
To: Jacob Garn, Chair of the Blanks (E) Working Group
From: Dale Bruggeman, Chair of the Statutory Accounting Principles (E) Working Group
Kevin Fry, Chair of the Valuation of Securities (E) Task Force
Re: Year-End 2021 Reporting for Residual Tranches Retained on Schedule D-1
Date: November 10, 2021

The purpose of this memo is to notify the Blanks (E) Working Group and interested parties on the reporting of residual tranches retained on Schedule D-1: Long-Term Bonds for year-end 2021. Furthermore, it intends to broadly communicate that use of the NAIC 5GI designation process for items that do not have contractual principal or interest payments reflects an incorrect application of the guidance.

As part of the bond proposal project, it was identified that there is inconsistency in practice with how residual tranches or interests are reported within the investment schedules, with some entities reporting on Schedule BA: Other Invested Assets, and other entities reporting on Schedule D-1, with either a self-assigned NAIC 5GI or NAIC 6 designation. Although action taken by the SAPWG will require residual tranches or interests to be reported on Schedule BA for year-end 2022, these items can be retained on Schedule D-1 for year-end 2021. However, if retained on Schedule D-1, the Working Group confirmed with the Securities Valuation Office that use of the NAIC 5GI process for residual tranches is an inaccurate application, and residual tranches or interests reported on Schedule D-1 shall be reported with an NAIC 6 designation. The following information defines residual tranches or interests subject to this clarification as well as why an NAIC 5GI designation cannot be used for these securities:

Residual Tranche / Interests: Reference to “residual tranches or interests” intends to capture 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 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.

Application of NAIC 5GI: The NAIC 5GI process, noted in the *Purposes and Procedures Manual of the NAIC Investment Analysis Office*, permits entities to self-assign an NAIC 5 when they can certify 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 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. The Valuation of Securities (E) Task Force is currently incorporating edits to mitigate future misapplication of the NAIC 5GI process.

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Please contact NAIC staff of the SAPWG or VOSTF with any questions.

Cc: Mary Caswell, Calvin Ferguson, Julie Gann, Robin Marcotte, Jim Pinegar, Jake Stultz, Charles Therriault

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