

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

Issue: Repack and Derivative Investments

Check (applicable entity):

	P/C	Life	Health
Modification of Existing SSAP	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
New Issue or SSAP	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>
Interpretation	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>

Description of Issue: This agenda item has been developed to address debt security investments with derivative components that do not qualify as structured notes. Although the original focus was on specific “credit repack” investments, the agenda item has been expanded to ensure that all debt security investments with derivative wrappers / components are captured.

As an overview of a special purpose vehicle (SPV) “repacking,” the structure consists of an SPV acquiring a debt security and reprofiling the cash flows by entering a derivative transaction with a derivative counterparty (known as “credit repacks”). The redesigned debt instrument (reflecting the combined debt security and derivative) is then sold to an investor. NAIC staff has recently received calls on the classification of repacks under the bond definition, but the discussions of these transactions have identified that additional guidance may be warranted to ensure consistent reporting of these transactions within the statutory financial statements. From the discussions, there are initiatives for these combined investments to become more prevalent with U.S. insurance entities, but investment makers have noted that these investments are already common in other countries.

As a key element, repacking (and potentially other derivative wrapped debt structures) takes two separate items (debt security and derivative) and combines them into one instrument that resembles a debt security. This is done at an SPV, with the SPV issuing a new debt security to the reporting entity. From discussions, there are several variations of the derivative components that can be combined with the debt security. Some of them are very simple (such as a cross-currency swap), but others are complex, altering both the amount and timing of cash flows. The structures can be customized allowing for ongoing innovation, benefiting insurers with the ability of entering derivative transactions to appropriately reduce risk, but creating difficulty in the ability to group repacks structures into limited exception guidance.

For all of these structures, the derivative arrangements could be entered into separately and do not need to be entered into as a combined transaction, however, the noted benefits for entering into a combined structure include:

- 1) **Derivative Margin / Collateral Requirement:** There is no daily settling of a margin requirement at the derivative counterparty based on fair value changes in the derivative. **This is because the debt security in the structure serves as constant collateral, and any amount owed to the derivative counterparty would be taken first from debt instrument cash flows before payment is made to the investor. (The derivative counterparty is senior in priority.)** The repack structure limits the collateral obligation to the debt security in the structure, so there is no potential for the reporting entity to be obligated for more collateral beyond the linked debt security. This is a benefit of a repack in comparison to normal derivatives that do not have a collateral limit.
 - Although perceived as a benefit from the entity / investment maker as it reduces liquidity risk associated with margin calls, from a statutory accounting perspective, if the transactions were reported separately and the debt investment was pledged as collateral, the debt instrument would be identified as a restricted asset. If the repack is collectively reported as a debt instrument, there would be no identification that the debt instrument is restricted or encumbered as collateral to the derivative counterparty. This is

because the restriction is at the SPV and not the reporting entity. Also, if separately engaging in derivative transactions, the derivative counterparty is known and reported. If a repack is collectively reported as a debt instrument, it is uncertain if the affiliation between the derivative counterparty and reporting entity would be known.

- 2) **Bond Reporting:** If these structures are accounted for as bonds, **reporting entities would determine measurement method and RBC impact based on the NAIC designation. Ultimately, this structure provides the reporting entity with a derivative arrangement, with no separate reporting or acknowledgement of the derivative instrument within the financial statements.**
 - From a statutory accounting perspective, if reporting is combined in a repack, derivatives would not be captured on Schedule DB and reporting entities would not be required to assess whether the derivative is effective under *SSAP No. 86—Derivatives*. (There is also a question on whether these arrangements would be captured in a reporting entity's derivative use plan filed with the domiciliary state.) Any obligation based on the performance of the derivative would not be reported in the investor's financials.
- 3) **RBC Impact:** By reporting as a bond investment, the reporting entity would incur a single RBC factor charge based on the NAIC designation on the debt security issued by the SPV.
 - From a statutory perspective, if the investment had been reported separately as a bond and a derivative, there would be RBC impacts for both components. The collateral pledged to the derivative counterparty (bond) would also be coded as a restricted asset. Whether the combined reporting results in a benefit to RBC depends on how the derivative would have been reported separately (at amortized cost or fair value) and whether the derivative is in a loss position. However, if reported separately, these components are captured in the RBC formula to reflect those dynamics.

The following identifies specific elements for discussion:

- 1) **Sale / Reacquisition:** A “credit repack” can be originated with a reporting entity's currently held debt security. In those situations, the insurer would sell the debt security to an SPV, that security would be combined with a derivative at the SPV, and the SPV would sell the restructured combined instrument back to the insurer.

From the discussions held, inconsistent interpretations may exist on whether the initial debt security should be reflected as disposed, with the reporting entity acquiring a new investment for the “repack.” The discussions have referred to “substantially similar” U.S. GAAP guidance and have noted that the base investment (original debt security) has not changed, therefore the action did not warrant disposal / new acquisition reporting. If this interpretation was applied, the original debt security would still be shown on the financial statements, but with the repack the issuer, yield and NAIC designation have been impacted. If it is concluded that the revised instrument is substantially similar to what was originally held and did not require a disposal / reacquisition, it is likely that there would be no indication in the financial statements that the entity has entered into a new arrangement that combines a debt security and derivative instrument. NAIC staff does not agree with interpretations that the repack is substantially similar based on existing guidance in SSAP No. 103, paragraph 52, but this has been noted as part of the discussions. Under SSAP No. 103, to be considered substantially the same, an investment needs to have the same primary obligor, identical contractual interest rates and identical form and type to provide the same risks and rights. Under a repack, the issuer, yield and designation are impacted as follows, disallowing consideration that the instrument is substantially the same:

- The revised issuer is the SPV and the new instrument is a combined instrument of the debt instrument and the derivative.
- The fees for engaging in this instrument are built into the investment yield, resulting in a lower yield than what would have been received if the original debt instrument was still held.

- The NAIC designation (CRP rating) could also be impacted, as the revised instrument reflects the credit quality of both the original issuer and the derivative counterparty. From discussions, this is often a 1-level decrease in rating.

Not all repacks involve a previously held debt instrument. An entity may acquire a repack directly from the SPV rather than sell a currently owned debt security to the SPV. From the discussions, if this was to occur, it is believed that entities would report the acquired investment as a bond (under existing SSAP guidance), unless the structure is considered to be a structured note under paragraph 5.g. of *SSAP No. 86—Derivatives*:

5.g. “Structured Notes” in scope of this statement are instruments defined in *SSAP No. 26R—Bonds* (often in the form of debt instruments), in which the amount of principal repayment or return of original investment is contingent on an underlying variable/interest¹. Structured notes that are “mortgage-referenced securities” are captured in *SSAP No. 43R—Loan-Backed and Structured Securities*.

There is also a question on whether all repacks should be considered structured notes. In a repack structure, if the debt security is liquidated early and there is an amount owed from the derivative performance, the SPV must first satisfy that amount to the derivative counterparty. This could result in a payment less than the principal amount being remitted to the insurer holder. Although the repack designs differ based on the derivative instrument and intent, in some situations this is only driven by the early liquidation of the structure and not a component that comes into play if the structure is held to maturity. In those structures, the design would not be considered a structured note. However, in other designs, the repack may reflect a structured note regardless, and the structured note guidance should be followed.

- 2) **Derivative Obligation:** A credit repack investment ultimately could allow an insurer to enter into derivative arrangements that are not separately reported or assessed within the scope of SSAP No. 86, which is currently explicit that embedded derivatives shall not be separated from the host contract. If the derivative was to be separately reported, it would only qualify for amortized cost treatment if determined to be highly effective pursuant to SSAP No. 86, otherwise it would be reported at fair value.

From discussions of these investment / derivative designs, NAIC staff has the impression that these derivative arrangements would be reported at fair value if held separately from the debt instrument. (Discussions have indicated that they would be separately reported at fair value under U.S. GAAP.) By combining with the debt security, and if permitted to follow bond accounting, reporting entities would utilize an amortized cost measurement for the combined credit repack based on the NAIC designation pursuant to current guidance within SSAP No. 26 / SSAP No. 43.

Although it has been communicated that the derivative is designed to match the maturity duration of the debt instrument, if the investment was to be liquidated in advance of the maturity date, the obligation with the derivative counterparty must still be satisfied. If the derivative was in a liability position, upon liquidation of the debt instrument, the SPV would collect the proceeds from the debt instrument and first remit any amount owed to the derivative counterparty before providing the remaining balance to the reporting entity. Although it depends on the derivative arrangement, in some designs, the reporting entity could receive less than the stated

¹ The “structured notes” captured within scope of this statement is specific to instruments in which the terms of the agreement make it possible that the reporting entity could lose all or a portion of its original investment amount (for other than failure of the issuer to pay the contractual amounts due). These instruments incorporate both the credit risk of the issuer, as well as the risk of an underlying variable/interest (such as the performance of an equity index or the performance of an unrelated security). Securities that are labeled “principal-protected notes” are captured within scope of this statement if the “principal protection” involves only a portion of the principal and/or if the principal protection requires the reporting entity to meet qualifying conditions in order to be safeguarded from the risk of loss from the underlying linked variable. Securities that may have changing positive interest rates in response to a linked underlying variable or the passage of time, or that have the potential for increased principal repayments in response to a linked variable (such as U.S. Treasury Inflation-Indexed Securities) that do not incorporate risk of original investment/principal loss (outside of default risk) are not captured as structured notes in scope of this statement.

principal amount of the bond. For these designs, unless the derivative was reported separately (or the repack was reported at fair value), the amount to be received at any point in time for the repack investment may be overstated due to the derivative impact. *(The inverse is also true, whereas if the derivative was in an asset position, the SPV would collect funds from the derivative counterparty and the reporting entity would receive an amount that exceeds the principal amount of the bond.)*

- 3) **Principles-Based Bond Definition Application**: The discussion with NAIC staff on credit repacks initially occurred due to questions on whether the repack is an issuer credit obligation (ICO) or an asset-backed security (ABS) under the principles-based bond definition. Initially, it was noted that a repack with a derivative that simply converted cash flows (fixed to floating or foreign currency), but which did not impact the timing or extent of cash flows could still potentially reflect an ICO obligation under the single-entity payer provision, assuming that the investment did not reflect a structured note. However, any design that was to alter the timing or amount of cash flows would result in an ABS classification. For example, if the repack altered the timing of cash flows so instead of periodic interest in line with the debt security terms, all interest payments were accumulated at the SPV and provided at maturity, this would require an ABS classification. If classified as an ABS, it was noted that there would be no substantive credit enhancement (as the structure simply passes through cash flows) and the structure would fail to qualify as a bond. However, after further assessment of these structures, NAIC staff recommends explicit guidance for the accounting of these combined debt / derivative structures. From discussions on these investments, a key driver is getting the combined structure classified as a Schedule D investment. From information shared, a vast array of different derivative structures could be combined with the debt security to form a combined item, with many different cashflow desired outcomes.

Ultimately, NAIC staff believes the issue goes further than bond classification as ICO or ABS. As such, this agenda item proposes SSAP guidance / interpretation to address all situations in which a debt security may be wrapped or combined with a derivative structure to ensure consistent and transparent reporting as well as information to the regulators on these investment transactions. NAIC staff believes the potential for these structures originates from the existing SSAP No. 86 guidance that indicates that embedded derivatives shall not be separated from the host contract and accounted for separately as a derivative instrument. NAIC staff notes that this SSAP No. 86 guidance allows these investment structures to be reported in ways that were perhaps not intended when that embedded derivative guidance was originally established.

Existing Authoritative Literature:

- ***SSAP No. 26R—Bonds (Effective Jan. 1, 2025)***

SSAP No. 26R includes the adopted principles-based bond definition and the provisions for detailing an ICO or ABS. Key provisions from this SSAP are provided below. These excerpts focus on the definition of a bond, the creditor relationship review involving pre-determined interest and principal payments, and relevant provisions of the ICO and ABS terms.

Specific Excerpts:

5. A bond shall be defined as 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 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.

6.d. In order for a debt instrument to represent a creditor relationship in accordance with **Paragraph 6**, it must have pre-determined principal and interest payments (whether fixed interest

or variable interest) with contractual amounts that do not vary based on the appreciation or depreciation (i.e., performance) of any underlying collateral value or other non-debt variable. For example, an issued security that has varying principal and interest payments based on the appreciation of referenced equity, real estate or other non-debt variable is precluded from bond treatment. This exclusion is not intended to restrict variables that are commonly related to debt instruments such as, but not limited to, plain-vanilla inflation or benchmark interest rate adjustments (such as with U.S. TIPs or SOFR-linked coupons, respectively), scheduled interest rate step-ups, or credit-quality related interest rate adjustments. This exclusion is also not intended to encompass nominal interest rate adjustments². For clarification purposes, all returns from a debt instrument in excess of principal are required to be considered as interest. Therefore, investments with “stated” interest and then “additional returns” to which the holder of the debt instrument is entitled are collectively considered as interest and shall be assessed together in determining whether the investment has variable principal or interest due to underlying referenced non-debt variables. Examples of securities excluded from the bond definition under this guidance:

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

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

7.g. Investments in the form of securities for which repayment is fully supported by an underlying contractual obligation of a single operating entity (e.g., Credit Tenant Loans (CTLs), Equipment trust certificates (ETCs), other lease backed securities, Funding Agreement Backed Notes (FABNs), etc.). For purposes of applying this principal concept, repayment is fully-supported by the underlying operating entity obligation if it provides cash flows for the repayment of all interest and at least 95% of the principal of the security.

8. An asset-backed security is a bond issued by an entity (an “ABS Issuer”) created for the primary

² Nominal interest rate adjustments are those that are too small to be taken into consideration when assessing the investment’s substance as a bond. Nominal adjustments are not typically influential factors in an investors’ evaluation of investment return and are often included to incentivize certain behavior of the issuer. An example would include sustainability-linked bonds where failure to achieve performance metrics could cause interest rate adjustments. In general, interest rate adjustments that adjust the total return from interest by more than 10% (e.g., >0.4% for a 4% yielding bond), would not be considered nominal. Further, any such adjustments that cause an investment to meet the definition of a structured note would not be considered nominal.

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

10. 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.

10a. *Substantive Credit Enhancement:* The intent of the criteria requiring the holder to be in a different economic position is to distinguish qualifying bonds from instruments with equity-like characteristics or where the substance of the transaction is more closely aligned with that of the underlying collateral. To qualify as an ABS under this standard, there is a requirement that there are substantive credit enhancements within the structure that absorb losses before the debt instrument being evaluated would be expected to absorb losses. This is inherent in the context of an issuer credit obligation in scope of SSAP No. 26R as the owners of the equity in the operating entity are the first to absorb any variability in performance of the operating entity. The same concept applies to asset-backed securities. If substantive credit enhancement did not exist, the substance of the debt instrument being evaluated would be more closely aligned with that of the underlying collateral than that of a bond. Credit enhancement that is merely nominal or lacks economic substance does not put a holder in a different economic position. The substantive credit enhancement

- ***SSAP No. 86—Derivatives***

SSAP No. 86 provides guidance for derivatives. Paragraph 5g addresses structured notes, paragraph 16 addresses variation margin, paragraph 17 addresses embedded derivative investments, with paragraphs 20-21 providing recognition guidance.

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

5g. “Structured Notes” in scope of this statement are instruments defined in *SSAP No. 26R—Bonds* (often in the form of debt instruments), in which the amount of principal repayment or return of original investment is contingent on an underlying variable/interest³. Structured notes that are “mortgage-referenced securities” are captured in *SSAP No. 43R—Loan-Backed and Structured Securities*.

³ The “structured notes” captured within scope of this statement is specific to instruments in which the terms of the agreement make it possible that the reporting entity could lose all or a portion of its original investment amount (for other than failure of the issuer to pay the contractual amounts due). These instruments incorporate both the credit risk of the issuer, as well as the risk of an underlying variable/interest (such as the performance of an equity index or the performance of an unrelated security). Securities that are labeled “principal-protected notes” are captured within scope of this statement if the “principal protection” involves only a portion of the principal and/or if the principal protection requires the reporting entity to meet qualifying conditions in order to be safeguarded from the risk of loss from the underlying linked variable. Securities that may have changing positive interest rates in response to a linked underlying variable or the passage of time, or that have the potential for increased principal repayments in response to a linked variable (such as U.S. Treasury Inflation-Indexed Securities) that do not incorporate risk of original investment/principal loss (outside of default risk) are not captured as structured notes in scope of this statement.

16. “Variation Margin” reflects the daily change in market value of derivative contracts (e.g., daily gain/loss on a derivative contract due to market movements). Amounts received/paid to adjust variation margin on derivative contracts that are both cleared and settled on an exchange shall be recognized as an adjustment to the carrying value of the derivative contract (e.g., futures). Amounts received/paid to adjust variation margin on all other derivative contracts shall be recognized on the balance sheet as an asset or liability separate from the carrying value of the derivative instrument. This treatment shall occur under statutory accounting regardless if the counterparty/exchange considers amounts exchanged for variation margin to be legal settlement or collateral. Changes in variation margin shall not be treated as realized gains or adjustments to the basis of the hedged item until the derivative contract has been sold, matured or expired.

Embedded Derivative Instruments

17. Contracts that do not in their entirety meet the definition of a derivative instrument, such as bonds, insurance policies, and leases, may contain “embedded” derivative instruments—implicit or explicit terms that affect some or all of the cash flows or the value of other exchanges required by the contract in a manner similar to a derivative instrument. The effect of embedding a derivative instrument in another type of contract (“the host contract”) is that some or all of the cash flows or other exchanges that otherwise would be required by the contract, whether unconditional or contingent upon the occurrence of a specified event, will be modified based on one or more underlyings. An embedded derivative instrument shall not be separated from the host contract and accounted for separately as a derivative instrument.

Recognition of Derivatives

20. Derivative instruments represent rights or obligations that meet the definitions of assets (SSAP No. 4—Assets and Nonadmitted Assets) or liabilities (SSAP No. 5R) and shall be reported in financial statements. In addition, derivative instruments also meet the definition of financial instruments as defined in SSAP No. 27—*Off-Balance-Sheet and Credit Risk Disclosures*. Should the cost basis of the derivative instrument be undefined (i.e., no premium is paid), the instrument shall be disclosed in accordance with paragraphs 46-50 of SSAP No. 100R—*Fair Value*. Derivative instruments used in hedging, income generation or replication (synthetic asset) transactions shall be recognized and measured in accordance with the specific provisions within this statement and are admitted assets to the extent they conform to the requirements of this statement.

21. Derivative instruments that are not used in hedging, income generation or replication (synthetic asset) transactions shall be considered “Other” derivatives. These derivatives shall be accounted for at fair value and the changes in fair value shall be recorded as unrealized gains or losses. These derivatives do not qualify as admitted assets.

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

SSAP No. 103 provides guidance for the transfers of assets and liabilities, including guidance for when a sale shall be considered to have occurred. Guidance is captured for when securities are sold/reacquired are considered to be substantially the same and how those transactions should be reflected. As detailed in paragraph 52, credit repack notes would not qualify as substantially the same as the credit repack generally has a different issuer, different yield and modified NAIC designation/CRP rating from the original underlying investment.

12. Repurchase agreements, reverse repurchase agreements, repurchase financing, collateral requirements and dollar repurchase agreements are described in paragraphs 102-118. When an asset is sold and the proceeds are reinvested within 30 days in the same or substantially the same security, such transfers shall be considered to be wash sales and shall be accounted for as sales as discussed in paragraphs 96-101 and disclosed as required by paragraph 28⁴. Unless there is a concurrent contract

⁴ Paragraph 28.1. also details the items that are excluded from the wash sale disclosure.

to repurchase or redeem the transferred financial assets from the transferee, the transferor does not maintain effective control over the transferred financial assets.

Agreement to Repurchase or Redeem Transferred Financial Assets

51. An agreement that both entitles and obligates the transferor to repurchase or redeem transferred financial assets from the transferee maintains the transferor's effective control over those assets as described in paragraph 8.c.(1) when all of the following conditions are met:

- a. The financial assets to be repurchased or redeemed are the same or substantially the same as those transferred (paragraph 52).
- b. The agreement is to repurchase or redeem them before maturity, at a fixed or determinable price.
- c. The agreement is entered into contemporaneously with, or in contemplation of, the transfer.

52. To be substantially the same, the financial asset that was transferred and the financial asset that is to be repurchased or redeemed need to have all of the following characteristics:

- a. The same primary obligor (except for debt guaranteed by a sovereign government, central bank, government-sponsored enterprise or agency thereof, in which case the guarantor and the terms of the guarantee must be the same);
- b. Identical form and type so as to provide the same risks and rights;
- c. The same maturity (or in the case of mortgage-backed pass-through and pay-through securities similar remaining weighted-average maturities that result in approximately the same market yield);
- d. Identical contractual interest rates;
- e. Similar assets as collateral; and
- f. The same aggregate unpaid principal amount or principal amounts within accepted "good delivery" standards for the type of security involved.

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 2023, the Working Group adopted the principles-based bond definition, which resulted in key revisions to *SSAP No. 26R—Bonds* and *SSAP No. 43R—Asset-Backed Securities*, and *SSAP No. 21R—Other Admitted Assets* for the review and classification of debt securities pursuant to the bond definition. This guidance is effective Jan. 1, 2025.

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

Convergence with International Financial Reporting Standards (IFRS): N/A

Staff Recommendation:

NAIC staff recommends that the Working Group move this item to the active listing as a new SAP concept and expose proposed edits to *SSAP No. 86—Derivatives*, to establish guidance that requires separate accounting and reporting of derivatives that are captured in debt security structures. This is a change from existing guidance that explicitly precludes the separation of embedded derivatives. In addition to these changes, minor revisions are also proposed to *SSAP No. 26—Bonds* and to the annual statement instructions to clarify application guidance. NAIC staff will also draft an issue paper to document these revisions.

From initial discussions with banks / investment makers, guidance to separate the derivative from the debt security is believed to be preferred over a conclusion that would preclude bond treatment for the combined structure. With the proposal, debt security repack structures will be treated similarly to investments where the bond and derivative are not combined. (Ultimately, there would be no capital benefit or detriment due to the structure.) Additionally, this proposal will allow transparency as to the derivatives being used and ensure compliance with the reporting entity's derivative use plan. (If this proposed guidance is not supported, the combined repack, which represents a debt structure, would need to be assessed under the bond definition. This may require more detailed guidance to assess different types of derivative structures to determine whether the repack should qualify as a bond or as a non-bond debt security.)

NAIC staff has not proposed revisions to SSAP No. 103 as the existing guidance is clear that a sale of a debt security which is subsequently or simultaneously reacquired as a credit repack would not meet the criteria of substantially the same. This is because a credit repack generally has a revised issuer, yield and NAIC designation to reflect the additional derivative risk. As noted, minor revisions have been proposed to the annual statement instructions to clarify that the sale of a security that is reacquired with different terms shall be reported as a sale on Schedule D-Part 4 and a new acquisition on Schedule D-Part 3.

Proposed Revisions to SSAP No. 86—Derivatives:

Embedded Derivative Instruments

17. Contracts that do not in their entirety meet the definition of a derivative instrument, such as ~~bonds~~, insurance policies, and leases, may contain “embedded” derivative instruments—implicit or explicit terms that affect some or all of the cash flows or the value of other exchanges required by the contract in a manner similar to a derivative instrument. The effect of embedding a derivative instrument in another type of contract (“the host contract”) is that some or all of the cash flows or other exchanges that otherwise would be required by the contract, whether unconditional or contingent upon the occurrence of a specified event, will be modified based on one or more underlyings. For these contracts, excluding debt securities with derivative components/wrappers pursuant to paragraph 18, an embedded derivative instrument shall not be separated from the host contract and accounted for separately as a derivative instrument.

18. Debt securities that have derivative components or wrappers shall initially be assessed to determine if they are a structured note pursuant to paragraph 5g. Structured notes shall not be bifurcated and shall be collectively reported as a derivative investment and shall be measured and reported pursuant to the guidance within this statement. Debt securities that are not structured notes, but have been combined with a derivative instrument^{FN1} shall be bifurcated with separate reporting as a debt security and a derivative instrument. Once the investment is bifurcated, the debt security shall be reviewed in accordance with the bond definition within SSAP No. 26—Bonds and captured as an issuer credit obligation, asset-backed security, or non-bond debt security, based on the characteristics of the debt security^{FN2}. If the debt security serves as collateral to the derivative counterparty, the reported debt security shall be coded as a restricted asset under SSAP No. 1—Accounting Policies, Risks & Uncertainties and Other Disclosures. The derivative shall be captured in scope of this statement, measured and classified pursuant to the guidance within and reported on Schedule DB.

New Footnote 1: This guidance applies to all debt securities with derivative components or wrappers but was incorporated in response to credit repack notes. With a credit repack, a debt security is combined with a derivative instrument at an SPV, with the reporting entity acquiring a new debt security (“repack”) from the SPV reflecting the combined components. This structure can be viewed as advantageous over the separate acquisition of a derivative instrument as the debt security held in the structure serves as the sole source of collateral to the derivative counterparty, reducing potential liquidity concerns based on future market fluctuations. However, if this repack structure was collectively reported as a debt security, information on the use of derivatives would not be identifiable within the statutory financial statements. A repack note often has a reduced interest yield from the stated yield of

the underlying debt security held in the structure to cover the fees of issuing the repack, as well as a revised NAIC designation/CRP rating that reflects the added risk of the SPV and derivative counterparty.

New Footnote 2: Assessment under the bond definition shall be based on the characteristics of the underlying debt security, but the issuer, investment yield, NAIC designation/CRP rating, as well as any other reported investment components, shall reflect the terms of the held (combined) investment and not the terms of the underlying security.

Proposed Revisions to SSAP No. 26—Bonds

4. This statement excludes:

- e. Replication (synthetic asset) transactions and debt security structures that have been combined with derivative components or wrappers addressed in *SSAP No. 86—Derivatives*. The admissibility, classification and measurement of a replication (synthetic asset) transactions are not preemptively determined by the principles-based bond definition and should be evaluated in accordance with the guidance on replication (synthetic asset) transactions within SSAP No. 86. Debt security structures combined with a derivative, such as a credit repack note that does not reflect a structured note, shall follow the guidance in SSAP No. 86 for bifurcation. After bifurcation, the underlying debt security is subject to the guidance in this statement in determining whether it qualifies for bond reporting.

Proposed Revisions to Annual Statement Instructions:

Schedule D – Part 4: Long Term Bonds and Stocks Sold, Redeemed or Otherwise Disposed Of During Current Year

This schedule should include a detailed listing of all securities that were sold/disposed of during the current reporting year that were owned as of the beginning of the current reporting year (amounts purchased and sold during the current reporting year are reported in detail on Schedule D, Part 5 and only in subtotal in Schedule D, Part 4). This should include all transactions that adjust the cost basis of the securities (except other-than-temporary impairments that are not part of a disposal transaction). ~~Thus, it~~ This schedule should not be used for allocations of TBAs to specific pools subsequent to initial recording in Schedule D, Part 3 or ~~other~~ situations ~~such as~~ that only involve CUSIP number changes. The following list of items provides examples (not all inclusive) of the items that should be included:

Pay downs of securities still owned (including CMO prepayments);

Subsequent partial sales of investment issues still owned;

Sales of securities to an SPV or other entity for which a new instrument is reacquired from the SPV/entity reflecting a combined instrument containing the original security and derivative instruments or other components (such as a credit repack note). The sale shall be captured on this schedule (or Schedule D, Part 5 if the debt security was acquired in the current year), and the new security shall be reported on Schedule D, Part 3.

Reallocation of the cost basis of an already owned stock to the cost basis of a new stock received as a dividend (e.g., spin off); and

Any decreases in the investments in SCA companies that adjust the cost basis, not including other-than-temporary impairments alone (e.g., subsequent return of capital from investments in SCA companies valued using the equity method).

Schedule D – Part 5: Long-Term Bonds and Stocks Acquired During the Year and Fully Disposed Of During Current Year

As with Schedule D, Parts 3 and 4, this schedule should ~~not~~ be used for ~~a~~ transactions ~~unless it that~~ affects the cost basis of the securities. ~~Thus, it~~ This schedule should not be used for allocations of TBAs to specific pools subsequent to initial recording in Schedule D, Part 3 or ~~other~~ situations ~~such as that only involve~~ CUSIP number changes. Refer to the examples on Schedule D, Part 4 of transactions that should be captured.

Existing Guidance in SSAP No. 103, paragraph 52 – No Revisions Proposed:

With this existing guidance, debt securities sold and reacquired as a credit repack should not be considered to be substantially the same. This is because the credit repack is acquired from a new issuer, with a revised yield and with revised risks and rights (including revised NAIC designation/CRP rating) to reflect the derivative components / counterparty. Comments are requested on different interpretations and if edits are needed to ensure proper application of this guidance.

52. To be substantially the same, the financial asset that was transferred and the financial asset that is to be repurchased or redeemed need to have all of the following characteristics:

- a. The same primary obligor (except for debt guaranteed by a sovereign government, central bank, government-sponsored enterprise or agency thereof, in which case the guarantor and the terms of the guarantee must be the same);
- b. Identical form and type so as to provide the same risks and rights;
- c. The same maturity (or in the case of mortgage-backed pass-through and pay-through securities similar remaining weighted-average maturities that result in approximately the same market yield);
- d. Identical contractual interest rates;
- e. Similar assets as collateral; and
- f. The same aggregate unpaid principal amount or principal amounts within accepted "good delivery" standards for the type of security involved.

Staff Review Completed by: Julie Gann, NAIC Staff—June 2024

<https://naiconline.sharepoint.com/teams/FRSStatutoryAccounting/NationalMeetings/A.NationalMeetingMaterials/2024/08-13-24SummerNationalMeeting/Meeting/E-24-16-RepacksandDerivativeWrapperInvestments.docx>