

Statutory Issue Paper No. 156

Bonds

STATUS

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Common Area

SUMMARY OF ISSUE

1. The guidance within this issue paper introduces substantive revisions to *SSAP No. 26—Bonds* (SSAP No. 26) pursuant to the Statutory Accounting Principles (E) Working Group’s (Working Group) Investment Classification Project (introduced as agenda item 2013-36). The Investment Classification Project reflects a comprehensive review to address a variety of issues pertaining to definitions, measurement and overall scope of the investment SSAPs.
2. The substantive revisions to SSAP No. 26 (illustrated in Exhibit A) under the Investment Classification Project, detailed within this issue paper, reflect the following key elements:
 - a. Removes SVO-identified instruments (as defined in the SSAP) from the definition of a bond, and provides guidance for these instruments separately from bonds. Within this explicit section, specific guidance for SVO-identified instruments is provided, which includes a requirement for these instruments to be reported at fair value (using net asset value (NAV) as a practical expedient), unless the investment qualifies for, and the reporting entity elects, use of a documented systematic value approach.
 - b. Incorporates the definition of “security” within the definition of a bond, as well as definitions for non-bond, fixed-income instruments captured in the scope of SSAP No. 26. These changes include removal of the term “bank participations” with inclusion of guidance to reflect bank loans acquired through a participation, assignment or syndication.

DISCUSSION

3. This issue paper intends to provide information on discussions that occurred when considering revisions to SSAP No. 26 under the Investment Classification Project, as well as the adopted revisions.

SVO-Identified Investments

4. Statutory accounting principles (SAPs) have historically allowed certain fund investments noted by the Securities Valuation Office (SVO) (SVO-identified investments) to be reported as bonds within SSAP No. 26. The process to include these investments within the scope of SSAP No. 26 is supported by SVO assessments that the underlying elements of the specific SVO-identified investments are comparable to bonds; therefore these investments should be treated in a similar manner as bonds, with comparable risk-based capital (RBC) charges.
5. Discussion of these specific SVO-identified investments was specifically noted as part of the Investment Classification Project as the accounting and reporting concepts applicable to bonds cannot be directly applied to these equity/fund investments. The prior application of SSAP No. 26 to these

investments has resulted with various interpretations or adjustments in applying the accounting and reporting requirements, with inconsistencies in application across different reporting entities.

6. With the discussions involving these investments, the Working Group has considered:
 - a. Continued inclusion of SVO-identified investments within the scope of SSAP No. 26.
 - b. Accounting and reporting revisions for SVO-identified investments.
 - c. Limitations restricting optional accounting treatment for SVO-identified ETFs.

Inclusion of SVO-Identified Investments in SSAP No. 26

7. As part of the Investment Classification Project, the Working Group was originally presented with an option to require a “contractual amount of principle due” in order for an investment to be captured within SSAP No. 26. After discussing this proposal, the Working Group agreed to continue including specifically noted SVO-identified investments within the scope of SSAP No. 26. This continued inclusion was supported as the SVO-identified investments are required to have underlying debt characteristics, and/or limited potential for significant fluctuation or risk. Furthermore, the Working Group identified that small and medium-size insurers may rely on these investment structures to supplement their bond portfolio. It was noted by interested parties that by requiring these investments to be captured in a separate SSAP, the accounting, reporting and RBC impact may be punitive to small and medium-size insurers.

8. The SVO-identified investments captured within the scope of SSAP No. 26, as defined in the December 31, 2015, *Purposes and Procedures Manual of the NAIC Investment Analysis Office*, are limited to:

- a. *Bond Fund List*: This listing only includes bond mutual funds that maintain specific parameters, which includes a requirement to invest 100% of its total assets in U.S. government securities, class 1 bonds that are issued or guaranteed as to payment of principal and interest by agencies and instrumentalities of the U.S. government, and collateralized repurchase agreements. This fund is restricted from investing in specific investments (e.g., derivatives, specific bonds, and certain securities) and is required to maintain the highest market risk rating given by an NAIC credit rating provider (CRP) to a fund that invests in class 1 bonds.
- b. *Exchange-Traded Funds – Bonds*: The P&P Manual identifies a presumption that shares of an ETF are to be reported as common stock, consistent with *SSAP No. 30—Unaffiliated Common Stock* (SSAP No. 30). However, that common stock presumption can be overcome if the ETF has been issued under a U.S. SEC Exemptive Order and the SVO determines that the assets held in the ETF portfolio are predominately bonds (in the case of a bond ETF) or predominately preferred stock (in the case of a preferred stock ETF) and the ETF permits a daily “look-through” to its portfolio assets. The analysis also includes a review of the use of any other instruments to achieve the ETF’s stated investment strategy, investment constraints and any other relevant information. The overall NAIC designation is based on a risk-weighted methodology of the assets held by the ETF. The classification by the SVO as “debt-like” or “preferred-stock-like” reflects the fact that the fund does not, nor does it intend to, invest in common stock or any material holdings incompatible with debt-like or preferred-stock-like treatment. Any investment in common stock would result with the ETF no longer being eligible for treatment under SSAP No. 26 or on Schedule D – Part 1.

Reporting Revisions for SVO-Identified Investments

9. In reviewing the reporting guidelines for SVO-identified investments, the Working Group noted that ETFs and bond mutual funds have previously been reported with other bond investments classified as “industrial and miscellaneous” on Schedule D – Part 1 (Long-Term Bonds Owned December 31). This reporting structure has hindered the ability to quickly identify these items on the investment schedule, and has prevented implementation of verification procedures to ensure specific reporting provisions for these investments are applied. For example, SVO-identified bond ETFs are not permitted to be reported as “FE” (filing-exempt), but a significant portion of these ETFs were identified (in the 2013, 2014 and 2015 year-end financial statements) as being incorrectly reported as FE. After considering whether SVO-identified investments shall be reported on a new sub-schedule, or on a separate reporting line¹, the Working Group agreed to continue including SVO-identified investments on Schedule D – Part 1, but to request the Blanks (E) Working Group to incorporate new subcategories (reporting lines) to distinguish SVO-identified investments from other investments on Schedule D – Part 1. The Blanks (E) Working Group adopted revisions consistent with this request, and new reporting lines are effective year-end 2016.

10. With the decision to continue reporting the SVO-identified investments directly on Schedule D – Part 1, rather than a sub-schedule, the Working Group noted that specific reporting columns would continue to not be applicable for these investments. The Working Group noted that these columns include those pertaining to par value, stated interest rates and contractual maturity dates, as these concepts do not exist in the SVO-identified funds. The Working Group requested additional guidance to be included within the Annual Statement instructions to assist with the reporting of these investments.

Accounting Revisions for SVO-Identified Investments

11. After deciding to retain the SVO-identified investments within the scope of SSAP No. 26, a key element discussed was the measurement method for these investments. SSAP No. 26 requires an amortized cost or fair value measurement method depending on the NAIC designation for the investment (and whether the reporting entity is an AVR/IMR filer). As the SVO-identified investments are equity/fund investments, without a stated par value, interest rate or maturity date, the SVO-identified investments do not “amortize” in a manner similar to bonds or other fixed-income instruments. In reviewing the annual statement instructions, references implied use of original cost for the SVO-identified investments. The Working Group identified that original cost for these equity / fund investments is an unacceptable measurement method and agreed that revisions to the measurement method was necessary for these SVO-identified investments.

12. In the discussion identifying prior use of original / historic cost for these investments, the Working Group noted concerns that original / historic cost does not provide a proper presentation of assets available for policyholders, with at least one state identifying that such investments are required to be presented at fair value (or NAV) under their state investment laws. The Working Group also identified that original / historic cost is inconsistent with the concept of an “economic valuation” per Insurance Core Principle (ICP) 14, Valuation:

14.5.3 The historic cost of an asset or liability may not reflect a current prospective valuation of the future cash flows and may therefore not be consistent with the current economic valuation of other assets or liabilities. Historic cost generally does not reflect changes in value over time. However, amortised cost, which adjusts the historic cost of an asset or liability over time, may reliably reflect the value of future cash flows, when used in conjunction with an adequacy or impairment test.

13. With the Working Group determination that original / historic cost is not an acceptable measurement method for these investments under statutory accounting, the Working Group considered requiring fair value (or NAV as a practical expedient) for all SVO-identified investments, noting that fair

¹ This decision occurred in a separate agenda item (Ref #2015-45: ETF Reporting in Investment Schedules).

value was the most appropriate measurement method for these equity/fund investments. Although a fair value (NAV) method was identified as being consistent with U.S. GAAP, readily available, and the best representation of assets available for policyholders as of a reporting date, the Working Group received comments from small and medium-size insurers that requiring fair value, with fair value fluctuations recognized as unrealized gains and losses, could be punitive to those insurers.

14. Comments from small and medium-size insurers highlighted that they utilize SVO-identified bond ETFs to access the bond market at a lower cost than directly holding bonds. These commenters noted that with a requirement to hold ETFs at fair value (or NAV), and the recognition of unrealized gains and losses, the financial statements could reflect volatility from the fair value fluctuations. The potential for this volatility (particularly when conducting risk / investment projections) may cause small and medium-size insurers to liquidate these investments, based on their investment policy requirements, and incur greater investments costs in order to directly acquire bonds. The commenters also noted that it is more difficult for small and medium-size insurers to acquire high-quality bonds, particularly with the market changes after 2008 and the investment restraints placed on banks and mortgage firms. These commenters communicated that small and medium-size insurers have access to a lower inventory of available bonds, and these holdings are often opaque, illiquid and frequently reflect private placements and small-debt issuances.

15. After assessing the small and medium-size insurer perspective, the Working Group agreed to consider, as a special reporting-entity election, a different measurement method for the SVO-identified investments. In making this decision, the Working Group directed that the measurement method should not be referred to as an “amortized cost” measurement, nor should it be included with the general measurement guidance for bonds. The Working Group noted that the accounting provisions for these investments should not be construed as providing any exceptions to state investment laws, particularly state laws that require fair value (or NAV) for these investments, and state laws involving investment concentration limits.

16. In response to the direction from the Working Group, NAIC staff proposed that the optional measurement method for these investments be referred to as the “systematic value” to reflect the systematic recognition of cash flows from the underlying bond holdings. The guidance reflected within this issue paper incorporates the concept of this “systematic value” measurement method as well as revisions to capture guidance for the SVO-identified investments within a new section in SSAP No. 26. After further discussion of the systematic value approach, the Working Group will coordinate with the Blanks (E) Working Group to clarify the instructions for reporting these investments.

Application of Fair Value or Systematic Value

17. With the identification that fair value was the most appropriate measurement method for SVO-identified investments, and that several reporting entities (including some small and medium-size insurers) would prefer to use a fair value measurement method, the Working Group agreed that the statutory accounting guidance would require use of fair value (allowing NAV as a practical expedient) as the measurement method for SVO-identified investments after initial recognition unless the reporting entity elects to use a documented systematic approach to amortize or accrete the investment in a manner that represents expected cash flows from the underlying bond holdings (systematic value). This issue paper provides this election for all SVO-identified investments; however, it is anticipated that the systematic value measurement method may only be applied for SVO-identified bond ETFs.

18. In addition to specifically electing its use, the Working Group agreed that certain criteria must be met in order for the investment to be reflected using a systematic value measurement method:

- a. *NAIC Designation:* SVO-identified investment must have a qualifying NAIC designation of NAIC 1 to 5 for AVR filers, and NAIC 1 or 2 for non-AVR filers. These NAIC designations correspond with the ability to use amortized cost for bonds in SSAP No. 26.

Reporting entities holding SVO-identified investments that do not qualify based on NAIC designation would not be permitted to elect use of the systematic value method and would be required to report these investments at fair value (or NAV).

i. Pursuant to this project, it was identified that some reporting entities have previously concluded that SVO-identified bond ETF investments are always high-quality investments with an NAIC 1 or NAIC 2 designation. This is not an accurate conclusion. Inclusion on the SVO-identified bond ETF listing indicates that the investment meets the overall requirements in the P&P Manual. A separate process to review the credit-quality of the underlying ETF holdings determines the NAIC designation. The SVO-identified bond ETF investments, as of December 31, 2015, included several ETFs with NAIC designations below an NAIC 2, including investments with NAIC 4 designations. With the SVO designation process, these investments could be classified at any NAIC designation level, including an NAIC 6. With the guidance proposed in this issue paper, non-AVR filers holding an SVO-identified bond ETF investment with an NAIC 3 (or lower) designation would be required to report the investment at fair value (or NAV) and would not be permitted to utilize the systematic value method.

b. *Irrevocable Election:* Reporting entities must make an irrevocable election (by CUSIP) to use systematic value at the time the investment is originally acquired. This election shall remain as long as the investment (by CUSIP) is held (subject to other requirements). Subsequent acquisitions of the same ETF (by CUSIP), if the ETF is already held, are required to follow the same measurement method originally elected.

i. The Working Group considered requiring reporting entities to designate either “fair value” or “systematic value” for all SVO-identified investments they owned that were included on an SVO listing (e.g., same measurement method for all investments included on the SVO-identified ETF-bond listing). However, as the information (e.g., cash flows) to calculate systematic value may not be readily available for all investments on an SVO listing, the Working Group noted that by requiring a measurement method election for all such investments held, the guidance would inadvertently restrict the SVO-identified investments a reporting entity could utilize. (If a reporting entity had designated use of the systematic value method for investments on the SVO-identified bond ETF listing, then the reporting entity would be restricted in only acquiring SVO-identified bond ETFs from issuers that provide data necessary to calculate a systematic value method.) In order to prevent these inadvertent restrictions, the Working Group agreed that the measurement method could be determined on a CUSIP-by-CUSIP basis.

ii. With the requirement to designate the measurement method at the time of acquisition, the issue paper includes guidance allowing investments held by the reporting entity, which were originally acquired before inclusion on the SVO listing, to be measured using systematic value if the investment is subsequently added to the SVO list. This guidance specifies that the subsequent systematic value designation would be a change in accounting principle (as defined in *SSAP No. 3—Accounting Changes and Corrections of Errors* (SSAP No. 3)), and requires a cumulative effect adjustment to capital and surplus as if the accounting method had been applied for all prior periods in which the investment was held. As items may be added to the SVO listing without notification to all reporting entities that hold those investments provisions were included to allow a reporting entity to designate use of the systematic value before the year-end reporting of

the investment in the year in which the SVO first includes the investment on their listing. As an example, with this approach, an ETF investment already held by the reporting entity that was designated as qualifying as an SVO-identified ETF in February could be captured within SSAP No. 30 (reported on Schedule D – Part 2, Section 2) in the first three quarters and captured at systematic value as an SVO-identified bond ETF, within SSAP No. 26 (reported on Schedule D – Part 1), at year-end. If the reporting entity continued to report the ETF as common stock, or reported the investment at fair value on Schedule D – Part 1 in the year-end financial statements, then the reporting entity would not be permitted to subsequently designate use of systematic value for that ETF investment. *(Paragraph 18.b.iii. addresses situations in which the investment is no longer captured on the SVO-identified listing.)*

- iii. The guidance for an irrevocable election requires that if the reporting entity elects to utilize the systematic method, the reporting entity must continue use of that measurement method as long as the investment (CUSIP) is held by the reporting entity and the investment continues to be on the SVO listing with a qualifying NAIC designation.
 - (a) Regardless of the election by the reporting entity, if the investment is no longer included on the SVO listing, then the investment would no longer be captured within SSAP No. 26 and the investment would be reported in accordance with the measurement method stipulated within the applicable SSAP. (In the case of an ETF, if the investment is removed from the SVO-identified bond ETF listing, the ETF would be captured within SSAP No. 30 and reported at fair value.)
 - (b) If the SVO-identified investment was to decline in NAIC designation (to an NAIC designation that does not qualify for systematic value), but was retained on the SVO-identified listing (still within the scope of SSAP No. 26), systematic value would not be permitted and the investment would be required to be reported at the lower of fair value or systematic value. In these situations, if systematic value is lower than fair value, a reporting entity is prevented from increasing the value of the investment to fair value.
 - (c) If the issuer of the SVO-identified investment originally provided information to calculate systematic value, but did not provide necessary information for subsequent reporting periods, the SVO-identified investment would no longer qualify for reporting at systematic value. In these situations, reporting entities that had previously designated use of systematic value for these investments would be required to report the investment at the lower of fair value or the systematic value that was last calculated when the issuer provided the necessary information. A reporting entity is prohibited from increasing the value of the investment above the last calculated systematic value.
 - (d) Under the irrevocable election guidance, a reporting entity could sell an entire investment (all of a particular CUSIP), reacquire the same investment, and make an election to apply a different measurement method. (For example, if the reporting entity held an SVO-identified investment previously at fair value, the reporting entity could sell the investment, reacquire and designate use of systematic value. Conversely, if the reporting entity previously held the investment at systematic value,

the reporting entity could sell the ETF, reacquire and use fair value.) However, the Working Group has agreed to establish restrictions to prevent a change in measurement method in response to wash sales, and to prevent different measurement methods within an interim reporting period. As such, a change in measurement method is only permitted if the reacquisition occurs 90 days after the full-sale (complete elimination of the CUSIP) of the SVO-identified investment. If a reporting entity reacquires an investment prior to 90 days after it was fully sold/disposed, then the reporting entity shall follow the measurement method utilized prior to the sale.

- c. *Systematic Value Determination:* The guidance requires reporting entities to follow a standard approach in determining systematic value.
 - i. The guidance restricts all reporting entities to one standard approach (as opposed to multiple models) in determining systematic value for all SVO-identified investments a company elects to report at systematic value. Deviating from the standard systematic value approach would be considered a permitted practice requiring domiciliary state approval. At the time of original election for systematic value, if an issuer of an SVO-identified Investment does not provide information in order to determine systematic value using the standard approach (e.g., cash flow details for the underlying bonds), the reporting entity holding the investment must obtain a permitted practice allowing a different systematic value calculation, otherwise the SVO-identified investment would not be permitted to be designated for systematic value.
 - ii. After considering two separate methods, the Working Group agreed that the systematic value shall reflect an “aggregated cash flow” (ACF) method in which the cash flow streams from the individual bond holdings are aggregated into a single cash flow stream. This method, originally offered by BlackRock, is considered an “aggregated cash flow” (ACF) method in which the cash flow streams from the individual bond holdings are aggregated into a single cash flow stream. These cash flows are scaled such that, when equated with the market price at which the ETF was purchased or sold, an internal rate of return is calculated, representing the investor’s initial book yield for the ETF. Although the initial book yield is utilized to determine the current period effective yield, and the resulting adjustments to the ETF’s reported (systematic) value, the book yield is recalculated at least quarterly in order to adjust the investor’s book yield to reflect current cash flow projections of the current bond holdings within the ETF. Exhibit B to the SSAP illustrates the method.

19. The guidance in paragraph 18.c.i., supporting a single measurement approach for systematic value was incorporated after consideration of comments noting consistency concerns if different methods to calculate systematic value were permitted. This discussion also noted that without specifying a single approach, regulators would be required to assess different calculations as part of their review of statutory financial statements, and reporting entities would be compelled to initially obtain approval on systematic value calculations or risk that regulators would subsequently disallow or modify a company’s calculations. The use of a single method was originally noted as concerning, particularly if the issuer of SVO-identified ETFs does not publicly provide the information necessary to calculate a systematic value under the specified method, as it could inadvertently promote (or discourage) reporting entities from holding specific SVO-identified bond ETFs from certain issuers. However, after considering comments, the Working Group agreed to specify one particular method for determining systematic value.

20. The Working Group considered both the “BlackRock” approach (dated Sept. 6, 2016) and the net present value (NPV) approach suggested by the NAIC Investment Analysis Office (IAO) for calculating systematic value.

- a. As detailed in paragraph 18.c.ii., the BlackRock approach incorporates a process in which the “initial purchase yield” is subsequently adjusted based on the changes to the cash flow projections of the underlying bond holdings in an ETF. When reviewing this approach, the NAIC Investment Analysis Office (IAO) provided a referral response noting that they did not support this approach, but instead supported a constant purchase yield (CPY) approach utilizing net present value (NPV) of cash flows.
- b. For the approach initially preferred by the IAO, the NPV of underlying bond cash flows would be determined at initial acquisition, resulting with subsequent amortization/accretion being driven by the NPV change of future cash flows discounted at the initial CPY. In discussing NAIC IAO approach, it was identified that the reported value of ETFs would be more economically consistent with the fair value of the ETF, but would be inconsistent with how the fair value of a bond reacts in response to changing market conditions. This discussion identified that the NPV method would reflect declines in cash flow from impaired bonds more timely than BlackRock’s ACF method, however, it was noted that when other-than-temporary impairments have occurred, the investment should be recognized as OTTI (with a recognized realized loss), rather than an adjustment to the reported value through amortization/accretion.
- c. After further considering the two approaches, the NAIC IAO identified that both approaches have positive and negative attributes. They identified that the NPV approach is not as volatile as fair value, but it is sensitive to changes in the underlying cash flows generated by ETF investments regardless of their source. The NAIC IAO noted that the BlackRock systematic value approach is stable, but insensitive to significant changes in the underlying cash flows, such as a credit default event. As a result of further consideration, the NAIC IAO recommended that the Working Group consider combining the strength of the two methodologies to achieve the desired accounting stability, but to also identify when an other than temporary impairment (OTTI) has occurred. They noted that regularly examining changes in the NPV, both period-to-period and from the date of initial acquisition, along with change in the fair value through net asset value, the NAIC IAO believes that there would likely be sufficient information available to determine if an OTTI has occurred when the systematic value methodology was being applied. As a result of this recommendation, the Working Group adopted use of the BlackRock proposed systematic value method and incorporated corresponding revisions to the OTTI guidance to require assessments using the net present value of expected cash flows.

AVR/IMR for SVO-Identified Investments

21. With the provisions to continue including SVO-identified investments within the scope of SSAP No. 26, and to permit a “systematic value” measurement method, guidance has also been included to clarify that determination of IMR and AVR is based on the inclusion of these investments within scope of SSAP No. 26, and not the equity/fund nature of these investments. As such, the recognition of realized gains/losses through AVR/IMR from the sale or disposal of SVO-identified investments captured within scope of SSAP No. 26 would be consistent with the assessments completed for realized gains/losses recognized from the sale or disposal of bonds. (This would include utilization of the weighted-average life of the underlying bonds in an SVO-identified bond ETF for establishing the IMR amortization duration bucket.) Also consistent with existing SSAP No. 26 guidance, if there is a recognized other-than-temporary impairment for an SVO-identified investment, the credit-loss impairment is recognized through AVR and the interest-related impairment is recognized through IMR.

- a. In discussing the AVR/IMR allocation, it was identified that the underlying bonds within a SVO-identified bond ETF can be removed from the ETF by the issuer and this would not trigger an AVR/IMR impact as the ETF investment is still held by the reporting entity. Although this results with different AVR/IMR treatment than if the underlying bond had been held directly by the reporting entity (and not within an ETF), the guidance reflects coordination of AVR/IMR impacts in accordance with the recognition of realized gains/losses. As part of this discussion, it was also identified that a reporting entity cannot control whether underlying bonds within an SVO-identified bond ETF are removed from the ETF, and information on gains and losses from the sale/disposal of underlying bonds resulted in gains and losses is not currently provided to holders. (Holders receive annual information on the net gains or losses from changes in the underlying bonds.)

Other-Than-Temporary Impairment for SVO-Identified Investments

22. With the provisions allowing use of systematic value for SVO-identified investments, guidance has been included to clarify the requirements to assess and recognize impairment. For SVO-identified investments held at systematic value, the guidance requires assessment of other-than-temporary impairment in response to adverse changes in estimated cash flows.

- a. ETFs Reported at Systematic Value:
 - i. A decision to sell an SVO-identified investment that has a fair value less than systematic value results in an other-than-temporary impairment that shall be recognized.
 - ii. In situations in which an SVO-identified investment has a fair value that is less than systematic value, the reporting entity must assess for other-than-temporary impairment. For these investments, a key determinant, along with other impairment indicators in *INT 06-07—Definition of Phrase “Other Than Temporary”* (INT 06-07), shall be whether the net present value of the projected cash flows for the underlying bonds in the SVO-identified investment have materially² declined from the prior reporting period (most recent issued financial statements). In calculating the net present value of the projected cash flows for each reporting period, entities shall use a constant present value yield using the initial book yield at acquisition. Consistent with INT 06-07, a predefined threshold to determine whether the decline in projected cash flows (e.g., percentage change) shall result in an other than temporary impairment has not been set by the Working Group as exclusive reliance on such thresholds removes the ability of management to apply its judgement.
 - iii. Upon identification of an SVO-identified investment as OTTI, the reporting entity shall recognize a realized loss equal to the difference between systematic value and the current fair value. (Although the determination of OTTI is likely based on projected cash flows, the realized loss recognized for the OTTI is based on the difference between systematic value and fair value.) The fair value of the SVO-identified investment on the date of the OTTI shall become the new cost basis of the investment.

² The net present value of cash flows will decline in a declining interest rate environment. Reporting entities shall use judgment when assessing whether the decline in cash flows is related to a decline in interest rates or the result of a non-interest related decline, and determine whether the decline represents an OTTI pursuant to INT 06-07.

- iv. Subsequent to recognition of an OTTI, the SVO-identified investment is required to be reported at the lower of the then-current period systematic value or fair value. As the underlying bonds can be replaced within an ETF, it is possible for a subsequent period systematic value and fair value to recover above the fair value that existed at the time an OTTI was recognized. As such, the requirement for subsequent reporting at the lower of systematic value or fair value is intended to be a current period assessment. For example, in reporting periods after an OTTI, the systematic value for an SVO-identified investment may exceed the fair value at the time of the OTTI, but in no event shall the reported systematic value exceed the then-current period fair value. If current calculated systematic value is lower than the current fair value, systematic value is required.

	Fair Value	Systematic Value	Net Present Value (CPY) ³	Action
1/1/2017	100	100	100	Acquisition
3/30/2017	85	98	80	Impairment Assessment
3/30/2017 Recognize OTTI	85	85	80	OTTI - Realized Loss \$13 (SV of \$98 less FV of \$85) After OTTI, ETF is reported at \$85
12/31/2017	90	83	80	Report at Systematic Value
12/31/2018	90	87	80	Report at Systematic Value <i>(Amount Reported has Increased beyond amount at time of OTTI, but is below current-period FV)</i>
12/31/2019	87	89	80	Report at Fair Value <i>(FV is Lower than current-period SV)</i>

b. ETFs Reported at Fair Value:

- i. Impairment guidance for SVO-identified investments reported at fair value is consistent with impairment guidance for investments captured under SSAP No. 30. Pursuant to this guidance, realized losses are required to be recognized when a decline in fair value is considered to be other-than-temporary. Subsequent fluctuations in fair value shall be recorded as unrealized gains or losses. Future declines in fair value which are determined to be other than temporary shall be recorded as realized losses. A decision to sell an impaired security results with an other-than-temporary impairment that shall be recognized.

Systematic Value Disclosures

23. The guidance to allow a “systematic value” measurement method incorporates additional disclosures for reporting entities electing this measurement method. These disclosures include information on the approach for determining systematic value, whether the reporting entity consistently uses fair value or systematic value for all SVO-identified investments, whether any investments are being

³ Initial values were selected to be 100 for illustrative purposes. At the time of OTTI, the book yield is reset to the yield to maturity, i.e., the yield that equates the fair value (which is the value to which the asset is written down) to the expected future cash flows.

reported differently from the prior reporting period (such as if the investment was sold and re-acquired), and identification of the securities that no longer qualify for systematic value measurement method.

SSAP No. 26 Definitions

Security Definition

24. One of the initial elements discussed as part of the Investment Classification Project was the definition of a “bond” captured within SSAP No. 26, and the use of that definition to distinguish between unsecured loans or collateral loans captured within *SSAP No. 20—Nonadmitted Assets* (SSAP No. 20) or *SSAP No. 21—Other Admitted Assets* (SSAP No. 21): Per existing guidance in SSAP No. 26, paragraph 2:

2. Bonds shall be defined as any securities representing a creditor relationship, whereby there is a fixed schedule for one or more future payments.

25. With this definition, the main distinction in separating a bond, from another structure reflecting a creditor relationship with a fixed schedule for payments (such as an unsecured or collateral loan), was the requirement for the structure to be a “security.” Although the term “security” was defined in *SSAP No. 37—Mortgage Loans*, using the U.S. GAAP definition, the term was not defined in SSAP No. 26. After reviewing the U.S. GAAP definition, the Working Group agreed to include the U.S. GAAP definition for “security” within SSAP No. 26 to better clarify the overall bond definition:

This SSAP adopts the GAAP definition of a security as it is used in FASB Codification Topic 320 and 860: 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 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 either is one of a class or series or by its terms is divisible into a class or series of shares, participations, interests, or obligations.

26. With the discussion of the bond definition, the Working Group was informed of prior situations in which unsecured or collateral loans, within scope of SSAP No. 20 or SSAP No. 21, were reported as bonds on Schedule D – Part 1 (rather than on Schedule BA – Other Long-Term Invested Assets) based on an assessment that the loan had been rated by a credit rating provider (CRP) or had received an NAIC designation. The Working Group received information that the reporting of investments is intended to be based on the nature of the investment, and the guidance within the applicable SSAP, and there are no instances under statutory accounting in which obtaining a CRP rating or an NAIC designation would change an investment’s applicable SSAP, reporting schedule, or override other SSAP guidance that required the investment to be nonadmitted. For example, collateral loans are captured within SSAP No. 21, reported on Schedule BA, and are only admitted to the extent qualifying collateral is held to offset the loan balance. If the loan balance exceeds the amount of qualifying collateral held, the loan balance not covered by collateral is nonadmitted. A CRP rating or NAIC designation alone does not change the SSAP, reporting schedule, and potential nonadmittance of the investment. (With the SVO-identified listings, an investment is included on the SVO listing if it meets specific parameters. The NAIC designation, which is a secondary process after the investment qualifies for inclusion on an SVO listing, does not change the inclusion of the security on the SVO listing.)

27. With the structure, and provisions of the SVO, reporting entities can submit a variety of investment structures for credit-assessments and NAIC designations. The ability to obtain a credit assessment on an investment is not intended to be utilized as support for reclassification of the investment within scope of another SSAP or to report the investment on a different reporting schedule. NAIC designations are often utilized to determine the measurement method of investments within a particular SSAP (such as amortized cost, or lower of amortized cost or fair value), but as noted above, do not change the nature of the investment or the applicable SSAP the investment should be captured within.

28. In addition to incorporating the definition of a “security” within the bond definition, the Working Group also considered definitions for certain investments previously identified to be within scope of SSAP No. 26, or referenced in the annual statement instructions as general classifications for bonds.

29. After reviewing proposed definitions, revisions have been proposed to incorporate changes and definitions of specific terms in SSAP No. 26. These terms are proposed to be included in a SSAP No. 26 glossary, shown as Exhibit A in the issue paper. (The existing SSAP No. 26 Exhibit detailing Amortization Treatment for Callable Bonds would move to Exhibit C.)

30. *Bank Loans Acquired through a Participation, Syndication or Assignment:* Prior guidance in SSAP No. 26 included reference to the term “bank participations” as being within the bond definition. As a result of questions received on investments, the term “bank participations” has been deleted from SSAP No. 26, and instead specific guidance for bank loans has been proposed for inclusion:

Bank Loan – Fixed-income instruments, representing indebtedness of a borrower, made by a financial institution and acquired by a reporting entity through an assignment, participation or syndication:

- a. Assignment – A bank loan assignment is defined as a fixed-income instrument in which there is the sale and transfer of the rights and obligations of a lender (as assignor) under an existing loan agreement to a new lender (and as assignee) pursuant to an Assignment and Acceptance Agreement (or similar agreement) which effects a novation under contract law, so the new lender becomes the direct creditor of and is in contractual privity with the borrower having the sole right to enforce rights under the loan agreement.
- b. Participation – A bank loan participation is defined as a fixed-income investment in which a single lender makes a large loan to a borrower and subsequently transfers (sells) undivided interests in the loan to other entities. Transfers by the originating lender may take the legal form of either assignments or participations. The transfers are usually on a nonrecourse basis, and the originating lender continues to service the loan. The participating entity may or may not have the right to sell or transfer its participation during the term of the loan, depending on the terms of the participation agreement. Loan Participations can be made on a parri-passu basis (where each participant shares equally) or a senior subordinated basis (senior lenders get paid first and the subordinated participant gets paid if there are sufficient funds left to make a payment).
- c. Syndication – A bank loan syndication is defined as a fixed-income investment in which several lenders share in lending to a single borrower. Each lender loans a specific amount to the borrower and has the right to repayment from the borrower. Separate debt instruments exist between the debtor and the individual creditors participating in the syndication. Each lender in a syndication shall account for the amounts it is owed by the borrower. Repayments by the borrower may be made to a lead lender that then distributes the collections to the other lenders of the syndicate. In those circumstances, the lead lender is simply functioning as a servicer and shall not recognize the aggregate loan as an asset. A loan syndication arrangement may result in multiple loans to the same borrower by different lenders. Each of those loans is considered a separate instrument.

31. The inclusion of a bank loan acquired by an assignment was an additional element incorporated within the issue paper after the August 15, 2015, direction by the Working Group. This inclusion was requested by the Valuation of Securities (E) Task Force in a referral dated June 10, 2016.

32. Bank loans acquired through a participation may have restrictions preventing the reporting entity from selling or transferring its participation during the term of the loan. The Working Group considered whether these revisions should impact investment classification, and it was identified that the right to sell or transfer an investment should not be criteria that influences whether a fixed-income investment is considered a bank loan captured within SSAP No. 26. As such, the issue paper and proposed SSAP was revised to remove proposed guidance requiring the ability to sell / transfer bank loans in order to be captured within SSAP No. 26.

33. *Hybrid Securities:* Prior guidance in SSAP No. 26 did not specifically identify hybrid securities. Rather, guidance for hybrid securities were included in the annual statement instructions as guidance for “General Classifications Bond Only” as follows:

Securities whose proceeds are accorded some degree of equity treatment by one or more of the nationally recognized statistical rating organizations and/or which are recognized as regulatory capital by the issuer’s primary regulatory authority. Hybrid securities are designed with characteristics of debt and equity and are intended to provide protection to the issuer’s senior note holders. Hybrid securities products are sometimes referred to as coupon securities. Examples of hybrid securities include Trust Preferreds, Yankee Tier 1s (with and without coupon step-ups) and debt-equity hybrids (with and without mandatory triggers).

This specifically excludes surplus notes, which are reported in Schedule BA, subordinated debt issues, which have no coupon deferral features; and “traditional” preferred stocks, which are reported in Schedule D Part 2, Section 1. With respect to preferred stock, traditional preferred stocks include, but are not limited to a) U.S. issuers that do not allow tax deductibility for dividends; and b) those issued as preferred stock of the entity or an operating subsidiary, not through a trust or a special purpose vehicle.

34. After considering the definition from the annual statement instructions, revisions were proposed to incorporate a definition for “hybrids” in SSAP No. 26, comparable to the definition included within the instructions, removing all examples except for the reference to a “trust-preferred” security, which was noted as being commonly treated as a hybrid security for annual statement reporting. A definition for a “trust-preferred” based on the SEC definition, has also been included within SSAP No. 26. Consistent with the prior guidance in the annual statement instructions for hybrids, the guidance in SSAP No. 26 specifically excludes surplus notes, subordinated debt issues which have no coupon deferrals, and “traditional” preferred stocks. The following definition for hybrids is proposed for inclusion in the SSAP:

Hybrids – Securities whose proceeds are accorded some degree of equity treatment by one or more of the nationally recognized statistical rating organizations (NRSRO) and/or which are recognized as regulatory capital by the issuer’s primary regulatory authority. Hybrid securities are designed with characteristics of debt and equity and are intended to provide protection to the issuer’s senior note holders. Hybrid securities are sometimes referred to as capital securities. An example of a hybrid is a trust-preferred security. Excluded from bond classification are surplus notes, which are reported on Schedule BA; subordinated debt issues, which have no coupon deferral features; and “traditional” preferred stocks, which should be captured under SSAP No. 32—*Preferred Stocks*. Traditional preferred stocks include, but are not limited to: a) U.S. issuers that do not allow tax deductibility for dividends; and b) those issued as preferred stock of the entity of an operating subsidiary, not through a trust or a special purpose trust.

35. With the inclusion of the hybrid definition, and the example of trust-preferred securities, a definition for trust-preferred securities has also been proposed for inclusion within the SSAP:

Trust Preferred Securities – Security possessing characteristics of both equity and debt. A company creates trust-preferred securities by creating a trust, issuing debt to it, and then having it issue preferred securities to investors. Trust-preferred securities are generally issued by bank holding companies. The preferred securities issued by the trust are what are referred to as trust-preferred securities. The security is a hybrid security with characteristics of both subordinated debt and preferred stock in that it is generally very long term (30 years or more), allows early redemption by the issuer, makes periodic fixed or variable interest payments, and matures at face value. In addition, trust preferred securities issued by bank holding companies will usually allow the deferral of interest payments for up to 5 years.

36. Definitions were also proposed for inclusion in the SSAP No. 26 glossary to define convertible bonds, mandatory convertible bonds, Yankee bonds, and zero-coupon bonds, all of which are noted to be within scope of SSAP No. 26:

Convertible Bond – A bond that can be converted into a different security, typically shares of common stock.

Mandatory Convertible Bonds - A type of convertible bond that has a required conversion or redemption feature. Either on or before a contractual conversion date, the holder must convert the mandatory convertible bond into the underlying common stock.

Yankee Bonds – A bond denominated in U.S. dollars that is publicly issued in the U.S. by foreign banks and corporations. According to the Securities Act of 1933, these bonds must first be registered with the Securities and Exchange Commission (SEC) before they can be sold. Yankee bonds are often issued in tranches. Yankee bonds, or bonds issued by foreign entities denominated in U.S. dollars are not considered hybrid securities unless they have equity-like features.

Zero Coupon Bond – A bond that does not pay interest during the life of the bond. Instead, investors buy zero coupon bonds at a deep discount from their face value, which is the amount a bond will be worth when it "matures" or comes due. When a zero coupon bond matures, the investor will receive one lump sum equal to the initial investment plus the imputed interest, which is discussed below. The maturity dates on zero coupon bonds are usually long-term. Because zero coupon bonds pay no interest until maturity, their prices fluctuate more than other types of bonds in the secondary market. In addition, although no payments are made on zero coupon bonds until they mature, investors may still have to pay federal, state, and local income tax on the imputed or "phantom" interest that accrues each year.

37. With the inclusion of the definitions identified in paragraph 34, the following elements are particularly noted:

- a. *Mandatory Convertible Bonds* – The proposed definition replaces “mandatory convertible securities” with “mandatory convertible bonds” to clarify that only mandatory convertible bonds are within scope of SSAP No. 26. Revisions to *SSAP No. 32—Preferred Stock* (SSAP No. 32) will be subsequently considered to provide guidance for mandatory convertible preferred stock securities.
- b. *Yankee Bonds* – In the guidance within the annual statement instructions for hybrids, a reference to “Yankee Tier 1s” was included as an example hybrid security. In accordance with information received, Yankee bonds meet the definition of a bond within SSAP No. 26 and are not considered hybrids unless they have equity-like features.
- c. *Zero Coupon Bonds* – Definition was incorporated to clarify the inclusion of these bonds within scope of SSAP No. 26. This definition was based on the SEC definition.

Transition

38. Transition guidance has been included to specify initial application of the guidance. Different transition guidance is provided depending on the change that will be reflected:

- a. For SVO-Identified Investments Not Designated for Systematic Value: As the revisions move the prior measurement method (amortized cost / original cost) to fair value (NAV), at transition, the reporting entity only needs to record the investment at the new measurement method with recognition of the unrealized gain or loss (change from prior reporting value to current fair value). As fair value fluctuations occur, the measurement of the SVO-identified investments will continue to reflect an updated measurement, based on current fair value with unrealized gains or losses recognized. For these investments, there is no need to reflect a cumulative-effect adjustment. (Reporting entities that have previously reported these investments at fair value will have no change at transition.)
- b. For SVO-Identified Investments Designated for Systematic Value: As the revisions move the prior measurement method (fair value / original cost) to systematic value, which is a new measurement concept, the reporting entity shall begin calculating systematic value using the SVO-identified investments portfolio's aggregated cash flows (ACF) on January 1, 2018, and use the December 31, 2017, book/adjusted carrying value to calculate the initial book yield. This new measurement approach is a change in accounting principle pursuant to SSAP No. 3, and shall be disclosed under SSAP No. 3, however, a cumulative effect adjustment to capital and surplus is not anticipated as reporting entities will be applying the book/adjusted carrying value as of December 31, 2017, to the aggregated cash flows on January 1, 2018, to calculate initial book yield.
 - i. In accordance with the systematic value methodology, at the next reporting period date, the reporting entity shall amortize or accrete the carrying value by the difference between the effective interest using the initial book yield, and the distributions received, and shall recalculate the new effective book yield using the new carrying value and ACF as of the last day of the reporting period.
 - ii. For situations in which there is an interval of time between when a company purchases an investment and when the investment is designated as an SVO-identified Investment eligible for systematic value, the book yield should be calculated by equating the book/adjusted carrying value at that time to the ACF.
- c. As the necessary historical ACF data is not available for calculating the initial book yield at acquisition for the Net Present Value Constant Purchase Yield (NPV-CPY) method for impairment recognition, reporting entities shall use recently published yield-to-maturity (YTM) as their constant purchase yield to be applied for NPV-CPY impairment recognition. For December 31, 2017, reporting, in addition to identifying the SVO-identified investments designated for systematic value, reporting entities shall disclose the CPY for each SVO-identified investment for NPV-CPY impairment recognition going forward.
- d. For SSAP No. 26 Scope Revisions: If the revisions to SSAP No. 26 (e.g., definitions) results with an investment no longer qualifying (or qualifying) within the scope of SSAP No. 26, this change shall be reflected prospectively from the effective date. As such, investments previously included within SSAP No. 26, that will move into the scope of another SSAP and reporting schedule shall be shown as dispositions on Schedule D – Part 4, and shown as an acquisition on the schedule for which it should be reported. (If the revisions move the investment into the scope of SSAP No. 26, the investment would

be reported as a disposition on the prior investment schedule and as an acquisition on the Schedule D – Part 3.) The fair value of the investment as of the effective date shall be reflected as the new cost basis.

Effective Date

39. The adoption of this issue paper by the Statutory Accounting Principles (E) Working Group, and the substantively-revised statement of statutory accounting principles (SSAP) occurred on April 8, 2017. The substantive revisions to SSAP No. 26 are detailed in Exhibit A of this issue paper, and reflected in the substantively-revised *SSAP No. 26R—Bonds*. The effective date of the guidance is December 31, 2017, in accordance with the specific transition guidance established within the SSAP. Users of the *Accounting Practices & Procedures Manual* should note that issue papers are not represented in the Statutory Hierarchy (see Section IV of the Preamble) and therefore the conclusions reached in this issue paper should not be applied until the corresponding SSAP has been adopted by the Plenary of the NAIC.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

- *SSAP No. 26—Bonds*

EXHIBIT A – Substantive Revisions to SSAP No. 26—Bonds:**SCOPE OF STATEMENT**

1. This statement establishes statutory accounting principles for bonds, ~~excluding loan-backed and structured securities~~ specific fixed-income investments, and particular funds identified by the Securities Valuation Office (SVO) as qualifying for bond treatment as identified in this statement.

2. This statement excludes:

- a. Loan-backed and structured securities addressed in *SSAP No. 43R—Loan-Backed and Structured Securities*.
- b. Securities that meet the definition in paragraph 3 with a maturity date of one year or less from date of acquisition, which qualify as cash equivalents or short-term investments. These investments are addressed in *SSAP No. 2R—Cash, Cash Equivalents, Drafts and Short-Term Investments*.
- c. Mortgage loans and other real estate lending activities made in the ordinary course of business. These investments are addressed in *SSAP No. 37—Mortgage Loans* and *SSAP No. 39—Reverse Mortgages*.

SUMMARY CONCLUSION

~~2.3.~~ Bonds shall be defined as any securities¹ representing a creditor relationship, whereby there is a fixed schedule for one or more future payments. This definition includes:

- a. U.S. Treasury securities;^(INT 01-25)
- b. U.S. government agency securities;
- c. Municipal securities;
- d. Corporate bonds, including Yankee bonds and zero-coupon bonds;
- e. ~~Bank participations;~~
- f. Convertible debt bonds, including mandatory convertible debt bonds as defined in paragraph 4011.b;
- f. Fixed-income instruments specifically identified:

¹ This statement adopts the GAAP definition of a security as it is used in FASB Codification Topic 320 and 860.

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 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 either is one of a class or series or by its terms is divisible into a class or series of shares, participations, interests or obligations.

- 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 acquired through a participation, syndication or assignment;
 - iii. Hybrid securities, 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).^(INT 06-02)
- ~~g. Certificates of deposit that have a fixed schedule of payments and a maturity date in excess of one year from the date of acquisition;~~
 - ~~h. Commercial paper;~~
 - ~~i. Exchange Traded Funds, which qualify for bond treatment, as identified in Part Six, Section 2, of the *Purposes and Procedures Manual of the NAIC Investment Analysis Office*;~~
 - ~~j. Bond Mutual Funds, which qualify for bond treatment, as identified in Part Six, Section 2, of the *Purposes and Procedures Manual of the NAIC Investment Analysis Office*; and~~
 - ~~k. Money Market Mutual Funds on the U.S. Direct Obligations/Full Faith and Credit Exempt List as identified in Part Six, Section 2, of the *Purposes and Procedures Manual of the NAIC Investment Analysis Office*².~~

~~Loan-backed and structured securities meet this definition, but are excluded from the scope of this statement, and are addressed in *SSAP No. 43R—Loan Backed and Structured Securities*. Securities which meet the definition above, but have a maturity date of one year or less from the date of acquisition are addressed in *SSAP No. 2R—Cash, Cash Equivalents, Drafts and Short Term Investments*. Mortgage loans and other real estate lending activities made in the ordinary course of business meet the definition above, but are not addressed in this statement. These types of transactions are addressed in *SSAP No. 37—Mortgage Loans* and *SSAP No. 39—Reverse Mortgages*. Investments in a debt instrument of a certified capital company (CAPCO) shall be reported as a bond in accordance with *INT 06-02: Accounting and Reporting for Investments in a Certified Capital Company (CAPCO)*.~~

4. The definition of a bond, per paragraph 3, does not include equity/fund investments, such as mutual funds or exchange-traded funds. However, the following types of SVO-identified investments are provided special statutory accounting treatment and are included within the scope of this statement. These investments shall follow the guidance within this statement, as if they were bonds, unless different treatment is specifically identified in paragraphs 23-29.

- a. Exchange traded funds (ETFs), which qualify for bond treatment, as identified in Part Six, Section 2 of the *Purposes and Procedures Manual of the NAIC Investment Analysis Office*. (SVO-identified ETFs are reported on Schedule D – Part 1.)
- b. Bond mutual funds which qualify for the Bond List, as identified in Part Six, Section 2 of the *Purposes and Procedures Manual of the NAIC Investment Analysis Office*. (SVO-identified bond mutual funds are reported on Schedule D – Part 1.)

² For year-end 2016, and in the interim 2017 financial statements, money market mutual funds registered under the Investment Company Act of 1940 and regulated under rule 2a-7 of the Act are short term investments, whether they are accounted for under SSAP No. 26 or SSAP No. 30. Pursuant to SSAP No. 2R, effective December 31, 2017, money market mutual funds shall be reported as cash equivalents and valued at fair value (net asset value allowed as a practical expedient).

~~3.5.~~ Bonds Investments within the scope of this statement meet the definition of assets as defined in *SSAP No. 4—Assets and Nonadmitted Assets* and are admitted assets to the extent they conform to the requirements of this statement.

Acquisitions, Disposals and Sales Changes in Unrealized Gains and Losses

~~4.6.~~ A bond acquisition or disposal shall be recorded on the trade date, (not the settlement date), except for the acquisition of private placement bonds which shall be recorded on the funding date. At acquisition, bonds shall be reported at their cost, including brokerage and other related fees.

~~5.7.~~ For reporting entities required to maintain an Interest Maintenance Reserve (IMR), the accounting for realized capital gains and losses on sales of bonds shall be in accordance with *SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve* (SSAP No. 7). For reporting entities required to maintain an asset valuation reserve (AVR), the accounting for unrealized gains and losses shall be in accordance with SSAP No. 7

~~8.~~ For reporting entities not required to maintain an IMR, realized gains and losses on sales of bonds shall be reported as net realized capital gains or losses in the statement of income. For reporting entities not required to maintain an AVR, unrealized gains and losses shall be recorded as a direct credit or charge to unassigned funds (surplus).

Amortized Cost

~~6.9.~~ Amortization of bond premium or discount shall be calculated using the scientific (constant yield) interest method taking into consideration specified interest and principal provisions over the life of the bond^(INT 07-01). Bonds containing call provisions (where the issue can be called away from the reporting entity at the issuer's discretion), except "make-whole" call provisions, shall be amortized to the call or maturity value/date which produces the lowest asset value (yield-to-worst). Although the concept for yield-to-worst shall be followed for all callable bonds, make-whole call provisions, which allow the bond to be callable at any time, shall not be considered in determining the timeframe for amortizing bond premium or discount unless information is known by the reporting entity indicating that the issuer is expected to invoke the make-whole call provision.

Application of Yield-to-Worst

~~7.10.~~ For callable bonds³, the first call date after the lockout period, (or the date of acquisition if no lockout period exists), shall be used as the "effective date of maturity" for reporting in Schedule D, Part 1. Depending on the characteristics of the callable bonds, the yield-to-worst concept in paragraph ~~6.9~~ shall be applied as follows:

- a. For callable bonds with a lockout period, premium in excess of the next call price⁴ (subsequent to acquisition⁵ and lockout period) shall be amortized proportionally over the length of the lockout period. After each lockout period (if more than one), remaining premium shall be amortized to the call or maturity value/date which produces the lowest asset value.

³ Callable bonds within the scope of ~~this~~ paragraph ~~10~~ excludes bonds with make-whole call provisions unless information is known by the reporting entity indicating that the issuer is expected to invoke the make-whole call provision.

⁴ Reference to the "next call price" indicates that the reporting entity shall continuously review the call dates/prices to ensure that the amortization (and resulting BACV) follows the yield-to-worst concept throughout the time the reporting entity holds the bond.

⁵ The reporting entity shall only consider call dates/prices that occur after the reporting entity acquires the bond. If all of the call dates had expired prior to the reporting entity acquiring the bond, the reporting entity would consider the bond continuously callable without a lockout period.

- b. For callable bonds without a lockout period, the book adjusted carrying value (at the time of acquisition) of the callable bonds shall equal the lesser of the next call price (subsequent to acquisition) or cost. Remaining premium shall then be amortized to the call or maturity value/date which produces the lowest asset value.
- c. For callable bonds that do not have a stated call price, all premiums over par shall be immediately expensed. For callable bonds with a call price at par in advance of the maturity date, all premiums shall be amortized to the call date.

Balance Sheet Amount

~~8-11.~~ Bonds, as defined in paragraph 3, ~~except mandatory convertible securities addressed in paragraph 10,~~ shall be valued and reported in accordance with this statement, the *Purposes and Procedures Manual of the NAIC Investment Analysis Office*, and the designation assigned in the NAIC *Valuations of Securities* product prepared by the NAIC Securities Valuation Office (SVO).

- a. ~~Bonds, except for mandatory convertible bonds:~~ For reporting entities that maintain an Asset Valuation Reserve (AVR), the bonds shall be reported at amortized cost, except for those with an NAIC designation of 6, which shall be reported at the lower of amortized cost or fair value. For reporting entities that do not maintain an AVR, bonds that are designated highest-quality and high-quality (NAIC designations 1 and 2, respectively) shall be reported at amortized cost; ~~with all other bonds (NAIC designations 3 to 6) shall be reported at the lower of amortized cost or fair value.~~
- b. ~~Mandatory convertible bonds:~~ Mandatory convertible bonds are subject to special reporting instructions and are not assigned NAIC designations or unit prices by the SVO. The balance sheet amount for mandatory convertible bonds shall be reported at the lower of amortized cost or fair value during the period prior to conversion. This reporting method is not impacted by NAIC designation or information received from credit rating providers (CRPs). Upon conversion, these securities will be subject to the accounting guidance of the statement that reflects their revised characteristics. (For example, if converted to common stock, the security will be in scope of SSAP No. 30—Unaffiliated Common Stock (SSAP No. 30), if converted to preferred stock, the security will be in scope of SSAP No. 32—Preferred Stocks (SSAP No. 32).)

~~9-12.~~ The premium paid on a zero coupon convertible bond that produces a negative yield as a result of the value of a warrant exceeding the bond discount shall be written off immediately so that a negative yield is not produced. The full amount of the premium should be recorded as amortization within investment income on the date of purchase.

~~10.~~ ~~Mandatory convertible securities are defined as a type of convertible bond that has a required conversion or redemption feature. Either on or before a contractual conversion date, the holder must convert the mandatory convertible security into the underlying common stock. Mandatory convertible securities are subject to special reporting instructions and are therefore not assigned NAIC designations or unit prices by the SVO. The balance sheet amount for mandatory convertible securities shall be reported at the lower of amortized cost or fair value during the period prior to conversion. This reporting method is not impacted by NAIC designation or information received from credit rating providers (CRPs). Upon conversion, these securities will be subject to the accounting guidance of the statement that reflects their revised characteristics.~~

~~11.~~ For reporting entities required to maintain an AVR, the accounting for unrealized gains and losses shall be in accordance with *SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve* (SSAP No. 7). For reporting entities not required to maintain an AVR, unrealized gains and losses shall be recorded as a direct credit or charge to unassigned funds (surplus).

Impairment

~~12~~.13. An other-than-temporary^(INT 06-07) impairment shall be considered to have occurred if it is probable that the reporting entity will be unable to collect all amounts due according to the contractual terms of a debt security in effect at the date of acquisition. A decline in fair value which is other-than-temporary includes situations where a reporting entity has made a decision to sell a security prior to its maturity at an amount below its carrying value. If it is determined that a decline in the fair value of a bond is other-than-temporary, an impairment loss shall be recognized as a realized loss equal to the entire difference between the bond's carrying value and its fair value at the balance sheet date of the reporting period for which the assessment is made. The measurement of the impairment loss shall not include partial recoveries of fair value subsequent to the balance sheet date. For reporting entities required to maintain an AVR/IMR, the accounting for the entire amount of the realized capital loss shall be in accordance with *SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve*. Credit related other-than-temporary impairment losses shall be recorded through the AVR; interest related other-than-temporary impairment losses shall be recorded through the IMR.

~~13~~.14. In periods subsequent to the recognition of an other-than-temporary impairment loss for a bond, the reporting entity shall account for the other-than-temporarily impaired security as if the security had been purchased on the measurement date of the other-than-temporary impairment. The fair value of the bond on the measurement date shall become the new cost basis of the bond and the new cost basis shall not be adjusted for subsequent recoveries in fair value. The discount or reduced premium recorded for the security, based on the new cost basis, shall be amortized over the remaining life of the security in the prospective manner based on the amount and timing of future estimated cash flows. The security shall continue to be subject to impairment analysis for each subsequent reporting period. Future declines in fair value which are determined to be other-than temporary shall be recorded as realized losses.

Income

~~14~~.15. Interest income for any period consists of interest collected during the period, the change in the due and accrued interest between the beginning and end of the period as well as reductions for premium amortization and interest paid on acquisition of bonds, and the addition of discount accrual. In accordance with *SSAP No. 34—Investment Income Due and Accrued*, investment income shall be reduced for amounts which have been determined to be uncollectible. Contingent interest may be accrued if the applicable provisions of the underlying contract and the prerequisite conditions have been met.

~~15~~.16. A bond may provide for a prepayment penalty or acceleration fee in the event the bond is liquidated prior to its scheduled termination date. Such fees shall be reported as investment income when received.

~~16~~.17. The amount of prepayment penalty and/or acceleration fees to be reported as investment income shall be calculated as follows:

- a. The amount of investment income reported is equal to the total proceeds (consideration) received less the par value of the investment; and
- a. Any difference between the book adjusted carrying value (BACV) and the par value at the time of disposal shall be reported as realized capital gains and losses, subject to the authoritative literature in *SSAP No. 7*.

Origination Fees

~~17~~.18. Origination fees represent fees charged to the borrower in connection with the process of originating or restructuring a transaction such as the private placement of bonds. The fees include, but are not limited to, points, management, arrangement, placement, application, underwriting, and other fees

pursuant to such a transaction. Origination fees shall not be recorded until received in cash. Origination fees intended to compensate the reporting entity for interest rate risks (e.g., points), shall be amortized into income over the term of the bond consistent with paragraph 69 of this statement. Other origination fees shall be recorded as income upon receipt.

Origination, Acquisition, and Commitment Costs

~~18-19.~~ Costs related to origination when paid in the form of brokerage and other related fees shall be capitalized as part of the cost of the bond, consistent with paragraph 46 of this statement. All other costs, including internal costs or costs paid to an affiliated entity related to origination, purchase or commitment to purchase bonds shall be charged to expense when incurred.

Commitment Fees

~~19-20.~~ Commitment fees are fees paid to the reporting entity that obligate the reporting entity to make available funds for future borrowing under a specified condition. A fee paid to the reporting entity to obtain a commitment to make funds available at some time in the future, generally, is refundable only if the bond is issued. If the bond is not issued, then the fees shall be recorded as investment income by the reporting entity when the commitment expires.

~~20-21.~~ A fee paid to the reporting entity to obtain a commitment to be able to borrow funds at a specified rate and with specified terms quoted in the commitment agreement, generally, is not refundable unless the commitment is refused by the reporting entity. This type of fee shall be deferred, and amortization shall depend on whether or not the commitment is exercised. If the commitment is exercised, then the fee shall be amortized in accordance with paragraph 69 of this statement over the life of the bond as an adjustment to the investment income on the bond. If the commitment expires unexercised, the commitment fee shall be recognized in income on the commitment expiration date.

Exchanges and Conversions

~~21-22.~~ If a bond is exchanged or converted into other securities (including conversions of mandatory convertible securities addressed in paragraph ~~1011.b.~~), the fair value of the bond surrendered at the date of the exchange or conversion shall become the cost basis for the new securities with any gain or loss realized at the time of the exchange or conversion. However, if the fair value of the securities received in an exchange or conversion is more clearly evident than the fair value of the bond surrendered, then it shall become the cost basis for the new securities.

SVO-Identified Investments

23. SVO-identified investments, as discussed in paragraph 4, are captured within the scope of this statement for accounting and reporting⁶ purposes only. The inclusion of these investments within this statement is not intended to contradict state law regarding the classification of these investments and does not intend to provide exceptions to state investment limitations involving types of financial instruments (e.g., equity/fund interests), or with regards to concentration risk (e.g., issuer).

24. SVO-identified investments shall be initially reported at cost, including brokerage and other related fees. Subsequently, SVO-identified investments shall be reported at fair value,⁷ with changes in

⁶ With the inclusion of these SVO-identified investments in Schedule D, Part 1 or Schedule DA, specific guidelines are detailed in the annual statement instructions for reporting purposes.

⁷ For these investments, net asset value (NAV) is allowed as a practical expedient to fair value.

fair value recorded as unrealized gains or losses) unless the reporting entity has elected use⁸ of a documented systematic approach to amortize or accrete the investment in a manner that represents the expected cash flows from the underlying bond holdings. This special measurement approach is referred to as the “systematic value” measurement method and shall only be used for the SVO-identified investments within the scope of this statement.

25. Use of the systematic value for SVO-identified investments is limited as follows:

- a. Systematic value is only permitted to be designated as the measurement method for AVR filers acquiring qualifying investments that have an NAIC designation of 1 to 5, and for non-AVR filers acquiring qualifying investments with an NAIC designation of 1 or 2. SVO-identified investments that have an NAIC designation of 6 for AVR filers or 3-6 for non AVR filers shall be measured at fair value.
- b. Designated use of a systematic value is an irrevocable election per qualifying investment (by CUSIP) at the time investment is originally acquired.⁹ Investments owned prior to being identified by the SVO as a qualifying SSAP No. 26R investment are permitted to be subsequently designated to the systematic value measurement method. This designation shall be applied as a change in accounting principle pursuant to *SSAP No. 3—Accounting Changes and Corrections of Errors* (SSAP No. 3), which requires the reporting entity to recognize a cumulative effect to adjust capital and surplus as if the systematic value measurement method had been applied retroactively for all prior periods in which the investment was held. The election to use systematic value for investments shall be made before the year-end reporting of the investment in the year in which the SVO first identifies the investment as a qualifying SSAP No. 26R investment.
- c. Once designated for a particular investment, the systematic value measurement method must be retained as long as the qualifying investment is held by the reporting entity and the investment remains within the scope of this statement with an allowable NAIC designation per paragraph 25.a. Upon a full sale/disposal of an SVO-identified investment (elimination of the entire CUSIP investment), after 90 days the reporting entity can reacquire the SVO-identified investment and designate a different measurement method. If the reporting entity was to reacquire the same investment within 90 days after it was sold/disposed, the reporting entity must utilize the measurement method previously designated for the investment. Subsequent/additional purchases of the same SVO-identified investment (same CUSIP) already held by a reporting entity must follow the election previously made by the reporting entity. If an investment no longer qualifies for a systematic value measurement because the NAIC designation has declined, then the security must be subsequently reported at the lower of “systematic value” or fair value. If the security has been removed from the SVO-identified listings, and is no longer in scope of this statement, then the security shall be measured and reported in accordance with the applicable SSAP.

⁸ The election to use systematic value is not a permitted or prescribed practice as it is an accounting provision allowed within this SSAP. Similarly, this election does not override state statutes, and if a state does not permit reporting entities the election to use systematic value as the measurement method, this is also not considered a permitted or prescribed practice. SVO-identified investments reported at fair value (NAV) or systematic value, if in accordance with the provisions of this standard, are considered in line with SSAP No. 26 and do not require permitted or prescribed disclosures under *SSAP No. 1—Accounting Policies, Risks & Uncertainties and Other Disclosures*.

⁹ This guidance requires investments purchased in lots to follow the measurement method established at the time the investment was first acquired.

- d. Determination of the designated systematic value must follow the established¹⁰ approach, which is consistently applied for all equity/fund SVO-identified investments designated for a systematic value. In all situations, an approach that continuously reflects “original” or “historical cost” is not an acceptable measurement method. The designated approach shall result with systematic amortization or accretion of the equity/fund investment in a manner that represents the expected cash flows from the underlying bond holdings.

26. Income distributions received from SVO-identified investments (cash or shares) shall be reported as interest income in the period in which it is earned. For those SVO-identified investments where the systematic value method is applied, interest income shall be recognized based on the book yield applied to the carrying value each period, similar to bonds.

27. For reporting entities required to hold an IMR and AVR reserve, realized and unrealized gains and losses for the SVO-identified investments shall be consistent with bonds within the scope of this standard. With this guidance, recognition of gains/losses (and corresponding AVR/IMR impacts) will be based on the ETF, and not activity that occurs within the ETF (e.g., such as changes in the underlying bonds held within the ETF). Also consistent with the guidance for bonds, if there is a recognized other-than-temporary impairment for an SVO-identified investment, the credit-loss impairment is recognized through AVR and the interest-related impairment is recognized through IMR.

28. SVO-identified investments reported at systematic value shall recognize other-than-temporary impairments in accordance with the following guidance:

- a. A decision to sell an SVO-identified investment that has a fair value less than systematic value results in an other-than-temporary impairment that shall be recognized.
- b. In situations in which an SVO-identified investment has a fair value that is less than systematic value, the reporting entity must assess for other-than-temporary impairment. For these investments, a key determinant, along with other impairment indicators in *INT 06-07: Definition of Phrase “Other Than Temporary,”* (INT 06-07) shall be whether the net present value of the projected cash flows for the underlying bonds in the SVO-identified investment have materially¹¹ declined from the prior reporting period (most recent issued financial statements) or from the date of acquisition. In calculating the net present value of the projected cash flows for each reporting period, entities shall discount cash flows using a constant purchase yield, which is the initial book yield at acquisition¹². Consistent with INT 06-07, a predefined threshold to determine whether the decline in projected cash flows (e.g., percentage change) shall result in an other than temporary impairment has not been set, as exclusive reliance on such thresholds removes the ability of management to apply its judgement.
- c. Upon identification of an SVO-identified investment as OTTI, the reporting entity shall recognize a realized loss equal to the difference between systematic value and the current fair value. (Although the determination of OTTI is likely based on projected cash flows, the realized loss recognized for the OTTI is based on the difference between systematic value and fair value.) The fair value of the SVO-identified investment on the date of the OTTI shall become the new cost basis of the investment.

¹⁰ Exhibit B details the established systematic value approach.

¹¹ The net present value of cash flows will decline in a declining interest rate environment. Reporting entities shall use judgment when assessing whether the decline in cash flows is related to a decline in interest rates or the result of a non-interest related decline, and determine whether the decline represents an OTTI pursuant to INT 06-07.

¹² Transition guidance in paragraph 35 shall be followed for initial application and for investments that are designated as SVO-identified investments eligible for systematic value.

- d. Subsequent to recognition of an OTTI, the SVO-identified investment is required to be reported at the lower of the then-current period systematic value or fair value. As the underlying bonds can be replaced within an ETF, it is possible for a subsequent period systematic value and fair value to recover above the fair value that existed at the time an OTTI was recognized. As such, the requirement for subsequent reporting at the lower of systematic value or fair value is intended to be a current period assessment. For example, in reporting periods after an OTTI, the systematic value for an SVO-identified investment may exceed the fair value at the time of the OTTI, but in no event shall the reported systematic value exceed the then-current period fair value. If current calculated systematic value is lower than the current fair value, systematic value is required.

29. Impairment guidance for SVO-identified investments reported at fair value is consistent with impairment guidance for investments captured under SSAP No. 30. Pursuant to this guidance, realized losses are required to be recognized when a decline in fair value is considered to be other-than-temporary. Subsequent fluctuations in fair value shall be recorded as unrealized gains or losses. Future declines in fair value which are determined to be other-than-temporary shall be recorded as realized losses. A decision to sell an impaired security results with an other-than-temporary impairment that shall be recognized.

Disclosures

22-30. The financial statements shall include the following disclosures:

- a. Fair value in accordance with *SSAP No. 100R—Fair Value* (SSAP No. 100R);
- b. Concentrations of credit risk in accordance with *SSAP No. 27—Off-Balance-Sheet and Credit Risk Disclosures* (SSAP No. 27);
- c. The basis at which the bonds, mandatory convertible securities, and SVO-identified investments identified in paragraph 4, are stated;
- d. Amortization method; for bonds and mandatory convertible securities, and if elected by the reporting entity, SVO-identified securities per paragraph 24. If utilizing systematic value measurement method approach for SVO-identified investments, the reporting entity must include the following information:
 - i. Whether the reporting entity consistently utilizes the same measurement method for all SVO-identified investments¹³ (e.g., fair value or systematic value). If different measurement methods are used¹⁴, information on why the reporting entity has elected to use fair value for some SVO-identified investments and systematic value for others.
 - ii. Whether SVO-identified investments are being reported at a different measurement method from what was used in an earlier current-year interim and/or in a prior annual statement. (For example, if reported at systematic value prior to the sale, and then reacquired and reported at fair value.) This disclosure is required in all interim reporting periods and in the year-end financial statements for the year in which an SVO-identified investment has been

¹³ As identified in paragraph 25.d., the established approach must be followed for all investments designated to use the systematic value method. As such, this disclosure is limited to situations in which a reporting entity uses both fair value and systematic value for reported SVO-identified investments.

¹⁴ The guidance in this statement allows different measurement methods by qualifying investment (CUSIP), but it is anticipated that companies will generally utilize a consistent approach for all qualifying investments.

reacquired and reported using a different measurement method from what was previously used for the investment. (This disclosure is required regardless of the length of time between the sale/reacquisition of the investments, but is only required in the year in which the investment is reacquired.)

- iii. Identification of securities still held that no longer qualify for the systematic value method. This should separately identify those securities that are still within the scope of SSAP No. 26R and those that are being reported under a different SSAP.
- e. For each balance sheet presented, the book/adjusted carrying values, fair values, excess of book/carrying value over fair value or fair value over book/adjusted carrying values for each pertinent bond or assets receiving bond treatment, category reported in Annual Statement Schedule D – Bonds issued by:
 - i. U.S. Governments;
 - ii. All Other Governments;
 - iii. States, Territories and Possessions (Direct and Guaranteed);
 - iv. U.S. Political Subdivisions of States, Territories and Possessions (Direct and Guaranteed);
 - v. U.S. Special Revenue & Special Assessment Obligations and all Non-Guaranteed Obligations of Agencies and Authorities of Governments and Their Political Subdivisions;
 - vi. Industrial & Miscellaneous (Unaffiliated);
 - vii. Hybrid Securities;
 - viii. Parent, Subsidiaries and Affiliates;
- f. For the most recent balance sheet, the book/adjusted carrying values and the fair values of bonds and assets receiving bond treatment, reported in statutory Annual Statement Schedule D – Part 1A due:
 - i. In one year or less (including items without a maturity date which are payable on demand and in good standing);
 - ii. After one year through five years;
 - iii. After five years through ten years;
 - iv. After ten years (including items without a maturity date which are either not payable on demand or not in good standing);
- g. For each period for which results of operations are presented, the proceeds from sales of bonds and assets receiving bond treatment, reported in Annual Statement Schedule D – Bonds and gross realized gains and gross realized losses on such sales.
- h. For each balance sheet presented, all bonds in an unrealized loss position for which other-than-temporary declines in value have not been recognized,

- i. The aggregate amount of unrealized losses (that is, the amount by which cost or amortized cost exceeds fair value), and
 - ii. The aggregate related fair value of bonds with unrealized losses.
- i. The disclosures in paragraphs 2230.h.i. and 2230.h.ii. should be segregated by those bonds that have been in a continuous unrealized loss position for less than 12 months and those that have been in a continuous unrealized loss position for 12 months or longer using fair values determined in accordance with SSAP No. 100R.
 - j. As of the most recent balance sheet date presented, additional information should be included describing the general categories of information that the investor considered in reaching the conclusion that the impairments are not other-than-temporary.
 - k. When it is not practicable to estimate fair value in accordance with SSAP No. 100R, the investor should disclose the following additional information, if applicable, as of each date for which a statement of financial position is presented in its annual financial statements:
 - i. The aggregate carrying value of the investments not evaluated for impairment, and
 - ii. The circumstances that may have a significant adverse effect on the fair value.
 - l. Separately identify structured notes, on a CUSIP basis, with information by CUSIP for actual cost, fair value, book/adjusted carrying value, and whether the structured note is a mortgage-referenced security.¹⁵
 - m. For securities sold, redeemed or otherwise disposed as a result of a callable feature (including make whole call provisions), disclose the number of CUSIPs sold, disposed or otherwise redeemed and the aggregate amount of investment income generated as a result of a prepayment penalty and/or acceleration fee.

23-31. Refer to the Preamble for further discussion regarding disclosure requirements. The disclosures in paragraphs 2230.b., 2230.e., 2230.f., 2230.g., 2230.h., 2230.i., 2230.j. and 2230.k. shall be included in the annual audited statutory financial reports only.

Relevant Literature

24-32. This statement adopts *AICPA Statement of Position 90-11, Disclosure of Certain Information by Financial Institutions About Debt Securities Held as Assets*, and *AICPA Practice Bulletin No. 4, Accounting for Foreign Debt/Equity Swaps*. This statement also adopts *FASB Staff Position 115-1/124-1, The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments*, paragraph 16, with modification to be consistent with statutory language in the respective statutory accounting statements. This statement adopts the GAAP definition of “security” as it is used in FASB Codification Topic 320 and 860.

25-33. This statement rejects the GAAP guidance for debt securities, which is contained in *ASU 2016-01. Financial Instruments – Overall, FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities, FASB Statement No. 91, Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases, FASB Emerging Issues Task Force No. 89-18, Divestitures of Certain Investment Securities to an Unregulated Commonly*

¹⁵ Determination of a “structured note” and “mortgage-referenced security” for this disclosure shall follow the definitions adopted within the *Purposes and Procedures Manual of the NAIC Investment Analysis Office*.

Controlled Entity under FIRREA, and FASB Emerging Issues Task Force No. 96-10, Impact of Certain Transactions on Held-to-Maturity Classifications Under FASB Statement No. 115.

Effective Date and Transition

~~26-34.~~ This statement is effective for years beginning January 1, 2001. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with SSAP No. 3—*Accounting Changes and Corrections of Errors*. The guidance in paragraphs ~~12-13~~ and ~~13~~ 14 was previously included within SSAP No. 99—*Accounting for Securities Subsequent to an Other-Than-Temporary Impairment* (SSAP No. 99) and was effective for reporting periods beginning on January 1, 2009, and thereafter, with early adoption permitted. In 2010, the guidance from SSAP No. 99 was incorporated within the impacted standards, with SSAP No. 99 superseded. The original impairment guidance included in this standard, and the substantive revisions reflected in SSAP No. 99 are retained for historical purposes in Issue Paper No. 131. Guidance reflected in paragraph ~~9~~12, incorporated from *INT 02-05: Accounting for Zero Coupon Convertible Bonds*, was originally effective December 8, 2002. Guidance adopted in December 2013 clarifying the ‘yield-to-worst’ concept for bonds with make-whole call provisions is a nonsubstantive change initially effective January 1, 2014, unless the company has previously been following the guidance. (Companies that have previously been following the original intent, as clarified in the revisions, should not be impacted by these changes.) The guidance in paragraph ~~16-17~~ with respect to the calculation of investment income for prepayment penalty and/or acceleration fees is effective January 1, 2017, on a prospective basis and is required for interim and annual reporting periods thereafter. Early application is permitted.

35. In April 2017, substantive revisions, as detailed in Issue Paper No. 156, were adopted. These revisions, effective December 31, 2017, clarify the definition of a bond and what is in scope of the bond definition, as well as incorporate new guidance for SVO-identified investments identified as in scope of SSAP No. 26R, but that are not considered bonds. As of the effective date, reporting entities shall modify the measurement method for SVO-identified investments to reflect the guidance in the substantive revisions as follows:

- a. For SVO-identified investments captured within SSAP No. 26R and held by the reporting entity at the time of transition that will be reported at fair value (or NAV), the reporting entity shall reflect an unrealized gain or unrealized loss for the difference between the prior book/adjusted carrying value and fair value (NAV). Subsequently the investment shall continue to be reported at fair value (or NAV) with fair value fluctuations recorded as unrealized gains or losses, until the time of sale or recognition of an other-than-temporary impairment.
- b. For SVO-identified investments captured within SSAP No. 26R and held by the reporting entity at the time of transition for which the reporting entity elects use of the systematic value measurement method, as of December 31, 2017, the reporting entity shall identify the SVO-identified investment with a code in the Annual Statement Schedule D - Part 1 and continue reporting the investment using the measurement method utilized throughout 2017. As the revisions move the prior measurement method (fair value/original cost) to systematic value, which is a new measurement concept, the reporting entity shall begin calculating systematic value using the SVO-identified investments portfolio’s aggregated cash flows (ACF) on January 1, 2018, and use the December 31, 2017, book/adjusted carrying value to calculate the initial book yield. This new measurement approach is a change in accounting principle pursuant to SSAP No. 3, and shall be disclosed under SSAP No. 3. However, a cumulative effect adjustment to capital and surplus is not anticipated as reporting entities will be applying the book/adjusted carrying value as of December 31, 2017, to the aggregated cash flows on January 1, 2018, to calculate initial book yield.

- i. In accordance with the systematic value methodology, at the next reporting period date, the reporting entity shall amortize or accrete the carrying value by the difference between the effective interest using the initial book yield, and the distributions received, and shall recalculate the new effective book yield using the new carrying value and ACF as of the last day of the reporting period.
- ii. For situations in which there is an interval of time between when a company purchases an investment and when the investment is designated as an SVO-identified investment eligible for systematic value, the book yield should be calculated by equating the book/adjusted carrying value at that time to the ACF.
- c. As the necessary historical ACF data is not available for calculating the initial book yield at acquisition for the net present value constant purchase yield (NPV-CPY) method for impairment recognition, reporting entities shall use recently published yield-to-maturity (YTM) as their constant purchase yield to be applied for NPV-CPY impairment recognition. For December 31, 2017, reporting, in addition to identifying the SVO-identified investments designated for systematic value, reporting entities shall disclose the CPY for each SVO-identified investment for NPV-CPY impairment recognition going forward.
- d. For SSAP No. 26R Scope Revisions: If the revisions reflected in SSAP No. 26R (e.g., definitions) result with an investment no longer qualifying (or qualifying) within the scope of SSAP No. 26R, this change shall be reflected prospectively from the effective date. As such, investments previously included within SSAP No. 26, that will move within the scope of another SSAP and reporting schedule shall be shown as dispositions on Schedule D – Part 4, and shown as an acquisition on the schedule for which it will be subsequently reported. (If the revisions move the investment into the scope of SSAP No. 26R, the investment shall be reported as a disposition on the prior investment schedule and as an acquisition on the Schedule D – Part 3.)

REFERENCES

Other

- *Purposes and Procedures Manual of the NAIC Investment Analysis Office*
- NAIC Valuation of Securities product prepared by the Securities Valuation Office

Relevant Issue Papers

- *Issue Paper No. 26—Bonds, Excluding Loan-Backed and Structured Securities*
- *Issue Paper No. 131—Accounting for Certain Securities Subsequent to an Other-Than-Temporary Impairment*

(Note: Exhibit – Amortization Treatment for Callable Bonds is not included in the issue paper. This Exhibit was renamed to Exhibit C.)

EXHIBIT A – GLOSSARY

Bank Loan – Fixed-income instruments, representing indebtedness of a borrower, made by a financial institution and acquired by a reporting entity through an assignment, participation or syndication:

- **Assignment** – A bank loan assignment is defined as a fixed-income instrument in which there is the sale and transfer of the rights and obligations of a lender (as assignor) under an existing loan agreement to a new lender (and as assignee) pursuant to an Assignment and Acceptance Agreement (or similar agreement) which effects a novation under contract law, so the new lender becomes the direct creditor of and is in contractual privity with the borrower having the sole right to enforce rights under the loan agreement.
- **Participation** – A bank loan participation is defined as a fixed-income investment in which a single lender makes a large loan to a borrower and subsequently transfers (sells) undivided interests in the loan to other entities. Transfers by the originating lender may take the legal form of either assignments or participations. The transfers are usually on a nonrecourse basis, and the originating lender continues to service the loan. The participating entity may or may not have the right to sell or transfer its participation during the term of the loan, depending on the terms of the participation agreement. Loan Participations can be made on a parri-passu basis (where each participant shares equally) or a senior subordinated basis (senior lenders get paid first and the subordinated participant gets paid if there are sufficient funds left to make a payment).
- **Syndication** – A bank loan syndication is defined as a fixed-income investment in which several lenders share in lending to a single borrower. Each lender loans a specific amount to the borrower and has the right to repayment from the borrower. Separate debt instruments exist between the debtor and the individual creditors participating in the syndication. Each lender in a syndication shall account for the amounts it is owed by the borrower. Repayments by the borrower may be made to a lead lender that then distributes the collections to the other lenders of the syndicate. In those circumstances, the lead lender is simply functioning as a servicer and shall not recognize the aggregate loan as an asset. A loan syndication arrangement may result in multiple loans to the same borrower by different lenders. Each of those loans is considered a separate instrument.

Bond – Securities representing a creditor relationship, whereby there is a fixed schedule for one or more future payments.

Convertible Bond – A bond that can be converted into a different security, typically shares of common stock.

Hybrids – Securities whose proceeds are accorded some degree of equity treatment by one or more of the nationally recognized statistical rating organizations (NRSRO) and/or which are recognized as regulatory capital by the issuer's primary regulatory authority. Hybrid securities are designed with characteristics of debt and equity and are intended to provide protection to the issuer's senior note holders. Hybrid securities are sometimes referred to as capital securities. An example of a hybrid is a trust-preferred security. Excluded from bond classification are surplus notes, which are reported on BA; subordinated debt issues, which have no coupon deferral features; and "Traditional" preferred stocks, which should be captured under SSAP No. 32. Traditional preferred stocks include, but are not limited to a) U.S. issuers that do not allow tax deductibility for dividends; and b) those issued as preferred stock of the entity of an operating subsidiary, not through a trust or a special purpose trust.

Trust Preferred Securities – Security possessing characteristics of both equity and debt. A company creates trust-preferred securities by creating a trust, issuing debt to it, and then having it issue preferred securities to investors. Trust-preferred securities are generally issued by bank holding companies. The preferred securities issued by the trust are what are referred to as trust-preferred securities. The security is

a hybrid security with characteristics of both subordinated debt and preferred stock in that it is generally very long term (30 years or more), allows early redemption by the issuer, makes periodic fixed or variable interest payments, and matures at face value. In addition, trust preferred securities issued by bank holding companies will usually allow the deferral of interest payments for up to 5 years.

Mandatory Convertible Bonds - A type of convertible bond that has a required conversion or redemption feature. Either on or before a contractual conversion date, the holder must convert the mandatory convertible bond into the underlying common stock.

Security – Adopts the GAAP definition of a security as it is used in FASB Codification Topic 320 and 860: 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 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 either is one of a class or series or by its terms is divisible into a class or series of shares, participations, interests, or obligations.

Yankee Bonds – A bond denominated in U.S. dollars that is publicly issued in the U.S. by foreign banks and corporations. According to the Securities Act of 1933, these bonds must first be registered with the Securities and Exchange Commission (SEC) before they can be sold. Yankee bonds are often issued in tranches. Yankee bonds, or bonds issued by foreign entities denominated in U.S. dollars are not considered hybrid securities unless they have equity-like features.

Zero Coupon Bond – A bond that does not pay interest during the life of the bond. Instead, investors buy zero coupon bonds at a deep discount from their face value, which is the amount a bond will be worth when it "matures" or comes due. When a zero coupon bond matures, the investor will receive one lump sum equal to the initial investment plus the imputed interest, which is discussed below. The maturity dates on zero coupon bonds are usually long-term. Because zero coupon bonds pay no interest until maturity, their prices fluctuate more than other types of bonds in the secondary market. In addition, although no payments are made on zero coupon bonds until they mature, investors may still have to pay federal, state, and local income tax on the imputed or "phantom" interest that accrues each year.

EXHIBIT B – SYSTEMATIC VALUE CALCULATION

The established systematic value method is considered an “aggregated cash flow” (ACF) method in which the cash flow streams from the individual bond holdings are aggregated into a single cash flow stream. These cash flows are scaled such that, when equated with the market price at which the ETF was purchased or sold, an internal rate of return is calculated, representing the investor’s initial book yield for the ETF. Although the initial book yield is utilized to determine the current period effective yield, and the resulting adjustments to the ETF’s reported (systematic) value, the book yield is recalculated at least quarterly in order to adjust the investor’s book yield to reflect current cash flow projections of the current bond holdings within the ETF.

The following calculation shall be followed by reporting entities electing systematic value:

1. Download cash flows file from ETF provider website		
NAV:	\$115.07	(Official end of day NAV, found on ETF provider website)
"Maturity":	12/8/2027	=SUMPRODUCT(Cashflow Dates Column, Principal Column)/SUM(Principal Column)
When paid:	monthly	
"Par value":	2500	# shares purchased
Monthly Effective Interest:	\$0.40	= (Recalculated Effective Book Yield from prior month x Prior Month Ending Book Value /12)
Distribution:	\$0.34	Found on provider website
Net "amortization/accretion":	\$0.06	= (Monthly Effective Interest) - (Distribution)
Prior Month Ending Book Value:	\$115.35	
NPV "Constant Yield Method"	\$117.10	= XNPV (Initial Book Yield, Cashflow column, Cashflow Date column) / 1000000
Initial Book Yield	4.15%	
Book ("Systematic") Value:	\$115.41	= (Prior Period Ending Book Value) + (Net "amortization/accretion")
Expense Ratio	0.1500%	
Recalculated Effective Book yield:	4.1639%	=XIRR(cashflows column, Cashflow Date column, 0.05)

***Note:**

All formulas on the left are at a per share level (excepting "Par Value" which represents the number of shares purchased for this lot).

The resulting values calculated on the left are aggregated to reflect the total number of shares held on the previous tabs reflecting how one might populate Schedule D Part 1 with these values.

Additionally, the cash flows in the data file are based on 1 million shares. This was done in order to make the cash flows easier to observe and work with (i.e. at a single share level, cash flows would be at fractional dollar levels). Therefore, in order to calculate the yield, investors must multiply the price of the ETF by 1 million shares and then use that value as a cash outflow against the positive cash inflows from the bond portfolio in order to calculate the IRR.

CUSIP	ASOF DATE	CALL TYPE	CASHFLOW DATE	INTEREST	PRINCIPAL	CASHFLOW
<div style="display: flex; justify-content: space-between;"> <div style="width: 20%;">2. Insert a row in between the column headings and the cashflow data.</div> <div style="width: 20%;">3. Filter for "Call Type" WORST (click "Data" at the top of Excel sheet, then click "Filter" and click the new dropdown box in the "Call Type" cell and select only "WORST").</div> <div style="width: 20%;">4. Enter the date of the cashflow data file underneath cashflow date</div> <div style="width: 20%;">5. Under the column "Cashflow" enter the following formula in Excel: =(-Ending Book Value)*1000000</div> </div>						
			8/31/2015			(115,414,059.56)
"Ticker"	8/31/2015	WORST	9/8/2015	136538.564	81472.372	218010.937
"Ticker"	8/31/2015	WORST	9/9/2015	5990.106	0	5990.106
"Ticker"	8/31/2015	WORST	9/10/2015	9706.324	0	9706.324