Advisory
NAIC Bond Project

NAIC Bond Project – Principles-Based Bond Definition

Principles-based bond definition update

- New principles-based bond definition – emphasis on substance rather than legal form of the security
- Judgment required to assess whether a security meets the definition of a bond
- Determination of which annual statement schedule a security is reported on (e.g. Schedule D, Schedule BA, or other) is data driven, requiring underlying security information; potentially more challenging due to investment structure complexity which is believed to have accelerated in recent years
- Annual statement schedules being expanded to capture more granular information about investments (e.g., Schedule D will separate **issuer credit obligations** from **asset-backed securities (ABSs)**; expanded data categories for Schedule BA investments)
- Potential for reclassification of investments between SSAPs 26, 43, 21, and 2R means changes in classification, measurement, recognition, and admissibility; reclassification between Schedule D and Schedule BA likely means changes in RBC

Key Considerations

01 There were **no grandfathering provisions**, so all investments held as of January 1, 2025 will need to be evaluated under the revised definitions.

02 This is **not a one-time exercise**, as all new investments purchased after the transition date will be evaluated under the principles-based bond definition on a go forward basis.

03 Investments **designed and marketed only to insurance companies** to obtain favorable risk-based capital (RBC) treatment should be subject to careful consideration and evaluation.

04 Certain securities designed to have an **original maturity of less than one year** will no longer be allowed to be reported as short-term investments on Schedule E.

05 Investments involving **special purpose vehicles with separate debt and equity components** will need to be assessed to determine if the underlying equity risk can be overcome to classify the debt portion as a bond.

06 ABSs backed by **cash generating non-financial assets** require a meaningful level of cash flows test to determine if a sufficient level of cash flows (more than 50% as a practical expedient) are from sources other than sale or refinance of collateral.

07 All ABSs must have **substantive credit enhancement** to be classified as a bond, which may be more challenging to document for non-investment grade securities.

08 Investments impacted **may not be what you expect**, as some GNMA securities, municipal bonds, ESG bonds and corporate debt have non-debt variables such as inverted interest rates or multipliers similar to embedded derivatives and impact the scheduled principal and interest by more than a nominal amount.

09 **Residual interests** have an updated accounting model using either allowable effective yield method or cost recovery (as a practical expedient).

10 Investments reclassified from Schedule D-1 to Schedule BA will need to be **re-assessed for admissibility**.

Applying the Principles-Based Bond Definition

What is a bond under the new principles-based definition?

Issuer Credit Obligation (SSAP No. 26R/ Schedule D-1-1)

Asset-Backed Security (ABS) (SSAP No. 43/ Schedule D-1-2)

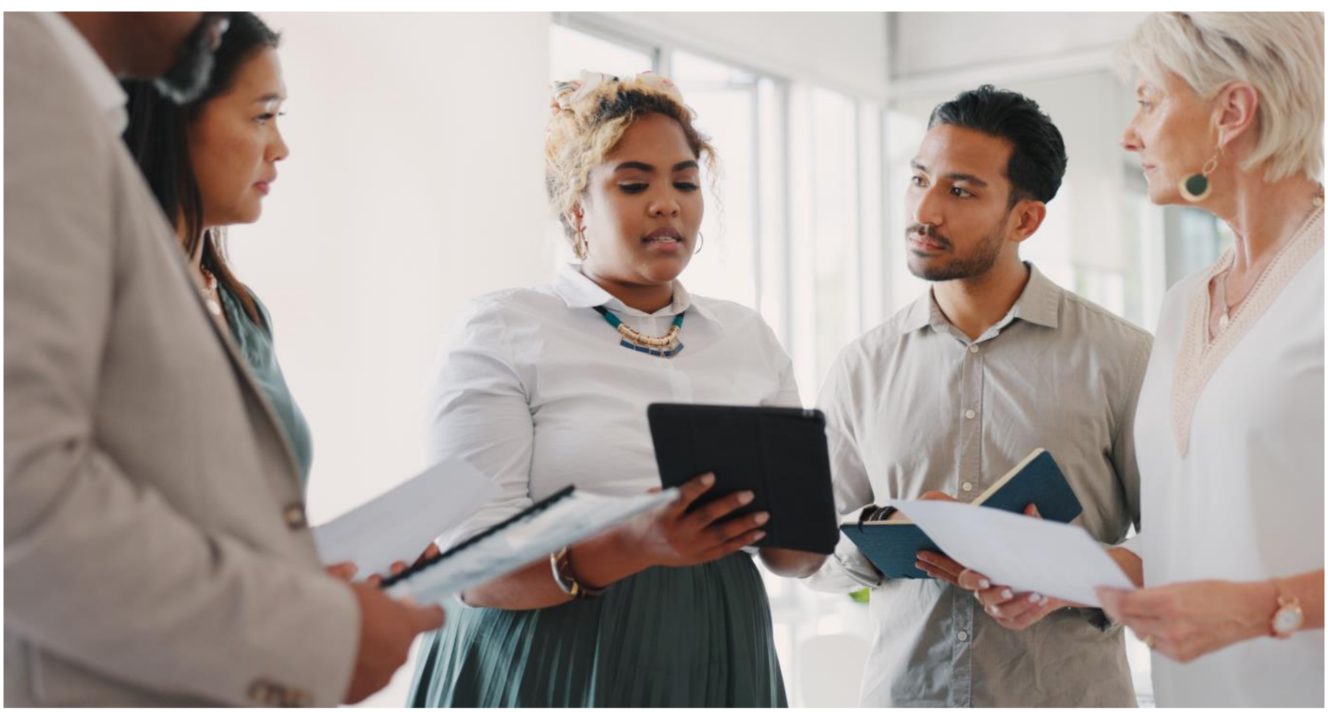
Underlying Assets (Financial assets)

Underlying Assets (Non-financial assets) - must generate **meaningful level of cash flows** to service the debt, other than through the sale or refinancing of the underlying assets held

The holder of debt instrument issued by ABS Issuer has to be in a different economic position than if the holder owned the ABS Issuer's assets directly, for example through **substantial credit enhancements** through guarantees, subordination and/or overcollateralization

Determination considers substance of the security not solely the legal form. And considers all investments the insurer owns in the investee as well as any other contractual agreements.

If the security does not meet principles-based definition of a bond – accounting under other appropriate SSAPs such as SSAP No. 21



Accounting change framework

KPMG point of view

Our approach tailors an industry-proven methodology with your current state of readiness across each business team to accelerate and drive efficiencies. We have a team of dedicated and qualified professionals ready to help you assess the impact of the new bond definition on your investment strategies, policies, capital management, and financial reporting.

Accounting, investments & reporting

- The NAIC's updates from the Bond Project have resulted in **substantial changes to the accounting for investments** and redefined the definition of a bond using a principles-based approach.
- Making the **"right" choice** means clearly defining the approach, outlining key accounting policy decisions, and revisiting these choices throughout the project.
- The standard requires a more granular assessment of securities considering their **substance rather than their form**.
- Ensure the **evaluation is done at the appropriate time** whether it be at origination of the investment or the date the investment is acquired by the Company.

Data, systems & processes

- Additional data points are needed to complete the assessment, particularly as it relates to testing for **meaningful level of cash flows,** assessing embedded features for **other than nominal impacts** to the scheduled cash flows, or evaluating **whether equity risks in a debt instrument can be overcome** for bond treatment.
- Companies need to develop processes for accumulating and storing all necessary data to support classification decisions both at transition and beyond. Companies will need to **centralize the collection of investment data** in a cost-efficient way.
- **Updates to existing recordkeeping systems** may be necessary to appropriately track and support decisions reached both at transition and moving forward.

Business implications

- The principles-based bond definition may result in Investments **reclassified between investment schedules** which could impact RBC charges, asset valuation reserve, and admissibility considerations.
- Investment strategies that have prioritized RBC treatment or have sought out opportunities to achieve RBC arbitrage will need to be **reconsidered and closely monitored and evaluated**.
- Additional implications are expected with **internal controls** and potential adjustment to **investment strategies and policies**.
- **Partnership with external service providers, particularly investment advisors or third party recordkeepers** to ensure availability of data and accuracy of reporting will be vital to successful implementation and ongoing compliance efforts.

Organizational change

- An appropriate **program structure** will drive decision-making, improve efficiency and help ensure accountability. Companies will need to **strike the right balance** between centralized and de-centralized structure to enable successful programs across all entities.
- A **roadmap** will help stakeholders understand the scope of the project, timing of activities, and provide a basis for detailed action plans.
- Appropriate **governance** (e.g., status update meetings, steering committee involvement and project risk management) are vital to the success of a large-scale accounting change implementation.

Assessment Approach – NAIC Bond Project

Scoping

- Identify inventory of investment securities
- Develop scoping phase project plan

Accounting Diagnostic

- Initial "quick assessment" to identify key impacts on accounting policy and disclosures

Document Reviews

- Validate diagnostic findings
- Sample basis
- Leverage contract types

Key Deliverables

- Workshop presentations
- Accounting Whitepapers
- Gap Assessment Report
- Contract Review Template
- More Accounting Whitepapers

Accounting Gaps

- Identify accounting gaps
- Feedback on management's accounting documentation

Data Requirements

- Identify types of information to meet accounting/disclosure requirements
- Determine information gaps

Broader Impact Evaluation

- Investment operations
- IT and Operations
- Capital planning
- Regulatory reporting
- Vendor management

Transition Options & Implementation Plan

- Assess transition impacts and design procedures to execute post implementation

Key Deliverables

- Final Assessment Report (e.g., technology impact assessment and key risk areas, broader organizational impact assessment)
- Deliver customized training based on assessment
- Implementation Roadmap

Contact us

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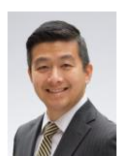

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