Overview of the New Statutory Principles-based Bond Standard

SIFM Holiday Conference 2024

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Agenda

1. Background and Overview
2. Decision Tree
3. Changes and Impacts
4. Implementation Considerations and Best Practices
5. Investment Considerations
6. Additional Resources

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Background and Overview

NAIC Principles-Based Bond Project

Background and Overview

- Originally introduced at Summer 2019 NAIC meeting around Collateralized Fund Obligations (“CFO”) investments.

- Intended to prevent restructuring of equity investments into debt investments to be reported as bonds on Schedule D.

- Project developed into a more comprehensive review of investments being made by insurers.
  - Elimination of investments with equity-like characteristics from being classified as bonds.
  - Increased focus on underlying collateral.

- Effective January 1, 2025.

NAIC Principles-Based Bond Project

Background and Overview

Bond – Instrument *Definition*

"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.

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."

Source: SSAP 26R Paragraph 5

NAIC Principles-Based Bond Project
Background and Overview

Bond – Instrument Characteristics

- Contractual, fixed schedule for one or more future payments.

- In-substance Creditor Relationship
  - Pre-determined principal and interest payments (fixed or variable interest).
  - Contractual amounts <u>do not vary</u> based on the appreciation or depreciation of underlying collateral or other non-debt variable.

- Instruments with a reliance on equity cash flows likely not a bond

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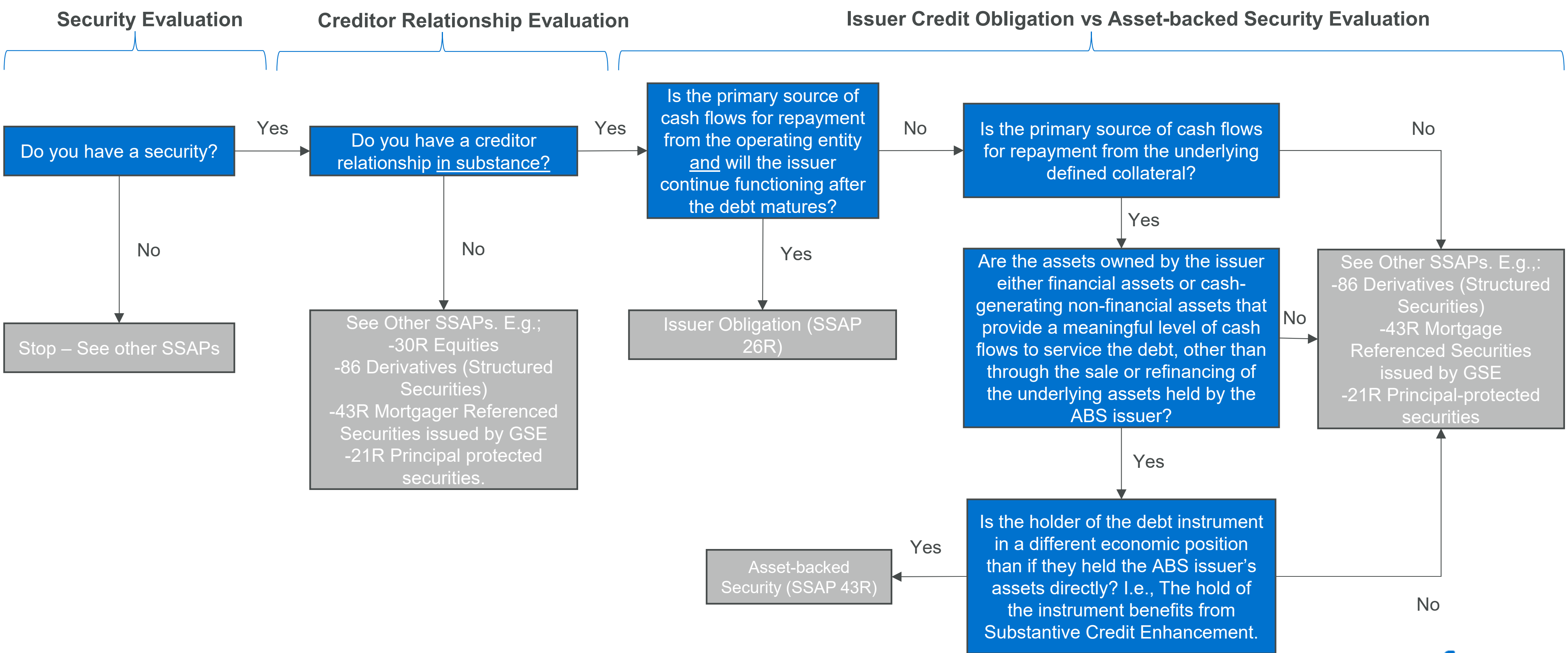
Decision Tree

NAIC Principles-Based Bond Project
Decision Tree



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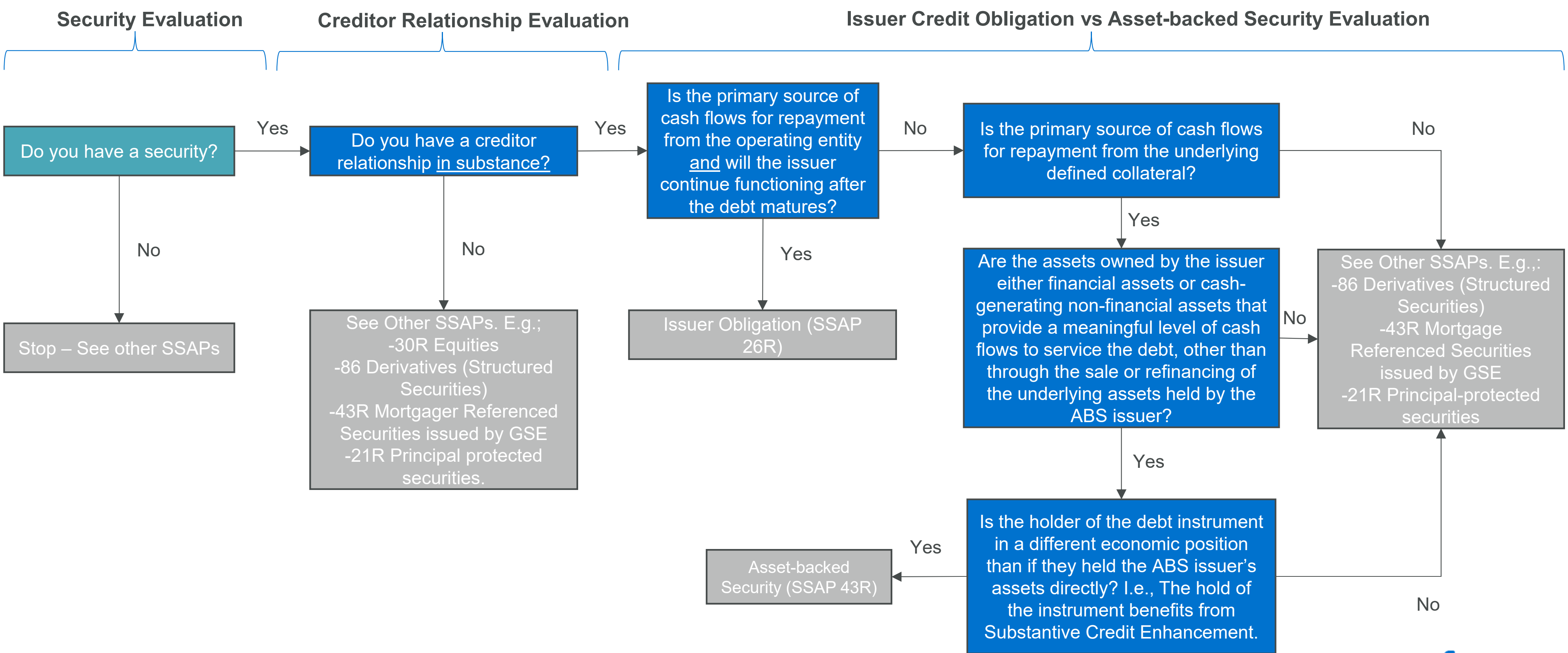
Decision Tree



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Decision Tree

Definition of 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 be 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."

Source: SSAP 26R Paragraph 5

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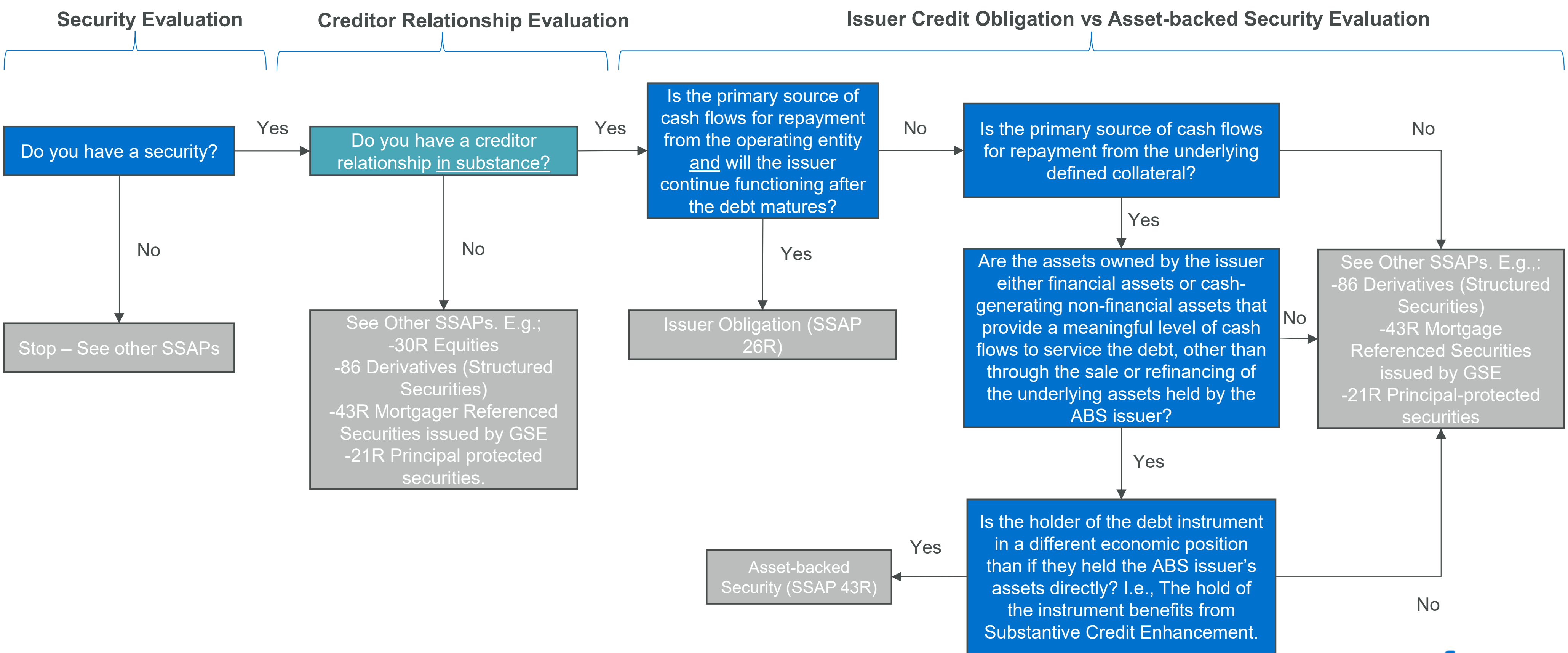
Decision Tree



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Decision Tree – Creditor Relationship

Does a creditor relationship exist?

Pre-Determined interest and principal payments	Contractual amounts do not vary based on appreciation/depreciation of underlying collateral	Most debt instruments collateralized by equity interests*	Reliance of the debt instrument on the sale of underlying equity interests or refinancing at maturity**
Creditor Relationship Exists		Creditor Relationship <u>Does Not</u> Exist	

*If equity risks have been sufficiently redistributed through the capital structure of the issuer, could still be creditor relationship.

**If equity valuation risk is mitigated and can be supported as bond risk, could represent creditor relationship.

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Creditor Relationship (cont.)

Debt Collateralized by Equity Interest – Rebuttable Presumption

- Rebuttable presumption is that debt instruments collateralized by equity interests are NOT considered a creditor relationship

- HOWEVER, if the characteristics of the underlying equity interests:
  - Lend themselves to predictable cash flows, AND
  - Underlying equity risks have been sufficiently redistributed

- THEN, the debt instrument MAY meet the criteria for a creditor relationship.
  - Factors to consider could include:
    - Number and diversification of underlying equity interests, liquidity facilities, over-collateralization, waiting period for distributions, capitalization of interest, covenants, reliance on ongoing sponsor commitments, etc..
  - Also, as reliance on sale or refinancing increases, the more compelling other factors need to be to overcome the rebuttable presumption.

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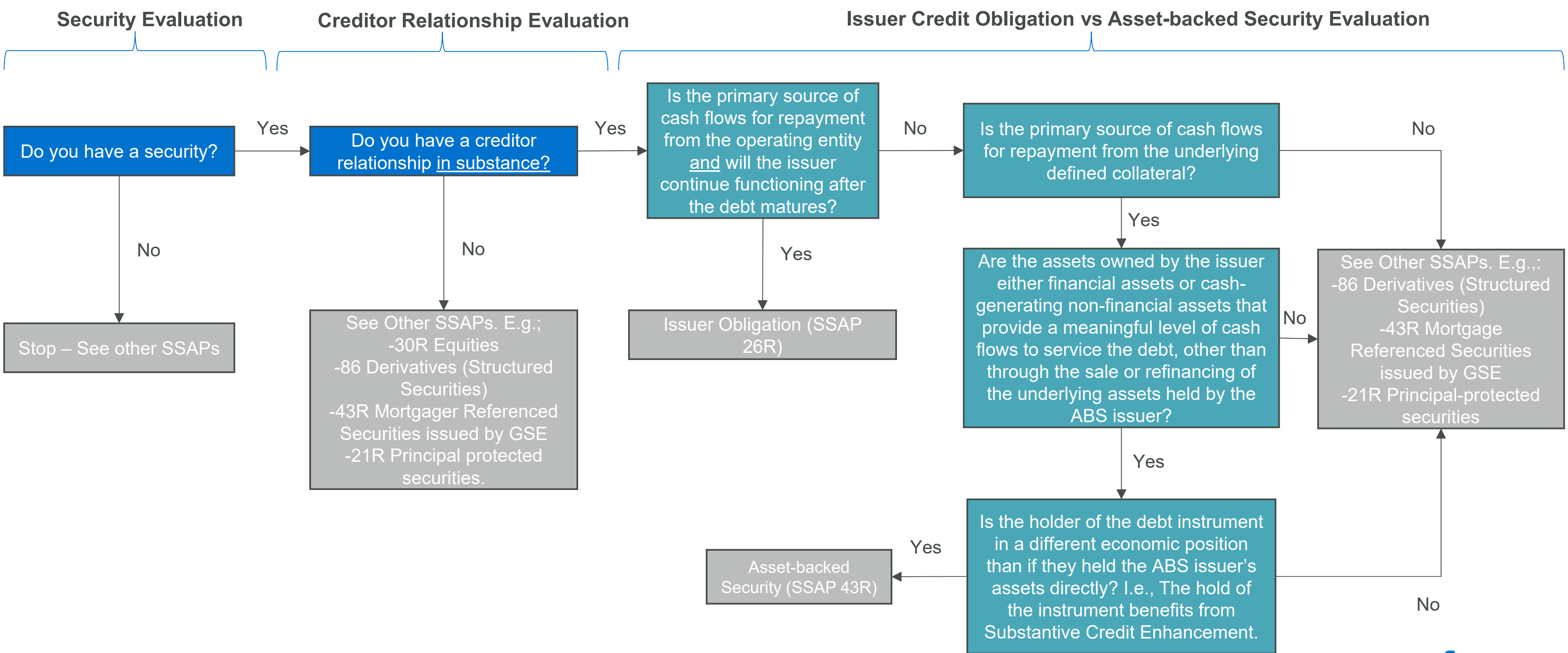
Decision Tree



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Issuer Credit Obligations vs Asset-Backed Securities

Issuer Credit Obligations

- Issuer is expected to continue functioning beyond the final maturity of the debt initially raised by the issuer.
- All returns from a bond instrument in excess of principal are required to be considered as interest.
- Examples include:
  - Corporate Bonds
  - US Treasuries
  - Municipal Securities

Asset Backed Securities

- Different economic position vs holding ABS issuer assets directly (i.e. Substantive Credit Enhancement)
  - Examples of substantive credit enhancements include, substantive guarantees, subordination, and/or overcollateralization.
- Assets owned by ABS issuer expected to generate “meaningful” level of cash flows towards repayment of the bond.
  - Examples include use, licensing, leasing servicing, or management fees.
- ABS issuer is not expected to continue functioning beyond the final maturity of the debt initially raised by the ABS issuer.
- Examples include:
  - Collateralized Loan Obligations
  - Securitized Collateralized Fund Obligations
  - Lease Backed Transactions

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Asset Backed Securities

Substantive Credit Enhancements

- Holder must be in different economic position vs. owning collateral directly.
  - IF holder would be in the same position, not an ABS, and not a bond.
  - Substantive Credit Enhancement through overcollateralization/subordination or other guarantee or recourse to support underlying risks can be recategorized as bond risk.
    - Should absorb loss prior to the debt instrument.

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Asset Backed Securities

Meaningful Cash Flows

- Meaningful cash flows are required for ABS backed by non-financial assets.

- The definition of meaningful is specific to each transaction, determined at origination, and considers the following factors:
  - Price volatility in the principal market for the underlying collateral
  - Liquidity in the principal market for the underlying collateral
  - Diversification characteristics of the underlying collateral
  - Overcollateralization of the underlying collateral relative to the debt obligation
  - Variability of cash flows from sources other than sale or refinancing, expected to be generated from the underlying collateral

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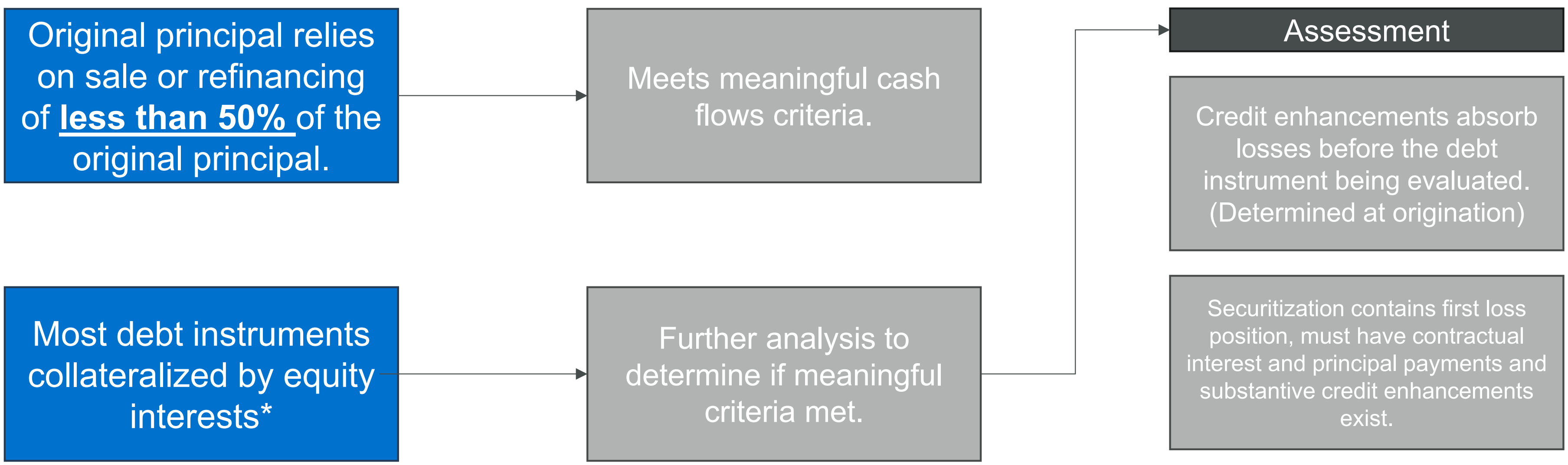
Asset Backed Securities

Meaningful Cash Flows – Practical Expedient



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Changes and Impacts

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Changes and Impacts

Accounting, Classification, and RBC Changes and Impacts

- Differences and changes in valuation methods
  - ABS Carry Value; Surplus Calculations, Asset Valuation Reserves (Life and Fraternal)
  - Starting in 2025, all ABS must be classified as long-term regardless of maturity date.
- Cash equivalents and short-term investment classification scrutiny
- Reclassification from Schedule D to Schedule BA
- State-dependent diversification rules
  - Prudent Person Approach/Finite Model
- Investments no longer classified as bonds move from Schedule D to Schedule BA
  - RBC charges based on schedule (20% RBC Charge for Schedule BA (*P&C, Health, Title Insurers*))
  - Consideration for investments moving between classifications will be critical
- Future investment strategy related to RBC calculation impacts

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Changes and Impacts

Transition Guidelines

- Disposal from Schedule D to Schedule BA will be at amortized cost.

- Assets previously reported at fair value on Schedule D as of 12/31/2024, reverse any unrealized adjustments on 1/1/2025 and dispose of the asset from Schedule D.
  - There is no recognized gain or loss on the disposal of the asset from Schedule D.

- Asset will be acquired onto Schedule BA and reported at amortized cost
  - Additional adjustments for correct Schedule BA valuation can then be made as part of the transition.

- This process of derecognizing from Schedule D as a disposal and recognizing it as an acquisition on Schedule BA will ensure schedules appropriately roll from period to period

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Implementation Considerations and Best Practices

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Implementation Considerations and Best Practices

Implementation Best Practices

- Following the standard-setting process over the past couple of years provides context to changes and helps with applications

- Project Management
  - Know who needs to be involved and get them up to speed and aware of timelines early
  - Organization and clarity of tasks and deadlines

- Classification Checklist / Decision Tree
  - Have a clean, executable checklist or decision tree that can be easily applied

- Industry groups and NAIC Blanks Working Group materials

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Implementation Considerations and Best Practices

Implementation Playbook

- Program Management – Implementation Plan
- Develop a Classification Decision Tree/Checklist
- Determine Universe of Investments for Evaluation (Schedule D)
- Perform Evaluation
  - New details on the nature of investments to determine the appropriate classification
  - Analysis documentation and creation of applicable workstreams for reclassification analysis
  - Multiple functional group involvement and messaging (i.e. Accounting Policy, STAT Reporting, Controllership, Investment Accounting, FP&A, Capital Management, Leadership)

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Implementation Considerations and Best Practices

Implementation Challenges / Issues

- Seeing a fair number of securities reclassified to collateral loans
  - To consider: Variances in collateral required to be held between model investment rule and certain state requirements
- Challenges when investments have features of both ICOs and ABS
  - For specific instances, the Blanks Working Group has created a Q&A document to address issues, including things such as PIK interest, Repack investments, double-barreled municipal bonds, and several others.
- Property and Casualty, Health, and Title companies will have a 20% RBC charge for Schedule BA.
- Life and Fraternal – for items that cannot use look-through, the RBC charge will be 45%.

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Implementation Considerations and Best Practices

What are we hearing?

- Some investment accounting vendors are assisting their clients with reclassifications; however, they are limited by the information received from their clients. In some cases, determining classification requires more information than in the past – most of which the vendors do not generally have.

- Some carriers feel that they do not need to deal with this until year-end 2025, but the reality is that it impacts Q1 2025.

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Investment Considerations

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Investment Considerations

RBC Treatment Impacted

- Certain assets will be moved from Schedule D Part 1 to Schedule BA, which may materially increase RBC charges.
  - Affected assets are primarily held by Life companies. RBC impact will vary depending on specific Schedule BA treatment. Best case: asset moves to BA but RBC charge remains the same. Worst case: asset also goes from bond RBC charge (typically single digit %) to equity charge (typically 30%)

  - Impact on RBC ratio is hard to generalize due to wide variation among insurer RBC factors. Moving assets from D to BA but keeping the same RBC charges would have a negligible impact. Materially increasing C-1o or C-1cs charge due to reclassification could be material depending on the number of affected assets and relative sizes of other RBC factors.
    - Major RBC impacts will likely be few and far between, though hard to call it unimportant as the Life industry has been closely tracking this change and vocal about their preferences and concerns

  - **Even if the RBC charge remains the same, moving assets to BA makes them less attractive at the margin as BA assets are viewed as more opaque and speculative than D bonds, are carried at lower of cost or amortized value (thus incorporate mark-to-market risk to surplus), and may limit risk-bearing capacity under statutory investment limits**

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Investment Considerations

Investment Behavior Changes

- Insurers may choose to reduce affected assets in response, though many are likely illiquid
  - Larger impact will likely be on how insurers invest going forward, rather than any attempt to dump existing holdings. This change has been a long time coming and the most-affected insurers have tracked its progress for years
  - **This change will probably not dramatically alter the investment behavior of more than a handful of insurers, though combined with other changes it may slow the adoption rate of private credit investments for the industry**

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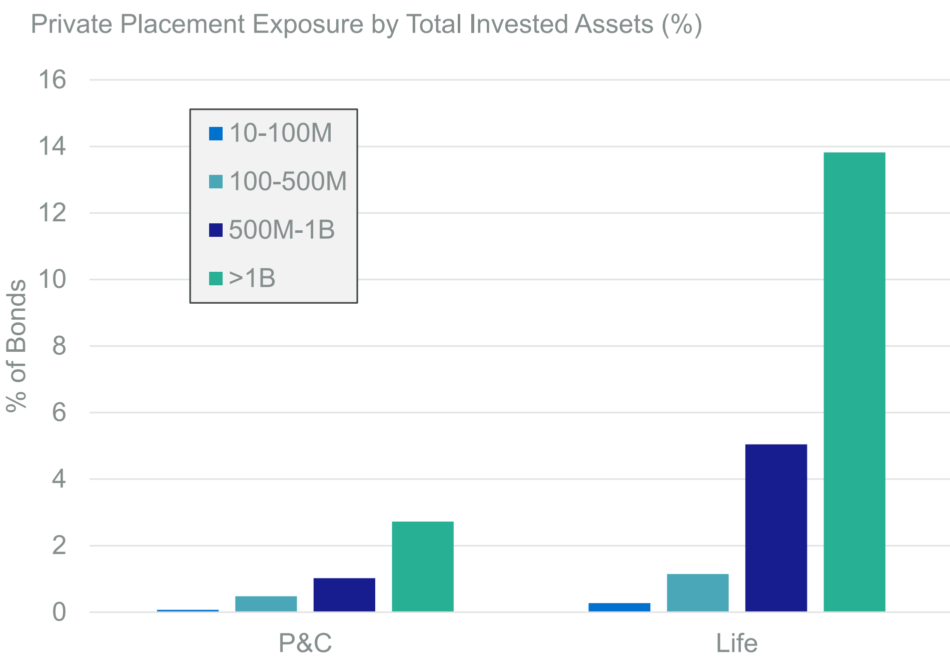
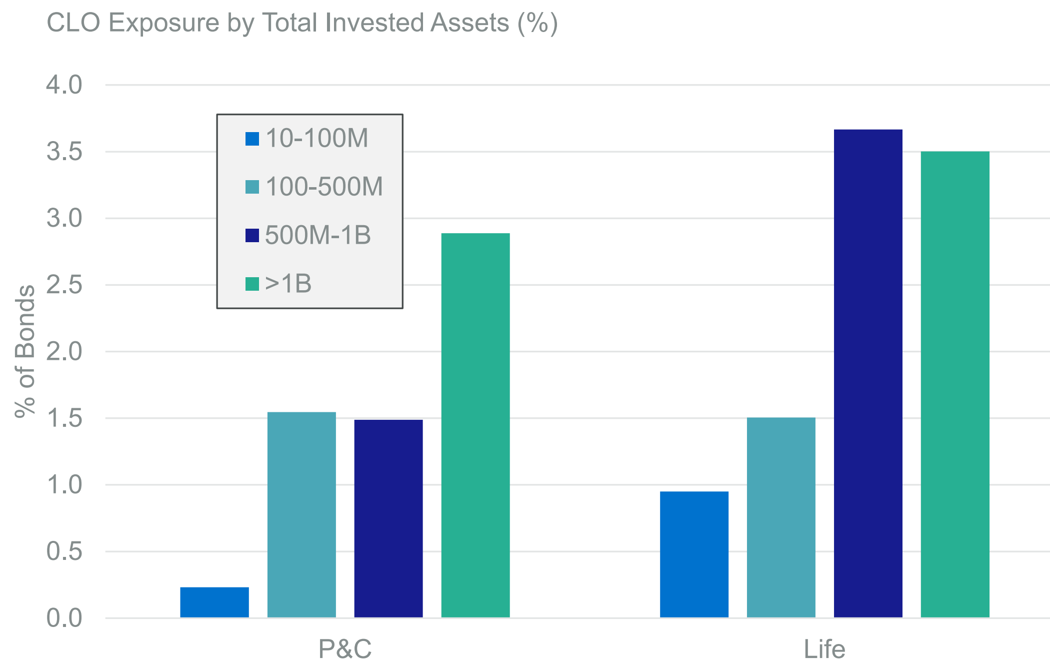
Investment Considerations

Large Life Insurers Most Affected





Source: S&P Capital IQ Pro. Data as of 12/31/23

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Investment Considerations

“Principles-Based” to Encourage, Not Stymie, Innovation

- The structure of the changes indicates a desire to settle multiple related concerns once and for all
  - PBBD is the largest part of a suite of related regulatory moves intended to increase transparency and validate ratings/RBC treatment of novel investment structures, particularly private credit
  - **Other changes include the potential to challenge/override FE ratings, increased disclosure requirements for private letter ratings, a new model-based approach to determining CLO ratings, and increased scrutiny of high-yielding assets in cash flow testing**

- Some affected securities historically seemed tailored to technically qualify as bonds while encompassing un-bond-like risks. The new approach emphasizes “substance rather than form”.

- By instituting principles and flowcharts for receiving Schedule D Part 1 status, the NAIC hopes to encourage legitimate innovation in security designs while closing perceived loopholes and eliminating ambiguity or need for case-by-case solutions

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Investment Considerations

Synthetic Securities Disadvantaged

- New security structures have been driven in part by PE-owned or –affiliated life insurers, leveraging sophisticated investment capabilities to tailor assets to prior regulatory requirements. Broader language in new approach will instead incentivize focus on seeking opportunities in investment markets rather than wording of regulations
  - **In particular, synthetic security designs combining a "performance asset" (equity, derivatives, equity tranche of structured deal, etc.) with a "principal payment asset" (Treasuries or other high-grade bonds) are likely to now wind up on Schedule BA and be rated at least as punitively as the individual underlying holdings were held separately**
    - One notable exception is convertible bonds, which may benefit from this change, though synthetic convertibles (incorporating debt and equity features from multiple different issuers) do fall under the new rules

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Investment Considerations

Implementation Already Underway

- The need to coordinate with investment accounting service providers to ensure a smooth transition is more pressing for most insurers than the need to adjust portfolio holdings
  - This is the largest re-ordering of the investment schedules in likely several decades
- Accounting software providers are already working to prepare new classification schemas and reporting templates to be ready for year-end 2025
  - If you haven't already, we advise communicating with them to check on implementation progress
  - Goal is typically to be ready to reclassify all assets effective 1/1/25, even if reporting won't occur until year-end
  - Some providers may be charging one-time fees or adjusting pricing to reflect increased workloads or data requirements
  - Private ABS with complex structures and lack of publicly-available data will likely require the longest lead time to reclassify
- Major investment accounting firms have published implementation guides and are proactively communicating with insurers and investment managers on what to expect in 2025
  - These can be helpful resources for firms who do investment accounting entirely in-house
- Although affected assets are not required to move to Schedule BA until 12/31/25 reporting, insurers may opt to do so earlier if desired

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Additional Resources

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Additional Resources

Links and Additional Resources

- NAIC has a free web-based course to help prepare for the changes
  - Start on any Monday and complete within one week
  - Only free to industry through the end of 2024
  - Registration link: https://web.cvent.com/event/920b55bf-8d48-4cab-9bad-b584b542931b/summary
  - All adopted materials are available at: https://content.naic.org/committees/e/statutory-accounting-principles-wg

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