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NAIC's SAPWG Exposes Proposed Definition of "Bond" for Purposes of SSAPs 26R and 43R: Mayer Brown

On May 20, 2021, the Statutory Accounting Principles (E) Working Group (SAPWG) of the Financial Condition (E) Committee of the US National Association of Insurance Commissioners (NAIC) exposed for public comment a proposed definition of "bond" for purposes of *Statement of Statutory Accounting Principles (SSAP) No. 26R* and *SSAP No. 43R*.

Background

The proposal sets out principles for determining whether a particular investment is a "bond" that is eligible to be reported by insurance companies on Schedule D, Part 1, of their statutory financial statements. Being able to treat an investment as a "bond" has notable advantages for insurance companies, including, in most cases, significantly lower risk-based capital charges than equity investments receive and the ability for life insurers to carry the investment at amortized cost, rather than marking it to market.

The proposal is the product of many months of meetings among the SAPWG staff and representatives of the Iowa Insurance Division (IID) and certain trade associations to expand upon the earlier conceptual proposal that the IID presented to the SAPWG last October.1 The new proposal supersedes an earlier draft issue paper developed by the SAPWG staff in March 2020, which would have administered shock therapy to the investment portfolios of life insurers, and which drew heavy criticism from the trade associations.

Perhaps significantly, the proposal foreshadows **possible** additional changes to required Schedule D reporting and states:

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.

What Qualifies as a Bond?

The proposal defines a "bond" 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 (ABS). The proposal then proceeds to explain what it means by each of those two categories.

Issuer Credit Obligations

For "issuer credit obligations" the proposal states (bold italic formatting here and in the subsequent sections of this Legal Update is ours for emphasis):

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 (defined below).

The proposal then provides examples of issuer credit obligations, which include, but are not limited to:

a. U.S. Treasury securities;

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. ETCs, EETCs, and CTLs for which repayment is ***fully supported by a lease*** to an operating entity;

h. Bonds issued by REITS or similar property trusts;

i. Bonds issued by business development corporations (BDCs), 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;

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. Hybrid securities issued by operating entities, 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).

It is unclear how lease extension/renewal options are to be treated for purposes of the "fully supported" requirement.

Bonds issued by 1940 Act-registered BDCs and closed-end funds are included on the above list of issuer credit obligations, but not unregistered funds. We think this is due to the fact that debt securities and preferred stock issued by registered funds have long been a major investment class for life insurers, and ever since the now-superseded draft issue paper was exposed for comment in March 2020, industry representatives have strongly advocated that the treatment of this investment class as bonds be preserved. It does raise the question, however, of why 1940 Act registration is required for a fund to be considered an "operating entity." Why shouldn't an unregistered fund engaged in the same activity be treated similarly?

Asset Backed Securities (ABS)

An ABS is defined as "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." The proposal states that ABS will be a "bond" if all three of the following conditions are satisfied:

1. The investor must have a "creditor relationship" ***in substance and not just legal form. This means that if the investment relies on "equity return cash flows," it must overcome the rebuttable presumption that it is not a bond by documented analysis supporting the recharacterization of such equity risk into bond risk by structuring and diversification of collateral***.

2. The assets owned by the ABS Issuer must be ***either financial assets or cash-generating non-financial assets***—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 (and not just through the sale or refinancing of the assets).

3. The holder of a debt instrument issued by an ABS Issuer must be ***in a different economic position*** than if the holder owned the ABS Issuer's assets directly—as a result of ***"sufficient" credit enhancement through guarantees (or other similar forms of recourse), subordination and/or overcollateralization***.

Regarding the "creditor relationship" requirement, the proposal states:

The analysis of whether a debt instrument that relies on cash flows from underlying equity interests for repayment represents a creditor relationship in substance should be conducted and documented by a reporting entity at the time such an investment is acquired. The level of documentation and analysis required to demonstrate that the rebuttable presumption has been overcome may vary based on the characteristics of the individual debt instrument, as well as the level of third-party and/or non-insurer market validation to which the issuance has been subjected. For example, a debt instrument backed by fewer, less diversified funds would require more extensive and persuasive documented analysis than one backed with a larger number of diversified funds. ***Likewise, a debt instrument that has been successfully marketed to unrelated and/or non-insurer investors, may provide enhanced market validation of the structure compared to one held only by related party and/or insurer investors where capital relief may be the primary motivation for the securitization.***

Significantly, the proposal provides a path for collateralized fund obligations (CFOs)—which were targeted to lose bond treatment under the now-superseded March 2020 draft issue paper—to continue to be treated as bonds if they satisfy the above three criteria. Among other things, the proposal notes that in instances where the assets owned by the ABS Issuer are equity interests, 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 of the equity interests.

Additional Guidance in the Proposal

The proposal includes a Glossary, explaining two of the key concepts in the ABS part of the definition: what constitutes a "meaningful" level of cash flows and what constitutes "sufficient" credit enhancement. The proposal also includes two appendices with illustrative examples.

Examples 1, 2 and 3 in Appendix I to the proposal indicate how the drafters think that the "creditor relationship" is to be analyzed. Of particular interest, example 1 describes a typical rated private equity feeder structure in which each investor (i) owns a pro rata share of the unsecured debt investments and equity interests outstanding, and (ii) is restricted from selling, assigning or transferring the unsecured debt investment without also selling, assigning, or transferring the equity interest to the same party. The drafters conclude that the debt investment does not have the required creditor relationship. It is unclear if this same result applies when the underlying fund is not "equity-like" and instead something else (e.g., private credit, real estate or infrastructure debt, etc.). Also, it would appear from the example that in a case where the debt and equity investments are not so restricted (i.e., one can be sold without the other) a different conclusion may apply.

The examples in Appendix II to the proposal provide similar indications for the contemplated determinations of "meaningful" cash flows and "sufficient" credit enhancement. Usefully, in discussing the "meaningful" cash flow requirement, the proposed definition offers a bright-line test that "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."

Issues Remaining to Be Resolved

Some issues not addressed in the proposal include:

- Treatment of synthetics (e.g., credit-linked notes)—are these permissible "issuer credit obligations"? What if they reference asset-backed-like pools?
- Transactions like "future flow" securitizations (i.e., not primarily derived from existing financial assets but from obligations to originate additional financial assets)—e.g., stranded cost tariff bonds.
- Certain "equity" arrangements like collateral trust certificates and whole pool pass-through interests.

Conclusion

The comment period for the proposal runs until July 15, 2021. Reaction to the proposal has been generally positive but with a recognition that more work needs to be done to refine it. Eventually, the proposal will need to be developed into an issue paper, which is a prerequisite for the SAPWG to adopt substantive changes to *SSAPs No. 26R* and *43R*. Accordingly, it will be some time before the changes to the SSAPs are finalized and even longer before they go into effect. That said, the general view of the proposal is that, thanks to the collaborative efforts by NAIC staff, IID staff and industry representatives that went into drafting it, the proposal provides a framework that all parties can live with. It addresses the concerns of NAIC staff and the SAPWG that determining whether an investment is a bond should look beyond the legal form of the investment to whether, in substance, it represents a creditor relationship. Yet it does so not by "throwing the baby out with the bath water" but in a principled and careful way that is informed by the insights of investment specialists from both the insurance industry and the regulatory community.

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1 Discussed in our related December 20, 2020 REVERSEInquiries Workshop “NAIC-related Developments for the Structured Investments Industry” webinar (video and presentation slides available here).

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