<u>Proposed Edits to the Principles-Based Bond Definition:</u>

1) **Explicit Inclusion of US Treasury Inflation-Indexed Securities (U.S. TIPS) (paragraph 2.a and footnote (FN) 2) –** This explicit inclusion was added as the definition has been revised to be more explicit that any security that has variable principal or interest based on an underlying equity investment, reference or derivative is not permitted as a bond. As U.S. TIPS are variable based on an inflation component (without the risk of loss), these are a stated exception to the definition. A similar exception currently exists in SSAP No. 26R. This guidance will allow for continued treatment of U.S. TIPS consistent with current guidance. With the revisions to the principle-based bond definition, any variable treatment driven from an underlying equity item will preclude bond reporting, regardless of whether the variable treatment could result with a risk of principle loss. As such, all principle-protected notes, where the investment includes equity items that can generate additional returns, will be precluded from bond treatment. From the historical discussion of structured notes, NAIC staff believes only U.S. TIPS warrant an exception to this guidance. However, if there are other such structures that should be specifically included, please provide notice of those securities to NAIC staff.

2) **Clarification of the Pass-Through Investments Permitted as Issuer Credit Obligations (paragraph 2.g.)** – The prior guidance identified equipment trust certificates (ETC), enhanced equipment trust certificate (EETC) and credit-tenant loans (CTLs) that were fully supported by a lease as issuer credit obligations. The guidance has been revised to be more generic (using those investments as examples, but not precluding future investment designs), and clarifies that "fully supported" requires cash flows for the repayment of all interest and 95% of the principal. This threshold would be in line with the residual risk provisions that the SVO assesses in determining SVO-Identified Credit Tenant Loans. (Note: The SVO-Identified CTLs are currently in-scope of SSAP No. 43R, but these investments would be considered in-scope of SSAP No. 26R as issuer credit obligations under the proposed revisions.)

3) **Removal of Hybrid Securities Reference (paragraph 2k.iii.)** – The deletion of the hybrid security reference does not intend to indicate that hybrid securities are prohibited from reporting on Schedule D-1, it only intends to clarify that such items shall be reviewed in accordance with the bond definition and reported on Schedule D-1 only if they qualify. Historically, a hybrid security was defined as a security with both debt and equity components, and a broad exception for such securities under the principles-based bond definition is not viable. Securities with both debt and equity components shall be reviewed and reported as bonds if they qualify as issuer obligations or ABS per the principles-based bond definition. (From information received, the original focus for hybrids (e.g., trust preferreds and Yankee bonds) have decreased in holdings.)

4) **Clarification of the SVO-Identified Bond ETFs (paragraph 2.k.iv)** – This revision is not a change. The prior definition had a reference to incorporate concepts from SSAP No. 26R paragraph 4, which previously included both SVO-Identified Bond ETFs and SVO-Bond Mutual (Govt) Funds. Since the Bond fund list was deleted by the SVO, only SVO-Identified Bond ETFs remain in scope of SSAP No. 26R. The tracked-change addition simply pulls in the reference that was remaining in paragraph 4.

5) **Clarification of "Returns" in Investments (paragraph 3.b.)** – This proposed edit intends to clarify that an investment with the potential for "additional returns" must be assessed as if the "additional returns" are a component of investment's interest. In other words, it's not permissible to have a 'stated interest' and then the potential for 'additional returns' and conclude that the investment does not have a variable interest based on equity interests. To prevent misapplication of the principle intent to review all investments holistically, the guidance has been clarified. This terminology has been noted in principle-protected securities and structured note transactions. As detailed in the issue paper, 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. 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.

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This revision intends to make it clear that the principles-based bond definition requires 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 holistically within the principles-based bond definition, with all potential returns considered in determining whether the structure qualifies as a creditor relationship.

6) **Deletion of Stapling Restriction (Appendix I – Example I**) - The original exposure of the principles-based bond definition included an initial example 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.

After considering comments from the first exposure period, as well as discussing within the study group of industry and regulators, this example has been 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 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.

7) **Revisions to Example Involving Portfolio of Equity Interests as Creditor Relationships (Appendix I – Example 3)** – There have been significant revisions to the example for when a reporting entity invests in a debt instrument issued from an SPV that owns underlying equity interests. The original example was designed to be explicit that the investment did not qualify as a bond. Instead, the example has been revised to provide information to assist users in determining whether the structure qualifies under the rebuttable presumption. As detailed, there is a rebuttable presumption that a debt instrument collateralized by equity interests does not qualify as a bond. The factors to consider in determining whether such an instrument reflects a creditor relationship / bond have been expanded to include the sources of cash flows to service the debt (such as dividend distributions versus sale of the underlying collateral). The guidance also notes that the reliance on the sale of underlying equity interests or refinancing at maturity does not preclude the rebuttable position from being overcome, but 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 such, as reliance on sale or refinancing increases, the other factors need to be more compelling to overcome the rebuttable presumption. The revisions also detail the expected documentation based on characteristics (.e.g., diversified) and number of equity interests that collateralize the debt instrument.

The current draft of the principles-based bond definition also reflects the previously exposed change to revise "sufficient credit enhancement" with "substantive credit enhancement." The interested parties' comment letter dated Feb. 18, 2022, communicated support for the proposed refinements to the sufficient credit enhancement concepts. The interested parties believe the clear articulation of the intent of the required substantive credit enhancement provides for a more understandable and workable proposed bond definition. The interested parties also communicated support for the revised examples, where the new substantive credit enhancement concept has been incorporated. As a result of these comments, the previously exposed changes to reflect the "substantive credit enhancement" have been accepted in the current version.

Issue Paper Overview:

Along with the revised principles-based bond definition, a draft issue paper is presented for exposure. This issue paper details the discussions / decisions that have occurred as well as some intended applications of the principles-based bond definition. (For example, it details the application of the guidance to principal-protected notes and structured notes.) The issue paper does not currently include any proposed SSAP revisions. To ensure a deliberative

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process on all aspects of the definition, it was noted that it would be appropriate to expose the revised definition and the issue paper prior to exposing actual SSAP revisions.

The issue paper identifies that proposed revisions to SSAP No. 26R and SSAP No. 43R are expected to incorporate the bond definition and will ultimately be captured within the issue paper. Additionally, it identifies that guidance will be needed to address investments that do not qualify as bonds. The issue paper requests comments on the following aspects:

- Are there investments that will not qualify as bonds that should be considered for reporting on a different schedule than Schedule BA? Comments on key investment characteristics that would appropriately distinguish these investments are requested.

- For investments that are captured on Schedule BA, should consideration occur to permit an amortized cost approach rather than a lower of cost or fair value measurement method? For investments in which an amortized cost approach is supported, what characteristics can be used to identify / support this measurement method? Should use of NAIC designations be permitted to drive the Schedule BA measurement method for these securities?

Furthermore, revisions are also expected to SSAP No. 2R, to address the ABS restriction (as the issue paper proposes that ABS be restricted from reporting as short-term or cash equivalents), 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.

Recommendation – March 2, 2022

NAIC staff recommends that the Working Group expose the revised principles-based bond definition as well as the initial draft issue paper for a public comment period ending May 6, 2022.

The Working Group is recommended to direct NAIC staff to continue discussions on the bond definition, particularly with proposed reporting changes, and developing SSAP revisions for subsequent exposure.

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