Statutory Accounting Principles (E) Working Group
Meeting Agenda
August 10, 2022
10:00 a.m. – Noon (Pacific)

A. <u>Consideration of Maintenance Agenda – Pending List</u>

1. Ref #2022-09: ASU 2022-01: Fair Value Hedging – Portfolio Layer Method
2. Ref #2022-10: ASU 2022-02: Troubled Debt Restructurings and Vintage Disclosures
3. Ref #2022-11: Collateral for Loans
4. Ref #2022-12: Review of INT 03-02: Modifications to an Existing Intercompany Pooling Arrangement
5. Ref #2022-13: Related Party - Footnote Updates

Ref #	Title	Attachment #
2022-09 SSAP No. 86 (Julie)	**ASU 2022-01: Fair Value Hedging – Portfolio Layer Method**	**A – Agenda Item**

Summary:
In August 2017, the FASB issued *ASU 2017-12, Derivatives and Hedging: Targeted Improvements to Accounting for Hedging Activities*. Under that ASU, the FASB added guidance to incorporate a "last-of-layer" method to make portfolio fair value hedge accounting more accessible for specific assets. Under the last-of-layer approach, for a closed portfolio of prepayable financial assets or one or more beneficial interests secured by a portfolio of prepayable financial instruments, entities were allowed to hedge a stated amount of the asset or assets in the closed portfolio that is anticipated to be outstanding for the designated hedged period. If the requirements for the last-of-layer method were met, prepayment risk is not incorporated into the measurement of the hedged item.

With the issuance of the last-of-layer guidance in ASU 2017-12, a number of questions were received. After considering those questions, *ASU 2022-01, Fair Value Hedging – Portfolio Layer Method* was issued to address. This ASU expanded the original guidance and provided additional specifications and guidance as follows:

- Expands the last-of-layer method that permitted only one hedged layer to allow multiple hedged layers of a single closed portfolio. This resulted in a name change from last-of-layer to "portfolio layer method."

- Expands the scope to include nonprepayable financial assets.

- Specifies that eligible hedging instruments in a single-layer hedge may include spot-starting or forward-starting constant notional swaps, or spot or forward-starting amortizing-notional swaps and that the number of hedged layers (that is single or multiple) corresponds with the number of hedges designated.

- Provides additional guidance on the accounting for and disclosure of hedge basis adjustments that are applicable to the portfolio layer method whether a single hedged layer or multiple hedged layers are designated.

- Specifies how hedge basis adjustments should be considered when determining credit losses (impairment) for the assets included in the closed portfolio.

The U.S. GAAP concepts for last-of-layer / portfolio layer method hedging within ASU 2017-12 and ASU 2022-01 are new concepts for statutory accounting. Although there is a general assessment that determination of effective hedges shall be consistent between SAP and U.S. GAAP, incorporating guidance to facilitate the portfolio layer method hedge approach for statutory accounting is expected to necessitate new concept revisions to *SSAP No. 86—Derivatives*.

Initial staff assessments on the U.S. GAAP guidance considered potential issues with how hedge basis adjustments are reflected, as U.S. GAAP prevents basis adjustments directly to assets hedged in a portfolio. However, after discussing with industry, and analyzing how the differences in measurement / recognition between U.S. GAAP and SAP impact this assessment, the basis adjustment impact for portfolio layer method hedges will only occur at the time of dedesignation. This is because SAP generally uses an amortized cost approach for effective hedges (if the hedged item is valued at amortized cost), and the derivative mirrors that measurement method. Under U.S. GAAP, where they both use a fair value method, basis adjustments occur frequently to reflect the change in fair value. With the SAP measurement approach, fair value hedge basis adjustments only occur at hedge termination or at dedesignation. As such, this is not a key SAP impact.

As detailed in the recommended action, industry has proposed to also capture the partial term hedging concepts from U.S. GAAP as part of the revisions proposed from this agenda item. One of the key concerns for partial term hedges was the potential for interim adjustments to hedged items (as the derivative term would no longer commonly match the hedged item term). Industry has proposed to limit the application of the partial term guidance only to the hedge of recognized assets (and not liabilities). This is a different application scope for partial term hedges from U.S. GAAP but mirrors the U.S. GAAP guidance for the portfolio layer method and will limit the potential for hedge basis adjustments to result with a financial statement presentation that a liability has been reduced when the actual liability has not been reduced. Although the existing guidance within SSAP No. 86 can result with this impact, it is limited as most derivatives mirror the term of the hedged item. Although NAIC staff still recommends a review of the existing guidance in SSAP No. 86 on how basis adjustments are reflected, by limiting the partial term approach to hedges of recognized assets, it permits the partial term hedge guidance to be incorporated before the broader discussion. From discussions with industry, the current application of the partial term hedge approach is limited to recognized assets, so this modification satisfies the current need and prevents significant concerns on how the guidance could impact the presentation of liabilities. Discussion of the partial term hedge approach was detailed in agenda item 2021-20, but key aspects are summarized below:

> <u>Partial Term Hedging:</u>
> This provision allows reporting entities to enter into fair value hedges of interest rate risk for only a portion of the term of the hedged financial instrument. Prior to the ASU, these sorts of arrangements were not successful in being identified as highly effective due to offsetting changes in the fair value as a result of the difference in timing between the hedged item's principal repayment and the maturity date of the hedging derivative. Under ASU 2017-12, an entity may measure the change in the fair value of the hedged item attributable to changes in the benchmark interest rate by "using an assumed term that begins when the first hedged cash flow begins to accrue and ends when the last hedged cash flow is due and payable." Also, the hedged item's assumed maturity will be the date on which the last hedged cash flow is due and payable, therefore a principal payment will be assumed to occur at the end of the specified partial term.

Recommendation:
NAIC staff has been working with industry representatives on ASU 2022-01 for portfolio layer method hedges, as well as on the U.S. guidance for partial term derivatives issued in ASU 2017-12. With these efforts, industry has provided NAIC staff suggested edits to incorporate key aspects of the U.S. GAAP guidance for portfolio layer method hedges and partial-term hedges into SSAP No. 86. **NAIC staff recommends that the Working Group classify this agenda item as a New SAP Concept and expose the proposed edits for comment. It is also recommended that the Working Group direct NAIC staff to prepare one issue paper with all recent and upcoming derivative revisions.** (The issue paper will contain other derivative revisions recently considered from U.S. GAAP.) Summary of Revisions Proposed in this Agenda Item – Portfolio Layer Method and Partial Term:

- <u>SSAP No. 86</u>: Revisions are proposed to paragraph 26 (fair value hedges) to detail criteria for portfolio and partial-term hedges. A small disclosure edit is proposed to paragraph 62 and guidance for reporting when the hedge is discontinued is proposed for inclusion in Exhibit C. Revisions have also been proposed to identify the adoption of *ASU 2022-01, Fair Value Hedging – Portfolio Layer Method* and to adopt with modification the guidance for partial-term hedges from ASU 2017-12. For the current proposal, the partial term hedge guidance

is limited to hedged assets (not liabilities.) This is different from U.S. GAAP, but further statutory discussion is needed on basis adjustments when hedging liabilities, especially under partial term. It has been suggested that the Working Group move forward with incorporating the guidance for hedged assets at this time, as that addresses the current industry need, and consider guidance for hedged liabilities subsequently. (It was noted that industry is not aware of situations of partial-term liability hedges. Furthermore, the adjustment for hedged liabilities is a broader issue in SSAP No. 86, so the revisions would be more expansive.) Portfolio layer method hedges are limited to recognized assets under U.S. GAAP, so proposed guidance for SAP for those hedges is consistent. (Industry has identified that the FASB may consider expanding the scope of portfolio layer method hedges to liabilities. If this occurs, consideration will then occur for statutory accounting.)

- Exhibit A – Assessment of Hedge Effectiveness: Limited revisions to paragraphs 17-18 to mirror updated U.S. GAAP guidance and add a new section

Ref #	Title	Attachment #
2022-10 SSAP No. 36 (Julie)	**ASU 2022-02: Troubled Debt Restructurings and Vintage Disclosures**	**B – Agenda Item**

Summary:
In April 2022, the Financial Accounting Standards Board (FASB) issued *Accounting Standards Update* (ASU) *2022-02: Troubled Debt Restructurings and Vintage Disclosures* to eliminate prior U.S. GAAP guidance for troubled debt restructurings (TDRs) by creditors and instead require an entity to evaluate whether the modification represents a new loan or a continuation of an existing loan. The elimination of the separate TDR recognition and measurement guidance was supported for U.S. GAAP as losses are captured in the allowance for credit losses, pursuant to *ASU 2016-13: Measurement of Credit Losses on Financial Instruments*. With ASU 2022-02, expanded U.S. GAAP disclosures have been incorporated for modifications provided to debtors experiencing financial difficulty. Also, the ASU revises the ASU 2016-13 vintage gross write-off disclosures for public business entities. The effective date of ASU 2022-02 is Jan. 1, 2023, for entities that have adopted ASU 2016-13. For entities that have yet to adopt ASU 2016-13 (also known as the "current expected credit loss" - CECL standard), the effective date of ASU 2022-02 will occur concurrently when an entity adopts ASU 2016-13.

Previously issued U.S. GAAP guidance involving TDRs by creditors was adopted with modification in *SSAP No. 36—Troubled Debt Restructuring*. This guidance was originally issued in *FAS 15, Accounting for Debtors and Creditors for Troubled Debt Restructurings* and then captured in the *FASB Accounting Standards Codification (ASC) 310-40: Receivables – Troubled Debt Restructuring by Creditors*. This ASC guidance has been predominantly superseded with the issuance of ASU 2022-02. Under the existing statutory accounting guidance, if the fair value of the modified loan is less than the recorded investment in the loan (including accrued interest, net deferred loan fees or costs, and unamortized premium or discount), a new cost basis is established at the fair value, with the difference recorded as a realized loss in the statement of operations.

Under ASU 2016-13 (the CECL standard) assets are reported at the net amount expected to be collected. For assets held at amortized cost, a valuation allowance reflecting expected credit losses is established and is deducted from the amortized cost basis to present the net carrying amount expected to be collected. For assets held at fair value, there is still an allowance for credit losses, however it is permissible for reversals of credit losses previously recorded to be reflected in net income. (For assets held at fair value, the CECL model does not change measurement method, but changes the process for recognizing fluctuations in fair value as a result of credit losses.)

Although consideration of ASU 2016-13 is still pending statutory accounting review, from initial assessments and industry outreach, a full adoption of the CECL standard is not likely to be supported. This is because 1) insurers more commonly hold assets at amortized cost under SAP and at fair value (as available for sale) under U.S. GAAP

– so the CECL model would significantly impact the measurement method under SAP, but not under U.S. GAAP, and 2) the asset-valuation reserve (AVR), a statutory accounting guidance applicable to life and fraternal insurers, establishes a reserve to offset potential credit-related investment losses on most investment categories. With ASU 2016-13 applicable to small public and non-public U.S. GAAP filers as of Jan. 1, 2023, NAIC staff are currently soliciting input from industry on key CECL impacts to assess for statutory accounting purposes. Once that information is received, a further review will occur on ASU 2016-13 to determine the extent that CECL concepts should be reflected within statutory accounting principles.

Under new U.S. GAAP guidance in ASU 2022-02, when the terms of the loan have been revised, creditors would determine whether the changes to the loan are more than minor and if the terms are at least as favorable to the lender as the terms for comparable loans to other customers with similar collection risks who are not refinancing / restructuring a loan. If these criteria are met, then the restructured loan would be accounted for as a new loan. If a new loan, any unamortized net fees or costs and any prepayment penalties from the original loan shall be recognized in interest income when the new loan is granted. If the criteria are not met, the unamortized net fees or costs from the original loan and any prepayment penalties shall be carried forward as a part of the net investment in the new loan. With this approach, the investment in the new loan consists of the net remaining investment in the original loan, any additional funds advanced to the borrower, any fees received, and direct loan origination costs associated with the refinancing or restructuring. It's important to highlight that this U.S. GAAP guidance does not address any loss for the restructured loan as recognition of losses would be captured in the allowance for credit losses pursuant to ASU 2016-13.

With ASU 2022-02, expanded disclosures on commitments and modified loans have been incorporated. Although some of the general concepts within the following U.S. GAAP disclosures are captured in SSAP No. 36, paragraph 23, the new U.S. GAAP disclosures are more specific that what was previously incorporated. (These disclosures are detailed in the agenda item.) In addition to the TDR for creditors guidance, ASU 2022-02 also incorporates and revises "vintage" disclosures for gross write-offs for public business entities involving financing receivables and net investment in leases. These disclosures were originally captured as part of the CECL guidance in ASU 2016-13 for all entities, and the revisions modify and restrict the disclosures to public business entities. (These are also detailed in the agenda item.)

Recommendation:
NAIC staff recommends that the Working Group move this item to the active listing, categorized as a SAP clarification, and expose the intent to retain existing guidance in *SSAP No. 36—Troubled Debt Restructuring* along with revisions to the relevant literature section to identify the rejection of ASU 2022-02 and detail the GAAP/SAP differences for the accounting of troubled debt restructurings for creditors. Note that the proposed revisions to SSAP No. 36, paragraph 26 addresses ASU 2022-02 and paragraphs 27-29 detail the historical differences that are currently in paragraphs 26-30. This minor reorganization was completed in a more reader friendly format as it includes moving old effective date language from the relevant literature section to the effective date paragraph. With this exposure, comments are requested on whether the expanded U.S. GAAP disclosures with modifications should be considered for statutory accounting.

NAIC staff recommends that the CECL disclosures, including the revisions for "vintage gross write-offs" for public business entities be considered as part of the review of ASU 2016-13 for expected credit losses. However, NAIC staff requests comments on this recommendation and whether the disclosures should be considered for in advance of reviewing ASU 2016-13 for statutory accounting.

Ref #	Title	Attachment #
2022-11 SSAP No. 20 (Robin)	**Collateral for Loans**	**C – Agenda Item**

Summary:
This agenda item has been drafted to address an inconsistency regarding the collateral loan guidance in *SSAP No. 20—Nonadmitted Assets* and *SSAP No. 21—Other Admitted Assets* These two statements contain guidance about unsecured and secured loans which is complementary.

SSAP No. 20 details the nonadmitted assets status of unsecured loans and loans secured by assets which do not qualify as investments. SSAP No. 20 also references write-off and impairment guidance in *SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets* for impaired and uncollectible loans. SSAP No. 20 provides that improperly collateralized loans include loans that do not have underlying assets that would otherwise qualify as admitted assets and states that such loans are nonadmitted assets because the collateral would be of questionable economic value if needed to fulfill policyholder obligations. SSAP No. 20 includes similar nonadmission guidance regarding loans on personal security, cash advances to officers or agents and for travel advances.

SSAP No. 21 details the requirements for collateral loans which can qualify to be admitted assets. It provides that the collateral loan must be secured by the pledge of an investment. A footnote further describes that investment collateral would be of a type that would be in Section 3 of *Appendix A-001—Investments of Reporting Entities*. SSAP No. 21 also references the nonadmission guidance in SSAP No. 20 for collateral loans secured by assets that do not qualify as investments. The referenced guidance in SSAP No. 20 notes that the underlying assets must qualify as admitted assets.

Both SSAP No. 20 and SSAP No. 21 identify the need for adequate collateral that qualifies as an "invested asset." SSAP No. 20 is explicit that the investment asset collateral must qualify as an admitted asset. Recent discussions with state regulators have highlighted that although SSAP No. 21 references the guidance in SSAP No. 20, that it would be beneficial to also note the need for the collateral to qualify as an admitted invested asset. This agenda item recommends a clarification to SSAP No. 21 that the acceptable invested asset collateral, for collateral loans must qualify as admissible invested assets.

Recommendation:
NAIC staff recommends that the Working Group move this item to the active listing, categorized as a SAP clarification, and expose the revisions to SSAP No. 21 to clarify that the invested assets pledged as collateral for admitted collateral loans must qualify as admitted invested assets.

Collateral Loans

4. Collateral loans are unconditional obligations[2] for the payment of money secured by the pledge of a~~n~~ qualifying investment[3] 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:

a. Loan Impairment—Determination as to the impairment of a collateral loan shall be based on current information and events. When it is considered probable that any portion of amounts due under the contractual terms of the loan will not be collected the loan is considered impaired. The impairment shall be measured based on the fair value of the collateral less estimated costs to obtain and sell the collateral. The difference between the net value of the collateral and the recorded asset shall be written off in accordance with *SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets*;

b. Nonadmitted Asset—In accordance with *SSAP No. 20—Nonadmitted Assets*, collateral loans secured by assets that do not qualify as investments which would otherwise be admitted shall be nonadmitted. Further, any amount of the loan outstanding which is in excess of the permitted relationship of fair value of the pledged investment to the collateral loan shall be treated as a nonadmitted asset.

[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 (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 that are also secured with collateral shall continue to be captured within scope of SSAP No. 26R.

[1] A qualifying ~~I~~investment defined as those assets listed in Section 3 of *Appendix A-001—Investments of Reporting Entities* which would ~~-~~if held by the insurer would qualify for admittance. For example, if the collateral would not qualify for admittance under SSAP No. 4 due to encumbrances or other third-party interests, then it does not meet the definition of "qualifying" and the collateral loan, or any portion thereof which is not adequately collateralized, is not permitted to be admitted.

Ref #	Title	Attachment #
2022-12 INT 03-02 (Robin)	**Review of INT 03-02*: Modification to an Existing Intercompany Pooling Arrangement***	**D – Agenda Item E - INT 03-02**

Summary:
This agenda item provides a review of Interpretation (INT) 03-02*: Modification to an Existing Intercompany Pooling Arrangement*, because of conflicts between INT 03-02 and *SSAP No. 25—Affiliates and Other Related Parties*. This agenda item was prompted by the recent focus of Statutory Accounting Principles (E) Working Group on related party transactions, recent queries to NAIC about how broadly to apply the guidance in INT 03-02 and the review of the SSAP No. 62R, paragraph INT 03-02 addresses the valuation of bonds in instances when bonds are used instead of cash for the payment among affiliates for amounts due on modifications to existing intercompany reinsurance pooling contracts. The discrepancy between the INT 03-02 and SSAP No. 25 has been identified through recent discussions evaluating related party transactions.

The primary accounting question that is a concern for this agenda item is INT 03-02, paragraph 11b which asks, "What is the appropriate valuation basis to be used for assets and liabilities that are transferred among affiliates in conjunction with the execution of a new reinsurance agreement(s) that serves to substantively modify an existing intercompany pooling arrangement?" The response provided in INT 03-02, paragraph 13 is, "The appropriate valuation basis to be used for assets and liabilities that are transferred among affiliates in conjunction with the execution of a new reinsurance agreement(s) that serves to substantively modify an existing intercompany pooling arrangement is statutory book value for assets and statutory value for liabilities. Book value is defined in the glossary of the *Accounting Practices and Procedure Manual*."

INT 03-02 lists that it is an interpretation of the following three reinsurance statements: *SSAP No. 61R—Life, Deposit-Type and Accident and Health Reinsurance*, *SSAP No. 62R—Property and Casualty Reinsurance* and *SSAP No. 63—Underwriting Pools. SSAP No. 25—Affiliates and Other Related Parties* is not listed as an interpreted statement. However, as described below, the consensus in INT 03-02, paragraph 13 is not consistent with the guidance in SSAP No. 25 regarding economic transactions between related parties.

The result of the consensus in INT 03-02, paragraph 13 allows assets used in affiliated payments for reinsurance contracts, which modify existing intercompany reinsurance pooling agreements, to be transferred using statutory book value. Note that in most cases, this means that bonds which are likely the primary assets that would be used,

would typically have a statutory book value that reflects amortized cost. The valuation of assets using statutory book value on transfer to an affiliate, can result in substantial differences from the cash equivalent (fair value) for the payment due. For example, bonds reported at amortized cost book value could have a corresponding fair value that is materially higher or lower. This difference in valuation can result in an unacknowledged dividend or with the passing on of an investment loss.

SSAP No. 25 describes economic transactions and non-economic transactions. Economic transactions are defined as arm's-length transactions which results in the transfer of the risks and rewards of ownership and represents a consummated act thereof, i.e., "permanence." SSAP No. 25, paragraph 18 indicates that economic transactions between related parties shall be recorded at fair value at the date of the transaction and also notes that to the extent that the related parties are affiliates under common control, the controlling reporting entity shall defer the effects of such transactions that result in gains or increases in surplus until such time that the asset is sold outside the group.

It is quite possible, by using transfers at book value instead of fair value, to design a transaction with a very significant economic effect. The following example illustrates the concern with the results of the guidance in INT 03-02. For this example, $100 million is due on an existing intercompany reinsurance pooling agreement. INT 03-02 would allow bonds to be settled using statutory book value which may not be reflective of the fair value equivalent of a cash settlement.

Asset used to settle	**Book Value (millions) measurement for settlement**	**Fair Value (millions)**	**Result**	**Consistent with SSAP No. 25 for an economic transaction?**
Cash	$100	$100	No difference in basis	Yes
Bonds	$100	$ 85	$15 difference in fair value means the paid party received an amount less than what is actually owed. This approach could allow reporting entities to transfer impaired assets to affiliates in lieu of assessing OTTI.	No
Bonds	$100	$110	$10 difference in fair value means the paid party has received an asset greater than what was owed. This dynamic could result in an unrecognized gain or dividend.	No

The INT 03-02 direction to use statutory book value for the transfer of bonds between affiliated entities in most instances would conflict with the primary guidance on affiliated transactions contained in *SSAP No. 25—Affiliates and Other Related Parties.* For example, economic transactions between related parties are valued using fair value. (There are more nuances in SSAP No. 25 when payments have the possibility of being economic for one entity and noneconomic for an upper-level parent). NAIC staff recommends that the treatment of transfers of assets between affiliates should be consistent for all intercompany transactions and there is not a compelling need to be different if assets are transferred instead of cash for intercompany reinsurance.

Under INT 03-02, for intercompany reinsurance transactions, takes an approach that either SSAP No. 25 or SSAP No. 62R may apply, but multiple Working Group discussions have noted that SSAP No. 25 provides the overarching guidance that is relevant in evaluating all related party transactions. INT 03-02, paragraph 8 indicates that the statutory accounting intention is to avoid surplus gains for the ceding entity as a result of implementing a modification to an intercompany pooling arrangement. However, the guidance in SSAP No, 62R, paragraph 37 uses a more punitive method of accounting if there is a gain in surplus to the ceding entity as a result of the intercompany reinsurance transaction. Therefore, NAIC staff would characterize the SSAP No. 62R guidance as imposing an accounting penalty if there is a gain, rather than seeking to avoid recognizing such a gain. The INT also characterizes

SSAP No. 25 as being for isolated transactions, which is inconsistent with discussions of the Working Group on the applicability of SSAP No. 25.

SSAP No. 62R, paragraph 36d includes an exception to retroactive reinsurance accounting which allows prospective accounting treatment for intercompany reinsurance agreements and any amendments thereto, among companies 100% owned by a common parent or ultimate controlling person provided there is no gain in surplus as a result of the transaction. Paragraph 37 provides that if there is a gain to the ceding entity that a more restrictive method of accounting is required which is less beneficial to the financial statements. Whereas the INT tries to argue that statutory intent is to avoid surplus gain, NAIC staff would note that the goal is not to avoid gain as a result of the reinsurance transaction, but to impose a different accounting if there is a gain. NAIC staff would characterize evaluating reinsurance agreements for SSAP No. 62R, paragraph 36d or paragraph 37 as using the cash flows or corresponding equivalent fair value (cash equivalent) of the amounts payable or receivable in the reinsurance transactions to determine if there is a gain or loss to the ceding entity. The reinsurance cash flows evaluated should be the same as if the bond was sold for fair value and resulting cash equivalent obligation was paid. The fact that the bond sold has a gain or loss is not part of the reinsurance contract evaluation, the reinsurance contract that is an economic transaction evaluation is based on the cash equivalent value of the assets transferred less the liabilities transferred. The evaluation of gain or loss on the intercompany reinsurance transaction should give the same answer if either cash or assets were transferred.

Recommendation:
NAIC staff recommends that the Working Group move this item to the active listing, categorized as a SAP clarification, and expose the intent to nullify INT 03-02, as it is inconsistent with SSAP No. 25 guidance regarding economic and non-economic transactions between related parties. The guidance in INT 03-02 can result with in essence, unrecognized gains (dividends) or losses through the using the statutory book valuation when using assets (bonds) to make payments to affiliates for modifications to existing intercompany reinsurance pooling agreements. Treatment of transfers of assets between affiliates should be consistent for all intercompany transactions and there is not a compelling need to be different when valuing assets for intercompany reinsurance transactions.

Ref #	Title	Attachment #
2022-13 SSAP No. 25 SSAP No. 97 (Jake)	**Related Parties – Footnote Updates**	**F – Agenda Item**

Summary:
On May 24, 2022, the Statutory Accounting Principles (E) Working Group adopted agenda item 2021-21 – Related Party Reporting, which clarified the reporting of affiliate transactions within existing reporting lines in the investment schedules and incorporated new reporting requirements for investment transactions with related parties. During the drafting process, a footnote was added to SSAP No. 25, paragraph 9, and a comment was received from interested parties that suggested to extend the exemption to foreign open-end investment funds governed and authorized in accordance with regulations established by the applicable foreign jurisdiction, which are within the scope of *SSAP No. 30R—Unaffiliated Common Stock*. At the May 24 meeting, the Working Group directed NAIC staff to make this modification.

Recommendation:
NAIC staff recommends that the Working Group move this item to the active listing, categorized as a SAP clarification, and expose revisions to SSAP No. 25 and SSAP No. 97 to incorporate language to exempt foreign open-end investment funds governed and authorized in accordance with regulations established by the applicable foreign jurisdiction from the look-through provisions included in SSAP No. 25.

B. <u>Consideration of Maintenance Agenda – Active Listing</u>

1. Ref #2021-25: Leasehold Improvements after Lease Termination
2. Ref #2019-21: Proposed Bond Definition

Ref #	Title	Attachment #
2021-25 SSAP No. 19 SSAP No. 73 (Jake)	**Leasehold Improvements after Lease Termination**	**G – Agenda Item**

<u>Summary:</u>
On December 11, 2021, the Working Group exposed SAP clarification revisions to *SSAP No. 19—Furniture, Fixtures, Equipment and Leasehold Improvements* and *SSAP No. 73—Health Care Delivery Assets and Leasehold Improvements in Health Care Facilities* to address questions about the treatment of leasehold improvements in situations where a leased property is purchased by the lessee during the lease term. In these scenarios, it was identified that the reporting entity had acquired a property that was initially subject to a lease; and per current statutory guidance, the amortization of leasehold improvements is only permitted over the shorter of the estimated useful life of the improvement or the lease term (as defined in *SSAP No. 22R—Leases*). In a normal lease termination, one where the lessee does not acquire said property, any remaining leasehold improvements at the time of termination shall be immediately expensed. This agenda item was initially drafted to clarify this guidance to articulate that in any scenario in which a lease terminates early, that all remaining leasehold improvements shall be immediately expensed.

At the 2022 Spring National Meeting, the Working Group directed NAIC staff to work with interested parties to further refine the guidance, and as a result have updated the proposed language to include an exclusion that would allow companies that provide direct healthcare to excludes situations where the real estate lease agreement has a purchase option that contains language that allows leasehold improvements necessary for the functionality of specific health care delivery assets to be excluded from the purchase cost of the real estate. After purchase, the leasehold improvements necessary for the functionality of healthcare delivery assets would follow the guidance for health care delivery assets in SSAP No. 73.

Recommendation:
NAIC staff recommends that the Working Group move this item to the active listing, categorized as SAP clarification and expose revisions to SSAP No. 19 and SSAP No. 73 to ensure that the guidance for the leasehold improvements matches the treatment provided in *SSAP No. 40R—Real Estate Investments.* These edits will clarify that amortization of leasehold improvements will immediately end when a lease is terminated and will require that any remaining, unamortized leasehold improvement balance be immediately expensed. This will include scenarios where the lease terminates naturally or when the lessee purchases a property it was leasing but **<u>proposes a limited, specific exclusion in SSAP No. 73 that allows leasehold improvements necessary for the functionality of specific health care delivery assets to be excluded in some cases from the purchase cost of the real estate</u>**. It is presumed that the purchase of a property from a third party would normally include the leasehold improvements as part of the full purchase price.

Ref #	Title	Attachment #
2019-21 SSAP No. 26R SSAP No. 43R (Julie)	**Proposed Bond Definition**	**H - Bond Definition I - Issue Paper J - SSAP No. 26R K - SSAP No. 43R**

Summary:
Pursuant to direction in October 2020, regulators and key industry representatives, have been working dedicatedly on the bond project to principally define a bond for reporting on Schedule D-1 and to improve accounting and reporting. The intent of this project is to establish principle-based guidance for determining bonds, with a focus of substance over form, in such a manner so that the framework and principles established will be able to work for an increasingly innovative market and will provide regulators and other financial statement users with the transparency for understanding the risks present in an insurer's investment portfolio.

In response to the direction from the July 18 call, the following documents have been prepared for Working Group exposure consideration:

- An updated principles-based bond definition. This document has been revised to reflect limited edits directed on July 18. (Previously exposed edits have been accepted, so only new edits are shown tracked.)

- An updated issue paper that reflects the overall discussion from July 18, as well as the noted edits to guidance. The issue paper has been revised to include discussion of feeder funds and how the assessment should focus on the substance of the underlying investment in determining bond classification.

- Proposed revisions to *SSAP No. 26R—Bonds* and *SSAP No. 43R—Asset Backed Securities* to incorporate the principles-based bond definition in authoritative statutory accounting guidance. (Please note, the revisions to SSAP No. 43R include a SSAP name change from "Loan-backed and Structured Securities".) In addition to incorporating the bond concepts, the revisions to SSAP No. 43R also include various revisions to reorganize or update the guidance. A summary page on both SSAPs details the revisions.

Please note that the bond definition (excluding Appendices) has been captured in its entirety within SSAP No. 26R. Then, only the components that pertain to asset backed securities has been captured in SSAP No. 43R. Although this puts key points in both SSAPs, it does result with duplication. NAIC staff solicits feedback on this approach. It was identified as desirable to include the full definition in one SSAP, but it was noted that not including the elements pertaining to asset backed securities in SSAP No. 43R could result with the need to go back and forth the two standards. Consideration was also given to including all the guidance in a single SSAP, however, it was noted that continued separation, particularly for the nuances of cash flow assessments and bifurcated impairment related to ABS, would result with improved clarity and application to the investments captured within the differing standards. Comments are welcome the proposed approach and with alternative suggestions to ensure ease of application.

In addition to the items proposed for exposure, it should also be noted that the Working Group has also recently exposed significant revisions to the reporting of bond investments with comments due Oct. 7:

- Proposed Reporting Lines - This document exposed July 18 proposes annual statement general instructions (reporting line descriptions) for suggested reporting lines to capture issuer credit obligations and asset-backed securities on Schedule D-1. The general classifications that currently exist are proposed to be deleted and new granular reporting lines are suggested.

- Schedule D-1 A/S Instructions – This document exposed July 18 details the overall approach to add a new Schedule D-1 schedule specific to asset-backed securities. D-1-1 would reflect issuer credit obligations (items captured in scope of SSAP No. 26R) and D-1-2 would reflect asset backed securities (items captured

in scope of SSAP No. 43R). This separation of the schedules is supported to enable different reporting columns based on the type of security. Columns that are proposed to be specific to issuer obligations and ABS are noted within the document. In addition to creating new columns, this document also details revisions to existing columns and instructions. There are instances in which columns are proposed to move to electronic only and situations in which the instructions are significantly revised as to what is included.

Recommendation:
NAIC staff recommends that the Working Group expose the updated bond definition, issue paper and SSAP edits for a comment period ending Oct. 7, 2022, to mirror the exposure timeframe of the reporting revisions. NAIC staff recognizes that there is a lot of content exposed, so additional time can be considered if needed. Preliminary comments or questions are welcome anytime during the exposure period. NAIC staff would like to particularly note appreciation for all regulators and industry involved within this project and would like to continue collaborating throughout the exposure timeframe. NAIC staff also notes that additional revisions to other standards and reporting schedules impacted by the changes are still pending. Those revisions are anticipated to be proposed for exposure during the 2022 Fall National Meeting.

ANY OTHER MATTERS

a. Review of GAAP Exposures – Attachment L (Robin)

The attachment details the items currently exposed by the FASB. NAIC staff recommends reviewing the issued ASUs under the standard SAP maintenance process. Comments are not recommended at this time – NAIC staff recommend review of the final issued ASU under the SAP Maintenance Process as detailed in *Appendix F—Policy Statements.*

b. Update for LATF coordination – Attachment M (Robin)

The attachment includes a detailed listing of the amendments made to the *Valuation Manual* by the Life Actuarial (A) Task Force since the 2021 NAIC Summer Meeting. The amendments were adopted by the Life Insurance and Annuities (A) Committee on July 20, 2022. The amendments will be considered for adoption by the Executive (EX) Committee and Plenary at the 2022 NAIC Summer. NAIC staff will provide a verbal update regarding coordination.

Comment Deadline for all Exposures is Friday, October 7, 2022.

https://naiconline.sharepoint.com/teams/FRSStatutoryAccounting/National Meetings/A. National Meeting Materials/2022/7-Summer NM/Meeting/0-8-2022 SAPWG Meeting Agenda.docx

Statutory Accounting Principles (E) Working Group
Maintenance Agenda Submission Form
Form A

Issue: ASU 2022-01 – Fair Value Hedging – Portfolio Layer Method

Check (applicable entity):

	P/C	Life	Health
Modification of Existing SSAP	☒	☒	☒
New Issue or SSAP	☐	☐	☐
Interpretation	☐	☐	☐

Description of Issue: In August 2017, the FASB issued *ASU 2017-12, Derivatives and Hedging: Targeted Improvements to Accounting for Hedging Activities*. Under that ASU, the FASB added guidance to incorporate a "last-of-layer" method to make portfolio fair value hedge accounting more accessible for specific assets. Under the last-of-layer approach, for a closed portfolio of prepayable financial assets or one or more beneficial interests secured by a portfolio of prepayable financial instruments, entities were allowed to hedge a stated amount of the asset or assets in the closed portfolio that is anticipated to be outstanding for the designated hedged period. If the requirements for the last-of-layer method were met, prepayment risk is not incorporated into the measurement of the hedged item.

With the issuance of the last-of-layer guidance in ASU 2017-12, a number of questions were received. After considering those questions, *ASU 2022-01, Fair Value Hedging – Portfolio Layer Method* was issued to address. This ASU expanded the original guidance and provided additional specifications and guidance as follows:

- Expands the last-of-layer method that permitted only one hedged layer to allow multiple hedged layers of a single closed portfolio. This resulted in a name change from last-of-layer to "portfolio layer method."

- Expands the scope to include nonprepayable financial assets.

- Specifies that eligible hedging instruments in a single-layer hedge may include spot-starting or forward-starting constant notional swaps, or spot or forward-starting amortizing-notional swaps and that the number of hedged layers (that is single or multiple) corresponds with the number of hedges designated.

- Provides additional guidance on the accounting for and disclosure of hedge basis adjustments that are applicable to the portfolio layer method whether a single hedged layer or multiple hedged layers are designated.

- Specifies how hedge basis adjustments should be considered when determining credit losses (impairment) for the assets included in the closed portfolio.

The U.S. GAAP concepts for last-of-layer / portfolio layer method hedging within ASU 2017-12 and ASU 2022-01 are new concepts for statutory accounting. Although there is a general assessment that determination of effective hedges shall be consistent between SAP and U.S. GAAP, incorporating guidance to facilitate the portfolio layer method hedge approach for statutory accounting is expected to necessitate new concept revisions to *SSAP No. 86—Derivatives*.

Initial staff assessments on the U.S. GAAP guidance considered potential issues with how hedge basis adjustments are reflected, as U.S. GAAP prevents basis adjustments directly to assets hedged in a portfolio. However, after discussing with industry, and analyzing how the differences in measurement / recognition between U.S. GAAP and SAP impact this assessment, the basis adjustment impact for portfolio layer method hedges will only occur at the time of dedesignation. This is because SAP generally uses an amortized cost approach for effective hedges (if the

hedged item is valued at amortized cost), and the derivative mirrors that measurement method. Under U.S. GAAP, where they both use a fair value method, basis adjustments occur frequently to reflect the change in fair value. With the SAP measurement approach, fair value hedge basis adjustments only occur at hedge termination or at dedesignation. As such, this is not a key SAP impact.

As detailed in the recommended action, industry has proposed to also capture the partial term hedging concepts from U.S. GAAP as part of the revisions proposed from this agenda item. One of the key concerns for partial term hedges was the potential for interim adjustments to hedged items (as the derivative term would no longer commonly match the hedged item term). Industry has proposed to limit the application of the partial term guidance only to the hedge of recognized assets (and not liabilities). This is a different application scope for partial term hedges from U.S. GAAP but mirrors the U.S. GAAP guidance for the portfolio layer method and will limit the potential for hedge basis adjustments to result with a financial statement presentation that a liability has been reduced when the actual liability has not been reduced. Although the existing guidance within SSAP No. 86 can result with this impact, it is limited as most derivatives mirror the term of the hedged item. Although NAIC staff still recommends a review of the existing guidance in SSAP No. 86 on how basis adjustments are reflected, by limiting the partial term approach to hedges of recognized assets, it permits the partial term hedge guidance to be incorporated before the broader discussion. From discussions with industry, the current application of the partial term hedge approach is limited to recognized assets, so this modification satisfies the current need and prevents significant concerns on how the guidance could impact the presentation of liabilities. Discussion of the partial term hedge approach was detailed in agenda item 2021-20, but key aspects are summarized below:

> Partial Term Hedging:
> This provision allows reporting entities to enter into fair value hedges of interest rate risk for only a portion of the term of the hedged financial instrument. Prior to the ASU, these sorts of arrangements were not successful in being identified as highly effective due to offsetting changes in the fair value as a result of the difference in timing between the hedged item's principal repayment and the maturity date of the hedging derivative. Under ASU 2017-12, an entity may measure the change in the fair value of the hedged item attributable to changes in the benchmark interest rate by "using an assumed term that begins when the first hedged cash flow begins to accrue and ends when the last hedged cash flow is due and payable." Also, the hedged item's assumed maturity will be the date on which the last hedged cash flow is due and payable, therefore a principal payment will be assumed to occur at the end of the specified partial term.
>
> The example provided under U.S. GAAP involves outstanding fixed rate debt. So, if an entity was to issue $100 million of five-year, noncallable, fixed-rate debt, the entity could designate a two-year, receive-fixed, pay variable, $100 million notional interest rate swap as a fair value hedge of the interest rate risk for the first two years of the debt's term. When calculating the change in the fair value of the debt attributable to changes in interest rate risk, the entity may assume that 1) the term of the hedged debt is two years, and 2) repayment of the outstanding debt occurs at the end of the second year. The ASU also permits use of the shortcut method to these partial-term fair value hedges of interest rate risk.

Key elements pertaining to portfolio layer method hedging under U.S. GAAP:

- For a closed portfolio of financial assets or one or more beneficial interests secured by a portfolio of financial instruments, an entity may designate as the hedged item or items a hedged layer or layers if the following criteria are met: (*Note – The FASB was asked to consider expanding the scope to include liabilities (specifically, insurance liabilities), and the FASB elected not to expand the portfolio layer method to include hedges of liabilities.)*
    - As part of the initial hedge documentation, an analysis is completed and documented to support the entity's expectation that the hedged item or items (that is, the hedged layer or layers in aggregate) is anticipated to be outstanding for the designated hedge period. That analysis shall incorporate the

entity's current expectations of prepayments, defaults, and other factors affecting the timing and amount of cash flows associated with the closed portfolio.

- For purposes of its analysis, the entity assumes that as prepayments, defaults, and other factors affecting the timing and amount of cash flows occur, they first will be applied to the portion of the closed portfolio that is not hedged.

- The entity applies the partial-term hedging guidance to the assets or beneficial interests used to support the entity's expectation. An asset that matures on a hedged layer's assumed maturity date meets this requirement.

- After a closed portfolio is established, an entity may designate new hedging relationships associated with the closed portfolio without dedesignating any existing hedging relationships associated with the closed portfolio if the criteria are met for those newly designated hedging relationships.

- For one or more existing hedged layer or layers that are designated under the portfolio layer method, the gain or loss (that is, the change in fair value) on the hedged item attributable to the hedged risk shall not adjust the carrying value of the individual beneficial interest or individual assets in or removed from the closed portfolio. Instead, that amount shall be maintained on a closed portfolio basis and recognized currently in earnings.

- If the hedged item is a hedged layer designated in a portfolio layer method hedge on a closed portfolio and the closed portfolio includes only available-for-sale debt securities, the entire gain or loss (that is, the change in fair value) on the hedged item attributable to the hedged risk shall be recognized in earnings rather than in other comprehensive income to offset the gain or loss on the hedging instrument. If the closed portfolio includes available-for-sale debt securities and assets that are not available-for-sale debt securities, an entity shall determine the portion of the change in fair value on the hedged item attributable to the hedged risk associated with the available-for-sale debt securities using a systematic and rational method. That amount shall be recognized in earnings rather than in other comprehensive income. An entity shall not adjust the carrying amount of the individual available-for-sale debt securities included in the closed portfolio.

- For each closed portfolio with one or more hedging relationships designated and accounted for under the portfolio layer method, an entity shall perform and document at each effectiveness assessment date an analysis that supports the entity's expectation that the hedged layer or layers in aggregate is still anticipated to be outstanding for the designated hedge period. That analysis shall incorporate the entity's current expectations of prepayments, defaults, and other factors affecting the timing and amount of cash flows associated with the closed portfolio using a method consistent with the method used to perform the analysis at initial hedge documentation.

- An adjustment that is maintained on a closed portfolio basis in a portfolio layer method hedge in accordance shall be amortized to earnings. Amortization shall begin no later than when the hedged item ceases to be adjusted for changes in its fair value attributable to the risk being hedged. The entity shall fully amortize that adjustment by the hedged item's assumed maturity date.

- An asset or liability that has been designated as being hedged remains subject to the applicable requirements for assessing impairment or credit losses for that type of asset or for recognizing an increased obligation for that type of liability. A portfolio layer method basis adjustment that is maintained on a closed portfolio basis for an existing hedge shall not be considered when assessing the individual assets or individual beneficial interest included in the closed portfolio for impairment or credit losses or when assessing a portfolio of assets for impairment or credit losses. An entity may not apply this guidance by analogy to other components of amortized cost basis. Because the hedging instrument is recognized separately as an asset or liability, its fair value or expected cash flows shall not be considered in applying those impairment or credit loss requirements to the hedged asset or liability.

- For a fair value hedge of interest rate risk in which the hedged item is designated for a partial term, an entity may measure the change in the fair value of the hedged item attributable to interest rate risk using an assumed term that begins when the first hedged cash flow begins to accrue and ends at the end of the designated hedge period. The assumed issuance of the hedged item occurs on the date that the first hedged cash flow begins to accrue. The assumed maturity of the hedged item occurs at the end of the designated hedge period. Additionally, an entity may have one or more separately designated partial-term hedging relationships outstanding at the same time for the same debt instrument (for example, 2 outstanding hedging relationships for consecutive interest cash flows in Years 1–3 and consecutive interest cash flows in Years 5–7 of a 10-year debt instrument).

- An entity may elect to discontinue (or partially discontinue) hedge accounting prospectively for all or a portion of the hedged layer for one or more hedging relationships associated with the closed portfolio at any time if a breach has not occurred and a breach is not anticipated. If multiple hedged layers are associated with the closed portfolio, the entity may voluntarily elect to dedesignate (or partially dedesignate) any hedges associated with that closed portfolio.

- For one or more hedging relationships designated under the portfolio layer method, an entity shall discontinue (or partially discontinue) hedge accounting in the following circumstances:

    - If the entity cannot support on a subsequent testing date that the hedged layer or layers are anticipated to be outstanding for the designated hedge period (that is, a breach is anticipated), it shall discontinue (or partially discontinue) hedge accounting for one or more hedging relationships for the portion of the hedged item that is no longer anticipated to be outstanding for the designated hedge period.

    - If on a subsequent testing date the outstanding amount of the closed portfolio of financial assets or one or more beneficial interests is less than the hedged layer or layers (that is, a breach has occurred), the entity shall discontinue (or partially discontinue) hedge accounting for one or more hedging relationships for the portion of the hedged item that is no longer outstanding.

- In the event of either an anticipated breach or a breach that has occurred, if multiple hedged layers are associated with a closed portfolio, an entity shall determine which hedge or hedges to discontinue (or partially discontinue) in accordance with an accounting policy election. That accounting policy election shall specify a systematic and rational approach to determining which hedge or hedges to discontinue (or partially discontinue). An entity shall establish its accounting policy no later than when it first anticipates a breach or when a breach has occurred (whichever comes first). After an entity establishes its accounting policy, it shall consistently apply its accounting policy to all portfolio layer method breaches (anticipated and occurred).

- If a portfolio layer method hedging relationship is discontinued (or partially discontinued) in a voluntary dedesignation or in anticipation of a breach, the basis adjustment associated with the dedesignated amount as of the discontinuation date shall be allocated to the remaining individual assets in the closed portfolio that supported the dedesignated hedged layer using a systematic and rational method. An entity shall amortize those amounts over a period that is consistent with the amortization of other discounts or premiums associated with the respective assets.

- For a portfolio layer method hedging relationship that is discontinued because a breach has occurred, as of the discontinuation date an entity shall:

- Determine the portion of the basis adjustment associated with the amount of the hedged layer that exceeds the closed portfolio (that is, the portion of the basis adjustment associated with the breach) using a systematic and rational method and immediately recognize that amount in interest income

- Disclose the information specified for the breach.

- A closed portfolio may simultaneously have a layer or layers that have been breached and a layer or layers that it anticipates will be breached. In that case, an entity shall apply the guidance in this paragraph for the breach or breaches that have occurred and the guidance for the anticipated breach or breaches.

- New disclosures that include:
  - Amortized cost basis of closed portfolios of financial assets or beneficial interests
  - Amount that represents the hedged layers
  - Basis adjustments associated with the hedged layers
  - Hedge basis adjustment recognized in current-period interest income because of a breach.
  - Circumstances that led to a breach.

Existing Authoritative Literature:

SSAP No. 86—Derivatives

Establishes statutory accounting guidance for derivative instruments and hedging, income generation and replication (synthetic asset) transactions.

Guidance for portfolio hedges is limited to fair value hedges as follows:

> 26. Fair value hedges qualify for hedge accounting if all of the following criteria are met:
>
> d. The hedged item is specifically identified as either all or a specific portion of a recognized asset or liability or of an unrecognized firm commitment. The hedged item is a single asset or liability (or a specific portion thereof) or is a portfolio of similar assets or a portfolio of similar liabilities (or a specific portion thereof);
>
> e. If similar assets or similar liabilities are aggregated and hedged as a portfolio, the individual assets or individual liabilities must share the risk exposure for which they are designated as being hedged. The change in fair value attributable to the hedged risk for each individual item in a hedged portfolio must be expected to respond in a generally proportionate manner to the overall change in fair value of the aggregate portfolio attributable to the hedged risk; and

Under existing guidance, hedges identified as 'portfolio' hedges that did not qualify within the limited parameters in paragraph 26 did not qualify as hedging and were not permitted "hedge accounting" treatment in the statutory financial statements. Without hedge accounting, the hedging instruments are required to be reported at fair value, with fluctuations in fair value gains and losses recognized through surplus.

> 22. Derivative instruments used in hedging transactions that meet the criteria of a highly effective hedge shall be considered an effective hedge and are permitted to be valued and reported in a manner that is consistent with the hedged asset or liability (referred to as hedge accounting). For instance, assume an entity has a financial instrument on which it is currently receiving income at a variable rate but wishes to receive income at a fixed rate and thus enters into a swap agreement to exchange the cash flows. If the transaction qualifies as an effective hedge and a financial instrument on a statutory basis is valued and reported at amortized cost, then the swap would also be valued and reported at amortized cost. Derivative instruments used in hedging transactions that do not meet or no longer meet the criteria of an effective hedge, or that meet the required criteria but the entity has chosen not to apply hedge accounting, shall be accounted for at fair value and the changes in the fair value shall be recorded as unrealized gains or unrealized losses (referred to as fair value accounting).

Activity to Date (issues previously addressed by the Working Group, Emerging Accounting Issues (E) Working Group, SEC, FASB, other State Departments of Insurance or other NAIC groups):

- Agenda item 2018-30: SSAP No. 86 – Hedge Effectiveness Documentation considered the revised hedge effectiveness documentation provisions incorporated within ASU 2017-12, Derivatives and hedging. The revisions from this agenda item were adopted Nov. 15, 2018, and were effective Jan. 1, 2019, with early adoption permitted. U.S. GAAP filers could only early adopt if they also early-adopted ASU 2017-12.

- Agenda item 2021-20: Effective Derivatives – ASU 2017-12 is considering other aspects pending from ASU 2017-12, primarily hedge effectiveness assessments, inclusion of guidance for excluded components and the measurement of excluded components.

Information or issues (included in *Description of Issue*) not previously contemplated by the Working Group: None

Convergence with International Financial Reporting Standards (IFRS): NA

Recommendation:
NAIC staff has been working with industry representatives on ASU 2022-01 for portfolio hedges, as well as on the U.S. guidance for partial term derivatives issued in ASU 2017-12. With these efforts, industry has provided NAIC staff suggested edits to incorporate key aspects of the U.S. GAAP guidance for portfolio hedges and partial-term hedges into SSAP No. 86. NAIC staff recommends that the Working Group classify this agenda item as a New SAP Concept and expose the proposed edits for comment. It is also recommended that the Working Group direct NAIC staff to prepare one issue paper with all recent derivative revisions.

Summary of Revisions Proposed in this Agenda Item – Portfolio Layer Method and Partial Term:

- SSAP No. 86: Revisions are proposed to paragraph 26 (fair value hedges) to detail criteria for portfolio and partial-term hedges. A small disclosure edit is proposed to paragraph 62 and guidance for reporting when the hedge is discontinued is proposed for inclusion in Exhibit C.

  Revisions have also been proposed to identify the adoption of *ASU 2022-01, Fair Value Hedging – Portfolio Layer Method* and to adopt with modification the guidance for partial-term hedges from ASU 2017-12. For the current proposal, the partial term hedge guidance is limited to hedged assets (not liabilities.) This is different from U.S. GAAP, but further statutory discussion is needed on basis adjustments when hedging liabilities, especially under partial term. It has been suggested that the Working Group move forward with incorporating the guidance for hedged assets at this time, as that addresses the current industry need, and consider guidance for hedged liabilities subsequently. (It was noted that industry is not aware of situations of partial-term liability hedges. Furthermore, the adjustment for hedged liabilities is a broader issue in SSAP No. 86, so the revisions would be more expansive.) Portfolio hedges are limited to recognized assets under U.S. GAAP, so proposed guidance for SAP for those hedges is consistent. (Industry has identified that the FASB may consider expanding the scope of portfolio hedges to liabilities. If this occurs, consideration will then occur for statutory accounting.)

- Exhibit A – Assessment of Hedge Effectiveness: Limited revisions to paragraphs 17-18 to mirror updated U.S. GAAP guidance and a new section (beginning with paragraph 46) for specific hedge assessment guidance on the portfolio layer method.

Staff Review Completed by: Julie Gann - NAIC Staff, April 2022

Proposed Edits to SSAP No. 86:

Fair Value Hedges (Note- subparagraphs 26a-c are not affected and are omitted for brevity)

26. Fair value hedges qualify for hedge accounting if all of the following criteria are met:

d. The hedged item is specifically identified as either all, ~~or~~ a specific portion, or the partial term of a recognized asset, or all or a specific portion of ~~or~~ a recognized liability or of an unrecognized firm commitment. The hedged item is a single asset or liability (or a specific portion or partial term thereof) or is a portfolio of similar assets or a portfolio of similar liabilities (or a specific portion thereof) or a closed portfolio of assets (pursuant to paragraph 26f and Exhibit A, paragraph 46) where assumed layer or layers is anticipated to be outstanding (or a specific portion thereof)[1]. For a partial term hedge of one or more consecutive selected contractual cash flows where the hedged item begins when the first hedge cash flow begins to accrue and ends at the end of the designation hedge period, the assumed maturity of the hedged item occurs at the end of the designated hedge period; *(ASC 815-25-35-13B Partial Term Hedging.)*

e. If similar assets or similar liabilities are aggregated and hedged as a portfolio, the individual assets or individual liabilities must share the risk exposure for which they are designated as being hedged. The change in fair value attributable to the hedged risk for each individual item in a hedged portfolio must be expected to respond in a generally proportionate manner to the overall change in fair value of the aggregate portfolio attributable to the hedged risk; and

f. For a closed portfolio of financial assets or one or more beneficial interests secured by a portfolio of financial instruments, an entity may designate as the hedged item or items a hedged layer or layers (this designation is referred to throughout as the "portfolio layer method" (detailed in Exhibit A). *(ASC 815-20-25-12A Portfolio Layer Method)*

~~f.~~g. If the hedged item is a financial asset or liability, a recognized loan servicing right, or a nonfinancial firm commitment with financial components, the designated risk being hedged is:

i. The risk of changes in the overall fair value of the entire hedged item;

ii. The risk of changes in its fair value attributable to changes in benchmark interest rate;

iii. The risk of changes in its fair value attributable to changes in the related foreign currency exchange rates; or

iv. The risk of changes in its fair value attributable to both changes in the obligor's creditworthiness and changes in the spread over the benchmark interest rate with respect to the related financial asset's or liability's credit sector at inception of the hedge (referred to as credit risk).

If the risk designated as being hedged is not the risk in paragraph 26.f.i., two or more of the other risks (benchmark interest rate risk, foreign currency exchange risk, and credit risk) may simultaneously be designated as being hedged.

The benchmark interest rate being hedged in a hedge of interest rate risk must be specifically identified as part of the designation and documentation at the inception of the hedging relationship. In calculating the change in the hedged item's fair value attributable to changes in the benchmark interest rate, the estimated coupon cash flows used in calculating fair value shall ~~must~~ be based on either~~all of~~ the full contractual cash flows ~~of the entire hedged item~~ or the benchmark rate

[1] For clarity, partial-term hedges and portfolio hedges addressed in paragraph 26.f.are limited to the situations in which the hedged item(s) is a recognized asset or a closed portfolio of financial assets. These hedging accounting methods are not permitted to hedge liabilities.

component of the contractual coupon cash flows of the hedged item determined at hedge inception. An entity may designate a fair value hedge of interest rate risk in which the hedged item is a prepayment instrument. The entity may consider only how changes in the benchmark interest rate affect the decision to settle the hedged item before its scheduled maturity (for example, an entity may consider only how change in the benchmark interest rate affect an obligor's decision to call a debt instrument when it has the right to do so.) The entity need not consider other factors that would affect this decision (for example, credit risk) when assessing hedge effectiveness. *(ASU 815-25-35-13 & 815-20-25-6B)*~~Excluding some of the hedged item's contractual cash flows (for example, the portion of the interest coupon in excess of the benchmark interest rate) from the calculation is not permitted.[2]~~ An entity may not simply designate prepayment risk as the risk being hedged for a financial asset. However, it can designate the option component of a prepayable instrument as the hedged item in a fair value hedge of the entity's exposure to changes in the fair value of that "prepayment" option, perhaps thereby achieving the objective of its desire to hedge prepayment risk. The effect of an embedded derivative of the same risk class must be considered in designating a hedge of an individual risk. For example, the effect of an embedded prepayment option must be considered in designating a hedge of benchmark interest rate risk.

Disclosure Requirements

62. Reporting entities shall disclose the following for all derivative contracts used:

a. General disclosures:

vii. The net gain or loss recognized in unrealized gains or losses during the perioding period resulting from derivatives that no longer qualify for hedge accounting. For portfolio layer method hedges, disclose circumstances that led to the breach. *(ASC 815-10-50-5C.)*

Staff Note: The shaded section reflects revised guidance adopted with agenda item 2021-20.

Relevant Literature

64. This statement adopts the framework established by FAS 133, *FASB Statement No. 137, Accounting for Derivative Instruments and Hedging Activities—Deferral of the Effective Date of FASB Statement No. 133, An amendment of FASB Statement No. 133* (FAS 137) and *FASB Statement No. 138, Accounting* for *Certain Derivative Instruments and Certain Hedging Activities, An amendment of FASB Statement No. 133* (FAS 138), for fair value and cash flow hedges, including its technical guidance to the extent such guidance is consistent with the statutory accounting approach to derivatives utilized in this statement. This statement adopts the provisions of FAS 133 and 138 related to foreign currency hedges. With the exception of guidance specific to foreign currency hedges and amendments specific to refining the hedging of interest rate risk (under FAS 138, the risk of changes in the benchmark interest rate would be a hedged risk), this statement rejects FAS No. 137 and 138 as well as the various related Emerging Issues Task Force interpretations. This statement adopts paragraphs 4 and 25 of *FASB Statement No. 149: Amendment of Statement 133 on Derivative Instruments and Hedging Activities* (FAS 149) regarding the definition of an underlying and guidance for assessing hedge effectiveness. (The adoption from FAS 149 on the assessment of hedge effectiveness is impacted by the adoption with modification of guidance from ASU 2017-12 as detailed in paragraph 65b, with the guidance from ASU 2017-12 superseding the prior adoption to the extent applicable.) All other paragraphs in FAS 149 are rejected as not applicable for statutory accounting. This statement adopts FSP FAS 133-1 and FIN 45-5*: Disclosures about Credit Derivatives and Certain Guarantees, An Amendment of FASB Statement No. 133 and FASB Interpretation No.45 and Clarification of the Effective Date of FASB Statement No. 161 (*FSP FAS 133-1 and FIN 45-4) and requires disclosures by sellers of credit derivatives.

~~[2] The first sentence of paragraph 26.d. that specifically permits the hedged item to be identified as either all or a specific portion of a recognized asset or liability or of an unrecognized firm commitment is not affected by the provisions in this subparagraph.~~

This statement rejects *FSP FIN 39-1, Amendments of FASB Interpretation No. 39*, and *ASU 2014-03, Derivatives and Hedging – Accounting for Certain Receive-Variable, Pay-Fixed Interest Rate Swaps – Simplified Hedge Accounting Approach*.

65. This statement adopts, with modification, certain revisions to ASC 815-20 included in ASU 2017-12. Remaining provisions of ASU 2017-12 will be subsequently assessed for statutory accounting and shall not be considered adopted for statutory accounting until that assessment is complete.

a. Revisions effective January 1, 2019 with early adoption permitted, are limited to specific provisions, and related transition guidance, pertaining to the documentation and assessment of hedge effectiveness and only includes: 1) provisions allowing more time to perform the initial quantitative hedge effectiveness assessment; 2) provisions allowing subsequent assessments of hedge effectiveness to be performed qualitatively if certain conditions are met; and 3) revisions regarding use of the critical terms and short-cut methods for assessing hedge effectiveness.

b. Revisions effective January 1, 2023, with early adoption permitted, are limited to the criteria for initial and subsequent hedge effectiveness detailed in the FASB Accounting Standards Codification (ASC) paragraphs 815-20-25-72 through 815-20-35-20, as modified through the issuance of ASU 2017-12. This adoption reflects statutory modifications to specify that the accounting and reporting of hedging instruments, including excluded components of the instruments, shall follow statutory specific guidance detailed in the statement. The intent of this guidance is to clarify that the determination of whether a hedging instrument qualifies as an effective hedge shall converge with U.S. GAAP, but that the measurement method shall continue to follow statutory specific provisions. The adoption of the referenced ASC paragraphs only extends to revisions incorporated through ASU 2017-12; therefore, any subsequent U.S. GAAP edits would require statutory accounting consideration before considered adopted.

c. Revisions effective _____, with early adoption permitted, are limited to the criteria for the portfolio layer method detailed in ASU 2022-01, criteria to only consider how changes in the benchmark interest rate affect the decision to settle the hedged item before its scheduled maturity date in 815-20-25-6B, adding option in calculating the change in the hedged item's fair value attributed to changes in the benchmark interest rate based on the benchmark rate components of the contractual cash flows detailed in FASB ASC 815-25-35-13, and the partial-term hedging method detailed in FASB ASC 815-25-35-13B. The adoption of the partial term hedging method reflects statutory modifications that limits its use only when the hedged item is a recognized asset. This is different than U.S. GAAP, which permits the partial term method for hedged liabilities. The statutory limitation is established to prevent interim basis adjustments to hedged liabilities that could present a reduction of reported liabilities on the financial statements when the actual liability has not been reduced. Reconsideration of this statutory limitation may occur after a broader project to consider how derivative basis adjustments to hedged liabilities shall be reflected in the financial statements.

Effective Date and Transition

74.~~73~~ This statement is effective for derivative transaction entered into or modified on or after January 1, 2003. A modification is any revision or change in contractual terms of the derivative. SSAP No. 31 applies to derivative transaction prior to January 1, 2003. Alternatively, an insurer may choose to apply this statement to all derivatives to which the insurer is a party as of January 1, 2003. In either case, the insurer is to disclose the transition approach that is being used.

a. Revisions adopted to paragraph 64 to reject FSP FIN 39-1 is effective January 1, 2013, for companies that have previously reported a position in the balance sheet that was net of counterparty

agreements. (Companies that have previously reported derivative instruments and/or related collateral gross shall not be impacted by these revisions.)

b. Revisions adopted in paragraph 16 clarify the reporting for amounts received/paid to adjust variation margin until the derivative contract has ended and are effective January 1, 2018, on a prospective basis, for reporting entities that have previously considered these amounts to reflect settlement or realized gains/losses. (Companies that have previously reported variation margin changes in line with the revisions shall not be impacted by these revisions.)

c. Revisions to incorporate limited provisions from ASU 2017-12 pertaining to the documentation of hedge effectiveness (detailed in paragraph 65) are effective January 1, 2019, with early adoption permitted for year-end 2018. However, if the reporting entity is a U.S. GAAP filer, the reporting entity may only elect early adoption if the entity has also elected early adoption of ASU 2017-12 for year-end 2018.

d. Revisions adopted April 2019 to explicitly include structured notes in scope of this statement are effective December 31, 2019. Revisions adopted July 2020 to define "derivative premium," require gross reporting of derivatives without the impact of financing premiums and require separate recognition of premiums payable and premiums receivable, are effective January 1, 2021.

e. Revisions adopted August 2022 that adopt with modification the criteria for initial and subsequent hedge effectiveness detailed in the FASB ASC paragraphs 815-20-25-72 through 815-20-35-20, as modified through the issuance of ASU 2017-12 and that incorporate statutory accounting revisions for the accounting and reporting of excluded components are effective January 1, 2023, with early adoption permitted. These revisions shall be applied prospectively for all new and existing hedges. Entities shall detail the adoption of this guidance as a change in accounting principle pursuant to *SSAP No. 3—Accounting Changes and Corrections of Errors.*

f. Revisions adopted _____ that adopt U.S. GAAP guidance for the portfolio layer method, U.S. GAAP guidance to only consider how changes in the benchmark interest rate affect the decision to settle the hedged item before its scheduled maturity, U.S. GAAP guidance adding option in calculating the change in the hedged item's fair value attributed to changes in the benchmark interest rate based on the benchmark rate component of the contractual coupon cash flows, that and adopt with modification U.S. GAAP guidance for partial term hedging are effective _____, with early adoption permitted. These revisions shall be applied prospectively to qualifying new hedges. *(Staff Note – Asking industry on the need to permit dedesignation / redesignation of existing hedges.)*

Proposed Edits to Exhibit C – Interest Rate Hedging

2d. Gain/Loss on Termination of a swap, collar or forward accounted for under hedge accounting (includes closing, exercise, maturity, and expiry):

i. Exercise—The remaining book value of the derivative shall become an adjustment to the cost or proceeds of the hedged item(s) received or disposed of individually or in aggregate;

ii. Sale, maturity, expiry, or other closing transaction of a derivative which is an effective hedge—Any gain or loss on the transaction, except for excluded components, will adjust the basis (or proceeds) of the hedged item(s) individually or in aggregate. If a portfolio layer method hedging relationship is discontinued (or partially discontinued) in a voluntary dedesignation or in anticipation of a breach, the basis adjustment associated with the dedesignated amount as of the discontinuation date shall be allocated to the remaining

individual assets in the closed portfolio that supported the dedesignated hedged layer using a systematic and rational method. Alternatively, if the item being hedged is subject to IMR, the gain or loss on the terminated hedging derivative may be realized and shall be subject to IMR upon termination. (ASU 815-25-40-9)

iii. Gain/loss on termination of derivatives will be recognized currently in net income (realized gain/loss) to the extent they ceased to be effective hedges.

iv. Upon the redesignation of a derivative from a currently effective hedging relationship-

(a) with an item(s) carried at amortized cost to another effective hedging relationship with an item(s) carried at amortized cost, the derivative shall continue to be recorded at amortized cost and no gain or loss on the derivative shall be recognized.

(b) with an item(s) carried at amortized cost or fair value to an effective relationship with an item(s) carried at fair value, the accounting for the derivative shall be consistent with (ii) above.

(c) with an item(s) carried at fair value to an effective relationship with an item(s) carried at amortized cost, the accounting for the derivative shall be consistent with (ii) above.

Exhibit A – Assessment of Effectiveness

17. All of the following conditions apply to both fair value hedges and cash flow hedges: *(815-20-25-104)*

e. The interest-bearing asset or liability is not prepayable, that is, able to be settled by either party before its scheduled maturity, or the assumed maturity date if the hedged item is measured as a partial-term hedge of interest rate risk in which the assumed maturity of the hedged items ~~occur on the date in which the last hedged cash flow is due and payable~~ ends at the end of the designated hedge period, in accordance with paragraph 815-25-35-13B, with the following qualifications:

i. This criterion does not apply to an interest-bearing asset or liability that is prepayable solely due to an embedded call option (put option) if the hedging instrument is a compound derivative composed of an interest rate swap and a mirror-image call option (put option).

ii. The call option embedded in the interest rate swap is considered a mirror image of the call option embedded in the hedged item if all of the following conditions are met:

18. All of the following incremental conditions apply to fair value hedges only: *(815-20-25-105 & 815-25-35-13B)*

a. The expiration date of the interest rate swap matches the maturity date of the interest-bearing asset or liability or the assumed maturity date if the hedged item is measured as a partial-term hedge of interest rate risk in which the assumed maturity of the hedged items ends at the end of the designated hedge period ~~occur on the date in which the last hedged cash flow is due and payable~~in ~~accordance with paragraph 815-25-35-13B~~.

Portfolio Layer Method (Note – New paragraphs at the end of Exhibit A.)

46. For a closed portfolio of financial assets or one or more beneficial interests secured by a portfolio of financial instruments, an entity may designate as the hedged item or items a hedged layer or layers (this designation is referred to throughout as the "portfolio layer method.*") (ASU 815-20-25-12A)*

a. As part of the initial hedge documentation, an analysis is completed and documented to support the entity's expectation that the hedged item or items (that is, the hedged layer or layers in aggregate) is anticipated to be outstanding for the designated hedge period. That analysis shall incorporate the entity's current expectations of prepayments, defaults, and other factors affecting the timing and amount of cash flows associated with the closed portfolio.

b. For purposes of its analysis in paragraph 46.a., the entity assumes that as prepayments, defaults, and other factors affecting the timing and amount of cash flows occur, they first will be applied to the portion of the closed portfolio that is not hedged; and

c. The entity applies the partial-term hedging guidance to the assets or beneficial interest used to support the entity's expectation in paragraph 46.a. An asset that matures on a hedged layer's assumed maturity date meets this requirement.

47. After a closed portfolio is established in accordance with paragraph 46, and entity may designate new hedging relationships associated with the closed portfolio without dedesignating any existing hedging relationships associated with the closed portfolio if the criteria of paragraph 46 are met for those newly designated hedging relationships. *(ASU 815-20-25-12B)*

48. For the portfolio layer method if both of the following conditions exist, the quantitative test described for similar assets (shared risk exposure) may be performed qualitatively on a hedge-by-hedge basis and only at hedge inception:

a. The hedged item is a hedged layer in a portfolio layer hedge and designated in accordance with paragraph 26.f. of SSAP No. 86.

b. An entity measures the change in fair value of the hedged item based on the benchmark rate component of the contractual coupon cash flows.

Using the benchmark rate component of the contractual coupon cash flows when all assets have the same assumed maturity date and prepayment risk does not affect the measurement of the hedged item results in all hedged items having the same benchmark rate component coupon cash flows. *(ASU 815-20-55-14A)*

49. For one or more hedging relationships designated under the portfolio layer method, an entity shall discontinue (or partially discontinue) hedge accounting in the following circumstances: *(ASU 815-25-40-8)*

a. If the entity cannot support on a subsequent testing date that the hedged layer or layers are anticipated to be outstanding for the designated hedge (that is, a breach is anticipated), it shall discontinue (or partially discontinue) hedge accounting for one or more hedging relationships for the portion of the hedged item that is no longer anticipated to be outstanding for the designated hedge period.

b. If on a subsequent testing date the outstanding amount of the closed portfolio of financial assets or one or more beneficial interests is less than the hedged layer or layers (that is, a breach has occurred), the entity shall discontinue (or partially discontinue) hedge accounting for one or more hedging relationships for the portion of the hedged item that is no longer outstanding.

50. In the event of either an anticipated breach (as described in paragraph 49.a.) or a breach that has occurred (as described in paragraph 49.b.) for portfolio layer method, if multiple hedged layers are associated with a closed

portfolio, an entity shall determine which hedge or hedges to discontinue (or partially discontinue) in accordance with an accounting policy election. That accounting policy election shall specify a systematic and rational approach to determining which hedge or hedges to discontinue (or partially discontinue). An entity shall establish its accounting policy no later than when it first anticipates a breach or when a breach has occurred (whichever comes first). After an entity establishes its accounting policy, it shall consistently apply its accounting policy to all portfolio layer method breaches (anticipated and occurred). *(ASU 815-25-40-8A)*

In the issue paper, the U.S. GAAP references not pulled into Exhibit will also be updated as follows:

Consideration of Prepayment Risk Using the ~~Last of Layer~~ Portfolio Layer Method

815-20-25-118A In a fair value hedge of interest rate risk designated under the portfolio layer ~~last-of-layer~~ method in accordance with paragraph 815-20-25-12A, an entity may exclude prepayment risk when measuring the change in fair value of the hedged item attributable to interest rate risk.

https://naiconline.sharepoint.com/teams/FRSStatutoryAccounting/National Meetings/A. National Meeting Materials/2022/7-Summer NM/Meeting/A - 22-09 - ASU 2022-01 - Portfolio Hedges.docx

Statutory Accounting Principles (E) Working Group
Maintenance Agenda Submission Form
Form A

Issue: ASU 2022-02 – Troubled Debt Restructurings and Vintage Disclosures

Check (applicable entity):

	P/C	Life	Health
Modification of Existing SSAP	☒	☒	☒
New Issue or SSAP	☐	☐	☐
Interpretation	☐	☐	☐

Description of Issue: In April 2022, the Financial Accounting Standards Board (FASB) issued *Accounting Standards Update* (ASU) *2022-02: Troubled Debt Restructurings and Vintage Disclosures* to eliminate prior U.S. GAAP guidance for troubled debt restructurings (TDRs) by creditors and instead require an entity to evaluate whether the modification represents a new loan or a continuation of an existing loan. The elimination of the separate TDR recognition and measurement guidance was supported for U.S. GAAP as losses are captured in the allowance for credit losses, pursuant to *ASU 2016-13: Measurement of Credit Losses on Financial Instruments*. With ASU 2022-02, expanded U.S. GAAP disclosures have been incorporated for modifications provided to debtors experiencing financial difficulty. Also, the ASU revises the ASU 2016-13 vintage gross write-off disclosures for public business entities. The effective date of ASU 2022-02 is Jan. 1, 2023, for entities that have adopted ASU 2016-13. For entities that have yet to adopt ASU 2016-13 (also known as the 'current expected credit loss' - CECL standard), the effective date of ASU 2022-02 will occur concurrently when an entity adopts ASU 2016-13.

Previously issued U.S. GAAP guidance involving TDRs by creditors was adopted with modification in *SSAP No. 36—Troubled Debt Restructuring*. This guidance was originally issued in *FAS 15, Accounting for Debtors and Creditors for Troubled Debt Restructurings* and then captured in the *FASB Accounting Standards Codification (ASC) 310-40: Receivables – Troubled Debt Restructuring by Creditors*. This ASC guidance has been predominantly superseded with the issuance of ASU 2022-02. Under the existing statutory accounting guidance, if the fair value of the modified loan is less than the recorded investment in the loan (including accrued interest, net deferred loan fees or costs, and unamortized premium or discount), a new cost basis is established at the fair value, with the difference recorded as a realized loss in the statement of operations.

Under ASU 2016-13 (also known as the 'current expected credit loss' - CECL standard) assets are reported at the net amount expected to be collected. For assets held at amortized cost, a valuation allowance reflecting expected credit losses is established and is deducted from the amortized cost basis to present the net carrying amount expected to be collected. For assets held at fair value, there is still an allowance for credit losses, which permits reversals of credit losses previously recorded to be reflected in net income. (For assets held at fair value, the CECL model does not change measurement method, but changes the process for recognizing fluctuations in fair value as a result of credit losses.)

Although consideration of ASU 2016-13 is still pending statutory accounting review, from initial assessments and industry outreach, a full adoption of the CECL standard is not likely to be supported. This is because 1) insurers more commonly hold assets at amortized cost under SAP and at fair value (as available for sale) under U.S. GAAP – so the CECL model would significantly impact the measurement method under SAP, but not under U.S. GAAP, and 2) the asset-valuation reserve (AVR), a statutory accounting guidance applicable to life and fraternal insurers, establishes a reserve to offset potential credit-related investment losses on most investment categories. With ASU 2016-13 applicable to small public and non-public U.S. GAAP filers as of Jan. 1, 2023, NAIC staff are currently soliciting input from industry on key CECL impacts to assess for statutory accounting purposes. Once that information is received, a further review will occur on ASU 2016-13 to determine the extent that CECL concepts should be reflected within statutory accounting principles.

Under new U.S. GAAP guidance in ASU 2022-02, when the terms of the loan have been revised, creditors would determine whether the changes to the loan are more than minor and if the terms are at least as favorable to the lender as the terms for comparable loans to other customers with similar collection risks who are not refinancing / restructuring a loan. If these criteria are met, then the restructured loan would be accounted for as a new loan. If a new loan, any unamortized net fees or costs and any prepayment penalties from the original loan shall be recognized in interest income when the new loan is granted. If the criteria are not met, the unamortized net fees or costs from the original loan and any prepayment penalties shall be carried forward as a part of the net investment in the new loan. With this approach, the investment in the new loan consists of the net remaining investment in the original loan, any additional funds advanced to the borrower, any fees received, and direct loan origination costs associated with the refinancing or restructuring. It's important to highlight that this U.S. GAAP guidance does not address any loss for the restructured loan as recognition of losses would be captured in the allowance for credit losses pursuant to ASU 2016-13.

With ASU 2022-02, expanded disclosures on commitments and modified loans have been incorporated. Although some of the general concepts within the following U.S. GAAP disclosures are captured in SSAP No. 36, paragraph 23, the following U.S. GAAP disclosures are more specific that what was previously incorporated:

1. Disclose if the creditor has a commitment to lend additional funds to debtors experiencing financial difficulty for which the creditor has modified the terms of the receivables in the form of principal forgiveness, an interest rate reduction, and other-than-insignificant payment delay, or a term extension in the current reporting period (ASU 310-10-50-36). (Note – This is similar to a prior GAAP disclosure for TDRs and reflected in concept within SSAP No. 36, paragraph 23.b.)

2. In addition to disclosures about the type and magnitude of certain modifications of receivables made to debtors experiencing financial difficulty (summarized in paragraphs 3-5 below), the financial effect of those modifications and the degree of success of the modification in mitigating potential credit losses, an entity shall consider providing information that helps financial statement users understand significant changes in the type of magnitude of modifications, including those modifications that, for example, were caused by a major credit event, even if the modifications would not require the disclosures detailed below.) (ASU 310-10-50-38)

3. For each period in which a statement of income is presented, and entity shall disclose the following information related to modifications of receivables that are in the form of principal forgiveness, an interest rate reduction, an other-than insignificant payment delay, or a term extension (or a combination thereof) made to debtors experiencing financial difficulty during the reporting period. (ASU 310-10-50-42)

    a. By class of financing receivable, qualitative and quantitative information about:

        i. The types of modifications utilized by an entity, including the total period-end amortized cost basis of the modified receivables and the percentage of modifications of receivables made to debtors experiencing financial difficulty relative to the total period-end amortized cost basis of receivables in the class of financing receivable.

        ii. The financial effect of the modification by type of modification, which shall provide information about the changes to the contractual terms as a result of the modification and shall include the incremental effect of principal forgiveness on the amortized cost basis of the modified receivables, as applicable, or the reduction in weighted-average interest rates (versus a range) for interest rate reductions.

        iii. Receivable performance in the 12 months after a modification of a receivable made to a debtor experiencing financial difficulty.

b. By portfolio segment, qualitative information about how those modifications and the debtors' subsequent performance are factored into determining the allowance for credit losses.

4. Receivables made be modified in more than one manner. An entity that modifies the same receivable in more than one manner shall provide disclosures sufficient for users to understand the different types of combinations of modifications provided to borrowers. For example, a receivable may be modified to provide both principal forgiveness and an interest rate reduction. In that case, an entity shall disclose the period-end amortized cost basis of that receivable in a separate category that reflects that a combination of mortification types has been granted. If another receivable was modified to provide both an interest rate reduction and a term extension, the period-end amortized cost basis of that receivable shall be presented in a different category. Multiple separate combinations categories may be necessary if significant. The same receivable's period-end amortized cost basis shall not be presented in multiple categories. (310-10-50-43)

5. For each period in which a statement of income is presented, an entity shall disclose the following information about financing receivables that had a payment default during the period and had been modified in the form of principal forgiveness, an interest rate reduction, an other-than-insignificant payment delay, or a term extension (or a combination thereof) within the previous 12 months preceding the payment default when the debtor was experiencing financial difficulty at the time of the modification. (310-10-50-44)

    a. By class of financing receivable, qualitative and quantitative information about those defaulted financing receivables, including the following:

        i. The type of contractual change the modification provided.

        ii. The amount of financing receivables that defaulted, including the period-end amortized cost basis for financing receivables that defaulted.

    b. By portfolio segment, qualitative information about how those defaults are factored into determining the allowance for credit losses.

    Per the ASU, the disclosures in paragraphs 3, 4 and 5 shall be provided regardless of whether a modification of a receivable to a debtor experiencing financial difficulty results in a new loan. (ASU 310-10-50-41)

In addition to the TDR for creditors guidance, ASU 2022-02 also incorporates and revises "vintage" disclosures for gross write-offs for public business entities involving financing receivables and net investment in leases. These disclosures were originally captured as part of the CECL guidance in ASU 2016-13 for all entities, and the revisions modify and restrict the disclosures to public business entities:

- When disclosing credit quality indicators of financing receivables and net investment in leases, a public business entity shall present the amortized cost basis within each credit quality indicator by year of origination (that is, vintage year). For purchased financing receivables and net investment in leases, an entity shall use the initial date of issuance to determine the year of origination, not the date of acquisition. For origination years before the fifth annual period, a public business entity may present the amortized cost basis of financing receivables and net investments in leases in the aggregate. For interim-period disclosures, the current year-to-date originations in the current reporting period are considered to the current-period originations. (326-20-50-6)

- A public business entity shall present the gross write-offs recorded in the current period, on a current year-to-date basis, for financing receivables and net investments in leases by origination year. For origination years before the fifth annual period, a public business entity may present the gross write-offs in the current period for financing receivables and net investments in leases in aggregate. The requirement to present the

amortized cost basis within each credit quality indicator by year of origination is not required for an entity that is not a public business entity. (326-20-50-6A)

Existing Authoritative Literature:

SSAP No. 36—Troubled Debt Restructuring

A troubled debt restructuring is defined as a debt restructuring whereby the creditor, for economic or legal reasons related to the debtor's financial difficulties, grants a concession to the debtor that it would not otherwise grant. Guidance in SSAP No. 36, adopted from U.S. GAAP for creditors, details the following:

- Determining whether a creditor has granted a concession
- Determining whether a debtor is experiencing financial difficulties
- Determining whether a restructuring results in a delay in payment that is insignificant
- Accounting by creditors
- Disclosure for creditors.

Key excerpts from the guidance in SSAP No. 36:

Accounting by Creditors

17. A creditor shall account for a troubled debt restructuring according to the type of the restructuring (receipt of assets in full satisfaction, modification of terms, combination of types). Generally, troubled debt restructuring involving the transfer of assets shall be accounted for at the fair value of the assets received. Troubled debt restructuring involving modification of terms shall be accounted for at fair value (as determined by acceptable appraisal methodologies) in accordance with *SSAP No. 100R—Fair Value*. If the restructured loan is collateral dependent, fair value shall be the fair value of the collateral. If the restructured loan is not collateral dependent, fair value shall be determined in accordance with SSAP No. 100R. If the determined fair value of the loan is less than the recorded investment in the loan (including accrued interest, net deferred loan fees or costs, and unamortized premium or discount), a new cost basis shall be established at the fair value with the difference being recorded as a realized loss in the statement of operations. After the troubled debt restructuring, a creditor shall account for the assets consistent with the statutory guidance for such assets.

18. A creditor shall account for assets, including foreclosed property and equity interests in corporations, joint ventures, or partnerships, received in satisfaction of the loan at their fair value (as determined by acceptable appraisal methodologies) at the time of restructuring or at the book value of the loan if lower. If the fair value is less than the book value, the required writedown shall be recognized as a realized capital loss. The creditor shall reclassify the asset from loans to the appropriate asset account, such as real estate or other invested assets, at the time that the creditor obtains clear title to the asset except for mortgage loans which shall follow the guidance in paragraph 18 of SSAP No. 37. After the troubled debt restructuring, a creditor shall account for the assets received in satisfaction of the loan consistent with the statutory guidance for similar assets.

19. Any fees received in connection with a modification of terms of a troubled debt restructuring shall be applied as a reduction of the recorded investment in the loan. All costs associated with the restructuring, including direct loan origination costs, shall be charged to expense as incurred.

Disclosure by Creditors

23. A creditor shall disclose in the financial statements the information captured in paragraphs 23.a., 23.b. and 23.c. about troubled debt restructuring as of the date of each balance sheet presented. Disclosures captured from paragraphs 23.d. and 23.e. are required in the statutory audited financial statements only:

a. As of the date of each statement of financial position presented, the recorded investment in the loans for which impairment has been recognized in accordance with this statement

and the related realized capital loss. (For mortgage loans, the disclosures in SSAP No. 37 shall also be completed.)

b. The amount of commitments, if any, to lend additional funds to debtors owing receivables whose terms have been modified in troubled debt restructuring

c. The creditor's income recognition policy for interest income on an impaired loan

d. For troubled debt restructurings that occurred during the annual reporting period, aggregated by type of instrument, qualitative and quantitative information on (1) how the items were modified and (2) the financial effects of the modifications

e. If restructured within the previous 12 months and there has been a payment default during that period, disclose qualitative and quantitative information about the defaulted instruments, aggregated by type of instrument, including: (1) type of instruments that defaulted and (2) the amount of recorded investments for which default occurred

24. Refer to the Preamble for further discussion regarding disclosure requirements.

25. This statement is not intended to modify the requirement for life and health insurers to complete the annual statement exhibit disclosing long-term mortgage loans in good standing with restructured terms.

Relevant Literature

26. This statement adopts with modification *FASB Statement No. 15*, *Accounting by Debtors and Creditors for Troubled Debt Restructurings* (FAS 15) to specify that creditors shall reclassify assets obtained in a troubled debt restructuring from loans to the appropriate asset account at the time the creditor obtains clear title to the asset, except for mortgage loans which shall be reclassified at the beginning of the redemption period unless it is probable that the mortgage loan will be redeemed and with modification to require that gains and losses from extinguishment of debt be reported as capital gains or losses, and charged to operations. In August 2012, this statement was revised to adopt paragraphs 310-40-15-13 through 310-40-15-18 and 310-40-15-20 of the FASB Codification incorporated through *FASB ASU 2011-02, A Creditors Determination of Whether a Restructuring Is a Troubled Debt Restructuring*. Also in August 2012, this statement adopted with modification the disclosure requirements included in paragraphs 310-10-50-33 through 310-10-50-34 of the FASB Codification originally incorporated from *ASU 2010-20, Receivables (Topic 310), Disclosures About the Credit Quality of Financing Receivables and the Allowance for Credit Losses*, deferred by *ASU 2011-01, Receivables (Topic 310), Deferral of the Effective Date of Disclosures about Troubled Debt Restructurings in Update No. 2010-20* and reinstated through ASU 2011-02. These disclosure requirements have been modified to be applicable for all troubled debt restructurings within the scope of SSAP No. 36, rather than limited to troubled debt restructurings of "financing receivables." The revisions adopted in August 2012 from ASU 2011-02 and ASU 2010-20 are effective January 1, 2013, with early application permitted.

27. This statement adopts paragraphs 9, 22, and 25 of *FASB Statement No. 114*, *Accounting by Creditors for Impairment of a Loan* (FAS 114). Paragraphs 6.d., 13 and 21 of FAS 114 are rejected. *FASB Statement No. 118*, *Accounting by Creditors for Impairment of a Loan—Income Recognition and Disclosures* is adopted as it relates to troubled debt restructuring.

28. This statement adopts *FASB Technical Bulletin 81-6, Applicability of Statement 15 to Debtors in Bankruptcy Situations* and *FASB Technical Bulletin 80-2, Classification of Debt Restructuring by Debtors and Creditors*. It also adopts *FASB Emerging Issue Task Force No. 87-18, Use of Zero Coupon Bonds in a Troubled Debt Restructuring*, *FASB Emerging Issue Task Force No. 87-19, Substituted Debtors in a Troubled Debt Restructuring*, *FASB Emerging Issue Task Force No. 89-15*, *Accounting for a Modification of Debt Terms When the Debtor is Experiencing Financial Difficulties* consistent with the modifications to FAS 15 discussed in this statement, *FASB Emerging Issues Task Force No. 96-22, Applicability of the Disclosures Required by FASB Statement No. 114 When a Loan Is Restructured in a Troubled Debt Restructuring into Two (or More) Loans* and *FASB EITF 02-4: Determining Whether a Debtor's Modification or Exchange of Debt Instruments is Within the Scope of FASB Statement No. 15.*

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.*

30. This statement rejects *FASB Emerging Issues Task Force No. 94-8, Accounting for Conversion of a Loan into a Security in a Troubled Debt Restructuring* and *FASB Technical Bulletin 94-1*, *Application of Statement 115 to Debt Securities Restructured in a Troubled Debt Restructuring*.

Activity to Date (issues previously addressed by the Working Group, Emerging Accounting Issues (E) Working Group, SEC, FASB, other State Departments of Insurance or other NAIC groups):

In 2020, in response to the COVID pandemic, the Statutory Accounting Principles (E) Working Group issued two interpretations providing limited time exceptions for troubled debt restructurings. INT 20-07, believed most widely used, provided limited-time practical expedients in determining whether restructured payments are considered insignificant. Both interpretations automatically expired on Jan. 2, 2022.

- INT 20-03: Troubled Debt Restructurings Due to COVID-19
- INT 20-07: Troubled Debt Restructuring of Certain Debt Investments Due to COVID-19

In 2016, with the issuance of ASU 2016-13, the Working Group began discussions on the CECL standard for statutory accounting. Although a number of preliminary discussions occurred, discussions halted as the effective date of U.S. GAAP standard (as well as other standards) was delayed in response to the COVID-19 pandemic. ASU 2016-13 is now effective January 2023 for smaller reporting public entities and nonpublic companies. When discussions were ongoing, a comment letter received from interested parties dated July 9, 2018, recommended that the NAIC retain the existing credit impairment guidance in statutory accounting principles. The discussion on ASU 2016-13 for statutory accounting is expected to resume in 2022.

Information or issues (included in *Description of Issue*) not previously contemplated by the Working Group: None

Convergence with International Financial Reporting Standards (IFRS): NA

Recommendation:

NAIC staff recommends that the Working Group move this item to the active listing, categorized as a SAP clarification, and expose the intent to retain existing guidance in *SSAP No. 36—Troubled Debt Restructuring* along with revisions to the relevant literature section to identify the rejection of ASU 2022-02 and detail the GAAP/SAP differences for the accounting of troubled debt restructurings for creditors. Note that paragraph 26 addresses ASU 2022-02 and paragraphs 27-29 detail the historical differences that were previously in paragraphs 26-30 in a more reader friendly format including moving old effective date language from the relevant literature section to the effective date paragraph. With this exposure, comments are requested on whether the expanded U.S. GAAP disclosures for modifications should be considered for statutory accounting.

NAIC staff recommends that the CECL disclosures, including the revisions for "vintage gross write-offs' for public business entities be considered as part of the review of ASU 2016-13 for expected credit losses. However, NAIC staff requests comments on this recommendation and whether the disclosures should be considered for statutory accounting in advance of reviewing ASU 2016-13 for statutory accounting.

Staff Review Completed by: Julie Gann - NAIC Staff, April 2022

Proposed Revisions to SSAP No. 36:

Relevant Literature

26. This statement rejects *ASU 2022-02, Troubled Debt Restructurings and Vintage Disclosures* and the U.S. GAAP guidance within the Accounting Standards Codification for troubled debt restructurings for creditors. This ASU is rejected as the U.S. GAAP guidance for troubled debt restructuring by creditors has been significantly modified to eliminate the separate recognition of losses from restructurings as losses are captured within the allowance for credit losses valuation account established pursuant to *ASU 2016-13, Financial Instruments – Credit Losses*. As statutory accounting has not adopted ASU 2016-13, the prior troubled debt restructuring adopted from U.S GAAP in effect prior to ASU 2016-13 and ASU 2022-02 has been retained. With the rejection of ASU 2022-02, reporting entities shall continue to apply the prior concepts within SSAP No. 36 when assessing and classifying modifications as troubled debt restructurings. These retained concepts do not permit entities to consider troubled debt restructurings as new loans and therefore do not permit immediate recognition of unamortized fees, costs, or prepayment penalties as interest income at the time of restructuring. Additionally, fees received by a reporting entity from a restructuring shall continue to reduce the recorded investment and all costs incurred by a reporting entity with the restructuring shall continue to be charged to expense as incurred.

27. Although the statutory accounting guidance for troubled debt restructurings for creditors no longer reflects authoritative guidance from U.S. GAAP, the guidance in SSAP No. 36 reflects the following superseded U.S. GAAP guidance as follows:

a. Adopted with modification *FASB Statement No. 15*, *Accounting by Debtors and Creditors for Troubled Debt Restructurings* (FAS 15) to specify that creditors shall reclassify assets obtained in a troubled debt restructuring from loans to the appropriate asset account at the time the creditor obtains clear title to the asset, except for mortgage loans which shall be reclassified at the beginning of the redemption period unless it is probable that the mortgage loan will be redeemed and with modification to require that gains and losses from extinguishment of debt be reported as capital gains or losses, and charged to operations.

b. Adopted paragraphs 310-40-15-13 through 310-40-15-18 and 310-40-15-20 of the FASB Codification incorporated through *FASB ASU 2011-02, A Creditors Determination of Whether a Restructuring Is a Troubled Debt Restructuring*

c. Adopted with modification the disclosure requirements included in paragraphs 310-10-50-33 through 310-10-50-34 of the FASB Codification originally incorporated from *ASU 2010-20, Receivables (Topic 310), Disclosures About the Credit Quality of Financing Receivables and the Allowance for Credit Losses*, deferred by *ASU 2011-01, Receivables (Topic 310), Deferral of the Effective Date of Disclosures about Troubled Debt Restructurings in Update No. 2010-20* and reinstated through ASU 2011-02. These disclosure requirements were modified to be applicable for all troubled debt restructurings within the scope of SSAP No. 36, rather than limited to troubled debt restructurings of "financing receivables."

d. Adopted paragraphs 9, 22, and 25 of *FASB Statement No. 114*, *Accounting by Creditors for Impairment of a Loan* (FAS 114). Adopted *FASB Statement No. 118*, *Accounting by Creditors for Impairment of a Loan—Income Recognition and Disclosures* as it relates to troubled debt restructuring.

e. Adopts *FASB Technical Bulletin 81-6, Applicability of Statement 15 to Debtors in Bankruptcy Situations* and *FASB Technical Bulletin 80-2, Classification of Debt Restructuring by Debtors and Creditors*, *FASB Emerging Issue Task Force No. 87-18, Use of Zero Coupon Bonds in a Troubled Debt Restructuring*, *FASB Emerging Issue Task Force No. 87-19, Substituted Debtors in a Troubled Debt Restructuring*, *FASB Emerging Issue Task Force No. 89-15*, *Accounting for a Modification of Debt Terms When the Debtor is Experiencing Financial Difficulties* consistent with the modifications to FAS 15, *FASB Emerging Issues Task Force No. 96-22, Applicability of the Disclosures Required by FASB*

Statement No. 114 When a Loan Is Restructured in a Troubled Debt Restructuring into Two (or More) Loans and *FASB EITF 02-4: Determining Whether a Debtor's Modification or Exchange of Debt Instruments is Within the Scope of FASB Statement No. 15.*

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

28. For historical reference purposes, the following superseded U.S. GAAP guidance was previously rejected within this statement:

a. Paragraph 6.d, 13 and 21 of FAS 114.

b. *FASB Emerging Issues Task Force No. 94-8, Accounting for Conversion of a Loan into a Security in a Troubled Debt Restructuring* and *FASB Technical Bulletin 94-1, Application of Statement 115 to Debt Securities Restructured in a Troubled Debt Restructuring*.

~~26. This statement adopts with modification *FASB Statement No. 15, Accounting by Debtors and Creditors for Troubled Debt Restructurings* (FAS 15) to specify that creditors shall reclassify assets obtained in a troubled debt restructuring from loans to the appropriate asset account at the time the creditor obtains clear title to the asset, except for mortgage loans which shall be reclassified at the beginning of the redemption period unless it is probable that the mortgage loan will be redeemed and with modification to require that gains and losses from extinguishment of debt be reported as capital gains or losses, and charged to operations. In August 2012, this statement was revised to adopt paragraphs 310-40-15-13 through 310-40-15-18 and 310-40-15-20 of the FASB Codification incorporated through *FASB ASU 2011-02, A Creditors Determination of Whether a Restructuring Is a Troubled Debt Restructuring*. Also in August 2012, this statement adopted with modification the disclosure requirements included in paragraphs 310-10-50-33 through 310-10-50-34 of the FASB Codification originally incorporated from *ASU 2010-20, Receivables (Topic 310), Disclosures About the Credit Quality of Financing Receivables and the Allowance for Credit Losses*, deferred by *ASU 2011-01, Receivables (Topic 310), Deferral of the Effective Date of Disclosures about Troubled Debt Restructurings in Update No. 2010-20* and reinstated through ASU 2011-02. These disclosure requirements have been modified to be applicable for all troubled debt restructurings within the scope of SSAP No. 36, rather than limited to troubled debt restructurings of "financing receivables." The revisions adopted in August 2012 from ASU 2011-02 and ASU 2010-20 are effective January 1, 2013, with early application permitted.~~

~~27. This statement adopts paragraphs 9, 22, and 25 of *FASB Statement No. 114, Accounting by Creditors for Impairment of a Loan* (FAS 114). Paragraphs 6.d., 13 and 21 of FAS 114 are rejected. *FASB Statement No. 118, Accounting by Creditors for Impairment of a Loan—Income Recognition and Disclosures* is adopted as it relates to troubled debt restructuring.~~

~~28. This statement adopts *FASB Technical Bulletin 81-6, Applicability of Statement 15 to Debtors in Bankruptcy Situations* and *FASB Technical Bulletin 80-2, Classification of Debt Restructuring by Debtors and Creditors*. It also adopts *FASB Emerging Issue Task Force No. 87-18, Use of Zero Coupon Bonds in a Troubled Debt Restructuring*, *FASB Emerging Issue Task Force No. 87-19, Substituted Debtors in a Troubled Debt Restructuring*, *FASB Emerging Issue Task Force No. 89-15, Accounting for a Modification of Debt Terms When the Debtor is Experiencing Financial Difficulties* consistent with the modifications to FAS 15 discussed in this statement, *FASB Emerging Issues Task Force No. 96-22, Applicability of the Disclosures Required by FASB Statement No. 114 When a Loan Is Restructured in a Troubled Debt Restructuring into Two (or More) Loans* and *FASB EITF 02-4: Determining Whether a Debtor's Modification or Exchange of Debt Instruments is Within the Scope of FASB Statement No. 15.*~~

~~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.*~~

~~30. This statement rejects *FASB Emerging Issues Task Force No. 94-8, Accounting for Conversion of a Loan into a Security in a Troubled Debt Restructuring* and *FASB Technical Bulletin 94-1, Application of Statement 115 to Debt Securities Restructured in a Troubled Debt Restructuring*.~~

Effective Date and Transition

~~31.~~29. ~~31.~~ This statement is effective for years beginning January 1, 2001. The provisions of this statement shall be applied to all troubled debt restructurings entered into on or after January 1, 2001. The adoption of FASB EITF 02-4: Determining Whether a Debtor's Modification or Exchange of Debt Instruments is within the Scope of FASB Statement No. 15 was incorporated from INT 03-12 and effective December 7, 2003. The revisions adopted in August 2012 from ASU 2011-02 and ASU 2010-20 are effective January 1, 2013, with early application permitted.

Comments Requested – Is additional disclosure information desired on troubled debt restructurings?

As detailed in the summary of new GAAP guidance, disclosures are expanded to allocate TDRs by type of modification – such as principal forgiveness, interest rate reduction, other-than-insignificant payment delay or term extension. Also under the new U.S. GAAP guidance, TDR disclosures are aggregated based on type of modification, and if more than one modification occurs, then a new category is reported to aggregate info for all contracts that have similar modifications. (So, modifications that encompass both principal forgiveness and interest rate reductions would be aggregated in a separate category, and modifications that include interest rate reductions and term extensions would be aggregated in a separate category.)

Below are the current disclosures and data-template for statutory financials. As shown, the data captured is limited.

Disclosure by Creditors

23. A creditor shall disclose in the financial statements the information captured in paragraphs 23.a., 23.b. and 23.c. about troubled debt restructuring as of the date of each balance sheet presented. Disclosures captured from paragraphs 23.d. and 23.e. are required in the statutory audited financial statements only:

a. As of the date of each statement of financial position presented, the recorded investment in the loans for which impairment has been recognized in accordance with this statement and the related realized capital loss. (For mortgage loans, the disclosures in SSAP No. 37 shall also be completed.)

b. The amount of commitments, if any, to lend additional funds to debtors owing receivables whose terms have been modified in troubled debt restructuring

c. The creditor's income recognition policy for interest income on an impaired loan

d. For troubled debt restructurings that occurred during the annual reporting period, aggregated by type of instrument, qualitative and quantitative information on (1) how the items were modified and (2) the financial effects of the modifications

e. If restructured within the previous 12 months and there has been a payment default during that period, disclose qualitative and quantitative information about the defaulted instruments, aggregated by type of instrument, including: (1) type of instruments that defaulted and (2) the amount of recorded investments for which default occurred

Note 5B. Debt Restructuring

		Current Year	Prior Year
(1)	The total recorded investment in restructured loans, as of year-end	$ _____	_____
(2)	The realized capital losses related to these loans	$ _____	_____
(3)	Total contractual commitments to extend credit to debtors owing receivables whose terms have been modified in troubled debt restructurings	$ _____	_____

https://naiconline.sharepoint.com/teams/FRSStatutoryAccounting/National Meetings/A. National Meeting Materials/2022/7-Summer NM/Meeting/B - 22-10 - ASU 2022-02 - TDR CECL - With Edits.docx

Statutory Accounting Principles (E) Working Group
Maintenance Agenda Submission Form
Form A

Issue: Collateral for Loans

Check (applicable entity):

	P/C	Life	Health
Modification of Existing SSAP	☒	☒	☒
New Issue or SSAP	☐	☐	☐
Interpretation	☐	☐	☐

Description of Issue:

This agenda item has been drafted to address an inconsistency regarding the collateral loan guidance in *SSAP No. 20—Nonadmitted Assets* and *SSAP No. 21—Other Admitted Assets* (See excerpts in Authoritative Literature). These two statements contain guidance about unsecured and secured loans which is complementary.

SSAP No. 20 details the **nonadmitted assets status** of unsecured loans and loans secured by assets which do not qualify as investments. SSAP No. 20 also references write off and impairment guidance in *SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets* for impaired and uncollectible loans. SSAP No. 20 provides that improperly collateralized loans include loans that do not have underlying assets that would otherwise qualify as **admitted assets** and stated that such loans are nonadmitted assets because the collateral would be of questionable economic value if needed to fulfill policyholder obligations. SSAP No. 20 includes similar nonadmission guidance regarding loans on personal security, cash advances to officers or agents and for travel advances.

SSAP No. 21 details the requirements for collateral loans which **can qualify to be admitted assets.** It provides that the collateral loan must be secured by the pledge of an investment. A footnote further describes that investment collateral would be of a type that would be in Section 3 of *Appendix A-001—Investments of Reporting Entities***. SSAP No. 21 also references the nonadmission guidance in SSAP No. 20 for** collateral loans secured by assets that do not qualify as investments. The referenced guidance in SSAP No. 20 notes that the underlying assets must qualify as admitted assets.

Both SSAP No. 20 and SSAP No. 21 identify the need for adequate collateral that qualifies as an invested asset. SSAP No. 20 is explicit that the investment asset collateral must qualify as an admitted asset. Recent discussions with state regulators have highlighted that although SSAP No. 21 references the guidance in SSAP No. 20, that it would be beneficial to also note the need for the collateral to qualify as an admitted invested asset. This agenda item recommends a clarification to SSAP No. 21 that the acceptable invested asset collateral, for collateral loans must qualify as admissible invested assets.

Existing Authoritative Literature:

***SSAP No. 20—Nonadmitted Assets* (Bolding added for emphasis):**

4. Consistent with paragraph 2, the following assets shall be nonadmitted:

   a. Deposits in Suspended Depositories—Amounts on deposit with suspended depositories may not be fully recoverable. Any amounts not reasonably expected to be recovered shall be written off in accordance with *SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets*. Amounts in excess of that written off shall be nonadmitted as they are not available to satisfy obligations to policyholders;

b. **Bills Receivable Not for Premium and Loans Unsecured or Secured by Assets That Do Not Qualify As Investments**—In accordance with SSAP No. 5R, amounts determined to be uncollectible or otherwise impaired shall be written off. Amounts in excess of that written off are not considered to be properly collateralized **as there are no underlying assets which would otherwise be admitted assets. Such amounts shall be nonadmitted as they may be of questionable economic value if needed to fulfill policyholder obligations. Receivables arising from working capital finance programs designated by the Securities Valuation Office are subject to the guidance in *SSAP No. 105R—Working Capital Finance Investments*;**

c. Loans on Personal Security, Cash Advances To, Or In The Hands Of, Officers Or Agents And Travel Advances—In accordance with SSAP No. 5R, amounts determined to be uncollectible or otherwise impaired shall be written off. Amounts in excess of that written off typically are **unsecured and as such have no underlying assets which would otherwise be admitted assets. Such amounts shall be nonadmitted as they may be of questionable economic value if needed to fulfill policyholder obligations. Some of these items may also be considered prepaid expenses which, per *SSAP No. 29—Prepaid Expenses*, are nonadmitted;**

d. All "Non-Bankable" Checks—Examples of "non-bankable" checks are NSF (non-sufficient funds) checks, post-dated checks, or checks for which payment has been stopped. Although these checks may still maintain probable future benefits (and thus meet the definition of assets), at the date on which they are non-bankable they are not available for policyholder obligations and shall be nonadmitted until the uncertainty related to the probable future benefit is resolved and the checks are converted to available funds;

e. Trade Names And Other Intangible Assets[1]—These assets, by their nature, are not readily marketable and available to satisfy policyholder obligations and shall be nonadmitted;

f. Automobiles, Airplanes and Other Vehicles—Automobiles, airplanes and other vehicles meet the definition of assets established in SSAP No. 4. However, they are not readily available to satisfy policyholder obligations and as a result the undepreciated portion shall be nonadmitted. The accounting for these assets shall be consistent with the accounting for equipment provided in *SSAP No. 19—Furniture, Fixtures, Equipment and Leasehold Improvements* or for commercial airplane leveraged leases, refer to the guidance in *SSAP No. 22R–Leases*;

g. Company's Stock as Collateral for Loan—When a reporting entity lends money and accepts its own stock as collateral for the loan, it shall report the amount of the loan receivable and any related accrued interest on the loan as a nonadmitted asset. The asset is nonadmitted as the collateral could not be used to satisfy the obligation in the event of default.

[1] Defensible intangible assets are defined as an intangible asset acquired in a business combination or an asset acquisition that an entity does not intend to actively use but does intend to prevent others from using. These may also be referred to as a "locked-up asset" because while the asset is not being actively used, it is likely contributing to an increase in the value of other assets owned by the entity. These assets are not readily available to satisfy policyholder obligations and shall be nonadmitted.

***SSAP No. 21 – Revised—Other Admitted Assets* (Bolding added for emphasis)**

Collateral Loans

4. Collateral loans are unconditional obligations[2] for the payment of money secured by the pledge of an investment[3] 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:

a. Loan Impairment—Determination as to the impairment of a collateral loan shall be based on current information and events. When it is considered probable that any portion of amounts due under the contractual terms of the loan will not be collected the loan is considered impaired. The impairment shall be measured based on the fair value of the collateral less estimated costs to obtain and sell the collateral. The difference between the net value of the collateral and the recorded asset shall be written off in accordance with *SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets*;

b. Nonadmitted Asset—In accordance with *SSAP No. 20—Nonadmitted Assets*, collateral loans secured by assets that do not qualify as investments shall be nonadmitted. Further, any amount of the loan outstanding which is in excess of the permitted relationship of fair value of the pledged investment to the collateral loan shall be treated as a nonadmitted asset.

Activity to Date (issues previously addressed by the Working Group, Emerging Accounting Issues (E) Working Group, SEC, FASB, other State Departments of Insurance or other NAIC groups): None

Information or issues (included in *Description of Issue*) not previously contemplated by the Working Group: None

Convergence with International Financial Reporting Standards (IFRS): Not applicable.

Staff Review Completed by: Robin Marcotte – NAIC Staff – July 2022

Staff Recommendation: NAIC staff recommends that the Working Group move this item to the active listing, categorized as a SAP clarification, and expose the revisions to SSAP No. 21 illustrated below which clarify that the invested assets pledged as collateral for admitted collateral loans must qualify as admitted invested assets.

[2] 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 (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 that are also secured with collateral shall continue to be captured within scope of SSAP No. 26R.

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

Proposed revisions to ***SSAP No. 21 – Revised—Other Admitted Assets***

Collateral Loans

4. Collateral loans are unconditional obligations[2] for the payment of money secured by the pledge of a~~n~~ qualifying investment[3] 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:

a. Loan Impairment—Determination as to the impairment of a collateral loan shall be based on current information and events. When it is considered probable that any portion of amounts due under the contractual terms of the loan will not be collected the loan is considered impaired. The impairment shall be measured based on the fair value of the collateral less estimated costs to obtain and sell the collateral. The difference between the net value of the collateral and the recorded asset shall be written off in accordance with *SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets*;

b. Nonadmitted Asset—In accordance with *SSAP No. 20—Nonadmitted Assets*, collateral loans secured by assets that do not qualify as investments which would otherwise be admitted shall be nonadmitted. Further, any amount of the loan outstanding which is in excess of the permitted relationship of fair value of the pledged investment to the collateral loan shall be treated as a nonadmitted asset.

[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 (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 that are also secured with collateral shall continue to be captured within scope of SSAP No. 26R.

[1] A qualifying ~~I~~investment defined as those assets listed in Section 3 of *Appendix A-001—Investments of Reporting Entities* which would ~~.~~if held by the insurer would qualify for admittance. For example, if the collateral would not qualify for admittance under SSAP No. 4 due to encumbrances or other third-party interests, then it does not meet the definition of "qualifying" and the collateral loan, or any portion thereof which is not adequately collateralized, is not permitted to be admitted.

https://naiconline.sharepoint.com/teams/FRSStatutoryAccounting/National Meetings/A. National Meeting Materials/2022/7-Summer NM/Meeting/C - 22-11 - Collateral loans .docx

Statutory Accounting Principles (E) Working Group
Maintenance Agenda Submission Form
Form A

Issue: Review of INT 03-02*: Modification to an Existing Intercompany Pooling Arrangement*

Check (applicable entity):

	P/C	Life	Health
Modification of Existing SSAP	☒	☒	☒
New Issue or SSAP	☐	☐	☐
Interpretation	☐	☐	☐

Description of Issue:
This agenda item provides a review of Interpretation (INT) 03-02*: Modification to an Existing Intercompany Pooling Arrangement*, because of conflicts between INT 03-02 and *SSAP No. 25—Affiliates and Other Related Parties*. This agenda item was prompted by the recent focus of Statutory Accounting Principles (E) Working Group on related party transactions, recent queries to NAIC about how broadly to apply the guidance in INT 03-02 and the review of the SSAP No. 62R, paragraph INT 03-02 addresses the valuation of bonds in instances when bonds are used instead of cash for the payment among affiliates for amounts due on modifications to existing intercompany reinsurance pooling contracts. The discrepancy between the INT 03-02 and SSAP No. 25 has been identified through recent discussions evaluating related party transactions. Key excerpts of INT 03-02 are in the Authoritative Literature section below.

The primary accounting question that is a concern for this agenda item is INT 03-02, paragraph 11b which asks, "What is the appropriate valuation basis to be used for assets and liabilities that are transferred among affiliates in conjunction with the execution of a new reinsurance agreement(s) that serves to substantively modify an existing intercompany pooling arrangement?" The response provided in INT 03-02, paragraph 13 is, "The appropriate valuation basis to be used for assets and liabilities that are transferred among affiliates in conjunction with the execution of a new reinsurance agreement(s) that serves to substantively modify an existing intercompany pooling arrangement is statutory book value for assets and statutory value for liabilities. Book value is defined in the glossary of the *Accounting Practices and Procedure Manual*."

INT 03-02 lists that it is an interpretation of the following three reinsurance statements: *SSAP No. 61R—Life, Deposit-Type and Accident and Health Reinsurance*, *SSAP No. 62R—Property and Casualty Reinsurance* and *SSAP No. 63—Underwriting Pools. SSAP No. 25—Affiliates and Other Related Parties* is not listed as an interpreted statement. However, as described below, the consensus in INT 03-02, paragraph 13 is not consistent with the guidance in SSAP No. 25 regarding economic transactions between related parties.

The result of the consensus in INT 03-02, paragraph 13 allows assets used in affiliated payments for reinsurance contracts, which modify existing intercompany reinsurance pooling agreements, to be transferred using statutory book value. Note that in most cases, this means that bonds which are likely the primary assets that would be used, would typically have a statutory book value that reflects amortized cost. The valuation of assets using statutory book value on transfer to an affiliate, can result in substantial differences from the cash equivalent (fair value) for the payment due. For example, bonds reported at amortized cost book value could have a corresponding fair value that is materially higher or lower. This difference in valuation can result in an unacknowledged dividend or with the passing on of an investment loss.

SSAP No. 25 describes economic transactions and non-economic transactions (See Authoritative Literature). Economic transactions are defined as arm's-length transactions which results in the transfer of the risks and rewards of ownership and represents a consummated act thereof, i.e., "permanence." SSAP No. 25, paragraph 18 indicates that economic transactions between related parties shall be recorded at fair value at the date of the transaction and also notes that to the extent that the related parties are affiliates under common control, the controlling reporting

entity shall defer the effects of such transactions that result in gains or increases in surplus until such time that the asset is sold outside the group.

It is quite possible, by using transfers at book value instead of fair value, to design a transaction with a very significant economic effect. The following example illustrates the concern with the results of the guidance in INT 03-02. For this example, $100 million is due on an existing intercompany reinsurance pooling agreement. INT 03-02 would allow bonds to be settled using statutory book value which may not be reflective of the fair value equivalent of a cash settlement.

Asset used to settle	**Book Value (millions) measurement for settlement**	**Fair Value (millions)**	**Result**	**Consistent with SSAP No. 25 for an economic transaction?**
Cash	$100	$100	No difference in basis	Yes
Bonds	$100	$ 85	$15 difference in fair value means the paid party received an amount less than what is actually owed. This approach could allow reporting entities to transfer impaired assets to affiliates in lieu of assessing OTTI.	No
Bonds	$100	$110	$10 difference in fair value means the paid party has received an asset greater than what was owed. This dynamic could result in an unrecognized gain or dividend.	No

The INT 03-02 direction to use statutory book value for the transfer of bonds between affiliated entities in most instances would conflict with the primary guidance on affiliated transactions contained in *SSAP No. 25—Affiliates and Other Related Parties.* For example, economic transactions between related parties are valued using fair value. (There are more nuances in SSAP No. 25 when payments have the possibility of being economic for one entity and noneconomic for an upper-level parent). NAIC staff recommends that the treatment of transfers of assets between affiliates should be consistent for all intercompany transactions and there is not a compelling need to be different if assets are transferred instead of cash for intercompany reinsurance.

Under INT 03-02, for intercompany reinsurance transactions, takes an approach that either SSAP No. 25 or SSAP No. 62R may apply, but multiple Working Group discussions have noted that SSAP No. 25 provides the overarching guidance that is relevant in evaluating all related party transactions. INT 03-02, paragraph 8 indicates that the statutory accounting intention is to avoid surplus gains for the ceding entity as a result of implementing a modification to an intercompany pooling arrangement. However, the guidance in SSAP No, 62R, paragraph 37 uses a more punitive method of accounting if there is a gain in surplus to the ceding entity as a result of the intercompany reinsurance transaction. Therefore, NAIC staff would characterize the SSAP No. 62R guidance as imposing an accounting penalty if there is a gain, rather than seeking to avoid recognizing such a gain. The INT also characterizes SSAP No. 25 as being for isolated transactions, which is inconsistent with discussions of the Working Group on the applicability of SSAP No. 25.

SSAP No. 62R, paragraph 36d (see Authoritative Literature) includes an exception to retroactive reinsurance accounting which allows prospective accounting treatment for intercompany reinsurance agreements and any amendments thereto, among companies 100% owned by a common parent or ultimate controlling person <u>provided there is no gain in surplus as a result of the transaction.</u> Paragraph 37 provides that if there is a gain to the ceding entity that a more restrictive method of accounting is required which is less beneficial to the financial statements. Whereas the INT tries to argue that statutory intent is to avoid surplus gain, NAIC staff would note that the goal is not to avoid gain as a result of the reinsurance transaction, but to impose a different accounting if there is a gain.

NAIC staff would characterize evaluating reinsurance agreements for SSAP No. 62R, paragraph 36d or paragraph 37 as using the cash flows or corresponding equivalent fair value (cash equivalent) of the amounts payable or receivable in the reinsurance transactions to determine if there is a gain or loss to the ceding entity. The reinsurance cash flows evaluated should be the same as if the bond was sold for fair value and resulting cash equivalent obligation was paid. The fact that the bond sold has a gain or loss is not part of the reinsurance contract evaluation, the reinsurance contract that is an economic transaction evaluation is based on the cash equivalent value of the assets transferred less the liabilities transferred. The evaluation of gain or loss on the intercompany reinsurance transaction should give the same answer if either cash or assets were transferred.

Existing Authoritative Literature:

03-02*: Modification to an Existing Intercompany Pooling Arrangement* is attached in full. The following excerpts are from INT 03-02:

> 8. Therefore, based on the foregoing guidance and background, the statutory accounting intent is to avoid surplus gains for the ceding entity as a result of implementing a modification to an intercompany pooling arrangement. On that basis, such a modification does not represent an economic transaction to the insurance group or to the impacted companies. As such, the transfer of both the assets and the liabilities valued at statutory book value ensures that there is no impact to surplus as a result of implementing a modification to an existing pooling arrangement.

11. The accounting issues are:

    a. What is the relevant guidance for modifications to intercompany pooling arrangements?

    b. What is the appropriate valuation basis to be used for assets and liabilities that are transferred among affiliates in conjunction with the execution of a new reinsurance agreement(s) that serves to substantively modify an existing intercompany pooling arrangement?

The Working Group reached a consensus as follows:

12. SSAP No. 62R provides accounting for property and casualty reinsurance agreements including specific guidance on intercompany pooling agreements. SSAP No. 62R provides two methods of accounting for changes in intercompany pooling agreements, depending on whether or not the pooling results in a gain in surplus.

13. The appropriate valuation basis to be used for assets and liabilities that are transferred among affiliates in conjunction with the execution of a new reinsurance agreement(s) that serves to substantively modify an existing intercompany pooling arrangement is statutory book value for assets and statutory value for liabilities. Book value is defined in the glossary of the *Accounting Practices and Procedure Manual*.

SSAP No. 25—Affiliates and Other Related Parties

Transactions Involving the Exchange of Assets or Liabilities

14. An arm's-length transaction is defined as a transaction in which willing parties, each being reasonably aware of all relevant facts and neither under compulsion to buy, sell, or loan, would be willing to participate. A transaction between related parties involving the exchange of assets or liabilities shall be designated as either an economic transaction or non-economic transaction. An economic transaction is defined as an arm's-length transaction which results in the transfer of the risks and rewards of ownership and represents a consummated act thereof, i.e., "permanence." The appearance of permanence is also an important criterion in assessing the economic substance of a transaction. In order for a transaction to have economic substance and thus warrant revenue (loss) recognition, it must appear unlikely to be reversed. If subsequent events or transactions reverse the effect of an earlier transaction prior to the issuance of the financial statements, the reversal shall be considered in determining whether economic substance existed

in the case of the original transaction. Subsequent events are addressed in SSAP No. 9—Subsequent Events. An economic transaction must represent a bonafide business purpose demonstrable in measurable terms. A transaction which results in the mere inflation of surplus without any other demonstrable and measurable betterment is not an economic transaction. The statutory accounting shall follow the substance, not the form of the transaction.

15. In determining whether there has been a transfer of the risks and rewards of ownership in the transfer of assets or liabilities between related parties, the following—and any other relevant facts and circumstances related to the transaction—shall be considered:

a. Whether the seller has a continuing involvement in the transaction or in the financial interest transferred, such as through the exercise of managerial authority to a degree usually associated with ownership;

b. Whether there is an absence of significant financial investment by the buyer in the financial interest transferred, as evidenced, for example, by a token down payment or by a concurrent loan to the buyer;

c. Whether repayment of debt that constitutes the principal consideration in the transaction is dependent on the generation of sufficient funds from the asset transferred;

d. Whether limitations or restrictions exist on the buyer's use of the financial interest transferred or on the profits arising from it;

e. Whether there is retention of effective control of the financial interest by the seller.

16. A transaction between related parties may meet the criteria for treatment as an economic transaction at one level of financial reporting, but may not meet such criteria at another level of financial reporting. An example of such a transaction is a reporting entity purchasing securities at fair value from an affiliated reporting entity that carried the securities at amortized cost. This transaction meets the criteria of an economic transaction at this level of financial reporting, and therefore, the selling reporting entity would record a gain and the acquiring reporting entity would record the securities at their cost (fair value on the transaction date). At the common parent level of reporting, this transaction has resulted in the mere inflation of surplus, and therefore, is a non-economic transaction. The parent reporting entity shall defer the net effects of any gain or increase in surplus resulting from such transactions by recording a deferred gain and an unrealized loss. The deferred gain shall not be recognized by the parent reporting entity unless and until arms-length transaction(s) with independent third parties give rise to appropriate recognition of the gain.

17. A non-economic transaction is defined as any transaction that does not meet the criteria of an economic transaction. Similar to the situation described in paragraph 16, transfers of assets from a parent reporting entity to a subsidiary, controlled or affiliated entity shall be treated as non-economic transactions at the parent reporting level because the parent has continuing indirect involvement in the assets.

18. When accounting for a specific transaction, reporting entities shall use the following valuation methods:

a. Economic transactions between related parties shall be recorded at fair value at the date of the transaction. To the extent that the related parties are affiliates under common control, the controlling reporting entity shall defer the effects of such transactions that result in gains or increases in surplus (see paragraph 16);

b. Non-economic transactions between reporting entities, which meet the definition of related parties above, shall be recorded at the lower of existing book values or fair values at the date of the transaction;

c. Non-economic transactions between a reporting entity and an entity that has no significant ongoing operations other than to hold assets that are primarily for the direct or indirect benefit or use of the reporting entity or its affiliates, shall be recorded at the fair value at the date of the transaction;

however, to the extent that the transaction results in a gain, that gain shall be deferred until such time as permanence can be verified;

d. Transactions which are designed to avoid statutory accounting practices shall be reported as if the reporting entity continued to own the assets or to be obligated for a liability directly instead of through a subsidiary.

Examples of transactions deemed to be non-economic include security swaps of similar issues between or among affiliated companies, and swaps of dissimilar issues accompanied by exchanges of liabilities between or among affiliates.

Transactions Involving Services

19. Transactions involving services between related parties can take a variety of different forms. One of the significant factors as to whether these transactions will be deemed to be arm's length is the amount charged for such services. In general, amounts charged for services are based either on current market rates or on allocations of costs. Determining market rates for services is difficult because the circumstances surrounding each transaction are unique. Unlike transactions involving the exchange of assets and liabilities between related parties, transactions for services create income on one party's books and expense on the second party's books, and therefore, do not lend themselves to the mere inflation of surplus. These arrangements are generally subject to regulatory approval.

20. Transactions involving services provided between related parties shall be recorded at the amount charged[1]. Regulatory scrutiny of related party transactions where amounts charged for services do not meet the fair and reasonable standard established by Appendix A-440, may result in (a) amounts charged being recharacterized as dividends or capital contributions, (b) transactions being reversed, (c) receivable balances being nonadmitted, or (d) other regulatory action. Expenses that result from cost allocations shall be allocated subject to the same fair and reasonable standards, and the books and records of each party shall disclose clearly and accurately the precise nature and details of the transaction. See *SSAP No 70—Allocation of Expenses* for additional discussion regarding the allocation of expenses.

SSAP No. 62R—Property and Casualty Reinsurance provides the following (**bolding added for emphasis**):

36. The accounting principles for retroactive reinsurance agreements in paragraph 34 shall not apply to the following types of agreements (which shall be accounted for as prospective reinsurance agreements unless otherwise provided in this statement):

a. Structured settlement annuities for individual claims purchased to implement settlements of policy obligations;

b. Novations, (i.e., (i) transactions in which the original direct insurer's obligations are completely extinguished, resulting in no further exposure to loss arising on the business novated or (ii) transactions in which the original assuming entity's obligations are completely extinguished) resulting in no further exposure to loss arising on the business novated, provided that (1) the parties to the transaction are not affiliates (or if affiliates, that the transaction has the prior approval of the domiciliary regulators of the parties) and (2) the accounting for the original reinsurance agreement will not be altered from retroactive to prospective;

[1] The amount charged shall be reviewed when there are any modifications or waivers subsequent to the establishment of the contract terms. If waivers or modifications to amounts charged occur, the related party transaction shall be reassessed to determine whether the contract continues to reflect fair and reasonable standards. If the transaction was with a parent or other stockholder and the charge for services has been fully waived, then the guidance in SSAP No. 72 for recognition as contributed capital (forgiveness of reporting entity obligation) or as a dividend (forgiveness of amount owed to the reporting entity) shall apply.

c. The termination of, or reduction in participation in, reinsurance treaties entered into in the ordinary course of business;

d. Intercompany reinsurance agreements, and any amendments thereto, among companies 100% owned by a common parent or ultimate controlling person provided there is no gain in surplus as a result of the transaction; or

e. Reinsurance/retrocession agreements that meet the criteria of property/casualty run-off agreements described in paragraphs 102-105.

37. **Retroactive reinsurance agreements resulting in surplus gain to the ceding entity (with or without risk transfer)** entered into between affiliates or between insurers under common control (as those terms are defined in Appendix A-440) shall be reported as follows:

a. The consideration paid by the ceding entity shall be recorded as a deposit and reported as a nonadmitted asset; and

b. No deduction shall be made from loss and loss adjustment expense reserves on the ceding entity's balance sheet, schedules, and exhibits.

Activity to Date (issues previously addressed by the Working Group, Emerging Accounting Issues (E) Working Group, SEC, FASB, other State Departments of Insurance or other NAIC groups):

INT 03-02 was exposed in March of 2003 and adopted in June 2003. The interpretation was not subsequently amended. The final vote on this consensus had three members opposed. The March 2003 exposure received six different comment letters to the Emerging Accounting Issues (E) Working Group from: 1) Ohio (EAIWG member); 2) New Hampshire (EAIWG member); 3) Interested parties, 4) Liberty Mutual and 5) PriceWaterhouseCoopers (one of the very few letters ever submitted directly by the firm.) and 6) CNA. Five out of the six commenters noted concerns that the proposed guidance (which was ultimately adopted) would conflict with SSAP No. 25 guidance regarding economic transactions. While the interested parties comment letter was more neutral, the verbal comments provided supported the use of SSAP No. 25.

Several commenters recommended not adopting the guidance regarding the use of book value and instead following SSAP No. 25 guidance for economic and non-economic transactions. The commenters noted that SSAP No. 25 directs the use of fair value when such transactions meet the definition of an economic transactions and that tax regulations would provide a result similar to SSAP No. 25. Multiple comments noted concerns similar to those highlighted in the illustration above. Commenters also noted that intercompany pooling reinsurance transaction are economic transactions. They noted that when assets (such as bonds valued at amortized cost) are transferred, if the assets have a different fair value than book value, that difference should be recognized since the transferor no longer controls the assets. Commenters also noted that treatment for reinsurance transactions for asset transfers should not be different than the treatment for other intercompany transactions.

CNA comments were supportive of adopting the exposed consensus, the comment letter provided illustrations and noted that intercompany reinsurance agreements were subject to regulatory approval. The comments tried to illustrate concerns possibly having premature gain / surplus recognition. .

The June 2003 minutes Emerging Accounting Issues (E) Working Group discussion on the INT 03-02 are excerpted below.

> The working group was referred to INT 03-02: *Modification to an existing intercompany pooling arrangement* (Attachment D). Written comments were received from Ohio, New Hampshire and interested parties. Ohio and New Hampshire believe that the transfer of assets and liabilities in an intercompany pooling arrangement constitute an economic transaction and the accounting guidance in SSAP No. 25—*Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties* (SSAP No. 25), should be followed. As such, the assets should be transferred at fair value and the ceding entity should record a realized gain or loss. Keith Bell (Travelers) spoke on behalf of interested parties. Interested parties

commented that if the transaction was considered to be an economic transaction, SSAP No. 25 should be followed. If the modification of an intercompany pooling arrangement is considered a noneconomic transaction, the guidance in SSAP No.62—*Property and Casualty Reinsurance*(SSAP No. 62) is applied, as such, statutory book value should be used for assets and statutory value should be used for liabilities. Jeff Alton (CNA) presented his comments by summarizing the statements made in his comment letter. Mr. Alton stated that no revenue recognition should occur and suggested using a modified statutory book value for transferring assets and liabilities. Mr. Clark stated that the Statutory Accounting Principles Working Group must address the recommended transfer at modified statutory book value as this recommendation would require substantive adjustments to statutory accounting principles. Shelly Zimmerman (Liberty Mutual) provided comments which supported that intercompany pooling changes should follow the accounting guidance in SSAP No. 25 as these are economic transactions between affiliates. Jean Connelly (PriceWaterhouseCoopers) provided comments that summarize those outlined in the comment letter. Ms. Connelly stated that intercompany pooling arrangements are economic transactions and that INT 03-01 provides a substantive change to SSAP No. 25.

Mr. Johnson then stated that he believes there is a stronger case for non-economic transaction treatment and as such, statutory book value is appropriate for valuation purposes. Additionally, all these transactions are subject to regulatory review under the Insurance Holding Company Act, affording regulators some control over the approval of these transactions. Mr. Fritsch commented that if this guidance is not adopted in the form of a new interpretation, SSAP No. 25 should be followed. Mr. Alton stated that he believes the current guidance in effect for intercompany pooling arrangements exists in SSAP No. 62, paragraph 30d which supports surplus neutrality: hence, the need is for an interpretation of paragraph 30d. Mr. Johnson stated that language clarification in SSAP No.61—*Life, Deposit-Type and Accident and Health Reinsurance*(SSAP No. 61) and SSAP No. 62 should be addressed as a project of the reinsurance subgroup of the SAPWG. Mr. Johnson made a motion to adopt Interpretation 03-02 with deletion of the first two sentences in paragraph 11. Mr. Stolte seconded the motion. Mr. Johnson requested a roll call vote. There were 9 yeas from Alabama, Connecticut, Florida, Illinois, Louisiana, Michigan, Texas, Pennsylvania and Virginia. There were 3 nays from New York, Ohio, and Wisconsin. Therefore, the working group adopted Interpretation 03-02 by consensus. Mr. Johnson also made a motion to refer to the Reinsurance Subgroup of the SAPWG, review of the current guidance in SSAP No. 61, SSAP No. 62 and SSAP No. 63—*Underwriting Pools and Associations Including Intercompany Pools.* Mr. Ford seconded the motion. The working group unanimously adopted the referral.

Information or issues (included in *Description of Issue*) not previously contemplated by the Working Group: None

Convergence with International Financial Reporting Standards (IFRS): Not Applicable

Staff Review Completed by: Robin Marcotte – NAIC Staff, July - 2022

Staff Recommendation: NAIC staff recommends that the Working Group move this item to the active listing, categorized as a SAP clarification, and expose the intent to nullify INT 03-02, as it is inconsistent with SSAP No. 25 guidance regarding economic and non-economic transactions between related parties. The guidance in INT 03-02 can result with in essence, unrecognized gains (dividends) or losses through the using the statutory book valuation when using assets (bonds) to make payments to affiliates for modifications to existing intercompany reinsurance pooling agreements. Treatment of transfers of assets between affiliates should be consistent for all intercompany transactions and there is not a compelling need to be different when valuing assets for intercompany reinsurance transactions.

https://naiconline.sharepoint.com/teams/FRSStatutoryAccounting/National Meetings/A. National Meeting Materials/2022/7-Summer NM/Meeting/D - 22-12 - Review INT 03-02.docx

Interpretation of the Emerging Accounting Issues (E) Working Group

INT 03-02: Modification to an Existing Intercompany Pooling Arrangement

INT 03-02 Dates Discussed

March 9, 2003; June 22, 2003

INT 03-02 References

Current:
SSAP No. 61R—Life, Deposit-Type and Accident and Health Reinsurance
SSAP No. 62R—Property and Casualty Reinsurance
SSAP No. 63—Underwriting Pools

INT 03-02 Issue

1. Insurance groups that utilize intercompany pooling arrangements often modify these arrangements from time to time for various business reasons. These business reasons commonly include mergers, acquisitions, dispositions or a restructuring of the group's legal entity structure. As an insurance group's business objectives and strategies evolve, it may be necessary for the insurance group's legal entity structure to similarly evolve in order to address the insurance group's business needs.

2. SSAP No. 63, paragraphs 5 and 7, defines and describes intercompany pooling as an arrangement among affiliated entities whereby "all of the pooled business is ceded to the lead entity and then retroceded back to the pool participants in accordance with their stipulated shares." This arrangement is established through "a conventional quota share reinsurance agreement…" Arrangements whereby there is one lead company that retains 100% of the pooled business and all or some of the affiliated companies have a 0% net share of the pool may qualify as intercompany pooling."

3. Therefore, in order to effectuate a modification to the existing intercompany pooling arrangement, companies must either 1) amend the existing reinsurance agreement, or 2) execute new agreements. The latter scenario may entail executing at least two agreements: a commutation of the existing agreement, and a new quota share agreement(s) that covers both past and future periods.

4. To illustrate, in order to effectuate a relatively simple modification, such as changing pooling participation percentages without changing the pool participants, companies often simply amend the existing pooling agreement. Alternatively, in order to effectuate a more complex modification, such as changing (by adding or removing) the number of pool participants, a company must commute the existing pooling agreement and execute a new quota share agreement(s). In conjunction with executing the appropriate reinsurance agreements, a transfer of assets and liabilities amongst the impacted affiliates is also required in order to implement the new reinsurance agreement(s). At issue is the appropriate valuation basis to be used for assets and liabilities that are transferred pursuant to the new reinsurance agreement(s).

5. Since SSAP No. 63 does not specifically address modifications to intercompany pooling arrangements, insurance groups that modify their intercompany pooling arrangements must refer elsewhere in Statutory Accounting Principles (SAP) for relevant guidance. The obvious guidance for such transactions is SSAP No. 62R since an intercompany pooling arrangement is, by definition, affiliated reinsurance. There is, however, a minority opinion that *SSAP No. 25—Affiliates and Other Related Parties* appears to apply due to the affiliated nature of these transactions. Since the guidance and intent of SSAP No. 62R and SSAP No. 25 provide for different valuation bases, this interpretation serves to provide definitive guidance as to which SSAP is relevant for these transactions and, therefore, clarify the

appropriate valuation basis to be used for assets and liabilities transferred pursuant to a modification to an intercompany pooling arrangement.

SSAP No. 62R Approach:

6. This approach refers to the guidance and statutory accounting intent from SSAP No. 62R since intercompany pooling arrangements are defined and established through reinsurance. Further, since modifications to intercompany pooling agreements typically involve the transfer of net liabilities incurred since the inception of the existing pooling agreement (i.e., prior to the effective date of the new agreement), the retroactive reinsurance accounting guidance in paragraphs 33-39 of SSAP No. 62R is applicable. Paragraph 33 states that this special accounting treatment is warranted "due to the potential abuses involving the creation of surplus to policyholders and the distortion of underwriting results…" However, paragraph 36.d. specifically applies to intercompany reinsurance arrangements, and amendments to intercompany reinsurance agreements, since the reinsurance agreement is among companies 100% owned by a common parent. This paragraph allows prospective accounting treatment for intercompany reinsurance agreements that do not result in a gain in surplus as a result of the transaction.

7. To provide historical perspective, prior to the adoption (with modification) of FASB *Statement No. 113, Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts* (FAS 113) as SAP, paragraph 36.d. was added as one of the SAP modifications. The intent of adding paragraph 36.d. was to specifically exclude intercompany reinsurance agreements among entities 100% owned by a common parent from retroactive reinsurance accounting requirements as a result of amending or modifying these agreements, provided there is no surplus gain. The presumption in this intent was that there would be no gains to the ceding entity resulting from implementing amendments or modifications to these types of reinsurance agreements.

8. Therefore, based on the foregoing guidance and background, the statutory accounting intent is to avoid surplus gains for the ceding entity as a result of implementing a modification to an intercompany pooling arrangement. On that basis, such a modification does not represent an economic transaction to the insurance group or to the impacted companies. As such, the transfer of both the assets and the liabilities valued at statutory book value ensures that there is no impact to surplus as a result of implementing a modification to an existing pooling arrangement.

SSAP No. 25 Approach:

9. An approach different from that which refers to reinsurance accounting guidance is to refer to the guidance in SSAP No. 25 since some may view a modification to an intercompany pooling agreement as a related party transaction involving the exchange of assets or liabilities. In this case, paragraphs 14-18 of SSAP No. 25 would appear applicable. This guidance specifies differing valuation bases, depending on whether the transaction is considered an economic or a non-economic transaction. SSAP No. 25, paragraph 14, states that "…The appearance of permanence is also an important criterion is assessing the economic substance of a transaction. In order for a transaction to have economic substance and thus warrant revenue (loss) recognition, it must appear unlikely to be reversed …" Since insurance groups often modify intercompany pooling arrangements, this type of transaction is not permanent, and may be construed as a non-economic transaction. SSAP No. 25, paragraph 18.b., states that "non-economic transactions … shall be recorded at the lower of existing book value or fair value at the date of the transaction."

10. It appears that this guidance is intended to address matters involving discrete or isolated transfers of assets and/or liabilities between affiliates rather than transfers of assets and liabilities effected in relation to executing reinsurance transactions (the guidance for which is SSAP No. 62R). Additionally, application of this guidance would result in a change to the surplus of the insurance group as a result of implementing a modification to an existing intercompany pooling arrangement. As previously stated, the

statutory accounting intent is to avoid surplus gains for the insurance group as a result of implementing a modification to an intercompany pooling arrangement.

11. The accounting issues are:

    a. What is the relevant guidance for modifications to intercompany pooling arrangements?

    b. What is the appropriate valuation basis to be used for assets and liabilities that are transferred among affiliates in conjunction with the execution of a new reinsurance agreement(s) that serves to substantively modify an existing intercompany pooling arrangement?

INT 03-02 Discussion

The Working Group reached a consensus as follows:

12. SSAP No. 62R provides accounting for property and casualty reinsurance agreements including specific guidance on intercompany pooling agreements. SSAP No. 62R provides two methods of accounting for changes in intercompany pooling agreements, depending on whether or not the pooling results in a gain in surplus.

13. The appropriate valuation basis to be used for assets and liabilities that are transferred among affiliates in conjunction with the execution of a new reinsurance agreement(s) that serves to substantively modify an existing intercompany pooling arrangement is statutory book value for assets and statutory value for liabilities. Book value is defined in the glossary of the *Accounting Practices and Procedure Manual*.

INT 03-02 Status

14. No further discussion is planned.

Statutory Accounting Principles (E) Working Group
Maintenance Agenda Submission Form
Form A

Issue: Related Parties – Footnote Updates

Check (applicable entity):

	P/C	Life	Health
Modification of Existing SSAP	☒	☒	☒
New Issue or SSAP	☐	☐	☐
Interpretation	☐	☐	☐

Description of Issue: At its May 24, 2022, meeting, the Statutory Accounting Principles (E) Working Group adopted agenda item 2021-21 – Related Party Reporting. That agenda item encompassed two main goals:

1. Clarified the reporting of affiliate transactions within existing reporting lines in the investment schedules, while remaining consistent with the definition of an "affiliate" pursuant to the *Insurance Holding Company System Regulatory Act* (Model #440), *SSAP No. 25—Affiliates and Other Related Parties* and *SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities*.

2. Incorporated new reporting requirements for investment transactions with related parties. This agenda item added a new column to annual statement reporting schedules: B – Mortgage Loans, D – Long-Term Bonds, DB – Derivatives, BA – Other Long-Term Invested Assets, DA – Short-Term Investments, E2 – Cash Equivalents, and DL – Securities Lending Collateral Assets where the reporting entity must select a code that best describes the related party relationship within the investment.

When agenda item 2021-21 was exposed for the final time on April 4, 2022, a footnote was added to SSAP No. 25, paragraph 9 that states "Consistent with SSAP No. 97, footnote 1, investments in an exchange traded fund (ETF) or a mutual fund (as defined by the SEC) does not reflect ownership in an underlying entity, regardless of the ownership percentage the reporting entity (or the holding company group) has of the ETF or mutual fund unless ownership of the ETF actually results in "control" with the power to direct or cause the direction of management of an underlying company. ETFs and mutual funds are comprised of portfolios of securities subject to the regulatory requirements of the federal securities laws." Among the comments received from interested parties after the April 4 exposure was a suggestion to extend the exemption to foreign open-end investment funds governed and authorized in accordance with regulations established by the applicable foreign jurisdiction, which are within the scope of *SSAP No. 30R—Unaffiliated Common Stock*.

As part of the adoption of agenda item 2021-21 at the May 24 meeting, NAIC staff were directed by the Working Group to make revisions to include foreign open-end funds SSAP No. 25 and SSAP No. 97 in the footnotes.

Existing Authoritative Literature:

SSAP No. 25—Affiliates and Other Related Parties (paragraph and footnote originally adopted on the May 24, 2022, Working Group call.)

> 9. For entities not controlled by voting interests, such as limited partnerships, trusts and other special purpose entities, control may be held by a general partner, servicer, or by other arrangements. The ability of the reporting entity or its affiliates to direct the management and policies of an entity through such arrangements shall constitute control as defined in paragraph 6. Additionally, a reporting entity or its affiliates may have indirect control of other entities through such arrangements. For example, if a limited partnership were to be controlled by an affiliated general partner, and that limited partnership held greater than 10% of the voting interests of another company[FN], indirect control shall be presumed to exist unless the presumption of control can be overcome as detailed in paragraph 7. If direct or indirect control exists,

whether through voting securities, contracts, common management or otherwise, the arrangement is considered affiliated under paragraph 5. Consistent with paragraph 8, a disclaimer of affiliation does not eliminate a "related party" distinction or disclosure requirements for material transactions pursuant to SSAP No. 25.

FN—Consistent with SSAP No. 97, footnote 1, investments in an exchange traded fund (ETF) or a mutual fund (as defined by the SEC) does not reflect ownership in an underlying entity, regardless of the ownership percentage the reporting entity (or the holding company group) has of the ETF or mutual fund unless ownership of the ETF actually results in "control" with the power to direct or cause the direction of management of an underlying company. ETFs and mutual funds are comprised of portfolios of securities subject to the regulatory requirements of the federal securities laws.

SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities

5. Control is defined as the possession, directly or indirectly, of the power to direct or cause the direction of the management and policies of the investee, whether through the (a) ownership of voting securities, (b) by contract other than a commercial contract for goods or nonmanagement services, (c) by common management, or (d) otherwise. Control shall be presumed to exist if a reporting entity and its affiliates directly or indirectly, own, control, hold with the power to vote, or hold proxies representing 10% or more of the voting interests of the entity[FN].

FN—Investments in an exchange traded fund (ETF) or a mutual fund (as defined by the SEC) does not reflect ownership in an underlying entity, regardless of the ownership percentage the reporting entity (or the holding company group) has of the ETF or mutual fund unless ownership of the ETF actually results in "control" with the power to direct or cause the direction of management of an underlying company. ETFs and mutual funds are comprised of portfolios of securities subject to the regulatory requirements of the federal securities laws. ETFs and mutual funds held by a reporting entity shall be reported as common stock, unless the ETF qualifies for bond or preferred stock treatment per the *Purposes and Procedures Manual of the NAIC Investment Analysis Office*. Reporting entities are not required to verify that SCAs (subject to SSAP No. 97) are represented in the portfolio of securities held in ETFs or mutual funds or to adjust the value of SCAs as a result of investments in ETFs or mutual funds.

Activity to Date (issues previously addressed by the Working Group, Emerging Accounting Issues (E) Working Group, SEC, FASB, other State Departments of Insurance or other NAIC groups): In March 2021, the Statutory Accounting Principles (E) Working Group adopted revisions to SSAP No. 25 pursuant to agenda item 2019-34: Related Parties, Disclaimers of Affiliation and Variable Interest Entities. Additionally, a new reporting Schedule Y, Part 3 was adopted by the Blanks (E) Working Group in proposal 2020-37BWG, with an initial effective date of Dec. 31, 2021, to capture information on all entities with ownership greater than 10%, the ultimate controlling parties of those owners and other entities that the ultimate controlling party controls.

The adopted revisions to SSAP No. 25 from agenda item 2019-34 are summarized as follows:

- Clarify the identification of related parties and ensure that any related party identified under U.S. GAAP or SEC reporting requirements would be considered a related party under statutory accounting principles.

- Clarify that non-controlling ownership over 10% results in a related party classification regardless of any disclaimer of control or disclaimer of affiliation.

- Clarify the impact of a disclaimer of control or disclaimer of affiliate under SAP. As detailed, such disclaimers impact holding company group allocation and reporting as an SCA under SSAP No. 97, but do not eliminate the classification as a "related party" and the disclosure of material transactions as required under SSAP No. 25.

- Rejected several U.S. GAAP standards addressing variable interest entities.

On May 24, 2022, the Working Group adopted agenda item 2021-21 – Related Party Reporting, which encompassed two main goals:

- Clarified the reporting of affiliate transactions within existing reporting lines in the investment schedules, while remaining consistent with the definition of an "affiliate" pursuant to Model #440, SSAP No. 25 and SSAP No. 97.

- Incorporated new reporting requirements for investment transactions with related parties. This agenda item added a new column to annual statement reporting schedules: B – Mortgage Loans, D – Long-Term Bonds, DB – Derivatives, BA – Other Long-Term Invested Assets, DA – Short-Term Investments, E2 – Cash Equivalents, and DL – Securities Lending Collateral Assets where the reporting entity must select a code that best describes the related party relationship within the investment.

Information or issues (included in *Description of Issue*) not previously contemplated by the Working Group: None

Convergence with International Financial Reporting Standards (IFRS): None

Staff Recommendation: NAIC staff recommends that the Working Group move this item to the active listing, categorized as a SAP clarification, and expose revisions to SSAP No. 25 and SSAP No. 97 to incorporate language to exempt foreign open-end investment funds governed and authorized in accordance with regulations established by the applicable foreign jurisdiction from the look-through provisions included in SSAP No. 25.

Proposed edits to SSAP No. 25:

9. For entities not controlled by voting interests, such as limited partnerships, trusts and other special purpose entities, control may be held by a general partner, servicer, or by other arrangements. The ability of the reporting entity or its affiliates to direct the management and policies of an entity through such arrangements shall constitute control as defined in paragraph 6. Additionally, a reporting entity or its affiliates may have indirect control of other entities through such arrangements. For example, if a limited partnership were to be controlled by an affiliated general partner, and that limited partnership held greater than 10% of the voting interests of another company[FN], indirect control shall be presumed to exist unless the presumption of control can be overcome as detailed in paragraph 7. If direct or indirect control exists, whether through voting securities, contracts, common management or otherwise, the arrangement is considered affiliated under paragraph 5. Consistent with paragraph 8, a disclaimer of affiliation does not eliminate a "related party" distinction or disclosure requirements for material transactions pursuant to SSAP No. 25.

FN—Consistent with SSAP No. 97, footnote 1, investments in an exchange traded fund (ETF), ~~or~~ a mutual fund (as defined by the SEC) or a foreign open-end investment funds governed and authorized in accordance with regulations established by the applicable foreign jurisdiction does not reflect ownership in an underlying entity, regardless of the ownership percentage the reporting entity (or the holding company group) has of the ETF, ~~or~~ mutual fund or foreign open-end investment fund unless ownership of the ~~ETF~~fund actually results in "control" with the power to direct or cause the direction of management of an underlying company. ETFs, ~~and~~ mutual funds and foreign open-end investment funds are comprised of portfolios of securities subject to the regulatory requirements of the federal securities laws or the applicable foreign jurisdictions laws.

Proposed edits to SSAP No. 97:

5. Control is defined as the possession, directly or indirectly, of the power to direct or cause the direction of the management and policies of the investee, whether through the (a) ownership of voting

securities, (b) by contract other than a commercial contract for goods or nonmanagement services, (c) by common management, or (d) otherwise. Control shall be presumed to exist if a reporting entity and its affiliates directly or indirectly, own, control, hold with the power to vote, or hold proxies representing 10% or more of the voting interests of the entity[FN].

FN—Investments in an exchange traded fund (ETF), ~~or~~ a mutual fund (as defined by the SEC) or a foreign open-end investment fund governed and authorized in accordance with regulations established by the applicable foreign jurisdiction does not reflect ownership in an underlying entity, regardless of the ownership percentage the reporting entity (or the holding company group) has of the ETF, ~~or~~ mutual fund or foreign open-end investment fund unless ownership of the fund~~ETF~~ actually results in "control" with the power to direct or cause the direction of management of an underlying company. ETFs, ~~and~~ mutual funds and foreign open-end investment funds are comprised of portfolios of securities subject to the regulatory requirements of the federal securities laws or the applicable foreign jurisdictions laws. ETFs, ~~and~~ mutual funds and foreign open-end investment funds held by a reporting entity shall be reported as common stock, unless the fund~~ETF~~ qualifies for bond or preferred stock treatment per the *Purposes and Procedures Manual of the NAIC Investment Analysis Office*. Reporting entities are not required to verify that SCAs (subject to SSAP No. 97) are represented in the portfolio of securities held in ETFs, ~~or~~ mutual funds or foreign open-end investment funds or to adjust the value of SCAs as a result of investments in ETFs, ~~or~~ mutual funds or foreign open-end investment funds.

Staff Review Completed by: Jake Stultz – NAIC Staff, July 2022

https://naiconline.sharepoint.com/teams/FRSStatutoryAccounting/National Meetings/A. National Meeting Materials/2022/7-Summer NM/Meeting/F - 22-13 - Related Party Footnote Revisions.docx

Statutory Accounting Principles (E) Working Group
Maintenance Agenda Submission Form
Form A

Issue: Leasehold Improvements After Lease Termination

Check (applicable entity):

	P/C	Life	Health
Modification of Existing SSAP	☒	☒	☒
New Issue or SSAP	☐	☐	☐
Interpretation	☐	☐	☐

Description of Issue:
During 2019, the Working Group adopted substantive revisions to *SSAP No. 22—Leases*, which created SSAP No. 22R. The updated guidance rejected financing lease treatment that was adopted in U.S. GAAP but incorporated language from ASC Topic 842, which kept SSAP No. 22R as consistent as possible with the principal concepts in the U.S. GAAP standard. The Working Group has addressed several additional FASB Accounting Standard Updates (ASU) since the initial adoption of Topic 842 and NAIC staff have received numerous inquiries from SAP reporting entities since the adoption of the substantive revisions to SSAP No. 22R.

NAIC staff received a question about the treatment of leasehold improvements in situations where a leased property is purchased by the lessee during the lease term and noted that there is no explicit guidance for these situations in *SSAP No. 19—Furniture, Fixtures, Equipment and Leasehold Improvements* nor *SSAP No. 73—Health Care Delivery Assets and Leasehold Improvements in Health Care Facilities*. In these scenarios, it was identified that the reporting entity had acquired the property that was initially subject to a lease; however regardless of the scenario, amortization of leasehold improvements is only permitted over the shorter of the estimated useful life of the improvement or the lease term (as defined in SSAP No. 22R). In a normal lease termination, one where the lessee does not acquire said property, any remaining leasehold improvements shall be immediately expensed. This agenda item has been drafted to clarify this guidance, to eliminate future questions and ensure consistent application.

Existing Authoritative Literature:
Guidance for property improvements and integral equipment is included in *SSAP No. 40R—Real Estate Investments*.

SSAP No. 40R (underlines added for emphasis):

> 18. Recognition of profit on sales of real estate investments shall be accounted for in accordance with FASB Statement No. 66, Accounting for Sales of Real Estate (FAS 66), except as modified in paragraph 20 of this statement, FASB Emerging Issues Task Force No. 87-9, Profit Recognition on Sales of Real Estate with Insured Mortgages or Surety Bonds, FASB Emerging Issues Task Force No. 87-29, Exchange of Real Estate Involving Boot, FASB Interpretation No. 43, Real Estate Sales an interpretation of FASB Statement No. 66 (FIN 43) and FASB Emerging Issues Task Force No. 00-13, Determining Whether Equipment is "Integral Equipment" Subject to FASB Statements No. 66 and No. 98(INT 06-13). <u>This statement applies to all sales of real estate including real estate with property improvements or integral equipment. The terms "property improvements" and "integral equipment" refer to any physical structure or equipment attached to the real estate that cannot be removed and used separately without incurring significant costs, such as an office building.</u> Additionally, this guidance applies to all transfers of financial assets that are in substance real estate.
>
> 31. <u>This statement adopts FASB Interpretation No. 43, Real Estate Sales, an Interpretation of FASB Statement No. 66 (FIN 43), which clarifies that the phrase "all real estate sales" includes sales of real estate with property improvements or integral equipment that cannot be removed and used separately from the real estate without incurring significant costs.</u> This statement adopts FASB Emerging Issues Task Force No. 84-17, Profit Recognition on Sales of Real Estate with Graduated Payment Mortgages or Insured Mortgages, FASB Emerging Issues Task Force No. 89-13, Accounting for the Cost of Asbestos Removal,

> FASB Emerging Issues Task Force No. 89-14, Valuation of Repossessed Real Estate, FASB Emerging Issues Task Force No. 90-8, Capitalization of Costs to Treat Environmental Contamination, FASB Emerging Issues Task Force No. 95-23, The Treatment of Certain Site Restoration/Environmental Exit Costs When Testing a Long-Lived Asset for Impairment, FASB Emerging Issues Task Force 97-11: Accounting for Internal Costs Relating to Real Estate Property Acquisitions, FASB Emerging Issues Task Force No. 98-8: Accounting for Transfers of Investments That Are in Substance Real Estate and FASB Emerging Issues Task Force No. 00-13, Determining Whether Equipment is "Integral Equipment" Subject to FASB Statements No. 66 and No. 98, which clarifies the term "integral equipment" as used in this statement.

Leasehold improvements are discussed in SSAP No. 19 and in SSAP No. 73.

SSAP No. 19:

> 5. Leasehold improvements that increase the value and enhance the usefulness of the leased asset meet the definition of assets established in SSAP No. 4. Within that definition, such items also meet the criteria defining nonadmitted assets. Accordingly, such assets shall be reported as nonadmitted assets and charged against surplus. These nonadmitted assets shall be amortized against net income over the shorter of their estimated useful life or the remaining lease term as defined in SSAP No. 22R. Leasehold improvements that do not meet the definition of assets shall be charged to expense when acquired.

SSAP No. 73:

> 9. Furniture, medical equipment and fixtures, and leasehold improvements shall be depreciated over their estimated useful lives but for a period not to exceed three years, except for a leasehold improvement which shall be amortized against net income over the shorter of its estimated useful life or the remaining lease term, using methods detailed in SSAP No. 19.

Activity to Date (issues previously addressed by the Working Group, Emerging Accounting Issues (E) Working Group, SEC, FASB, other State Departments of Insurance or other NAIC groups): The Working Group adopted substantive revisions in agenda item 2016-02 to SSAP No. 22 to incorporate language from *ASU 2016-02, Leases (Topic 842)*, which retained the treatment of leases as operating leases by the lessor but incorporated some of the new language and guidance from ASU 2016-02.

Information or issues (included in *Description of Issue*) not previously contemplated by the Working Group: None

Convergence with International Financial Reporting Standards (IFRS):
The intent of Topic 842 is to make U.S. GAAP lease treatment more closely resemble that of IFRS lease treatment in *IFRS 16—Leases*.

Staff Recommendation:
NAIC staff recommend that the Working Group move this item to the active listing, categorized as nonsubstantive and expose revisions to SSAP No. 19 and SSAP No. 73 to ensure that the guidance for the leasehold improvements matched the treatment provided in *SSAP No. 40R—Real Estate Investments.* These edits will clarify that amortization of leasehold improvements will immediately end when a lease is terminated and will require that any remaining, unamortized leasehold improvement balance be immediately expensed. This will include scenarios where the lease terminates naturally or when the lessee purchases a property it was leasing. It is presumed that the purchase of a property from a third party would include the leasehold improvements as part of the full purchase price.

<u>SSAP No. 19:</u>

> 5. Leasehold improvements that increase the value and enhance the usefulness of the leased asset meet the definition of assets established in SSAP No. 4. Within that definition, such items also meet the

criteria defining nonadmitted assets. Accordingly, such assets shall be reported as nonadmitted assets and charged against surplus. These nonadmitted assets shall be amortized against net income over the shorter of their estimated useful life or the remaining lease term, as defined in SSAP No. 22R. Leasehold improvements that do not meet the definition of assets shall be charged to expense when acquired. The amortization of leasehold improvements (including property improvements and integral equipment) shall cease, with any remaining amount immediately expensed, in any event in which the lease is terminated in advance of the lease term. This includes situations in which leased real estate is acquired by the reporting entity lessor. If leased real estate is acquired, recognition of the real estate shall follow the provisions in *SSAP No. 40R—Real Estate Investments*.

SSAP No. 73:

9. Furniture, medical equipment and fixtures, and leasehold improvements shall be depreciated over their estimated useful lives but for a period not to exceed three years, except for a leasehold improvement which shall be amortized against net income over the shorter of its estimated useful life or the remaining lease term, using methods detailed in SSAP No. 19. The amortization of leasehold improvements (including property improvements and integral equipment) shall cease, with any remaining amount immediately expensed, in any event in which the lease is terminated in advance of the lease term. This includes situations in which leased real estate is acquired by the reporting entity lessor. If leased real estate is acquired, recognition of the real estate shall follow the provisions in *SSAP No. 40R—Real Estate Investments.*

Staff Review Completed by Jake Stultz, September 2021

Status:
On December 11, 2021, the Statutory Accounting Principles (E) Working Group moved this agenda item to the active listing, categorized as nonsubstantive, and exposed revisions to SSAP No. 19 and SSAP No. 73 to ensure that the guidance for the leasehold improvements matches the treatment provided in SSAP No. 40. These edits clarify that amortization of leasehold improvements will immediately end when a lease is terminated and will require that any remaining, unamortized leasehold improvement balance be immediately expensed. This will include scenarios where the lease terminates naturally or when the lessee purchases a property it was leasing.

On April 4, 2022, the Statutory Accounting Principles (E) Working Group reviewed comments on prior exposed revisions which intended to clarify that in any scenario in which a lease terminates early, all remaining leasehold improvements shall be immediately expensed. The Working Group directed NAIC staff to continue to work with interested parties to refine the guidance for subsequent consideration.

https://naiconline.sharepoint.com/teams/FRSStatutoryAccounting/National Meetings/A. National Meeting Materials/2022/7-Summer NM/Meeting/G - 21-25 - Leasehold Improvements after Lease Termination.docx

Statutory Accounting Principles (E) Working Group
Proposed Bond Definition
~~May 20, 2021March 2, 2022~~August 10, 2022

Introduction: Pursuant to the direction from the Statutory Accounting Principles (E) Working Group in October 2020, a small group of regulators and industry have been meeting regularly to draft a bond definition for consideration. The intent of this project is to clarify what should be considered a bond (whether captured in *SSAP No. 26R—Bonds* or *SSAP No. 43R—Loan-Backed and Structured Securities*) and reported on Schedule D-1: Long-Term Bonds. **This exposure document reflects the direction of the Working Group from the July 18, 2022, call in which comments received after the March 2022 exposure were discussed. This exposure is accompanied by a proposed issue paper that details the discussions in developing the principles-based bond definition as well as proposed statutory accounting revisions to SSAP No. 26R and SSAP No. 43R. Proposed reporting changes were exposed July 18, 2022.**

Below is the proposed principles-based definition of a bond eligible for reporting on Schedule D, Part 1.

1. A bond shall be defined as any security[1] 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**.**

   [Need to incorporate concepts of paragraph 2 of current SSAP No. 26R but not recast here for brevity]

   Determining whether a security represents a creditor relationship should consider its substance, rather than solely the legal form of the instrument. The analysis 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. See Appendix I for examples of securities that, despite their legal form, do not represent a creditor relationship in substance.

2. An issuer credit obligation is a bond, the repayment of which is supported primarily by the general creditworthiness of an operating entity or entities. Support consists of direct or indirect recourse to an operating entity or entities, which 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,

[1] 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.

governmental unit, or other provider of goods or services, but not a natural person or ABS Issuer (defined below). Examples of issuer credit obligations include, but are not limited to:

a. U.S. Treasury securities, including U.S. Treasury Inflation-Indexed Securities[2];(INT 01-25)
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 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.
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 11.b;
k. Fixed-income instruments specifically identified:
    i. Certifications of deposit that have a fixed schedule of payments and a maturity date in excess of one year from the date of acquisition;
    ii. Bank loans that are obligations of operating entities, issued directly by a reporting entity or acquired through a participation, syndication or assignment;
    iii. Debt instruments in a certified capital company (CAPCO).(INT 06-02)
    iv. Exchange Traded Funds (ETFs) that qualify for bond treatment as identified in the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* and published on the SVO's webpage. (These instruments are referred to as SVO-Identified ETFs.)

[2] The inclusion of U.S. Treasury Inflation-Indexed Securities clarifies that securities with plain-vanilla inflation adjustment mechanisms are not intended to be captured within the provisions that restrict bond classification to securities that have principal and interest payments that vary based on appreciation or depreciation of an underlying referenced variable. Inflation adjustment mechanisms are considered plain-vanilla if it is based on a widely recognized measure of inflation and excludes those that involve either leverage (such as a multiplier) or an inverse adjustment relationship. As detailed in paragraph 3b, securities that have principal and interest payment variations due to valuation changes of a referenced variable (such as the appreciation of equity or real estate cause variations of changes in the principle or interest of a security structure) are intended to be precluded from bond treatment under the principles-based bond definition~~identifies these securities as an explicit exception to the principles-based bond definition that prohibits securities from being reported on Schedule D-1 that have variable principal or interest due to underlying equity appreciation or depreciation, or an equity-based derivative~~.

3. An asset[3] backed security is a bond issued by an entity (an "ABS Issuer") created for the primary purpose of raising debt capital backed by financial assets[4] 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[5]. 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"), though 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.

   There are two defining characteristics that must be present for a security to meet the definition of an asset backed security:

   a. 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[6] 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 assets). Reliance on cash flows from the sale or refinancing of cash generating non-financial assets does not preclude a bond from being classified as an asset backed security so long as the condition in the preceding sentence is met. See Appendix II for examples (2, 3 and 4) illustrating the evaluation of the meaningful criteria.

   b. 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[7] credit enhancement through guarantees (or other similar forms of recourse), subordination and/or overcollateralization. ~~. In instances where the assets owned by the ABS Issuer are equity interests, the~~T~~t~~the debt instrument must have pre-determined principal and interest payments (whether fixed interest or variable interest) with contractual amounts that do not vary based on the

[3] 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 substantive credit enhancement.

[4] SSAP No. 103R 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.

[5] 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 not an issuer credit obligation.

[6] The term "meaningful" is defined in the Glossary.
[7] The term "substantive credit enhancement" is defined in the Glossary.

appreciation or depreciation of any underlying collateral value or other variable ~~the equity interests~~. For example, an issued security that has varying principal and interest payments based on the appreciation of referenced equity, real estate or other variable is precluded from bond treatment. Plain-vanilla inflation adjustments (such as with U.S. TIPs) are not captured within these appreciation or depreciation adjustment exclusions and therefore, are not excluded from bond classification. (For clarification purposes, all returns from an ABS in excess of principal repayment 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 ~~equity interests~~referenced variables.) See Appendix II for examples illustrating the evaluation of the sufficient criteria.

4. 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.

Note: The elements captured below are not components of the core bond definition. However, comments are requested on the proposal to separately identify on Schedule D-1 or a subschedule of D-1, those ABS that qualify as bonds under the definition and have certain characteristics noted below. The purpose of separate identification would be to improve transparency and provide more specific disclosures applicable to bonds with such characteristics.

A separate reporting section on Schedule D, Bonds is being contemplated, for the purpose of capturing additional disclosures for regulators, for the following:

Any asset backed securities where:

1) the underlying collateral comprises cash generating non-financial assets and does not meet the practical expedient for evaluating the meaningful criteria defined in paragraph 3a and the glossary, or

2) the underlying collateral comprises financial assets that are not self-liquidating.

Glossary

Meaningful – 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 is specific to each transaction, determined at origination, and should consider the following factors:

1. The price volatility in the principal market for the underlying collateral;
2. The liquidity in the principal market for the underlying collateral;
3. The diversification characteristics of the underlying collateral (i.e., types of collateral, geographic location(s), source(s) of cash flows within the structure, etc.);
4. The overcollateralization of the underlying collateral relative to the debt obligation; and
5. The variability of cash flows, from sources other than sale or refinancing, expected to be generated from the underlying collateral.

Factors #1 and #5 are directly related to the "meaningful" requirement. That is, as price volatility or variability of cash flows increase, 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. Factors #2, #3 and #4 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.

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 asset 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 above.

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 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 Issuer Credit Obligation 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.

The first loss position~~tranche (or tranches if the first tranche is not itself substantive)~~ may be issued as part of the 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 ~~tranche~~ 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 accounting should follow the guidance applicable to the type of instrument (i.e., debt vs. equity); however, regardless of the type of instrument, it~~the structure does not qualify as a Schedule D bond and should be reported on Schedule BA.

Appendix I

Examples of securities that, despite their legal form, do not represent creditor relationships in substance:

Example 1:

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.

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 or other referenced variable, is a bond under this standard as such security would contain equity-like characteristics. A bond under this standard is required to have pre-determined principal and interest payments (whether fixed interest or variable interest) and comply with the structured note guidance within paragraph XXX.

Example 2:

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 issuer credit obligation.

Rationale:

Determining whether debt instruments collateralized by equity interests qualify as bonds under this statement 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 of these factors, 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:

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

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.

Furthermore, this analysis 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 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.

Appendix II

Examples of analysis of asset backed securities under the criteria as defined in paragraphs 3a and 3b:

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.

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 3b. 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 3.b., to determine if the holder is in a substantively different economic position that if the holder held the ABS Issuer's assets directly.

Example 2:

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%.

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 equipment to service the final debt balloon payment. The loan-to-value at maturity is expected to decline to 40% 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.

Rationale:

The equipment is a cash generating non-financial asset which is 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 50% of the principal payments. In reaching this 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 collateral value to provide for the balloon payment through sale or refinancing in light of its characteristics. While the equipment 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 (40% loan-to-value) that would be able to be recovered by sale or refinancing even if it were to mature at such point in time.

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 equipment directly, in accordance with the requirements in paragraph 3.b. In reaching this conclusion, the reporting entity noted that the debt instrument starts with a 70% loan-to-value, which continues to improve over the life of the debt as the loan balance amortizes more quickly than the expected economic depreciation on the underlying equipment. 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 equipment directly.

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.

Example 3:

A reporting entity invested in a debt instrument with the same characteristics as described in Example 2, except that the existing equipment 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 equipment cannot be re-leased, there would not be enough cash flows to service the scheduled principal and interest payments, and the equipment would have to be liquidated to pay off the debt upon default.

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 equipment was highly predictable and supported the conclusion that the equipment was expected to produce meaningful cash flows to service the debt.

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.

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%.

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.

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.

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 3.b. 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.

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.

https://naiconline.sharepoint.com/teams/frsstatutoryaccounting/national meetings/a. national meeting materials/2022/7-summer nm/meeting/h - draft bond definition 8-10-22.docx

Statutory Issue Paper No. 1XX

Principles-Based Bond Definition

STATUS
Exposure Document Aug. 10, 2022, Comments Due Oct. 7, 2022

Original SSAP: SSAP No. 26 and SSAP No. 43
Current Authoritative Guidance: SSAP No. 26R and SSAP No. 43R

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. The guidance within this issue paper introduces new statutory accounting concept revisions to *SSAP No. 26R—Bonds* (SSAP No. 26R) and *SSAP No. 43R—Loan-backed and Structured Securities* (SSAP No. 43R) 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 Investment Classification Project reflects a comprehensive review to address a variety of issues pertaining to definitions, measurement and overall scope of the investment SSAPs. Although SSAP No. 26R 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. 26R instead of SSAP No. 43R. As the focus of this current project is on the substance of investments, regardless of whether they include an SPV for issuance, this project includes both SSAP No. 26R and SSAP No. 43R.

SUMMARY CONCLUSION

2. Investments eligible for reporting on Schedule D-1 shall comply with the principles-based definition of a bond or be specifically noted in scope of SSAP No. 26R or SSAP No. 43R. Revisions to reflect the principles-based bond definition will be incorporated to SSAP No. 26R and SSAP No. 43R. Tracked changes to reflect this guidance are shown in Exhibit A & B.

DISCUSSION

3. The discussion of this issue originally began in August 2019 with agenda item 2019-21: SSAP No. 43R – Equity Investments. This agenda item was drafted to consider clarification to SSAP No. 43R 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 comprehensive review of SSAP No. 43R 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. 43R. (This history has been retained in Exhibit ___ of this Issue Paper.)

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. 26R and SSAP No. 43R: Pursuant to the comments received, it was identified that many insurers had different interpretations of the adopted 2010 revisions that separated investments between SSAP No. 26R and SSAP No. 43R 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. 43R were, under some interpretations, eligible to be captured in scope of SSAP No. 26R.

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. 43R. 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 first 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 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 the 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, with a request for exposure.

9. This issue paper intends to provide information on discussions that occurred when considering the principles-based bond definition and the needed statutory accounting revisions to specify the types of investments that shall be reported on Schedule D-1: Long-Term Bonds.

a. This issue paper, along with the principles-based bond definition, was exposed 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 paragraph 3b of the bond definition 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.)

iii. Document the outcome of small group discussions around the application of the bond principles (particularly the equity-backed example in Appendix I) 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 examples currently in Appendix I of the bond definition 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 in to SSAP No. 26R will not be identified in the bond definition. The Working Group was explicit that the inclusion of an investment in-scope of SSAP No. 26R 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. 26R 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 if acquired within those timeframes. 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. 43R and reported on Schedule D-1.

iv. The Working Group did not direct changes to the exposed 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 issuer credit obligations 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 asset backed securities 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 asset backed securities rather than issuer credit obligations. The comment letter also raised concerns around guidance included for evaluating project finance debt as it is perceived 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 to qualify as issuer obligations. As such, project finance bonds issued by operating entities and other municipal revenue bonds will be retained as issuer credit obligations 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. This issue paper, along with the principles-based bond definition, and proposed SSAP revisions was exposed _____, with comments due _____. *(To be updated after next action.)*

Discussion of Principles-Based Bond Concepts

10. Pursuant to the "small group" discussions comprised of industry, Iowa representatives 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 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 asset backed security: 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. Specific elements and discussion points are detailed within.

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—Other Admitted Assets*. 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 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 requirements, as they would not be permitted for Schedule D-1 reporting.

15. The statutory accounting guidance in SSAP No. 26R 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—Nonadmitted Assets* or *SSAP No. 21—Other Admitted Assets* 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 such arrangements that qualify for 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)" is 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.,). Structures reported 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. 26R, 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 just the legal form, along with consideration of other investments owned in the investee and other contractual arrangements.

18. Original regulator concerns with the current guidance and reporting were in part due to the identification of investments with underlying equity interests that were structured to resemble bond instruments. This discussion 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) type structure) is a mechanism to reclassify these equity instruments and characterize them as bonds. The lack of current 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 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 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 such types of seasoned funds are securitized, referred to as 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. A regulator concern arises when features that facilitate the production of predictable cash flows are not present. In such a case, 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 SPV-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 on Schedule D-1.

21. Although the full disallowance of equity-backed debt would prevent these 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 only works when there are appropriate safeguarding principles established, which require a relatively high standard of proof.

22. An investment for which the primary risk for non-payment is equity devaluation is not consistent with the substance-intent for what is expected to be on Schedule D-1 under the principles-based definition.

Allowing these items to be reported 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 that they have historically, all while characterizing the investment as a bond exposure. As such, it was noted as critical that appropriate safeguards be incorporated to address this concern, which is why the small group supported a rebuttable presumption that equity-backed ABS do not qualify to be reported on Schedule D-1 unless a documented analysis supporting the predictability of cash flows is completed to overcome that presumption.

23. The principles-based 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 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 will be present to qualify. 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, an arrangement where the debt is issued from a feeder fund, and the feeder fund has an equity interest in another fund, which only holds debt instruments and passes those fixed income cash flows through the structure to the ultimate debt holder, may have substance aligned with a debt investment rather than a single equity investment. This conclusion would be supported if the terms of the structure ensure that underlying fixed income cash flows are passed through. Factors that create uncertainty as to the timing and/or amount of the pass through of the underlying cash flows would 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 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 call into question the substance as a debt-backed investment. Similarly, if the structure was ultimately backed by equity interests (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, such 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)

~~27.~~28. Security structures that qualify as creditor relationship are divided between issuer credit obligations and ABS. The initial distinction between an issuer credit obligation and an ABS is a key factor with the principle-based bond concepts. Given their differing characteristics, investments that qualify as issuer credit obligations 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 issuer obligations to avoid those detailed assessments.

~~28.~~29. Determining whether an investment reflects an issuer credit obligation or an ABS focuses on the issuer and the primary source of repayment of the instrument. An issuer credit obligation represents a bond structure where the repayment is supported primarily 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.

~~29.~~30. The prior assessments to divide structures between SSAP No. 26R and SSAP No. 43R 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 issuer credit obligation 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 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 to recognize a non-qualifying investment as a bond simply by moving it to a debt-issuing SPV to resemble a creditor relationship with a future payment obligation. Furthermore, the guidance does not preclude the use of SPVs in issuer credit obligations. 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 issuer credit obligation (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, such structures that simply reflect a pass-through of cash flows or performance from the underlying collateral and provide no economic difference than if holding the underlying collateral items directly should not be characterized as bonds.

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, 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 issuer obligation or asset backed security. This distinction aligns the accounting and measurement with the characteristics of the bond. As asset backed securities rely on the cash flows of underlying collateral, the measurement method described in SSAP No. 43R, 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.

~~30.~~31. 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 issuer credit obligation, 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. 26R, 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. (e.g., CTLs, 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 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) or other such structures. Although some may consider CFOs to be similar to closed-end funds, that assessment is not supported for classification as an

issuer credit obligation. Instruments considered to reflect CFOs (and other like structures) are required to be assessed as asset-backed securities for inclusion on Schedule D-1.

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 issuer credit operations, 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 issuer credit obligations 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 on Schedule D-1, or is classified as an issuer credit obligation or ABS. Instruments (even if identified as "project finance") that do not qualify as issuer credit obligations as they 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 issuer credit obligation intends to highlight a specific exception to the determination as a creditor relationship as the variation is due to plain-vanilla inflation adjustment mechanisms. Under the definition, securities with principal or interest payments that vary based on the appreciation or depreciation of referenced equity, real estate or other referenced variables are precluded from bond treatment ~~interests~~ as they do not reflect creditor relationships. Although US TIPS are indexed to the consumer price index and grows with inflation, these securities shall be captured as issuer credit obligations on Schedule D-1.

~~31.~~32. This Schedule D-1 project is not expected to reconsider certain investments previously considered by the Working Group and explicitly permitted for Schedule D-1 reporting. As such, unless subsequently addressed within this project, the following investment types are expected to continue to qualify as Schedule D-1 investments and be classified as issuer credit obligations. (By including these investments as issuer credit obligations, these investments are not subject to the assessments of sufficiency 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.

~~32.~~33. 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. 26R, 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 proposal, 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 on Schedule D-1 in accordance with the principal-based bond definition. If the securities qualify as issuer credit obligations 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 with a significant reduction in the issuance of these securities. If these securities continue to be held by insurers, they should be assessed for reporting on Schedule D-1 under the principal-based bond proposal. If these securities do not qualify for 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 on Schedule D-1 under the principal-based bond proposal.

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 on Schedule D-1 only if they qualify.

~~33.~~34. For securities that represent principal-protected notes (or principal-protected securities) and structured notes that have been previously captured within SSAP No. 26R or SSAP No. 43R, the principles-based bond definition will no longer permit these security structures to be reported on Schedule D-1. Fundamentally, these structures have the potential for variable principal or interest / returns, or both, due to the underlying equity appreciation or depreciation, ~~or~~ an equity-based derivative, or other referenced variable. This structural characteristic precludes these investments from being captured as issuer credit

obligations 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 Schedule D-1 reporting when the structure also includes other collateral with the potential to generate additional interest or returns. Such structures must be viewed wholistically 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 note / security 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, but the structure also incorporates other investments, at origination or over the life of the structure, that are intended to generate returns or other assets to the reporting entity note holder. These returns, often based on underlying equity factors, prevents 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 still safeguards principal returns, but the structure acquires 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 Schedule D-1 reporting as they would not qualify as issuer credit obligations 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.

b. A structured note is an instrument in which the terms make it possible that the reporting entity holder could lose all or a portion of its original investment amount for a reason 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. Due to the underlying variable that determines principal repayment, these structures (regardless of if in a trust/SPV) do not qualify as creditor relationships and do not qualify for Schedule D-1 reporting. Existing guidance identifies that structured notes shall be captured in *SSAP No. 86—Derivatives*

~~34.~~35. The guidance in the principles-based bond proposal requires "assessment at origination" in determining whether a security complies for Schedule D-1 reporting. This provision intends to reflect the reporting entity's understanding of the intent and ultimate structure of the security at origination, not simply what a structure holds on the day of origination. It is not permissible to conclude that a principal-protected note is an issuer credit obligation 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 issuer creditor obligation or ABS (as applicable) requires an assessment of the full structure as it is ultimately intended by the reporting entity at the time of acquisition.

~~35.~~36. Consistent with prior guidance in SSAP No. 26R, mortgage loans and other real estate lending activities, which are not securities, made in the ordinary course of business are excluded from Schedule D-1. Those investments shall follow the application statutory accounting guidance in *SSAP No. 37—Mortgage Loans* and *SSAP No. 39—Reverse Mortgages*.

Asset Backed Securities and Required Components

~~36.~~37. An Asset Backed Security (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.

~~37.~~38. To qualify on Schedule D-1 as an ABS, there are two defining characteristics that must be present. If the structure is a not an issuer credit obligation 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. 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.

~~38.~~39. 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 MBS), and insurers may benefit from prior analysis when acquiring similar subsequent structures, an automatic assessment is not permitted for this requirement.

~~39.~~40. 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.

~~40.~~41. 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.

~~41.~~42. 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 Issuer Credit Obligation 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 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.

~~42.~~43. 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 implies a quantitative assessment of credit quality is 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 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.

~~43.~~44. 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. Evaluation of whether a credit enhancement has substance may involve an evaluation of the level of overcollateralization (LTV) or the capacity of whatever form of subordination, guarantee or recourse to absorb collateral losses. As noted, 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.

~~44.~~45. 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 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 Schedule D-1 reporting 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 the holder of the debt instrument held 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, 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.

~~c.~~d. The first loss position may be issued as part of the securitization in the form of debt or equity interest, or it may be retained by the sponsor and not be issued as part of the securitization. The holder of the loss position, or whether 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 include 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.

~~45.~~46. 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.

~~46.~~47. 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.

~~47.~~48. 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. 43R 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.

~~48.~~49. 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 Schedule D-1 reporting if they meet the meaningful cash generation criteria throughout the term of the instrument other than through the sale/refinancing at maturity.

~~49.~~50. 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 asset-backed securities 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, so that the full structure qualifies for Schedule D-1 reporting 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 asset-backed 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 on Schedule D-1 and shall be reported on Schedule BA at the lower of amortized cost or fair value.

~~50.~~51. 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.

~~51.~~52. 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 criteria. 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 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.

Additional Elements for Asset Backed Securities

~~52.~~53. When establishing the ABS definition and required components, various aspects were discussed to improve clarity on the application of the guidance.

~~53.~~54. Determination of "Assets" Backing Securities: Although the definition of an asset detailed in SSAP No. 4 is applied throughout the 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.

~~54.~~55. 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.

~~55.~~56. 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 on Schedule D-1. Note that statutory accounting has not historically restricted bonds backed by inadmissible assets from being admissible either, nor has it included any kind of evaluation of the cash flow producing ability of underlying assets. The proposed 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).

~~56.~~57. 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. 103R—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.

~~57.~~58. 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 conveyed by 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 themselves 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 cash flows from the underlying collateral (rental cars) are expected to generate at least 50% of the original principal, then the meaningful criteria would be met through the practical expedient.

~~58.~~59. 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 for 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.

~~59.~~60. 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 issuer credit obligations. For these structures, the dedicated operational cash flows represent the defined collateral pool and should not be classified as issuer credit obligations 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 operations.

~~60.~~61. 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 do not have contractual principal or interest payments, but rather provide payment after contractual 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 contractual interest and principal payments. In all instances, despite whether other tranches of the investment structure qualify for Schedule D-1 reporting, residual tranches do not qualify for reporting on Schedule D-1.

~~61.~~62. Under prior guidance in SSAP No. 43R, 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 previously reported these residual tranches on Schedule BA: Other Long-Term Invested Assets. However, it was noted that some reporting entities have reported these tranches on Schedule D-1 as a component of the securitization or as a beneficial interest in scope of SSAP No. 43R. Although residual tranches (first loss tranches) are not rated, when reported on Schedule D-1, an NAIC designation would be required. From information obtained, entities reporting residual tranches on Schedule D-1 have either been reporting as self-assigned 6* or applied the NAIC 5GI concept to self-designate these securities. Under the 5GI concept, the 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 has no contractual interest or principal payments. 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 may be 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.

~~62.~~63. With the identification that residual tranches are inconsistently reported, with some entities reporting on D-1 and others reporting on Schedule BA, the Working Group drafted and exposed agenda item 2021-15: SSAP No. 43R – Residual Tranches in September 2021 as an interim action prior to the conclusion of the bond proposal project. The guidance within this agenda item clarifies that residual tranches shall be reported on Schedule BA at lower of amortized cost or fair value. The guidance also clarifies 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. 43R that reflect loss layers without contractual interest or principal payments. Payments to holders of these items 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.

~~63.~~64. On November 10, 2021, the Statutory Accounting Principles (E) Working Group adopted the agenda item, 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

allows time for reporting entities to implement this change and corresponds with a Blanks (E) Working Group proposal to incorporate separate reporting lines for residuals, based on underlying characteristics, 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.

~~64.~~65. Along with the action to specify the Schedule BA reporting for residuals, the 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 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 Working Group also provided the Task Force 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.

~~65.~~66. Stapling of investments: The original exposure of the principles-based bond definition (May 2021) included an initial example (originally referred to as Appendix I – Example I) 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 original example, although the debt instrument would separately qualify as a creditor relationship for bond reporting, when considering the entirety of the holdings (both the 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 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 equity tranche to safeguard payment under the debt tranche.) Under that initial proposed guidance, all holdings under such situations, including the debt tranches, would not qualify as creditor relationships and would not qualify for bond reporting.

~~66.~~67. 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 the entire 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 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 differing SAP guidance 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 equity tranche separately from a debt tranche. It was identified that without an active market for 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 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 done 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 an 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 equity recognition based on the characteristics of the specific tranche.

~~67.~~68. ABS as Short-Term or Cash Equivalents: With the required focus and requirements to be met for asset-backed securities, 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, even if acquired within one year or less from the maturity date, to allow for full assessment of the extent of ABS by the regulators. Investments captured in scope of *SSAP No. 2R—Cash, Cash Equivalents, Drafts and Short-Term Investments* 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. (Drafting Note – Corresponding edits will be needed to SSAP No. 2R.)

Key Discussions / Aspects in Developing the Definition:

~~68.~~69. 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 flows requirement for non-financial asset backed securities. 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 asset-backed securities.

~~69.~~70. The requirement for a non-financial asset backed security to produce meaningful cash flows to service the debt other than through the sale or refinancing of the collateral assets ensures that structures captured 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.

~~70.~~71. 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 proposal is to clarify what shall be reported as long-term bonds on Schedule D-1. Non-financial asset backed securities 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 proposal does not factor in investment or credit quality within the determination of whether a structure qualifies for reporting on Schedule D-1. Permitting an assessment based on overcollateralization would introduce a concept that credit quality determines Schedule D-1 reporting, and that is not an accurate conclusion in line with the principle concepts of bond classification.

~~71.~~72. Consistent with prior conclusions, reporting 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 reporting 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 asset backed securities must produce meaningful cash flows through the use of the underlying collateral assets other than through the sale or refinancing of the assets.

~~72.~~73. Additionally, through the small group discussions around the refinancing restriction noted above, 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 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% charge. This will have the effect of bringing the overall weighted-average capital charge on the underlying investments from 30% to approximately 10-15%, as an example. 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 able or appropriate to address through the accounting standards but may warrant discussion for 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.

~~73.~~74. Use of NAIC Designation / SVO Review in Determining 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" 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. As such, 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 obtain 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 other SSAP guidance required for an investment to be an admitted asset.

~~74.~~75. Questions have been received whether an NAIC designation in the AVS+ product or an assessment of an investment from an RTAS submission can be utilized as support that an investment qualifies 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 on Schedule D-1 as an issuer credit obligation or an ABS. As part of this project, consideration is planned to expand the ability to report and use NAIC designations on Schedule BA (or other schedules) 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.

~~75.~~76. 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. It is anticipated that NAIC staff on the statutory accounting side and within the SVO would assist this small group.

~~76.~~77. 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 for these investments. If the strips qualify within the definition as issuer credit obligations, they would be captured in scope of that guidance. If the strips qualified as asset-backed securities, 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 required to be reported on Schedule BA and not permitted to be reported on Schedule D-1.)

~~77.~~78. 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.

~~78.~~79. 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 also 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/PO) were noted to be considered U.S. government issues and would be captured with other securities backed by the U.S. government as issuer obligations. Specific identification of U.S. Treasury strips as specific elements as issuer credit obligations, 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 issuer credit obligations and shall be reviewed in accordance with the asset-backed security concepts to determine whether the strip qualifies for reporting 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.

~~79.~~80. The discussion of IO/PO strips identified that there is likely 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.

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

~~80.~~81. As detailed in paragraph 1 of the principles-based bond definition, an initial determinant in the principles-based bond definition 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.

~~81.~~82. 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.

~~82.~~83. 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 this standard as such security would contain equity-like characteristics.

~~83.~~84. 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 issuer credit obligation.

~~84.~~85. Example 2 Rationale: Determining whether debt instruments collateralized by equity interests qualify as bonds under this statement 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)

~~85.~~86. 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.

~~86.~~87. Furthermore, this analysis 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 and Credit-Enhancement Concepts

~~87.~~88. As detailed in paragraph 3b of the principles-based bond definition, all asset-backed security structures are required to provide substantive credit enhancement to qualify for Schedule D-1 reporting. Furthermore, asset-backed security 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. Examples 4-7 provide examples of analysis under these criteria:

~~88.~~89. Example 4 – 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.

~~89.~~90. Example 4 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 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 of paragraph 3b of the principles-based bond definition. 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 3b of the principles-based bond definition to determine if the holder is in a substantively different economic position than if the holder held the ABS Issuer's assets directly.

~~90.~~91. Example 5 - Lease in SPV with 50% 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 loan-to-value at origination is 70%.

~~91.~~92. 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 equipment to service the final debt balloon payment. The loan-to-value at maturity is expected to decline to 40% 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.

~~92.~~93. Example 5 Rationale: The equipment is a cash generating non-financial asset which is 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 50% of the principal payments. In reaching this 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 collateral value to provide for the balloon payment through sale or refinancing in light of its characteristics. While the equipment 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 (40% loan-to-value) that would be able to be recovered by sale or refinancing even if it were to mature at such point in time.

~~93.~~94. 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 equipment directly, in accordance with the requirements of paragraph 3.b of the principles-based bond definition. In reaching this conclusion, the reporting entity noted that the debt instrument starts with a 70% loan-to-value, which continues to improve over the life of the debt as the loan balance amortizes more quickly than the expected economic depreciation on the underlying equipment. 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 equipment directly.

~~94.~~95. 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.

~~95.~~96. Example 6 – Lease in SPV With Lease Term Less than Debt Instrument: A reporting entity invested in a debt instrument with the same characteristics as described in Example 5, except that the existing equipment 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 equipment cannot be re-leased, there would not be enough cash flows to service the scheduled principal and interest payments, and the equipment would have to be liquidated to pay off the debt upon default.

~~96.~~97. Example 6 – Rationale: All details of this example, including the expected collateral cash flows, are consistent with those in Example 5, except that the cash flows in Example 5 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 equipment was highly predictable and supported the conclusion that the equipment was expected to produce meaningful cash flows to service the debt.

~~97.~~98. 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.

~~98.~~99. Example 7 - 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 loan-to-value at origination is 70%.

~~99.~~100. 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.

~~100.~~101. Example 7 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

~~101.~~102. 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 paragraph 3.b of the principles-based bond definition. 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.

~~102.~~103. 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.

Reflecting the Principles-Based Bond Proposal in SSAP

~~103.~~104. This issue paper proposes that statutory accounting principles reflect the principles-based bond concepts and the specific accounting guidance for bonds (issuer obligations) and asset backed securities be captured as substantive revisions to two existing SSAPs:

a. SSAP No. 26R--Bonds

b. SSAP No. 43R—Loan-Backed and Structured Securities

~~104.~~105. Although there will be new statutory accounting concepts added to these SSAPs, certain aspects of the SSAPs will be retained and unchanged. With this approach, all of the relevant guidance will be in the original SSAPs for these investment types, which will allow the continuation of prior references when discussing these investment structures.

~~105.~~106. In addition to the revisions to SSAP No. 26R and SSAP No. 43R, additional new statutory accounting concepts are expected to detail the accounting and reporting for structures that do not qualify as bonds.

Issue Paper Drafting Note:

During the July 18, 2022, Statutory Accounting Principles (E) Working Group call, the Working Group directed the following:

- *Develop revisions to SSAP No. 26R and SSAP No. 43R to incorporate the principal-based bond definition for exposure consideration at the 2022 Summer National Meeting.*
- *Develop revisions for subsequent exposure consideration that provide measurement guidance and admittance parameters for investments that will not be captured as bonds and will move from Schedule D-1 to Schedule BA.*
- *To not incorporate provisions for New Market Tax Credits investments within the bond project, and to consider these investments in a separate agenda item. It was identified that these investments may ultimately not be scoped within the bond project, but may have separate guidance similar to existing guidance on tax credits that currently exists within the statutory accounting principles.*

Furthermore, revisions are also expected to SSAP No. 2R, to address the ABS restriction, as well as SSAP No. 103R, to clarify that only beneficial interests that qualify as ABS will be accounted for under SSAP No. 43R. Comments are requested on whether other SSAPs will also be impacted and need to be revised.

History of the Definition / Scope Development of SSAP No. 43R

The following section details the historical development of SSAP No. 43R. Due to various revisions that have been reflected since its original adoption, this information is retained for historical reference on the SSAP No. 43R guidance prior to the reflection of the principles-based bond proposal.

~~106.~~107. *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.

~~107.~~108. The original issue paper to SSAP No. 43 (Issue Paper No. 43) cited guidance originally contained in Chapter 1, *Bonds and Loaned 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.

~~108.~~109. 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 trusteed 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.

~~109.~~110. 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.

~~110.~~111. In 2009, the Working Group adopted a substantively-revised SSAP No. 43R (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. 43R, 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."

~~111.~~112. 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. 43R 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. 43R. 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.

~~112.~~113. 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. 43R (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. 43R, 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

~~113.~~114. Between the adoption of agenda item 2010-12 and the items adopted in 2019, there were several revisions to SSAP No. 43R, 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.

~~114.~~115. 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[1] 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 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[2] 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. 43R transaction is a related party arrangement[3]. Loan-backed and structured securities meet the definition of assets as defined in

---

[1] 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.

[2] 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.

[3] As discussed in paragraph 4.a. of this statement, a SSAP No. 43R security may still be considered a related party transaction even if the asset trustee or security issuer is a non-related party.

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. 103R,

c. Loan-backed and structured securities for which it is probable, either known at acquisition or identified during the holding period[4], 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. 103R and purchased beneficial interests in securitized financial assets[5].

Benefits of Reporting in Scope of SSAP No. 43R

~~115.~~116. 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. 43R may be more advantageous than capturing in scope of *SSAP No. 26R—Bonds*. These benefits include:

a. Capturing an investment in scope of SSAP No. 26R or SSAP No. 43R 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. 43R trust has been particularly noted as providing "regulatory capital relief.")

b. Capturing an investment in scope of SSAP No. 26R or SSAP No. 43R 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. 43R 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 43R 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 43R 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.)

[4] 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.

[5] The accounting requirements related to these types of securities included in paragraphs 22-25 shall be determined at acquisition or initial transfer.

ii. The SSAP No. 43R bifurcated impairment can be considered an advantage over SSAP No. 26R as under SSAP No. 43R, 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. 26R, 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. 43R 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. 43R 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 that refers to the junior-most layer of issued SSAP No. 43R 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. 43R 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. 43R 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. 43R 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 the Current Scope / Definition Application of SSAP No. 43R

~~116.~~117. With the existing guidance in SSAP No. 43R, 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.

~~117.~~118. As an additional issue of the existing guidance, questions have been raised on whether securities captured in scope of SSAP No. 43R 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. 43R, 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. 43R 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.

Proposed Revisions to SSAP No. 26R

Summary of Revisions:

1. Paragraphs 1-4 updates the scope guidance (and exclusions) for SSAP No. 26R. These revisions specifically identify issuer credit obligations as the focus of SSAP No. 26R as well as name specific investments captured in scope. The guidance excludes asset-backed securities, as those investments will be captured in SSAP No. 43R, as well as structured notes, principal-protected notes and other securities that will have varying principal or interest based on underlying equity appreciation or depreciation, an equity-based derivative or other referenced variable.

2. Paragraph 3 includes specific guidance for investments acquired with a maturity date of one year or less from the date of acquisition. This guidance identifies that SSAP No. 26R is applicable for the accounting guidance, but that the investments are captured in SSAP No. 2R and shall follow that guidance for reporting and disclosures. The approach for this guidance is different than current SSAP No. 26R, as that guidance identifies that these items are excluded from SSAP No. 26R. This exclusion can be confusing as the guidance in SSAP No. 2R directs investments in scope to be accounted for in the same manner as similar long-term investments.

3. Paragraphs 5-12 predominantly reflect guidance from the principle-based bond definition. Items shaded in yellow are slight wording changes to incorporate the guidance within the SSAP.

4. Paragraphs 15-38 only include minimal edits mostly for paragraph references and clarity. For investments captured in scope there are no proposed changes to measurement guidance or accounting provisions.

5. Paragraphs 40-41 (disclosures) reflect revisions to eliminate the general reporting categories. Pursuant to the bond project, reporting revisions are being considered for enhanced granularity and transparency. These broad categories are proposed to be eliminated. The elimination of these categories does not impact the actual disclosure elements.

6. Paragraphs 41-45 incorporate effective date and transition guidance as well as historical guidance in the development of SSAP No. 26R. Prior guidance in SSAP No. 26R providing transition guidance for SVO-Identified bond ETFs has been elimination or shortened as the guidance for initial application (between Dec. 31, 2017, to Jan. 1, 2018) is no longer applicable.

7. Exhibit A - Glossary has been expanded to incorporate more key terms.

8. Exhibit B - Investment Examples is new and reflects the Appendix from the principles-based bond definition on structures that do not represent creditor relationships.

9. Other Edits – References to Schedule D-1 have been deleted. With the discussions on potential reporting changes, and a potential divide between SSAP No. 26R and SSAP No. 43R into separate reporting schedules, this explicit schedule name has been deleted. In its place, reference has been included as "reporting as a bond."

10. Shading Notes: Items shaded in yellow highlight differences from the bond definition. These are only in paragraphs where the bulk of the guidance is a direct pull from the bond definition and mostly pertain to grammatical / wording edits to incorporate the bond definition into the SSAP. Items shaded in gray are notes to staff on areas that may need to be updated with future edits (such as paragraph references.)

SCOPE OF STATEMENT

1. ~~This~~ 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*. ~~establishes statutory accounting principles for bonds, specific fixed-income investments, and particular funds identified by the Securities Valuation Office (SVO) as qualifying for bond treatment as identified in this statement.~~

~~1.~~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;

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

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

(Note – This short-term guidance doesn't change current guidance. Under SSAP No. 2R, short-term investments shall be accounted for similar to long-term investments. The proposed change prevents circular guidance where short-term investments are excluded from SSAP No. 26R and then SSAP No. 2R points back to SSAP No. 26R for accounting.)

~~2.~~4. This statement excludes:

~~a. Loan-backed and structured securities addressed in *SSAP No. 43R—Loan-Backed and Structured Securities.*~~

~~b. Securities that meet the definition in paragraph 3 with a maturity date of one year or less from date of acquisition, which qualify as cash equivalents or short-term investments. These investments are addressed in *SSAP No. 2R—Cash, Cash Equivalents, Drafts and Short-Term Investments*.~~

~~c. Securities that meet the definition in paragraph 3, 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 contractual amount due. These investments, although in the form of a debt instrument, incorporate 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*, unless the investment is a mortgage-referenced security addressed in *SSAP No. 43R—Loan-Backed and Structured Securities*. This exclusion 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 principal amount due/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 (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 this exclusion if the "principal protection" involves only a portion of the principal/original investment amount and/or if the 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 in this exclusion. Securities within the scope of SSAP No. 43R, foreign denominated bonds (if only by virtue of their denomination in a foreign currency) and securities comprising elements of risk consistent with replication (synthetic assets) transactions (RSATs) as defined in the *Purposes and Procedures Manual of the NAIC Investment Analysis Office*, are also not captured in this exclusion. This exclusion does not impact RSATs as defined in SSAP No. 86.~~

~~d.~~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 asset-backed security (ABS). These investments shall follow the guidance in *SSAP No. 43R—Asset-Backed Securities*

~~e.~~c. Securities that provide varying principal or interest based on underlying equity appreciation or depreciation, an equity-based derivative, or other referenced variable are excluded under the principles-based bond definition. This includes principal-protected notes (or principal protected securities) and structured notes[1] that have any components within the structure that can provide returns based on underlying equity influences or other referenced variables. (As detailed in footnote 4, securities with plain-vanilla inflation adjustment mechanisms, such as U.S. TIPs) are excluded from this restriction.)

SUMMARY CONCLUSION

Principal-Based Bond Definition

[1] The structural design of principal-protected notes and structured notes precludes these investments from being captured as issuer credit obligations or ABS as such investments do not represent a creditor relationship in substance. 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 when the structure also includes other collateral with the potential to general additional interest or returns. Such structures must be viewed wholistically within the principles-based bond definition, with all potential returns considered in determining whether the structure qualifies as a creditor relationship.

5. A bond shall be defined as any security[2] 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.

6. Determining whether a security represents a creditor relationship should consider its substance, rather than solely the legal form of the instrument. The analysis 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. See Exhibit B for examples of securities that, despite their legal form, do not represent a creditor relationship in substance.

~~3.~~7. An issuer credit obligation is a bond, where repayment of the security instrument is supported primarily by the general creditworthiness of an operating entity or entities. Support consists of direct or indirect recourse to an operating entity or entities, which 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:~~Bonds shall be defined as any securities[3] representing a creditor relationship, whereby there is a fixed schedule for one or more future payments. This definition includes:~~

a. U.S. Treasury securities, including U.S. Treasury Inflation-Indexed Securities[4];(INT 01-25)

b. U.S. government agency securities;

---

[2] 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.

~~[3] This statement adopts the GAAP definition of a security as it is used in FASB Codification Topic 320 and 860.~~

~~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 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.~~

[4] The inclusion of U.S. Treasury Inflation-Indexed Securities clarifies that securities with plain-vanilla inflation adjustment mechanisms are not intended to be captured within the provisions that restrict bond classification to securities that have principal and interest payments that vary based on appreciation or depreciation of an underlying referenced variable. Inflation adjustment mechanisms are considered plain-vanilla if it is based on a widely recognized measure of inflation and excludes those that involve either leverage (such as a multiplier) or an inverse adjustment relationship. As detailed in paragraph 3b, securities that have principal and interest payment variations due to valuation changes of a referenced variable (such as the appreciation of equity or real estate cause variations of changes in the principle or interest of a security structure) are intended to be precluded from bond treatment under the principles-based bond definition

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. Convertible bonds, issued by holding companies that own operating entities; ~~including mandatory convertible bonds as defined in paragraph 11.b;~~

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 (ETC), 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.

~~e. Fixed-income instruments specifically identified:~~

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

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

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

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

8. An asset[5] backed security is a bond issued by an entity (an "ABS Issuer") created for the primary purpose of raising debt capital backed by financial assets[6] or cash generating non-financial assets owned

[5] 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.

[6] *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

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[7]. 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.

9. There are two defining characteristics that must be present for a security to meet the definition of an asset backed security:

a. 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[8] 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.

b. 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[9] credit enhancement through guarantees (or other similar forms of recourse), subordination and/or overcollateralization. The debt instrument 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 variable. For example, an issued security that has varying principal and interest payments based on the appreciation of referenced equity, real estate or other variable is precluded from bond treatment. Plain-vanilla inflation adjustments (such as with U.S. TIPs) are not captured within these appreciation or depreciation adjustment exclusions and therefore are not excluded from bond classification. (For clarification purposes, all returns from an ABS 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 variables.)

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

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.

[7] 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.

[8] The term "meaningful" is defined in the Glossary.
[9] The term "substantive credit enhancement" is defined in the Glossary.

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.

4.11. The definition of a bondcreditor relationship, per paragraph 63, 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 interests in the issuer. , such as mutual funds or exchange-traded funds. 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 the following types of SVO-identified investments 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 bondsissuer credit obligations, unless different treatment is specifically identified in paragraphs 32-3823-29.

f. 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 published on the SVO's web page of *www.NAIC.org*. (SVO-identified ETFs are reported on Schedule D – Part 1.)

12. The first loss position may be issued as part of thea 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 positions(s), if the first loss position(s) lacks contractual payments along with 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 structure does not qualify for reporting as a bond on Schedule D-1 and shall be reported on Schedule BA: Other Long-Term Invested Assets.

13. 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.*

5.14. 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[10]

Acquisitions, Disposals and Changes in Unrealized Gains and Losses

6.15. 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.

[10] 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.

~~7.~~16. 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.

~~8.~~17. 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 required to maintain an AVR, unrealized gains and losses shall be recorded as a direct credit or charge to unassigned funds (surplus).

Amortized Cost

~~9.~~18. 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.[11] (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

~~10.~~19. For callable bonds[12], 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"~~ for reporting in Schedule D, Part 1~~. Depending on the characteristics of the callable bonds, the yield-to-worst concept in paragraph 18~~9~~ shall be applied as follows:

a. For callable bonds with a lockout period, premium in excess of the next call price[13] (subsequent to acquisition[14] 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.

---

[11] For perpetual bonds with an effective call option, any applicable premium shall be amortized utilizing the yield-to-worst method.

[12] Callable bonds within the scope of paragraph 19~~0~~ 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 D includes illustrations for the amortization of callable bonds.

[13] 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.

[14] 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.

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

~~11.~~20. Bonds~~, as defined in paragraph 3,~~ 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).

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*.)

~~12.~~21. 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

~~13.~~22. An other-than-temporary(INT 06-07) 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.[15] 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

[15] 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.

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.

~~14.~~23. 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 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

~~15.~~24. 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.

~~16.~~25. 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.

~~17.~~26. The amount of prepayment penalty and/or acceleration fees 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[16]:

   i. To the extent an entity has in place a process to identify explicit prepayment penalty or acceleration fees, 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 fees, the reporting entity shall calculate the resulting realized gain as the difference between

[16] 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.

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

~~18.~~27. 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 income over the term of the bond consistent with paragraph 18~~9~~ of this statement. Other origination fees shall be recorded as income upon receipt.

Origination, Acquisition and Commitment Costs

~~19.~~28. 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~~6~~ 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

~~20.~~29. 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.

~~21.~~30. 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~~9~~ 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

~~22.~~31. If a bond is exchanged or converted into other securities (including conversions of mandatory convertible securities addressed in paragraph ~~11~~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 ~~Investments~~ Bond Exchange-Traded Funds

~~23.~~32. SVO-identified bond exchange-traded fund (ETF) investments, as discussed in paragraph 2~~4~~, are captured within the scope of this statement for accounting and reporting[17] purposes only. The inclusion of these investments within this statement is not intended to contradict state law regarding the classification

[17] With the inclusion of these SVO-identified investments ~~in Schedule D, Part 1 or Schedule DA~~as bonds, specific guidelines are detailed in the annual statement instructions for reporting purposes.

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).

~~24.~~33. 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,[18] with changes in fair value recorded as unrealized gains or losses) unless the reporting entity has elected use[19] 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.

~~25.~~34. 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[20]. 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 ~~25~~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

[18] For these investments, net asset value (NAV) is allowed as a practical expedient to fair value.

[19] 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*.

[20] This guidance requires investments purchased in lots to follow the measurement method established at the time the investment was first acquired.

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.

d. Determination of the designated systematic value must follow the established[21] approach, which is consistently applied for all ~~equity/fund~~ 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.

~~26.~~35. 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.

~~27.~~36. 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.

~~28.~~37. 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[22] 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~~[23]~~. 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.

[21] Exhibit B details the established systematic value approach.

[22] 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.

~~[23] Transition guidance in paragraph 35 shall be followed for initial application and for investments that are designated as SVO-identified investments eligible for systematic value.~~

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.

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.

~~29.~~38. 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

~~30.~~39. 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~~4~~, 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~~24~~. 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[24] (e.g., fair value or systematic value). If different measurement methods are used[25], information on why the reporting entity

[24] As identified in paragraph ~~25~~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.

[25] 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.

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 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. ~~receiving bond treatment, category reported in Annual Statement Schedule D – Bonds issued by:~~

~~f. i. U.S. Governments;~~

~~g. ii. All Other Governments;~~

~~h. iii. States, Territories and Possessions (Direct and Guaranteed);~~

~~i. iv. U.S. Political Subdivisions of States, Territories and Possessions (Direct and Guaranteed);~~

~~j. v. U.S. Special Revenue & Special Assessment Obligations and all Non-Guaranteed Obligations of Agencies and Authorities of Governments and Their Political Subdivisions;~~

~~k. vi. Industrial & Miscellaneous (Unaffiliated);~~

~~l. vii. Hybrid Securities;~~

~~m.~~e. ~~viii. Parent, Subsidiaries and Affiliates;~~

~~n.~~f. For the most recent balance sheet, the book/adjusted carrying values and the fair values of bonds and assets ~~receiving bond treatment~~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).

~~o.~~g. For each period for which results of operations are presented, the proceeds from sales of bonds and assets ~~receiving bond treatment~~in scope of this Statement~~, reported in Annual Statement Schedule D – Bonds~~ and gross realized gains and gross realized losses on such sales.

~~p.~~h. For each balance sheet presented, all ~~bonds~~ 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.

~~q.~~i. The disclosures in paragraphs ~~30~~39.h.i. and ~~30~~39.h.ii. should be segregated by ~~those bonds~~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.

~~r.~~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.

~~s.~~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.

~~t.~~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.

~~31.~~40. Refer to the Preamble for further discussion regarding disclosure requirements. The disclosures in paragraphs ~~30~~39.b., ~~30~~39.e., ~~30~~39.f., ~~30~~39.g., ~~30~~39.h., ~~30~~39.i., ~~30~~39.j. and ~~30~~39.k. shall be included in the annual audited statutory financial reports only.

Relevant Literature

~~32.~~41. 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.

~~33.~~42. 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

43. Revisions to SSAP No. 26R to incorporate the principle-based bond concepts are effective _____. 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 (ABS) 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.

44. Investments that were reported as a bond on Schedule D-1: Long-Term Bonds as of December 31, ____ 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, _____. These investments shall be accounted for in accordance with the resulting SSAP that addresses the specific investment structure. This could result with either a gain or loss in the measurement of the investment at the time of the reclassification. A change resulting from the application of this statement shall be accounted for as a change in accounting principle in accordance with SSAP No. 3.

Historical Adoption and Revisions of SSAP No. 26R:

45. 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 ~~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.~~

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 ~~The guidance in paragraphs 13 and 14 was previously included within~~ *SSAP No. 99—Accounting for Securities Subsequent to an Other-Than-Temporary Impairment* ~~and was effective for reporting periods beginning on January 1, 2009, and thereafter, with early adoption permitted. In 2010, the guidance from SSAP No. 99 was incorporated within the impacted standards, with SSAP No. 99 superseded~~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 ~~reflected in paragraph 12, incorporated~~ from *INT 02-05: Accounting for Zero Coupon Convertible Bonds*.~~,~~

d. ~~was originally effective December 8, 2002.~~ Guidance adopted in December 2013 clarifying the 'yield-to-worst' concept for bonds with make-whole call provisions ~~is a nonsubstantive change~~was initially effective January 1, 2014, unless the company had~~s~~ previously been following the guidance. (Companies that have previously been following the original intent, as clarified in the revisions, ~~should not~~were not ~~be~~ impacted by these changes.)

e. The guidance ~~in paragraph 17 with respect to~~on the calculation of investment income for prepayment penalties~~y~~ and/or acceleration fees ~~is~~ was effective January 1, 2017, on a prospective basis and ~~i~~was required for interim and annual reporting periods thereafter, with ~~. E~~early application ~~is~~ 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.

~~i.~~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 included 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.

~~b. In April 2017, substantive revisions, as detailed in Issue Paper No. 156, were adopted. These revisions, effective December 31, 2017, clarify the definition of a bond and what is in scope of the bond definition, as well as incorporate new guidance for SVO-identified investments identified as in scope of SSAP No. 26R, but that are not considered bonds. As of the effective date, reporting entities shall modify the measurement method for SVO-identified investments to reflect the guidance in the substantive revisions as follows:~~

~~c. For SVO-identified investments captured within SSAP No. 26R and held by the reporting entity at the time of transition that will be reported at fair value (or NAV), the reporting entity shall reflect an unrealized gain or unrealized loss for the difference between the prior book/adjusted carrying value and fair value (NAV). Subsequently the investment shall continue to be reported at fair value (or NAV) with fair value fluctuations recorded as unrealized gains or losses, until the time of sale or recognition of an other-than-temporary impairment.~~

~~d. For SVO-identified investments captured within SSAP No. 26R and held by the reporting entity at the time of transition for which the reporting entity elects use of the systematic~~

~~value measurement method, as of December 31, 2017, the reporting entity shall identify the SVO-identified investment with a code in the Annual Statement Schedule D – Part 1 and continue reporting the investment using the measurement method utilized throughout 2017. As the revisions move the prior measurement method (fair value/original cost) to systematic value, which is a new measurement concept, the reporting entity shall begin calculating systematic value using the SVOiIdentified investments portfolio's aggregated cash flows (ACF) on January. 1, 2018, and use the December 31, 2017, book/adjusted carrying value to calculate the initial book yield. This new measurement approach is a change in accounting principle pursuant to SSAP No. 3, and shall be disclosed under SSAP No. 3. However, a cumulative effect adjustment to capital and surplus is not anticipated as reporting entities will be applying the book/adjusted carrying value as of December 31, 2017, to the aggregated cash flows on January 1, 2018, to calculate initial book yield.~~

~~e. 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.~~

~~f. 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 ACF.~~

~~g. 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. For December 31, 201,7 reporting, in addition to identifying the SVO-identified investments designated for systematic value, reporting entities shall disclose the CPY for each SVO-identified investment for NPV-CPY impairment recognition going forward.~~

~~h. For SSAP No. 26R Scope Revisions: If the revisions reflected in SSAP No. 26R (e.g., definitions) result with an investment no longer qualifying (or qualifying) within the scope of SSAP No. 26R, this change shall be reflected prospectively from the effective date. As such, investments previously included within SSAP No. 26, that will move within the scope of another SSAP and reporting schedule shall be shown as dispositions on Schedule D – Part 4, and shown as an acquisition on the schedule for which it will be subsequently reported. (If the revisions move the investment into the scope of SSAP No. 26R, the investment shall be reported as a disposition on the prior investment schedule and as an acquisition on the Schedule D – Part 3.)~~

~~i.~~b. ~~Revisions adopted April 2019, to~~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, ~~are~~ were effective December 31, 2019.

~~j.~~c. ~~On July 30, 2020, nonsubstantive revisions were adopted~~Revisions to clarify existing guidance that all prepayment penalty 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 ~~an~~ the effective

date of January 1, 2021, with early application permitted, ~~is~~ 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 – GLOSSARY

Asset-Backed Security - An asset-backed security 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 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. Many ABS Issuers are in the form of a trust or special purpose vehicle ("SPV"), though 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. There are two defining characteristics that must be present for a security to meet the definition of an asset backed security:

- Assets owned by the ABS Issuer are either financial assets or cash-generating non-financial assets.
- 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 sufficient credit enhancement through guarantees (or other similar forms of recourse), subordination and/or overcollateralization.

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.

Bond – Securities that qualify under the principles-based bond definition as an issuer credit obligation or asset-backed security. The application of guidance to "bonds" in this standard also encompasses the non-bond items detailed in paragraph 2 specifically identified to receive bond accounting and reporting

treatment. SSAP No. 43R includes qualifying asset-backed securities. ~~representing a creditor relationship, whereby there is a fixed schedule for one or more future payments.~~

Cash-Generating Non-Financial Assets - 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, other than through the sale or refinancing of the assets.

Convertible Bond – A bond that can be converted into a different security, typically shares of common stock.

Financial Asset - SSAP No. 103R 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. 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.

~~**Hybrids** – Securities whose proceeds are accorded some degree of equity treatment by one or more of the nationally recognized statistical rating organizations (NRSRO) and/or which are recognized as regulatory capital by the issuer's primary regulatory authority. Hybrid securities are designed with characteristics of debt and equity and are intended to provide protection to the issuer's senior note holders. Hybrid securities are sometimes referred to as capital securities. An example of a hybrid is a trust-preferred security. Excluded from bond classification are surplus notes, which are reported on BA; subordinated debt issues, which have no coupon deferral features; and "Traditional" preferred stocks, which should be captured under SSAP No. 32R. Traditional preferred stocks include, but are not limited to a) U.S. issuers that do not allow tax deductibility for dividends; and b) those issued as preferred stock of the entity of an operating subsidiary, not through a trust or a special purpose trust.~~

Issuer Credit Obligation – An issuer credit obligation is a bond, the repayment of which is supported primarily by the general creditworthiness of an operating entity or entities. Support consists of direct or indirect recourse to an operating entity or entities, which 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.

~~**Trust Preferred Securities** – Security possessing characteristics of both equity and debt. A company creates trust-preferred securities by creating a trust, issuing debt to it, and then having it issue preferred securities to investors. Trust-preferred securities are generally issued by bank holding companies. The preferred securities issued by the trust are what are referred to as trust-preferred securities. The security is a hybrid security with characteristics of both subordinated debt and preferred stock in that it is generally very long term (30 years or more), allows early redemption by the issuer, makes periodic fixed or variable interest payments, and matures at face value. In addition, trust preferred securities issued by bank holding companies will usually allow the deferral of interest payments for up to 5 years.~~

Mandatory Convertible Bonds - A type of convertible bond that has a required conversion or redemption feature. Either on or before a contractual conversion date, the holder must convert the mandatory convertible bond into the underlying common stock.

Meaningful - 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 is specific to each transaction, determined at origination, and should consider the following factors:

1. The price volatility in the principal market for the underlying collateral;
2. The liquidity in the principal market for the underlying collateral;
3. The diversification characteristics of the underlying collateral (i.e., types of collateral, geographic location(s), source(s) of cash flows within the structure, etc.);
4. The overcollateralization of the underlying collateral relative to the debt obligation; and
5. The variability of cash flows, from sources other than sale or refinancing, expected to be generated from the underlying collateral.

Factors #1 and #5 are directly related to the "meaningful" requirement. That is, as price volatility or variability of cash flows increase, 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. Factors #2, #3 and #4 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.

Meaningful Practical Expedient - 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 asset 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 definition.

Principal Protected Note / Security – A principal-protected note / security 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, but the structure also incorporates other investments, at origination or over the life of the structure, that are intended to generate returns or other assets to the reporting entity note holder. These returns, often based on underlying equity factors or other referenced variables, prevents 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 still safeguards principal returns, but the structure acquires 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 bond reporting as they would not qualify as issuer credit obligations 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.

Security – Adopts the GAAP definition of a security as it is used in FASB Codification Topic 320 and 860: 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 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.

Structured Note – A structured note is an instrument in which the terms make it possible that the reporting entity holder could lose all or a portion of its original investment amount for a reason 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 or referenced variable. Due to the underlying variable that determines principal repayment, these structures (regardless of if in a trust/SPV) do not qualify as creditor relationships and do not qualify for bond reporting. Existing guidance identifies that structured notes shall be captured in *SSAP No. 86—Derivatives*

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 hold's 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 with a significant reduction in the issuance of these securities. If these securities continue to be held by insurers, they should be assessed for reporting as a bond under the principal-based bond proposal. If these securities do not qualify for bond reporting, presumably, these securities would be reported as preferred stock in scope of SSAP No. 32R.~~Security possessing characteristics of both equity and debt. A company creates trust preferred securities by creating a trust, issuing debt to it, and then having it issue preferred securities to investors. Trust preferred securities are generally issued by bank holding companies. The preferred securities issued by the trust are what are referred to as trust preferred securities. The security is a hybrid security with characteristics of both subordinated debt and preferred stock in that it is generally very long term (30 years or more), allows early redemption by the issuer, makes periodic fixed or variable interest payments, and matures at face value. In addition, trust preferred securities issued by bank holding companies will usually allow the deferral of interest payments for up to 5 years.~~

Yankee Bonds – A bond denominated in U.S. dollars that is publicly issued in the U.S. by foreign banks and corporations. According to the Securities Act of 1933, these bonds must first be registered with the Securities and Exchange Commission (SEC) before they can be sold. Yankee bonds are often issued in tranches. ~~Yankee bonds, or bonds issued by foreign entities denominated in U.S. dollars are not considered hybrid securities unless they have equity-like features.~~

Zero Coupon Bond – A bond that does not pay interest during the life of the bond. Instead, investors buy zero coupon bonds at a deep discount from their face value, which is the amount a bond will be worth when it "matures" or comes due. When a zero coupon bond matures, the investor will receive one lump sum equal to the initial investment plus the imputed interest, which is discussed below. The maturity dates on zero coupon bonds are usually long-term. Because zero coupon bonds pay no interest until maturity, their prices fluctuate more than other types of bonds in the secondary market. In addition, although no payments are made on zero coupon bonds until they mature, investors may still have to pay federal, state, and local income tax on the imputed or "phantom" interest that accrues each year.

Exhibit B: Investment Examples – Structure Does Not Represent a Creditor Relationship

1. As detailed in paragraphs 5-6, the initial determinant in the principles-based bond definition is whether the investment is a security that represents a creditor relationship in substance. Examples included in this exhibit intend to identify scenarios that do not reflect an in-substance creditor relationship.

2. **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.

3. **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, an equity-based derivative, or other referenced variable, is a bond under this standard as such security would contain equity-like characteristics. A bond under this standard is required to have pre-determined principal and interest payments (whether fixed interest or variable interest)~~and comply with the structured note guidance within paragraph XXX~~.

4. **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 issuer credit obligation

5. **Example 2 Rationale:** Determining of 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:

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

6. 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.

7. Furthermore, this analysis 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 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.

EXHIBIT CB – 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 **cash flows** file from ETF provider website.

NAV:	$115.07	(Official end-of-day NAV found on ETF provider website)
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 provider website
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%	
~~Recalulated~~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 ~~Schedule D Part 1~~ 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 wih (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. **8/31/20X1**			5. Under the column "CASHFLOW" enter the following formula in Excel: =(-Ending Book Value)*1000000 **(115,414,059.56)**
"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 D~~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			**104**	2	105.25
01/01/2012	Call Date		104	**104**		
12/31/2012	Year-End Reporting			**103.5**	0.5	104.50
12/31/2013	Year-End Reporting			**103**	0.5	103.75
01/01/2014	Call Date		103	**103**		
12/31/2014	Year-End Reporting			**102.5**	0.5	103
12/31/2015	Year-End Reporting			**102**	0.5	102.25
01/01/2016	Call Date Exercised		102	**102**		

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 ~~15~~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	**103.50**
01/01/2012	Call Date		106	104		**103.50**
12/31/2012	Year-End Reporting			103.5	0.5	**103**
12/31/2013	Year-End Reporting			103	0.5	**102.50**
01/01/2014	Call Date		103	103		**102.50**
12/31/2014	Year-End Reporting			102.5	0.5	**102**
12/31/2015	Year-End Reporting			102	0.5	**101.50**
01/01/2016	Call Date Exercised		102	102		**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	102	100	101.50	(1.50)

* Per paragraph ~~15~~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	**103.50**
01/01/2012	Call Date		106	104		**103.50**
12/31/2012	Year-End Reporting			103	0.5	**103**
12/31/2013	Year-End Reporting			**102**	1	102.50
01/01/2014	Call Date		102	**102**		102.50
12/31/2014	Year-End Reporting			**101.5**	0.5	102
12/31/2015	Year-End Reporting			**101**	0.5	101.50
01/01/2016	Call Date Exercised		101	**101**		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 ~~15~~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	**100**	There is no subsequent amortization as the premium was fully expensed at acquisition.	104
12/31/2011	Year-End Reporting		100	**100**		103.50
12/31/2012	Year-End Reporting		100	**100**		103
12/31/2013	Year-End Reporting		100	**100**		102.50
12/31/2014	Year-End Reporting		100	**100**		102
12/31/2015	Year-End Reporting		100	**100**		101.50
01/01/2016	Year-End Reporting		100	**100**		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 prepayment penalty or acceleration fees.

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

Proposed Revisions to SSAP No. 43R

Summary of Revisions:

1. Paragraphs 1-4 updates the scope guidance (and exclusions) for SSAP No. 43R. These revisions specifically identify asset backed securities as the focus of SSAP No. 43R as well as identifies securities excluded from scope. With the change in terminology, the SSAP has been renamed as "Asset Backed Securities." Corresponding edits will be needed to other SSAPs and other documents that reference the old SSAP No. 43R title of "Loan-Backed and Structured Securities."

2. Paragraphs 5-9 incorporate guidance from the principles-based bond definition specific to asset backed securities. Items shaded in yellow are slight wording changes to incorporate the guidance within the SSAP.

3. Beginning with paragraph 11, and throughout the SSAP, the structure has been revised for readability. In addition to moving paragraphs (or partial pargraphs) to different locations, revisions have also been proposed to clarify and update the guidance. The current SSAP No. 43R paragraph has been included in parentheticals for tracking / reference purposes.

4. The prior approach in SSAP No. 43R that divided guidance between whether cash flows was probable or not probable and whether it was for beneficial interests was deemed to be confusing and contradictory. The guidance has been revised to capture guidance collectively for the assessment of cash flows and for the accretable yield / changes to the effective yield. This guidance has been updated to reflect concepts from U.S. GAAP. (Paragraphs 21-30 of the current proposal.)

5. The relevant literature section, beginning in paragraph 51, has been revised to identify changes from the prior adoption of U.S. GAAP. Under the proposed guidance, no U.S. GAAP standards will be identified as adopted for statutory accounting purposes and previously adopted standards will be identified as rejected.

6. The effective literature guidance in paragraph 52 has been updated to be specific to this SSAP. Prior guidance adopted to SSAP No. 43R, which had prior effective dates noted, has been deleted.

7. Appendix A incorporates guidance from the principles-based bond definition on examples for the analysis of asset backed securities.

8. The old Exhibit A – Question and Answer Implementation Guide is currently retained in the SSAP and has not been updated. NAIC staff is uncertain as to the extent the guidance in this Q&A needs to be retained and comments are requested during the exposure period. If the exhibit is retained, updates will be subsequently considered to ensure it is line with the revised guidance in the SSAP.

9. As detailed within this statement, additional revisions are expected to SSAP No. 2R and SSAP No. 103R to make corresponding edits in line with the revised guidance within this statement. These revisions wil be subsequent drafted and exposed.

10. Shading Notes: Items shaded in yellow highlight differences from the bond definition. These are only in paragraphs where the bulk of the guidance is a direct pull from the bond definition and mostly pertain to grammatical / wording edits to incorporate the bond definition into the SSAP. Items shaded in gray are notes on areas that may need to be updated with future edits (such as paragraph references) or commentary that will not be retained in the SSAP.

Statement of Statutory Accounting Principles No. 43 - Revised

~~Loan-Backed and Structured~~Asset Backed Securities

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.~~investments in loan-backed securities, structured securities and mortgage-referenced securities. In accordance with *SSAP No. 103R—Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, retained beneficial interests from the sale of loan-backed securities and structured securities are accounted for in accordance with this statement~~. Each security shall be individually assessed as an asset-backed security and reported separately regardless of whether the security was issued in combination or as a unit with other investments. ~~In addition, mortgage loans in scope of *SSAP No. 37—Mortgage Loans* that qualify under an SVO structural assessment are in scope of this statement as credit tenant loans (CTLs).~~ Items captured in scope of this statement are collectively referred to as ~~loan-backed~~asset-backed securities. Note – Need to update SSAP No. 103 so that only qualifying ABS are captured in SSAP No. 43R. Paragraph 2 of SSAP No. 103 has a direct pointer to 43R for beneficial interests. Also referenced in paragraphs 11c and 18.)

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~~ 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[1] 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. (P5)

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 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. (Note – This is new guidance. Corresponding edits needed to SSAP No. 2R.)

4. This statement excludes:

   a. Security structures captured in scope of *SSAP No. 26R—Bonds*.

---

[1] 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.

b. Mortgage loans in scope of *SSAP No. 37—Mortgage* Loans that qualify under an SVO structural assessment as SVO-Identified Credit Tenant Loans are excluded as these are captured as issuer credit obligations under SSAP No. 26R.

c. Security structures that do not qualify as Asset-Backed Securities, including structures that provide varying principal or interest based on underlying equity appreciation or depreciation, an equity-based derivative, or other referenced variable. This includes principal-protected notes (or principal protected securities) and structured notes[2] that have any components within the structure that provide returns based on underlying reference variables.

SUMMARY CONCLUSION

Principles-Based Bond Definition - Asset Backed Security

5. An asset[3] backed security is a bond issued by an entity (an "ABS Issuer") created for the primary purpose of raising debt capital backed by financial assets[4] 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[5]. 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"), though 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.

a. Pursuant to SSAP No. 26R, a bond is any security 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**.** (Bonds that qualify as issuer credit obligations are in scope of SSAP No. 26R.)

b. Determining whether a security represents a creditor relationship should consider its substance, rather than solely the legal form of the instrument. The analysis of whether a

[2] The structural design of principal-protected notes and structured notes precludes these investments from being captured as issuer credit obligations or ABS on Schedule D-1 as such investments do not represent a creditor relationship in substance. 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 when the structure also includes other collateral with the potential to general additional interest or returns. Such structures must be viewed wholistically within the principles-based bond definition, with all potential returns considered in determining whether the structure qualifies as a creditor relationship.

[3] 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 substantive credit enhancement.

[4] *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.

[5] 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 in scope of this statement and not an issuer credit obligation in scope of SSAP No. 26R.

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.

c. Whether a structure qualifies as a security that reflects an in-substance creditor relationship, and whether it represents an issuer credit obligation or ABS pursuant to the principles-based bond definition detailed in SSAP No. 26R shall be determined prior to the application of the ABS guidance within this statement.

6. There are two defining characteristics that must be present for a security to meet the definition of an asset backed security[6]:

a. 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.

b. 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. The debt instrument 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 variable. For example, an issued security that has varying principal and interest payments based on the appreciation of referenced equity, real estate or other variable is precluded from bond treatment. Plain-vanilla adjustments (such as U.S. TIPs in scope of SSAP No. 26R) are not captured within these appreciation or depreciation adjustment exclusions and therefore are not excluded from bond classification. (For clarification purposes, all returns from an ABS 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 reference variables.)

7. *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 6a is specific to each transaction, determined at origination, and shall consider the following factors:

1. The price volatility in the principal market for the underlying collateral;
2. The liquidity in the principal market for the underlying collateral;
3. The diversification characteristics of the underlying collateral (i.e., types of collateral, geographic location(s), source(s) of cash flows within the structure, etc.);
4. The overcollateralization of the underlying collateral relative to the debt obligation; and

[6] Appendix ___ includes examples of analysis for asset backed securities.

5. The variability of cash flows, from sources other than sale or refinancing, expected to be generated from the underlying collateral.

Factors #1 (price variability) and #5 (variability of cash flows) are directly related to the "meaningful" requirement. That is, as price volatility or variability of cash flows increase, 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. Factors #2 (liquidity), #3 (diversification) and #4 (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.

8. 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 7.

9. *Substantive Credit Enhancement:* Pursuant to paragraph 6b, 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.

a. 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 structure does not qualify for reporting as a ~~as a Schedule D~~ bond and should be reported on Schedule BA: Other Long-Term Invested Assets.

~~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.~~

~~5.~~10. 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. ~~Loan-backed and structured~~Asset 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. *(P6 – This guidance reflects adopted revisions from Ref #2021-21))*

a. Although an asset backed ~~loan-backed or structured~~ security may be acquired from a non-related issuer, if the assets held in trust predominantly[7] 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 ~~loan-backed or structured~~ 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 loan-backed or structured 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*.

~~6. 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,~~

[7] 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. 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. 103R,~~

~~c. Loan-backed and structured securities for which it is probable, either known at acquisition or identified during the holding period[8], 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. 103R and purchased beneficial interests in securitized financial assets[9].~~

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

~~7.~~11. Items in scope of this statement~~At acquisition, loan-backed and structured securities, except for loan-backed or structured securities that are beneficial interests that are not of high credit quality or can contractually be prepaid or otherwise settled in such a way that the reporting entity would not recover substantially all of its recorded amount[10] (see paragraphs 22-25),~~ shall initially be reported at cost, including brokerage and related fees, unless otherwise detailed in paragraph 13. Acquisitions and dispositions shall be recorded on the trade date, not the settlement date, except for the acquisition of private placement asset-backed securities ~~loan-backed and structured 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. (P8)

12. 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: (New – but partly from P22.)

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.

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.~~13. 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.~~loan-backed or structured security, consistent with paragraph 8 of this statement.~~ All other costs, including internal costs or costs paid to an affiliated

---

~~[8] 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.~~

~~[9] The accounting requirements related to these types of securities included in paragraphs 22-25 shall be determined at acquisition or initial transfer.~~

~~[10] As referenced in the Relevant Literature section, this statement adopts EITF 99-20, including the scope requirements of that guidance.~~

entity related to origination, purchase, or commitment to purchase asset-backed securities~~loan-backed and structured securities~~, shall be charged to expense when incurred. (P44)

~~9.~~14. 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 loan-backed or structured security consistent with paragraph 17~~9~~ of this statement. Other origination fees shall be recorded as income upon receipt. (P43)

15. 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~~, is~~ refundable only if the loan-backed or structured security is issued. If the ~~loan-backed or structured~~ security is not issued, then the fees shall be recorded as investment income by the reporting entity when the commitment expires. (P45)

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~~, 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 17~~9~~ of this statement over the life of the asset-backed security ~~loan-backed or structured security~~ as an adjustment to the investment income on the ~~loan-backed or structured~~ security. If the commitment expires unexercised, the commitment fee shall be recognized in income on the commitment expiration date. (P46)

Subsequent Carrying Value Method, Amortization, Accruals and Prepayment Penalties

~~10.~~16. After initial recognition, the carryng value shall be determined in accordance with the reported NAIC designation. ~~Loan-backed and structured securities shall be valued and reported in accordance with this statement,~~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)[11]~~, and the designation assigned in the *NAIC Valuations of Securities* product prepared by the NAIC Securities Valuation Office or equivalent specified procedure. The carrying value method shall be determined as follows~~: (P26)

a. For reporting entities that maintain an Asset Valuation Reserve (AVR), loan-backed and structured securities, excluding residual tranches or interests, shall be reported at amortized cost, except for those with an NAIC designation of 6, which shall be reported at the lower of amortized cost or fair value.

b. For reporting entities that do not maintain an AVR, loan-backed and structured securities designated highest-quality and high-quality (NAIC designations 1 and 2, respectively), excluding residual tranches or interests, shall be reported at amortized cost; loan-backed and structured securities that are designated medium quality, low quality, lowest quality and in or near default (NAIC designations 3 to 6, respectively) shall be reported at the lower of amortized cost or fair value.

[11] Paragraphs provide guidance on the NAIC financial modeling approach applicable to certain securities in determining NAIC designations.

c. For residual tranches or interests[12] captured in scope of this statement, all reporting entities shall report the item on Schedule BA: Other Long-Term Invested Assets at the lower of amortized cost or fair value. Changes in the reported value from the prior period shall be recorded as unrealized gains or losses. For reporting entities that maintain an AVR, the accounting for unrealized gains and losses shall be in accordance with *SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve*.

~~11.~~17. 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.(INT 07-01) 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 and structured~~asset-backed securities is expected to occur, not the stated maturity period. (P9)

~~12.~~18. 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 loan-backed and structured 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. (P10)

~~13. For reporting entities required to maintain an IMR, the accounting for realized capital gains and losses on sales of loan-backed and structured securities shall be in accordance with paragraph 38 of this statement. For reporting entities not required to maintain an IMR, realized gains and losses on sales of loan-backed and structured securities shall be recorded on the trade date and shall be reported as net realized capital gains or losses in the Statement of Income.~~ *(Note: Included with AVR guidance.)*

~~14.~~19. An asset-backed ~~loan-backed or structured~~ 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. (P12)

~~15.~~20. The amount of prepayment penalty and/or acceleration fees to be reported as investment income shall be calculated as follows: (P13)

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.

~~Collection of All Contractual Cashflows is Probable~~Assessment of Cash Flows and Impact of Prepayments

~~16.~~21. ~~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 19-21 provide guidance for securities in which collection of all contractual cash flows is not probable and paragraphs 22-25 provide guidance for beneficial interests.)~~ Prepayments ~~are~~ can be a significant variable element in the cash flows received from ~~of loan-backed and structured~~asset-backed securities because they

[12] Reference to "residual tranches or interests" intends to capture securitization tranches and beneficial interests as well as other structures captured in scope of this statement that reflect loss layers without any contractual payments, whether principal or interest, or both. Payments to holders of these investments occur after contractual interest and principal payments have been made to other tranches or interests and are based on the remaining available funds. Although payments to holders can occur throughout an investment's duration (and not just at maturity), such instances still reflect the residual amount permitted to be distributed after other holders have received contractual interest and principal payments.

may affect the yield and determine the expected maturity against which the yield is evaluated. For example, with a mortgage-backed security, ~~F~~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~~ when rising interest rates ~~which~~ 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). ~~Differences in cash flows can also result from other changes in the cash flows from the underlying assets.~~ If the underlying assets are delinquent or otherwise not generating expected cash flows, such items~~which~~ 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 ~~gain/~~loss~~es~~ ~~have not~~ has been recognized~~booked~~. (P14)

~~17.~~22. Changes in currently estimated cash flows, including the effect of prepayment assumptions, on ~~loan-backed and structured~~all asset-backed securities shall be reviewed periodically, at least quarterly. The prepayment rates of the underlying assets~~loans~~(as applicable) 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. (P15)

~~18.~~23. ~~Loan-backed and structured~~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 1 designations[13]. ~~, using either the prospective or retrospective adjustment methodologies, consistently applied by type of securities. However, if at anytime 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 19-21.~~ (P16)

~~19.~~24. 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. (P17)

~~20.~~25. 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

[13] 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. Under the NAIC designation mapping, this equates to an NAIC 1 designation. For purposes of SAP, reporting entities may elect to apply the prospective method to all securities, however, the retrospective method is limited to the NAIC 1 designated investments. Reporting entities are not required to apply the retrospective method in all allowable situations and are permitted to only apply the retrospective method to selected NAIC 1 securities. The NAIC 1 designation also include single A ratings, therefore mandating the retrospective approach to all NAIC 1 securities would force companies to utilize different methods for the same security between U.S. GAAP and SAP.

of the investment. The current amortized cost basis for the asset-backed security~~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. (P18) *(Note – Since retrospective method is proposed to be limited to NAIC 1, the reference to amortized cost is appropriate. If the NAIC 1 limitation is not supported, then this would need to indicate the "adjusted cost basis" so that is reflects securities held either at AC or FV.)*

Accretable Yield and Changes to Effective Yield

26. 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[14]. 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. (P20 – In Part) (FASB Glossary / ASC 325-40-35-1) *(Note – Modified to be applicable to all ABS and not just those with known credit deterioration.)*

27. 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. 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 determination for purposes of determining a gain or loss under SSAP No. 103R. (ASC 325-40-35-3/ P25)

28. 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 assert-backed security's reference amount. The reference amount 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. (ASC 325-40-35-4, 4A and 4B)

~~21.~~29. 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 conformity under SSAP No. 3, with the amount of periodic accretion adjusted over the remaining life of the asset-backed security.

30. 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. The cash flows shall be discounted at a rate equal to the current yield used to accrete the asset-backed security. (ASC 325-40-35-5 & 6.) (Note – This guidance was midway in existing paragraph 24b.)

[14] 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.

~~Collection of All Contractual Cashflows is Not Probable~~

~~22. The following guidance applies to loan-backed and structured securities with evidence of deterioration of credit quality since origination for which it is probable, either known at acquisition or identified during the holding period, that the investor will be unable to collect all contractually required payments receivable, except for those beneficial interests that are not of high credit quality or can contractually be prepaid or otherwise settled in such a way that the reporting entity would not recover substantially all of its recorded amount determined at acquisition (see paragraphs 22-25).~~

~~23. The reporting entity shall recognize the excess of all cash flows expected at acquisition over the investor's initial investment in the loan-backed or structured security as interest income on an effective-yield basis over the life of the loan-backed or structured security (accretable yield).[15] Any excess of contractually required cash flows over the cash flows expected to be collected is the nonaccretable difference. Expected prepayments shall be treated consistently for determining cash flows expected to be collected and projections of contractual cash flows such that the nonaccretable difference is not affected. Similarly, the difference between actual prepayments and expected prepayments shall not affect the nonaccretable difference.~~

~~24. An investor shall continue to estimate cash flows expected to be collected over the life of the loan-backed or structured security. If, upon subsequent evaluation:~~

~~a. The fair value of the loan-backed or structured security has declined below its amortized cost basis, an entity shall determine whether the decline is other than temporary(INT 06-07). For example, if, based on current information and events, there is a decrease in cash flows expected to be collected (that is, the investor is unable to collect all cash flows expected at acquisition plus any additional cash flows expected to be collected arising from changes in estimate after acquisition (in accordance with paragraph 21.b.), an other-than-temporary impairment shall be considered to have occurred. The investor shall consider both the timing and amount of cash flows expected to be collected in making a determination about whether there has been a decrease in cash flows expected to be collected.~~

~~b. Based on current information and events, if there is a significant increase in cash flows previously expected to be collected or if actual cash flows are significantly greater than cash flows previously expected, the investor shall recalculate the amount of accretable yield for the loan-backed or structured security as the excess of the revised cash flows expected to be collected over the sum of (1) the initial investment less (2) cash collected less (3) other-than-temporary impairments plus (4) amount of yield accreted to date. The investor shall adjust the amount of accretable yield by reclassification from nonaccretable difference. The adjustment shall be accounted for as a change in estimate in conformity with *SSAP No. 3—Accounting Changes and Corrections of Errors*, with the amount of periodic accretion adjusted over the remaining life of the loan-backed or structured security (prospective method).~~

~~Beneficial Interests~~

~~25. The following paragraphs provide statutory accounting guidance for interest income and impairment for a reporting entity that continues to hold an interest in securitized financial assets accounted for as sales under SSAP No. 103R, or that purchases a beneficial interest in securitized financial assets that are not of high credit quality or can contractually be prepaid or otherwise settled in such a way that the reporting entity would not recover substantially all of its recorded amount, determined at acquisition or the~~

~~[15] A loan-backed or structured security may be acquired at a discount because of a change in credit quality or rate or both. When a loan-backed or structured 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 loan-backed or structured security.~~

~~date of transfer[16]. Beneficial interests that are of high credit quality and cannot contractually be prepaid or otherwise settled in such a way that the reporting entity would not recover substantially all of its recorded investment, shall be accounted for in accordance with paragraphs 14-18.~~

~~26. The reporting entity shall recognize the excess of all cash flows attributable to the beneficial interest estimated at the acquisition/transaction date (referred to herein as the transaction date) over the initial investment (the accretable yield) as interest income over the life of the beneficial interest using the effective yield method. If the holder of the beneficial interest is the reporting entity that transferred the financial assets for securitization, the initial investment would be the fair value of the beneficial interest as of the date of transfer, as required by SSAP No. 103R. The amount of accretable yield shall not be displayed in the balance sheet.~~

~~27. The reporting entity that holds a beneficial interest shall continue to update the estimate of cash flows over the life of the beneficial interest. If upon evaluation:~~

~~a. Based on current information and events it is probable that there is a favorable (or an adverse) change in estimated cash flows from the cash flows previously projected, then the investor shall recalculate the amount of accretable yield for the beneficial interest on the date of evaluation as the excess of estimated cash flows over the beneficial interest's reference amount (the reference amount is equal to (1) the initial investment less (2) cash received to date less (3) other-than-temporary impairments recognized to date [as described in paragraph 24.b.] plus (4) the yield accreted to date. 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 beneficial interest. Based on estimated cash flows, interest income may be recognized on a beneficial interest even if the net investment in the beneficial interest is accreted to an amount greater than the amount at which the beneficial interest could be settled if prepaid immediately in its entirety.~~

~~b. The fair value of the beneficial interest has declined below its reference amount; a reporting entity shall determine whether the decline is other-than-temporary. If, based on current information and events it is probable that there has been an adverse change in estimated cash flows (in accordance with paragraph 24.a.), then (1) an other-than-temporary impairment shall be considered to have occurred and (2) the beneficial interest shall be written down to the current estimate of cash flows at the financial reporting date discounted at a rate equal to the current yield used to accrete the beneficial interest with the resulting change being recognized as a realized loss. Determining whether there has been a favorable (or an adverse) change in estimated cash flows from the cash flows previously projected (taking into consideration both the timing and amount of the estimated cash flows) involves comparing the present value of the remaining cash flows as estimated at the initial transaction date (or at the last date previously revised) against the present value of the cash flows estimated at the current financial reporting date. The cash flows shall be discounted at a rate equal to the current yield used to accrete the beneficial interest. If the present value of the original cash flows estimated at the initial transaction date (or the last date previously revised) is less than the present value of the current estimate of cash flows expected to be collected, the change is considered favorable (that is, an other-than-temporary impairment shall be considered to have not occurred). If the present value of the original cash flows estimated at the initial transaction date (or the last date previously revised) is greater than the present value of the current estimated cash flows, the change is considered adverse (that is, an other-than-temporary impairment shall be considered to have occurred). However, absent any other factors that indicate an other-than-temporary impairment has occurred,~~

~~[16] The accounting requirements related to these types of securities included in paragraphs 22-25 shall be determined at acquisition or initial transfer. As referenced in the Relevant Literature section, this statement adopts EITF 99-20 (as amended by FAS 166), including the scope requirements of that guidance.~~

~~changes in the interest rate of a "plain-vanilla," variable-rate beneficial interest generally shall not result in the recognition of an other-than-temporary impairment[17] (a plain-vanilla, variable-rate beneficial interest does not include those variable-rate beneficial interests with interest rate reset formulas that involve either leverage or an inverse floater).~~

~~28. 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 determination for purposes of determining a gain or loss under SSAP No. 103R. Subsequent to the transaction date, estimated cash flows are defined as the holder's estimate of the amount and timing of estimated principal and interest cash flows based on the holder's best estimate of current information and events. A change in estimated cash flows is considered in the context of both timing and amount of the estimated cash flows.~~

Recognition of Realized and Unrealized Gains and Losses and Impairment Guidance

~~29.~~31. 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. For reporting entities required to maintain an AVR, the accounting for unrealized gains and losses shall be reported through the AVR~~in accordance with paragraph 38 of this statement~~. 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)

~~30.~~32. 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 ~~The application of this reporting requirement resulting from NAIC designation (i.e., lower of cost or fair value)~~ is not a substitute for other-than-temporary impairment recognition ~~(paragraphs 35-39)~~. For securities reported at fair value where an other-than-temporary impairment has been determined ~~to have occurred~~, the ~~realized~~ loss recognized ~~from the other-than-temporary impairment shall first be applied towards~~reflects the realization of ~~any~~ unrealized losses previously recorded ~~as a result of~~from fluctuations in ~~the security's~~ fair value ~~due to the reporting requirements~~. (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 40 and 41.) After the recognition of ~~the~~an other-than-temporary impairment, securities reported at the lower of amortized cost or fair value ~~the security~~ shall continue to report unrealized gains and losses ~~as a result of~~from fluctuations in fair value. (P31 & 30)

~~31. If the fair value of a loan-backed or structured security is less than its amortized cost basis at the balance sheet date, an entity shall assess whether the impairment is other than temporary. Amortized cost basis includes adjustments made to the cost of an investment for accretion, amortization, collection of cash, previous other-than-temporary impairments recognized as a realized loss.~~

~~32.~~33. If an entity intends to sell the ~~loan-backed or structured~~asset-backed security (that is, it has decided to sell the security), an other-than-temporary impairment shall be considered to have occurred. (P32)

~~[17] Changes in the interest rate of a "plain-vanilla," variable-rate beneficial interest (a plain-vanilla, variable-rate beneficial interest does not include those variable-rate beneficial interests with interest rate reset formulas that involve either leverage or an inverse floater) generally should not result in the recognition of an other-than-temporary impairment. For plain-vanilla, variable-rate beneficial interests, the yield is changed to reflect the revised interest rate based on the contractual interest rate reset formula. For example, if a beneficial interest pays interest quarterly at a rate equal to LIBOR plus 2 percent, the yield of that beneficial interest is changed prospectively to reflect changes in LIBOR. However, changes in the fair value of a plain-vanilla, variable-rate beneficial interest due to credit events should be considered when evaluating whether there has been an other-than-temporary impairment.~~

~~33.~~34. If an entity does not intend to sell the loan-backed or structured security, the entity shall assess whether it has the intent and ability[18] 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. (P33)

~~34.~~35. 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. Therefore, in those 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 ~~(that is, a non-interest related decline[19] exists)~~, 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 ~~loaned-backed or structured~~ 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. (P34)

~~35.~~36. In determining whether an ~~non-interest related decline exists~~ 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 loan-backed or structured 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).[20] 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.) (P35)

~~a. For securities accounted for under paragraphs 14-18 – the effective interest rate of the loan-backed or structured security 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).[1]~~

~~b. For securities accounted for under paragraphs 19-21 – the effective interest rate is the rate implicit immediately prior to the recognition of the other-than-temporary impairment.~~

~~c. For securities accounted for under paragraphs 22-25 – the reporting entity shall apply the guidance in paragraph 24.b.~~

---

[18] 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).

~~[19] A non-interest related decline is a decline in value due to fundamental credit problems of the issuer. Fundamental credit problems exist with the issuer when there is evidence of financial difficulty that may result in the issuer being unable to pay principal or interest when due. An interest related decline in value may be due to both increases in the risk-free interest rate and general credit spread widening.~~

[20] See Footnote 1.

~~36.~~37. 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. (P41, ASC 325-40-35-10A)

~~37.~~38. 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"[21]). 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. (P42)

~~38.~~39. When an other-than-temporary impairment has occurred because the entity intends to sell the security or has assessed that 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 the investment's amortized cost basis and its fair value at the balance sheet date (full impairment). ~~(This guidance includes~~For asset-backed~~loan-backed and structured~~ securities ~~previously~~ held at lower of amortized cost or fair value~~market. For these securities~~, 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.) (P36)

~~39.~~40. 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 ~~loan-backed or structured~~ security's effective interest rate in accordance with paragraph 36~~35~~ (bifurcated impairment). ~~(This guidance includes loan-backed and structured securities previously~~For asset-backed securities held at lower of cost or ~~market~~fair value~~. For these securities, upon recognition of an other-than-temporary impairment~~, unrealized losses would be ~~considered~~ realized for the non-interest related decline. Hence, unrealized losses could continue

[21] 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.

to be reflected for these securities ~~due to the reporting requirements.)~~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.) (P37)

~~40.~~41. For reporting entities required to maintain an AVR or IMR, ~~the accounting for~~ all unrealized gains and losses shall be reported through the AVR~~in accordance with paragraph 38.a~~. For realized gains and losses, an analysis is required on whether the realized loss reflects an interest or non-interest related decline[22]. ~~the AVR and IMR analysis required and provision to allocate gains and losses between AVR and IMR~~The analysis required is the same regardless whether ~~the~~ 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 addressed in paragraphs 38.b. through 38.f~~are as follows (P38).:

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~~the accounting shall follow the premise in paragraph 38, as detailed in paragraphs 38.b. through 38.f. for specific transactions.~~ 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. ~~Gains and losses shall only be reflected in IMR when realized and as appropriate based on the analysis of interest and non-interest factors.~~

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)~~portion of the other-than-temporary impairment losses shall be recorded through the AVR; the interest related other-than-temporary impairment losses shall be recorded through the 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. ~~As such, an entity shall report the loss in separate AVR and IMR components as appropriate.~~

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 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

[22] 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.

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.

~~41.~~42. 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~~For situations where an other-than-temporary impairment is recognized pursuant to paragraphs 36 and 37 of this statement, the previous amortized cost basis less the other-than-temporary impairment recognized as a realized loss shall become the new amortized cost basis of the investment. That new amortized cost basis shall not be adjusted for subsequent recoveries in fair value. Therefore~~, the prospective adjustment method shall be used ~~for periods subsequent to loss recognition~~toadjust the effective yield in future periods to reflect those changes. (P39)

~~42.~~43. In periods subsequent to the recognition of an other than temporary impairment loss for an asset-backed ~~loan-backed or structured~~ 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 loan-backed or structured security. (P40)

~~a. For securities accounted for under paragraphs 14-21, if upon subsequent evaluation, there is a significant increase in the cash flows expected to be collected or if actual cash flows are significantly greater than cash flows previously expected, such changes shall be accounted for as a prospective adjustment to the accretable yield in accordance with paragraphs 19-21. The security shall continue to be subject to impairment analysis for each subsequent reporting period. The new amortized cost basis shall not be changed for subsequent recoveries in fair value. Future declines in fair value which are determined to be other-than-temporary shall be recorded as realized losses.~~

~~b. For beneficial interests accounted for under paragraphs 22-25, a reporting entity shall apply the guidance in paragraphs 23-24 to account for changes in cash flows expected to be collected.~~

Designation Guidance (Adopted at 2022 Spring NM)

~~43.~~44. For RMBS/CMBS 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 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 non-legacy security, meaning one which closed after December 31, 2012, the NAIC designation and NAIC designation category assigned by the NAIC Securities Valuation Office must be used. For those 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 legacy securities is as follows:

i. Step 1: Determine Initial Designation – The current amortized cost (divided by remaining par amount) of a loan-backed or structured 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 16~~26~~ 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 ~~27~~44.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 ~~27~~44.a.ii.).

b. All Other Loan-Backed and Structured Securities: For securities not subject to paragraph ~~27~~44.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 16~~26~~.

~~**Specific Interim Reporting Guidance Financially Modeled Securities**~~

~~44.~~45. For securities that will be financially modeled under paragraph ~~27~~46, 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 ~~27~~46, 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 ~~27~~46.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 ~~27~~46.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 ~~28~~46.a. or ~~28~~46.b., are required to follow the analytical procedures for non-financially modeled securities (paragraph ~~27~~46.b. 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 ~~27~~46.b. as appropriate).

Giantization/Megatization of FHLMC or FNMA Mortgage-Backed Securities

~~45.~~46. 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. (P47)

~~46.~~47. 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. (P48)

~~47.~~48. Transaction fees charged by the issuing agencies shall be capitalized and amortized over the life of the repooled security. (P49)

~~**Structured Securities Acquired for a Specified Investment Strategy**~~

~~48. To achieve certain strategic investment results, structured securities may be issued in combination with other structured securities as a unit or a pair. One strategy involves the purchase of two structured securities with opposite interest rate reset provisions. Under that strategy, the fixed coupon rate or maturity date for each structured security would be determined shortly after issuance depending on movements in market interest rates. Following that reset date, the resulting yields on each of the structured securities will move in opposite directions; however, the average yield of the two securities will generally reflect the market yield of the combined instruments in effect on the issuance date. In situations when structured securities are issued in combination with other structured securities as a unit or a pair, each structured security shall be accounted for separately in accordance with the appropriate SSAP. The guidance in paragraph 8 of SSAP No. 103R on the accounting for transfers of entire financial assets or group of entire financial assets that qualify as sales shall be applied to each structured security upon transfer.~~ *(Note – Reference to individual assessment moved to scope.)*

Disclosures

49. In addition to the disclosures required for invested assets in general, the following disclosures regarding ~~loan-backed and structured~~asset-backed securities shall be made in the financial statements. Regardless of the allowances within paragraph 63 of the Preamble, the disclosures in paragraph ~~51~~49.f., ~~51~~49.g. and ~~51~~49.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 ~~loan-backed and structured~~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 30.e., 30.f. and 30.g.

50. Refer to the Preamble for further discussion regarding disclosure requirements. All disclosures within this statement, except disclosures included in paragraphs ~~51~~49.b., ~~51~~49.k. and ~~51~~49.m., shall be included within the interim and annual statutory financial statements. Disclosure requirements in paragraphs ~~51~~49.b., ~~51~~49.k. and ~~51~~49.m. are required in the annual audited statutory financial statements only.

Relevant Literature

51. 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.

Note – With adoption, U.S. GAAP standards previously adopted in SSAP No. 43R will be identified as rejected for statutory accounting. With the issuance of this standard, all relevant literature guidance will be removed. This information can be detailed in the issue paper for historical tracking purposes. GAAP guidance previously adopted that will no longer be identified as adopted within this guidance are shown as deleted text below:

~~51. This statement adopts *FASB Emerging Issues Task Force No. 99-20, Exchange of Interest-Only and Principal-Only Securities for a Mortgage-Backed Security*, as amended by *FAS 166, Accounting for Transfers of Financial Assets, An Amendment of FAS 140*, and *FASB Staff Position EITF 99-20-1, Amendments to the Impairment Guidance of EITF Issue No. 99-20*. This statement adopts paragraphs 5, 7 and 9 of AICPA *Statement of Position 03-03, Accounting for Certain Loans or Debt Securities Acquired in a Transfer* (SOP 03-03) for loan-backed and structured securities only. With the exception of this specific adoption, consideration of SOP 03-03 is still pending consideration for statutory accounting.~~

~~52. This statement rejects *ASU 2018-03, Recognition and Measurement of Financial Assets and Financial Liabilities, ASU 2016-01, Financial Instruments—Overall, FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities* and *FASB Statement No. 91*, Accounting *for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases.*~~

~~53. This statement also rejects *FASB Emerging Issues Task Force No. 89-4, Accounting for a Purchased Investment in a Collateralized Mortgage Obligation Instrument or in a Mortgage-Backed Interest-Only Certificate*, *FASB Emerging Issues Task Force No. 90-2, Exchange of Interest-Only and Principal-Only Securities for a Mortgage-Backed Security*, *FASB Emerging Issues Task Force No. 93-18, Recognition of Impairment for an Investment in a Collateralized Mortgage Obligation Instrument or in a Mortgage-Backed Interest-Only Certificate*, *FASB Emerging Issues Task Force No. 96-12, Recognition of Interest Income and Balance Sheet Classification of Structured Notes*, and *FASB Emerging Issues Task Force* No. *98-15, Structured Notes Acquired for a Specified Investment Strategy.*~~

Effective Date and Transition

52. This statement is effective for years beginning January 1, XXXX. 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*.

~~54. 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*. Subsequent revisions to this statement include:~~

~~a. Substantive revisions pertaining to valuation and impairment based on expected cash flows, as detailed in *Issue Paper No. 140—Substantive Revisions to SSAP No. 43—Loan-Backed and Structured Securities*, were effective September 30, 2009. (Transition guidance previously included in SSAP No. 43R was removed from the SSAP in the *As of March 2018 Accounting Practices and Procedures Manual* but is retained for historical purposes in the issue paper.)~~

~~b. Substantive revisions to incorporate a new method to determine the final NAIC designation were effective, on a prospective basis, for reporting periods ending on or after December 31, 2009. In 2011, revisions were incorporated to this process to be consistent with the (P&P Manual). These revisions expanded the guidance to explicitly detail the process for "financial modeling" and "modified filing exempt" securities.~~

~~c. Nonsubstantive revisions to clarify the accounting for gains and losses between AVR and IMR securities were adopted in June 2010 with a January 1, 2011, effective date with early application allowed. Reporting entities that had previously bifurcated gains and losses between AVR and IMR for sale transactions were restricted from reversing prior bifurcations and were prohibited from reverting to a process that did not bifurcate gains and losses in the period between adoption and the effective date.~~

~~d. Nonsubstantive revisions, reflected in paragraph 50, to incorporate guidance from *INT 00-11: EITF 98-15: Structured Notes Acquired for a Specified Investment Strategy* were effective September 11, 2000.~~

~~e. Nonsubstantive revisions pertaining to the calculation of investment income for prepayment penalty and/or acceleration fees, reflected in paragraph 13, were effective January 1, 2017, on a prospective basis with early application permitted.~~

~~f. Nonsubstantive revisions to eliminate the modified filing exempt (MFE) method were effective March 31, 2019, with early adoption permitted for year-end 2018. Early adoption was considered an "all or nothing" approach. As such, reporting entities that did not elect to early adopt were required to apply the MFE process to all applicable SSAP No. 43R securities as of year-end 2018, whereas reporting entities that elected to early adopt were not permitted to use the MFE process for any SSAP No. 43R securities for year-end 2018.~~

~~g. Revisions adopted April 2019 to explicitly include mortgage-referenced securities in scope of this statement are effective December 31, 2019.~~

~~h. Nonsubstantive revisions adopted in November 2021 to clarify that residual tranches or interests (as defined in footnote 10) shall be reported at the lower of amortized cost or fair value on Schedule BA: Other Invested Assets are effective December 31, 2022. 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.~~

~~55. For securities purchased prior to January 1, 1994, where historical cash flows are not readily available for applying the retrospective method, the reporting entity may use January 1, 1994, as the acquisition date and the then book value as the cost for purposes of determining yield adjustments in future periods.~~

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*
- ~~*Issue Paper No. 43—Loan-Backed and Structured Securities*~~
- ~~*Issue Paper No. 140—Loan-Backed and Structured Securities, Revised September, 2009*~~

Appendix - Examples of Analysis for Asset Backed Securities

1. As detailed in paragraphs 4-5, 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 3b. 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 3.b., 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 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%.

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 equipment to service the final debt balloon payment. The loan-to-value at maturity is expected to decline to 40% 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.

6. **Example 2 Rationale**: The equipment is a cash generating non-financial asset which is 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 50% of the principal payments. In reaching this 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 collateral value to provide for the balloon payment through sale or refinancing in light of its characteristics. While the equipment 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 (40% loan-to-value) that would be able to be recovered by sale or refinancing even if it were to mature at such point in time.

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 equipment directly, in accordance with the requirements in paragraph 3.b. In reaching this conclusion, the reporting entity noted that the debt instrument starts with a 70% loan-to-value, which continues to improve over the life of the debt as the loan balance amortizes more quickly than the expected economic depreciation on the underlying equipment. 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 equipment 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 equipment 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 equipment cannot be re-leased, there would not be enough cash flows to service the scheduled principal and interest payments, and the equipment 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 equipment was highly predictable and supported the conclusion that the equipment 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 are in paragraph 3.b. 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 A – QUESTION AND ANSWER IMPLEMENTATION GUIDE

Note – Comments on this Exhibit and whether it shall be updated and retained or deleted with the substantively revised new SSAP are requested during the exposure. If retained, all references to LBSS will be updated to reflect "asset backed securities."

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 51.f. and 51.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 LBSS 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 LBSS 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 34, 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 37, 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 loan-backed or structured 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 32 or 33, an other-than-temporary impairment shall be considered to have occurred. As detailed in paragraph 36, 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 33 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 loan-backed and structured securities, the assessment of "intent and ability" is intended to be a high standard. Despite the intent of paragraph 33, 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 34 of SSAP No. 43R states that "A decrease in cash flows expected to be collected on a loan-backed or structured 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 16 states that "Loan-backed and structured 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."

5.2 The language in paragraph 34 is consistent with GAAP, and the GAAP guidance related to the treatment of prepayments in the consideration of credit losses was intended to provide clarification for determining the "cash flows expected to be collected" on interest-only securities and other similar securities that can be contractually prepaid or otherwise settled in such a way that the holder would not recover substantially all of the investment. These securities are generally accounted for in accordance with paragraphs 19-25 of SSAP No. 43R, which requires that an entity estimate cash flows expected to be collected including both amount and timing. Therefore, for securities under SSAP No. 43R, excluding those accounted for under paragraphs 19-25, decreases in cash flows resulting in contractual prepayments should be considered yield adjustments rather than potential credit losses.

6. Question – Are the disclosure requirements within paragraphs 51.f. and 51.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 on 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 40 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 loan-backed or structured 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 LBSS 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 LBSS 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.

Summer National Meeting - Review of GAAP Exposures for Statutory Accounting:

Pursuant to a 2014 direction from the SAPWG chair, there is a desire for the Statutory Accounting Principles (E) Working Group to be more proactive in considering FASB exposures that may be significant to statutory accounting and reporting. Historically, the SAPWG has commented on limited, key FASB exposures – mostly pertaining to insurance contracts and financial instruments. To ensure consideration of all FASB exposures, staff has prepared this memorandum to highlight the current exposures, comment deadlines, and to provide a high-level summary of the exposed item's potential impact to statutory accounting. It is anticipated that this information would assist the Working Group in determining whether a comment letter should be submitted to the FASB on the issues. Regardless of the Working Group's election to submit comments to the FASB on proposed accounting standards, under the NAIC Policy Statement on Statutory Accounting Principles Maintenance Agenda Process, issued US GAAP guidance noted in the hierarchy within Section V of the Preamble to the *Accounting Practices and Procedures Manual* must be considered by the Statutory Accounting Principles (E) Working Group.

FASB Exposures: http://www.fasb.org/jsp/FASB/Page/SectionPage&cid=1175805074609

Exposed FASB Guidance	Comment Deadline & Initial Staff Comments
Proposed Accounting Standards Update—*Financial Services—Insurance (Topic 944): Transition for Sold Contracts*	August 8, 2022
Invitation to Comment—Accounting for Government Grants by Business Entities: Potential Incorporation of IAS 20, *Accounting for Government Grants and Disclosure of Government Assistance, into Generally Accepted Accounting Principles*	September 9, 2022

Proposed Accounting Standards Update—*Financial Services—Insurance (Topic 944): Transition for Sold Contracts*

Information from FASB Exposure Draft:
The Board issued Accounting Standards Update No. 2018-12, *Financial Services—Insurance (Topic 944): Targeted Improvements to the Accounting for Long-Duration Contracts* (LDTI), in August 2018. The amendments in Update 2018-12 require an insurance entity to apply a retrospective transition method as of the beginning of the earliest period presented or the beginning of the prior fiscal year if early application is elected. The Board received stakeholder feedback indicating that applying the LDTI guidance to contracts that were derecognized because of a sale or disposal of individual or a group of contracts or legal entities before the LDTI effective date likely would not provide decision-useful information to investors and other financial statement users and may result in significant operability challenges for insurance entities to apply the guidance.

As such, the Board is issuing this proposed Update to reduce implementation costs and complexity associated with the adoption of LDTI for contracts that have been derecognized because of a sale or disposal of individual or a group of contracts or legal entities before the LDTI effective date. Otherwise, an insurance entity would be required to reclassify a portion of the previously recognized gains or losses to the LDTI transition adjustment because of the adoption of a new accounting standard. Because there is no effect on an insurance entity's future cash flows, such a reclassification could be misleading to financial statement users.

Staff Review and Commentary:
Comment deadline is August 8, 2022

Invitation to Comment—Accounting for Government Grants by Business Entities: Potential Incorporation of IAS 20, *Accounting for Government Grants and Disclosure of Government Assistance, into Generally Accepted Accounting Principles*

Information from FASB Exposure Draft:
The purpose of this Invitation to Comment is to solicit broad stakeholder feedback on the recognition, measurement, and presentation requirements of IAS 20, *Accounting for Government Grants and Disclosure of Government Assistance*. Specifically, the FASB staff would like to understand whether the requirements of IAS 20 as it relates to the accounting for government grants, represent a workable solution for improving generally accepted accounting principles (GAAP) in the U.S. financial reporting environment for business entities. The FASB staff would like to understand whether:

1. The requirements, including the scope and definition of the terms *government* and *government grants*, are understandable and operable in the U.S. financial reporting environment.
2. The requirements improve comparability in the accounting for government grants by business entities that apply GAAP.
3. Any suggested changes should be made to the provisions of IAS 20 as it relates to the accounting for government grants (and the reasons for those suggested changes).
4. The requirements provide decision-useful information to investors and other allocators of capital (i.e., investors).
5. Any current practice issues arise when applying the government grant accounting requirements in IAS 20.

Staff Review and Commentary:
Comment deadline is September 9, 2022

NAIC staff recommend that ASU be reviewed under the SAP Maintenance Process as detail in *Appendix F—Policy Statements.* Additionally, NAIC staff do not believe a response on the invitation to comment is warranted at this time.

https://naiconline.sharepoint.com/teams/FRSStatutoryAccounting/National Meetings/A. National Meeting Materials/2022/7-Summer NM/Meeting/L - Review of GAAP Exposures.docx

NAIC National Association of Insurance Commissioners
& The Center for Insurance Policy and Research

MEMORANDUM

TO: Dale Bruggeman (MO), Chair, Statutory Accounting Principles (E) Working Group
Kevin Clark, (IA), Vice Chair, Statutory Accounting Principles (E0 Working Group

FROM: Mike Boerner (TX), Chair, Life Actuarial (A) Task Force,
Craig Chupp (VA), Vice Chair, Life Actuarial (A) Task Force

DATE: July 27, 2022

RE: Life Actuarial (A) Task Force Coordination with the Statutory Accounting Principles (E) Working Group
Summer 2022

The Statutory Accounting Principles (E) Working Group charges requires the Working Group to *coordinate with the Life Actuarial (A) Task Force on changes to the AP&P Manual related to the Valuation Manual VM-A, Requirements, and VM-C, Actuarial Guidelines, as well as other Valuation Manual requirements. This process will include the receipt of periodic reports on changes to the Valuation Manual on items that require coordination*. To facilitate the coordination, the Task Force will provide to the Working Group a memorandum of Valuation Manual amendments, actuarial guidelines and valuation related NAIC model revisions prior to each NAIC National Meeting. This memorandum provides the Working Group updates to the publications since the 2021 NAIC Summer Meeting.

Valuation Manual – Attachment A to this memo includes a detailed listing of the amendments made to the Valuation Manual since the 2021 NAIC Summer Meeting. The amendments were adopted by the Life Insurance and Annuities (A) Committee on July 20, 2022. The amendments will be considered for adoption by the Executive (EX) Committee and Plenary at the 2022 NAIC Summer Meeting.

Actuarial Guidelines – Since the 2021 NAIC Summer Meeting the Task Force has created or revised the actuarial guidelines created listed below:

Actuarial Guideline XXV – Calculation of Minimum Reserves and Minimum Nonforfeiture Values for Policies with Guaranteed Increasing Death Benefits Based on an Index
Life Insurance and Annuities (A) Committee adoption – Dec. 15, 2021
Executive (EX) Committee and Plenary adoption – Dec. 16, 2021

Actuarial Guideline LIII – Application of the Valuation Manual for Testing the Adequacy of Life Reserves
Life Insurance and Annuities (A) Committee adoption - July 20, 2022
Executive (EX) Committee and Plenary consideration at the 2022 NAIC Summer Meeting.

NAIC Models – The Task Force has not created or revised any models since the 2021 NAIC Summer Meeting

EXECUTIVE OFFICE • 444 North Capitol Street NW, Suite 700 • Washington, DC 20001-1509 p | 202 471 3990 f | 816 460 7493
CENTRAL OFFICE • 1100 Walnut Street, Suite 1500 • Kansas City, MO 64106-2197 p | 816 842 3600 f | 816 783 8175
CAPITAL MARKETS & INVESTMENT ANALYSIS OFFICE • One New York Plaza, Suite 4210 • New York, NY 10004 p | 212 398 9000 f | 212 382 4207
www.naic.org

LATF VM Amendment	Valuation Manual Reference	Valuation Manual Amendment Proposal Descriptions	LATF Adoption Date
2020-12	VM-01, VM-20, VM-21, VM-31	Create consistency between CDHS determination in VM-20 and VM-21. Revise hedge modeling to only require CDHS if modeling future hedging reduces the reserves under VM-20 or TAR under VM-21.	6/9/22
2021-11	VM-21, section 12 and various others	Add a section for other assumptions requirement in VM-21 which covers general guidance and requirements for assumptions, and expense assumptions.	2/3/22
2021-12	VM-21 Section 6.B.3.a, VM-21 Section 6.B.6.a, VM-21 Section 6.B.6.b, VM-21 Section 6.C.4, VM-21 Section 6.C.10, VM-21 Section 6.C.11	Correct CSMP reference and clarify requirements for VA contracts with no minimum guaranteed benefits in Additional Standard Projection Amount in VM-21 Section 6.C. These three prescribed assumptions are Partial Withdrawal, Account Value Depletion, and Other Voluntary Contract Termination.	11/18/21
2021-13	VM-20 Sect. 9.C.6.e, VM-20 Sect. 9.C.7, VM-31 Sect. 3.D.3.o.	It has been observed that adding the prescribed mortality margins for some Life/LTC combination products cause modeled reserves to decrease rather than increase.	11/4/21
2022-01	VM-20 Section 8.C.18	Clarifying the Valuation Manual treatment of the pre-reinsurance ceded reserve and the reserve credit for retrocessions	3/10/22
2022-02	VM-31	Revise language and add an explicit cross-reference to the VM-21 section since it has further details on how to demonstrate compliance	3/31/22
2022-03	VM-20, VM-21, VM-31	General cleanup, including updating cross-references, better consistency between VM-20 and VM-21, where reasonable, and making clarifying edits.	3/31/22
2022-04	VM-20 Section 9.F.8, App 2.F, App 2.G	LIBOR transition to the Secured Overnight Financing Rate (SOFR) - Updated VM-20 prescribed swap spreads guidance to facilitate the LIBOR transition to SOFR.	6/30/22
2022-05	VM-51 App 1, App 4	Add dividend plan code & Covid-19 indicator; change field identifier; correct Appendix 1 reference.	5/12/22