

# Statutory Issue Paper No. 169

## Principles-Based Bond Definition

### STATUS

Finalized August 13, 2024

**Original SSAP: SSAP No. 26 and SSAP No. 43**

**Current Authoritative Guidance: SSAP No. 21, SSAP No. 26 and SSAP No. 43**

### Type of Issue:

Common Area

### SUMMARY OF ISSUE

1. The guidance within this issue paper details the new statutory accounting concept revisions to *SSAP No. 26—Bonds* (SSAP No. 26), *SSAP No. 43—Loan-backed and Structured Securities* (SSAP No. 43) and *SSAP No. 21—Other Admitted Assets* (SSAP No. 21) pursuant to the Statutory Accounting Principles (E) Working Group’s (Working Group) Investment Classification Project as well as in response to expanding investment structures that have been reported on Schedule D-1: Long-Term Bonds. The revisions and discussions detailed within reflects a comprehensive review, referred to as the “Principles-Based Bond Project,” to establish principal concepts for determining whether a debt security qualifies for reporting as a bond. Although SSAP No. 26 was previously revised pursuant to the Investment Classification Project in 2017, it was identified that some entities were classifying securities issued from special purpose vehicles (SPVs) in scope of SSAP No. 26 instead of SSAP No. 43. As the focus of this Principles-Based Bond Project is on the substance of investments, regardless of whether they include an SPV for issuance, this project includes all debt securities and encompasses both SSAP No. 26 and SSAP No. 43.

### SUMMARY CONCLUSION

2. Investments eligible for reporting as bonds on Schedule D-1<sup>1</sup> shall comply with the principles-based definition of a bond or be specifically noted in scope of SSAP No. 26 or SSAP No. 43. Revisions to reflect the principles-based bond definition have been incorporated to SSAP No. 26, with SSAP No. 43 revised for accounting and reporting guidance for investments that qualify as asset-backed securities under the SSAP No. 26 bond definition. SSAP No. 21 has been revised to detail accounting and reporting guidance for debt securities that do not qualify as bonds under SSAP No. 26 and to provide guidance for the accounting and reporting of residual interests. Lastly, various revisions to other SSAPs have been incorporated to update guidance and/or references to the bond guidance. The final adopted SSAPs and other revisions are shown in the exhibits to this issue paper.

### DISCUSSION

3. The discussion of this issue originally began in August 2019 with agenda item 2019-21: SSAP No. 43 – Equity Investments. This agenda item was drafted to consider clarification to SSAP No. 43 particularly with regards to collateralized fund obligations and similar structures that reflect underlying equity interests. In response to the discussion of comment letters in January 2020, this project was expanded to include a

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<sup>1</sup> Pursuant to reporting changes adopted in response to the principles-based bond definition, issuer credit obligations (ICO) in scope of *SSAP No. 26—Bonds* will be reported on *Schedule D-1-1: Bonds* and asset-backed security (ABS) investments that qualify as bonds under SSAP No. 26 but follow *SSAP No. 43—Asset-Backed Securities* for accounting and reporting will be reported on *Schedule D-1-2: Asset-Backed Securities*. Throughout this issue paper, these bond investments (both ICO and ABS) are collectively referred to as bonds reported on Schedule D-1.

comprehensive review of SSAP No. 43 under the Working Group's Investment Classification Project, with NAIC staff directed to prepare a discussion document for subsequent review.

4. A preliminary discussion document was exposed for comment on March 18, 2020. Although there were no proposed recommendations in that exposed document, it captured the following:

- a. History of the definition / scope development of SSAP No. 43. (This history has been retained in this issue paper, beginning with paragraph 124.)
- b. Definitions of asset-backed securities (ABS) from the Code of Federal Regulations (CFR), the Securities Exchange Act of 1934 and NAIC Model 280, Investments of Insurers Model Act (Defined Limits Version).
- c. Potential options for the accounting and reporting of ABS based on whether they were considered traditional securitizations in accordance with the Code of Federal Regulations (CFR) (17 CFR 229.1101(c)) definition of an ABS or non-traditional securitizations that did not comply with the CFR definition.

5. In response to this initial exposure, a detailed comment letter dated July 31, 2020, was received from interested parties. Although a variety of elements were noted, two key issues were the primary focus:

- a. Separation between SSAP No. 26 and SSAP No. 43: Pursuant to the comments, it was identified that many insurers had different interpretations of the adopted 2010 revisions that separated investments between SSAP No. 26 and SSAP No. 43 due to the presence of a "trust" or an "SPV" structure. As such, investment designs that had been identified as concerning due to the underlying investments in the SPV (e.g., equity-driven investments) believed by some to be limited to SSAP No. 43 were, under some interpretations, eligible to be captured in scope of SSAP No. 26.
- b. Defining an asset-backed security: The comments received focused heavily on whether the 17 CFR definition captured securities within the 1933 or 1934 Securities Act. The proposed use of the 17 CFR definition, which is the ABS definition used by the SEC as a nationally recognized statistical ratings organization (NRSRO) registered for asset-backed securities, was intended to allow consistency in ABS items permitted for NRSRO designations. Furthermore, it was only the first "broad brush" in determining whether an investment would be initially captured in scope of SSAP No. 43. Regardless, based on the comments received, which noted variations between the 1933 and 1934 Securities Act, differences of assessments based on whether an entity is the issuer or acquirer, the legal scrutiny that may be required in determining whether an investment complies with the definition, as well as a recommendation for independent principles for determining an investment as an asset-backed security, it was identified that further discussion should occur before utilizing the CFR definition of an asset-backed security.

6. After considering the interested parties' July 31, 2020, comments, the Working Group directed that a small group of industry work with Iowa representatives and NAIC staff to define what should be considered a bond for reporting on Schedule D-1. It was identified that some investment designs, which have been previously captured on Schedule D-1 or are proposed for inclusion on that schedule, may be well-performing assets, but are not bonds and should not be captured on Schedule D-1. It was also noted that regulators are not anticipating these sorts of investment structures when reviewing D-1 and assessing investment risk. These small group discussions began December 1, 2020, and continued until the bond proposal was initially exposed for public comment on May 20, 2021.

7. After considering the comment letters from the May 2021 exposure, on August 26, 2021, the Working Group affirmed the direction of the principle-based bond concepts and directed NAIC staff to

utilize those concepts in proposing statutory accounting revisions. With this explicit direction, it was noted that all elements of the principles-based bond proposal, and the reflection of those concepts in statutory accounting guidance, is subject to continued discussion and deliberation. Revised guidance for Schedule D-1 investment classification will not be considered authoritative statutory guidance until the specific effective date detailed in adopted authoritative SSAP. With the direction to proceed with the development of statutory guidance to reflect the principle-based concepts, the Working Group directed that NAIC staff continue to work with the small group of regulators and industry to discuss concepts, review proposed language and consider innovating investment designs. (During this meeting, the small group was repurposed and referred to as the “study” group with additional regulators participating.)

8. From September 2021 through January 2022, the study group of regulators and industry met to continue discussions on the bond proposal definition. Key elements discussed during this timeframe included 1) the requirement for a credit enhancement that puts the holder of an ABS in a different economic position from holding the underlying collateral directly, 2) the contractual stapling restriction, and 3) guidance for when a debt instrument is issued from an SPV that owns a portfolio of equity interests. Revisions from these discussions, as well as other aspects to clarify the definition and an initial issue paper were presented to the Statutory Accounting Principles (E) Working Group on March 2, 2022, and exposed. Subsequently, the full Working Group discussed and exposed revisions to the draft guidance until adoption.

9. This issue paper intends to provide information on discussions that occurred when considering the principles-based bond definition and the statutory accounting revisions to specify the types of investments that shall be reported on Schedule D-1: Long-Term Bonds. A summary of the exposure periods and adoption actions are detailed below:

- a. On March 2, 2022, this issue paper, along with the principles-based bond definition, was exposed, with comments due May 6, 2022. The Working Group heard comments on July 18, 2022, and directed limited edits to be reflected while also deciding not to incorporate revisions for a number of industry-proposed comments.
- b. On August 10, 2022, this issue paper, along with the principles-based bond definition, and proposed revisions to SSAP No. 26 and SSAP No. 43 was exposed, with comments due October 7, 2022. Comments were received from Interested Parties, Fermat Capital and the industry Lease-Backed Securities Working Group. After considering comments, the Working Group incorporated certain revisions.
- c. On November 16, 2022, after considering comments from the August 2022 exposure, the Working Group exposed revisions to SSAP No. 26 and SSAP No. 43. The Working Group also exposed revisions to other SSAPs that will be impacted with the bond project revisions. These edits included revisions to detail the short-term and cash equivalent restriction for ABS in *SSAP No. 2—Cash, Cash Equivalents, Drafts and Short-Term Investments* as well as guidance for debt securities that do not qualify as bonds in SSAP No. 21. This guidance was exposed until February 10, 2023.
- d. On March 22, 2023, during the 2023 Spring National Meeting, the Working Group considered comments received and exposed updated guidance, with a comment period ending June 9, 2023, to reflect most of the interested party comments.
- e. On August 13, 2023, during the 2023 Summer National Meeting, the Working Group adopted the exposed revisions to SSAP No. 26, SSAP No. 43 and the document detailing revisions to other SSAPs with an effective date of January 1, 2025. With this action, it was noted that no comments had been received on these exposed items. Also on August 13, 2023, the Working Group considered comments on the exposed SSAP No. 21 on the guidance for non-bond debt securities that do not qualify as bonds and on residual interests and exposed a revised SSAP No. 21 until September 29, 2023.

- f. On December 1, 2023, during the 2023 Fall National Meeting, the Working Group considered comments received on SSAP No. 21, predominantly focused on the accounting and measurement of residual interests and exposed an updated SSAP No. 21 until January 22, 2024.
- g. On February 20, 2024, the Working Group received a revised SSAP No. 21 that was updated to reflect interested parties' comments during the interim. The Working Group exposed the revised SSAP No. 21 for a shortened comment period ending March 7, 2024, to allow for possible adoption consideration during the 2024 Spring National Meeting.
- h. On March 16, 2024, during the 2024 Spring National Meeting, the Working Group adopted new statutory accounting guidance within SSAP No. 21 for "Debt Securities That Do Not Qualify as Bonds" and for "Residual Tranches or Interests/Loss Positions." The new sections are effective January 1, 2025, but reporting entities may elect to adopt the residual guidance for year-end 2024. With this action, all planned statutory accounting guidance for the principles-based bond definition was adopted.

### **Discussion of Principles-Based Bond Concepts**

10. Pursuant to the "small group" discussions comprised of industry, Iowa regulators and NAIC staff, the broad principle-based bond concepts discussed on August 26, 2021, reflected the following key concepts:

- a. Definition of a bond requires a security structure, representing a creditor relationship, that is considered an Issuer Credit Obligation (ICO) or an Asset-Backed Security (ABS).
- b. The assessment of whether a security represents a creditor relationship requires consideration of the substance, rather than the legal form of the document, as well as consideration of other investments owned in the investee and other contractual arrangements. A security that possesses equity-like characteristics or that represents an ownership interest in the issuer in substance does not represent a creditor relationship.
- c. An ABS is a bond issued by an entity created for the primary purpose of raising debt capital backed by financial assets or cash generating non-financial assets owned by the ABS Issuer, whereby repayment is primarily derived from the cash flows associated with the underlying defined collateral rather than the cash flows of an operating entity.
- d. There are two defining characteristics that must be present for a security to meet the definition of an ABS: 1) The holder of a debt instrument issued by an ABS issuer is in a different economic position than if the holder owned the ABS Issuer's assets directly, and 2) When the assets owned by the ABS are non-financial assets, the assets are expected to generate a meaningful level of cash flows towards repayment of the bond other than through the sale or refinancing of the non-financial assets.

11. Various discussions and components were addressed in the establishment of these broad concepts and throughout the development of the principles-based bond definition. Specific elements and discussion points are detailed within this issue paper.

### **Security Structure Representing a Creditor Relationship**

12. Similar to long-standing guidance in defining a bond, the principles-based bond concepts only permit security structures to be considered eligible for Schedule D-1 reporting. Although the concepts continue reference to the adopted security definition from U.S. GAAP, the guidance is expanded to require that the evaluation of the structure under the security definition considers the substance of the instrument rather than solely its legal form.

13. The consideration of whether a structure reflects a “security” is a key factor in determining the appropriate SSAP for accounting and reporting. A structure with one or more future payments that qualifies as a security has historically been captured as a bond, with measurement and risk-based capital (RBC) charges based on the NAIC designation. Under the prior SSAP guidance, bond securities did not require additional provisions for admittance and would likely only be subject to nonadmittance based on state investment limits. This treatment is distinctly different than a “non-security” structure considered to be a loan under SSAP No. 20—*Nonadmitted Assets* or SSAP No. 21. For these structures, the ability to admit the loan under the SSAP provisions is contingent on the nature of the loan and qualifying collateral or related party assessments. (State investment limits may have additional loan-to-value requirements that impact admittance.) Loans (other than mortgage loans) are captured on Schedule BA: Other Long-Term Invested Assets and are likely limited by state investment limits along with other invested assets reported on Schedule BA. Although the RBC charge for admitted collateral loans is lower than other Schedule BA investments, the RBC charge is still higher than Schedule D-1 investments with most NAIC designations.

14. Over time, since the codification of statutory accounting principles, various industry comments have been received questioning the difference between loans and securities (e.g., bonds), particularly with the different reporting outcomes. This discussion was also revisited as part of the principles-based bond proposal, and it was concluded that structures must meet the security definition to be captured as a bond on Schedule D-1. Although industry requested “loans with recourse” to be added to the bond scope paragraph as well as an explicit reference to “loans” as a type of investment captured in the bond definition, these proposals were not supported for inclusion. This discussion highlighted that the security definition is not a high threshold to meet, and direct loans should not be reflected as bonds if they do not qualify as securities. With this discussion it was noted that an investment could meet the definition of a bond regardless of the legal form (paper) it was written on and/or how it was described (such as a bond, note, obligation, etc.). Although an instrument could be described as a “loan,” if it meets the security definition requirements and other principle concepts, it shall be captured as a bond. The same concept would be true for instruments named as a “bond” but that do not meet the security or other principle-based bond requirements, as they would not be permitted for reporting as a bond on Schedule D-1.

15. The statutory accounting guidance in SSAP No. 26 and *SSAP No. 37—Mortgage Loans* adopts the U.S. GAAP definition of a security as it is used in FASB Codification Topic 320 and 860:

- a. Security: A share, participation, or other interest in property or in an entity of the issuer or an obligation of the issuer that has all of the following characteristics:
  - i. It is either represented by an instrument issued in bearer or registered form or, if not represented by an instrument, is registered in books maintained to record transfers by or on behalf of the issuer.
  - ii. It is of a type commonly dealt in on securities exchanges or markets or, when represented by an instrument, is commonly recognized in any area in which it is issued or dealt in as a medium for investment.
  - iii. It either is one of a class or series or by its terms is divisible into a class or series of shares, participations, interests, or obligations.

16. The “security/non-security” discussion highlighted that the naming convention of an investment (as a “note,” “bond,” “obligation,” “loan,” or other such term) does not determine the correct underlying SSAP or reporting location. Non-security structures (other than mortgage loans) shall be captured as collateral or non-collateral loans pursuant to SSAP No. 20 or SSAP No. 21 as applicable. To prevent incorrect assumptions that all loans could be captured as issuer credit obligations, the group agreed not to include explicit reference to loan structures within the principles-based bond concepts and instead refer to the substance of the investment structure. Additionally, the following existing guidance was noted as support for this conclusion and to further highlight that the naming convention does not override the

structural design of an investment when it comes to reporting or the application of statutory accounting principles.

- a. Existing guidance in SSAP No. 21 states that if an instrument meets the definition of a bond, but has supporting collateral, then the investment is not classified as a collateral loan. This concept was affirmed as part of the principles-based bond discussion, noting that investments that qualify for bond reporting on Schedule D-1 shall not be classified as collateral loans regardless of whether there is collateral backing the investment.
- b. Guidance in *SSAP No. 25—Affiliates and Other Related Parties* applies to all transactions, regardless of the SSAP that governs the underlying accounting and reporting. As such, the provisions in SSAP No. 25 that require assessment of “loans or advances (including debt, public or private)” are intended to apply to all forms of lending from a reporting entity to a related party. As such, this guidance applies regardless of the naming convention of the agreement (e.g., loan, bond, note, obligation, etc.). Investments reported as bonds on Schedule D-1 that reflect related party transactions shall only be admitted if the requirements in SSAP No. 25 are met. In addition to having a specific due date and written agreements, these requirements include specific assessments based on whether the arrangement is with a parent or principal owner or to other related parties.

17. After determining whether a structure represents a security, the next component for the principle-based bond definition is assessing whether the security represents a creditor relationship. Although the reference to a “creditor relationship” may seem very similar to prior guidance in SSAP No. 26, that prior guidance did not explicitly detail the intended meaning of a “creditor relationship” but simply identified that such structures have a fixed schedule for one or more future payments. This prior guidance resulted with interpretations that structures qualified as “bonds” strictly on legal form. With the focus of the principles-based definition, it is explicit that the assessment of a whether a security represents a creditor relationship requires consideration of the substance, rather than just the legal form, along with consideration of other investments owned in the investee and other contractual arrangements.

18. Original regulator concerns with the historical guidance and reporting were in part due to the identification of investments with underlying equity interests that were structured to resemble bond instruments. Discussions that occurred as part of the principles-based bond project identified that there is a significant incentive for insurers to characterize equity exposures, which would traditionally be captured on Schedule BA, as bonds due to the favorable capital treatment. Transferring or acquiring them as debt issued by an SPV (such as through a collateralized fund obligation (CFO) structure) is a mechanism to reclassify these equity instruments and characterize them as bonds. These discussions noted that the lack of historical safeguards in existing SSAPs also provides significant opportunity for these reclassifications.

19. Equity investments differ from other types of financial assets in that they generally do not have contractual pre-determined principal or interest payments. Distributions are typically at the discretion of whichever decision maker has control of the entity. However, certain types of entities have greater likelihood and predictability of cash flows than others. For example, private equity and debt funds are often designed to have finite lives that begin with a capital raising and investment phase, and once the portfolio is built and seasoned, investments are monetized, returns are realized, and distributed to investors. Therefore, while there can be variability in timing and amounts of cash flows, distributions can be expected with some level of predictability compared to other types of equity investments (e.g., publicly traded companies). Private debt funds are more predictable still given that the underlying investments of the fund have contractual cash flows. If a large, diversified pool of seasoned funds are securitized, (often in the form of a CFO), there can be a level of predictable cash flows that is suited to support a bond, when coupled with the overcollateralization, liquidity facilities, and other protections that are built into the structure.

20. Regulator concerns arise when features that facilitate the production of predictable cash flows are not present. In such situations, when there are not predictable cash flows equipped to service the debt,

repayment may rely on sale or refinancing of the underlying equity investments at maturity in order to satisfy the debt. In that case, equity valuation risk may be the primary risk for the non-payment of the issued debt. If repayment predominantly relies on a point-in-time equity valuation (such as at maturity), then the substance of the risk is not consistent with what is expected of a bond reported on Schedule D-1.

21. Although the full disallowance of equity-backed debt would prevent these regulator concerns, there is a position that there are CFO securitizations (or other investments) of well-diversified, seasoned funds for which there is compelling evidence that there will be sufficient cash distributions to amortize the debt and structure protections that minimize the residual equity exposure. The approach to allow such CFO securitizations/investments to be reported as bonds only works when there are appropriate safeguarding principles established, which require a relatively high standard of proof.

22. An investment for which the primary non-payment risk is equity devaluation is not consistent with the substance-intent for what is expected to be reported as a bond on Schedule D-1 under the principles-based definition. Allowing such investments to be reported as bonds on Schedule D-1 could result with the regulatory arbitrage that regulators are concerned about without any real mitigants. This could ultimately result in a situation where industry has taken on significantly more equity risk than they have historically, all while characterizing the investment as a bond exposure. As such, it was noted as critical that appropriate safeguards be incorporated into the principles-based bond definition to address this concern. This is why the guidance reflects a rebuttable presumption that equity-backed ABS do not qualify to be reported as bonds on Schedule D-1 unless a documented analysis supporting the predictability of cash flows is completed that demonstrates bond-like cashflows that supports different treatment from that presumption.

23. The principles-based bond definition is clear that a security that possesses equity-like characteristics or that represents an ownership interest in the issuer in substance does not represent a creditor relationship. Examples of equity investments, equity holdings and equity-like interests include any security ultimately reflecting an ownership or membership interest in an entity (such as common stock, preferred stock, private equity holdings, investments in joint ventures, partnerships, and LLCs) as well as any structure that reflects the performance of an entity (such as dividends or capital gains). Furthermore, examples of equity instruments also include any debt instrument where the risk/reward profile is substantially similar to an equity interest.

24. With the prohibition of equity-like structures or items that represent ownership interests, there is a rebuttable presumption that debt instruments collateralized by equity interests do not qualify as bonds because they do not reflect a creditor relationship in substance. Notwithstanding this rebuttable presumption, it is possible for such a debt instrument to represent a creditor relationship if the characteristics of the underlying equity interests lend themselves to the production of predictable cash flows and the underlying equity risks have been sufficiently redistributed through the capital structure of the issuer.

25. With the establishment of the principles-based bond definition, this rebuttable presumption was specifically discussed, and it was concluded that the determination of whether debt instruments collateralized by equity interests qualify as bonds inherently requires significant judgment and analysis. Unlike debt instruments collateralized with contractual cash flows, or debt instruments collateralized by cash-generating non-financial assets, debt instruments collateralized by equity interests may be dependent on cash flow distributions that are not contractually required to be made, predetermined, and/or may not be controlled by the issuer of the debt. In some instances, sale or refinancing of the underlying equity interests may be the only means of generating cash flows to service the debt instruments. If this is the situation, then it is expected that compensating factors from other characteristics of the structure will be present that supports classifying the investment as a bond. For example, if the source of cash flows is driven from the sale or refinancing, then an appropriate, compensating level of overcollateralization would be required to overcome the presumption that the structure does not qualify as a bond.

26. For debt instruments that are collateralized by equity interests, various factors should be considered in determining whether debt collateralized by equity interests qualify as bonds. Additionally, to overcome

the presumption that the structure does not qualify as a bond, it is presumed that reporting entities will have sufficient documentation supporting this conclusion. Factors to consider include, but are not limited to, the following:

- a. Number and diversification of the underlying equity interests
- b. Characteristics of the equity interests
- c. Liquidity facilities
- d. Overcollateralization
- e. Waiting period for the distributions / paydowns to begin
- f. Capitalization of interest
- g. Covenants (e.g., loan-to-value trigger provisions)
- h. Reliance on ongoing sponsor commitments
- i. Source(s) of expected cash flows to service the debt (i.e., dividend distributions from the underlying collateral vs. sale of the underlying collateral)

27. The assessment of equity-backed securities should be looked at, not only in form, but in substance. For example, a common arrangement exists where debt is issued from a feeder fund, and the feeder fund has an equity interest in another fund which predominantly holds debt instruments. The fund passes those fixed-income cash flows through the structure to the ultimate feeder fund debt holder(s), in a way that produces substantially the same risk profile to the debt holders as a collateralized loan obligation (CLO). Accordingly, such an arrangement may have its substance aligned with a debt investment rather than a single equity investment, despite the direct holding being a fund investment. This conclusion would be supported if the terms of the structure ensure that the underlying fixed-income cash flows are passed through. Factors that add additional uncertainty as to the timing and/or amount of the pass-through of cash flows from the underlying debt instruments may call into question a conclusion that a feeder fund structure is a debt-backed structure in substance. For example, discretion of an underlying fund manager to withhold distribution of the underlying cash flows passed through from underlying debt instruments may create uncertainties as to the timing and/or amount of cash flows in such a manner that is more characteristic of an equity investment. Likewise, a feeder fund structure that is not expected to provide for regular cash interest payments would also call into question the substance as a debt-backed investment. Features that are customary to CLOs and other asset-backed securities would not ordinarily call the investment's substance into question on its own. For example, a waterfall structure dictating the pass-through and order of payments or retaining sufficient funds for covering contractual underlying fund level payments (e.g., investment management fees, legal costs, and other customary fund level expenses) are common to CLOs and other ABS, as are customary payment in kind (PIK) features designed to address temporary liquidity issues where the PIK then gets prioritized in the waterfall structure. These customary features do not constitute manager discretion that would call into question a conclusion that a feeder fund structure is a debt-backed structure in substance.

28. Conversely, if the feeder fund debt ultimately relies on equity interests for repayment (the final fund holds equity interests that generate the pass-through cash flows), the held debt instrument from the feeder fund would have to meet the requirements of paragraph 26 while looking at the substance of equity interests supporting the debt. Regardless of the underlying collateral, feeder fund arrangements would have to meet the other relevant parts of the standard (e.g., have a substantive credit enhancement, etc.) to qualify for bond reporting. Investments that resemble feeder fund structures will require entity review to determine the underlying source of cash flows and identify the uncertainties or vulnerabilities that could impact the cash flows that will be passed through to the reporting entity holder. Ultimately, the conclusion that a

structure represents a feeder fund shall not automatically qualify the structure for bond classification but shall not automatically preclude bond classification. Substance over form should be the determining factor in these and similar situations.

### **Determination of Issuer Credit Obligation or Asset-Backed Security (ABS)**

29. Security structures that qualify as creditor relationships are divided between ICO and ABS. The initial distinction between ICO and an ABS is a key factor with the principle-based bond concepts. Given their differing characteristics, investments that qualify as ICO are not required to complete assessments for qualifying credit enhancements or meaningful cash flow generation. As such, it is critical to ensure that structures which should be considered ABS or that reflect non-qualifying Schedule D-1 structures, are not classified as ICO to avoid those detailed assessments.

30. Determining whether an investment reflects an ICO or an ABS focuses on the issuer and the primary source of repayment of the instrument. An ICO represents a bond structure where the repayment is supported primarily<sup>2</sup> by the general creditworthiness of an operating entity or entities. The support for this structure consists of direct or indirect recourse to an operating entity or entities. An “operating entity” can be any sort of business entity, not-for-profit organization, or other provider of goods or services, but cannot be a natural person or an Asset-Backed Security (ABS) Issuer. An ABS is a bond issued by an entity (an ABS Issuer) created for the primary purpose of raising debt capital backed by financial assets or cash generating non-financial assets owed by the ABS Issuer, whereby repayment is primarily derived from the cash flows associated with the underlying defined collateral rather than the cash flows of an operating entity.

31. The prior assessments to divide structures between SSAP No. 26 and SSAP No. 43 seemed to focus primarily on legal form (issued by trust/SPV that held pledged assets) or on the basis of prepayment risk within the structure (meaning, that the expected timing of cash flows may vary, impacting the effective interest rate). Under the principle-based bond definition, neither of these components shall be used as a determinant in concluding whether a structure represents an ICO or an ABS.

- a. The prior guidance which focused on the use of an SPV relied more on legal form than the substance of the transaction. Although it is common that many ABS Issuers are in the form of a trust or SPV, the presence or lack of a trust or SPV is not a definitive criterion in determining that a security meets the definition of bond intended as a Schedule D-1 investment, or that it is limited to a classification as an ABS. A key component of the principles-based bond definition is that it will not be possible for insurers to classify a non-qualifying investment as a bond simply by moving it to a debt-issuing SPV that resembles a creditor relationship with a future payment obligation. Furthermore, the guidance does not preclude the use of SPVs in ICO structures. Such structures are commonly utilized in project finance arrangements to separate business operations that support specific debt instruments, or to facilitate efficient marketing of an specific ICO design (e.g., funding agreement backed notes). Although packaging investments together in an SPV, with an SPV-issued note may currently result with better RBC charges due to the current ability to report such items as bonds, structures that simply reflect a pass-through of cash flows or performance from the underlying collateral and provide no economic difference than if

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<sup>2</sup> To clarify the phrase “supported primarily by the general creditworthiness of an operating entity,” this means that the full repayment is expected to come from cash flows generated by the operating entity, not from collateral, although secondary recourse to collateral may be present. If it is expected that a majority of repayment will come from operating entity cash flows, but it is expected that some cash flows will come from collateral, this investment does not qualify as an issuer credit obligation and shall be assessed as an asset-backed security. The expectation must be that full repayment will be generated from operating entity cash flows. For asset-backed securities, the expectation is that the source of cash flows will come from collateral, even though there may be secondary recourse to an operating entity.

holding the underlying collateral items directly shall not be characterized as bonds under the principles-based bond definition.

- b. With regards to the prior interpretation that SSAP classification was based on the presence of prepayment risk, which was not an interpretation based on any explicit guidance to that effect, under the principles-based bond definition, the presence or absence of prepayment risk will continue to play no role in SSAP classification. Classification is based on whether the investment has the substance of an ICO or ABS. This distinction aligns the accounting and measurement with the characteristics of the bond structure. As ABS rely on the cash flows of underlying collateral, the measurement method described in SSAP No. 43, which requires a quarterly review of underlying cash flow assumptions, is appropriate regardless of whether variations in timing of cash flows impact the effective yield. This methodology captures variations in both timing and amount of the underlying cash flows.

32. Whether an issuer of debt represents an operating entity or ABS Issuer is expected to be clear in most instances, but certain instances may be less clear. Ultimately, for an ICO, it comes down to whether support for repayment consists of direct or indirect recourse to an operating entity or entities. In addition to “traditional bond” structures previously included in SSAP No. 26, examples of issuer credit obligations include:

- a. Investments in the form of securities for which repayment is fully supported by an underlying contractual obligation of a single operating entity. Examples can include credit tenant loans (CTLs), equipment trust certificates (ETCs), other lease backed securities, Funding Agreement Backed Notes (FABNs), etc. For purposes of applying this principle concept, repayment is fully-supported by the underlying operating entity obligation if it provides cash flows for the repayment of all interest and at least 95% of the principal of the security.
- b. Bonds issued by real estate investment trusts (REITS) or similar property trusts.
- c. Bonds issued by funds representing operating entities. Determining whether a fund represents an operating entity can generally be made by evaluating the substance of the entity and its primary purpose. A fund representing an operating entity has the primary purpose of raising equity capital and generating returns to its equity investors. Ancillary debt may be issued to fund operations or produce levered returns to equity holders. These debt issuances occur in accordance with the fund’s primary equity-investor objective. Debt securities issued by closed-end funds and business development corps registered under the 1940 Act are permitted automatic qualification as issuer credit obligations as those funds are subject to strict limits or reporting components on the leverage (debt issuance) within the fund. This safe harbor for SEC-registered funds should not be viewed to extend to funds that are not SEC-registered by analogy, through comparison of leverage levels for example. All other funds should be classified in accordance with the determination of the issuer’s primary purpose. (For example, although some registered funds allow a large percentage of debt, non-registered funds with comparable amounts of issued debt may reflect debt securities from feeder funds or equity-backed ABS, and those debt securities are required to be assessed as ABS. As such, the percentage of debt permitted for a registered funds should not be utilized as a proxy in determining whether debt issued from a fund is permitted to be captured within the guidance.) ~~Bonds issued by business development corporations, closed-end funds or similar operating entities, in each case registered under the 1940 Act. With this inclusion, it is important to highlight that the intent is specific to bonds issued from SEC registered entities. The reference to “similar entities” is not intended to capture items issued from collateralized fund obligations (CFOs), feeder funds or other such structures. In contrast, an ABS Issuer has a primary purpose of raising debt capital and its structural terms and features serve to support this purpose. More~~

distinctively, the contractual terms of the structure generally define how each cash flow generated by the collateral is to be applied. For these structures, there is little or no discretion afforded to the manager/servicer of the vehicle and any discretion that is allowed is narrowly defined in the contractual agreements. The hardwiring of debtholder protections allows for the issuance of higher amounts of debt securities to be issued than what would be possible for a fund representing an operating entity. These features support the entity's primary purpose of raising debt capital. Although, some may consider CFOs or feeder funds to be similar to closed-end funds, that assessment is not supported for classification as an ICO. Instruments considered to reflect CFOs (and other like structures) are required to be assessed as ABS for inclusion as a bond reported on Schedule D-1. Paragraphs 27-28 also detail the assessment expected in classifying feeder funds, and the requirement to determine the source of the underlying cash flows in determining classification and if the structure qualifies for reporting as a bond on Schedule D-1.

Note: Paragraph 32.c. revised with agenda item 2024-01 on September 12, 2024.

- d. Project finance debt issued by operating entities. These investments reflect financing of a single asset or “operation” (such as a toll road or power generation facility) that collateralizes a debt issuance and the cash flows produced by the asset/operation service the debt, where the issuer may also represent an operating entity. These designs have characteristics of both ICO, as the operation constitutes a stand-alone business, as well as characteristics of ABS, as they are formed for the purpose of raising debt capital backed by the cash flows from collateral held by a bankruptcy-remote entity. When viewed holistically, these issuing entities are typically used to facilitate the financing of an operating component of a project sponsor or municipality. Although the use of a bankruptcy-remote entity (e.g., SPV) facilitates the efficient raising of debt as a source of financing, the primary purpose is to finance an operating project. Therefore, when the issuing entity represents a stand-alone business producing its own operating revenues and expenses, where the primary purpose is to finance an operating project, the issuing entity shall be considered an operating entity despite certain characteristics that resemble ABS issuances.
  - i. It is important to highlight that the guidance for project finance is strictly for instruments issued by operating entities, similar to other instruments that qualify as ICO under the principles-based bond definition. Consistent with other concepts, the naming convention (e.g., referring to an instrument as project finance) or the presence or absence of an SPV/trust structure are not definitive components in determining whether an investment qualifies for reporting as a bond on Schedule D-1, or is classified as an ICO or ABS. Instruments (even if identified as “project finance”) that do not qualify as ICO as they are not issued by operating entities, shall be assessed for qualification for reporting on Schedule D-1 as ABS. If the instruments do not qualify for reporting as ABS, they shall not be reported on Schedule D-1.
- e. U.S. Treasury Inflation-Protected Securities (TIPs): The inclusion of U.S. TIPs specifically as an ICO intends to highlight a specific exception to the determination as a creditor relationship as the variation is due to plain-vanilla inflation adjustment mechanisms. Although U.S. TIPs are specific as ICO, under the bond definition, in order for a debt instrument to represent a creditor relationship for both ICO and ABS, it must have pre-determined principal and interest payments (whether fixed interest or variable interest) with contractual amounts that do not vary based on the appreciation or depreciation (e.g.,

performance) of any underlying collateral value or other non-debt variable<sup>3</sup>. For example, an issued security that has varying principal and interest payments based on the appreciation of referenced equity, real estate or other non-debt variables are precluded from bond treatment as they do not reflect creditor relationships. Although US TIPS are indexed to the consumer price index and grow with inflation, these securities shall be captured as ICO on Schedule D-1-1.

33. This principles-based bond project is not expected to reconsider certain investments previously considered by the Working Group and explicitly permitted for bond reporting on Schedule D-1. As such, unless subsequently addressed, the following investment types are expected to continue to qualify as Schedule D-1 investments, classified as ICO. (By including these investments as ICO, these investments are not subject to the assessments of sufficient credit enhancement or meaningful cash flow generation required for ABS securities.)

- a. Certificates of deposit that have a fixed schedule of payments and a maturity date in excess of one year from the date of acquisition.
- b. Bank loans that are obligations of operating entities, issued directly by a reporting entity or acquired through a participation, syndication or assignment.
- c. Debt instruments in a certified capital company (CAPCO).
- d. SVO-Identified Bond ETFs.

34. The investment structures explicitly permitted for Schedule D-1 reporting no longer includes a generic reference to “hybrid securities.” Under prior guidance in SSAP No. 26, hybrid securities, defined in the annual statement instructions as securities with characteristics of both debt and equity securities, were included and captured on a specific Schedule D-1 reporting line. Examples in the annual statement instructions included Trust Preferred Securities and Yankee Tier 1 bonds, however, both types of securities are no longer overly prevalent, although some insurers may continue to have them in their portfolios. Pursuant to the intent of the principle-based bond definition, a broad exception for securities that have characteristics of both debt and equity is not viable. Rather, to ensure that securities are classified and reported based on the substance of the investments, securities with characteristics of both debt and equity shall be assessed for inclusion as a bond for reporting on Schedule D-1 in accordance with the principal-based bond definition. If the securities qualify as ICO or ABS, then they can be reported on Schedule D-1.

- a. Trust Preferred Securities – With these securities, there is a trust funded by debt where shares of the trust are then sold to investors in the form of preferred stock. The shares held are referred to as “trust preferred” securities. These securities have characteristics of both stock and debt. While the trust is funded with debt, the shares are considered to be preferred stocks and pay dividends like preferred stock. However, since the trust holds the bank’s debt as the funding vehicle, the payments received by investors are considered interest payments. These securities are considered equities under U.S. GAAP but are taxed as debt obligations by the IRS. With the Dodd-Frank reforms, the incentives for banks to issue trust-preferred securities decreased, resulting in a significant reduction in the issuance of these securities. If these securities continue to be held by insurers, they should be assessed

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<sup>3</sup> The principles-based bond definition requirement for pre-determined principal and interest payments with contractual payments that do not vary based on the performance of an underlying collateral value or other non-debt variable does not intend to encompass nominal interest rate adjustments. Nominal interest rate adjustments are those that are too small to be taken into consideration when assessing the investment’s substance as a bond. Nominal adjustments are not typically influential factors in an investors’ evaluation of investment return and are often included to incentivize certain behavior of the issuer. An example would include sustainability-linked bonds where failure to achieve performance metrics could cause interest rate adjustments. In general, interest rate adjustments that adjust the total return from interest by more than 10% (e.g., >0.4% for a 4% yielding bond), would not be considered nominal. Further, any such adjustments that cause an investment to meet the definition of a structured note would not be considered nominal.

for reporting as a bond on Schedule D-1 under the principal-based bond definition. If these securities do not qualify as a bond for reporting on Schedule D-1, presumably, these securities would be reported as preferred stock on Schedule D-2-1.

- b. Yankee Bond – A Yankee bond is one issued by a foreign bank or company but that is traded in the U.S and priced in U.S. dollars. Yankee bonds are normally issued in tranches, with a large debt structure financing arrangement, with each tranche having different levels of risk, interest rates and maturities. The non-U.S. issuers have to register Yankee bonds with the SEC before offering the bond for sale. If these securities are held by insurers, they should be assessed for reporting as a bond on Schedule D-1 under the principal-based bond definition.
- c. Other Hybrid Securities – From information received, it was noted that some reporting entities have previously reported securities on Schedule D-1 as hybrids due to a code in Bloomberg that identified the security as having characteristics of both debt and equity. Such securities shall be reviewed in accordance with the principles-based bond definition and reported as a bond on Schedule D-1 only if they qualify.

35. For securities that represent principal-protected securities and structured notes that have been previously captured within SSAP No. 26 or SSAP No. 43, the principles-based bond definition will no longer permit these security structures to be reported as bonds on Schedule D-1. Fundamentally, these structures have the potential for variable principal or interest / returns, or both, due to appreciation or depreciation (i.e., performance) of an underlying collateral value or other non-debt variable. This structural characteristic precludes these investments from being captured as ICO or ABS as the investment does not represent a creditor relationship in substance. It should be clear that the principles-based bond definition is intended to require a structural assessment inclusive of all investment components, therefore it is not permissible to segregate components within a structure, such as bond collateral supporting principal and interest payments to determine bond reporting on Schedule D-1 when the structure also includes other collateral with the potential to generate additional interest or returns. Such structures must be viewed holistically within the principles-based bond definition, with all potential returns considered in determining whether the structure qualifies as a creditor relationship.

- a. A principal-protected security is defined in *the Purposes and Procedures Manual of the NAIC Investment Analysis Office*, but generally includes a high-quality traditional bond (such as a U.S. Treasury) that is used to safeguard principal repayment at the structure's maturity, along with performance components where payments originate from, or are determined by, non-fixed-income securities. These returns, often based on underlying equity factors, prevent these structures from qualifying as a creditor relationship. In addition to the traditional design of principal-protected notes, other designs have been identified that may provide "interest" payments in the form of tax-credits based on underlying equity exposures. (So, a high-quality bond safeguards principal returns, but the structure includes equity elements that provide tax credits to the note holder as a form of interest.) Although the classification of a creditor-relationship may not be as clear in this example, such designs would further be disqualified from reporting as a bond on Schedule D-1 as they would not qualify as ICO due to the different forms of collateral within the structure (considering both the bond and equity items) and such structures would not qualify as ABS as there is generally no credit enhancement. These investments shall follow the guidance for non-bond debt securities in *SSAP No. 21—Other Admitted Assets*.
- b. A structured note is a security that otherwise meets the definition of a bond, but for which the contractual amount of the instrument to be paid at maturity (or the original investment) is at risk for other than failure of the borrower to pay the principal amount due. These instruments, although in the form of a debt instrument, incorporate the risk of an underlying variable in the terms of the agreement, and the issuer obligation to return the full principal

is contingent on the performance of the underlying variable. These investments are addressed in *SSAP No. 86—Derivatives*. Mortgage-referenced securities issued by a government sponsored enterprise are explicit inclusions in scope of SSAP No. 43. Foreign-denominated bonds subject to variation as a result of foreign current fluctuations are not structured notes.

36. The guidance in the principles-based bond definition requires “assessment at origination” in determining whether a security qualifies for reporting as a bond on Schedule D-1. This provision intends to reflect the reporting entity’s understanding of the intent and ultimate structure of the security’s focus at origination, not simply what a structure holds on the day of origination. It is not permissible to conclude that a principal-protected security is an ICO at origination (when the structure includes only a US Treasury and cash) and disregard the intended use of the cash in the structure to subsequently acquire other investments to generate additional returns. The determination of whether an investment qualifies as a creditor-relationship, and then as an ICO or ABS (as applicable), requires an assessment by the reporting entity of the full structure at the time of acquisition as it was ultimately intended by the issuer at the time of origination.

37. Consistent with prior guidance in SSAP No. 26, mortgage loans and other real estate lending activities, which are not securities, made in the ordinary course of business are excluded from bond classification on Schedule D-1. Those investments shall follow the applicable statutory accounting guidance in SSAP No. 37 and *SSAP No. 39—Reverse Mortgages*.

### **Asset-Backed Securities and Required Components**

38. An ABS is a bond issued by an entity (an ABS Issuer) created for the primary purpose of raising debt capital backed by financial assets or cash generating non-financial assets owed by the ABS Issuer, whereby repayment is primarily derived from the cash flows associated with the underlying defined collateral rather than the cash flows of an operating entity. In most instances, the ABS Issuer is not expected to continue functioning beyond the final maturity of the debt initially raised by the ABS Issuer. As previously noted, ABS Issuers are often in the form of 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.

39. To qualify for bond reporting on Schedule D-1 as an ABS, there are two defining characteristics that must be present. If the structure is not an ICO or identified for specific inclusion on Schedule D-1, and does not meet these ABS requirements, the instrument is not permitted to be reported as a bond. Assessment on these aspects is investment specific, with determination at origination by the reporting entity based on the overall intent and ultimate expected holdings of the structure:

- a. **Substantive Credit Enhancement:** The holder of the debt obligation issued by the ABS Issuer is in a different economic position than if the holder owned the ABS Issuer’s assets directly.
- b. **Cash Generating Collateral Assets:** The assets owed by the ABS Issuer are either financial assets or cash-generating non-financial assets. Cash-generating non-financial assets are defined as assets that are expected to generate a meaningful source of cash flows for repayment of the bond through use, licensing leasing, servicing or management fees, or other similar cash flow generation other than through the sale or refinancing of the assets.

40. **Substantive Credit Enhancement:** The component for substantive credit enhancement is required for all ABS structures. There are no practical expedients or thresholds that can be applied in determining whether a structure reflects substantive credit enhancement. Although certain structures may only require a limited analysis (such as agency-backed mortgage-backed securities—MBS), and insurers may benefit

from prior analysis when acquiring similar subsequent structures, an automatic assessment is not permitted for this requirement.

41. To qualify as an ABS, the holder of the debt obligation is required to be in a different economic position than if the holder owned the ABS issuer's assets directly. For purposes of this assessment, the holder of the instrument is considered to be in a different economic position if the instrument benefits from substantive credit enhancement through guarantees (or other similar forms of recourse), subordination and/or overcollateralization. This element is required for all ABS designs, regardless of the collateral that is backing the ABS.

42. The requirement for substantive credit enhancement is intended to address investment designs crafted to appear as a debt / bond structure for reporting and RBC purposes, but for which the holder does not have a "more than nominal" change to the risk or reward profile than if they held the underlying investment directly. This guidance prevents using a specifically designed legal form (such as transferring assets to an SPV and acquiring an SPV-issued note), but which lacks any economic substance, to obtain favorable measurement and RBC impact or to avoid nonadmittance that would occur if the assets were directly held by the reporting entity.

43. The intent of the "substantive" threshold requiring the holder to be in a different economic position is to distinguish qualifying bonds from instruments with equity-like characteristics or where the substance of the transaction is more closely aligned with that of the underlying collateral. To qualify as a bond under this standard, there is a requirement that there are substantive credit enhancements within the structure that absorb losses before the debt instrument being evaluated would be expected to absorb losses. This is inherent in the context of an ICO as the owners of the equity in the operating entity are the first to absorb any variability in performance of the operating entity. The same concept applies to ABS. If substantive credit enhancement did not exist, the substance of the investment would be more closely aligned with that of the underlying collateral than that of a bond. Credit enhancement that is merely nominal or lacks economic substance does not put a holder in a different economic position.

44. The original exposure (May 2021) detailed this ABS requirement as a "sufficient" credit enhancement and detailed the provision as the level of credit enhancement a market participant (i.e., reasonable investor) would conclude is expected to absorb losses (or decreases in cash flows) to the same degree as other debt instruments of similar quality, under a range of stress scenarios (i.e., scenarios are similar to stress scenarios performed for other debt instruments of the same quality). This original proposal noted that losses are those a market participant would estimate with consideration of historical losses (including loss recoveries) on similar collateral, current market conditions, reasonable and supportable forecasts, and prepayment assumptions associated with the collateral. Excluded from the estimate of expected losses are historical gains on similar collateral and expected market appreciation on the collateral. After further discussion of this concept, it was identified that the term sufficient and its proposed definition implied a quantitative assessment of credit quality was required. As a result, the proposed concept could be interpreted to mean that a reperformance of the credit underwriting process would be needed to support accounting classification, which is not the intent and could be seen to violate the policy that credit ratings do not determine accounting classification, as well as introduce an administrative reporting burden that is both duplicative and lacking any added value. Further, a misinterpretation could occur that would permit satisfaction of this component if a credit rating or NAIC designation was obtained. The intent of the concept is not to address credit quality. Rather, the intent is to require that there must be economic substance to support the transformation of the underlying collateral risk, to bond risk. As a result of these discussions, revisions were incorporated to revise the terminology and related definition to reflect a "substantive credit enhancement." In addition to eliminating a perception that reporting entities could use credit ratings to support this distinction, this guidance incorporates principle concepts to ensure that the provision cannot be satisfied with structural elements that are merely nominal or lack economic substance.

45. Substantive credit enhancement can come in various forms, including but not limited to, subordination/overcollateralization, guarantees, or other forms of recourse. In whatever form the credit

enhancement comes in, it must be of a level of significance that the holder of the debt instrument is in a substantively different position than owning the underlying collateral directly. Assessment of whether a credit enhancement has substance may involve an evaluation of the level of overcollateralization (loan-to-value or LTV) or the capacity of whatever form of subordination, guarantee or recourse to absorb collateral losses. The guidance intends to be specific that an NAIC designation, obtained from either the NAIC Securities Valuation Office (SVO) or from a Credit Rating Provider (CRP) does not provide standalone evidence to support a conclusion that the structure includes a substantive credit enhancement. Although the presence of independent market validation may provide evidence supporting the substance of a credit enhancement, that provision shall not be interpreted to indicate that the presence of an NRSRO rating is automatic validation that the substantive threshold has been met.

46. The following elements were specifically discussed with regards to the requirement for a substantive credit enhancement:

- a. **Agency-Backed Pass-Through Structures (e.g., RMBS/CMBS):** These structures, when they have an agency guarantee, are expected to meet the substantive credit enhancement requirement with little analysis. Although the reporting entity participates on a proportional basis in the cash flows from the underlying mortgage loans held by the SPV, the reporting entity is in a different economic position than if it owned the underlying mortgages directly because the credit risk has been redistributed and assumed by the agencies.
- b. **Non-Agency Backed Pass-Through Structures:** Unlike the above agency-backed example, a pass-through MBS without a credit enhancement, if one were to exist, would not put the holder in a different economic position as owning the mortgage loans directly as they would participate proportionally in the first dollar of losses on the underlying loans. Pursuant to the intent of the overall principles-based bond / Schedule D-1 project and required substantive credit enhancement, the guidance does not permit use of an SPV to recharacterize an asset to qualify for reporting as a bond on Schedule D-1 if the holder is in the same economic position as holding the underlying investments directly. This would apply to any type of underlying asset. In contrast, if a debt instrument represents a senior interest in the pool of loans, through existence of a subordinated tranche for example, the holder may conclude that it is in a different economic position from holding the loans directly, provided the subordination is determined to be substantive.
- c. **Loan-To-Value (LTV) Assessments:** An assessment of LTV at origination may provide evidence of substantive credit enhancement through overcollateralization. The review should be a holistic assessment, evaluating the expected LTV over the life of the transaction, in conjunction with the liquidity and market value volatility of the underlying collateral, particularly in points in time when the underlying equipment is expected to be off-lease or at the time of maturity if refinancing or sale is required. It is appropriate to consider any expected economic depreciation, but it is not appropriate to factor in any expected economic appreciation. Although an expected decline in the LTV ratio may support the presence of a credit enhancement, a declining LTV is not required, and an increasing LTV is not prohibited, as long as the structure continues to provide a substantive credit enhancement. An expected high LTV at maturity, relative to the market value volatility of the underlying collateral, is considered to lack substantive overcollateralization and would require other forms of credit enhancement in order to meet the substantive credit enhancement criteria.
- d. The first loss position may be issued as part of an ABS structure in the form of debt or equity interest, or it may be retained by the sponsor and not be issued as part of the structure. The holder of the loss position, regardless of if it is issued as a tranche or retained by the issuer, does not impact the determination of whether the loss position provides substantive credit enhancement. Rather, the assessment focuses on whether the holder of

the debt instrument is in a substantively different position than owning the underlying collateral directly. This assessment includes consideration on the first loss position (or more senior positions, if the first loss position is not sufficient) regardless of the holder of the loss positions. If the first loss position (or a more senior position(s), if the first loss position(s) lacks substantive credit enhancement) is issued as part of the structure and does not have substantive credit enhancement and is held by a reporting entity, the investment(s) does not qualify for reporting as a bond as it is a residual interest. All residual interests shall follow the accounting and reporting guidance in SSAP No 21.

47. **Meaningful Level of Cash Flows to Service Debt:** The element for meaningful cash flow generation is only a requirement for ABS that are backed by non-financial assets. ABS designs backed by financial assets, when there is no future performance obligation outside of default risk that could impact the ability to generate cash flows to service the debt, are not required to be assessed under the meaningful cash flow requirement.

48. To qualify as an ABS, there must be a meaningful level of cash flows generated from non-financial assets backing an ABS to service the debt, other than through the sale or refinancing of the assets. The evaluation is specific to each transaction and should consider the market volatility and remarketing potential of the underlying collateral, the variability of the cash flows produced, as well as the diversification of the source of cash flows within the structure. The main intent of this guidance is to ensure that non-financial assets supporting structures reported as bonds on Schedule D-1 encompass a level of “cash generation” that is conducive to servicing traditional bond-like cash flows.

49. Consistent with the substance theme of the principles-based bond proposal, this guidance intends to prohibit situations in which the legal form of an investment is utilized to receive favorable accounting and reporting treatment, while the primary non-payment risk is the point-in-time valuation of an underlying asset. The prior guidance in SSAP No. 43 that focused on placing collateral assets in trust, with the SPV issuing a debt instrument, enabled situations in which non-cash generating structures could be reported as bonds on Schedule D-1. As a simple example, this guidance prevents artwork from being captured as the collateral backing a debt instrument issued by an SPV, with the reporting entity then reporting the SPV-issued note as a bond investment that reflects the expected future value that will be received upon the ultimate sale of the artwork.

50. The guidance requires meaningful cash generation to satisfy the debt instrument throughout the duration of the debt term. The timing of the cash generation, at points prior to maturity of the investment, is a key element as it intends to specifically exclude transactions in which the underlying assets must be sold or refinanced at maturity to produce cash to meet the meaningful requirement. However, this restriction is not intended to automatically exclude all structures that may incorporate collateral asset sales or refinancing throughout the debt duration as part of the expected cash generation. An example could be the securitization of short-term rental car receivables. Such a design could encompass both the rental car lease payments as well as periodic sales of the rental cars as the means to generate meaningful cash flows to service the debt. This design, with planned periodic sales of the non-financial collateral assets over the debt term, is distinctly different than a structure in which cash flows are not meaningfully generated over the course of the debt term and would rely predominantly on the sale or refinancing of the underlying collateral at maturity to satisfy the debt obligation. This restriction also does not exclude all structures that have any amount of sales or refinancing at the end of the debt term. Such investments can qualify for reporting as a bond on Schedule D-1 if they meet the meaningful cash generation criteria throughout the term of the instrument other than through the sale/refinancing at maturity.

51. The assessment of meaningful cash flows may require detailed evaluations as it is not permissible to conclude that the presence of any cash flows generated within the structure will result with the investment reaching the “meaningful” threshold. It is also not expected to commonly see ABS structures that include both financial and non-financial collateral. Such designs shall be reviewed to determine that the structure is in line with the principle intent of the bond definition and has not been developed to circumvent separate

assessment or reporting of non-financial asset components. As a simplistic example, including mortgage-backed securities and artwork in a single structure, and identifying that the cash flows of the MBS satisfies the meaningful threshold with the artwork representing a minimal residual element, with a conclusion that the full structure qualifies for reporting as a bond on Schedule D-1 is not reflective of the intent of the principles-based standard. If there are instances in which financial asset and non-financial asset collateral are combined in a single ABS structure, consideration should occur on the intent of commingling these collateral elements pursuant to the intent of the principles-based bond definition and in assessing the meaningful cash flow requirements. Structures identified that have been developed to circumvent the provisions of the principle-based bond definition are not permitted to be reported as a bond on Schedule D-1 and shall be captured as a non-bond debt security in scope of SSAP No. 21.

52. The assessment of meaningful cash flows is specific to each transaction, determined at origination, and should consider various factors collectively in determining if the meaningful threshold is met. For this assessment, it is noted that an increase in price volatility or variability of cash flows requires a greater percentage of cash flows generated to service the debt from sources other than the sale or refinancing of the underlying collateral. On the flip side, as liquidity, diversification or overcollateralization increase, the required percentage of cash flows generated to service the debt from sources other than the sale or refinancing of the underlying collateral is permitted to decrease. The following factors should be considered with the assessment of meaningful cash flows:

- a. Price volatility in the principal market in the underlying collateral.
- b. Liquidity in the principal market for the underlying collateral.
- c. Diversification characteristics of the underlying collateral (i.e., types of collateral, geographic locations, sources of cash flows within the structure, etc.)
- d. Overcollateralization of the underlying collateral relative to the debt obligation.
- e. Variability of cash flows, from sources other than sale or refinancing, expected to be generated from the underlying collateral.

53. The assessment of meaningful cash flows does permit a practical expedient under the principles-based bond definition. A reporting entity may consider an asset for which less than 50% of the original principal relies on sale or refinancing to meet the meaningful cash-flow generating criteria. (A structure with contractual cash flows that does not satisfy all of the interest stipulated in the structure does not qualify under the practical expedient.) In applying this practical expedient, only contractual cash flows of the non-financial asset may be considered. This practical expedient should not be construed to mean that assets cannot meet the meaningful criteria if they rely on the sale or refinancing to service any interest, an amount greater than 50% of the original principal or if they rely on cash flows that are not contracted at origination. Rather, such instances do not qualify under the practical expedient and would require a complete analysis of the noted factors in determining whether the meaningful cash-generating criteria has been met.

#### **Additional Elements for Asset-Backed Securities**

54. When establishing the ABS definition and required components, various aspects were discussed to improve clarity on the application of the guidance.

55. Determination of “Assets” Backing Securities: Although the definition of an asset detailed in *SSAP No. 4—Assets and Nonadmitted Assets*, is applied throughout statutory accounting principles, the question was raised as to where the asset definition would be applied in determining a qualifying ABS. For example, an entity that expects to have subsequent receivables from future operations does not have recognized “assets” from those expectations as the requirements of the asset definition have not been met. However, if that entity were to sell the rights to future cash flows from expected operations, the selling entity would

receive cash (a qualifying asset), and the acquiring entity would also have a recognized asset from the acquired right to future cash flows.

56. For purposes of qualifying as an “asset” permitted in an ABS structure, the definition of an asset must be met by the ABS Issuer. In some situations, particularly when the asset represents a right to future cash flows, the asset may not be in a form that could be liquidated to provide payment towards the debt obligations. (For example, if the asset represents acquired rights to future royalties, those royalty rights would have to materialize to have liquid assets available toward the debt obligations.) The ability to liquidate the backing collateral asset at a single point in time does not impact the structural determination of whether the issued security meets the definition of an ABS provided that the assets are expected to produce meaningful cash flows to service the debt terms. Additionally, the inability to liquidate the assets backing the instrument may impact the assessment of what constitutes substantive credit enhancement. Failure of cash flows to materialize may impact recoverability and require impairment of an ABS.

57. There is no requirement for a collateral asset backing an ABS structure to qualify as an admitted asset under statutory accounting. Assessing whether the underlying asset qualifies for admittance is not necessary as non-financial assets backing ABS must meet the meaningful cash-generating criteria. If the structure fails to meet the meaningful cash-generating requirement, the instrument does not qualify for reporting as a bond on Schedule D-1. Statutory accounting has not historically restricted bonds backed by inadmissible assets from being admissible, nor has it included any kind of evaluation of the cash flow producing ability of underlying assets. The principles-based bond definition adds a requirement to evaluate the cash flow producing ability of the underlying collateral but continues to recognize that assets that may not be admissible if held individually on an insurer’s balance sheet, may be well suited to support bond-like cash flows when securitized in large numbers with appropriate structuring (e.g. prioritization of cash flows).

58. Determining Whether the Structure Reflects “Financial” or “Non-Financial” Assets: The definition of a “financial asset” has previously been adopted from U.S. GAAP and is reflected in *SSAP No. 103—Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* as cash, evidence of an ownership interest in an entity, or a contract that conveys to one entity a right 1) to receive cash or another financial instrument from a second entity or 2) to exchange other financial instruments on potentially favorable terms with the second entity.

59. For purposes of excluding financial assets from the ABS meaningful cash generation criteria, the financial asset definition was clarified, for the avoidance of doubt, to not include assets for which the realization of benefits from the rights to receive or exchange financial assets depends on the completion of a performance obligation such as with a lease, mortgage servicing right, royalty rights, etc. For purposes of applying the ABS guidance, when there is a performance obligation required before the cash flows are generated, the assets represent non-financial assets, or a means through which non-financial assets produce cash flows, until the performance obligation has been satisfied. As another way to assess this clarification, if the assets backing the ABS are only subject to default risk (meaning the risk of nonpayment is solely based on failure of the underlying payer to satisfy its unconditional promise to pay), then the asset is a financial asset. If the asset is subject to any other risk in addition to default risk, then the assets represent non-financial assets. As simple illustrative examples:

- a. A mortgage-backed security (MBS), where the underlying mortgages have been securitized into a structure, the mortgage receivables represent unconditional promises to pay, with no further performance obligation of the lender or any other party. This structure is considered to be backed by financial assets. Although this structure is excluded from the meaningful cash flow assessment, it must still comply with the substantive credit enhancement requirement.
- b. A structure that represents the securitization of rental car leases is contingent on the lessor performing its side of the transaction (providing the car for use) before the lessee is

obligated to pay. Therefore, a lease is a non-financial asset due to the performance obligation that must be satisfied in order for payment to become unconditional. Additionally, as is the case with short-term car rentals, the lease (rental agreement) may not be in place and the structure may represent a securitization of the rights to future rental payments, which adds an additional performance condition. This structure combines performance risk with default risk, resulting with the structure not qualifying for classification as being backed by financial assets. For this structure, the reporting entity would have to complete assessments that 1) the structure results with substantive credit enhancement and 2) the structure produces meaningful cash flows over the term of the instrument to satisfy the debt obligation other than through the sale or refinancing at maturity. If at origination, the contractual cash flows from the underlying collateral (leased rental cars) would be sufficient to satisfy all of the interest and at least 50% of the original principal, then the meaningful criteria would be met through the practical expedient. That means, as discussed in SSAP No. 26, paragraph 9.b., that the practical expedient can only be used if less than 50% of the principal relies upon sale or refinancing.

60. Whole-Business Securitizations: In most ABS structures, the assets backing the cash flows are specified and limited to a distinct collateral pool. For example, dedicated cash flows from specific lease arrangements, or specific receivables from credit cards or mortgages. However, ABS structures can exist that represent an entire range of operating revenues or cash flows generated by the business. These structures are often referred to as “whole business” or “operating asset” securitizations. These structures, which could only include cash flows from certain operating segments, and not necessarily the entire business of a company’s operations, transfer the cash flows from the dedicated operations first to the investment holders, with the operating entity receiving their “operation proceeds” after the investment holders have been paid. This is different from a traditional bond structure where the operating entity first receives the proceeds from their operations and has discretion on how it uses those proceeds to continue operations and pay expenses and then ultimately pay the bond holders according to the debt terms. Further, debt holders in a whole-business securitization generally only have recourse to the cash flow streams pledged to support the debt, unlike a general credit obligation of the operating entity.

61. For the principles-based bond definition, structures that refer to whole-business securitizations, or that refer to operation proceeds as the collateral for the source of debt repayment still meet the definition as an ABS and do not reflect ICO. For these structures, the dedicated operational cash flows represent the defined collateral pool and should not be classified as ICO based on an interpretation that the proceeds represent the cash flows of an operating entity as they are not supported by the general creditworthiness of an operating entity, but rather only on referenced cash flow streams from the entity’s operations.

62. Residual Tranches / “Equity” Components of Schedule D-1 Qualifying Structures: The assessment of qualifying Schedule D-1 investments has to consider the overall investment structure but focuses primarily on the specific instrument held by the reporting entity. Structures, particularly ABS, may include residual tranches that provide payment after pre-determined principal and interest payments have been made to other tranches or interests based on remaining available funds. Although payments to residual note holders could 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 interest and principal payments. In all instances, despite whether other tranches of the investment structure qualify for reporting as a bond on Schedule D-1 reporting, residual tranches do not qualify for bond reporting on Schedule D-1.

63. Under prior guidance in SSAP No. 43, there was no exclusion that restricted residual tranches of qualifying securitizations from being captured in scope and being reported as bonds. From the outreach performed in developing the principles-based bond definition, it was identified that several insurers have historically reported these residual tranches on Schedule BA: Other Long-Term Invested Assets. However, it was noted that some reporting entities have reported these items as a bond on Schedule D-1 as a component of the securitization or as a beneficial interest in scope of SSAP No. 43. Although residual tranches (first loss tranches) do not receive CRP ratings or NAIC SVO designations, when reported on

Schedule D-1, an NAIC designation is required. From information obtained, entities reporting residual tranches on Schedule D-1 have either been reporting as self-assigned 6\* or they applied the NAIC 5GI concept to self-designate these securities. Under the 5GI concept, the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (P&P Manual) permits self-designation as an NAIC 5 if the documentation necessary for a full SVO credit analysis does not exist, the issuer is current on all principal and interest payments, and the reporting entity has an expectation that they will receive all contracted interest and principal. The use of the NAIC 5GI concept to self-designate residual tranches on Schedule D-1 is a misapplication of this guidance. It is faulty to conclude that an investment is current and will provide all contractual interest and principal payments when the investment provides payments based on remaining funds after obligations to other issued debt instruments from the structure are satisfied. Furthermore, the 5GI provision was intended to prevent an NAIC 6 designation simply because the documentation for a full credit analysis could not be provided or reviewed, such as situations involving foreign securities when the supporting documents are in a foreign language. The NAIC 5GI provision was not intended to permit self-assignment of an NAIC 5 designation to securities that would not qualify as a fixed-income instrument eligible for an NAIC designation under the P&P Manual.

64. With the identification that residual tranches are inconsistently reported, with some entities reporting as bonds on D-1 and others reporting on Schedule BA, the Working Group drafted and exposed agenda item 2021-15: SSAP No. 43 – Residual Tranches in September 2021 as an interim action prior to the conclusion of the bond project. The guidance within that agenda item clarified that residual tranches shall be reported on Schedule BA at lower of amortized cost or fair value. The guidance also clarified that the reference to residual tranches intends to capture securitization tranches and beneficial interests, as well as other structures captured in scope of SSAP No. 43 that reflect loss layers where failing to remit contractual interest or principal payments does not result in an act of default. Payments to holders of residual interests occur after contractual interest and principal payments have been made to holders of other tranches or interests and are based on the remaining available funds. Although payments can occur throughout an investment’s duration, such instances still reflect the residual amount permitted to be distributed after other holders have received contracted interest and principal payments.

65. On November 10, 2021, the Statutory Accounting Principles (E) Working Group adopted agenda item 2021-15, clarifying that residual tranches are required to be reporting on Schedule BA: Other Long-Term Assets beginning December 31, 2022, with early adoption permitted. The effective date of this action allowed time for reporting entities to implement this change and to correspond with a Blanks (E) Working Group proposal to incorporate separate reporting lines for residuals, based on underlying characteristics of the structure, on Schedule BA. With the adoption of this guidance, the Working Group noted that reporting entities may elect to reclassify residual tranches or interests to Schedule BA in advance of the effective date. As of the effective date, residual tranches or interests previously reported on Schedule BA shall be reclassified to the appropriate residual tranche Schedule BA reporting line based on the underlying characteristics of the investment structure.

66. Along with the action to specify the Schedule BA reporting for residuals, the Statutory Accounting Principles (E) Working Group and the Valuation of Securities (E) Task Force provided a joint memorandum to the Blanks (E) Working Group to specifically identify that application of the NAIC 5GI process to residuals is an inaccurate application. Residual tranches or interests reported on Schedule D-1 for year-end 2021 shall be reported with an NAIC 6. The Task Force also received a referral requesting clarification of the NAIC 5GI process so future misapplications could be mitigated. The Task Force considered specific changes to address residuals and adopted those revisions during the 2021 Fall National Meeting.

67. Subsequent to the guidance adopted in agenda item 2021-15, additional revisions were adopted to SSAP No. 48—*Joint Ventures, Partnerships and Limited Liability Companies* (agenda item 2023-12) and to SSAP No. 30—*Unaffiliated Common Stock* and SSAP No. 32—*Preferred Stock* (agenda item 2023-23) to clarify that all residuals, regardless of legal form of the investment, shall be reported on the dedicated residual reporting lines on Schedule BA.

68. The adoption of SSAP No. 21 in accordance with the principles-based bond project, incorporated guidance for non-bond debt securities and residual interests. The residual guidance includes the definition, common traits in identifying residuals as well as accounting and reporting guidance. Although adopted with a January 1, 2025, effective date consistent with the bond project, reporting entities are permitted to early-adopt the residual guidance in 2024. This SSAP No. 21 residual guidance has the following key aspects:

- a. Residuals are permitted to be admitted assets if debt securities from the same securitization qualify (or would qualify) as admitted assets. If a debt security held from the same structure is (or would be) nonadmitted, then any residual interests or first loss positions held from the same structure do not qualify as admitted assets. Residuals in the legal form of a SSAP No. 48 investment are not subject to the SSAP No. 48 audit requirements for admittance as they are captured in scope of SSAP No. 21 and not SSAP No. 48.
- b. Residuals shall be initially reported at cost, or allocated cost (using proportional fair values) if acquired along with debt tranches from the securitization. Subsequent to initial acquisition, residuals shall be reported at either 1) the lower of adjusted cost or fair value under the Allowable Earned Yield method, with temporary reductions in fair value reported as unrealized losses, or 2) at the calculated practical expedient method permitted in SSAP No. 21. For the residual guidance, amortized cost is defined as the cost the residual reduced for distributions in excess of the Allowable Earned Yield and other-then-temporary impairments (OTTI). The Allowable Earned Yield is established at acquisition as the discount rate that equates the initial best estimate of the residual's cash flows to its acquisition cost. With this approach, interest income is recorded under the effective yield method using the Allowable Earned Yield, capped by the amount of cash distributions received. Amounts received in excess of the Allowable Earned Yield reduces amortized cost. The practical expedient calculates book/adjusted carrying value (BACV) such that all distributions received are treated as a reduction in BACV. With this approach, the reporting entity will not recognize any interest or investment income until the residual tranche has a BACV of zero.
- c. Residuals shall be assessed for OTTI on an ongoing basis, with required assessment anytime that fair value is less than the reported value. For residuals measured using the Allowable Earned Yield method, an OTTI is considered to have occurred if the present value of expected cash flows discounted by the Allowable Earned Yield is less than amortized cost. For residuals measured under the practical expedient, an OTTI shall be considered to have occurred if the fair value of the residual is less than the BACV.
- d. The residual guidance is adopted prospectively and includes transition guidance in applying the revised measurement method for securities previously captured in scope of another SSAP. This guidance mirrors concepts from the transition of the principles-based bond definition.

69. Stapling of Investments: The original exposure of the principles-based bond definition (May 2021) included an initial example detailing a situation where "equity interests" from a tranche (such as residuals) were required to be held by a reporting entity when holding debt tranches. That language identified situations where the reporting entity would be restricted from selling, assigning, or transferring the unsecured debt investment without also selling, assigning or transferring the equity interest to the same party. This restriction is often referred to as the "stapling" of investments. Pursuant to the guidance in the initial example, although the debt instrument would separately qualify as a creditor relationship for bond reporting, when considering the entirety of the holdings (both the residual/equity interests and debt tranches combined), the investment would be considered an equity instrument in substance. Although the debt instrument would appear to have a higher priority of payment, that priority would be supported by the residual/equity interest the reporting entity has to hold. Ultimately, the reporting entity would be subordinate to themselves as they would recognize a loss on the residual/equity tranche to safeguard

payment under the debt tranche. Under that initial proposed example, all holdings under such situations, including the debt tranches, would not qualify as creditor relationships and would not qualify for bond reporting.

70. After considering comments from the first exposure period, as well as discussing within the small group of industry and regulators, this example was eliminated from the principles-based bond definition. These discussions ultimately concluded that tranches that separately qualify as bonds should be reported as bonds even if other tranches from a structure that do not qualify as bonds are also held by the reporting entity. Elements noted as part of the decision to remove the stapling restriction include:

- a. A key element in the initial proposal to require all of the holdings as equity was to ensure that the risk of the holdings was properly captured. It was noted that recent developments to tranche investments that were previously reported as investments in LLCs or joint ventures could result in RBC arbitrage. This is because the risk of the investment would be concentrated in a specific tranche intended to absorb losses, and only that limited tranche would be reported on Schedule BA with higher RBC charges. This would allow the debt tranches (as they are subordinated by the equity tranche) to likely qualify as bonds with Schedule D-1 reporting and lower RBC charges. However, because risk has been concentrated into the smaller equity tranche as a result of leverage, and because Schedule BA RBC charges are fixed and insensitive to leverage, there is a lowering of risk-based capital in total despite no change in risk. The subsequent discussions highlighted that this is an RBC issue for the equity tranche and is not an accounting classification issue. As consideration on appropriate risk charges for residual tranches has been requested to the Financial Condition (E) Committee and is a discussion item for the RBC Investment Risk and Evaluation (E) Working Group, this issue is not within the focus of the Statutory Accounting Principles (E) Working Group. It was also noted that consideration of statutory accounting provisions (such as nonadmittance) to achieve a desired risk assessment would be an inappropriate use of the accounting guidance. It was also noted that the investments within scope of these discussions are likely permitted for admittance under state law and incorporating statutory guidance different from state law would only result with identification of prescribed practices as domiciliary state laws and statutes are the ultimate authority for the application of SAP.
- b. It was also identified that the initial exposed example was specific to investments that were “stapled” under contractual terms. This guidance would have only been applicable to dynamics in which there was an explicit restriction in the sale, assignment, or transfer of the residual/equity tranche separately from a debt tranche. It was identified that without an active market for residual/equity tranches (which is common) the explicit restrictions would not be necessary to achieve a similar result. Structures would only need to be designed to require initial acquisition of residual/equity tranches when acquiring debt tranches (with removal of the explicit disposal restrictions) to avoid the proposed stapling guidance. Since the proposed guidance could be easily avoided, the guidance would not address the underlying concern.
- c. This discussion noted that it is quite common for acquisitions to require purchases of a vertical slice of a structure and for investments to be stapled for a short duration of time. These provisions are generally made for easier marketing and for easier compliance with conflict-of interest provisions. The short-term aspect of some stapled investments raised concerns as to how bond-qualifying debt tranches would be reported if stapling provisions to a residual/equity tranche were subsequently eliminated. This was identified as likely requiring a schedule move (from BA to D-1) with potential other accounting and reporting impacts (such as with NAIC designations and measurement method). This discussion noted that an issuer’s stapling of investments may reflect a legitimate business purpose, and not intend for RBC arbitrage, and the elimination of such components after the stated

timeframe could cause confusion or unnecessary noise in the financial statements from the reclassification of investments. This discussion further supported that the acquisition of different tranches, even if explicitly stapled, should not prevent separate debt (bond) and residual/equity recognition based on the characteristics of the specific tranche.

71. **ABS as Short-Term or Cash Equivalent:** With the required assessments and requirements for a security to qualify as ABS, as well as dedicated reporting based on the underlying collateral assets, ABS will no longer be permitted to be reported as short-term or cash equivalents. All qualifying ABS will be required to be reported on Schedule D-1-2, even if acquired within one year or less from the maturity date, to allow for full assessment of ABS held by a reporting entity by regulators. Investments captured in scope of SSAP No. 2 are intended to reflect situations in which limited risk remains, either from changes in credit-quality or interest rates, due to the short-duration until maturity. As ultimate cash flows from ABS may have other risks beyond default risk or interest rate risk (such as performance factors, balloon payments, collateral quality), reporting as a cash equivalent or short-term investment is not permitted to prevent inappropriate assumptions of the investment's remaining potential risk.

### **Key Discussions / Aspects in Developing the Definition**

72. **Refinancing Risk / Residual Risk Exposure:** Discussion of refinancing risk (where there is outstanding debt owed at maturity that will need to be refinanced for the remaining principal to be received by the note holder) was a key element discussed in accordance with the meaningful cash flow requirement for non-financial ABS. This discussion highlighted that traditional refinancing risk is accepted in the context of corporate debt but is viewed differently when assessing the cash flows of non-financial assets in an ABS structure. This differentiation was confirmed, with identification that there are concerns unique to non-financial ABS.

73. The requirement for a non-financial ABS to produce meaningful cash flows to service the debt other than through the sale or refinancing of the collateral assets ensures that structures captured as a bond on Schedule D-1 actually reflect bond-like cash flows. Structures that rely on the sale or refinancing at maturity to generate cash flows to repay debt obligations ultimately reflect a point-in-time reliance on the underlying collateral asset values that does not reflect the intent of Schedule D-1 reporting of bond-like cash flows. These structures are more reflective of the underlying collateral risk, ultimately contingent on the market at a future point in time and whether the underlying assets can be sold or refinanced in accordance with original expectations at the time of the structure origination.

74. A key comment raised by industry with regards to the meaningful cash flow requirement, and the restriction against relying on the sale/refinancing at maturity to produce meaningful cash flows, is that consideration should be given to the level of overcollateralization that exists in a structure if the meaningful requirement will not be met without sale or refinancing. These industry comments take the position that as the level of overcollateralization to the debt obligation increases, then there is a greater likelihood that the debt issuer will be successful in refinancing or selling the assets and generate the means to repay the debt obligation. Although overcollateralization is a factor in securities for bond classification, allowing overcollateralization to override the requirement for meaningful cash flows other than the refinancing / sale at maturity is not permitted for the following reasons:

- a. The intent of the principles-based bond definition is to clarify what shall be reported as bonds on Schedule D-1. Non-financial ABS that do not generate meaningful cash flows and rely on the refinancing or sale of the underlying assets do not reflect bond-like cash flows and are not characteristic of bond investments. These structures ultimately reflect equity (point-in-time) valuation risks of the assets held as collateral.
- b. The industry position that overcollateralization safeguards the asset performance is an argument that supports the quality of the structure, but not the substance of the investment design. The principles-based bond definition does not factor in investment or credit quality

within the determination of whether a structure qualifies for reporting as a bond on Schedule D-1. Permitting an assessment based on overcollateralization would introduce a concept that credit quality determines bond / Schedule D-1 reporting, and that is not an accurate conclusion in line with the principle concepts of bond classification.

75. Consistent with prior conclusions, reporting an investment as a bond on Schedule D-1 is not indicative of the quality of the investment, but rather reflects securities expected to generate bond-like cash flows. Securities reported as bonds on Schedule D-1 may be of high-quality or low-quality, but the reporting is based on the substance of the structure, which ultimately requires bond-like cash flows for all investments. This includes a requirement that non-financial ABS must produce meaningful cash flows through the use of the underlying collateral assets other than through the sale or refinancing of the assets.

76. Additionally, through the small group discussions around the refinancing restriction, it was noted that even if a debt instrument meets all of the criteria to be reported as a bond on Schedule D-1, there will still be a potential for unintentional RBC arbitrage related to securitizations, because the residual tranches absorb all of the redistributed risk of the underlying collateral, but receives a fixed RBC charge that is not in any way risk-rated. While this could be the case in any type of securitization, it is particularly pronounced if the underlying collateral is equity investments. Equity investments generally receive a base 30% RBC charge for life companies. If equity investments are securitized, the bond tranches will get low bond charges (<2%), while the residual tranche will continue to receive a flat 30% base charge. This will have the effect of bringing the overall weighted-average capital charge on the underlying investments from 30% to approximately 10-15%. This will occur even if the bond tranches have all of the substance associated with a bond. Following these discussions, it was identified that this regulatory concern may not be appropriate to address through the accounting standards but may warrant discussion under the Capital Adequacy (E) Task Force. Subsequent discussions from the Financial Condition (E) Committee directed the new RBC working group (the RBC Investment Risk and Evaluation (E) Working Group) to evaluate this and any other investment-related RBC items. Subsequent to these discussions, the RBC Investment Risk and Evaluation (E) Working Group assumed a project to assess RBC factors for residual interests. An interim approach was adopted to include a 30% base RBC factor with a 15% sensitivity test for year-end 2023, with a 45% base RBC factor and 0% sensitivity for year-end 2024. Continued discussion is expected under a long-term project.

77. Use of NAIC Designation / SVO Review in Determining Bond / Schedule D-1 Reporting: The accuracy of the financial statements, and compliance with statutory accounting provisions, is the responsibility of the reporting entity. Assessment and compliance with key concepts, such as the “meaningful cash flow generation” and “substantive credit enhancement” concepts for ABS are also the responsibility of the reporting entity, along with appropriate documentation of these assessments for regulator review when requested. Consistent with the existing *NAIC Policy Statement on Coordination of the Accounting Practices and Procedures Manual and the Purposes and Procedures Manual of the NAIC Investment Analysis Office*, a reporting entity cannot utilize an NAIC designation to conclude on the substance of an investment or the resulting reporting schedule. Pursuant to the policy statement, obtaining an NAIC designation does not change an investment’s applicable SSAP, annual or quarterly statement reporting schedule, or override SSAP guidance required for an investment to be an admitted asset.

78. Questions have been received whether an NAIC designation in the AVS+ product or an assessment of an investment from a “Regulatory Treatment Analysis Service” (RTAS) submission from the SVO can be utilized as support that an investment qualifies as a bond for Schedule D-1 reporting. These are inaccurate interpretations on the use of NAIC designations within those products. The assignment of an NAIC designation (either from the SVO or CRP) reflects the credit quality of an investment. An assessment of credit quality does not provide assurances that the investment qualifies for reporting as a bond on Schedule D-1 as an ICO or an ABS. As part of this principles-based bond project, consideration is planned to expand the ability to report and use NAIC designations on Schedule BA so that investments that do not qualify as bonds can have appropriate risk assessments that factor in the credit quality of the investment. This capability would ultimately depend on action by the Capital Adequacy (E) Task Force.

79. Although the NAIC designation and RTAS processes cannot be used in determining Schedule D-1 compliance, it is envisioned that a small group of regulators and NAIC staff could be formed to review specific investment structures under the principle-based concepts to assist in assessments of complex new investment designs. If formed, it is anticipated that NAIC staff on the statutory accounting side and within the SVO would assist this small group.

80. Interest Only / Principal Only Strips: Discussion occurred on whether specific guidance should direct the reporting of interest only (IO) and principal only (PO) strips. The resulting conclusion from this discussion was that the principle concepts from the bond definition should continue to be applied to these investments. If the strips qualify within the definition as ICO, they would be captured in scope of that guidance. If the strips qualified as ABS, they would be captured in scope of that guidance. It was noted that interest-only strips shall also be assessed in accordance with the residual guidance. If the interest-only strip reflects excess interest (e.g., remaining differential spread from interest collected from interest paid), these investments would be akin to a residual investment without contractual interest or principal payments and shall be captured in scope of that guidance. (Residuals are in scope of SSAP No. 21 and required to be reported on Schedule BA. Residuals are not permitted to be reported on Schedule D-1.)

81. The discussion of IO/PO strips with industry representatives identified that they are not overly prevalent investments with insurance reporting entities. It was also noted that IO/PO based on RMBS are relatively rare due to the prepayment risk, however those based on CMBS generally have contractual provisions that prohibit prepayments, thus ensuring that they act more akin to typical bonds. This discussion further highlighted that changes to the principal-based bond definition are not justified for IO/PO investments, and insurers should document their accounting policies for these investments to demonstrate compliance with the bond definition.

82. The discussion of IO/PO strips focused on U.S. Treasury strips and mortgage-backed securities as likely investments, but it was noted that the application of the overall bond definition concepts should be applied to any future design of these investments. Specific elements noted for the two general designs:

- a. U.S. Treasury Strips: Treasury Strips are created when a bond's coupons are separated from the bond. The coupons separated from the bond are sold individually (IO), becoming separate securities from the principal payments due at maturity (PO). U.S. Treasury Strips are backed by the U.S. government. U.S. Treasury strips (IO and PO) are considered U.S. government issues and would be captured with other securities backed by the U.S. government as ICO. Specific identification of U.S. Treasury strips as a separate reporting line of ICO investments, captured within the U.S. government category, was noted to be repetitive and not necessary.
- b. Mortgage-Backed Securities and Other Non-Treasury Strips: Other IO and PO strips are required to be assessed in accordance with the principle concepts of the bond definition. It is anticipated that non-U.S. strips (including mortgage-backed security strips) would not qualify as ICO and shall be reviewed in accordance with the ABS concepts to determine whether the strip qualifies for reporting as a bond on Schedule D-1. The separation of the principal and interest components into separate securities does not change the application of the principle concepts for determining whether a security qualifies as a bond. It was noted that IO strips could be high in the capital structure (supported by subordination) or could represent residual interests (reflecting the spread between proceeds collected and contractual interest). The specific details of the individual IO/PO security shall determine the appropriate accounting and reporting.

83. The discussion of IO/PO strips identified that there is no current need to have separate reporting lines to identify these items within the investment schedules. However, it was identified that the ability to identify these investments with a code (or other feature) would allow for future aggregation and assessment. This was requested to be considered as part of the reporting revisions.

84. Embedded Derivatives / Underlying Variables: Discussion occurred on the language that precludes bond reporting based on the appreciation or depreciation of an underlying collateral value or other variable. Although industry comments noted that the intent of the language was understood, it was identified that the language could be interpreted to mean that amounts in both the magnitude and timing of principal and interest payments must be known in advance, and it could also be interpreted to mean the amounts need to be contractual in nature but can still vary as long as the variability is not dependent on the appreciation or depreciation of an asset or variable. It was also noted that the reference to “other variable” could be interpreted to mean interest is not allowed to vary based on any variable or just the appreciation or depreciation of the variable. After discussing these comments, revisions were drafted to clarify that the exclusion is not intended to restrict variables that are commonly related to debt instruments, such as but not limited to, plain vanilla inflation or benchmark interest rate adjustments (such as with U.S. TIPs or SOFR-Linked coupons), scheduled interest rate step-ups, or credit-quality related interest rate adjustments. Furthermore, as detailed in footnote 3, this exclusion is not intended to encompass nominal interest rate adjustments. This guidance has also been incorporated within the provisions for determining whether a debt instrument represents a creditor relationship and is applicable for debt instruments structured as ICO and ABS.

### **Accounting for Debt Securities That Do Not Qualify as Bonds**

85. Securities that reflect debt instruments that do not qualify for bond reporting as an ICO or an ABS shall follow specific guidance captured in SSAP No. 21 and be reported on Schedule BA. Investments in scope of this guidance are limited to items that would be in scope of SSAP No. 26, but that do not qualify for bond reporting as they reflect:

- a. Debt securities for which the investment does not reflect a creditor relationship in substance.
- b. Debt securities that do not qualify for bond reporting due to a lack of substantive credit enhancement.
- c. Debt securities that do not qualify for bond reporting due solely to a lack of meaningful cash flows.

86. The debt securities captured in the SSAP No. 21 guidance meet the definition of assets as defined in SSAP No. 4 and are admitted assets to the extent they conform to the requirements within SSAP No. 21. The provisions are specific that the guidance for non-bond debt securities in SSAP No. 21 shall not be inferred to other securities or investment structures.

87. Debt securities in scope of SSAP No. 21 that do not qualify as bonds under SSAP No. 26 and for which the primary source of repayment is derived through rights to underlying collateral, qualify as admitted assets if the underlying collateral primarily qualify as admitted invested assets. As detailed in the SSAP No. 21 guidance pertaining to residual tranches, any residual tranches or first loss positions held from the same securitization that did not qualify as a bond under SSAP No. 26 also only qualify as admitted assets to the extent the underlying collateral primarily qualifies as admitted invested assets.

88. Debt securities in scope of the SSAP No. 21 guidance shall be reported at acquisition at cost, including brokerage and other related fees on Schedule BA. Subsequent measurement shall reflect the lower of amortized cost or fair value. Changes in measurement to reflect the lower value or to reflect changes in fair value shall be recorded as unrealized gains or losses. Debt securities in scope of SSAP No. 21 shall then follow the guidance in SSAP No. 43 for calculating amortized cost, for determining and recognizing other-than-temporary impairments and for allocating unrealized and realized gains and losses between the asset valuation reserve (AVR) and the interest maintenance reserve (IMR).

89. During the SSAP No. 21 discussion, industry inquired on the direction to utilize SSAP No. 43 for the components detailed in paragraph 88, and not separately assess securities to determine if they are more akin to ICO or ABS and using either SSAP No. 26 or SSAP No. 43 based on those assessments for the calculation of amortized cost, OTTI and allocating AVR/IMR. With this discussion, it was noted that investments that fail the creditor relationship test are identified before determining whether the security would be an ICO or ABS, and as the components of SSAP No. 43 are more relevant for debt securities that do not qualify as bonds, and to ensure consistency for all non-bond debt securities in scope of SSAP No. 21, the decision to utilize SSAP No. 43 for all debt securities that do not qualify as bonds was retained.

### **Transition Guidance**

90. At the time of transition to apply the guidance adopted to reflect the principles-based bond definition, reporting entities shall make their best efforts to assess investments to determine whether they qualify within the bond definition for reporting on Schedule D-1. The bond definition requires assessments at the time of acquisition (as of the origination date), and it is recognized that reporting entities may not have the means to complete historical assessments for securities held at the time of transition. For these instances, if information is not readily available for reporting entities to assess a security as of the date at origination, reporting entities may utilize current or acquisition information in concluding that a security qualifies for reporting as a bond as either an ICO or ABS.

91. Investments that were reported as a bond on Schedule D-1: Long-Term Bonds as of December 31, 2024, that do not qualify under the principle-based bond definition shall be reported as a disposal from that schedule, with a reacquisition on the appropriate reporting schedule as of January 1, 2025. These investments shall be accounted for in accordance with the resulting SSAP that addresses the specific investment structure. For securities that are reported at the lower of amortized cost or fair value under the guidance in SSAP No. 21 for non-bond debt securities, this could result with an unrealized loss in the measurement of the investment at the time of the reclassification. Although the adoption of this guidance is considered a change in accounting principle under *SSAP No. 3—Accounting Changes and Corrections of Errors*, the following transition guidance shall be applied on January 1, 2025, to ensure consistency in reporting and to allow investment schedules to roll appropriately:

- a. Securities reclassified from Schedule D-1 as they no longer qualify under the bond definition shall be reported as a disposal from Schedule D-1 at amortized cost. Although no proceeds are received, amortized cost at the time of disposal shall be reported as consideration on Schedule D-4.
  - i. For securities held at amortized cost at the time of disposal, BACV and amortized cost shall agree, preventing gain or loss recognition at the time of reclassification.
  - ii. For securities held at fair value under the lower of amortized cost or fair value measurement method, previously reported unrealized losses shall be reversed on January 1, 2025, prior to disposal, resulting with a reported value that mirrors amortized cost at the time of disposal. This action prevents realized loss recognition at time of reclassification.
- b. Securities reclassified from Schedule D-1 shall be recognized on the subsequent schedule (e.g., Schedule BA) with an actual cost that agrees to the disposal value (amortized cost). Immediately subsequent to recognition on the resulting schedule, the securities shall be reported in accordance with the measurement method prescribed by the applicable SSAP:
  - i. For securities previously reported at fair value on Schedule D-1 (under a lower of amortized cost or fair value measurement method), the reporting entity will recognize an unrealized loss to match the previously reported BACV.

Subsequently, the security will continue to reflect a lower of amortized cost or fair value measurement method.

- ii. For securities previously reported at amortized cost on Schedule D-1, if the subsequent applicable SSAP guidance requires a lower of amortized cost or fair value measurement method, then the reporting entity shall recognize an unrealized loss to the extent fair value is less than amortized cost.
- c. After application of the transition guidance all securities shall reflect either the same reported value as of December 31, 2024 (amortized cost or fair value) or a lower reported value (if the security is subject to the lower of amortized cost or fair value measurement method). There should be no instances that result with a security having a greater reported value than what was presented on December 31, 2024. Subsequent to transition, securities reported at fair value may incur unrealized gains or losses due to fair value fluctuations but should never have unrealized gains that result with a BACV that exceeds amortized cost.

92. With this transition guidance, changes in measurement for securities reclassified under the bond definition will be reported as a change in unrealized capital gains (losses) in the first quarter 2025 financial statements (unless sold in the interim with a realized gain or loss) and not as a change in accounting principle. To enable regulators the ability to identify the impact of securities reclassified under the bond definition, the following disclosure for the 2025 first quarter financial statement is required:

- a. Aggregate BACV for all securities reclassified off Schedule D-1.
- b. Aggregate BACV after transition for all securities reclassified off Schedule D-1 that resulted with a change in measurement basis. (This shall be a subset of the aggregate BACV reclassified off Schedule D-1 and captures the securities that moved from an amortized cost to a fair value measurement method under the lower of amortized cost or fair value approach.)
- c. Aggregate surplus impact for securities reclassified off Schedule D-1. This shall include the difference between BACV as of December 31, 2024, and BACV after transition for those securities that moved from an amortized cost to a fair value measurement method under the lower of amortized cost or fair value approach.

93. ABS that were previously reported as short-term (Schedule DA) or as a cash equivalent (Schedule E2) shall be reclassified to be reported on Schedule D-1-2 on January 1, 2025. Similar to the process detailed above, the securities shall be removed from Schedule DA and E2 at amortized cost, with reversal of any unrealized loss prior to the reclassification. The amortized cost shall be reported as “consideration received on disposals” on Schedule DA – Verification Between Years or Schedule E-2 – Verification Between Years, as applicable based on the prior reporting location. The security shall be recognized as an ABS acquired on Schedule D-3 at amortized cost. Immediately after initial recognition, if the security was required to be held at fair value, under the lower of amortized cost or fair value measurement method, the reporting entity shall recognize an unrealized loss.

94. The transition guidance shall be applied prospectively beginning with the first year of adoption (January 1, 2025). For disclosures that provide comparative information, reporting entities shall not restate the prior year’s information in the 2025 disclosure.

### **Investment Examples – Securities That Do Not Represent Creditor Relationship Despite Legal Form**

95. As detailed in the principles-based bond definition, an initial determinant is whether the investment is a security that represents a creditor relationship in substance. Examples included intend to identify scenarios that do not reflect an in-substance creditor relationship.

96. Example 1 – Debt Instrument from SPV with Large Number of Diversified Equity Interests: A reporting entity invests in a debt instrument issued by a SPV that holds a large number of diversified equity interests with characteristics that support the production of predictable cash flows. The structure contains sufficient overcollateralization and liquidity provisions to ensure the production of adequate cash flows to service both principal and interest payments without significant reliance on refinancing or sale of the underlying equity investments. The debt instrument’s periodic principal or interest payments, or both, contractually vary based on the appreciation or depreciation of the equity interests held in the SPV.

97. Example 1 – Rationale: Because the instrument’s principal or interest payments, or both, contractually vary with the appreciation or depreciation of the underlying equity interests, it contains an equity-like characteristic that is not representative of a creditor relationship. It would be inappropriate to conclude that a security with any variation in principal or interest payments, or both, due to underlying equity appreciation or depreciation, or an equity-based derivative, is a bond under the principles-based bond definition as such security would contain equity-like characteristics.

98. Example 2 – Debt Instrument from SPV with Few Equity Interests, Not an Issuer Credit Obligation: A reporting entity invests in a debt instrument issued from a SPV that owns a portfolio of equity interests, and the debt instrument does not meet the definition of an ICO.

99. Example 2 – Rationale: Determining whether debt instruments collateralized by equity interests qualify as bonds under the principles-based bond definition inherently requires significant judgment and analysis. Unlike debt instruments collateralized by assets with contractual cash flows, or debt instruments collateralized by cash-generating non-financial assets, debt instruments collateralized by equity interests may be dependent on cash flow distributions that are not contractually required to be made and/or may not be controlled by the issuer of the debt. In some instances, sale or refinancing of the underlying equity interests may be the only means of generating cash flows to service the debt instruments. As a result, there is a rebuttable presumption that a debt instrument collateralized by equity interests does not qualify as a bond. Notwithstanding this rebuttable presumption, it is possible for such debt instruments to qualify as bonds, if the characteristics of the underlying equity interests lend themselves to the production of predictable cash flows and the underlying equity risks have been sufficiently redistributed through the capital structure of the issuer. Factors to consider in making this determination include but are not limited to:

- a. Number and diversification of the underlying equity interests
- b. Characteristics of the underlying equity interests (vintage, asset-types, etc.)
- c. Liquidity facilities
- d. Overcollateralization
- e. Waiting period for distributions/paydowns to begin
- f. Capitalization of interest
- g. Covenants (e.g., loan-to-value trigger provisions)
- h. Reliance on ongoing sponsor commitments
- i. Source(s) of expected cash flows to service the debt (i.e., dividend distributions from the underlying collateral vs. sale or refinancing of the underlying collateral)

100. While reliance on the sale of underlying equity interests or refinancing at maturity does not preclude the rebuttable presumption from being overcome, it does require that other characteristics mitigate the inherent reliance on equity valuation risk to support the transformation of underlying equity risk to bond

risk. As reliance on sale or refinancing increases, the more compelling the other factors needed to overcome the rebuttable presumption become.

101. The analysis of the underlying structure should be conducted and documented by a reporting entity at the time such an investment is acquired. The level of documentation and analysis required will vary based on the characteristics of the individual debt instrument, as well as the level of third-party and/or non-insurance company market validation to which the issuance has been subjected. For example, a debt instrument collateralized by fewer, less diversified equity interests would require more extensive and persuasive documented analysis than one collateralized by a large and diversified portfolio of equity interests. Likewise, a debt instrument that has been successfully marketed to unrelated and/or non-insurance company investors may provide enhanced market validation of the structure compared to one held only by related party and/or insurance company investors where capital relief may be the primary motivation for the securitization.

### **Investment Examples – Analysis of ABS Under the Meaningful Cash Flows and Substantive Credit Enhancement Concepts**

102. All ABS structures are required to provide substantive credit enhancement to qualify for bond reporting on Schedule D-1. Furthermore, ABS structures that are backed by non-financial assets must generate meaningful cash flows to service the debt without reliance on the sale or refinancing at the maturity of the investment. The following provides examples of analysis under these criteria.

103. Example 3 – Agency Mortgage-Backed Securities: A reporting entity invests in debt instruments issued from a SPV sponsored by the Government National Mortgage Association (GNMA), the Federal National Mortgage Association (FNMA) and the Federal Home Loan Mortgage Corporation (Freddie Mac) (collectively, “Agency or Agencies”). These debt instruments pass through principal and interest payments received from underlying mortgage loans held by the SPV to the debtholders proportionally, with principal and interest guaranteed by the Agencies. While there is prepayment and extension risk associated with the repayment of the underlying mortgage loans, the credit risk associated with the mortgage loans is assumed by the Agencies.

104. Example 3 Rationale: Although the reporting entity participates on a proportional basis in the cash flows from the underlying mortgage loans held by the SPV, the reporting entity is in a different economic position than if it owned the underlying mortgage loans directly because the credit risk has been redistributed and assumed by the Agencies. This is a substantive credit enhancement because a market participant (i.e., knowledgeable investor transacting at arm’s length) would conclude the Agency guarantee is expected to absorb all losses from the debt instrument. Therefore, the holder of the debt instrument is in a substantively different economic position than if the holder owned the ABS Issuer’s unguaranteed assets directly. When guarantees do not cover 100% of principal and interest as the Agency guarantees do in this example, it is still appropriate to determine if the guarantee is substantive in accordance with the requirements of the principles-based bond definition to determine if the holder is in a substantively different economic position than if the holder held the underlying assets directly.

105. Example 4 – Debt Instrument Issued by an SPV: A reporting entity invested in a debt instrument issued by a SPV. Payments under the instrument are secured by a note, a legal assignment from the borrower of a lease for real property and an assignment of the lease payments from an operating entity tenant. Additional security is provided by a mortgage on the leased property (the “underlying collateral”). The leased property is owned by the borrower under the note and the SPV does not have any ownership interest in the underlying collateral, though it has legal recourse to it through the mortgage. The tenant makes contractually-fixed payments over the life of the lease to the borrower, who has assigned both the lease and the lease payments to the SPV as security for the debt. While the debt is outstanding, the lease, the lease payment, and the mortgage all serve as security for the debtholders. Should a default occur, the debtholders can foreclose on and liquidate the real property as well as submit an unsecured lease claim in the lessee’s

bankruptcy for any defaulted lease payments. The loan-to-value (LTV) (as a percentage of property value) at origination is 100%.

106. The existing lease payments are sufficient to cover all interest payments and all scheduled debt amortization payments over the life of the debt instrument. However, at debt maturity, there is a balloon payment due, totaling 50% of the original outstanding debt principal amount. The corresponding lease has no balloon payment due at lease maturity, so the SPV will either need to refinance the debt or sell the underlying collateral to service the final debt balloon payment. The property has a high probability of appreciating in value over the term, however, ignoring any potential for appreciation, the 50% loan-to-value at maturity is the expected figure at the end of the debt term based solely on scheduled amortization payments. The real property is expected to be subject to some market value volatility and periods of lower liquidity at certain points in time but has a predictable value range and ready market over a longer period of time, such that the property could be liquidated over a reasonable period of time, if necessary.

107. Example 4 Rationale: The reporting entity determined that as a debtholder, they are in a fundamentally different position than if the real estate was owned directly. The lease is a cash generating non-financial asset which is expected to generate a meaningful level of cash flows for the repayment of the bonds which covers all interest payments and 50% of the principal payments. The level of reliance on the collateral value for sale or refinancing is just over the cutoff for using the practical expedient (greater than 50%), so a full analysis is required. In reaching its determination, the reporting entity considered the predictable nature of the cash flows, which are contractually fixed for the life of the debt instrument, as well as the ability of the underlying collateral value to provide for the balloon payment through sale or refinancing in light of its characteristics. While the real property may have some market value volatility and periods of lower liquidity at points in time, the cash flows produced by the lease were concluded to reduce the loan balance to a level (50% loan-to-value) that would be able to be recovered by sale or refinancing at the maturity of the loan.

108. The reporting entity also determined that the structure provides substantive credit enhancement in the form of overcollateralization to conclude that investors are in a different economic position than holding the real property directly, in accordance with the requirements of the principles-based bond definition. In reaching this conclusion, the reporting entity noted that although the debt instrument starts with a 100% loan-to-value (not including the value of the contractually required lease payments), contractual fixed payments from the lease provide additional security such that the reporting entity is in a different economic position than owning the property directly. Lease cash flows are sufficient to cover the payment of all interest and 50% of the outstanding principal over the term of the lease. In the context of the predictable nature of the cash flows and collateral value range over time, the reporting entity concluded that a market participant (i.e., a knowledgeable investor transacting at arm's length) would consider this level of overcollateralization to put the investor in a substantially different economic position than owning the underlying property directly.

109. For the purpose of determining whether there is substantive overcollateralization, it is appropriate to consider any expected economic depreciation, if it is reasonably expected, but it is not appropriate to consider any expected economic appreciation. Note that a debt instrument with a LTV that is expected to decrease over time is not necessarily deemed to have substantive overcollateralization.

110. Example 5 – Debt Instrument Issued by an SPV With Lease Term Less than Debt Instrument: A reporting entity invested in a debt instrument with the same characteristics as described in Example 4, except that the existing lease at the time of origination has a contractual term that is shorter than that of the debt instrument. It is expected with a high degree of probability that the lease will be renewed, and a substantial leasing market exists to replace the lessee should they not renew. However, in the unlikely circumstance that the property cannot be re-leased, there would not be enough cash flows to service the scheduled principal and interest payments, and the property would have to be liquidated to pay off the debt upon default.

111. Example 5 – Rationale: All details of this example, including the expected collateral cash flows, are consistent with those in Example 4, except that the cash flows in Example 4 are contractually fixed for the duration of the debt while the cash flows in this example are subject to re-leasing risk. Notwithstanding the involvement of re-leasing risk, the reporting entity concluded that the ability to re-lease the property was highly predictable and supported the conclusion that the underlying collateral was expected to produce meaningful cash flows to service the debt.

112. This distinction is to highlight that the expected cash flows of a cash-generating non-financial asset may or may not be contractually fixed for the term of the bond. Certain securitized cash flow streams may not by their nature lend themselves to long-term contracts (e.g., single-family home rentals), but may nevertheless lend themselves to the production of predictable cash flows. While the non-contractual nature of the cash flows is an important consideration in determining whether a non-financial asset is expected to produce meaningful cash flows to service the debt, it does not, in and of itself, preclude a reporting entity from concluding that the assets are expected to produce meaningful cash flows.

113. Example 6 – Lease in SPV with 80% Balloon Payment: A reporting entity invested in a debt instrument issued by a SPV that owns equipment which is leased to an equipment operator. The equipment operator makes lease payments to the SPV, which are passed through to service the SPV's debt obligation. While the debt is outstanding, the equipment and lease are held in trust and pledged as collateral for the debtholders. Should a default occur, the debtholders can foreclose on and liquidate the equipment as well as submit an unsecured lease claim in the lessee's bankruptcy for any defaulted lease payments. The LTV at origination is 70%.

114. The existing lease payments are sufficient to cover all interest payments and all scheduled debt amortization payments over the life of the debt instrument. However, at maturity, there is a balloon payment due, totaling 80% of the original outstanding principal amount. The corresponding lease has no balloon payment due at lease maturity, so the SPV will either need to refinance the debt or sell the underlying equipment to service the final debt balloon payment. The LTV at maturity is expected to increase to 95% considering the scheduled principal amortization payments net of the expected economic depreciation in the equipment value over the term of the debt. The equipment is expected to be subject to some market value volatility and periods of lower liquidity at certain points in time but has a predictable value range and ready market over a longer period of time, such that the equipment could be liquidated over a reasonable period of time, if necessary.

115. Example 6 Rationale: The equipment is a cash generating non-financial asset which is not expected to generate a meaningful level of cash flows for the repayment of the issued debt via the existing lease that covers all interest payments and 20% of principal payments. In reaching this determination, the reporting entity considered that, while the cash flows being produced are predictable, the ability to recover the principal of the debt investment is almost entirely reliant on the equipment retaining sufficient value to sell or refinance to satisfy the debt.

116. The reporting entity also determined that the structure lacks a substantive credit enhancement to conclude that investors are in a different economic position than holding the equipment directly, in accordance with the requirements of the principles-based bond definition. In reaching this conclusion, the reporting entity noted that the debt starts with a 70% LTV, but the overcollateralization is expected to deteriorate over the term of the debt as the equipment economically depreciates more quickly than the debt amortizes. This results in a high LTV (i.e., 95%) at maturity, relative to the market value volatility of the underlying collateral. Despite the predictable nature of the cash flows, the reporting entity concluded that the debt instrument lacked a substantive level of overcollateralization to conclude that the investor is in a different economic position than owning the underlying equipment directly. It was determined that the level of overcollateralization, as determined by a market participant (i.e., a knowledgeable investor transacting at arm's length), is nominal. Therefore, the reporting entity concluded that it was in a substantively similar position as if it owned the equipment directly.

117. For the purposes of determining whether there is substantive overcollateralization, it is appropriate to consider any expected economic depreciation, if it is reasonably expected, but it is not appropriate to factor in any expected economic appreciation. Note that a debt instrument with a LTV that is expected to increase over time is not necessarily deemed to have nominal overcollateralization.

### **Reflecting the Principles-Based Bond Proposal in SAP**

118. The principles-based bond definition and the specific accounting guidance for bonds, including ICO and ABS, and the guidance for debt securities that do not qualify as bond be captured as new SAP concepts to existing SSAPs:

- a. *SSAP No. 26—Bonds (Exhibit 1)*
- b. *SSAP No. 43—Asset-Backed Securities* (renamed from Loan-Backed and Structured Securities) (Exhibit 2)
- c. *SSAP No. 21—Other Admitted Assets (Exhibit 3)*

119. For SSAP No. 26, the revisions capture the full bond definition, and the guidance for determining whether a security qualifies as either an ICO or an ABS. The accounting guidance for ICO is retained within SSAP No. 26 and is not changed with the inclusion of the bond definition. Other key revisions include transition guidance to reclassify debt securities that do not qualify as bonds from Schedule D-1 to the subsequent schedule and to delete the glossary as no longer necessary.

120. For SSAP No. 43, in addition to revising the name to “Asset-Backed Securities,” revisions reorder and streamline the existing guidance. Although the broad measurement concepts and requirements to assess cash flows have not changed, the guidance specific to whether collection of cash flows is probable, not probable, and pertains to beneficial interests has been eliminated. The guidance has been rewritten to provide consistent guidance for the assessment of cash flows and considering the impact of prepayments. These revisions are not expected to result in significant deviations from past practice as the resulting guidance is believed to be reflective of prominent past industry interpretations. Clarifications have been included to ensure recognition of an other-than-temporary impairment whenever a security is in an impaired state (fair value is less than amortized cost, regardless of if an unrealized loss has been recognized) and there is an adverse change in cash flows expected to be collected. Other key revisions include transition guidance to reclassify debt securities that do not qualify as bonds from Schedule D-1 to the subsequent schedule as well as to incorporate guidance that prohibits reporting ABS as cash equivalents or short-term investments and the process to reclassify any securities reported as such as of the effective date.

121. For SSAP No. 21, revisions incorporate new guidance for the accounting and reporting for debt securities that do not qualify as bonds as well as residual interests. For both sections, the revisions specify new measurement and admittance concepts for these securities and specify reporting on Schedule BA in designated reporting lines. For residuals, guidance is included for the recognition of other-than-temporary impairments and transition guidance for situations where the residual had a different measurement method prior to the effective date.

122. In addition, Exhibit 4 details “revisions to other SSAPs” adopted in accordance with the principles-based bond definition. This section identifies all SSAPs that have modified guidance, which predominantly reflects updated terms and references, but includes the revisions to SSAP No. 2 to restrict ABS from being in scope.

### **Discussion of Comments Received and Exposures**

123. This section details key comments received from exposures of the principles-based bond definition revisions and the Working Group’s consideration for potential edits.

- a. Per the exposure of the issue paper and principles-based bond definition on March 2, 2022, with comments due May 6, 2022. The Working Group heard comments on July 18, 2022, and directed limited edits to be reflected as followed:
- i. Revise the guidance related to U.S. Treasury Inflation Protected Securities (TIPs) and to clarify the guidance regarding variable contractual principal and interest payments. These revisions clarified that securities with plain-vanilla inflation adjustment mechanisms are not intended to be captured within the provisions that restrict bond classification due to varying principal or interest payments, as well as clarified that other variances in contractual amounts due to reference variables (and not just equity interests) are intended to be precluded from bond treatment.
  - ii. Revise guidance describing substantive credit enhancements, particularly to revise reference to the first loss “tranche” as the first loss “position” and clarify that securitization tranches that do not have contractual principal and interest payments along with substantive credit enhancement do not qualify as a Schedule D Bond and shall be reported on Schedule BA. (Tranches without contractual principal and interest payments are considered residual tranches shall be on Schedule BA.) (Subsequent to these edits further discussion and updates to the residual guidance were adopted. These revisions improve the guidance and remove specific references to contractual principal and interest payments.)
  - iii. Document the outcome of small group discussions around the application of the bond principles, particularly the equity-backed example, to feeder fund structures. Feeder fund structures shall not automatically be assumed to qualify for bond classification (even if the ultimate collateral is fixed income), nor be automatically precluded bond classification. The substance of the investment should be the determining factor in these and other similar situations. In particular, the assessment of feeder fund structures should evaluate whether the structure ensures the pass through of the underlying cash flows, or whether uncertainty as to the timing or amount of cash flows is introduced by the structure.
  - iv. Requested interested parties to work with NAIC staff in proposing revisions to capture the elements that may introduce equity-like characteristics into the main components of the bond definition.
- b. In addition to the revisions incorporated from the July 18, 2022, call, the Working Group also heard comments and elected not to incorporate revisions for the following items:
- i. The Working Group identified that non-bond items that are specifically scoped into SSAP No. 26 will not be identified in the bond definition. The Working Group was explicit that the inclusion of an investment in-scope of SSAP No. 26 did not make the investment a “bond” and such a distinction is necessary to prevent scope-creep or inference of other investments into the bond definition. For example, although SVO-Identified Bond ETFs, SVO-Identified CTLs and certificates of deposit that exceed one year are explicit inclusions to SSAP No. 26 and reported on Schedule D-1, these investments are not bonds.
  - ii. The Working Group did not incorporate industry-proposed edits to limit guidance that requires the consideration of all returns to equity-backed ABS. Rather, the Working Group clarified that all investments that have contractual principal and interest that can fluctuate due to a referenced variable shall consider all returns in excess of principal repayment as interest when determining whether the investment qualifies for bond reporting under the principles-based definition.

- iii. The Working Group did not agree with comments supporting ABS to be reported as cash equivalents or short-term investments even if acquired with a maturity date that is less than 90-days or 1-year away. To ensure proper assessment under the bond definition, and reporting based on the underlying components of the investments, the Working Group retained the provisions that all ABS shall be captured within SSAP No. 43 and be reported on Schedule D-1-2.
  - iv. The Working Group did not direct changes to the bond definition or issue paper after considering the industry “Lease-Backed Securities Working Group” May 5, 2022, comment letter. That letter, which is consistent with their prior comments, proposes to capture securities as ICO if they pass-through cash flows unaltered (such as with certain lease-backed structures) and are supported primarily by a single rated credit payor, though principal repayment is not fully supported by the obligation of that payor. The discussion noted that these securities shall follow the guidance for ABS if they are not fully supported by an underlying contractual obligation of a single operating entity, including the criteria for substantive credit enhancement and meaningful cash flows. The Working Group identified that these structures are not based on the credit worthiness of a single operating entity and rely on the underlying collateral for repayment, which is why they should be considered ABS rather than ICO. The comment letter also raised concerns around the guidance for evaluating project finance debt noting a perception that inconsistent classification may occur for investments with similar characteristics. As a result of the discussion, there were no changes to the exposed bond definition. Working Group members and other interested parties noted during the discussion that the guidance pertaining to project finance is intended to provide guidance for evaluating issuers that share characteristics of both operating entities and ABS Issuers (i.e., the middle of the spectrum). Nevertheless, the guidance is clear that issuers of project finance debt must themselves have the characteristics of operating entities in order for the debt instrument to qualify as an ICO. As such, project finance bonds issued by operating entities and other municipal revenue bonds will be retained as ICO as the design of these structures are supported by the credit worthiness of a single operating entity and are therefore different than the investment structures presented by the industry Lease-Backed Securities Working Group.
- c. Per the exposure of the principles-based bond definition, and proposed revisions to SSAP No. 26 and SSAP No. 43 on August 10, 2022, with comments due October 7, 2022, comments were received from Fermat Capital, the industry Lease-Backed Securities Working Group and Interested Parties. After considering the comments, the following key revisions were incorporated:
- i. Revisions to incorporate the entire bond definition within SSAP No. 26, with a deletion of bond definition guidance from SSAP No. 43. With this change, securities that qualify as ABS after application of the bond definition will follow the measurement and reporting guidance within SSAP No. 43. This edit prevents unintended inconsistencies in the guidance that could occur if aspects of the bond definition are in both SSAPs.
  - ii. Revisions to incorporate the guidance for determining a creditor relationship, which was in an exhibit, into the body of guidance within SSAP No. 26.
  - iii. Revisions to the examples for ABS analysis, which were moved to SSAP No. 26, to reflect a scenario in which payments under the instrument are secured by a note, a legal assignment from the borrower of a lease for real property and the

assignment of the lease payments from an operating entity tenant. This revision was in response to comments from the industry Lease-Backed Security Working Group and detail that the SPV does not need to have ownership interest in the underlying collateral for the security to qualify as an ABS.

- iv. Revisions to SSAP No. 26 to clarify that investments with specific guidance and reporting lines (such as surplus notes, working capital finance investments (WCFI) and structured settlements) shall follow the guidance in their specific SSAP and be reported on designated reporting lines. This edit was made in response to the comments from Fermat Capital, who identified that WCFI meet the definition of ICO. These investments shall follow the guidance *in SSAP No. 105—Working Capital Finance Investments* and be reported on their specific reporting lines on Schedule BA.
  - v. Revisions to SSAP No. 26, and the addition of a new footnote, to clarify that the general creditworthiness of an entity can be direct or indirect recourse and is the primary source of repayment for issuer credit obligations.
  - vi. Revisions to SSAP No. 26 to clarify application when interest and principal vary based on the performance of an underlying value or variable. The revised guidance adds language to clarify that the exclusion is not intended to restrict variables that are commonly linked to debt instruments, such as plain-vanilla inflation or benchmark interest rates.
  - vii. Revisions to SSAP No. 26 to delete the proposed glossary, with the inclusion of the bank loan definition into a footnote. Other definitions were identified as not being necessary for retained inclusion in the statement.
  - viii. Revisions to SSAP No. 43 to identify Freddie-Mac When Issued Trust Certificates, pursuant to *INT 22-01: Freddie Mac When Issued K-Deal (WI Trust) Certificates*, as an explicit scope inclusion.
  - ix. Revisions to SSAP No. 43 to clarify the guidance for prospective adjustment method for high-credit quality investments, and on the assessment of cash flows. This guidance clarifies that if a security is in an unrealized loss position, and there is an adverse change in cash flow, the entity shall recognize an other-than-temporary impairment.
  - x. Revisions to both SSAP No. 26 and SSAP No. 43 to provide specialized transition and disclosure guidance for the reclassification of securities previously reported that will no longer qualify for reporting as bonds.
  - xi. Revision to the issue paper to clarify the application of the principles-based bond definition to feeder funds.
- d. Per an exposure on November 16, 2022, of SSAP No. 26, SSAP No. 43 and other SSAPs that will be impacted under the bond project, until February 10, 2023, revisions were incorporated to reflect most of the interested party comments. The revised documents were discussed and exposed at the 2023 Spring National Meeting. Most of the edits were minor, but the following elements are specifically noted:
- i. Revisions to SSAP No. 26 incorporated an exception for nominal interest rate adjustments. The guidance defines the exception as being too small to be taken into consideration when assessing an investment's substance as a bond. This revision was added based on industry's comments on inadvertent impact to

- sustainability-linked bonds, but the exception guidance is not limited to those specific bonds.
- ii. Revisions clarify that replication (synthetic asset) transactions are addressed in *SSAP No. 86—Derivatives* and are not impacted by the principles-based bond definition.
  - iii. Revisions to SSAP No. 26 to explicitly identify that residuals, including first loss positions, do not qualify as bonds and shall be captured in *SSAP No. 21—Other Admitted Assets*.
  - iv. Revisions specific to transition that clarify that investment assessments are required as of origination and to permit current or acquisition information in determining whether investments qualify as bonds at the time of transition. The guidance was also clarified that the transition guidance shall be applied prospectively beginning with the first year of adoption. For disclosures that provide comparable information, reporting entities shall not restate the prior year's information in the 2025 disclosure.
  - v. With an exposure of the revised documents, an updated SSAP No. 21 was also exposed to update guidance for the measurement of debt securities at the lower of amortized cost or fair value and to incorporate proposed accounting and reporting guidance for residuals.
- e. The Statutory Accounting Principles (E) Working Group received comments on June 9, 2023, from the 2023 Spring National Meeting exposure. No comments were received on SSAP No. 26, SSAP No. 43 or the document that detailed revisions to other SSAPs. The Working Group adopted the SSAP revisions reflected in these documents on August 12, 2023, during the 2023 Summer National Meeting, effective January 1, 2025.
  - f. During the 2023 Summer National Meeting, the Working Group considered comments on SSAP No. 21 pertaining to the guidance for debt securities that do not qualify as bonds and for residual interests and exposed a revised SSAP No. 21 until September 29, 2023. The revisions for debt securities that do not qualify as bonds reflect a majority of interested parties' comments.
    - i. For debt securities that do not qualify as bonds, revisions clarify that if the primary source of repayment is derived through underlying collateral, the investment shall only be admitted if the underlying collateral qualifies as admitted invested assets. For residuals, revisions clarify that if the reporting entity holds a debt tranche from the same securitization, and the debt tranche does not qualify as a bond (either an ICO or ABS), and the debt security does not qualify as an admitted asset under SSAP No. 21, then the residual does not qualify as an admitted asset.
    - ii. Revisions proposed new measurement methods for residuals. This guidance is different from what was proposed by interested parties but intends to reflect the highly uncertain amount and timing of residual cashflows. This proposed guidance will require all cash flows received to be treated as a return of principal until the BACV is zero. At that point, all cashflows received would be treated as interest income. This proposed guidance was noted to best suit how residuals work conceptually. The reporting BACV will reflect the potential risk of loss prior to recovering the initial investment, rather than requiring an assessment of potential loss over the entire life of the securitization.

- g. During the 2023 Fall National Meeting, the Working Group considered comments and exposed an updated SSAP No. 21 until January 22, 2024. No comments were received on the section for non-bond debt securities, but comments focused on the guidance for residual interests. Revisions reflected in the 2023 Fall National Meeting exposure:
  - i. Revisions capture an Allowable Earned Yield method for the measurement of residuals. This guidance will limit the extent interest income can be recognized without recognizing cash flows as return of principal. Provisions were also included to permit a practical expedient to allow all cash flows received to be taken as a reduction of BACV. Under the practical expedient, interest income would not be recognized until BACV was zero.
  - ii. Revisions clarified the treatment of reductions in fair value as unrealized losses and updated OTTI guidance to be consistent with SSAP No. 43 and the assessment of the present value of expected cash flow to the BACV.
- h. On February 22, 2024, an updated SSAP No. 21 reflecting a variety of edits from working with industry throughout the interim was exposed until March 7, 2024. The shortened comment period was proposed to allow for adoption consideration during the 2023 Spring National Meeting.
  - i. Revisions for residual incorporate the definition and characteristics captured in other SSAPs to make SSAP No. 21 the location for all residual guidance. All residuals shall follow the accounting, admittance and reporting guidance detailed in SSAP No. 21.
  - ii. Revisions clarified that residuals shall be accounted for at the lower of Allowable Earned Yield method or fair value, or under the practical expedient.
  - iii. Revisions eliminated the guidance that directed reclassification of residuals to other SSAPs and reporting schedules in situations when the residual tranches cease to meet the definition of residual tranches. With the deletion, once classified as a residual, an investment would retain that classification and reporting until it is disposed by the reporting entity.
  - iv. Revisions separate the OTTI calculation between items measured at the Allowable Earned Yield method and those that follow the practical expedient.
  - v. Revisions incorporate transition guidance for residuals that were accounted for under a different SSAP prior to the effective date.
  - vi. Revisions prescribe a January 1, 2025, effective date, but permit early adoption of the residual guidance.

### **History of Definition / Scope Development of SSAP No. 43 – Before the Principles-Based Definition**

*The following section details the historical development of SSAP No. 43 along with the prior benefits for reporting investments in scope of SSAP No. 43 and key issues from the prior guidance. Due to various revisions that have been reflected since its original adoption, this information is retained for historical reference on the SSAP No. 43 guidance prior to the reflection of the principles-based bond proposal.*

124. SSAP No. 43—*Loan-Backed and Structured Securities* was originally effective with the SAP codification and resulted with separate guidance for “bonds” (in SSAP No. 26) and “loan-backed and structured securities” (in SSAP No. 43). (The initial guidance indicated that investments in scope of SSAP No. 43 met the definition of a bond in SSAP No. 26—*Bonds, excluding Loan-backed and Structured*

*Securities*.) Although most of the guidance between the original SSAP No. 26 and SSAP No. 43 was the same, the guidance in SSAP No. 43 recognized the need to review (at least quarterly) the assumptions and resulting cash flows of the underlying loans, as changes in assumptions could necessitate a recalculation of the effective yield or other-than-temporary impairment.

125. The original issue paper to SSAP No. 43 (Issue Paper No. 43) cited guidance originally contained in Chapter 1, *Bonds and Loan Backed and Structured Securities*, from the *Accounting Practices and Procedures Manual of the Life and Accident and Health Insurance Companies*. The issue paper identified that the *Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies* contained similar guidance. In this Issue Paper No. 43, and the original SSAP No. 43, loan-backed securities were defined as “pass-through certificates, collateralized mortgage obligations (CMOs) and other securitized loans...” The reference to “securitized loans” was a key aspect of this original definition.

126. Original definition / scope guidance for SSAP No. 43:

2. Loan-backed securities are defined as pass-through certificates, collateralized mortgage obligations (CMOs), and other securitized loans not included in structured securities, as defined below, for which the payment of interest and/or principal is directly proportional to the interest and/or principal received by the issuer from the mortgage pool or other underlying securities.

3. Structured securities are defined as loan-backed securities which have been divided into two or more classes for which the payment of interest and/or principal of any class of securities has been allocated in a manner which is not proportional to interest and/or principal received by the issuer from the mortgage pool or other underlying securities.

4. Loan-backed securities are issued by special-purpose trusts (issuer) established by a sponsoring parent organization. Mortgage loans or other securities securing the loan-backed obligation are acquired by the issuer and pledged to an independent trustee under the issuer's obligation has been fully satisfied. The investor can only look to the issuer's assets (primarily the trustee's assets or third parties such as insurers or guarantors) for repayment of the obligation. As a result, the sponsor and its other affiliates may have no financial obligation under the instrument, although one of those entities may retain the responsibility for servicing the underlying mortgage loans. Some sponsors do guarantee the performance of the underlying loans.

5. Loan-backed securities meet the definition of assets as defined in *SSAP No. 4—Assets and Nonadmitted Assets* and are admitted asset to the extent they conform to the requirements of this statement.

127. In agenda item 2007-26, *FAS 156: Accounting for Servicing of Financial Assets an amendment of FASB Statement No. 140*, the Working Group adopted with modification FAS 156 in *SSAP No. 91R—Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, revising the terminology for “retained interests” to “interests that continue to be held by the transferor.” This action also clarified that beneficial interests from the sale of loan-backed and structured securities shall be accounted for in accordance with SSAP No. 43. This initial adoption identified that the holder of a beneficial interest in securitized financial assets should recognize the excess of all cash flows attributed to the beneficial interest estimated at the acquisition date over the initial investment as interest income over the life of the beneficial interest using the effective yield method.

128. In 2009, the Working Group adopted a substantively-revised SSAP No. 43 (effective September 30, 2009). The focus of the substantive revisions was to revise the valuation and impairment requirements based on the cash flows expected to be collected for the securities, rather than fair value. Although the focus of the revisions was inclusion of impairment guidance based on whether an entity has an intent to sell, whether an entity does not have the intent and ability to hold a security, and when there is a non-interest related decline if there is no intent to sell and the entity has the intent and ability to hold, the revisions resulted in a significant rewrite of the guidance in SSAP No. 43, including the guidance for beneficial

interests. This guidance expanded the prior scope inclusion from “beneficial interests from the sale of LBSS,” to include “purchased beneficial interests in securitized financial assets.”

129. In agenda item 2010-12, Clarify Definitions of Loan-Backed and Structured Securities, the Working Group received a regulator-sponsored, nonsubstantive Form A with a proposal to revise the definitions of a loan-backed and structured security (LBSS). As a result of this proposal, the definition was revised to eliminate the reference to “securitized loans” and instead refer to “securitized assets.” These revisions were adopted with an effective date of January 1, 2011.

- a. Although the agenda item simply identifies that this item was exposed in August 2010, and then adopted after a single exposure in October 2010, with an effective date of January 1, 2011, there were significant comments received during the exposure period. In short summary, these comments highlighted that the scope of the changes were intended to move fixed-income assets that had been accounted for as bonds under SSAP No. 26 to SSAP No. 43 as LBSS. Particularly, the comments noted concerns with the movement of equipment trust certificates and credit tenant loans from the accounting provisions of SSAP No. 26 to the accounting rules of SSAP No. 43. These comments stated that “instruments with radically different sources of cash flows and risk characteristics utilize trust structures, and not all should be classified as loan-backed.” There were no changes incorporated to the proposed guidance as a result of these comments, and the revisions were adopted as exposed.

130. In 2019, revisions to the definition and scope section were also adopted to clarify the identification of affiliate/related party transactions (agenda item 2019-03) as well as to explicitly capture mortgage-referenced securities issued from a government sponsored enterprise in scope of SSAP No. 43 (agenda item 2018-17). The inclusion of mortgage-referenced securities was a distinct departure from the “trust” structure required in determining inclusion within scope of SSAP No. 43, but was incorporated as the securities (with the referenced pool of assets), functions similarly to the securities held in trust and the referenced pool of assets can be assessed for the underlying credit risk

131. Between the adoption of agenda item 2010-12 and the items adopted in 2019, there were several revisions to SSAP No. 43, but those revisions did not impact the definition / scope of the statement. Those revisions included changes to incorporate price-point NAIC designations, guidance for interim financials for RMBC/CMBS, clarification of disclosures, updating Q/A guidance, and guidance for prepayment fees.

132. Definition of loan-backed and structured securities in the “As of March 2020” AP&P Manual:

2. Loan-backed securities are defined as securitized assets not included in structured securities, as defined below, for which the payment of interest and/or principal is directly proportional to the payments received by the issuer from the underlying assets, including but not limited to pass-through securities, lease-backed securities, and equipment trust certificates.
3. Structured securities are defined as loan-backed securities which have been divided into two or more classes for which the payment of interest and/or principal of any class of securities has been allocated in a manner which is not proportional to payments received by the issuer from the underlying assets.
4. Loan-backed securities are issued by special-purpose corporations or trusts (issuer) established by a sponsoring organization. The assets securing the loan-backed obligation are acquired by the issuer and pledged to an independent trustee until the issuer’s obligation has been fully satisfied. The investor only has direct recourse to the issuer’s assets but may have secondary recourse to third parties through insurance or guarantee for repayment of the obligation. As a result, the sponsor and its other affiliates may have no financial obligation under the instrument, although one of those entities may retain the responsibility for servicing the underlying assets. Some sponsors do guarantee the performance of the underlying assets.

- a. In determining whether a loan-backed structure is a related party investment, consideration shall be given to the substance of the transaction, and the parties whose action or performance materially impacts the insurance reporting entity holding the security. For example, although a loan-backed security may be acquired from a non-related issuer, if the assets held in trust predominantly<sup>4</sup> reflect assets issued by affiliates of the insurance reporting entity, and the insurance reporting entity only has direct recourse to the assets held in trust, the transaction shall be considered an affiliated investment, and the transaction shall also be subject to the accounting and reporting provisions in *SSAP No. 25—Affiliates and Other Related Parties*.

5. Mortgage-referenced securities do not meet the definition of a loan-backed or structured security but are explicitly captured in scope of this statement. In order to qualify as a mortgage-referenced security, the security must be issued by a government sponsored enterprise<sup>5</sup> in the form of a “credit risk transfer” in which the issued security is tied to a referenced pool of mortgages. These securities do not qualify as “loan-backed securities” as the pool of mortgages are not held in trust and the amounts due under the investment are not backed or secured by the mortgage loans. Rather, these items reflect instruments in which the payments received are linked to the credit and principal payment risk of the underlying mortgage loan borrowers captured in the referenced pool of mortgages. For these instruments, reporting entity holders may not receive a return of their full principal as principal repayment is contingent on repayment by the mortgage loan borrowers in the referenced pool of mortgages. Unless specifically noted, the provisions for loan-backed securities within this standard apply to mortgage-referenced securities.

6. Investments within the scope of this statement are also subject to the provisions and disclosure requirements of SSAP No. 25 if the SSAP No. 43 transaction is a related party arrangement<sup>6</sup>. Loan-backed and structured securities meet the definition of assets as defined in *SSAP No. 4—Assets and Nonadmitted Assets* and are admitted assets to the extent they conform to the requirements of this statement and SSAP No. 25.

7. The scope of this statement encompasses all types of loan-backed and structured securities, including, but not limited to, the following:

- a. Loan-backed and structured securities acquired at origination,
- b. Loan-backed and structured securities acquired subsequent to origination for which it is probable, at acquisition, that the reporting entity will be able to collect all contractually required payments receivable, and are accounted for at acquisition under SSAP No. 103,

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<sup>4</sup> In applying this guidance, a reporting entity is not required to complete a detailed review of the assets held in trust to determine the extent, if any, the assets were issued by related parties. Rather, this guidance is a principle concept intended to prevent situations in which related party transactions (particularly those involving affiliates) is knowingly captured in a SSAP No. 43 structure and not identified as a related party transaction (or not reported as an affiliated investment on the investment schedule) because of the involvement of a non-related trustee or SSAP No. 43 security issuer. As identified in *SSAP No. 25—Affiliates and Other Related Parties*, it is erroneous to conclude that the inclusion of a non-related intermediary, or the presence of non-related assets in a structure predominantly comprised of related party investments, eliminates the requirement to identify and assess the investment transaction as a related party arrangement.

<sup>5</sup> Currently, only Fannie Mae and Freddie Mac are the government sponsored entities that issue qualifying mortgage-referenced securities. However, this guidance would apply to mortgage-referenced securities issued by any other government sponsored entity that subsequently engages in the transfer of residential mortgage credit risk.

<sup>6</sup> As discussed in paragraph 4.a. of this statement, a SSAP No. 43 security may still be considered a related party transaction even if the asset trustee or security issuer is a non-related party.

- c. Loan-backed and structured securities for which it is probable, either known at acquisition or identified during the holding period<sup>7</sup>, that the reporting entity will be unable to collect all contractually required payments receivable, and
- d. Transferor's beneficial interests in securitization transactions that are accounted for as sales under SSAP No. 103 and purchased beneficial interests in securitized financial assets<sup>8</sup>.

#### Benefits of Reporting in Scope of SSAP No. 43 – Before the Principles-Based Definition

133. There are a variety of benefits for reporting investments as bonds on Schedule D-1. Also, with regards to bifurcated impairment, capturing an investment in scope of SSAP No. 43 may be more advantageous than capturing in scope of *SSAP No. 26—Bonds*. These benefits include:

- a. Capturing an investment in scope of SSAP No. 26 or SSAP No. 43 results with reporting the investment on Schedule D-1, Long-Term Bonds. By reporting on this bond schedule, the investment is generally not subject to investment limitations, the asset is admitted and the investment has the benefit of lower risk-based capital (RBC) charges based on NAIC designation. (Moving held equity instruments from Schedule BA into a SSAP No. 43 trust has been particularly noted as providing “regulatory capital relief.”)
- b. Capturing an investment in scope of SSAP No. 26 or SSAP No. 43 may result in amortized cost reporting and a delay in recognizing decreases in value or other-than-temporary impairments than if the assets held in trust were reported separately on the statutory financial statements.
  - i. Under the SSAP No. 43 bifurcated impairment model, an entity is not required to recognize an OTTI or deviate from an amortized cost measurement as long as the entity can assert that they have the intent and ability to hold the SSAP No. 43 security to recover the amortized cost basis and there is no non-interest related decline. (This has been a key factor in the PPN design, as a high-quality bond is placed in trust (along with other assets), and the bond – over several years – will single-handedly satisfy the contractual requirements of the 43 issued security, preventing any recognition of OTTI or a reduction of NAIC designation even when the other securities held in trust could completely default to zero.)
  - ii. The SSAP No. 43 bifurcated impairment can be considered an advantage over SSAP No. 26 as under SSAP No. 43, if there is an intent and ability to hold the asset, a reporting entity only has to recognize an OTTI for the portion of the non-interest related loss. Under SSAP No. 26, if there is any assessed OTTI (despite if interest or credit related), a reporting entity must recognize an OTTI down to the then-current fair value for the security.
  - iii. Prior to the principles-based bond project, guidance in SSAP No. 43 did not differentiate between different types of tranches or payment streams for the issued securities. This is easiest to illustrate through the “equity” tranche of a SSAP No. 43 investment but could be a factor if payments are provided sequentially. (Sequential payments are used to pay the senior notes first, until paid in full, before payments are allocated to junior notes.) For the “equity” tranche, which is a term

<sup>7</sup> Securities classified within the type of paragraph 7.a. or 7.b. may be required to change classification to type 6.c. when it becomes probable that the reporting entity will be unable to collect all contractually required payments receivable.

<sup>8</sup> The accounting requirements related to these types of securities included in paragraphs 22-25 shall be determined at acquisition or initial transfer.

that refers to the junior-most layer of issued SSAP No. 43 securities, this tranche is the first-loss position and only receives payment after all other layers have been satisfied. Without prior guidance in SSAP No. 43 for this layer, entities were able to classify these residual tranches as “bonds” on Schedule D-1, which did not properly reflect the nature of those investments.

- c. SSAP No. 43 permits admittance of the security without any verification to the assets held in trust. As such, if a reporting entity was to derecognize a joint venture or LLC from Schedule BA and reacquire through the ownership of a SSAP No. 43 security, the reporting entity would be permitted to admit the security without any verification of the joint venture or LLC held in trust. Under *SSAP No. 48—Joint Ventures, Partnerships and Limited Liability Companies*, assets must have audited support (audited U.S. GAAP financials, audited reconciliation to U.S. GAAP, audited IFRS financials or audited U.S. tax basis equity) in order to be admitted in the statutory financial statements.

#### Key Issues with Scope/Definition Application of SSAP No. 43 – Before the Principles-Based Definition

134. With the existing guidance in SSAP No. 43, there are no restrictions to the assets that can be placed in trust and used to support securities issued from the trust structure. Although these structural designs are referred to as “securitizations” and reported as debt instruments, these investment structures may not reflect actual securitizations in which cash flows from multiple contractual debt obligations held in trust are used to pay principal and interest payments on the trust-issued security. The assets being securitized may include assets that are not cash flow producing, creating reliance on an underlying collateral valuation risk. Or there may be no economic substance to the use of the securitization structure, such that the insurer is in the same economic position as owning the underlying assets directly. As a result, there is a regulatory concern that assets being represented as bonds may contain unidentifiable risks that regulators would not traditionally associate with bond risk.

135. As an additional issue of the existing guidance, questions have been raised on whether securities captured in scope of SSAP No. 43 would be “asset-backed securities” as defined by the Code of Federal Regulations (17 CFR 229.1101(c)). These questions have arisen as an SEC identified nationally recognized statistical rating organization (NRSRO) must be specifically approved to provide ratings of “asset-backed securities.” Since the CFR definition is different than what is permitted in scope of SSAP No. 43, a rating from an NRSRO approved as a credit rating provider (CRP) that may not be approved by the SEC for “asset-backed securities” could provide a valid rating for a SSAP No. 43 instrument permitted as “filing exempt” if that asset was not an “asset-backed security.” This has caused questions as regulators have identified designations given by CRPs not SEC approved to provide “ABS” designations and have questioned the use of these CRP ratings in determining the NAIC designation.

#### Issue Paper Exhibits:

Adopted revisions reflecting the principles-based bond definition are included in the affected SSAPs in the *As of March 2025 Accounting Practices and Procedures Manual* and not duplicated within this issue paper. The issue paper retained for historical purposes on the Statutory Accounting Principles (E) Working Group web page will include the following exhibits to retain the adopted guidance as of January 1, 2025.

- Exhibit 1 – *SSAP No. 26—Bonds*
- Exhibit 2 – *SSAP No. 43—Asset-Backed Securities*
- Exhibit 3 – *Revisions to SSAP No. 21—Other Admitted Assets*
- Exhibit 4 – *Revisions to Other SSAPs*

## Statement of Statutory Accounting Principles No. 26

### Bonds

#### STATUS

Type of Issue.....	Common Area
Issued .....	August 13, 2023
Effective Date .....	January 1, 2025
Affects.....	Replaces SSAP No. 26R on January 1, 2025
Affected by.....	No other pronouncements
Interpreted by .....	INT 01-25; INT 06-02; INT 06-07; INT 07-01
Relevant Appendix A Guidance.....	None

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## SCOPE OF STATEMENT

1. The principles-based definition of a bond within this statement shall be utilized to identify whether security structures should be reported as bonds. Investments that qualify within the principles-based definition as an issuer credit obligation shall follow the accounting guidance within this statement. Investments that qualify within the principles-based definition as an asset-backed security (ABS) shall follow the accounting guidance in *SSAP No. 43R—Asset-Backed Securities*.
2. In addition to security investments that qualify under the principles-based definition as issuer credit obligations, certain specific instruments are also captured in scope of this statement:
  - a. Certificates of deposit that have a fixed schedule of payments and a maturity date in excess of one year from the date of acquisition;
  - b. Bank loans that are obligations of operating entities issued directly by a reporting entity or acquired through a participation, syndication or assignment<sup>1</sup>;
  - c. Debt instruments in a certified capital company (CAPCO) <sup>(INT 06-02)</sup>
  - d. Exchange Traded Funds (ETFs) that qualify for bond treatment as identified in the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* and included in the ‘SVO-Identified Bond ETF List’ published on the SVO’s webpage. (These instruments are referred to as SVO-Identified Bond ETFs.)
  - e. Mortgage loans in scope of *SSAP No. 37—Mortgage Loans* that qualify under an SVO structural assessment and are identified as SVO-Identified Credit Tenant Loans.
3. Securities that qualify as issuer credit obligations with a maturity date of one year or less from date of acquisition that qualify as cash equivalents or short-term investments shall follow the accounting requirements of this statement. These investments are also captured in *SSAP No. 2R—Cash, Cash*

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<sup>1</sup> **Bank Loan** – Fixed-income instruments, representing indebtedness of a borrower, made by a financial institution. Bank loans can be issued directly by a reporting entity or acquired through an assignment, participation or syndication:

- **Assignment** – A bank loan assignment is defined as a fixed-income instrument in which there is the sale and transfer of the rights and obligations of a lender (as assignor) under an existing loan agreement to a new lender (and as assignee) pursuant to an Assignment and Acceptance Agreement (or similar agreement) which effects a novation under contract law, so the new lender becomes the direct creditor of and is in contractual privity with the borrower having the sole right to enforce rights under the loan agreement.
- **Participation** – A bank loan participation is defined as a fixed-income investment in which a single lender makes a large loan to a borrower and subsequently transfers (sells) undivided interests in the loan to other entities. Transfers by the originating lender may take the legal form of either assignments or participations. The transfers are usually on a nonrecourse basis, and the originating lender continues to service the loan. The participating entity may or may not have the right to sell or transfer its participation during the term of the loan, depending on the terms of the participation agreement. Loan Participations can be made on a parri-passu basis (where each participant shares equally) or a senior subordinated basis (senior lenders get paid first and the subordinated participant gets paid if there are sufficient funds left to make a payment).
- **Syndication** – A bank loan syndication is defined as a fixed-income investment in which several lenders share in lending to a single borrower. Each lender loans a specific amount to the borrower and has the right to repayment from the borrower. Separate debt instruments exist between the debtor and the individual creditors participating in the syndication. Each lender in a syndication shall account for the amounts it is owed by the borrower. Repayments by the borrower may be made to a lead lender that then distributes the collections to the other lenders of the syndicate. In those circumstances, the lead lender is simply functioning as a servicer and shall not recognize the aggregate loan as an asset. A loan syndication arrangement may result in multiple loans to the same borrower by different lenders. Each of those loans is considered a separate instrument.

*Equivalents, Drafts and Short-Term Investments* and shall follow the reporting and disclosure requirements of that statement.

4. This statement excludes:
- a. Mortgage loans and other real estate lending activities made in the ordinary course of business. These investments are addressed in *SSAP No. 37—Mortgage Loans* and *SSAP No. 39—Reverse Mortgages*.
  - b. Investments that qualify within the principles-based definition as an ABS. These investments shall follow the guidance in *SSAP No. 43R—Asset-Backed Securities*
  - c. Securities that provide varying principal or interest based on underlying equity appreciation or depreciation, an equity-based derivative, real estate or other non-debt variable, as described in paragraph 6.d.
  - d. Securities that do not qualify as bonds pursuant to the principles-based bond definition, including first loss positions that lack contractual payments or substantive credit enhancement. These investments shall follow the appropriate guidance in *SSAP No. 21R—Other Admitted Assets*.
  - e. Replication (synthetic asset) transactions addressed in *SSAP No. 86—Derivatives*. The admissibility, classification and measurement of a replication (synthetic asset) transactions are not preemptively determined by the principles-based bond definition and should be evaluated in accordance with the guidance on replication (synthetic asset) transactions within *SSAP No. 86*.
  - f. Investments that are captured specifically within other SSAPs. For example, reporting entity acquired structured settlements are captured in scope of *SSAP No. 21R—Other Admitted Assets*, held surplus notes are captured in scope of *SSAP No. 41R—Surplus Notes* and working capital finance investments are captured in scope of *SSAP No. 105—Working Capital Finance Investments*. Investments captured in scope of other SSAPs are subject to the measurement and admittance provisions of those SSAPs. Furthermore, investments that have specific reporting lines on dedicated schedules (such as with both surplus notes and WCFI) shall be reported on their dedicated lines.

## SUMMARY CONCLUSION

### Principles-Based Bond Definition

5. A bond shall be defined as any security<sup>2</sup> representing a creditor relationship, whereby there is a fixed schedule for one or more future payments, and which qualifies as either an issuer credit obligation or an asset-backed security as described in this statement. Determining whether a security represents a creditor relationship should consider its substance, rather than solely the legal form of the instrument. The analysis

<sup>2</sup> This statement adopts the GAAP definition of a security as it is used in FASB Accounting Standards Codification Topics 320 and 860. Evaluation of an investment under this definition should consider the substance of the instrument rather than solely its legal form.

Security: A share, participation, or other interest in property or in an entity of the issuer or an obligation of the issuer that has all of the following characteristics:

- a. It is either represented by an instrument issued in bearer or registered form or, if not represented by an instrument, is registered in books maintained to record transfers by or on behalf of the issuer.
- b. It is of a type commonly dealt in on securities exchanges or markets or, when represented by an instrument, is commonly recognized in any area in which it is issued or dealt in as a medium for investment.
- c. It is either one of a class or series or by its terms is divisible into a class or series of shares, participations, interests or obligations.

of whether a security represents a creditor relationship should consider all other investments the reporting entity owns in the investee as well as any other contractual arrangements. A security that in substance possesses equity-like characteristics or represents an ownership interest in the issuer does not represent a creditor relationship. While not intended to be all-inclusive, paragraphs 6.a.-6.d. discuss specific elements that may introduce equity-like characteristics:

- a. Determining whether a debt instrument represents a creditor relationship in substance when the source of cash flows for repayment is derived from underlying equity interests inherently requires significant judgment and analysis. Unlike a debt instrument collateralized by assets with contractual cash flows, debt instruments collateralized by equity interests are dependent on cash flow distributions that are not contractually required to be made and are not controlled by the issuer of the debt. As a result, there is a rebuttable presumption that a debt instrument collateralized by equity interests does not represent a creditor relationship in substance. Notwithstanding this rebuttable presumption, it is possible for such a debt instrument to represent a creditor relationship if the characteristics of the underlying equity interests lend themselves to the production of predictable cash flows and the underlying equity risks have been sufficiently redistributed through the capital structure of the issuer. Factors to consider in making this determination include but are not limited to:
  - i. Number and diversification of the underlying equity interests
  - ii. Characteristics of the underlying equity interests (vintage, asset-types, etc.)
  - iii. Liquidity facilities
  - iv. Overcollateralization
  - v. Waiting period for distributions/paydowns to begin
  - vi. Capitalization of interest
  - vii. Covenants (e.g., loan-to-value trigger provisions)
  - viii. Reliance on ongoing sponsor commitments
- b. While reliance of the debt instrument on sale of underlying equity interests or refinancing at maturity does not preclude the rebuttable presumption from being overcome, it does require that the other characteristics mitigate the inherent reliance on equity valuation risk to support the transformation of underlying equity risk to bond risk. As reliance on sale or refinancing increases, the more compelling the other factors needed to overcome the rebuttable presumption become.
- c. Analysis of whether the rebuttable presumption for underlying equity interests is overcome shall be conducted and documented by a reporting entity at the time such an investment is acquired. The level of documentation and analysis required will vary based on the characteristics of the individual debt instrument, as well as the level of third-party and/or non-insurance company market validation to which the issuance has been subjected. For example, a debt instrument collateralized by fewer, less diversified equity interests would require more extensive and persuasive documented analysis than one collateralized by a larger diversified portfolio of equity interests. Likewise, a debt instrument that has been successfully marketed to unrelated and/or non-insurance company investors, may provide enhanced market validation of the structure compared to one held only by related party and/or insurance company investors where capital relief may be the primary motivation for the securitization.
- d. In order for a debt instrument to represent a creditor relationship in accordance with Paragraph 6, it must have pre-determined principal and interest payments (whether fixed interest or variable interest) with contractual amounts that do not vary based on the appreciation or depreciation (i.e., performance) of any underlying collateral value or other

non-debt variable. For example, an issued security that has varying principal and interest payments based on the appreciation of referenced equity, real estate or other non-debt variable is precluded from bond treatment. This exclusion is not intended to restrict variables that are commonly related to debt instruments such as, but not limited to, plain-vanilla<sup>3</sup> inflation or benchmark interest rate adjustments (such as with U.S. TIPs or SOFR-linked coupons, respectively), scheduled interest rate step-ups, or credit-quality related interest rate adjustments. This exclusion is also not intended to encompass nominal interest rate adjustments<sup>4</sup>. For clarification purposes, all returns from a debt instrument in excess of principal are required to be considered as interest. Therefore, investments with “stated” interest and then “additional returns” to which the holder of the debt instrument is entitled are collectively considered as interest and shall be assessed together in determining whether the investment has variable principal or interest due to underlying referenced non-debt variables. Examples of securities excluded from the bond definition under this guidance:

- i. Structured Notes, which are securities that otherwise meet the definition of a bond, but for which the contractual amount of the instrument to be paid at maturity (or the original investment) is at risk for other than the failure of the borrower to pay the principal amount due, are excluded from the bond definition. These investments, although in the form of a debt instrument, incorporate the risk of an underlying variable in the terms of the agreement, and the issuer obligation to return the full principal is contingent on the performance of the underlying variable. These investments are addressed in *SSAP No. 86—Derivatives*. Mortgage-referenced securities issued by a government sponsored enterprise are explicit inclusions in scope of *SSAP No. 43*. Foreign-denominated bonds subject to variation as a result of foreign currency fluctuations are not structured notes.
- ii. Principal-protected securities, as defined in the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* are excluded from the bond definition as they have a performance component whose payments originate from, or are determined by, non-fixed income securities. These investments shall follow the guidance for non-bond securities in *SSAP No. 21—Other Admitted Assets*.

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<sup>3</sup> Inflation or benchmark interest rate adjustment mechanisms are considered plain-vanilla if based on widely recognized measures of inflation or interest rate benchmarks and excludes those that involve either leverage (such as a multiplier) or an inverse adjustment relationship.

<sup>4</sup> Nominal interest rate adjustments are those that are too small to be taken into consideration when assessing the investment’s substance as a bond. Nominal adjustments are not typically influential factors in an investors’ evaluation of investment return and are often included to incentivize certain behavior of the issuer. An example would include sustainability-linked bonds where failure to achieve performance metrics could cause interest rate adjustments. In general, interest rate adjustments that adjust the total return from interest by more than 10% (e.g., >0.4% for a 4% yielding bond), would not be considered nominal. Further, any such adjustments that cause an investment to meet the definition of a structured note would not be considered nominal.

6. An issuer credit obligation is a bond, for which the general creditworthiness of an operating entity or entities through direct or indirect recourse, is the primary<sup>5</sup> source of repayment. Operating entity or entities includes holding companies with operating entity subsidiaries where the holding company has the ability to access the operating subsidiaries' cash flows through its ownership rights. An operating entity may be any sort of business entity, not-for-profit organization, governmental unit, or other provider of goods or services, but not a natural person or "ABS Issuer" (as defined in paragraph 8). Examples of issuer credit obligations include, but are not limited to:

- a. U.S. Treasury securities, including U.S. Treasury Inflation-Indexed Securities;<sup>(INT 01-25)</sup>
- b. U.S. government agency securities;
- c. Municipal securities issued by the municipality or supported by cash flows generated by a municipally-owned asset or entity that provides goods or services (e.g., airport, toll roads, etc.);
- d. Corporate bonds issued by operating entities, including Yankee bonds and zero-coupon bonds;
- e. Corporate bonds, issued by holding companies that own operating entities;
- f. Project finance bonds issued by operating entities;
- g. Investments in the form of securities for which repayment is fully supported by an underlying contractual obligation of a single operating entity (e.g., Credit Tenant Loans (CTLs), Equipment trust certificates (ETCs), other lease backed securities, Funding Agreement Backed Notes (FABNs), etc.). For purposes of applying this principal concept, repayment is fully-supported by the underlying operating entity obligation if it provides cash flows for the repayment of all interest and at least 95% of the principal of the security.
- h. Bonds issued by real estate investment trusts (REITs) or similar property trusts;
- i. Bonds issued by business development corporations, closed-end funds, or similar operating entities, in each case registered under the 1940 Act.
- j. Convertible bonds issued by operating entities, including mandatory convertible bonds as defined in paragraph 20.b.

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<sup>5</sup> "Primary" refers to the first in order of repayment source, not to a majority of the sources of repayment. For example, an issuer obligation may have secondary recourse to collateral upon default of the operating entity but would otherwise be expected to be fully repaid with cash flows of the operating entity. This differs from an asset-backed security for which the primary source of repayment is from cash flows of the collateral.

7. An asset-backed security<sup>6</sup> is a bond issued by an entity (an “ABS Issuer”) created for the primary purpose of raising debt capital backed by financial assets<sup>7</sup> or cash generating non-financial assets owned by the ABS Issuer, for which the primary source of repayment is derived from the cash flows associated with the underlying defined collateral rather than the cash flows of an operating entity<sup>8</sup>. In most instances, the ABS Issuer is not expected to continue functioning beyond the final maturity of the debt initially raised by the ABS Issuer. Also, many ABS Issuers are in the form of a trust or special purpose vehicle (“SPV”), although the presence or lack of a trust or SPV is not a definitive criterion for determining that a security meets the definition of an asset-backed security. The provisions in paragraphs 9-10 detail the two defining characteristics that must be present for a security to meet the definition of an asset-backed security.

8. The assets owned by the ABS Issuer are either financial assets or cash-generating non-financial assets. Cash-generating non-financial assets are defined as assets that are expected to generate a meaningful level of cash flows toward repayment of the bond through use, licensing, leasing, servicing or management fees, or other similar cash flow generation. For the avoidance of doubt, there must be a meaningful level of cash flows to service the debt, other than through the sale or refinancing of the underlying assets held by the ABS Issuer. Reliance on cash flows from the sale or refinancing of cash generating non-financial assets does not preclude a security from being classified as an asset-backed security so long as the conditions in this paragraph are met.

- a. *Meaningful Level of Cash Flows:* Determining what constitutes a “meaningful” level of cash flows generated to service the debt from sources other than the sale or refinancing of the underlying collateral pursuant to paragraph 9 is specific to each transaction, determined at origination, and shall consider the following factors:
- i. The price volatility in the principal market for the underlying collateral;
  - ii. The liquidity in the principal market for the underlying collateral;
  - iii. The diversification characteristics of the underlying collateral (i.e., types of collateral, geographic location(s), source(s) of cash flows within the structure, etc.);
  - iv. The overcollateralization of the underlying collateral relative to the debt obligation; and
  - v. The variability of cash flows, from sources other than sale or refinancing, expected to be generated from the underlying collateral.

The factors for price variability and the variability of cash flows are directly related to the “meaningful” requirement. That is, as price volatility or variability of cash flows increase,

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<sup>6</sup> The underlying collateral supporting an asset-backed security shall meet the definition of an asset by the ABS Issuer. Certain forms of collateral, such as rights to future cash flows, may not be recognized as assets by the selling entity but may be recognized as assets when sold to an ABS Issuer. These assets are permitted as the collateral supporting an asset-backed security, although they may not represent an asset that can be liquidated to provide payment toward the issued debt obligations (i.e., if the future cash flows do not materialize). The limited ability to liquidate the underlying collateral supporting an asset-backed security does not impact the structural determination of whether an issued security meets the definition of an asset-backed security but may impact the recoverability of the investment, as well as the consideration of whether there is sufficient credit enhancement.

<sup>7</sup> *SSAP No. 103R—Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* defines a financial asset as cash, evidence of an ownership interest in an entity, or a contract that conveys to one entity a right (a) to receive cash or another financial instrument from a second entity or (b) to exchange other financial instruments on potentially favorable terms with the second entity. As a point of clarity, for the purposes of this standard, financial assets do not include assets for which the realization of the benefits conveyed by the above rights depends on the completion of a performance obligation (e.g., leases, mortgage servicing rights, royalty rights, etc.). These assets represent non-financial assets, or a means through which non-financial assets produce cash flows, until the performance obligation has been satisfied.

<sup>8</sup> Dedicated cash flows from an operating entity can form the underlying defined collateral in an asset-backed security. This dynamic, perhaps noted in a whole-business securitization, still reflects an asset-backed security and is not an issuer credit obligation.

the required percentage of cash flows generated to service the debt from sources other than the sale or refinancing of the underlying collateral must also increase. The factors for liquidity, diversification and overcollateralization are inversely related to the “meaningful” concept. That is, as liquidity, diversification or overcollateralization increase, the required percentage of cash flows generated to service the debt from sources other than the sale or refinancing of the underlying collateral may decrease.

- b. As a practical expedient to determining whether a cash generating non-financial asset is expected to produce meaningful cash flows, a reporting entity may consider an asset for which less than 50% of the original principal relies on sale or refinancing to meet the meaningful criteria. In applying this practical expedient, only contractual cash flows of the non-financial assets may be considered. This practical expedient should not be construed to mean that assets cannot meet the meaningful criteria if they rely on sale or refinancing to service greater than 50% of the original principal or if they rely on cash flows that are not contracted at origination. Rather, such instances would require a complete analysis of the considerations described within the meaningful level of cash flows definition in paragraph 9.

9. The holder of a debt instrument issued by an ABS Issuer is in a different economic position than if the holder owned the ABS Issuer’s assets directly. The holder of the debt instrument is in a different economic position if such debt instrument benefits from substantive credit enhancement through guarantees (or other similar forms of recourse), subordination and/or overcollateralization.

- a. *Substantive Credit Enhancement:* The intent of the criteria requiring the holder to be in a different economic position is to distinguish qualifying bonds from instruments with equity-like characteristics or where the substance of the transaction is more closely aligned with that of the underlying collateral. To qualify as an ABS under this standard, there is a requirement that there are substantive credit enhancements within the structure that absorb losses before the debt instrument being evaluated would be expected to absorb losses. This is inherent in the context of an issuer credit obligation in scope of SSAP No. 26R as the owners of the equity in the operating entity are the first to absorb any variability in performance of the operating entity. The same concept applies to asset-backed securities. If substantive credit enhancement did not exist, the substance of the debt instrument being evaluated would be more closely aligned with that of the underlying collateral than that of a bond. Credit enhancement that is merely nominal or lacks economic substance does not put a holder in a different economic position. The substantive credit enhancement required to be in a different economic position is specific to each transaction; determined at origination; and refers to the level of credit enhancement a market participant (i.e., knowledgeable investor transacting at arm’s length) would conclude is substantive.
- b. The first loss position may be issued as part of a securitization in the form of a debt or equity interest, or it may be retained by the sponsor and not issued as part of the securitization. If the first loss position (or a more senior position(s), if the first loss position(s) lacks contractual payments along with a substantive credit enhancement) is issued as part of the securitization, and does not have contractual principal and interest payments along with substantive credit enhancement and is held by a reporting entity, the investment(s) does not qualify for reporting as a bond and shall be reported on Schedule BA: Other Long-Term Invested Assets at the lower of amortized cost or fair value consistent with the treatment for residuals. (These items are further addressed in *SSAP No. 21R—Other Admitted Assets.*)

10. Whether an issuer of debt represents an operating entity or ABS Issuer is unambiguous in most instances, but certain instances may be less clear. For example, an entity may operate a single asset such as

a toll road or power generation facility (e.g., project finance) which serves to collateralize a debt issuance, and the cash flows produced by the operation of the assets are pledged to service the debt. In many such instances, the entity is structured as a bankruptcy-remote entity that is separate from the municipality or project sponsor. Such entities have characteristics of operating entities as the operation of the asset constitutes a stand-alone business. They also have many common characteristics of ABS Issuers as they are formed for the purpose of raising debt capital backed by the cash flows from collateral held by a bankruptcy-remote entity. When viewed more holistically, these issuing entities are typically being used to facilitate the financing of an operating component of a project sponsor or municipality. The use of a bankruptcy-remote entity facilitates the efficient raising of debt to finance the operating project, but the primary purpose is to finance an operating project. Therefore, structures in which the issuing entity represents a stand-alone business producing its own operating revenues and expenses, where the primary purpose is to finance an operating project, shall be considered operating entities despite certain characteristics they may share with ABS Issuers.

11. The definition of a creditor relationship, per paragraph 6, does not include equity/fund investments (such as mutual funds or exchanged-traded funds), or securities that possess equity-like characteristics or that represent an ownership interest in the issuer. However, as identified in paragraph 2, exchange traded funds (ETFs), which qualify for bond treatment, as identified in Part Three of the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* and included in the ‘SVO-Identified Bond ETF List’ published on the SVO’s webpage are provided special statutory accounting treatment and are included within the scope of this statement. These investments shall follow the guidance within this statement, as if they were issuer credit obligations, unless different treatment is specifically identified in paragraphs 32-38.

12. Investments within the scope of this statement issued by a related party, or acquired through a related party transaction, are also subject to the provisions, admittance assessments and disclosure requirements of *SSAP No. 25—Affiliates and Other Related Parties*.

13. Investments within the scope of this statement meet the definition of assets as defined in *SSAP No. 4—Assets and Nonadmitted Assets* and are admitted assets to the extent they conform to the requirements of this statement and *SSAP No. 25*.

### **Accounting and Reporting Guidance for Investments that Qualify as Issuer Credit Obligations<sup>9</sup>**

#### **Acquisitions, Disposals and Changes in Unrealized Gains and Losses**

14. A bond acquisition or disposal shall be recorded on the trade date (not the settlement date) except for the acquisition of private placement bonds which shall be recorded on the funding date. At acquisition, bonds shall be reported at their cost, including brokerage and other related fees. The reported cost of a bond received as a property dividend or capital contribution shall be the initial recognized value. *SSAP No. 25* shall be used to determine whether a transfer is economic or noneconomic for initial recognition.

15. For reporting entities required to maintain an interest maintenance reserve (IMR), the accounting for realized capital gains and losses on sales of bonds shall be in accordance with *SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve*. For reporting entities required to maintain an asset valuation reserve (AVR), the accounting for unrealized gains and losses shall be in accordance with *SSAP No. 7*.

16. For reporting entities not required to maintain an IMR, realized gains and losses on sales of bonds shall be reported as net realized capital gains or losses in the statement of income. For reporting entities not

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<sup>9</sup> For all references to “bond” investments beginning in paragraph 15, this term intends to refer to investments that are permitted accounting and reporting treatment within scope of this standard.

required to maintain an AVR, unrealized gains and losses shall be recorded as a direct credit or charge to unassigned funds (surplus).

### Amortized Cost

17. Amortization of bond premium or discount shall be calculated using the scientific (constant yield) interest method taking into consideration specified interest and principal provisions over the life of the bond.<sup>10</sup> (INT 07-01) Bonds containing call provisions (where the issue can be called away from the reporting entity at the issuer's discretion), except "make-whole" call provisions, shall be amortized to the call or maturity value/date which produces the lowest asset value (yield-to-worst). Although the concept for yield-to-worst shall be followed for all callable bonds, make-whole call provisions, which allow the bond to be callable at any time, shall not be considered in determining the timeframe for amortizing bond premium or discount unless information is known by the reporting entity indicating that the issuer is expected to invoke the make-whole call provision.

### Application of Yield-to-Worst

18. For callable bonds<sup>11</sup>, the first call date after the lockout period (or the date of acquisition if no lockout period exists) shall be used as the "effective date of maturity." Depending on the characteristics of the callable bonds, the yield-to-worst concept in paragraph 18 shall be applied as follows:

- a. For callable bonds with a lockout period, premium in excess of the next call price<sup>12</sup> (subsequent to acquisition<sup>13</sup> and lockout period) shall be amortized proportionally over the length of the lockout period. After each lockout period (if more than one), remaining premium shall be amortized to the call or maturity value/date which produces the lowest asset value.
- b. For callable bonds without a lockout period, the book adjusted carrying value (at the time of acquisition) of the callable bonds shall equal the lesser of the next call price (subsequent to acquisition) or cost. Remaining premium shall then be amortized to the call or maturity value/date which produces the lowest asset value.
- c. For callable bonds that do not have a stated call price, all premiums over par shall be immediately expensed. For callable bonds with a call price at par in advance of the maturity date, all premiums shall be amortized to the call date.

### Balance Sheet Amount

19. Bonds 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 (SVO).

<sup>10</sup> For perpetual bonds with an effective call option, any applicable premium shall be amortized utilizing the yield-to-worst method.

<sup>11</sup> Callable bonds within the scope of paragraph 19 excludes bonds with make-whole call provisions unless information is known by the reporting entity indicating that the issuer is expected to invoke the make-whole call provision. Exhibit C includes illustrations for the amortization of callable bonds.

<sup>12</sup> Reference to the "next call price" indicates that the reporting entity shall continuously review the call dates/prices to ensure that the amortization (and resulting BACV) follows the yield-to-worst concept throughout the time the reporting entity holds the bond.

<sup>13</sup> The reporting entity shall only consider call dates/prices that occur after the reporting entity acquires the bond. If all of the call dates had expired prior to the reporting entity acquiring the bond, the reporting entity would consider the bond continuously callable without a lockout period.

- a. Bonds, except for mandatory convertible bonds: For reporting entities that maintain an asset valuation reserve (AVR), the bonds 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. For reporting entities that do not maintain an AVR, bonds that are designated highest-quality and high-quality (NAIC designations 1 and 2, respectively) shall be reported at amortized cost; all other bonds (NAIC designations 3 to 6) shall be reported at the lower of amortized cost or fair value. For perpetual bonds which do not possess or no longer possess an effective call option, the bond shall be reported at fair value regardless of NAIC designation.
- b. Mandatory convertible bonds: Mandatory convertible bonds are subject to special reporting instructions and are not assigned NAIC designations or unit prices by the SVO. The balance sheet amount for mandatory convertible bonds shall be reported at the lower of amortized cost or fair value during the period prior to conversion. This reporting method is not impacted by NAIC designation or information received from credit rating providers (CRPs). Upon conversion, these securities will be subject to the accounting guidance of the statement that reflects their revised characteristics. (For example, if converted to common stock, the security will be in scope of *SSAP No. 30R—Unaffiliated Common Stock*, if converted to preferred stock, the security will be in scope of *SSAP No. 32R—Preferred Stocks*.)

20. The premium paid on a zero coupon convertible bond that produces a negative yield as a result of the value of a warrant exceeding the bond discount shall be written off immediately so that a negative yield is not produced. The full amount of the premium should be recorded as amortization within investment income on the date of purchase.

### Impairment

21. An other-than-temporary<sup>(INT 06-07)</sup> impairment shall be considered to have occurred if it is probable that the reporting entity will be unable to collect all amounts due according to the contractual terms of a debt security in effect at the date of acquisition.<sup>14</sup> A decline in fair value which is other-than-temporary includes situations where a reporting entity has made a decision to sell a security prior to its maturity at an amount below its carrying value. If it is determined that a decline in the fair value of a bond is other-than-temporary, an impairment loss shall be recognized as a realized loss equal to the entire difference between the bond's carrying value and its fair value at the balance sheet date of the reporting period for which the assessment is made. The measurement of the impairment loss shall not include partial recoveries of fair value subsequent to the balance sheet date. For reporting entities required to maintain an AVR/IMR, the accounting for the entire amount of the realized capital loss shall be in accordance with *SSAP No. 7*. The other-than-temporary impairment loss shall be recorded entirely to either AVR or IMR (and not bifurcated between credit and non-credit components) in accordance with the annual statement instructions.

22. In periods subsequent to the recognition of an other-than-temporary impairment loss for a bond, the reporting entity shall account for the other-than-temporarily impaired security as if the security had been purchased on the measurement date of the other-than-temporary impairment. The fair value of the bond on the measurement date shall become the new cost basis of the bond and the new cost basis shall not be adjusted for subsequent recoveries in fair value. The discount or reduced premium recorded for the security, based on the new cost basis, shall be amortized over the remaining life of the security in the prospective manner based on the amount and timing of future estimated cash flows. The security shall continue to be

<sup>14</sup> If a bond has been modified from original acquisition, the guidance in *SSAP No. 36—Troubled Debt Restructuring* and paragraph 22 of *SSAP No. 103R—Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* shall be followed, as applicable. After modification of original terms, future assessments to determine other-than-temporary impairment shall be based on the modified contractual terms of the debt instrument.

subject to impairment analysis for each subsequent reporting period. Future declines in fair value which are determined to be other-than temporary shall be recorded as realized losses.

## Income

23. Interest income for any period consists of interest collected during the period, the change in the due and accrued interest between the beginning and end of the period as well as reductions for premium amortization and interest paid on acquisition of bonds, and the addition of discount accrual. In accordance with *SSAP No. 34—Investment Income Due and Accrued*, investment income shall be reduced for amounts which have been determined to be uncollectible. Contingent interest may be accrued if the applicable provisions of the underlying contract and the prerequisite conditions have been met.

24. A bond may provide for a prepayment penalty or acceleration fee in the event the bond is liquidated prior to its scheduled termination date. Such fees shall be reported as investment income when received.

25. The amount of prepayment penalty and/or acceleration fee to be reported as investment income or loss shall be calculated as follows:

- a. For called or tendered bonds in which the total proceeds (consideration) received exceeds par:
  - i. The amount of investment income reported is equal to the consideration received less the par value of the investment; and
  - ii. Any difference between the book adjusted carrying value (BACV) and the par value at the time of disposal shall be reported as realized capital gains and losses, subject to the authoritative literature in *SSAP No. 7*.
- b. For called or tendered bonds in which the consideration received is less than par<sup>15</sup>:
  - i. To the extent an entity has in place a process to identify an explicit prepayment penalty or acceleration fee, these should be reported as investment income. (An entity shall consistently apply their process. Once a process is in place, an entity is required to maintain a process to identify prepayment penalties for called bonds in which consideration received is less than par.)
  - ii. After determining any explicit prepayment penalty or acceleration fee, the reporting entity shall calculate the resulting realized gain as the difference between the remaining consideration and the BACV, which shall be reported as realized capital gain, subject to the authoritative literature in *SSAP No. 7*.

## Origination Fees

26. Origination fees represent fees charged to the borrower in connection with the process of originating or restructuring a transaction such as the private placement of bonds. The fees include, but are not limited to, points, management, arrangement, placement, application, underwriting and other fees pursuant to such a transaction. Origination fees shall not be recorded until received in cash. Origination fees intended to compensate the reporting entity for interest rate risks (e.g., points) shall be amortized into

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<sup>15</sup> This guidance applies to situations in which consideration received is less than par but greater than the book adjusted carrying value (BACV). Pursuant to the yield-to-worst concept, bonds shall be amortized to the call or maturity date that produces the lowest asset value. In the event a bond has not been amortized to the lowest value prior to the call, or in cases of an accepted tender bond offer (BACV is greater than the consideration received), the entire difference between consideration received and the BACV shall be reported to investment income.

income over the term of the bond consistent with paragraph 18 of this statement. Other origination fees shall be recorded as income upon receipt.

### **Origination, Acquisition and Commitment Costs**

27. Costs related to origination when paid in the form of brokerage and other related fees shall be capitalized as part of the cost of the bond, consistent with paragraph 15 of this statement. All other costs, including internal costs or costs paid to an affiliated entity related to origination, purchase or commitment to purchase bonds shall be charged to expense when incurred.

### **Commitment Fees**

28. Commitment fees are fees paid to the reporting entity that obligate the reporting entity to make available funds for future borrowing under a specified condition. A fee paid to the reporting entity to obtain a commitment to make funds available at some time in the future, generally, is refundable only if the bond is issued. If the bond is not issued, then the fees shall be recorded as investment income by the reporting entity when the commitment expires.

29. A fee paid to the reporting entity to obtain a commitment to be able to borrow funds at a specified rate and with specified terms quoted in the commitment agreement, generally, is not refundable unless the commitment is refused by the reporting entity. This type of fee shall be deferred, and amortization shall depend on whether or not the commitment is exercised. If the commitment is exercised, then the fee shall be amortized in accordance with paragraph 18 of this statement over the life of the bond as an adjustment to the investment income on the bond. If the commitment expires unexercised, the commitment fee shall be recognized in income on the commitment expiration date.

### **Exchanges and Conversions**

30. If a bond is exchanged or converted into other securities (including conversions of mandatory convertible securities addressed in paragraph 20.b.), the fair value of the bond surrendered at the date of the exchange or conversion shall become the cost basis for the new securities with any gain or loss realized at the time of the exchange or conversion. However, if the fair value of the securities received in an exchange or conversion is more clearly evident than the fair value of the bond surrendered, then it shall become the cost basis for the new securities.

### **SVO-Identified Bond Exchange –Traded Funds**

31. SVO-identified bond exchange-traded fund (ETF) investments, as discussed in paragraph 2.d., are captured within the scope of this statement for accounting and reporting<sup>16</sup> purposes only. The inclusion of these investments within this statement is not intended to contradict state law regarding the classification of these investments and does not intend to provide exceptions to state investment limitations involving types of financial instruments (e.g., equity/fund interests), or with regards to concentration risk (e.g., issuer).

32. SVO-identified bond ETF investments shall be initially reported at cost, including brokerage and other related fees. Subsequently, SVO-identified bond ETF investments shall be reported at fair value,<sup>17</sup> with changes in fair value recorded as unrealized gains or losses) unless the reporting entity has elected

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<sup>16</sup> With the inclusion of these SVO-identified investments as bonds, specific guidelines are detailed in the annual statement instructions for reporting purposes.

<sup>17</sup> For these investments, net asset value (NAV) is allowed as a practical expedient to fair value.

use<sup>18</sup> of a documented systematic approach to amortize or accrete the investment in a manner that represents the expected cash flows from the underlying bond holdings. This special measurement approach is referred to as the “systematic value” measurement method and shall only be used for the SVO-identified bond ETF investments within the scope of this statement.

33. Use of the systematic value for SVO-identified bond ETF investments is limited as follows:
- a. Systematic value is only permitted to be designated as the measurement method for AVR filers acquiring qualifying investments that have an NAIC designation of 1 to 5, and for non-AVR filers acquiring qualifying investments with an NAIC designation of 1 or 2. SVO-identified investments that have an NAIC designation of 6 for AVR filers or 3-6 for non AVR filers shall be measured at fair value.
  - b. Designated use of a systematic value is an irrevocable election per qualifying investment (by CUSIP) at the time investment is originally acquired<sup>19</sup>. Investments owned prior to being identified by the SVO as a qualifying SSAP No. 26R investment are permitted to be subsequently designated to the systematic value measurement method. This designation shall be applied as a change in accounting principle pursuant to *SSAP No. 3—Accounting Changes and Corrections of Errors*, which requires the reporting entity to recognize a cumulative effect to adjust capital and surplus as if the systematic value measurement method had been applied retroactively for all prior periods in which the investment was held. The election to use systematic value for investments shall be made before the year-end reporting of the investment in the year in which the SVO first identifies the investment as a qualifying SSAP No. 26R investment.
  - c. Once designated for a particular investment, the systematic value measurement method must be retained as long as the qualifying investment is held by the reporting entity and the investment remains within the scope of this statement with an allowable NAIC designation per paragraph 34.a. Upon a full sale/disposal of an SVO-identified investment (elimination of the entire CUSIP investment), after 90 days the reporting entity can reacquire the SVO-identified investment and designate a different measurement method. If the reporting entity was to reacquire the same investment within 90 days after it was sold/disposed, the reporting entity must utilize the measurement method previously designated for the investment. Subsequent/additional purchases of the same SVO-identified investment (same CUSIP) already held by a reporting entity must follow the election previously made by the reporting entity. If an investment no longer qualifies for a systematic value measurement because the NAIC designation has declined, then the security must be subsequently reported at the lower of “systematic value” or fair value. If the security has been removed from the SVO-identified listings, and is no longer in scope of this statement, then the security shall be measured and reported in accordance with the applicable SSAP.

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<sup>18</sup> The election to use systematic value is not a permitted or prescribed practice as it is an accounting provision allowed within this SSAP. Similarly, this election does not override state statutes, and if a state does not permit reporting entities the election to use systematic value as the measurement method, this is also not considered a permitted or prescribed practice. SVO-identified investments reported at fair value (NAV) or systematic value, if in accordance with the provisions of this standard, are considered in line with SSAP No. 26R and do not require permitted or prescribed disclosures under *SSAP No. 1—Accounting Policies, Risks & Uncertainties and Other Disclosures*.

<sup>19</sup> This guidance requires investments purchased in lots to follow the measurement method established at the time the investment was first acquired.

- d. Determination of the designated systematic value must follow the established<sup>20</sup> approach, which is consistently applied for all SVO-identified bond ETF investments designated for a systematic value. In all situations, an approach that continuously reflects “original” or “historical cost” is not an acceptable measurement method. The designated approach shall result with systematic amortization or accretion of the equity/fund investment in a manner that represents the expected cash flows from the underlying bond holdings.

34. Income distributions received from SVO-identified bond ETF investments (cash or shares) shall be reported as interest income in the period in which it is earned. For those SVO-identified bond ETF investments where the systematic value method is applied, interest income shall be recognized based on the book yield applied to the carrying value each period, similar to bonds.

35. For reporting entities required to hold an IMR and AVR reserve, realized and unrealized gains and losses for the SVO-identified bond ETF investments shall be consistent with bonds within the scope of this standard. With this guidance, recognition of gains/losses (and corresponding AVR/IMR impacts) will be based on the ETF, and not activity that occurs within the ETF (e.g., such as changes in the underlying bonds held within the ETF). Also consistent with the guidance for bonds, recognized losses from other-than-temporary impairments shall be recorded entirely to either AVR or IMR (and not bifurcated between credit and non-credit components) in accordance with the annual statement instructions.

36. SVO-identified bond ETF investments reported at systematic value shall recognize other-than-temporary impairments in accordance with the following guidance:

- a. A decision to sell an SVO-identified bond ETF investment that has a fair value less than systematic value results in an other-than-temporary impairment that shall be recognized.
- b. In situations in which an SVO-identified bond ETF investment has a fair value that is less than systematic value, the reporting entity must assess for other-than-temporary impairment. For these investments, a key determinant, along with other impairment indicators in *INT 06-07: Definition of Phrase “Other Than Temporary,”* shall be whether the net present value of the projected cash flows for the underlying bonds in the SVO-identified investment have materially<sup>21</sup> declined from the prior reporting period (most recent issued financial statements) or from the date of acquisition. In calculating the net present value of the projected cash flows for each reporting period, entities shall discount cash flows using a constant purchase yield, which is the initial book yield at acquisition. Consistent with INT 06-07, a predefined threshold to determine whether the decline in projected cash flows (e.g., percentage change) shall result in an other than temporary impairment has not been set, as exclusive reliance on such thresholds removes the ability of management to apply its judgement.
- c. Upon identification of an SVO-identified investment as OTTI, the reporting entity shall recognize a realized loss equal to the difference between systematic value and the current fair value. (Although the determination of OTTI is likely based on projected cash flows, the realized loss recognized for the OTTI is based on the difference between systematic value and fair value.) The fair value of the SVO-identified investment on the date of the OTTI shall become the new cost basis of the investment.

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<sup>20</sup> Exhibit B details the established systematic value approach.

<sup>21</sup> The net present value of cash flows will decline in a declining interest rate environment. Reporting entities shall use judgment when assessing whether the decline in cash flows is related to a decline in interest rates or the result of a non-interest related decline, and determine whether the decline represents an OTTI pursuant to INT 06-07.

- d. Subsequent to recognition of an OTTI, the SVO-identified bond ETF investment is required to be reported at the lower of the then-current period systematic value or fair value. As the underlying bonds can be replaced within an ETF, it is possible for a subsequent period systematic value and fair value to recover above the fair value that existed at the time an OTTI was recognized. As such, the requirement for subsequent reporting at the lower of systematic value or fair value is intended to be a current period assessment. For example, in reporting periods after an OTTI, the systematic value for an SVO-identified investment may exceed the fair value at the time of the OTTI, but in no event shall the reported systematic value exceed the then-current period fair value. If current calculated systematic value is lower than the current fair value, systematic value is required.

37. Impairment guidance for SVO-identified bond ETF investments reported at fair value is consistent with impairment guidance for investments captured under SSAP No. 30R. Pursuant to this guidance, realized losses are required to be recognized when a decline in fair value is considered to be other-than-temporary. Subsequent fluctuations in fair value shall be recorded as unrealized gains or losses. Future declines in fair value which are determined to be other-than-temporary shall be recorded as realized losses. A decision to sell an impaired security results with an other-than-temporary impairment that shall be recognized.

## Disclosures

38. The financial statements shall include the following disclosures:
- a. Fair value in accordance with *SSAP No. 100R—Fair Value*;
  - b. Concentrations of credit risk in accordance with *SSAP No. 27—Off-Balance-Sheet and Credit Risk Disclosures*;
  - c. The basis at which the bonds, mandatory convertible securities, and SVO-identified bond ETF investments identified in paragraph 2.d., are stated;
  - d. Amortization method for bonds and mandatory convertible securities, and if elected by the reporting entity, the approach for determining the systematic value for SVO-identified securities per paragraph 33. If utilizing systematic value measurement method approach for SVO-identified investments, the reporting entity must include the following information:
    - i. Whether the reporting entity consistently utilizes the same measurement method for all SVO-identified investments<sup>22</sup> (e.g., fair value or systematic value). If different measurement methods are used<sup>23</sup>, information on why the reporting entity has elected to use fair value for some SVO-identified investments and systematic value for others.
    - ii. Whether SVO-identified investments are being reported at a different measurement method from what was used in an earlier current-year interim and/or in a prior annual statement. (For example, if reported at systematic value prior to the sale, and then reacquired and reported at fair value.) This disclosure is required

<sup>22</sup> As identified in paragraph 34.d., a consistent approach must be followed for all investments designated to use the systematic value method. As such, this disclosure is limited to situations in which a reporting entity uses both fair value and systematic value for reported SVO-identified investments.

<sup>23</sup> The guidance in this statement allows different measurement methods by qualifying investment (CUSIP), but it is anticipated that companies will generally utilize a consistent approach for all qualifying investments.

in all interim reporting periods and in the year-end financial statements for the year in which an SVO-identified investment has been reacquired and reported using a different measurement method from what was previously used for the investment. (This disclosure is required regardless of the length of time between the sale/reacquisition of the investments, but is only required in the year in which the investment is reacquired.)

- iii. Identification of securities still held that no longer qualify for the systematic value method. This should separately identify those securities that are still within the scope of SSAP No. 26R and those that are being reported under a different SSAP.
- e. For each balance sheet presented, the book/adjusted carrying values, fair values, excess of book/carrying value over fair value or fair value over book/adjusted carrying values for each pertinent bond or assets in scope of this statement.
- f. For the most recent balance sheet, the book/adjusted carrying values and the fair values of bonds and assets in scope of this statement, reported in statutory Annual Statement Schedule D – Part 1A due:
  - i. In one year or less (including items without a maturity date which are payable on demand and in good standing);
  - ii. After one year through five years;
  - iii. After five years through ten years;
  - iv. After ten years (including items without a maturity date which are either not payable on demand or not in good standing).
- g. For each period for which results of operations are presented, the proceeds from sales of bonds and assets in scope of this Statement and gross realized gains and gross realized losses on such sales.
- h. For each balance sheet presented, all items in scope of this Statement in an unrealized loss position for which other-than-temporary declines in value have not been recognized:
  - i. The aggregate amount of unrealized losses (that is, the amount by which cost or amortized cost exceeds fair value) and
  - ii. The aggregate related fair value of bonds with unrealized losses.
- i. The disclosures in paragraphs 39.h.i. and 39.h.ii. should be segregated by items that have been in a continuous unrealized loss position for less than 12 months and those that have been in a continuous unrealized loss position for 12 months or longer using fair values determined in accordance with SSAP No. 100R.
- j. As of the most recent balance sheet date presented, additional information should be included describing the general categories of information that the investor considered in reaching the conclusion that the impairments are not other-than-temporary.
- k. When it is not practicable to estimate fair value in accordance with SSAP No. 100R, the investor should disclose the following additional information, if applicable, as of each date for which a statement of financial position is presented in its annual financial statements:

- i. The aggregate carrying value of the investments not evaluated for impairment, and
  - ii. The circumstances that may have a significant adverse effect on the fair value.
- l. For securities sold, redeemed or otherwise disposed as a result of a call or tender offer feature (including make-whole call provisions), disclose the number of CUSIPs sold, disposed or otherwise redeemed and the aggregate amount of investment income generated as a result of a prepayment penalty and/or acceleration fee.

39. Refer to the Preamble for further discussion regarding disclosure requirements. The disclosures in paragraphs 39.b., 39.e., 39.f., 39.g., 39.h., 39.i., 39.j. and 39.k. shall be included in the annual audited statutory financial reports only.

### Relevant Literature

40. This statement adopts *AICPA Statement of Position 90-11, Disclosure of Certain Information by Financial Institutions About Debt Securities Held as Assets*, and *AICPA Practice Bulletin No. 4, Accounting for Foreign Debt/Equity Swaps*. This statement also adopts *FASB Staff Position 115-1/124-1, The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments*, paragraph 16, with modification to be consistent with statutory language in the respective statutory accounting statements. This statement adopts the GAAP definition of “security” as it is used in FASB Codification Topic 320 and 860. This statement refers to the definition of “financial assets” captured in SSAP No. 103R adopted from U.S. GAAP. As noted in footnote 7, for purposes of this statement, and in applying the principles-based bond definition, financial assets do not include assets that depend on the completion of a performance obligation. When there is a performance obligation, the asset represents non-financial assets, or a means through which non-financial assets produce cash flows, until the performance obligation has been satisfied.

41. This statement rejects the GAAP guidance for debt securities, which is contained in *ASU 2020-08, Codification Improvements to Subtopic 310-20, Receivables – Nonrefundable Fees and Other Costs*, *ASU 2018-03, Recognition and Measurement of Financial Assets and Financial Liabilities*, *ASU 2017-08, Premium Amortization on Purchased Callable Debt Securities*, *ASU 2016-01, Financial Instruments – Overall*, *FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities*, *FASB Statement No. 91, Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*, *FASB Emerging Issues Task Force No. 89-18, Divestitures of Certain Investment Securities to an Unregulated Commonly Controlled Entity under FIRREA*, and *FASB Emerging Issues Task Force No. 96-10, Impact of Certain Transactions on Held-to-Maturity Classifications Under FASB Statement No. 115*.

### Effective Date and Transition

42. Revisions to SSAP No. 26R, adopted August 2023, to incorporate the principle-based bond concepts are effective January 1, 2025. These revisions incorporate principle concepts on what should be reported as a long-term bond. Securities that qualify as issuer credit obligations within the principle concepts are captured within scope of SSAP No. 26R. Securities that qualify as asset-backed securities within the principle concepts are captured within scope of SSAP No. 43R. Securities that do not qualify as issuer credit obligations or ABS, unless specifically permitted in scope of these statements, are not permitted to be reported as a bond.

43. At the time of transition, reporting entities shall make their best efforts to assess investments to determine whether they qualify within the bond definition for reporting on Schedule D-1. The bond definition requires assessments at the time of acquisition (as of the origination date), and it is recognized that reporting entities may not have the means to complete historical assessments for securities held at the time of transition. For these instances, if information is not readily available for reporting entities to assess a security as of the date at origination, reporting entities may utilize current or acquisition information in

concluding that a security qualifies for reporting as a bond as either an issuer obligation or asset-backed security.

44. Investments that were reported as a bond on Schedule D-1: Long-Term Bonds as of December 31, 2024, that do not qualify under the principle-based bond concepts shall be reported as a disposal from that schedule, with a reacquisition on the appropriate reporting schedule as of January 1, 2025. These investments shall be accounted for in accordance with the resulting SSAP that addresses the specific investment structure. For securities that are reported at the lower of amortized cost or fair value under the new applicable guidance, this could result with an unrealized loss in the measurement of the investment at the time of the reclassification. Although the adoption of this guidance is considered a change in accounting principle under SSAP No. 3, the following transition guidance shall be applied on January 1, 2025, to ensure consistency in reporting and to allow investment schedules to roll appropriately:

- a. Securities reclassified from Schedule D-1 as they no longer qualify under the bond definition shall be reported as a disposal from Schedule D-1 at amortized cost. Although no proceeds are received, amortized cost at the time of disposal shall be reported as consideration on Schedule D-4.
  - i. For securities held at amortized cost at the time of disposal, book adjusted carrying value and amortized cost shall agree, preventing gain or loss recognition at the time of reclassification.
  - ii. For securities held at fair value under the lower of amortized cost or fair value measurement method, previously reported unrealized losses shall be reversed on Jan. 1, 2025, prior to disposal, resulting with a reported value that mirrors amortized cost at the time of disposal. This action prevents realized loss recognition at time of reclassification.
- b. Securities reclassified from Schedule D-1 shall be recognized on the subsequent schedule (e.g., Schedule BA) with an actual cost that agrees to the disposal value (amortized cost). Immediately subsequent to recognition on the resulting schedule, the securities shall be reported in accordance with the measurement method prescribed by the applicable SSAP:
  - i. For securities previously reported at fair value on Schedule D-1 (under a lower of amortized cost or fair value measurement method), the reporting entity will recognize an unrealized loss to match the previously reported book adjusted carrying value. Subsequently, the security will continue to reflect a lower of amortized cost or fair value measurement method.
  - ii. For securities previously reported at amortized cost on Schedule D-1, if the subsequent statement requires a lower of amortized cost or fair value measurement method, then the reporting entity shall recognize an unrealized loss to the extent fair value is less than amortized cost.
  - iii. After application of paragraph 45.b.i. and 45.b.ii. all securities shall reflect either the same reported value as of December 31, 2024 (amortized cost or fair value) or a lower reported value (if the security is subject to the lower of amortized cost or fair value measurement method). There should be no instances that result with a security having a greater reported value than what was presented on December 31, 2024. Subsequent to transition, securities reported at fair value may incur unrealized gains or losses due to fair value fluctuations, but should never have

unrealized gains that result with a book adjusted carrying value that exceeds amortized cost.

45. With this transition guidance, changes in measurement for securities reclassified under the bond definition will be reported as a change in unrealized capital gains (losses) in the first quarter 2025 financial statements (unless sold in the interim with a realized gain or loss) and not as a change in accounting principle. To enable regulators the ability to identify the impact of securities reclassified under the bond definition, the following disclosure for the 2025 first quarter financial statement is required:

- a. Aggregate book adjusted carrying value for all securities reclassified off Schedule D-1.
- b. Aggregate book adjusted carrying value after transition for all securities reclassified off Schedule D-1 that resulted with a change in measurement basis. (This shall be a subset of paragraph 46.a. and captures the securities that moved from an amortized cost to a fair value measurement method under the lower of amortized cost or fair value approach.)
- c. Aggregate surplus impact for securities reclassified off Schedule D-1. This shall include the difference between book adjusted carrying value as of December 31, 2024, and book adjusted carrying value after transition for those securities that moved from an amortized cost to a fair value measurement method under the lower of amortized cost or fair value approach.

46. For clarification purposes, the transition guidance shall be applied prospectively beginning with the first year of adoption (Jan. 1, 2025). For disclosures that provide comparative information, reporting entities shall not restate the prior year's information in the 2025 disclosure.

#### **Historical Adoption and Revisions to Original SSAP No. 26R**

47. For historical reference, the original adoption, and subsequent revisions to SSAP No. 26R prior to the adoption of the principles-based bond definition are detailed below:

- a. SSAP No. 26R was originally effective for years beginning January 1, 2001.
- b. Guidance for the accounting of securities subsequent to other than temporary impairments was originally effective for reporting periods beginning on January 1, 2009, with early adoption permitted. This guidance was incorporated from *SSAP No. 99—Accounting for Securities Subsequent to an Other-Than-Temporary Impairment* in 2010. The original impairment guidance included in this standard, and the substantive revisions reflected in SSAP No. 99 are retained for historical purposes in Issue Paper No. 131.
- c. Guidance pertaining to the accounting for zero-coupon convertible bonds was originally effective December 8, 2002, and was subsequently incorporated into this statement from *INT 02-05: Accounting for Zero Coupon Convertible Bonds*.
- d. Guidance adopted in December 2013 clarifying the 'yield-to-worst' concept for bonds with make-whole call provisions was initially effective January 1, 2014, unless the company had previously been following the guidance. (Companies that have previously been following the original intent, as clarified in the revisions, were not impacted by these changes.)
- e. The guidance on the calculation of investment income for prepayment penalties and/or acceleration fees was effective January 1, 2017, on a prospective basis and was required for interim and annual reporting periods thereafter, with early application permitted.

- f. In April 2017, revisions were incorporated in accordance with the investment classification project. These revisions are detailed in Issue Paper No. 156 and were effective December 31, 2017. These revisions clarified the scope of the bond definition as well as incorporated new guidance for SVO-Identified Bond ETFs identified in scope of this statement. Retained transition / application guidance is captured as follows:
- i. For situations in which there is an interval of time between when a company purchases an investment and when the investment is designated as an SVO-identified investment eligible for systematic value, the book yield should be calculated by equating the book/adjusted carrying value at that time to the portfolio's aggregate cash flows (ACF). For these situations, the ETF shall be reported as a disposed security on the prior reporting schedule and reported as an acquisition.
  - ii. In accordance with the systematic value methodology, at the next reporting period date, the reporting entity shall amortize or accrete the carrying value by the difference between the effective interest using the initial book yield, and the distributions received, and shall recalculate the new effective book yield using the new carrying value and ACF as of the last day of the reporting period.
  - iii. As the necessary historical ACF data is not available for calculating the initial book yield at acquisition for the net present value constant purchase yield (NPV-CPY) method for impairment recognition, reporting entities shall use recently published yield-to-maturity (YTM) as their constant purchase yield to be applied for NPV-CPY impairment recognition.
  - iv. If the investment no longer qualifies as an SVO-Identified Bond ETF in scope of statement, this change shall be reflected prospectively from the effective date. Investments previously captured in this statement, that will move within the scope of another SSAP and reporting schedule shall be shown as dispositions on and shown as an acquisition on the schedule for which it will be subsequently reported.
- g. The guidance to explicitly exclude securities for which the contract amount of the instrument to be paid at maturity (or the original investment) is at risk for other than failure of the borrower to pay the contractual amount due, were effective December 31, 2019.
- h. Revisions to clarify existing guidance that all prepayment penalties and acceleration fees for when a bond is liquidated prior to its scheduled maturity date, including those from tendered bonds, shall follow the guidance in SSAP No. 26R was effective January 1, 2021. Reporting entities that have historically applied this guidance shall not change historical practices, but the effective date of January 1, 2021, with early application permitted, was allowed for reporting entities to make systems changes to capture tendered bonds in scope of this guidance.

## REFERENCES

### Other

- *Purposes and Procedures Manual of the NAIC Investment Analysis Office*
- NAIC Valuation of Securities product prepared by the Securities Valuation Office

**Relevant Issue Papers**

- *Issue Paper No. 26—Bonds, Excluding Loan-Backed and Structured Securities*
- *Issue Paper No. 131—Accounting for Certain Securities Subsequent to an Other-Than-Temporary Impairment*
- *Issue Paper No. 156—Bonds*
- *Issue Paper No. XX—Principles-Based Bond Definition*

**EXHIBIT A - EXAMPLES OF ANALYSIS FOR ASSET-BACKED SECURITIES**

1. As detailed in paragraphs 9-10, the holder of an asset-backed securities is 1) required to be in a different economic position than if the holder owned the ABS Issuer's assets directly, and 2) if the assets owned by the ABS Issuer are cash generating non-financial assets, then the assets are expected to generate a meaningful level of cash flows towards repayment of the bond through use, licensing, leasing servicing or management fees, or other similar cash flow generation. (This guidance requires a meaningful level of cash flows to service the debt other than through the sale or refinancing of the assets.) This appendix details example analysis for these meaningful cash flow and substantive credit enhancements.

2. **Example 1:** A reporting entity invests in debt instruments issued from a SPV sponsored by the Government National Mortgage Association (GNMA), the Federal National Mortgage Association (FNMA) and the Federal Home Loan Mortgage Corporation (Freddie Mac) (collectively, "Agency or Agencies"). These debt instruments pass through principal and interest payments received from underlying mortgage loans held by the SPV to the debtholders proportionally, with principal and interest guaranteed by the Agencies. While there is prepayment and extension risk associated with the repayment of the underlying mortgage loans, the credit risk associated with the mortgage loans is assumed by the Agencies.

3. **Example 1 Rationale:** Although the reporting entity participates on a proportional basis in the cash flows from the underlying mortgage loans held by the SPV, the reporting entity is in a different economic position than if it owned the underlying mortgage loans directly because the credit risk has been redistributed and assumed by the Agencies. This is a substantive credit enhancement because a market participant (i.e., a knowledgeable investor transacting at arm's length) would conclude the Agency guarantee is expected to absorb all losses before the debt instrument being evaluated. Therefore, the holder of the debt instrument is in a substantively different economic position than if the holder owned the ABS Issuer's unguaranteed assets directly, in accordance with the requirements in paragraph 10. When guarantees do not cover 100% of principal and interest as the Agency guarantees do in this example, it is still appropriate to determine if the guarantee is substantive in accordance with the requirements in paragraph 10, to determine if the holder is in a substantively different economic position that if the holder held the ABS Issuer's assets directly.

4. **Example 2:** A reporting entity invested in a debt instrument issued by a SPV. Payments under the instrument are secured by a note, a legal assignment from the borrower of a lease for real property and an assignment of the lease payments from an operating entity tenant. Additional security is provided by a mortgage on the leased property (the "underlying collateral"). The leased property is owned by the borrower under the note -- the SPV does not have any ownership interest in the underlying collateral, though it has legal recourse to it through the mortgage. The tenant makes contractually-fixed payments over the life of the lease to the borrower, who has assigned both the lease and the lease payments to the SPV as security for the debt. While the debt is outstanding, the lease, the lease payments, and the mortgage all serve as security for the debtholders. Should a default occur, the debtholders can foreclose on and liquidate the real property as well as submit an unsecured lease claim in the lessee's bankruptcy for all or a portion of the defaulted lease payments. The loan-to-value (as a percentage of property value) at origination is 100%.

5. The existing lease payments are sufficient to cover all interest payments and all scheduled debt amortization payments over the life of the debt instrument. However, at debt maturity, there is a balloon payment due, totaling 50% of the original outstanding debt principal amount. The corresponding lease has no balloon payment due at lease maturity, so the SPV will either need to refinance the debt or sell the underlying collateral to service the final debt balloon payment. The property has a high probability of appreciating in value over the term, however ignoring any potential for appreciation, the 50% loan-to-value at maturity is the expected figure at the end of the debt term based solely on scheduled amortization payments. The real property is expected to be subject to some market value volatility and periods of lower

liquidity at certain points in time but has a predictable value range and ready market over a longer period of time, such that the property could be liquidated over a reasonable period of time, if necessary.

6. **Example 2 Rationale:** The reporting entity determined that the debtholder was in a fundamentally different position than if the real estate was owned directly. The lease is a cash generating non-financial asset which is expected to generate a meaningful level of cash flows for the repayment of the bonds which covers all interest payments and 50% of the principal payments. The level of reliance on the collateral value for sale or refinancing is just over the cutoff for using the practical expedient (<50%), so a full analysis is required. In reaching its determination, the reporting entity considered the predictable nature of the cash flows, which are contractually fixed for the life of the debt instrument, as well as the ability of the underlying collateral value to provide for the balloon payment through sale or refinancing in light of its characteristics. While the real property may have some market value volatility and periods of lower liquidity at points in time, the cash flows produced by the lease were concluded to reduce the loan balance to a level (50% loan-to-value) that would be able to be recovered by sale or refinancing at the maturity of the loan.

7. The reporting entity also determined that the structure provides substantive credit enhancement in the form of overcollateralization to conclude that investors are in a different economic position than holding the real property directly, in accordance with the requirements in paragraph 10. In reaching this conclusion, the reporting entity noted that although the debt instrument starts with a 100% loan-to-value (not including the value of the contractually required lease payments), contractual fixed payments from the lease provide additional security such that the reporting entity is in a different economic position than owning the property directly. Lease cash flows are sufficient to cover the payment of all interest and 50% of the outstanding principal over the term of the lease. In the context of the predictable nature of the cash flows and collateral value range over time, the reporting entity concluded that a market participant (i.e., knowledgeable investor transacting at arm's length) would consider this level of overcollateralization to put the investor in a substantively different economic position than owning the underlying property directly.

8. For the purposes of determining whether there is substantive overcollateralization, it is appropriate to consider any expected economic depreciation, if it is reasonably expected, but it is not appropriate to consider any expected economic appreciation. Note that a debt instrument with a loan-to-value that is expected to decrease over time is not necessarily deemed to have substantive overcollateralization.

9. **Example 3:** A reporting entity invested in a debt instrument with the same characteristics as described in Example 2, except that the existing lease at the time of origination has a contractual term that is shorter than that of the debt instrument. It is expected with a high degree of probability that the lease will be renewed, and a substantial leasing market exists to replace the lessee should they not renew. However, in the unlikely circumstance that the property cannot be re-leased, there would not be enough cash flows to service the scheduled principal and interest payments, and the property would have to be liquidated to pay off the debt upon default.

10. **Example 3 Rationale:** All details of Example 3, including the expected collateral cash flows, are consistent with those in Example 2, except that the cash flows in Example 2 are contractually fixed for the duration of the debt while the cash flows in Example 3 are subject to re-leasing risk. Notwithstanding the involvement of re-leasing risk, the reporting entity concluded that the ability to re-lease the property was highly predictable and supported the conclusion that the underlying collateral was expected to produce meaningful cash flows to service the debt.

11. This distinction is to highlight that the expected cash flows of a cash-generating non-financial asset may or may not be contractually fixed for the term of the bond. Certain securitized cash flow streams may not by their nature lend themselves to long-term contracts (e.g., single-family home rentals), but may nevertheless lend themselves to the production of predictable cash flows. While the non-contractual nature of the cash flows is an important consideration in determining whether a non-financial asset is expected to

produce meaningful cash flows to service the debt, it does not, in and of itself, preclude a reporting entity from concluding that the assets are expected to produce meaningful cash flows.

12. **Example 4:** A reporting entity invested in a debt instrument issued by a SPV that owns equipment which is leased to an equipment operator. The equipment operator makes lease payments to the SPV, which are passed through to service the SPV's debt obligation. While the debt is outstanding, the equipment and lease are held in trust and pledged as collateral for the debtholders. Should a default occur, the debtholders can foreclose on and liquidate the equipment as well as submit an unsecured lease claim in the lessee's bankruptcy for any defaulted lease payments. The loan-to-value at origination is 70%.

13. The existing lease payments are sufficient to cover all interest payments and all scheduled debt amortization payments over the life of the debt instrument. However, at maturity, there is a balloon payment due, totaling 80% of the original outstanding principal amount. The corresponding lease has no balloon payment due at lease maturity, so the SPV will either need to refinance the debt or sell the underlying equipment to service the final debt balloon payment. The loan-to-value at maturity is expected to increase to 95% considering the scheduled principal amortization payments net of the expected economic depreciation in the equipment value over the term of the debt. The equipment is expected to be subject to some market value volatility and periods of lower liquidity at certain points in time, but has a predictable value range and ready market over a longer period of time, such that the equipment could be liquidated over a reasonable period of time, if necessary.

14. **Example 4 Rationale:** The equipment is a cash generating non-financial asset which is not expected to generate a meaningful level of cash flows for the repayment of the bonds via the existing lease that covers all interest payments and 20% of principal payments. In reaching this determination, the reporting entity considered that, while the cash flows being produced are predictable, the ability to recover the principal of the debt investment is almost entirely reliant on the equipment retaining sufficient value to sell or refinance to satisfy the debt.

15. The reporting entity also determined that the structure lacks substantive credit enhancement to conclude that investors are in a different economic position than holding the equipment directly, in accordance with the requirements in paragraph 10. In reaching this conclusion, the reporting entity noted that the debt starts with a 70% loan-to-value, but the overcollateralization is expected to deteriorate over the term of the debt as the equipment economically depreciates more quickly than the debt amortizes. This results in a high loan-to-value (i.e., 95%) at maturity, relative to the market value volatility of the underlying collateral. Despite the predictable nature of the cash flows, the reporting entity concluded that the debt instrument lacked a substantive level of overcollateralization to conclude that the investor is in a different economic position than owning the underlying equipment directly. It was determined that the level of overcollateralization, as determined by a market participant (i.e., a knowledgeable investor transacting at arm's length), is nominal. Therefore, the reporting entity concluded that it was in a substantively similar position as if it owned the equipment directly.

16. For the purposes of determining whether there is substantive overcollateralization, it is appropriate to consider any expected economic depreciation, if it is reasonably expected, but it is not appropriate to factor in any expected economic appreciation. Note that a debt instrument with a loan-to-value that is expected to increase over time is not necessarily deemed to have nominal overcollateralization.

**EXHIBIT B – SYSTEMATIC VALUE CALCULATION**

The established systematic value method is considered an “aggregated cash flow” (ACF) method in which the cash flow streams from the individual bond holdings are aggregated into a single cash flow stream. These cash flows are scaled such that, when equated with the market price at which the ETF was purchased or sold, an internal rate of return is calculated, representing the investor’s initial book yield for the ETF. Although the initial book yield is utilized to determine the current period effective yield, and the resulting adjustments to the ETF’s reported (systematic) value, the book yield is recalculated at least quarterly in order to adjust the investor’s book yield to reflect current cash flow projections of the current bond holdings within the ETF.

The following calculation shall be followed by reporting entities electing systematic value:

1. Download <b>cash flows</b> file from <u>ETF provider website</u> .	
NAV:	\$115.07 (Official end-of-day NAV found on <u>ETF provider website</u> )
Maturity:	12/8/2027 = SUMPRODUCT (CASHFLOW_DATE column, PRINCIPAL column)/SUM (PRINCIPAL column)
When Paid:	Monthly
Par Value:	2,500 # shares purchased
Monthly Effective Interest:	\$0.40 = (Recalculated Effective Book Yield from prior month x Prior Month Ending Book Value /12)
Distribution:	\$0.34 Found on <u>provider website</u>
Net Amortization/Accretion:	\$0.06 = (Monthly Effective Interest) – (Distribution)
Prior Month Ending Book Value:	\$115.35
NPV Constant Yield Method:	\$117.10 = XNPV (Initial Book Yield, CASHFLOW column, CASHFLOW_DATE column) / 1000000
Initial Book Yield:	4.15%
Book (Systematic) Value:	\$115.41 = (Prior Period Ending Book Value) + (Net “amortization/ accretion”)
Expense Ratio:	0.1500%
Recalculated Effective Book Yield:	4.1639% =XIRR(CASHFLOW column, CASHFLOW_DATE column, 0.05)

All formulas on the left are at a per share level (excepting “Par Value” which represents the number of shares purchased for this lot).

The resulting values calculated on the left are aggregated to reflect the total number of shares held on the previous tabs reflecting how one might populate the reporting schedule with these values.

Additionally, the cash flows in the data file are based on 1 million shares. This was done in order to make the cash flows easier to observe and work with (i.e., at a single share level, cash flows would be at fractional dollar levels). Therefore, in order to calculate the yield, investors must multiply the price of the ETF by 1 million shares and then use that value as a cash outflow against the positive cash inflows from the bond portfolio in order to calculate the IRR.

CUSIP	ASOF_DATE	CALL_TYPE	CASHFLOW_DATE	INTEREST	PRINCIPAL	CASHFLOW
2. Insert a row in between the column headings and the cash flow data.		3. Filter for “Call Type” is WORST. (Click “Data” at the top of Excel sheet, then click “Filter” and click the new dropdown box in the “Call Type” cell and select only “WORST.”)		4. Enter the date of the cash flow data file underneath cash flow date.		5. Under the column “CASHFLOW” enter the following formula in Excel: =(-Ending Book Value)*1000000
			<b>8/31/20X1</b>			<b>(115,414,059.56)</b>
“Ticker”	8/31/20X1	WORST	9/8/20X1	136,538.564	81,472.372	218,010.937
“Ticker”	8/31/20X1	WORST	9/9/20X1	5,990.106	0	5,990.106
“Ticker”	8/31/20X1	WORST	9/10/20X1	9,706.324	0	9,706.324

**EXHIBIT C – AMORTIZATION TREATMENT FOR CALLABLE BONDS****Example 1: Call Price Less Than BACV Throughout the Life of the Bond**

12/31/2008 – Issuance of Bond. Par = 100/10-Year Bond (Matures 12/31/2018)

01/01/2009 – Call Date/Call Price 107

12/15/2010 – Reporting Entity Acquires Bond. Cost = 106

01/01/2012 – Scheduled Call Date Subsequent to Reporting Entity Acquisition. Call Price 104

01/01/2014 – Scheduled Call Date Subsequent to Reporting Entity Acquisition. Call Price 103

01/01/2016 – Scheduled Call Date Subsequent to Reporting Entity Acquisition. Call Price 102

General Note for Examples: The reporting entity purchased the bond at a premium (cost was greater than par). The 1/1/2009 call date and price is ignored as it occurred prior to the reporting entity acquiring the bond. The bolded numbers represent the lowest asset value at each reporting period. The bond is amortized to the lowest asset value, which in this scenario is amortizing to the call dates and prices. (The standard amortization to the maturity date is shown as it should be compared to the amortization to the call date/price to verify that the BACV at any given reporting date reflects the lowest asset value.)

Date	Action	Cost	Call Price	BACV (Under Call Date/Price)	Amortization to the Lowest Value	BACV Under Standard Amortization
12/15/2010	Acquired	106		106		106
12/31/2011	Lockout Period			<b>104</b>	2	105.25
01/01/2012	Call Date		104	<b>104</b>		
12/31/2012	Year-End Reporting			<b>103.5</b>	0.5	104.50
12/31/2013	Year-End Reporting			<b>103</b>	0.5	103.75
01/01/2014	Call Date		103	<b>103</b>		
12/31/2014	Year-End Reporting			<b>102.5</b>	0.5	103
12/31/2015	Year-End Reporting			<b>102</b>	0.5	102.25
01/01/2016	Call Date Exercised		102	<b>102</b>		

**Standard Amortization**

This table shows the amortization with a purchase date of 12/15/2010 at \$106 through the maturity date of 12/31/2018.

	12/15/2010	12/31/2011	12/31/2012	12/31/2013	12/31/2014	12/31/2015	12/31/2016	12/31/2017	12/31/2018
Amortization		.75	.75	.75	.75	.75	.75	.75	.75
BACV		105.25	104.50	103.75	103	102.25	101.50	100.75	100

	Consideration	Par Value	BACV at Disposal Date	Realized Gain/Loss*
01/01/2016 Call Exercised	102	100	102	(2)

\* Per paragraph 26, the entity would recognize a \$(2) loss (BACV less par), and investment income of \$2 (consideration less par).

**Example 2: Call Price Could be Greater Than BACV**

12/31/2008 – Issuance of Bond. Par = 100/10-Year Bond (Matures 12/31/2018)

01/01/2009 – Call Date/Call Price 107

12/15/2010 – Reporting Entity Acquires Bond. Cost = 104

01/01/2012 – Scheduled Call Date Subsequent to Reporting Entity Acquisition. Call Price 106

01/01/2014 – Scheduled Call Date Subsequent to Reporting Entity Acquisition. Call Price 103

01/01/2016 – Scheduled Call Date Subsequent to Reporting Entity Acquisition. Call Price 102

The bolded numbers represent the lowest asset value:

Date	Action	Cost	Call Price	BACV (Under Call Date / Price)	Amortization To the Lowest Asset Value	BACV Under Standard Amortization
12/15/2010	Acquired	104		104		104
12/31/2011	Lockout Period		106	104	0.5	<b>103.50</b>
01/01/2012	Call Date		106	104		<b>103.50</b>
12/31/2012	Year-End Reporting			103.5	0.5	<b>103</b>
12/31/2013	Year-End Reporting			103	0.5	<b>102.50</b>
01/01/2014	Call Date		103	103		<b>102.50</b>
12/31/2014	Year-End Reporting			102.5	0.5	<b>102</b>
12/31/2015	Year-End Reporting			102	0.5	<b>101.50</b>
01/01/2016	Call Date Exercised		102	102		<b>101.50</b>

**Standard Amortization**

This table shows the amortization with a purchase date of 12/15/2010 at \$104 through the maturity date of 12/31/2018.

12/15/2010	12/31/2011	12/31/2012	12/31/2013	12/31/2014	12/31/2015	12/31/2016	12/31/2017	12/31/2018
Amortization	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50
BACV	103.50	103	102.50	102	101.50	101	100.50	100

	Consideration	Par Value	BACV at Disposal Date	Realized Gain/Loss*
01/01/2016 Call Exercised	102	100	101.50	(1.50)

\* Per paragraph 26, the entity would recognize a \$(1.50) loss (BACV less par), and investment income of \$2 (consideration less par).

**Example 3: Call Price Could be Greater Than BACV**

12/31/2008 – Issuance of Bond. Par = 100/10-Year Bond (Matures 12/31/2018)

01/01/2009 – Call Date/Call Price 107

12/15/2010 – Reporting Entity Acquires Bond. Cost = 104

01/01/2012 – Scheduled Call Date Subsequent to Reporting Entity Acquisition. Call Price 106

01/01/2014 – Scheduled Call Date Subsequent to Reporting Entity Acquisition. Call Price 102

01/01/2016 – Scheduled Call Date Subsequent to Reporting Entity Acquisition. Call Price 101

Note – This illustration shows that the evaluation of whether standard amortization (to the maturity date) or the call date price may change over the time. The bolded numbers represent the lowest asset value:

Date	Action	Cost	Call Price	BACV (Under Call Date / Price)	Amortization To the Lowest Asset Value	BACV Under Standard Amortization
12/15/2010	Acquired	104		104		
12/31/2011	Lockout Period		106	104	0.5	<b>103.50</b>
01/01/2012	Call Date		106	104		<b>103.50</b>
12/31/2012	Year-End Reporting			103	0.5	<b>103</b>
12/31/2013	Year-End Reporting			<b>102</b>	1	102.50
01/01/2014	Call Date		102	<b>102</b>		102.50
12/31/2014	Year-End Reporting			<b>101.5</b>	0.5	102
12/31/2015	Year-End Reporting			<b>101</b>	0.5	101.50
01/01/2016	Call Date Exercised		101	<b>101</b>		101.50

**Standard Amortization**

This table shows the amortization with a purchase date of 12/15/2010 at \$104 through the maturity date of 12/31/2018.

12/15/2010	12/31/2011	12/31/2012	12/31/2013	12/31/2014	12/31/2015	12/31/2016	12/31/2017	12/31/2018
Amortization	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50
BACV	103.50	103	102.50	102	101.50	101	100.50	100

	Consideration	Par Value	BACV at Disposal Date	Realized Gain/Loss*
01/01/2016 Call Exercised	101	100	101	(1)

\* Per paragraph 26, the entity would recognize a \$(1) loss (BACV less par), and investment income of \$1 (consideration less par).

**Example 4: Continuously Callable Bond – Callable at Par After Initial Lockout Period**

12/31/2008 – Issuance of Bond. Par = 100/10-Year Bond (Matures 12/31/2018)  
 01/01/2009 – Call Date / Call Price 107 – Continuously Callable Thereafter at Par  
 12/15/2010 – Reporting Entity Acquires Bond. Cost = 104

The bolded numbers represent the lowest asset value:

Date	Action	Cost	Call Price	BACV (Under Call Date/Price)	Amortization To the Lowest Asset Value	BACV Under Standard Amortization
12/15/2010	Acquired	104		100	4	
12/31/2010	Year-End Reporting		100	<b>100</b>	There is no subsequent amortization as the premium was fully expensed at acquisition.	104
12/31/2011	Year-End Reporting		100	<b>100</b>		103.50
12/31/2012	Year-End Reporting		100	<b>100</b>		103
12/31/2013	Year-End Reporting		100	<b>100</b>		102.50
12/31/2014	Year-End Reporting		100	<b>100</b>		102
12/31/2015	Year-End Reporting		100	<b>100</b>		101.50
01/01/2016	Year-End Reporting		100	<b>100</b>		101.50

Standard Amortization								
This table shows the amortization with a purchase date of 12/15/2010 at \$104 through the maturity date of 12/31/2018.								
12/15/2010	12/31/2011	12/31/2012	12/31/2013	12/31/2014	12/31/2015	12/31/2016	12/31/2017	12/31/2018
Amortization	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50
BACV	103.50	103	102.50	102	101.50	101	100.50	100

	Consideration	Par Value	BACV at Disposal Date	Realized Gain/Loss*
01/01/2016 Call Exercised	100	100	100	0

\* Since the call price is par and could occur immediately after acquisition, the premium is immediately expensed. When the bond is called, there is no gain or loss as the consideration received equals the BACV.

**Example 5: Determination of Prepayment Penalty When Call Price is Less Than Par**

Call Price Less than Par				
Entity 1			Entity 2	
Par	100		Par	100
BACV	24		BACV	25
Consideration	26		Consideration	26
Explicit fee	1		Explicit fee	1
Remaining consideration	25		Remaining consideration	25
Gain	2		Gain	0
Income*	0		Income**	1

\*Entity 1 does not have in place a process to identify explicit an prepayment penalty or acceleration fee.

\*\*Entity 2 has in place a process to identify an explicit prepayment penalty or acceleration fee.

<https://naiconline.sharepoint.com/teams/FRSStatutoryAccounting/NationalMeetings/A.NationalMeetingMaterials/2023/8-13-23SummerNationalMeeting/Adoptions/19-21a-SSAP26R-8-13-23.docx>

## Statement of Statutory Accounting Principles No. 43

### Asset-Backed Securities

#### STATUS

Type of Issue.....	Common Area
Issued .....	August 13, 2023
Effective Date .....	January 1, 2025
Affects.....	Replaces SSAP No. 43R on January 1, 2025
Affected by .....	No other pronouncements
Interpreted by.....	INT 06-07; INT 07-01; INT 22-01
Relevant Appendix A Guidance .....	None

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#### SCOPE OF STATEMENT

1. This statement establishes statutory accounting principles for each security investment that qualifies as an asset-backed security (ABS) under the principles-based bond definition detailed in *SSAP No. 26R—Bonds*. Each security shall be individually assessed under the bond definition to determine applicability as an asset-backed security and reported separately regardless of whether the security was issued in combination or as a unit with other investments. Items captured in scope of this statement are collectively referred to as asset-backed securities.

2. In addition to security investments that qualify under the principles-based definition as an asset-backed security, certain specific investments are also captured in scope of this statement:

- a. Mortgage Referenced Securities that do not meet the definition of an asset-backed security. In order to qualify as a mortgage-referenced security, the security must be issued by a government sponsored enterprise<sup>1</sup> or by a special purpose trust in a transaction sponsored by a government sponsored enterprise in the form of a “credit risk transfer.” In these situations, the issued security is tied to a referenced pool of mortgages and the payments received are linked to the credit and principal payment risk of the underlying mortgage loan borrowers captured in the referenced pool of mortgages. For these instruments, reporting entity holders may not receive a return of their full principal as principal repayment is contingent on repayment by the mortgage loan borrowers in the referenced pool of mortgages. Unless specifically noted, the provisions within this standard apply to mortgage-referenced securities.
  - b. Freddie-Mac When Issued K-Deal (WI Trust) Certificates fully guaranteed by Freddie Mac are included in scope of this statement from original acquisition, and not initially reported as a derivative forward contract. <sup>(INT 22-01)</sup>
3. Securities captured in scope of this statement are not permitted to be reported as cash equivalents or short-term investments in scope of *SSAP No. 2R—Cash, Cash Equivalents, Drafts and Short-Term Investments* even if acquired within one year or less from the maturity date. Investments captured in scope of *SSAP No. 2R* are intended to reflect situations in which limited risk remains, either from changes in credit quality or interest rates, due to the short-duration until maturity. As ultimate cash flows from asset-backed securities may have other risks beyond default risk or interest rate risk (such as performance factors, balloon payments, collateral quality) reporting as a cash equivalent or short-term investment is not permitted to prevent inappropriate assumptions of the investment’s remaining potential risk.
4. This statement excludes:
- a. Securities captured in scope of *SSAP No. 26R—Bonds*.
  - b. Mortgage loans in scope of *SSAP No. 37—Mortgage Loans* that qualify under an SVO structural assessment as SVO-Identified Credit Tenant Loans. These investments are excluded as these are captured as issuer credit obligations under *SSAP No. 26R*.
  - c. Securities that do not qualify as Asset-Backed Securities per the bond definition in *SSAP No. 26R—Bonds*. This exclusion includes residual or interests, as well as first loss positions, that do not have contractual payments or substantive credit enhancement. Debt securities that do not qualify and residual interests shall follow guidance in *SSAP No. 21R—Other Admitted Assets*.

## SUMMARY CONCLUSION

### Principles-Based Bond Definition - Asset-Backed Security

5. Investments within the scope of this statement issued by a related party or acquired through a related party transaction or arrangement are also subject to the provisions, admittance assessments and disclosure requirements of *SSAP No. 25—Affiliates and Other Related Parties*. In determining whether a security is a related party investment, consideration should be given to the substance of the transaction, and the parties whose action or performance materially impacts the insurance reporting entity holding the security. Asset-

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<sup>1</sup> Currently, only Fannie Mae and Freddie Mac are the government sponsored entities that either directly issue qualifying mortgage-referenced securities or sponsor transactions in which a special purpose trust issues qualifying mortgage-reference securities. However, this guidance would apply to mortgage-referenced securities issued by any other government sponsored entity that subsequently engages in the transfer of mortgage credit risk.

backed securities meet the definition of assets as defined in *SSAP No. 4—Assets and Nonadmitted Assets* and are admitted assets to the extent they conform to the requirements of this statement and *SSAP No. 25*.

- a. Although an asset-backed security may be acquired from a non-related issuer, if the assets held in trust predominantly<sup>2</sup> reflect assets issued by affiliates of the insurance reporting entity, and the insurance reporting entity only has direct recourse to the assets held in trust, the transaction shall be considered an affiliated investment. In such situations where the underlying collateral assets are issued by related parties that do not qualify as affiliates, these securities shall be identified as related party investments in the investment schedules.
- b. An asset-backed security may involve a relationship with a related party but not be considered an affiliated investment. This may be because the relationship does not result in direct or indirect control of the issuer or because there is an approved disclaimer of control or affiliation. Regardless of whether investments involving a related party relationship are captured in the affiliated investment reporting lines, these securities shall be identified as related party investments in the investment schedules. Examples of related party relationships would include involvement of a related party in sponsoring or originating the asset-backed security or any type of underlying servicing arrangement. For the avoidance of doubt, investments from any arrangement that results in direct or indirect control, including control through a servicer or other controlling arrangement, shall be reported as affiliated in accordance with *SSAP No. 25—Affiliates and Other Related Parties*.

### **Initial Reporting Value and Recognition of Origination and Commitment Fees & Costs**

6. Items in scope of this statement shall initially be reported at cost, including brokerage and related fees, unless otherwise detailed in paragraph 8. Acquisitions and dispositions shall be recorded on the trade date, not the settlement date, except for the acquisition of private placement asset-backed securities which shall be recorded on the funding date. For securities where all information is not known as of the trade date (e.g., actual payment factors and specific pools), a reporting entity shall make its best estimate based on known facts.

7. For assets that qualify in scope of this statement that result from a securitization or transfer of assets by the reporting entity captured in *SSAP No. 103R*, the guidance in that *SSAP* determines the initial reporting value:

- a. For asset-backed securities resulting from transfers of participating interests that qualify as a sale, the participating interests in financial assets that continue to be held by the reporting entity transferor shall be measured and reported at the date of transfer by allocating the previous carrying amount between the participating interests transferred and sold, and the participating interests that are not transferred and continue to be held by the reporting entity, based on their relative fair values.

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<sup>2</sup> In applying this guidance, a reporting entity is not required to complete a detailed review of the assets held in trust to determine the extent, if any, the assets were issued by related parties. Rather, this guidance is a principle concept intended to prevent situations in which related party transactions (particularly those involving affiliates) is knowingly captured in a *SSAP No. 43R* structure and not identified as a related party transaction (or not reported as an affiliated investment on the investment schedule) because of the involvement of a non-related trustee or *SSAP No. 43R* security issuer. As identified in *SSAP No. 25—Affiliates and Other Related Parties*, it is erroneous to conclude that the inclusion of a non-related intermediary, or the presence of non-related assets in a structure predominantly comprised of related party investments, eliminates the requirement to identify and assess the investment transaction as a related party arrangement.

- b. For asset-backed securities resulting from transfers of an entire financial asset or group of entire financial assets that qualify as a sale, assets obtained, including beneficial interests, shall be initially recognized at fair value.
  - c. For asset-backed securities resulting from the transfer of assets that do not qualify as sales, the reporting entity transferor shall continue to report the transferred financial assets with no change in measurement.
8. Costs related to origination when paid in the form of brokerage and other related fees shall be capitalized as part of the cost of the asset-backed security. All other costs, including internal costs or costs paid to an affiliated entity related to origination, purchase, or commitment to purchase asset-backed securities, shall be charged to expense when incurred.
9. Origination fees represent fees charged to the borrower (paid to the reporting entity) in connection with the process of originating or restructuring a transaction. The fees include, but are not limited to, points, management, arrangement, placement, application, underwriting, and other fees pursuant to such a transaction. Origination fees shall not be recorded until received in cash. Origination fees intended to compensate the reporting entity for interest rate risks (e.g., points), shall be amortized into income over the term of the asset-backed security consistent with paragraph 12 of this statement. Other origination fees shall be recorded as income upon receipt.
10. Commitment fees are fees paid to the reporting entity that obligate the reporting entity to make available funds for future borrowing under a specified condition:
- a. A fee paid to the reporting entity to obtain a commitment to make funds available at some time in the future is generally refundable only if the asset-backed security is issued. If the security is not issued, then the fees shall be recorded as investment income by the reporting entity when the commitment expires.
  - b. A fee paid to the reporting entity to obtain a commitment to borrow funds at a specified rate and with specified terms quoted in the commitment agreement is generally not refundable unless the commitment is refused by the reporting entity. This type of fee shall be deferred, and amortization shall depend on whether or not the commitment is exercised. If the commitment is exercised, then the fee shall be amortized in accordance with paragraph 12 of this statement over the life of the asset-backed security as an adjustment to the investment income on the security. If the commitment expires unexercised, the commitment fee shall be recognized in income on the commitment expiration date.

### **Subsequent Carrying Value Method, Amortization, Accruals and Prepayment Penalties**

11. After initial recognition, the carrying value shall be determined in accordance with the reported NAIC designation. The determination of NAIC designations shall be in accordance with the requirements detailed in the *Purposes and Procedures Manual of the NAIC Investment Analysis Office (P&P Manual)*<sup>3</sup>:
- a. For reporting entities that maintain an Asset Valuation Reserve (AVR), asset-backed 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.

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<sup>3</sup> Paragraphs 39-40 provide guidance on the NAIC financial modeling approach applicable to certain securities in determining NAIC designations.

- b. For reporting entities that do not maintain an AVR, asset-backed 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.
- c. For residual tranches or interests<sup>4</sup>, 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*. These items are captured in *SSAP No. 21R—Other Admitted Assets* and subject to admittance restrictions detailed in that statement.
12. Amortization of premium or discount shall be calculated using the scientific (constant yield) interest method and shall be recorded as an adjustment to investment income.<sup>(INT 07-01)</sup> The interest method results in a constant effective yield equal to the prevailing rate at the time of purchase or at the time of subsequent adjustments to book value. The amortization period shall reflect estimates of the period over which repayment of principal of the asset-backed securities is expected to occur, not the stated maturity period. (P9)
13. Interest shall be accrued using the effective-yield method using the redemption prices and redemption dates used for amortizing premiums and discounts. Interest income consists of interest collected during the period, the change in the due and accrued interest between the beginning and end of the period as well as reductions for premium amortization and interest paid on acquisition of asset-backed securities, and the addition of discount accrual. Contingent interest may be accrued if the applicable provisions of the underlying contract and the prerequisite conditions have been met.
14. An asset-backed security may provide for a prepayment penalty or acceleration fee in the event the investment is liquidated prior to its scheduled termination date. These fees shall be reported as investment income when received.
15. The amount of prepayment penalty and/or acceleration fees to be reported as investment income shall be calculated as follows:
- a. The amount of investment income reported is equal to the total proceeds (consideration) received less the par value of the investment; and
  - b. Any difference between the book adjusted carrying value (BACV) and the par value at the time of disposal shall be reported as realized capital gains and losses subject to the authoritative literature in *SSAP No. 7*.

### Assessment of Cash Flows and Impact of Prepayments

16. Prepayments can be a significant variable element in the cash flows received from asset-backed securities because they may affect the yield and determine the expected maturity against which the yield is

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<sup>4</sup> Reference to “residual tranches or interests” intends to capture securitization tranches and beneficial interests as well as other structures 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.

evaluated. For example, with a mortgage-backed security, falling interest rates generate faster prepayment of the mortgages underlying the security, shortening its duration. This causes the reporting entity to reinvest assets sooner than expected at potentially less advantageous rates. This is called prepayment risk. Extension risk is created when rising interest rates slow repayment and can significantly lengthen the duration of the security. In addition to interest rate risk, other factors can influence the cash flows generated from an asset-backed securities. These factors include, but are not limited to, defaults of the underlying payors as well as performance requirements that must occur before cash flows can be generated from the underlying assets (such as with leases or royalty rights). If the underlying assets are delinquent or otherwise not generating expected cash flows, such items should be reflected in the cash flow analysis through diminishing security cash flows. Updated cash flow assessments shall continue to occur even if the underlying assets have not been liquidated and regardless of whether an other-than-temporary loss has been recognized.

17. Changes in currently estimated cash flows, including the effect of prepayment assumptions, on all asset-backed securities shall be reviewed periodically, at least quarterly. The prepayment rates of the underlying assets shall be used to determine prepayment assumptions. Prepayment assumptions shall be applied consistently across portfolios to all asset-backed securities backed by similar collateral (similar with respect to coupon, issuer, and age of collateral). Reporting entities shall use consistent assumptions across portfolios for similar collateral within controlled affiliated groups. Since each reporting entity may have a unique method for determining the prepayment assumptions, it is impractical to set standard assumptions for the industry. Relevant sources and rationale used to determine each prepayment assumption shall be documented by the reporting entity.

18. Asset-backed securities shall be revalued using the currently estimated cash flows, including new prepayment assumptions. Reporting entities may utilize the prospective adjustment method for all asset-backed securities, or they may elect to utilize the retrospective adjustment methodology to specific asset-backed securities that are reported with NAIC designations that are of high credit quality<sup>5</sup> at the time of acquisition by the reporting entity. That is, the reporting entity shall determine if it will apply the retrospective or prospective method at the time of acquisition depending on the NAIC designation at that time and can only apply retrospective (as a policy election) to securities that of high credit. Subsequently, if an investment is downgraded below high credit quality, the reporting entity may continue to apply the retrospective method unless the security is other-than-temporarily impaired.

19. The prospective approach recognizes, through the recalculation of the effective yield to be applied to future periods, the effects of all cash flows whose amounts differ from those estimated earlier and the effects and changes in projected cash flows. Under the prospective method, the recalculated effective yield will equate the amortized cost of the investment to the present value of the anticipated future cash flows. The recalculated yield is then used to accrue income on the investment balance for subsequent accounting periods. There are no accounting changes in the current period unless the security is determined to be other than temporarily impaired.

20. The retrospective methodology changes both the yield and the amortized cost so that expected future cash flows produce a return on the investment equal to the return now expected over the life of the investment as measured from the date of acquisition. Under the retrospective method, the recalculated effective yield will equate the present value of the actual and anticipated cash flows with the original cost of the investment. The current amortized cost basis for the asset-backed security is then increased or decreased to the amount that would have resulted had the revised yield been applied since inception, and investment income is correspondingly decreased or increased.

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<sup>5</sup> Under U.S. GAAP, application of the retrospective method for beneficial interests in securitized financial assets, which would generally encompass most asset backed securities defined within SSAP 43R, is limited to “high quality” investments. This has been interpreted to be investments with AA or better ratings.

## Accretable Yield and Changes to Effective Yield for Application of Prospective Method

21. At initial acquisition of an asset-backed security, the reporting entity shall determine the accretable yield. The accretable yield is the excess of cash flows expected to be collected over the reporting entity's initial investment in the asset-backed security. The accretable yield shall be recognized as interest income on an effective-yield basis over the life of the asset-backed security<sup>6</sup>. The nonaccretable difference is the contractually required payments in excess of the cash flows expected to be collected. The nonaccretable difference shall not be recognized as an adjustment to yield, a loss accrual or a valuation allowance for credit risk. For transactions initially captured in SSAP No. 103R resulting from a reporting entity's transfer of assets, all cash flows estimated at the transaction date are defined as the holder's estimate of the amount and timing of estimated future principal and interest cash flows used in determining the purchase price or the holder's fair value for purposes of determining a gain or loss under SSAP No. 103R.

22. After the transaction date, cash flows expected to be collected are defined as the holder's estimate of the amount and timing of the estimated principal and interest cash flows based on the holder's best estimate of current considerations and reasonable and supportable forecasts. Expected cash flows are re-evaluated each quarter to determine if there has been a favorable (or an adverse) change in cash flows versus the previous estimate.

23. If upon evaluation there is a favorable (or an adverse) change in cash flows expected to be collected from the cash flows previously projected, the reporting entity shall recalculate the amount of accretable yield for the asset-backed security on the date of evaluation as the excess of cash flows expected to be collected over the asset-backed security's current amortized cost. The amortized cost is equal to the initial investment minus cash received to date, minus write-offs of the amortized cost basis (e.g., recognized other than temporary impairments) plus the yield accreted to date. If the security is in an impaired state (meaning, fair value is less than amortized cost, regardless if an unrealized loss has been recognized because the security is reported at amortized cost) and there is an adverse change in cash flows expected to be collected, an other-than-temporary impairment shall be considered to have occurred as described in paragraph 30 and requires recognition of a realized loss pursuant to paragraph 35. However, an adverse change in cash flows due solely to changes in the interest rate of a "plain-vanilla", variable-rate asset-backed security generally shall not result in the recognition of an other-than-temporary impairment (a plain-vanilla, variable-rate asset-backed investment does not include those variable-rate investments with interest rate reset formulas that involve either leverage or an inverse floater).

24. A favorable (or an adverse) change in cash flows expected to be collected is considered in the context of both timing and amount of the cash flows expected to be collected. Based on cash flows expected to be collected, interest income may be recognized on an asset-backed security even if the net investment in the asset-backed security is accreted to an amount greater than the amount at which the asset-backed security could be settled if prepaid immediately in its entirety. The adjustment shall be accounted for prospectively as a change in estimate in conformity with SSAP No. 3, with the amount of periodic accretion adjusted over the remaining life of the asset-backed security.

25. Determining whether there has been a favorable (or an adverse) change in cash flows expected to be collected from the cash flows previously projected (taking into consideration both the timing and amount of the cash flows expected to be collected) involves comparing the present value of the remaining cash flows expected to be collected at the initial transaction date (or at the last date previously revised) against the present value of the cash flows expected to be collected at the current financial reporting date. Both the

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<sup>6</sup> An asset-backed security may be acquired at a discount because of a change in credit quality or rate or both. When a security is acquired at a discount that relates, at least in part, to the security's credit quality, the effective interest rate is the discount rate that equates the present value of the investor's estimate of the security's future cash flows with the purchase price of the security.

current and previous sets of cash flows shall be discounted at a rate equal to the current yield used to accrete the asset-backed security.

### **Recognition of Realized and Unrealized Gains and Losses and Impairment Guidance**

26. Asset-backed securities required to be reported at the lower of amortized cost or fair value shall report changes from the prior reporting period as unrealized gains or losses unless an other-than-temporary impairment has occurred. For reporting entities required to maintain an AVR, the accounting for unrealized gains and losses shall be reported through the AVR. For reporting entities not required to maintain an AVR, unrealized gains and losses shall be recorded as a direct credit or charge to unassigned funds (surplus). (P29)

27. Assessment of an other-than-temporary impairment is required for all asset-backed securities when fair value is less than the amortized cost basis. The amortized cost basis includes adjustments made to the cost of an investment for accretion, amortization, collection of cash, and previous other-than-temporary impairments recognized as a realized loss. Reporting a security at the lower of amortized cost or fair value is not a substitute for other-than-temporary impairment recognition. For securities reported at fair value where an other-than-temporary impairment has been determined, the loss recognized reflects the realization of unrealized losses previously recorded from fluctuations in fair value. (The extent to which unrealized losses are realized depends on whether the other-than-temporary impairment is considered a full impairment or a bifurcated impairment pursuant to paragraphs 34 and 35.) After the recognition of an other-than-temporary impairment, securities reported at the lower of amortized cost or fair value shall continue to report unrealized gains and losses from fluctuations in fair value.

28. If an entity intends to sell the asset-backed security (that is, it has decided to sell the security), an other-than-temporary impairment shall be considered to have occurred.

29. If an entity does not intend to sell the asset-backed security, the entity shall assess whether it has the intent and ability<sup>7</sup> to retain the investment in the security for a period of time sufficient to recover the amortized cost basis. If the entity does not have the intent and ability to retain the investment for the time sufficient to recover the amortized cost basis, an other-than-temporary impairment shall be considered to have occurred.

30. If the entity does not expect to recover the entire amortized cost basis of the security, the entity would be unable to assert that it will recover its amortized cost basis even if it does not intend to sell the security and the entity has the intent and ability to hold. (This includes situations in which an entity has an adverse change in cash flows expected to be collected for a security that is an impaired position (meaning, fair value is less than amortized cost, regardless of if an unrealized loss has been recognized.) In such situations, an other-than temporary impairment shall be considered to have occurred. (For mortgage-referenced securities, an OTTI is considered to have occurred when there has been a delinquency or other credit event in the referenced pool of mortgages such that the entity does not expect to recover the entire amortized cost basis of the security.) In assessing whether the entire amortized cost basis of the security will be recovered, an entity shall compare the present value of cash flows expected to be collected from the security with the amortized cost basis of the security. If present value of cash flows expected to be collected is less than the amortized cost basis of the security, the entire amortized cost basis of the security will not be recovered, and an other-than-temporary impairment shall be considered to have occurred. A decrease in the present value of cashflows expected to be collected on an asset-backed security that results from an increase or decrease in expected prepayments on the underlying assets shall be considered in the estimate of the present value of cashflows expected to be collected.

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<sup>7</sup> This assessment shall be considered a high standard due to the accounting measurement method established for the securities within the scope of this statement (amortized cost).

31. In determining whether an other than-temporary impairment has occurred, an entity shall calculate the present value of cash flows expected to be collected based on an estimate of the expected future cash flows of the impaired asset-backed security, discounted at the security's effective interest rate. For securities in which there was no nonaccretable yield and for which there has been no changes to estimated cash flows since acquisition, the effective interest rate is the rate of return implicit in the security (that is, the contractual interest rate adjusted for any net deferred fees or costs, premium, or discount existing at the origination or acquisition of the security).<sup>8</sup> For all other securities, the effective interest rate is the rate implicit immediately prior to the recognition of the other-than-temporary impairment. (Meaning, the effective interest rate as adjusted to reflect the last revised assessment of expected cash flows.)

32. It is inappropriate to automatically conclude that a security is not other-than-temporarily impaired because all of the scheduled payments to date have been received. However, it also is inappropriate to automatically conclude that every decline in fair value represents an other-than-temporary impairment. Further analysis and judgment are required to assess whether a decline in fair value indicates that it is probable that the holder will not collect all of the contractual or estimated cash flows from the security. In addition, the length of time and extent to which the fair value has been less than cost can indicate a decline is other than temporary. The longer and/or the more severe the decline in fair value, the more persuasive the evidence that is needed to overcome the premise that it is probable that the holder will not collect all of the contractual or estimated cash flows from the issuer of the security.

33. In making its other-than-temporary impairment assessment, the holder shall consider all available information relevant to the collectibility of the security, including information about past events, current conditions, and reasonable and supportable forecasts, when developing the estimate of future cash flows. Such information generally shall include the remaining payment terms of the security, prepayment speeds, the financial condition of the issuer(s), expected defaults, and the value of any underlying collateral. To achieve that objective, the holder shall consider, for example, industry analyst reports and forecasts, sector credit ratings, and other market data that are relevant to the collectibility of the security. The holder also shall consider how other credit enhancements affect the expected performance of the security, including consideration of the current financial condition of the guarantor of a security (if the guarantee is not a separate contract) and/or whether any subordinated interests are capable of absorbing estimated losses on the loans underlying the security. The remaining payment terms of the security could be significantly different from the payment terms in prior periods (such as for some securities backed by "nontraditional loans"<sup>9</sup>). Thus, the holder shall consider whether a security backed by currently performing loans will continue to perform when required payments increase in the future (including "balloon" payments). The holder also shall consider how the value of any collateral would affect the expected performance of the security. If the fair value of the collateral has declined, the holder needs to assess the effect of that decline on the ability of the holder to collect the balloon payment.

34. When an other-than-temporary impairment has occurred because the entity intends to sell the security or has assessed that they do not have the intent and ability to retain the investments in the security for a period of time sufficient to recover the amortized cost basis, the amount of the other-than-temporary impairment recognized in earnings as a realized loss shall equal the entire difference between

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<sup>8</sup> An asset-backed security may be acquired at a discount because of a change in credit quality or rate or both. When a security is acquired at a discount that relates, at least in part, to the security's credit quality, the effective interest rate is the discount rate that equates the present value of the investor's estimate of the security's future cash flows with the purchase price of the security.

<sup>9</sup> A nontraditional loan may have features such as (a) terms that permit principal payment deferral or payments smaller than interest accruals (negative amortization), (b) a high loan-to-value ratio, (c) multiple loans on the same collateral that when combined result in a high loan-to-value ratio, (d) option adjustable-rate mortgages (option ARMs) or similar products that may expose the borrower to future increases in repayments in excess of increases that result solely from increases in the market interest rate (for example, once negative amortization results in the loan reaching a maximum principal accrual limit), (e) an initial interest rate that is below the market interest rate for the initial period of the loan term and that may increase significantly when that period ends, and (f) interest-only loans that should be considered in developing an estimate of future cash flows.

the investment's amortized cost basis and its fair value at the balance sheet date (full impairment). For asset-backed securities held at lower of amortized cost or fair value, upon recognition of an other-than-temporary impairment, all unrealized losses would be considered realized and the current fair value becomes the new cost basis.)

35. When an other-than-temporary impairment has occurred because the entity does not expect to recover the entire amortized cost basis of the security even if the entity has no intent to sell and the entity has the intent and ability to hold, the amount of the other-than-temporary impairment recognized as a realized loss shall equal the difference between the investment's amortized cost basis and the present value of cash flows expected to be collected, discounted at the security's effective interest rate in accordance with paragraph 31 (bifurcated impairment). For asset-backed securities held at lower of cost or fair value, unrealized losses would be realized for the non-interest related decline. Hence, unrealized losses could continue to be reflected for these securities based on the difference between the current fair value and the present value of cash flows expected to be collected. (After recognizing an OTTI in these situations, the present value of cash flows expected to be collected becomes the new cost basis of the security.)

36. For reporting entities required to maintain an AVR or IMR, all unrealized gains and losses shall be reported through the AVR. For realized gains and losses, an analysis is required on whether the realized loss reflects an interest or non-interest related decline<sup>10</sup>. The analysis required is the same regardless of whether a realized loss results from an impairment write-down or whether there was a gain or loss upon sale. Guidance on specific scenarios resulting in realized gains and losses are as follows:

- a. Unrealized Gains and Losses – Record all unrealized gains and losses through AVR. At the time an unrealized gain or loss is realized, allocation between AVR or IMR will depend on the analysis and bifurcation between interest or non-interest related declines Unrealized gains or losses that are realized shall be reversed from AVR before the recognition of the realized gain or loss within AVR and IMR.
- b. Other-Than-Temporary Impairment – Non-interest related other-than-temporary impairment losses shall be recorded through the AVR and interest-related OTTI losses shall be recorded through the IMR. If the reporting entity wrote the security down to fair value due to the intent to sell or because the entity does not have the intent and ability to retain the investment for a period of time sufficient to recover the amortized cost basis, the entity shall bifurcate the realized loss between non-interest related (AVR) and interest related (IMR). The analysis for bifurcating impairment losses between AVR and IMR shall be completed as of the date when the other-than-temporary impairment is determined. Entities that recognized an OTTI based on the difference between amortized cost and the present value of expected cash flows shall recognize the full realized loss through AVR.
- c. Security Sold at a Loss Without Prior OTTI – An entity shall bifurcate the loss into AVR and IMR portions depending on interest and non-interest related declines in accordance with the analysis performed as of the date of sale.
- d. Security Sold at a Loss With Prior OTTI – An entity shall bifurcate the current realized loss into AVR and IMR portions depending on interest and non-interest related declines in accordance with the analysis performed as of the date of sale. An entity shall not adjust

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<sup>10</sup> Pursuant to INT 06-07, the term interest-related includes a declining value due to both increases in the risk free interest rate and general credit spread widening. Credit spreads can widen or contract for a variety of reasons, including supply/demand imbalances in the marketplace or the perceived higher/lower risk of an entire sector. If the declining value is caused, in whole or in part, due to credit spreads widening, but not due to fundamental credit problems of the issuer, the change in credit spreads is deemed to be interest-related.

previous allocations to AVR and IMR that resulted from previous recognition of other-than-temporary impairments.

- e. Security Sold at a Gain With Prior OTTI – An entity shall bifurcate the gain into AVR and IMR portions depending on interest and non-interest factors in accordance with the analysis performed as of the date of sale. The bifurcation between AVR and IMR that occurs as of the date of sale may be different from the AVR and IMR allocation that occurred at the time of previous other-than-temporary impairments. An entity shall not adjust previous allocations to AVR and IMR that resulted from previous recognition of other-than-temporary impairments.
- f. Security Sold at a Gain Without Prior OTTI – An entity shall bifurcate the gain into AVR and IMR portions depending on interest and non-interest factors in accordance with the analysis performed as of the date of sale.

37. This statement does not permit reversals of recognized other-than-temporary impairments based on subsequent recoveries of fair value. If there are subsequent changes to the cash flows expected to be collected, the prospective adjustment method shall be used to adjust the effective yield in future periods to reflect those changes.

38. In periods subsequent to the recognition of an other than temporary impairment loss for an asset-backed security, the reporting entity shall account for the other-than-temporarily impaired security as if the security had been purchased on the measurement date of the other-than-temporary impairment at an amortized cost basis equal to the previous amortized cost basis less the other-than-temporary impairment recognized as a realized loss. The difference between the new amortized cost basis and the cash flows expected to be collected shall be accreted as interest income. A reporting entity shall continue to estimate the present value of cash flows expected to be collected over the life of the asset-backed security.

### Designation Guidance

39. For Residential Mortgage-Backed Securities (RMBS), Commercial Mortgage-Backed Securities (CMBS) and Collateralized Loan Obligations (CLOs) securities within the scope of this statement, the initial NAIC designation used to determine the carrying value method and the final NAIC designation for reporting purposes is determined using a multi-step process or the NAIC designation assigned by the NAIC Securities Valuation Office. The P&P Manual provides detailed guidance. A general description of the processes is as follows:

- a. Financial Modeling: Pursuant to the P&P Manual, the NAIC identifies select securities where financial modeling must be used to determine the NAIC designation. For a modeled RMBS/CMBS legacy security, meaning one which closed prior to January 1, 2013, the NAIC designation is based on financial modeling incorporating the insurers' carrying value. For a modeled RMBS/CMBS non-legacy security, meaning one which closed after December 31, 2012, or modeled CLO, the NAIC designation and NAIC designation category assigned by the NAIC Securities Valuation Office must be used. For those RMBS/CMBS legacy securities that are financially modeled, the insurer must use NAIC CUSIP specific modeled breakpoints provided by the modelers in determining initial and final designation for these identified securities. As specified in the P&P Manual, a modeled legacy security RMBS or CMBS tranche that has no expected loss, as compiled and published by the NAIC Securities Valuation Office, under any of the selected modeling scenarios would be assigned an NAIC 1 designation and NAIC 1.A designation category regardless of the insurer's book/adjusted carrying value. The three-step process for modeled RMBS/CMBS legacy securities is as follows:

- i. Step 1: Determine Initial Designation – The current amortized cost (divided by remaining par amount) of an asset-backed security is compared to the modeled breakpoint values assigned to each NAIC designation and NAIC designation category for each CUSIP to establish the **initial** NAIC designation.
  - ii. Step 2: Determine Carrying Value Method – The carrying value method, either the amortized cost method or the lower of amortized cost or fair value method, is then determined as described in paragraph 11 based upon the initial NAIC designation from Step 1.
  - iii. Step 3: Determine Final Designation – The final NAIC designation is determined by comparing the carrying value (divided by remaining par amount) of a security (based on paragraph 39.a.ii.) to the NAIC CUSIP specific modeled breakpoint values assigned to the NAIC designation and NAIC designation category for each CUSIP or is mapped to an NAIC designation category, according to the instructions in the P&P Manual. This final NAIC designation shall be applicable for statutory accounting and reporting purposes and the NAIC designation category will be used for investment schedule reporting and establishing RBC and AVR charges. The final NAIC designation is not used for establishing the appropriate carrying value method in Step 2 (paragraph 39.a.ii.).
- b. All Other Asset-Backed Securities: For securities not subject to paragraph 39.a. (financial modeling) follow the established designation procedures according to the appropriate section of the P&P Manual. The NAIC designation shall be applicable for statutory accounting and reporting purposes (including determining the carrying value method and establishing the AVR charges). The carrying value method is established as described in paragraph 11.

40. For securities that will be financially modeled under paragraph 39, the guidance in this paragraph shall be applied in determining the reporting method for such securities acquired in the current year for quarterly financial statements. Securities reported as of the prior-year end shall continue to be reported under the prior-year end methodology for the current-year quarterly financial statements. For year-end reporting, securities shall be reported in accordance with paragraph 39, regardless of the quarterly methodology used. (P28)

- a. Reporting entities that acquired the entire financial modeling database for the prior-year end are required to follow the financial modeling methodology (paragraph 39.a.) for all securities acquired in the subsequent year that were included in the financial modeling data acquired for the prior year-end.
- b. Reporting entities that acquired identical securities (identical CUSIP) to those held and financially modeled for the prior year-end are required to follow the prior year-end financial modeling methodology (paragraph 39.a.) for these securities acquired subsequent to year-end.
- c. Reporting entities that do not acquire the prior-year financial modeling information for current-year acquired individual CUSIPs, and are not captured within paragraphs 40.a. or 40.b., are required to follow the analytical procedures for non-financially modeled securities (paragraph 39.b. as appropriate) until the current year financial modeling information becomes available and then follow the procedures for financially modeled securities (paragraph 27.a., as appropriate). Reporting entities that do acquire the individual CUSIP information from the prior-year financial modeling database shall use that information for interim reporting.

- d. Reporting entities that acquire securities not previously modeled at the prior year-end are required to follow the analytical procedures for non-financially modeled securities (paragraph 39.b. as appropriate) until the current year financial modeling information becomes available and then follow the procedures for financially modeled securities (paragraph 27.a., as appropriate).

### **Giantization/Megatization of FHLMC or FNMA Mortgage-Backed Securities**

41. Giantization/megatization of mortgage-backed securities is defined as existing pools of FHLMC or FNMA mortgage-backed securities (MBS) with like coupon and prefix which are repooled together by the issuing agency creating a new larger security. The new Fannie Mae “Mega” or Freddie Mac “Giant” is a guaranteed MBS pass-through representing an undivided interest in the underlying pools of loans.

42. Repooled FHLMC and FNMA securities meet the definition of substantially the same as defined in *SSAP No. 103R—Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. The transaction shall not be considered a sale/purchase and no gain or loss shall be recognized. To properly document the repooling, the transaction shall be reported through Schedule D of the annual statement as a disposition and an acquisition.

43. Transaction fees charged by the issuing agencies shall be capitalized and amortized over the life of the repooled security.

### **Disclosures**

44. In addition to the disclosures required for invested assets in general, the following disclosures regarding asset-backed securities shall be made in the financial statements. Regardless of the allowances within paragraph 63 of the Preamble, the disclosures in paragraph 44.f., 44.g. and 44.h. of this statement are required in separate, distinct notes to the financial statements:

- a. Fair values in accordance with *SSAP No. 100R—Fair Value*.
- b. Concentrations of credit risk in accordance with *SSAP No. 27*;
- c. Basis at which the asset-backed securities are stated;
- d. The adjustment methodology used for each type of security (prospective or retrospective);
- e. Descriptions of sources used to determine prepayment assumptions.
- f. All securities within the scope of this statement with a recognized other-than-temporary impairment, disclosed in the aggregate, classified on the basis for the other-than-temporary impairment: (1) intent to sell, (2) inability or lack of intent to retain the investment in the security for a period of time sufficient to recover the amortized cost basis, or (3) present value of cash flows expected to be collected is less than the amortized cost basis of the security.
- g. For each security with an other-than-temporary impairment, recognized in the current reporting period by the reporting entity, as the present value of cash flows expected to be collected is less than the amortized cost basis of the securities:
  - i. The amortized cost basis, prior to any current-period other-than-temporary impairment.
  - ii. The other-than-temporary impairment recognized in earnings as a realized loss.

- iii. The fair value of the security.
  - iv. The amortized cost basis after the current-period other-than-temporary impairment.
- h. All impaired securities (fair value is less than cost or amortized cost) for which an other-than-temporary impairment has not been recognized in earnings as a realized loss (including securities with a recognized other-than-temporary impairment for non-interest related declines when a non-recognized interest related impairment remains):
- i. The aggregate amount of unrealized losses (that is, the amount by which cost or amortized cost exceeds fair value) and
  - ii. The aggregate related fair value of securities with unrealized losses.
- i. The disclosures in (i) and (ii) above should be segregated by those securities that have been in a continuous unrealized loss position for less than 12 months and those that have been in a continuous unrealized loss position for 12 months or longer using fair values determined in accordance with SSAP No. 100R.
- j. Additional information should be included describing the general categories of information that the investor considered in reaching the conclusion that the impairments are not other-than-temporary.
- k. When it is not practicable to estimate fair value, the investor should disclose the following additional information, if applicable:
- i. The aggregate carrying value of the investments not evaluated for impairment, and
  - ii. The circumstances that may have a significant adverse effect on the fair value.
- l. For securities sold, redeemed or otherwise disposed as a result of a callable feature (including make whole call provisions), disclose the number of CUSIPs sold, disposed or otherwise redeemed and the aggregate amount of investment income generated as a result of a prepayment penalty and/or acceleration fee.
- m. The items in the scope of this statement are also subject to the annual audited disclosures in *SSAP No. 26R—Bonds*, paragraphs. 39.e., 39.f. and 39.g.

45. Refer to the Preamble for further discussion regarding disclosure requirements. All disclosures within this statement, except disclosures included in paragraphs 44.b., 44.k. and 44.m., shall be included within the interim and annual statutory financial statements. Disclosure requirements in paragraphs 44.b., 44.k. and 44.m. are required in the annual audited statutory financial statements only.

### Relevant Literature

46. This statement reflects specific statutory accounting guidance for assets that qualify as asset-backed securities under the statutory accounting principles-based bond definition. The classification of investments as ‘bonds’ for statutory accounting and reporting purposes differs from the U.S. GAAP determination of a “debt instrument” and this statement reflects statutory specific measurement and impairment guidance for investments captured in scope. This statement does incorporate limited U.S. GAAP concepts, particularly with the determination of accretable yield and consideration of changes in expected cash flows using the retrospective or prospective method. However, due to the statutory accounting specifications on scope, measurement method and impairment, no U.S. GAAP standards are considered adopted within this

statement. Concepts that converge with U.S. GAAP are limited to the extent they are detailed in this statement.

### Effective Date and Transition

47. This statement adopted August 13, 2023, is effective for years beginning January 1, 2025. The revisions to this statement, and *SSAP No. 26R—Bonds*, incorporate principal concepts on what should be reported as a long-term bond. Securities that qualify as issuer credit obligations within the principal concepts are captured within scope of SSAP No. 26R. Securities that qualify as asset-backed securities within the principal concepts are captured within scope of SSAP No. 43R. Securities that do not qualify as issuer credit obligations or ABS, unless specifically permitted in scope of these statements, are not permitted to be reported as a bond.

48. At the time of transition, reporting entities shall make their best efforts to assess investments to determine whether they qualify within the bond definition for reporting as issuer credit obligations on Schedule D-1-1 or asset-backed securities on Schedule D-1-2. The bond definition requires assessments at the time of acquisition (as of the origination date), and it is recognized that reporting entities may not have the means to complete historical assessments for securities held at the time of transition. For these instances, if information is not readily available for reporting entities to assess a security as of the date at origination, reporting entities may utilize current or acquisition information in concluding that a security qualifies for reporting as a bond as either an issuer obligation or asset-backed security.

49. Investments that were reported as a bond on Schedule D-1: Long-Term Bonds as of December 31, 2024, that do not qualify under the principle-based bond concepts shall be reported as a disposal from that schedule, with a reacquisition on the appropriate reporting schedule as of January 1, 2025. These investments shall be accounted for in accordance with the resulting SSAP that addresses the specific investment structure. For securities that are reported at the lower of amortized cost or fair value under the new applicable guidance, this could result with an unrealized loss in the measurement of the investment at the time of the reclassification. Although the adoption of this guidance is considered a change in accounting principle under SSAP No. 3, the following transition guidance shall be applied on January 1, 2025, to ensure consistency in reporting and to allow investment schedules to roll appropriately:

- a. Securities reclassified from Schedule D-1 as they no longer qualify under the bond definition shall be reported as a disposal from Schedule D-1 at amortized cost. Although no proceeds are received, amortized cost at the time of disposal shall be reported as consideration on Schedule D-4.
  - i. For securities held at amortized cost at the time of disposal, book adjusted carrying value and amortized cost shall agree, preventing gain or loss recognition at the time of reclassification.
  - ii. For securities held at fair value under the lower of amortized cost or fair value measurement method, previously reported unrealized losses shall be reversed on Jan. 1, 2025, prior to disposal, resulting with a reported value that mirrors amortized cost at the time of disposal. This action prevents realized loss recognition at time of reclassification.
- b. Securities reclassified from Schedule D-1 shall be recognized on the subsequent schedule (e.g., Schedule BA) with an actual cost that agrees to the disposal value (amortized cost). Immediately subsequent to recognition on the resulting schedule, the securities shall be reported in accordance with the measurement method prescribed by the applicable SSAP:

- i. For securities previously reported at fair value on Schedule D-1 (under a lower of amortized cost or fair value measurement method), the reporting entity will recognize an unrealized loss to match the previously reported book adjusted carrying value. Subsequently, the security will continue to reflect a lower of amortized cost or fair value measurement method.
- ii. For securities previously reported at amortized cost on Schedule D-1, if the subsequent statement requires a lower of amortized cost or fair value measurement method, then the reporting entity shall recognize an unrealized loss to the extent fair value is less than amortized cost.
- iii. After application of paragraph 49.b.i. and 49.b.ii. all securities shall reflect either the same reported value as of December 31, 2024 (amortized cost or fair value) or a lower reported value (if the security is subject to the lower of amortized cost or fair value measurement method). There should be no instances that result with a security having a greater reported value than what was presented on December 31, 2024. Subsequent to transition, securities reported at fair value may incur unrealized gains or losses due to fair value fluctuations, but should never have unrealized gains that result with a book adjusted carrying value that exceeds amortized cost.

50. With this transition guidance, changes in measurement for securities reclassified under the bond definition will be reported as a change in unrealized capital gains (losses) in the first quarter 2025 financial statements (unless sold in the interim with a realized gain or loss) and not as a change in accounting principle. To enable regulators the ability to identify the impact of securities reclassified under the bond definition, the following disclosure for the 2025 first quarter financial statement is required:

- a. Aggregate book adjusted carrying value for all securities reclassified off Schedule D-1.
- b. Aggregate book adjusted carrying value after transition for all securities reclassified off Schedule D-1 that resulted with a change in measurement basis. (This shall be a subset of paragraph 50.a. and captures the securities that moved from an amortized cost to a fair value measurement method under the lower of amortized cost or fair value approach.)
- c. Aggregate surplus impact for securities reclassified off Schedule D-1. This shall include the difference between book adjusted carrying value as of December 31, 2024, and book adjusted carrying value after transition for those securities that moved from an amortized cost to a fair value measurement method under the lower of amortized cost or fair value approach.

51. Asset-backed securities that were previously reported as short-term (Schedule DA) or as a cash equivalent (Schedule E2) shall be reclassified to be reported on Schedule D-1-2 on Jan. 1, 2025. Similar to the process detailed in paragraph 49, the securities shall be removed from DA and E2 at amortized cost, with reversal of any unrealized loss prior to the reclassification. The amortized cost shall be reported as “consideration received on disposals” on Schedule DA – Verification Between Years or Schedule E-2 – Verification Between Years, as applicable based on the prior reporting location. The security shall be recognized as an ABS acquired on Schedule D-3 at amortized cost. Immediately after initial recognition, if the security was required to be held at fair value, under the lower of amortized cost or fair value measurement method, the reporting entity shall recognize an unrealized loss.

52. For clarification purposes, the transition guidance shall be applied prospectively beginning with the first year of adoption (Jan. 1, 2025). For disclosures that provide comparative information, reporting entities shall not restate the prior year's information in the 2025 disclosure.

## REFERENCES

### Other

- *Purposes and Procedures Manual of the NAIC Investment Analysis Office*
- NAIC Valuation of Securities product prepared by the Securities Valuation Office

### Relevant Issue Papers

- *Issue Paper No. XX—Principles Based Bond Definition*

**EXHIBIT A – QUESTION AND ANSWER IMPLEMENTATION GUIDE**

This exhibit addresses common questions regarding the valuation and impairment guidance detailed in SSAP No. 43R.

**Index to Questions**

No.	Question
1	Are reporting entities permitted to establish an accounting policy to write down a SSAP No. 43R other-than-temporarily impaired security, for which a “non-interest” related decline exists, to fair-value regardless of whether the reporting entity intends to sell, or has the intent and ability to hold?
2	Can a reporting entity avoid completing a cash-flow assessment or testing for a specific other-than-temporarily impaired security when the entity believes there is a clear cash-flow shortage (i.e., non-interest related impairment) and elect to recognize a full impairment for the SSAP No. 43R security (no impairment bifurcation), with fair value becoming the new amortized cost basis, and recognition of the full other-than-temporary impairment as a realized loss?
3	Can reporting entities change their “intend to sell” or “unable to hold” assertions and recover previously recognized other-than-temporary impairments?
4	How do the regulators intend the phrase “intent and ability to hold” as used within SSAP No. 43R to be interpreted?
5	How do contractual prepayments affect the determination of credit losses?
6	Are the disclosure requirements within paragraphs 44.f. and 44.g. of SSAP No. 43R required to be completed for the current reporting quarter only, or as a year-to-date cumulative disclosure?
7	If an impairment loss is recognized based on the "present value of projected cash flows" in one period is the entity required to get new cash flows every reporting period subsequent or just in the periods where there has been a significant change in the actual cash flows from projected cash flows?
Questions 8-10 are specific to securities subject to the financial modeling process. (This process is limited to qualifying RMBS/CMBS securities reviewed by the NAIC Structured Securities Group.) The guidance in questions 8-10 shall not be inferred to other securities in scope of SSAP No. 43R.	
8	Do ABS purchased in different lots result in a different NAIC designation for the same CUSIP? Can reporting entities use a weighted average method determined on a legal entity basis?
9	The NAIC Designation process for ABS may incorporate loss expectations that differ from the reporting entity’s expectations related to OTTI conclusions. Should the reporting entities be required to incorporate recovery values obtained from data provided by the service provider used for the NAIC Designation process for impairment analysis as required by SSAP No. 43R?

No.	Question
10	For companies that have separate accounts, can the NAIC designation be assigned based upon the total legal entity or whether it needs to be calculated separately for the general account and the total separate account?

Questions 8-10 are specific to securities subject to the financial modeling process. (This process is limited to qualifying RMBS/CMBS securities reviewed by the NAIC Structured Securities Group.) The guidance in questions 8-10 shall not be inferred to other securities in scope of SSAP No. 43R.

**1. Question** - Are reporting entities permitted to establish an accounting policy to write down a SSAP No. 43R other-than-temporarily impaired security, for which a “non-interest” related decline exists, to fair value regardless of whether the reporting entity intends to sell, or has the intent and ability to hold?

1.1 Pursuant to the guidance in SSAP No. 43R, optionality is not permitted. As such, an accounting policy that differs from SSAP No. 43R would be considered a departure from statutory accounting principles as prescribed by the NAIC *Accounting Practices and Procedures Manual*.

**2. Question** – Can a reporting entity avoid completing a cash-flow assessment or testing for a specific other-than-temporarily impaired security when the entity believes there is a clear cash-flow shortage (i.e., non-interest related impairment) and elect to recognize a full impairment for the SSAP No. 43R security (no impairment bifurcation), with fair value becoming the new amortized cost basis, and recognition of the full other-than-temporary impairment as a realized loss?

2.1 Under the basis of SSAP No. 43R, an entity is not permitted to elect a write-down to fair value in lieu of assessing cash flows and bifurcating “interest” and “non-interest” impairment components. As noted in paragraph 30, if the entity does not have the intent to sell, and has the intent and ability to hold, but does not expect to recover the entire amortized cost basis of the security, the entity shall compare the present value of cash flows expected to be collected with the amortized cost basis of the security. If present value of cash flows expected to be collected is less than the amortized cost basis of the security, the entire amortized cost basis of the security will not be recovered (a non-interest decline exists) and an other-than-temporary impairment shall be considered to have occurred. Pursuant to paragraph 35, when an other-than-temporary impairment has occurred because the entity does not expect to recover the entire amortized cost basis of the security even if the entity has no intent to sell and the entity has the intent and ability to hold, the amount of the other-than-temporary impairment recognized as a realized loss shall equal the difference between the investment’s amortized cost basis and the present value of cash flows expected to be collected, discounted at the asset-backed security’s effective interest rate.

2.2 If the entity does not want to assess cash flows of an impaired security (fair value is less than amortized cost), the entity can designate the security as one the entity intends to sell, or one that the entity does not have the intent and ability to hold, providing it is reflective of the true intent and assessment of the ability of the entity. Once an impaired security has this designation, pursuant to paragraphs 28 or 29, an other-than-temporary impairment shall be considered to have occurred. As detailed in paragraph 34, the amount of the other-than-temporary impairment recognized in earnings as a realized loss shall equal the entire difference between the investment’s amortized cost basis and its fair value at the balance sheet date.

2.3 As addressed in question 3 of this Question and Answer Guide, reporting entities are not permitted to change assertions regarding their intent to sell or their lack of intent and ability

to hold. Once the security has been identified as one the entity intends to sell, or as a security that the entity does not have the intent and ability to hold, that assertion shall not change as long as the entity continues to hold the security.

**3. Question - Can reporting entities change their “intend to sell” or “unable to hold” assertions and recover previously recognized other-than-temporary impairments?**

- 3.1 No, a reporting entity is not permitted to change assertions and reverse previously recognized SSAP No. 43R other-than-temporary impairments. Although an entity may elect to hold a security due to a favorable change in the security’s fair value, once the security has been identified as one the entity intends to sell, or as a security that the entity does not have the intent and ability to hold for purposes of initially recognizing an other-than-temporary impairment, that assertion shall not change as long as the entity continues to hold the security.
- 3.2 Reporting entities that have recognized an other-than-temporary impairment on a SSAP No. 43R security in a manner corresponding with an assertion on the intent to sell or the lack of the intent and ability to hold, for which a subsequent other-than-temporary impairment has been identified, shall recognize a realized loss for the difference between the current amortized cost (reflecting the previously recognized SSAP No. 43R other-than-temporary impairment) and the fair value at the balance sheet date of the subsequent impairment. Thus, bifurcation of impairment between interest and non-interest related declines is not permitted for securities in which an other-than-temporary impairment was previously recognized on the basis that the reporting entity had the intent to sell, or lacked the intent and ability to hold, regardless if the entity has subsequently decided to hold the security.
- 3.3 Reporting entities shall reclassify a security as one for which there is an intent to sell, or for which there is not an intent or ability to hold, regardless if a bifurcated other-than-temporary impairment had previously been recognized, as soon as the entity realizes that they can no longer support a previous assertion to hold the security. In making such reclassifications, if the security is impaired, the difference between the amortized cost (reflecting the initial non-interest other-than-temporary impairment recognized) and fair value at the balance sheet date of the reclassification shall be recognized as a realized loss, with fair value reflecting the new amortized cost basis. Once such a reclassification occurs, and the security is classified as one for which there is an intent to sell, or for which there is not an intent and ability to hold, the security must continue to carry that assertion until it is no longer held by the reporting entity.

**4. Question – How do the regulators intend the phrase “intent and ability to hold” as used within SSAP No. 43R to be interpreted?**

- 4.1 SSAP No. 43R paragraph 29 states in part “...the entity shall assess whether it has the intent and ability to retain the investment in the security for a period of time sufficient to recover the amortized cost basis. If the entity does not have the intent and ability to retain the investment for the time sufficient to recover the amortized cost basis, an other-than-temporary impairment shall be considered to have occurred.”
- 4.2 The intent of this language within SSAP No. 43R is focused on ensuring that, as of the balance sheet date, after considering the entity’s own cash or working capital requirements and contractual or regulatory obligations and all known facts and circumstances related to the impaired security, the entity does not have the intention of selling the impaired security and has the current intent and ability to hold the security to recovery. Due to impairment

bifurcation provisions provided within SSAP No. 43R, and the amortized cost measurement method generally permitted for asset-backed securities, the assessment of “intent and ability” is intended to be a high standard. Despite the intent of paragraph 29, it is identified that information not known to the entity may become known in subsequent periods and/or facts and circumstances related to an individual holding or group of holdings may change thereby influencing the entity’s subsequent determination of intent and ability with respect to a security or securities.

- 4.3 If a reporting entity asserts that it has the intent and ability to hold a security, or group of securities, until recovery of the amortized cost, but sells or otherwise disposes the security or securities prior to such recovery, the reporting entity shall be prepared to justify this departure from their original assertion to examiners and auditors. SSAP No. 43R purposely does not identify specific circumstances in which a change in assertion would be justifiable, but requires judgment from management, examiners and auditors on whether future assertions warrant closer review.
- 4.4 Delaying recognition of other-than-temporary impairments is a cause of serious concern by the regulators, and entities that habitually delay such recognition through false assertions on the “intent and ability to hold” may face increased scrutiny and regulatory action by their domiciliary state. It is imperative that a reporting entity recognize the full other-than-temporary impairment as soon as the entity realizes that they will no longer be able to hold the security until recovery of the amortized cost basis. Greater scrutiny shall be placed on securities sold or otherwise disposed shortly after a financial statement reporting date if such securities had been excluded from the full other-than-temporary impairment recognition on the basis of the reporting entity’s intent and ability to hold.
- 4.5 As noted in paragraph 3.3 of this question and answer guide, once a security is classified as one for which there is an intent to sell, or for which there is not an intent and ability to hold, the security must continue to carry that assertion until the security is no longer held by the reporting entity.

**5. Question** – How do contractual prepayments affect the determination of credit losses?

- 5.1 Paragraph 30 of SSAP No. 43R states that “A decrease in cash flows expected to be collected on asset-backed security that results from an increase in prepayments on the underlying assets shall be considered in the estimate of present value of cash flows expected to be collected.” Paragraph 18 states that “Asset-backed securities shall be revalued using the currently estimated cash flows, including new prepayment assumptions. Reporting entities may utilize the prospective adjustment method for all asset-backed securities that are reported with NAIC designations that are of high credit at the of acquisition by the reporting entity.”

**6. Question** – Are the disclosure requirements within paragraphs 44.f. and 44.g. of SSAP No. 43R required to be completed for the current reporting quarter only, or as a year-to-date cumulative disclosure?

- 6.1 The disclosures should reflect the year-to-date other-than-temporary impairments. The “fair value” reported within the disclosure is intended to reflect the fair value at the date of the other-than-temporary impairment and shall not be updated due to the fluctuations identified at subsequent reporting dates. If a security has more than one other-than-temporary impairment identified during a fiscal reporting year, the security shall be included on the disclosure listing separately for each identified other-than-temporary impairment. Notation shall be included in the disclosure identifying the other-than-temporary impairments that were recognized for each respective reporting period.

**7. Question** – If an impairment loss is recognized based on the "present value of projected cash flows" in one period is the entity required to get new cash flows every reporting period subsequent or just in the periods where there has been a significant change in the actual cash flows from projected cash flows?

7.1 The guidance in paragraph 38 of SSAP No. 43R indicates that a reporting entity shall continue to estimate the present value of cash flows expected to be collected over the life of the asset-backed security. This guidance is explicit that the reporting entity shall continue to estimate the present value of cash flows expected to be collected over the life of the loan-backed or structured security.

7.2 As provided in paragraph 2.2 of this Q&A, if the entity does not want to assess cash flows of an impaired security (fair value is less than amortized cost), the entity can designate the security as one the entity intends to sell, or one that the entity does not have the intent and ability to hold, providing it is reflective of the true intent and assessment of the ability of the entity. Reporting entities subject to the requirements of AVR and IMR should allocate the impairment loss between AVR and IMR accordingly.

**8. Question** – Do ABS purchased in different lots result in a different NAIC designation for the same CUSIP? Can reporting entities use a weighted average method determined on a legal entity basis?

8.1 Under the financial modeling process (applicable to qualifying RMBS/CMBS reviewed by the NAIC Structured Securities Group), the amortized cost of the security impacts the "final" NAIC designation used for reporting and RBC purposes. As such, securities subject to the financial modeling process acquired in different lots can result in a different NAIC designation for the same CUSIP. In accordance with the current instructions for calculating AVR and IMR, reporting entities are required to keep track of the different lots separately, which means reporting the different designations. For reporting purposes, if a SSAP No. 43R security (by CUSIP) has different NAIC designations by lot, the reporting entity shall either 1) report the aggregate investment with the lowest applicable NAIC designation or 2) report the investment separately by purchase lot on the investment schedule. If reporting separately, the investment may be aggregated by NAIC designation. (For example, all acquisitions of the identical CUSIP resulting with an NAIC 1 designation may be aggregated, and all acquisitions of the identical CUSIP resulting with an NAIC 3 designation may be aggregated.)

**9. Question** – The NAIC Designation process for ABS subject to the financial modeling process may incorporate loss expectations that differ from the reporting entity's expectations related to OTTI conclusions. Should the reporting entities be required to incorporate recovery values obtained from data provided by the service provider used for the NAIC Designation process for impairment analysis as required by SSAP No. 43R?

9.1 In accordance with *INT 06-07: Definition of Phrase "Other Than Temporary,"* reporting entities are expected to "consider all available evidence" at their disposal, including the information that can be derived from the NAIC designation.

**10. Question** - For companies that have separate accounts, can the NAIC designation be assigned based upon the total legal entity or whether it needs to be calculated separately for the general account and the total separate account?

10.1 The financial modeling process for qualifying RMBS/CMBS securities is required for applicable securities held in either the general or separate account.

**Exhibit 3 – Revisions to SSAP No. 21—Other Admitted Assets**

**Bond Definition – Debt Securities that Do Not Qualify as Bonds**

**Residual Tranches or Interests/Loss Positions**

**Adopted March 16, 2024 – Effective January 1, 2025**

On March 16, 2024, the Statutory Accounting Principles (E) Working Group adopted new statutory accounting guidance for “Debt Securities that Do Not Qualify as Bonds” and for “Residual Tranches or Interests/Loss Positions” within *SSAP No. 21—Other Admitted Assets*. The new sections are shown below. (Existing guidance from SSAP No. 21, paragraph 22 under ‘Effective Date and Transition’ is duplicated within and becomes paragraph 40 after the revisions.) The revisions are effective Jan. 1, 2025. Reporting entities may elect to adopt the residual guidance (detailed in paragraphs 28-37) for year-end 2024.

**Debt Securities That Do Not Qualify as Bonds**

20. The guidance within paragraphs 20-27 of this statement shall apply for any security, as defined in *SSAP No. 26—Bonds*, whereby there is a fixed schedule for one or more future payments (referred to herein as debt securities), but for which the security does not qualify for bond reporting under SSAP No. 26 as an issuer credit obligation or an asset backed security. Investments in scope of this guidance are limited to:

- a. Debt securities for which the investment does not reflect a creditor relationship in substance.
- b. Debt securities that do not qualify for bond reporting due to a lack of substantive credit enhancement.
- c. Debt securities that do not qualify for bond reporting due solely to a lack of meaningful cash flows.

21. Debt securities as described in this statement meet the definition of assets as defined in SSAP No. 4 and are admitted assets to the extent they conform to the requirements of this statement. The guidance in these paragraphs shall not be inferred to other securities or investment structures that are not otherwise addressed in statutory accounting, nor shall it be applied to any investments that are captured within other statutory accounting guidance.

22. Debt securities in scope of this standard that do not qualify as bonds under SSAP No. 26 and for which the primary source of repayment is derived through rights to underlying collateral, qualify as admitted assets if the underlying collateral primarily qualify as admitted invested assets. As detailed in paragraph 31, in the section pertaining to residual tranches, any residual tranches or first loss positions held from the same securitization that did not qualify as a bond under SSAP No. 26 also only qualify as admitted assets to the extent the underlying collateral primarily qualifies as admitted invested assets.

23. Debt securities in scope of this statement shall be initially reported at acquisition at cost, including brokerage and other related fees on *Schedule BA: Other Long-Term Invested Assets*.

24. Debt securities captured in scope of this statement shall be reported at the lower of amortized cost or fair value. Changes in measurement to reflect a lower value or to reflect changes in fair value shall be recorded as unrealized gains or losses.

25. Debt securities that do not qualify as bonds in the scope of this statement shall follow the guidance in *SSAP No. 43—Asset-Backed Securities* for calculating amortized cost, for determining and recognizing other-than-temporary impairments and for allocating unrealized and realized gains and losses between the asset valuation reserve (AVR) and interest maintenance reserve (IMR).
26. Investment income shall be recorded, with assessments for collectability and nonadmittance completed and recognized, pursuant to *SSAP No. 34—Investment Income Due and Accrued*.
27. Securities captured within this section shall be included in all invested asset disclosures, along with the following disclosures:
- a. Fair values in accordance with *SSAP No. 100—Fair Value*
  - b. Concentrations of credit risk in accordance with *SSAP No. 27*
  - c. Basis at which the securities are stated
  - d. The adjustment methodology used for each type of security (prospective or retrospective)
  - e. Descriptions of sources used to determine prepayment assumptions
  - f. All securities within the scope of this statement with a recognized other-than-temporary impairment, disclosed in the aggregate, classified on the basis for the other-than-temporary impairment: (1) intent to sell, (2) inability or lack of intent to retain the investment in the security for a period of time sufficient to recover the amortized cost basis, or (3) present value of cash flows expected to be collected is less than the amortized cost basis of the security.
  - g. For each security with an other-than-temporary impairment, recognized in the current reporting period by the reporting entity, as the present value of cash flows expected to be collected is less than the amortized cost basis of the securities:
    - i. The amortized cost basis, prior to any current-period other-than-temporary impairment.
    - ii. The other-than-temporary impairment recognized in earnings as a realized loss.
    - iii. The fair value of the security.
    - iv. The amortized cost basis after the current-period other-than-temporary impairment.
  - h. All impaired securities (fair value is less than cost or amortized cost) for which an other-than-temporary impairment has not been recognized in earnings as a realized loss (including securities with a recognized other-than-temporary impairment for non-interest related declines when a non-recognized interest related impairment remains):
    - v. The aggregate amount of unrealized losses (that is, the amount by which cost or amortized cost exceeds fair value) and
    - vi. The aggregate related fair value of securities with unrealized losses.
  - i. The disclosures in (i) and (ii) above should be segregated by those securities that have been in a continuous unrealized loss position for less than 12 months and those that have been

in a continuous unrealized loss position for 12 months or longer using fair values determined in accordance with SSAP No. 100.

- j. Additional information should be included describing the general categories of information that the investor considered in reaching the conclusion that the impairments are not other-than-temporary.
- k. When it is not practicable to estimate fair value, the investor should disclose the following additional information, if applicable:
  - i. The aggregate carrying value of the investments not evaluated for impairment, and
  - ii. The circumstances that may have a significant adverse effect on the fair value.
- l. For securities sold, redeemed, or otherwise disposed as a result of a callable feature (including make whole call provisions), disclose the number of CUSIPs sold, disposed or otherwise redeemed and the aggregate amount of investment income generated as a result of a prepayment penalty and/or acceleration fee.

#### *Residual Tranches or Interests/Loss Positions*

28. A residual interest or a residual security tranche (collectively referred to as residuals) exists in investment structures that issue one or more classes of debt securities created for the primary purpose of raising debt capital backed by collateral assets. The primary source of debt repayment is derived through rights to the cash flows of a discrete pool of collateral assets. These designs could be backed directly or indirectly through a feeder fund. The collateral assets generate cash flows that provide interest and principal payments to debt holders through a contractually prescribed distribution methodology (e.g., waterfall dictating the order and application of all collateral cash flows). Once those contractual requirements are met, the remaining cash flows 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 holders in the structure continue to receive payments from the collateral so long as there are cash flows in excess of the debt obligations. The payments to the residual holder may vary significantly, both in timing and amount, based on the underlying collateral performance.

29. The structural design of a residual interest or residual security tranche can vary, but the overall concept is that they receive the remaining cash flows after all debt holders receive contractual interest and principal payments. Determining whether an investment in a structure 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 or 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. Additionally, it would be expected that the equity position in an ABS Issuer, as defined in SSAP 26, would be classified as a residual tranche.

- a. Residuals often do not have contractual principal or interest.
- b. Residuals may be structured with terms that appear to be stated principal or interest but that lack substance, and 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.

- c. Residuals do not have credit ratings or NAIC assigned designations. Rather, they are first loss positions that provide subordination to support the credit quality of the typically rated debt tranches.
- d. 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 debt tranche holders receive contractual principal and interest payments.
- e. Frequently, there are contractual triggers that divert cash flows from the residual holders to the debt tranches if the structure becomes stressed.

30. Residual tranches or interests do not qualify for bond reporting. Residuals shall follow the accounting and admittance guidance within this statement and are required to be reported on Schedule BA: Other Long-Term Invested Assets.

31. As stated in paragraph 22, residuals are permitted to be admitted assets if debt securities from the same structure qualify (or would qualify) as admitted assets. If the debt security from a structure is (or would be) nonadmitted due to the requirements under paragraph 22, then any residual interests or first loss positions held from the same structure also do not qualify as admitted assets and shall be reported as nonadmitted assets.

32. Residuals shall be initially reported at cost, or allocated cost (using proportional fair values if acquired along with debt tranches from the securitization). Subsequent to initial acquisition, residuals shall be reported at either 1) the lower of amortized cost or fair value under the Allowable Earned Yield method detailed in paragraphs 33-34, with temporary reductions in fair value reported as an unrealized loss, or 2) at the calculated practical expedient method detailed in paragraph 35.

33. For purposes of this statement for residuals only, amortized cost shall be defined as the cost to acquire the residual reduced for distributions in excess of the Allowable Earned Yield and other-then-temporary impairments (OTTI). The Allowable Earned Yield shall be established at acquisition as the discount rate that equates the initial best estimate of the residual's cash flows to its acquisition cost. The Allowable Earned Yield is not to be updated after acquisition.

34. Interest income shall be recorded under the effective yield method using the Allowable Earned Yield, capped by the amount of cash distributions received. To the extent that the Allowable Earned Yield, applied to the current amortized cost, exceeds the cash distributions received, such unrecognized interest income may be carried forward to future periods to be recognized when sufficient cash distributions are received. To the extent cash distributions exceed the Allowable Earned Yield (including any unrecognized interest carried forward), the amortized cost shall be reduced by the excess. As a result of this method, the amortized cost shall not be increased unless there is a subsequent investment (i.e., an additional purchase with additional consideration remitted).

35. Reporting entities may elect a practical expedient in lieu of the Allowable Earned Yield detailed in paragraphs 33-34 and calculate Book/Adjusted Carrying Value (BACV) such that all distributions received are treated as a reduction in BACV. With this approach, the reporting entity will not recognize any interest or investment income until the residual tranche has a BACV of zero. Once the residual has a zero BACV, distributions received shall be recognized as interest income.

- a. Reporting entities applying the practical expedient shall continue to report residuals on Schedule BA, including those with a zero BACV. Any subsequent distributions shall be reported as interest income until the structure matures/terminates, is unwound, or no longer meets the definition of a residual.

- b. Reporting entities are required to apply the practical expedient to all residuals held.
  - c. Reporting entities that wish to discontinue use of the practical expedient approach and move towards the Allowable Earned Yield method are required to specify and disclose an explicit transition date, and only apply the Allowable Earned Yield method to residuals acquired after that date. Residuals held prior to the disclosed accounting method transition date shall continue to follow the practical expedient until those residuals mature/terminate or are unwound.
36. Residuals shall be assessed for other-than-temporary impairment (OTTI) on an ongoing basis, with required assessment anytime that fair value is less than the reported value.
- a. For residuals measured using the Allowable Earned Yield method, as detailed in paragraphs 33-34, an OTTI shall be considered to have occurred if the present value of expected cash flows discounted by the Allowable Earned Yield, is less than amortized cost. Upon identification of an OTTI, the reporting entity shall recognize a realized loss equal to the difference between the amortized cost and the present value of expected cash flows, with the present value of expected cash flows becoming the new amortized cost to which the Allowable Earned Yield is applied. After the OTTI is recognized, distributions received from the residual shall continue to be recorded in accordance with paragraphs 33-34. Subsequent recoveries in cash flows shall not result in increases to the amortized cost.
  - b. For residuals measured under the practical expedient, as detailed in paragraph 35, an OTTI shall be considered to have occurred if the fair value of the residual is less than the BACV. The reporting entity shall recognize a realized loss equal to the difference between the fair value and the BACV, with the fair value becoming the new BACV. After the OTTI is recognized, distributions received from the residual shall continue to be recorded in accordance with paragraph 35. Subsequent recoveries in cash flows shall not result in increases to the BACV.
37. Residuals recognized on Schedule BA as of December 31, 2024, and accounted for under a different SSAP, shall follow the following measurement transition guidance as of January 1, 2025:
- a. Reporting entity shall determine whether they will follow the Allowable Earned Yield method detailed in paragraphs 33-34, or the practical expedient detailed in paragraph 35, for all residuals.
  - b. Residuals previously accounted for under SSAP No. 26 or SSAP No. 43 shall prospectively apply the Allowable Earned Yield measurement method elected under this Statement using the amortized cost as of December 31, 2024, as the starting point in the calculation. Residuals that will follow the practical expedient shall be recognized on January 1, 2025, at the lower of amortized cost or fair value as of December 31, 2024, realizing any unrealized loss existing at that date.
  - c. Residuals reported under the equity method or fair value as of December 31, 2024, (as they were previously captured in scope of SSAP No. 30, 32 or 48) with unrealized gains or losses recognized, shall recognize any unrealized position as realized, with the reported value as of December 31, 2024, becoming the January 1, 2025, cost basis for subsequent measurement under this statement.

### Effective Date and Transition

~~22~~40. This statement is effective for years beginning January 1, 2001. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with *SSAP No. 3—Accounting Changes and Corrections of Errors*. The guidance for structured settlements when the reporting entity acquires the legal right to receive payments is effective December 31, 2018. The clarification regarding audits of qualifying collateral pledged for collateral loans in the footnote 2 to paragraph 4 requires applicable audits to be obtained for the 2023 reporting period in the subsequent year. In periods after year-end 2023, the audits of equity collateral pledged for collateral loans are required to be obtained for the reporting year in which it was pledged and annually thereafter. The annual audit lag shall be consistent from period to period.

41. Revisions adopted March 16, 2024, to add guidance for “Debt Securities That Do Not Qualify as Bonds” and for “Residual Tranches or Interests/Loss Positions” are initially effective Jan. 1, 2025, to correspond with the effective date of the principles-based bond definition. The guidance for residual tranches is permitted for early application. Reporting entities that apply this guidance in 2024 shall continue to follow the transition guidance in paragraph 37 using the modified dates that correspond to the reporting entity’s application date.

## Bond Definition - Revisions to other SSAPs Adopted Aug. 13, 2023

### SSAP Reference Revisions

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1. ***SSAP No. 2R—Cash, Cash Equivalents, Drafts and Short-Term Investments***

SSAP No. 26R: Updated reference in paragraph 18. No revisions needed to paragraph 7 or 15.

SSAP No. 43R: Adjusted title references in paragraphs 7 and 15.

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2. ***SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve***

SSAP No. 43R: Adjusted reference in paragraph 3.

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3. ***SSAP No. 15—Debt and Holding Company Obligations***

SSAP No. 26R: No revisions needed to paragraph 13.

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4. ***SSAP No. 21—Other Admitted Assets***

SSAP No. 26R: Updated footnote 1 and clarified guidance for GICs in paragraphs 14-17.

SSAP No. 43R: Adjusted reference in paragraph 6 to asset-backed securities that qualify.

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5. ***SSAP No. 36—Troubled Debt Restructuring***

SSAP No. 26R: No revisions needed to paragraph 29.

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6. ***SSAP No. 43R—Asset-Backed Securities***

SSAP No. 26R: Updated disclosure reference that link to SSAP No. 26R, paragraph 51.m.

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7. ***SSAP No. 86—Derivatives***

SSAP No. 26R and SSAP No. 43R: Updated the guidance for structured notes in paragraph 5.g. and replication (synthetic assets) in Footnote 5.

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8. ***SSAP No. 95—Nonmonetary Transactions***

SSAP No. 26R: No revisions needed to paragraph 6.

SSAP No. 43R: Adjusted the citation to SSAP No. 43R in paragraph 6.

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9. ***SSAP No. 100R—Fair Value***

SSAP No. 26R: No revisions needed to Footnote 3.

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10. ***SSAP No. 103R—Transfers and Servicing of Financial Assets and Extinguishments of Liabilities***

SSAP No. 43R: Revisions remove the direct pointer of beneficial interests as in scope of SSAP No. 43R and incorporate guidance for reporting under the applicable SSAP in paragraphs 2, 11 and 18.

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**11. INT 01-25: Accounting for U.S. Treasury Inflation-Indexed Securities**

SSAP No. 26: No revisions needed.

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**12. 06-02: Accounting and Reporting for Investments in a Certified Capital Company (CAPCO)**

SSAP No. 26: Updated paragraph reference in paragraph 5.a.

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**13. 06-07: Definition of Phrase “Other Than Temporary”**

SSAP No. 26: No revisions needed.

SSAP No. 43R: Updated reference in list of applicable SSAPs.

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**14. INT 07-01: Application of the Scientific (Constant Yield) Method in Situations of Reverse Amortization**

SSAP No. 26R: Removed quoted guidance.

SSAP No. 43R: Updated reference in list of applicable SSAPs and removed quoted guidance.

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**15. INT 19-02: Freddie Mac Single Security Initiative**

SSAP No. 26R: No revisions needed.

SSAP No. 43R: Updated reference in list of applicable SSAPs and in paragraph 1.

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**16. INT 22-01: Freddie Mac When Issued K-Deal (WI Trust) Certificates**

SSAP No. 43R: Updated reference in list of applicable SSAPs and in paragraph 1.

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**Summary of SAP Guidance Revisions**

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**17. SSAP No. 2R—Cash, Cash Equivalents, Drafts and Short-Term Investments**

Revisions preclude asset-backed securities that are in scope of SSAP No. 43R from being reported as cash equivalents or short-term investments. The revisions also identify items captured on Schedule BA as non-bond securities. (These revisions also add reference to working capital finance investments, but that is not new guidance, but was not explicitly stated in SSAP No. 2R.)

Summary of SAP Reference Revisions:**SSAP No. 2R—Cash, Cash Equivalents, Drafts and Short-Term Investments**

7. Regardless of maturity date, related party or affiliated investments that would be in scope of *SSAP No. 26R—Bonds*, *SSAP No. 43R—~~Loan-Backed and Structured~~Asset-Backed Securities*, or that would be reported as “Other Invested Assets” shall be reported as long-term investments if any of the following conditions apply,<sup>1</sup> unless the reporting entity has re-underwritten the investment, maintained appropriate re-underwriting documentation, and each participating party had the ability to independently review the terms and can terminate the transaction prior to renewal.

- a. The reporting entity does not reasonably expect the investment to terminate on the maturity date. This provision includes investments that are expected to be renewed (or rolled) with a maturity date that ends subsequent to the initial 90-day timeframe.
- b. The investment was previously reported as a cash equivalent investment and the initial maturity timeframe has passed. If an investment is reported as a cash equivalent and it is unexpectedly renewed/rolled, the reporting entity is not permitted to continue to report the held security as a cash equivalent, regardless of the updated maturity date, and shall report the security as a long-term investment. An investment is only permitted to be reported as a cash equivalent for one quarter reporting period. Meaning, if an investment was reported as a cash equivalent in the first quarter, it is not permitted to be reported as a cash equivalent in the second quarter.
- c. The reporting entity reacquired the investment (or a substantially similar investment) within one year after the original security matured or was terminated. These reacquired securities shall be reported as long-term investments. (These securities are also not permitted to be reported as short-term investments, regardless of the maturity date of the reacquired investment.)

Footnote 1: Cash equivalents subject to the provisions of paragraph 7 are not permitted to be subsequently reported as short-term investments, even if the updated/reacquired maturity date is within one year. These investments shall be reported as long-term investments. To avoid changes in reporting schedules, reporting entities are permitted to report securities as long-term investments at initial acquisition, regardless of the initial maturity date.

15. Regardless of maturity date, related party or affiliated investments in scope of *SSAP No. 26R—Bonds*, *SSAP No. 43R—~~Loan-Backed and Structured~~Asset-Backed Securities*, or that would be reported as “Other Invested Assets” shall be reported as long-term investments if any of the following conditions apply,<sup>2, 3</sup> unless the reporting entity has re-underwritten the investment, maintained appropriate re-underwriting documentation, and each participating party had the ability to independently review the terms and can terminate the transaction prior to renewal.

- a. The reporting entity does not reasonably expect the investment to terminate on the maturity date. This provision includes investments that are expected to be renewed (or rolled) with a maturity date that ends subsequent to the initial “less than one year” timeframe.
- b. The investment was previously reported as a short-term investment and the initial maturity timeframe has passed. If an investment is reported as a short-term investment and it is unexpectedly renewed/rolled, the reporting entity is not permitted to continue to report the held security as a short-term investment (or as a cash equivalent) regardless of the updated maturity date and shall report the security as a long-term investment. An investment is only permitted to be reported as a short-term investment for one annual reporting period. Meaning, if an investment was reported as a short-term investment as of December 31, 2018, it is not permitted to be reported as short-term investment as of December 31, 2019.

- c. The reporting entity reacquired the investment (or a substantially similar investment) within one year after the original security matured or was terminated. These reacquired securities shall be reported as long-term investments. (These securities are also not permitted to be reported as cash equivalent investments regardless of the maturity date of the reacquired investment.)

Footnote 2: Reverse repurchase transactions are excluded from these provisions if admitted in accordance with collateral requirements pursuant to *SSAP No. 103R—Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*.

Footnote 3: Short-term investments subject to the provisions of paragraph 15 are not permitted to be subsequently reported as cash equivalents, even if the updated/reacquired maturity date is within 90 days. These investments shall be reported as long-term investments. To avoid changes in reporting schedules, reporting entities are permitted to report securities as long-term investments at initial acquisition, regardless of the initial maturity date.

## Disclosures

18. The following disclosures shall be made for short-term investments in the financial statements:
- Fair values in accordance with *SSAP No. 100R—Fair Value*;
  - Concentrations of credit risk in accordance with *SSAP No. 27—Off-Balance-Sheet and Credit Risk Disclosures*;
  - Basis at which the short-term investments are stated.
  - The items in the scope of this statement are also subject to the annual audited disclosures in *SSAP No. 26R—Bonds*, paragraph ~~39.f~~<sup>30.f</sup>.
  - Identification of cash equivalents (excluding money market mutual funds as detailed in paragraph 8) and short-term investments (or substantially similar investments), which remain on the same reporting schedule for more than one consecutive reporting period. This disclosure is satisfied by use of a designated code in the investment schedules of the statutory financial statements.

### ***SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve***

3. The IMR and AVR shall be calculated and reported as determined per guidance in the SSAP for the specific type of investment (e.g., SSAP No. 43R for ~~loan-backed and structured~~ asset-backed securities), or if not specifically stated in the respective SSAP, in accordance with the NAIC *Annual Statement Instructions* for Life and Accident and Health Insurance Companies.

### ***SSAP No. 15—Debt and Holding Company Obligations - (No Changes)***

13. Convertible debt securities and convertible preferred stock with beneficial conversion features are to be valued according to the appropriate statutory accounting statement; *SSAP No. 26R—Bonds* or *SSAP No. 32R—Preferred Stock*.

**SSAP No. 21R—Other Admitted Assets****Collateral Loans**

4. Collateral loans are unconditional obligations<sup>1</sup> for the payment of money secured by the pledge of an investment<sup>2</sup> and meet the definition of assets as defined in SSAP No. 4, and are admitted assets to the extent they conform to the requirements of this statement. The outstanding principal balance on the loan and any related accrued interest shall be recorded as an admitted asset subject to the following limitations:

Footnote 1: For purposes of determining a collateral loan in scope of this statement, a collateral loan does not include investments captured in scope of other statements. For example, *SSAP No. 26R—Bonds* includes securities [that qualify as issuer creditor obligations and SSAP No. 43—Asset-Backed Securities includes securities that qualify as asset-backed securities under the bond definition](#). ~~(as defined in that statement) representing a creditor relationship whereby there is a fixed schedule for one or more future payments.~~ Investments captured in SSAP No. 26R or SSAP No. 43R that are also secured with collateral shall continue to be captured within scope of ~~SSAP No. 26R~~ [those statements](#).

Footnote 2: Investment defined as those assets listed in Section 3 of *Appendix A-001—Investments of Reporting Entities*.

6. A reporting entity that acquires (directly or indirectly) structured settlement payment rights<sup>3</sup> through a factoring company, excluding securitizations [that qualify as asset-backed securities captured in scope of](#) SSAP No. 43R, shall report the acquisition as follows:

- a. Period-certain (non-life contingent) structured settlement income streams shall be reported as other long-term invested assets<sup>4</sup>, and are admitted assets if the rights to the future payments from a structured settlement have been legally acquired in accordance with all state and federal requirements. If the structured settlement has not met all legal requirements, including the court-approved transfer from the original recipient, then the reporting entity shall recognize the appropriate excise tax obligation and the structured settlement shall be nonadmitted.
- b. Life-contingent structured settlement income streams shall be reported as other long-term invested assets on Schedule BA and shall be nonadmitted. (Nonadmittance is required regardless if the right to future payments has been legally transferred.)

Footnote 3: This guidance is specific to acquired structured settlement income streams (legal right to receive future payments from a structured settlement) and does not capture accounting and reporting guidance for the acquisition of any insurance product (e.g., life settlement, annuities, etc.).

Footnote 4: Reporting entities that hold qualifying structured settlement payment rights shall report the security on Schedule BA either as an “any other class of asset” or as a “fixed or variable interest rate investment with underlying characteristics of other fixed income instruments” if the structured settlement payment right qualifies for reporting within that reporting line (e.g., NAIC designation).

**Guaranteed Investment Contracts**

14. Guaranteed Investment Contracts (GICs) purchased for investment purposes meet the definition of assets as defined in SSAP No. 4, and are admitted assets to the extent they conform to the requirements of this statement. [This includes an investment in a GIC payment stream which can be created when an intermediary purchases individual GICs, pools them, and sells the rights to the payment stream.](#)

[15. GICs acquired in a security structure that qualify under the bond definition as an issuer obligation or asset-backed security shall follow the accounting guidance within SSAP No. 26R or SSAP No. 43R as applicable.](#)

~~15.16.~~ Purchases of GIC investments that do not meet the definition of a security, but for which all contractual rights and ownership of the GIC result in an investment similar to a corporate bond, shall be reported at amortized cost and ~~accounted for in accordance with the guidance in SSAP No. 26R—Bonds included on Schedule BA: Other Long-Term Invested Assets.~~ If, in accordance with SSAP No. 5R, it is probable that the carrying value of a GIC is not fully recoverable the investment shall be considered impaired. Accordingly, the cost basis of the investment shall be written down to the undiscounted estimated cash flows and the amount of the write down shall be accounted for as a realized loss. The new cost basis shall not be changed for subsequent recoveries in fair value.

~~16.~~ An investment in a GIC payment stream is created when an intermediary purchases individual GICs, pools them, and sells the rights to the payment stream. These investments shall be reported as other long-term invested assets and shall be carried at amortized cost.

~~17.~~ If, in accordance with SSAP No. 5R, it is probable that the carrying value of a GIC is not fully recoverable the investment shall be considered impaired. Accordingly, the cost basis of the investment shall be written down to the undiscounted estimated cash flows and the amount of the write down shall be accounted for as a capital loss. The new cost basis shall not be changed for subsequent recoveries in fair value.

#### **SSAP No. 36—Troubled Debt Restructuring (No Changes)**

29. Although FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases* (FAS 91) was rejected in SSAP No. 26R—Bonds, this statement is consistent with paragraph 14 of FAS No. 91.

#### **SSAP No. 43R—Asset-Backed Securities**

##### **Disclosures**

51. In addition to the disclosures required for invested assets in general, the following disclosures regarding loan-backed and structured securities shall be made in the financial statements. Regardless of the allowances within paragraph 63 of the Preamble, the disclosures in paragraph 51.f., 51.g. and 51.h. of this statement are required in separate, distinct notes to the financial statements:

- m. The items in the scope of this statement are also subject to the annual audited disclosures in SSAP No. 26R—Bonds, paragraphs ~~39.e., 30.e., 39.f., 30.f.~~ and ~~39.g., 30.g.~~

#### **SSAP No. 86—Derivatives**

5. Derivative instruments include, but are not limited to; options, warrants used in a hedging transaction and not attached to another financial instrument, caps, floors, collars, swaps, forwards, futures, structured notes with risk of principal/original investment loss based on the terms of the agreement (in addition to default risk), and any other agreements or instruments substantially similar thereto or any series or combination thereof.

- g. “Structured Notes” ~~in scope of this statement are instruments defined in SSAP No. 26R—Bonds (often in the form of debt instruments),~~ in scope of this statement are instruments in which the amount of principal repayment or return of original investment is contingent on an underlying variable/interest<sup>5</sup>; ~~where the terms of the agreement make it possible that the reporting entity could lose all or a portion of its original investment amount (for other than failure of the issuer to pay the contractual amounts due).~~ ~~Structured notes that are~~

“~~m~~Mortgage-referenced securities” issued by a government sponsored enterprise in the form of credit-risk transfers where an issue security is tied to a referenced pool are mortgages are captured in SSAP No. 43R—*Loan-Backed and Structured Securities*.

Footnote 5 - ~~The “structured notes” captured within scope of this statement is specific to instruments in which the terms of the agreement make it possible that the reporting entity could lose all or a portion of its original investment amount (for other than failure of the issuer to pay the contractual amounts due).~~ These instruments incorporate both the credit risk of the issuer, as well as the risk of an underlying variable/interest (such as the performance of an equity index or the performance of an unrelated security). Securities that are labeled “principal-protected notes” are captured within scope of this statement if the “principal protection” involves only a portion of the principal and/or if the principal protection requires the reporting entity to meet qualifying conditions in order to be safeguarded from the risk of loss from the underlying linked variable. Securities that may have changing positive interest rates in response to a linked underlying variable or the passage of time, or that have the potential for increased principal repayments in response to a linked variable (such as U.S. Treasury Inflation-Indexed Securities) that do not incorporate risk of original investment/principal loss (outside of default risk) are not captured as structured notes in scope of this statement. A replication (synthetic asset) transaction addressed within this standard may reproduce the investment characteristics of an otherwise permissible investment that would not meet the principles-based bond definition (e.g., is distinct from a “structured note” as defined here); the admissibility, classification and measurement of a replication (synthetic asset) transaction are not preemptively determined by the principles-based bond definition, and should be evaluated in accordance with the guidance on replication (synthetic asset) transactions within this standard.

### ***SSAP No. 95—Nonmonetary Transactions***

6. Fair value of assets received or transferred in a nonreciprocal transfer shall be measured based on statutory accounting principles for the type of asset transferred. Accordingly, the value shall be determined in accordance with SSAP No. 26R—*Bonds*, SSAP No. 30R—*Unaffiliated Common Stock*, SSAP No. 32R—*Preferred Stock*, SSAP No. 37—*Mortgage Loans*, SSAP No. 39—*Reverse Mortgages*, SSAP No. 40R—*Real Estate Investments*, SSAP No. 43R—~~*Loan-Backed and Structured*~~*Asset-Backed Securities*, SSAP No. 90—*Impairment or Disposal of Real Estate Investments* or other applicable statements. The guidance provided in SSAP No. 25 shall be followed in accounting for nonreciprocal transactions with affiliates and other related parties as defined in that statement.

### ***SSAP No. 100—Fair Value (No Changes)***

48. For each class of assets and liabilities measured and reported<sup>3</sup> at fair value or NAV in the statement of financial position after initial recognition. The reporting entity shall determine appropriate classes of assets and liabilities in accordance with the annual statement instructions.

Footnote 3: The term “reported” is intended to reflect the measurement basis for which the asset or liability is classified within its underlying SSAP. For example, a bond with an NAIC designation of 2 is considered an amortized cost measurement and is not included within this disclosure even if the amortized cost and fair value measurement are the same. An example of when such a situation may occur includes a bond that is written down as other-than-temporarily impaired as of the date of financial position. The amortized cost of the bond after the recognition of the other-than-temporary impairment may agree to fair value, but under SSAP No. 26R this security is considered to still be reported at amortized cost.

### ***SSAP No. 103R—Transfers and Servicing of Financial Assets and Extinguishments of Liabilities***

2. This statement focuses on the issues of accounting for transfers and servicing of financial assets and extinguishments of liabilities. This statement establishes statutory accounting principles for transfers and servicing of financial assets, including asset securitizations and securitizations of policy acquisition costs, extinguishments of liabilities, repurchase agreements, repurchase financing and reverse repurchase agreements, including dollar repurchase and dollar reverse repurchase agreements that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts). This statement discusses generalized situations. Facts and circumstances and specific contracts need to be considered carefully in applying this statement. Securitizations of nonfinancial assets are outside

the scope of this statement. Transfers of financial assets that are in substance real estate shall be accounted for in accordance with *SSAP No. 40R—Real Estate Investments*. Additionally, retained beneficial interests from the sale of ~~loan-backed or structured~~ asset-backed securities are to be accounted for in accordance with the statutory accounting statement that is applicable to the investment retained ~~with~~ SSAP No. 43R—Loan-Backed and Structured Securities, Revised. If the retained security does not qualify for reporting as a bond under the bond definition detailed in SSAP No. 26R, it shall be reported as a debt security that does not qualify as a bond in scope of SSAP No. 21R—Other Admitted Assets.

11. Upon completion of a transfer of an entire financial asset or a group of entire financial assets that satisfies the conditions to be accounted for as a sale (see paragraph 8), the transferor (seller) shall:

- a. Derecognize the transferred financial assets;
- b. Recognize and initially measure at fair value servicing assets, servicing liabilities, and any other assets obtained (including a transferor’s beneficial interest in the transferred financial assets) and liabilities incurred<sup>1</sup> in the sale (paragraphs 60 and 62-66).
- c. For reporting entities required to maintain an Interest Maintenance Reserve (IMR), the accounting for realized and unrealized capital gains and losses shall be determined per the guidance in the SSAP for the specific type of investment ~~(e.g., SSAP No. 43R for loan-backed and structured securities)~~, or if not specifically stated in the related SSAP, in accordance with *SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve*. For reporting entities not required to maintain an IMR, realized capital gains and losses shall be reported as net realized capital gains or losses in the statement of income, and unrealized capital gains and losses shall be reported as net unrealized gains and losses in unassigned funds (surplus).

The transferee shall recognize all assets obtained and any liabilities incurred, and initially measure them at fair value.

Footnote 1: Some assets that might be obtained and liabilities that might be incurred include cash, put or call options that are held or written (for example, guarantee or recourse obligations), forward commitments (for example, commitments to deliver additional receivables during the revolving periods of some securitizations) and swaps (for example, provisions that convert interest rates from fixed to variable).

### Financial Assets Subject to Prepayment

18. Financial assets, except for instruments that are within the scope of *SSAP No. 86—Derivatives*, that can contractually be prepaid or otherwise settled in such a way that the holder would not recover substantially all of its recorded investment shall be assessed in accordance with the bond definition captured in SSAP No. 26R—Bonds to determine appropriate accounting and reporting. Securities that do not qualify for bond reporting shall be captured as debt securities that do not qualify as bonds in scope of SSAP No. 21R—Other Admitted Assets. ~~subsequently measured in accordance with the statutory accounting statement that is applicable to the financial asset, subsequently measured like investments in debt securities and loan-backed and structured securities in accordance with SSAP No. 43R. Examples of such financial assets include, but are not limited to, interest-only strips, other beneficial interests, loans, or other receivables.~~

### INT 01-25: Accounting for U.S. Treasury Inflation-Indexed Securities

- No Change – Applies to SSAP No. 26R.

***INT 06-02: Accounting and Reporting for Investments in a Certified Capital Company (CAPCO)***

5. For Issue 1, the Working Group came to a consensus that reporting entities should account and report for investments in CAPCO's consistent with the agreement structure within the guidance provided below:

- h. Investment in a debt instrument of a CAPCO shall be reported as a bond in accordance with 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 (Valuations of Securities manual) as stated in SSAP No. 26R, paragraph 20~~11~~.
- i. Investment in an equity interest of a CAPCO shall be reported as common stock and reported at fair value as stated in SSAP No. 30R, paragraph 8.
- j. Investment in preferred stock interest of a CAPCO shall be reported as preferred stock in accordance with 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 (Valuations of Securities manual) as stated in SSAP No. 32R, paragraphs 19-22.
- k. Investment in a Joint Venture, Partnership and Limited Liability Company (LLC) shall be reported in accordance with SSAP No. 48, paragraphs 5-6. The reported value of the investment shall be decreased in proportion to the premium tax credits utilized.
- l. The tax credits shall be recognized as a reduction of the tax liabilities as they are utilized. Tax credits received are not to be included in investment income.

***INT 06-07: Definition of Phrase "Other Than Temporary"***

- Update interpreted SSAP list to reference to *SSAP No. 43R—Asset-Backed Securities*

***INT 07-01: Application of the Scientific (Constant) Yield Method in Situations of Reverse Amortizations***

1. SSAP No. 26R and SSAP No. 43R both reference the use of the scientific or constant yield method of amortization of a premium or a discount. ~~SSAP No. 26R—Bonds provides the following (bolding added for emphasis):~~

**~~Amortized Cost~~**

~~9. Amortization of bond premium or discount shall be calculated using the scientific (constant yield) interest method taking into consideration specified interest and principal provisions over the life of the bond. Bonds containing call provisions (where the issue can be called away from the reporting entity at the issuer's discretion) shall be amortized to the call or maturity value/date which produces the lowest asset value (yield to worst).~~

~~SSAP No. 43R—Loan Backed and Structured Securities provides the following (bolding added for emphasis):~~

## Amortization

~~8. Amortization of premium or discount shall be calculated using the scientific (constant yield) interest method and shall be recorded as an adjustment to investment income. The interest method results in a constant effective yield equal to the prevailing rate at the time of purchase or at the time of subsequent adjustments to book value. The amortization period shall reflect estimates of the period over which repayment of principal of the loan-backed securities is expected to occur, not the stated maturity period.~~

## Collection of All Contractual Cashflows is Probable

~~12. The following guidance applies to loan-backed and structured securities for which it is probable that the investor will be able to collect all contractually required payments receivable. (Paragraphs 17-19 provide guidance for securities in which collection of all contractual cash flows is not probable and paragraphs 20-24 provide guidance for beneficial interests.) Prepayments are a significant variable element in the cash flow of loan-backed securities because they affect the yield and determine the expected maturity against which the yield is evaluated. Falling interest rates generate faster prepayment of the mortgages underlying the security, shortening its duration. This causes the reporting entity to reinvest assets sooner than expected at potentially less advantageous rates. This is called prepayment risk. Extension risk is created by rising interest rates which slow repayment and can significantly lengthen the duration of the security. Differences in cash flows can also result from other changes in the cash flows from the underlying assets. If assets are delinquent or otherwise not generating cash flow, which should be reflected in the cash flow analysis through diminishing security cash flows, even if assets have not been liquidated and gain/losses have not been booked.~~

~~13. Changes in currently estimated cash flows, including the effect of prepayment assumptions, on loan-backed securities shall be reviewed periodically, at least quarterly. The prepayment rates of the underlying loans shall be used to determine prepayment assumptions. Prepayment assumptions shall be applied consistently across portfolios to all securities backed by similar collateral (similar with respect to coupon, issuer, and age of collateral). Reporting entities shall use consistent assumptions across portfolios for similar collateral within controlled affiliated groups. Since each reporting entity may have a unique method for determining the prepayment assumptions, it is impractical to set standard assumptions for the industry. Relevant sources and rationale used to determine each prepayment assumption shall be documented by the reporting entity.~~

~~14. Loan-backed securities shall be revalued using the currently estimated cash flows, including new prepayment assumptions, using either the prospective or retrospective adjustment methodologies, consistently applied by type of securities. However, if at any time during the holding period, the reporting entity determines it is no longer probable that they will collect all contractual cashflows, the reporting entity shall apply the accounting requirements in paragraphs 17-19.~~

~~15. The prospective approach recognizes, through the recalculation of the **effective yield** to be applied to future periods, the effects of all cash flows whose amounts differ from those estimated earlier and the effects and changes in projected cash flows. Under the prospective method, the recalculated effective yield will equate the carrying amount of the investment to the present value of the anticipated future cash flows. The recalculated yield is then used to accrue income on the investment balance for subsequent accounting periods. There are no accounting changes in the current period unless the security is determined to be other than temporarily impaired.~~

~~16. The retrospective methodology changes both the yield and the asset balance so that expected future cash flows produce a return on the investment equal to the return now expected over the life of the investment as measured from the date of acquisition. Under the retrospective method, the recalculated **effective yield** will equate the present value of the actual and anticipated cash flows with the original cost of the investment. The current balance is then increased or decreased to the amount that would have resulted had the revised yield been applied since inception, and investment income is correspondingly decreased or increased.~~

2. This interpretation~~The following~~ identifies three situations where, using a constant yield methodology for determining amortization or accretion, changes in amortized value move in the opposite direction of what is expected. That is, if a security is purchased at a premium, the constant yield methodology will, in certain cases, cause the amortized value to move to a discount during the life of the security. Conversely, if the security were purchased at a discount, the constant yield methodology will, in certain cases, cause the amortized value to move to a premium during the life of the security.

#### ***INT 19-02: Freddie Mac Single Security Initiative***

- Update interpreted SSAP list to reference to *SSAP No. 43R—Asset-Backed Securities*
  1. This interpretation has been issued to provide a limited-scope exception to the exchange and conversion guidance in *SSAP No. 26R—Bonds* as well as prescribe guidance in *SSAP No. 43R—Asset-Backed ~~Loan-Backed and Structured~~ Securities* (SSAP No. 43R) for instruments converted in accordance with the Freddie Mac Single Security Initiative. Under this initiative, reporting entities will be permitted to exchange “45-day securities” for “55-day securities” without any material change to the securities, or to the loans that back the securities. (With the exchange, there would be a 10-day delay in payment cycle.)

#### ***INT 22-01: Freddie Mac When Issued K-Deal (WI Trust) Certificates***

- Update interpreted SSAP list to reference to *SSAP No. 43R—Asset-Backed Securities*
  1. This interpretation is to address questions on the accounting and reporting for Freddie Mac “When-Issued K-Deal (WI Trust) Certificates” (WI Program). Ultimately, the question is whether the structure should be initially captured in scope of *SSAP No. 43R—~~Loan-Backed and Structured~~Asset-Backed Securities* or as a forward contract in scope of *SSAP No. 86—Derivatives*.

## Summary of SAP Guidance Revisions:

### *SSAP No. 2R—Cash, Cash Equivalents, Drafts and Short-Term Investments*

#### Cash Equivalents

6. Cash equivalents are short-term, highly liquid investments that are both (a) readily convertible to known amounts of cash, and (b) so near their maturity that they present insignificant risk of changes in value because of changes in interest rates. Only investments with original maturities<sup>1</sup> of three months or less can qualify under this definition, with the exception of money market mutual funds, as detailed in paragraph 8, and cash pooling, as detailed in paragraph 9. Regardless of maturity date, the following investments are not permitted to be reported as cash equivalents and shall be reported on the investment schedule that corresponds to the SSAP for which the investment is applicable:

a. Asset-backed securities captured in scope of SSAP No. 43R.

b. All debt securities that do not qualify as bonds which are in scope of SSAP No. 21R.

~~a.c. , d~~ Derivative instruments in scope of SSAP No. 86 or SSAP No. 108 shall not be reported as cash equivalents and shall be reported as derivatives on Schedule DB.

d. Working capital finance investments in scope of SSAP No. 105R.

~~b.e.~~ Securities with terms that are reset at predefined dates (e.g., an auction-rate security that has a long-term maturity and an interest rate that is regularly reset through a Dutch auction) or have other features an investor may believe results in a different term than the related contractual maturity shall be accounted for based on the contractual maturity at the date of acquisition, except where other specific rules within the statutory accounting framework currently exist.

#### Short-Term Investments

14. Short-term investments are investments that do not qualify as cash equivalents with remaining maturities (or repurchase dates under reverse repurchase agreements) of one year or less at the time of acquisition. Short-term investments can include, but are not limited to bonds, commercial paper, reverse repurchase agreements, and collateral and mortgage loans which meet the noted criteria. Short-term investments shall not include investments specifically classified as cash equivalents as defined in this statement, certificates of deposit, or derivatives. Regardless of maturity date, the following investments are not permitted to be reported as cash equivalents and shall be reported on the investment schedule that corresponds to the SSAP for which the investment is applicable:

a. Asset-backed securities captured in scope of SSAP No. 43R.

b. All debt securities that do not qualify as bonds which are in scope of SSAP No. 21R.

~~c.~~ d Derivative instruments in scope of SSAP No. 86 or SSAP No. 108 shall not be reported as short term investments and shall be reported as derivatives on Schedule DB.

d. Working capital finance investments in scope of SSAP No. 105R.

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<sup>1</sup> Original maturity means original maturity to the entity holding the investment. For example, both a three-month U.S. Treasury bill and a three-year Treasury note purchased three months from maturity qualify as cash equivalents. However, a Treasury note purchased three years ago does not become a cash equivalent when its remaining maturity is three months.