpose vehicle, though the presence or lack of a trust or special purpose vehicle is not a definitive criterion for determining that a security meets the definition of an asset backed security.

4. Inherent in the definition of a bond, whether represented by an issuer obligation or asset backed security, is the notion that the creditor has a senior interest in the assets of the issuer. The most subordinated interest, sometimes referred to as the first-loss position, represents the interest of an equity holder, rather than a creditor. Therefore, in order to meet the definition of a bond, a more-than-insignificant subordinated interest must be present.