**Statutory Accounting Principles (E) Working Group**

**Maintenance Agenda Submission Form**

**Form A**

## **Issue:** VOSTF – Bank Loan Referral

**Check (applicable entity):**

 P/C Life Health

Modification of existing SSAP [x]  [x]  [x]

New Issue or SSAP [ ]  [ ]  [ ]

Interpretation [ ]  [ ]  [ ]

Description of Issue: This agenda item has been drafted to consider the June 2016 referral from the Valuation of Securities (E) Task Force pertaining to the guidance for bank loans in the *Purposes and Procedures Manual of the NAIC Investment Analysis Office.* The referral requests that the Working Group consider the proposed amendment to the P&P Manual. Although some aspects of the proposed amendment are consistent with key aspects of the definition of a bank loan in *SSAP No. 26R—Bonds*, the proposed details in the P&P Manual include specific structures that are identified as bank loans. The intent of this agenda item is to review and determine whether the example structures are consistent with the intent of the regulators on what should be captured in SSAP No. 26R. *(The referral is captured as an addendum to this Form A, with the key aspects captured below.)*

Part Two – Filing with the SVO

Section 1. General Definitions Used in This Manual

The following definitions are intended to have relevance only for this Manual. No suggestion is intended that these definitions have any relevance to any other NAIC publication.

**Bank Loan** means an Obligation that is a Term Loan or a Revolving Credit Facility (including a Borrowing Base Loan) made by a bank or non-bank financial institution and extended as a Bilateral Loan or as a Syndicated Loan including a Leveraged Loan and a DIP Financing, acquired by an insurer in a Syndication, by Assignment or as a Participation as each such capitalized term is defined below.

***Assignment*** means and refers to the sale and transfer of the rights and obligations of a lender (as assignor) under an existing loan agreement to an insurer as a new lender (and as assignee) pursuant to an Assignment and Acceptance Agreement which effects a novation under contract law so the insurer becomes the direct creditor of and is in contractual privity with the borrower having the sole right to enforce rights under the loan agreement.

***Bilateral Loan*** means a loan made by a bank or other financial institution between that lender and the borrower.

***Borrowing Base Loan*** means a Revolving Credit Facility where the amount borrowed is the lesser of a specified amount or the amount of a borrowing base comprised of eligible accounts receivable and eligible inventory of the borrower.

***DIP Financing*** means a loan made by a bank, other financial institution or by an insurer to a borrower that is a debtor-in-possession while the borrower is in bankruptcy made in reliance on a super-priority lien and other legal and collateral protections afforded the lender by bankruptcy rules and regulations under the U.S. Bankruptcy Code; as more particularly defined in Part Three, Section 3 of this Manual.

***Leveraged Loan*** means a loan made by a bank or other financial institution to borrowers assigned credit rating provider (CRP) credit ratings of BB/Ba or below or the NAIC Designation equivalent by the SVO.

***Participation*** means and refers to a sale of an interest in a loan by a lender to an insurer (the participant) pursuant to a Participation Agreement which places the insurer in a direct contractual relationship only with the lender who retains record title to the loan, remains liable to perform under the loan agreement and has the exclusive right to deal with and enforce remedies against the borrower and where the insurer does not become a party to or acquire the right to enforce the loan agreement.

***Revolving Credit Facility*** means a bank or other financial institution commitment to lend a specified maximum amount over which may be drawn at any time throughout the term of the loan and which provides for the re- borrowing of repaid amounts and is payable in one payment at the end of the term of the loan.

***Syndication***means and refers to a syndicate organized by a lead bank or other financial institution where other banks and financial institutions commit to lend a proportion of the total amount of money needed by the borrower by making separate loans to the borrower so the insurer and each other lender is in a direct contractual relationship to the borrower.

***Syndicated Loan***means a loan acquired by an insurer in a Syndication.

***Term Loan*** means a loan made by a bank or other financial institution providing the borrower an agreed upon amount over a defined time period with payment due at or by the end of the term where amounts borrowed and repaid cannot be reborrowed.

The following is the section pertaining to DIP Financing:

### d) DIP Financing

 (i) Definitional Attributes

DIP financings are post-petition loans made to a company that has filed for protection under Chapter 11 of the U.S. Bankruptcy Code (Code). A copy of the court order approving such financing must accompany loans made pursuant to Sections 364(b), (c) or (d) of the Code that are submitted to the SVO. The submission should also include a complete set of documentation pertaining to the loan and, if so requested by the SVO staff, a legal opinion or analysis of the DIP lender's status with regard to the debtor's pre-petition creditors.

(ii) General Methodology

When assessing the credit quality of a DIP Financing, the SVO shall assess: 1) the factors that led the debtor to file for bankruptcy and the challenges the debtor must meet to emerge from bankruptcy; 2) the structural elements of the financing; 3) the size of the DIP financing as a percentage of the debtor’s pre-petition debt; and 4) the collateral coverage for the DIP Financing.

 (iii) General Assessment Criteria

* The causes of the debtor’s filing and the challenges facing the debtor are assessed by reference to the debtor’s financial condition and capital structure prior to the filing, the viability of the debtor’s business model, the likelihood of emerging as a going concern and attracting financing to fully repay the DIP financing when the debtor emerges, and the potential for full repayment of the DIP Financing if the debtor is not successful in its reorganization.
* Structural elements of the DIP Financing include interest rates, repayment and prepayment terms, representations and warranties, covenants and events of default; whether the DIP Financing is advanced on the basis of eligible collateral or against attained milestones; the nature and extent of liens granted; collateral protection under first or second liens; the nature and mix of collateral; and whether collateral can be readily converted to cash.
* As a general principle, the smaller the DIP Financing in relation to prepetition debt, the less of a burden debt service is likely to be on the company during reorganization.
* The SVO shall assess collateral coverage on the basis of various sources of information to arrive at conservative collateral values based on asset quality and proximity to cash.

**Existing Authoritative Literature:**

*SSAP No. 26R—Bonds* provides the statutory accounting guidance for bonds, including what is captured in scope.

1. Bonds shall be defined as any securities representing a creditor relationship, whereby there is a fixed schedule for one or more future payments. This definition includes:
2. Fixed-income instruments specifically identified:

i. Certifications of deposit that have a fixed schedule of payments and a maturity date in excess of one year from the date of acquisition;

ii. **Bank loans issued directly by a reporting entity or 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)

The definition of a Bank Loan is captured in the glossary to SSAP No. 26R:

**Bank Loan** – Fixed-income instruments, representing indebtedness of a borrower, made by a financial institution. Bank loans can be issued directly by a reporting entity or acquired 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.

**SSAP No. 21—Other Admitted Assets** provides statutory accounting guidance for collateral loans, including provisions that must be met for admittance:

### Collateral Loans

1. Collateral loans are unconditional obligations for the payment of money secured by the pledge of an investment[[1]](#footnote-1) and meet the definition of assets as defined in SSAP No. 4, and are admitted assets to the extent they conform to the requirements of this statement. The outstanding principal balance on the loan and any related accrued interest shall be recorded as an admitted asset subject to the following limitations:
2. Loan Impairment—Determination as to the impairment of a collateral loan shall be based on current information and events. When it is considered probable that any portion of amounts due under the contractual terms of the loan will not be collected the loan is considered impaired. The impairment shall be measured based on the fair value of the collateral less estimated costs to obtain and sell the collateral. The difference between the net value of the collateral and the recorded asset shall be written off in accordance with *SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets* (SSAP No. 5R);
3. Nonadmitted Asset—In accordance with *SSAP No. 20—Nonadmitted Assets*, collateral loans secured by assets that do not qualify as investments shall be nonadmitted. Further, any amount of the loan outstanding which is in excess of the permitted relationship of fair value of the pledged investment to the collateral loan shall be treated as a nonadmitted asset.

**Information or issues (included in *Description of Issue*) not previously contemplated by the Working Group:** None.

Staff Recommendation:

NAIC staff recommends that the Working Group move this item to the active listing, classified as nonsubstantive, and expose this agenda item with a request of comments on the proposed referral response to the VOSTF. Particularly, this exposure requests comments on the staff recommendation not to include Borrowing Base Loans, DIP financing and Revolving Credit Facility in the P&P Manual as bank loans. As detailed below, NAIC staff has noted that borrowing base loans and DIP financing should be more appropriately classified as collateral loans, subject to the guidance in *SSAP No. 21—Other Admitted Assets*, rather than reported as a “bank loan” in scope of SSAP No. 26R. (NAIC staff identifies that an NAIC designation is currently not reported for collateral loans on Schedule BA.) Because of these differences in accounting classification, NAIC staff does not recommend expanding the recently adopted definition of bank loans in SSAP No. 26R (Agenda item 2013-36) to encompass items already included in SSAP No. 21.

To avoid confusion regarding the appropriate accounting treatment, NAIC staff recommends a referral response to the Task Force suggesting revisions to identify that the accounting and reporting of the noted investments shall follow the guidance in the AP&P Manual, which would classify the Borrowing Base Loan and DIP Financing as collateral loans. (It is noted that the proposed P&P Manual guidance indicates that the definitions are for the P&P Manual only, but NAIC staff notes that the reference to “bank loans” would imply that the structures are permitted within SSAP No. 26R.) NAIC staff notes that the proposed guidance for the P&P Manual should also be expanded to include “direct issuances” of bank loans to be consistent with the guidance adopted in SSAP No. 26R.

Key elements for discussion:

* Borrowing Base Loan – This loan appears to be a collateral loan backed by accounts receivable or inventory subject to the guidance in SSAP No. 21. Pursuant to that guidance, collateral loans secured by assets that do not qualify as investments shall be nonadmitted. Neither accounts receivable nor inventory would qualify as an investment that supports admittance under SSAP No. 21.

* DIP Financing – This loan has been made to a company in bankruptcy, which may also be supported by collateral. As payment of the loan would be contingent on the company emerging from a going concern and attracting financing to repay the DIP loan, it seems that this lending structure should be restricted to a “collateral loan” classification, as defined in SSAP No. 21, with admittance limited to the qualifying investments securing the loan.
* Revolving Credit Facility – This structure should be clarified to indicate that a commitment to provide lending is not an asset that can be recognized on the financial statements. Rather, only the actual loaned amount would be considered an asset that could be recognized.

Staff Review Completed by: Julie Gann – January 2018

Status:

On March 24, 2018, the Statutory Accounting Principles (E) Working Group moved this agenda item to the active listing, categorized as nonsubstantive, and exposed this agenda item with a request for comments on the proposed referral response to the Valuation of Securities (E) Task Force on its draft guidance for bank loans. This response suggests revisions to indicate that investments shall follow the guidance in the *Accounting Practices and Procedures Manual*, which would classify borrowing base loans and debtor in possession (DIP) financings as collateral loans.

On August 4, 2018, the Statutory Accounting Principles (E) Working Group deferred discussion of this agenda item and directed NAIC staff to conduct further analysis on borrowing base loans and debtor-in-possession financing.

On April 6, 2019, the Statutory Accounting Principles (E) Working Group exposed revisions to *SSAP No. 21—Other Admitted Assets*, as detailed below, to clarify that a security in scope of another SSAP does not get reclassified as a “collateral loan” because it is also secured with collateral. After considering comments on these proposed revisions, an assessment will occur on a referral response to the Valuation of Securities (E) Task Force. If these revisions are incorporated, it is anticipated that the referral response will request revisions to the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* to reference the guidance.

Collateral Loans

1. Collateral loans are unconditional obligationsFN for the payment of money secured by the pledge of an investment[[2]](#footnote-2)[1] and meet the definition of assets as defined in SSAP No. 4, and are admitted assets to the extent they conform to the requirements of this statement. The outstanding principal balance on the loan and any related accrued interest shall be recorded as an admitted asset subject to the following limitations:

a.          Loan Impairment—Determination as to the impairment of a collateral loan shall be based on current information and events. When it is considered probable that any portion of amounts due under the contractual terms of the loan will not be collected the loan is considered impaired. The impairment shall be measured based on the fair value of the collateral less estimated costs to obtain and sell the collateral. The difference between the net value of the collateral and the recorded asset shall be written off in accordance with *SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets* (SSAP No. 5R);

b.          Nonadmitted Asset—In accordance with *SSAP No. 20—Nonadmitted Assets*, collateral loans secured by assets that do not qualify as investments shall be nonadmitted. Further, any amount of the loan outstanding which is in excess of the permitted relationship of fair value of the pledged investment to the collateral loan shall be treated as a nonadmitted asset.

New Footnote: For purposes of determining a collateral loan in scope of this statement, a collateral loan does not include investment securities captured in scope of other statements. For example, SSAP No. 26R includes securities (as defined in that statement) representing a creditor relationship whereby there is a fixed schedule for one or more future payments. Securities captured in SSAP No. 26R that are also secured with collateral shall continue to be captured within scope of SSAP No. 26R.

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1. Investment defined as those assets listed in Section 3 of Appendix A-001: *Investments of Reporting Entities*. [↑](#footnote-ref-1)
2. [1] Investment defined as those assets listed in Section 3 of *Appendix A-001—Investments of Reporting Entities*. [↑](#footnote-ref-2)