March 2022 SAPWG Call

Issues & Trends

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Meeting highlights

During its call on March 2, 2022, the Statutory Accounting Principles Working Group (SAPWG) **exposed** the following:

— a revised principles-based bond definition; and

— a draft issue paper detailing discussions and concepts in the development of the proposed principles-based bond definition.

2 Principles-based bond definition

Revised principles-based bond definition

Action. SAPWG exposed a revised principles-based bond definition. Comments are due May 6, 2022.

The proposed principles-based definition of a bond is a 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 (ABS).

The revisions update the proposed definition by:

— Including US Treasury Inflation-Indexed Securities (US TIPS) as an example of issuer credit obligations, consistent with current guidance in SSAP No. 26R.[1] The principal of US TIPS are variable based on inflation, without risk of loss. They were added as an exception to the principles-based bond definition that does not permit a security with a variable principal or interest based on an underlying equity investment, reference or derivative to be reported as a bond.

— Clarifying the treatment of pass-through securities by stating that investments in the form of securities for which repayment is fully supported by an underlying contractual obligation of a single operating entity meet the definition of issuer credit obligations. The revisions also:

  – make the guidance more generic and include credit-tenant loans, equipment trust certificates, other lease backed securities, and funding agreement backed notes as examples of issuer credit obligations; and
  – state that 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.

— Removing reference to hybrid securities issued by operating entities as an example of issuer credit obligations. This change clarifies that these securities should be reviewed to determine if they meet the principles-based bond definition and reported on Schedule D-1.

— Clarifying that Exchange Traded Funds that qualify for bond treatment as identified in the Purposes and Procedures Manual of the NAIC Investment Analysis Office and published on the Security Valuation Office's webpage are an example of fixed income instruments that are

[1] SSAP No. 26R, Bonds

issuer credit obligations. This revision incorporates a concept that is currently included in SSAP No. 26R.

- Clarifying that when determining whether a security meets the definition of an ABS, an insurer would be required to consider all returns in excess of principal repayments as interest. Insurers would evaluate both the stated interest and additional returns collectively when determining whether the investment has variable interest based on underlying equity interests.
- Removing Example 1 in Appendix I of the principles-based bond definition that provided guidance on a scenario where equity interests from a tranche were required to be held by an insurer when holding debt tranches. This example was also referred to as an example of stapling investments. Based on comments received, SAPWG determined that tranches that separately qualify as bonds would be reported as bonds, even if other tranches from a structure that do not qualify as bonds are also held by the insurer. The risk-based capital treatment for these investments will be addressed by the Risk-Based Capital Investment Risk and Evaluation Working Group.
- Modifying Example 3 in Appendix 1 of the principles-based bond definition to assist insurers in determining when the rebuttable presumption that a debt instrument collateralized by equity interest does not qualify as a bond can be overcome.

Draft issue paper

Action. SAPWG exposed a draft issue paper about the proposed principles-based bond definition. Comments are due May 6, 2022.

The draft issue paper summarizes SAPWG's discussions about the proposed principles-based bond definition and the statutory accounting revisions needed to specify the types of investments that would be reported on Schedule D-1. It states that investments reported on Schedule D-1 would have to comply with the principles-based definition of a bond or be specifically listed as in scope of SSAP No. 26R or SSAP No. 43R.[2] Revisions to reflect the principles-based bond definition are expected to be included in SSAP Nos. 26R and 43R.

The draft issue paper discusses the following concepts for the proposed principles-based bond definition:

- The definition of a bond requires a security structure, not a loan, representing a creditor relationship. The naming convention of an investment, such as a bond, a note, or an obligation, does not override the structural design. An instrument described as a loan that meets the security definition requirements and other concepts in the principles-based bond definition would be captured as a bond on Schedule D-1. Conversely, an instrument named as a "bond" but that does not meet the security or other concepts in the principles-based bond definition would not be permitted for Schedule D-1 reporting.

[2] SSAP No. 43R, Loan-backed and structured securities

- The security has to be either an issuer credit obligation or an ABS.
  - an issuer credit obligation represents a bond structure where the repayment is supported primarily by the general creditworthiness of an operating entity or entities;
  - an ABS is a bond issued 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 of the underlying collateral rather than the cash flows of an operating entity.
- The issue paper discusses assessing whether the security represents a creditor relationship including that:
  - the assessment would require consideration of the substance, rather than the legal form of the instrument, and 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 would not represent a creditor relationship; and
  - there is a rebuttable presumption that debt instruments collateralized by equity interests would not qualify as bonds because they would not, in substance, reflect a creditor relationship.

  The assessment of whether a security meets the principles-based definition would be required to be done at origination. This assessment would reflect the insurer's understanding of the intent and ultimate structure of the security at origination, not what a structure holds on the day of origination.
- To be reported on Schedule D-1, an ABS would have to have two characteristics:
  - Substantive credit enhancement – The holder of the debt instrument must be in a substantively different economic position than if the holder owned the ABS issuer's assets directly. This could come in different forms, including but not limited to, subordination, overcollateralization, guarantees, or other forms of recourse.
  - Collateral assets – The assets owned by the ABS issuer would be either financial assets or cash-generating non-financial assets. For nonfinancial 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 nonfinancial assets.

    The intent of this guidance is to ensure that nonfinancial assets encompass a level of cash generation similar to traditional bond-like cash flows. The assessment of meaningful cash flows permits a practical expedient allowing an insurer to consider an asset to have met this criteria when less than 50% of the original principal relies on sale or refinancing.

The issue paper discusses additional elements that were considered in establishing the ABS definition, including the:

- determination of an ABS;
- determination of whether a structure reflects financial or nonfinancial assets;
- consideration of whole-business securitizations;
- consideration of residual tranches and the concept of stapling of investments; and
- prohibition of an ABS from being recorded as short-term or cash equivalents.

The issue paper also provides examples of two scenarios that do not, in substance, represent creditor relationships despite their legal form:

- investment in debt instrument from a special purpose vehicle (SPV) that holds a large number of diversified equity interests with characteristics that support the production of predictable cash flows.
- investment in debt instrument from a SPV that owns a portfolio of equity interests, and the debt instrument does not meet the definition of an issuer credit obligation

It also includes four examples that provide analysis of ABS structures when considering the concepts of the substantive credit enhancement and meaningful level of cash flows when an insurer invests in debt instruments issued from an SPV that:

- are sponsored by the Government National Mortgage Association, the Federal National Mortgage Association, and the Federal Home Loan Mortgage Corporation;
- owns equipment leased to an equipment operator with a 50% balloon payment;
- owns equipment leased to an equipment operator with a 50% balloon payment, except that the existing equipment lease at the time of origination has a contractual term that is shorter than the term of the debt instrument; and
- owns equipment leased to an equipment operator that requires an 80% balloon payment.

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