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NAIC Provides Helpful Guidance on the Accounting Treatment for Insurance Company Investments in CRTs

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At its Summer National Meeting in Chicago (August 12-15, 2024), the NAIC announced important guidance relating to the statutory accounting treatment of insurance companies' investments in bank credit risk transfer ("CRT") transactions.

Under the guidance, which is in the form of a **Q&A**:

- Although the new principles-based bond definition (SSAP No. 26) refers to ABS as being repaid with cash flows produced by collateral "owned" by the issuer, "*[t]he term 'owned' as used for this purpose is not necessarily intended to align with a legal view of ownership, but rather, all economic value to which the creditor has recourse*."
- Although the new bond definition requires a "creditor relationship" which generally requires that interest and principal payments do not vary based on a "non-debt variable," "*an ABS Issuer that owns derivatives in the structures (such as a credit default swap or total return swap) that solely transfers the performance of the referenced pool into the ABS structure does not automatically disqualify ABS classification, but the assessment of derivatives within a structure must be closely considered*."

Although this guidance is not authoritative and remains subject to public comment and subsequent change, it is helpful in providing assurance that CRTs can qualify for bond treatment.

Some further background:

What is the new principles-base definition of "bond"?

- Under **SSAP No. 26**, which was issued on August 13, 2023, and takes effect on January 1, 2025, a bond is defined as: "any security representing a creditor relationship, whereby there is a fixed schedule for one or more future payments, and which qualifies as either an issuer credit obligation or an asset-backed security as described in this statement."
- New SSAP No. 26 is the culmination of a four-year project to develop a definition of "bond" that is principles-based and that focuses on substance, rather than legal form.

Why is it important to an insurance company that an investment be treated as a "bond" under statutory accounting principles ("SAP")?

- *Lower RBC Charge*. Bonds receive lower risk-based capital charges than other types of securities (*e.g.*, common stock). Risk-based capital charges for bonds held by insurance companies are based on the credit quality designation that the NAIC assigns.
- *Not Marked-to-Market*. Under SAP, bonds do not have to be marked to market on the insurance company's balance sheet. Rather, bonds are reported at amortized cost as long as they are above the lowest credit quality designation, NAIC-6.

What are statutory accounting principles (SAP)?

- Insurers authorized to do business in the United States and its territories are required to prepare statutory financial statements in accordance with **statutory accounting principles ("SAP")**, not generally-accepted accounting principles ("GAAP").

- SAP are detailed within the NAIC Accounting Practices and Procedures Manual ("AP&P Manual"). The AP&P Manual contains the Statements of Statutory Account Principles ("SSAPs").
- The Statutory Accounting Principles ("E") Working Group ("SAPWG") is responsible for developing and adopting revisions to the AP&P Manual. SAPWG is a working group of the Accounting Practices and Procedures ("E") Task Force, which is a task force that reports to the NAIC's **Financial Condition ("E") Committee**.

What is the NAIC?

- In the United States, insurance is regulated primarily at the state level. The **National Association of Insurance Commissioners ("NAIC")** plays a coordinating role. The NAIC is a standard setting organization governed by the chief insurance regulators from the 50 states, the District of Columbia, and five U.S. territories to coordinate regulation of multistate insurers.
- The NAIC delegates its work to various committees, including the Financial Condition ("E") Committee. That committee is the central forum and coordinator of solvency-related considerations of the NAIC relating to, among other things, accounting practices and procedures, and the valuation of securities.