Statutory Accounting Principles (E) Working Group

**Maintenance Agenda Submission Form**

**Form A**

## **Issue:** Affiliate Transactions

**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 revisions to statutory accounting principles to clarify “affiliate” reporting, when underlying investments continue to reflect “affiliate” transactions. Although this design could be constructed in a variety of ways, the following scenario provides a simple example:

* Reporting entity holds affiliated securities (e.g., bonds).
* Reporting entity transfers affiliated securities to “independent” trustee in a *SSAP No. 43R—Loan-backed and Structured Securities* arrangement.
* Reporting entity acquires securities issued from the SSAP No. 43R structure, backed by the affiliated securities held in the trust.
* With this design, instead of reporting affiliated investments, the reporting entity attempts to report an investment in an “independent” issuer, although the insurer continues to only have direct recourse against the affiliated assets held in trust. (Per SSAP No. 43R, the insurer only has direct recourse to the assets held in trust, and the sponsor may have no financial obligation for the security.)

Since it is likely not possible to detail the variety of ways investments could be repackaged to appear unrelated when affiliate risk is still held by the entity, this agenda item proposes the inclusion of principal concepts in *SSAP No. 25—Affiliates and Other Related Parties*. These concepts intend to highlight that despite the inclusion of an unrelated intermediary, transactions that involve affiliates, or risks of an affiliate (e.g., affiliate debt issuances) shall be reported as a related party transaction or an investment in an affiliate for statutory accounting principles.

Existing Authoritative Literature:

*SSAP No. 25—Affiliates and Other Related Parties*: This SSAP provides guidance for all transactions involving related parties and affiliates, regardless if the transaction would also be captured in a specific SSAP. As identified in this SSAP, related party transactions are subject to abuse, and require specialized accounting rules and increased regulatory scrutiny.

Activity to Date (issues previously addressed by the Working Group, Emerging Accounting Issues (E) Working Group, SEC, FASB, other State Departments of Insurance or other NAIC groups): Agenda item 2016-40: Definition of LBSS, was considered by the Statutory Accounting Principles (E) Working Group to improve the definition, and what is captured in scope, for loan-backed and structured securities. This agenda item was ultimately disposed without statutory accounting revisions. Disposal was supported by industry, as industry identified that the proposed definition and scope changes would likely result with unintended consequences and inconsistent application. With the action to dispose, the Working Group directed NAIC staff to research specific elements on the application of SSAP No. 43R and subsequently report findings so that the Working Group could consider whether clarifying revisions are necessary. Although that research is still pending, NAIC staff has been made aware of situations in which SSAP No. 43R structures have been used to circumvent affiliate reporting.

In response to the initial exposure (December 2016) of agenda item 2016-40 and the proposed revisions to SSAP No. 43R, comments from industry were received. Although these comments addressed several aspects, the comments specifically addressed the requirements of SSAP No. 25, and noted that industry was not aware of any abuse associated with SSAP No. 25 involving structured finance transactions:

Excerpt from the May 19, 2017 Interested Parties’ Comment letter:

We are aware that many insurers have engaged in related party transactions that involve structured finance securities over the past several years. Related party securitizations have been used by insurers for many important and substantive business reasons, such as to reduce risk for a specific insurance company, share risks among various insurance/non-insurance entities, and to provide related party insurance companies the opportunity to share in investment income for certain higher yielding assets. Additionally, related party securitizations have been entered into by insurers to transfer varied amounts of risk to outside third parties while at the same time spreading the risk among related party insurance and non-insurance entities. These transactions are substantive in that they have reduced risk and improved the related Risk-Based Capital for insurers. **We do not believe SAPWG’s intent was to prevent such transactions from occurring; rather, to prevent insurers from circumventing the guidance in SSAP No. 25 by entering into a related party transaction such as a structured finance transaction. We believe SSAP No. 25 is very clear about the requirements for related party transactions to be arm’s length and that inflation of surplus must be deferred, for example. We are not aware of any abuse associated with SSAP No. 25 when related to structured finance transactions. As a result, we do not believe additional guidance is necessary.**

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

**Convergence with International Financial Reporting Standards (IFRS):** Not applicable.

Staff Recommendation:

NAIC staff recommends that the Working Group move this item to the active listing, categorized as nonsubstantive, and expose revisions as follows:

1) Revisions to *SSAP No. 25—Affiliates and Other Related Parties* to clarify the continued application of SSAP No. 25, as well as an “affiliated” classification, when a transaction is in substance a related party transaction, even if there is a non-related intermediary.

2) Revisions to *SSAP No. 26R—Bonds*, *SSAP No. 32—Preferred Stock* and *SSAP No. 43R—Loan-backed and Structured Securities* to identify that investment transactions are subject to the principal provisions of SSAP No. 25.

In proposing these revisions, NAIC staff believes they are consistent with the industry comments received in May 2017 on the applicability of SSAP No. 25 for investments captured in scope of SSAP No. 43R. Furthermore, with the identification of situations that appear to circumvent the SSAP No. 25 provisions through the use of a SSAP No. 43R structure, it is appropriate to further clarify the guidance to prevent future occurrences.

Proposed Revisions to SSAP No. 25:

1. Related party transactions are subject to abuse because reporting entities may be induced to enter transactions that may not reflect economic realities or may not be fair and reasonable to the reporting entity or its policyholders. As such, related party transactions require specialized accounting rules and increased regulatory scrutiny. This statement establishes statutory accounting principles and disclosure requirements for related party transactions.

2. This statement shall be followed for all related party transactions even if the transaction is also governed by other statutory accounting principles. Furthermore, this statement shall be followed in all transactions which involve unrelated parties as intermediaries between related parties. In determining whether a transaction is a related party transaction, consideration shall be given to the substance of the agreement, and the parties whose actions or performance materially impact the insurance reporting entity under the transaction. For example, an investment acquired from a non-related intermediary, in which the investment return is predominantly contingent on the performance of a related party, shall be considered an affiliated investment. As a general principle, it is erroneous to conclude that the mere inclusion of a non-related intermediary eliminates the requirement to assess and properly identify the related party transaction in accordance with the provisions of this statement. It is also erroneous to conclude that the presence of non-related assets in a structure predominantly comprised of related party investments, eliminates the requirement to assess and identify the investment transaction as a related party / affiliated arrangement.

3. If a company receives the stock of an affiliated company as a capital contribution rather than through a purchase, the transaction shall be accounted for according to *SSAP No. 25—Affiliates and Other Related Parties* (SSAP No. 25)*, SSAP No. 95—Nonmonetary Transactions* (SSAP No. 95), or *SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities* (SSAP No. 97),based on the details of each transaction*.*  The statutory purchase method within *SSAP No. 68—Business Combinations* (SSAP No. 68) is not applicable for stock received as a capital contribution.

Proposed Revisions to *SSAP No. 26R—Bonds:*

5. Investments within the scope of this statement issued by a related party, or acquired through a related party transaction, are also subject to the provisions and disclosure requirements of *SSAP No. 25—Affiliates and Other Related Parties*. 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 and SSAP No. 25.

Proposed Revisions to *SSAP No. 32—Preferred Stock*

2. Investments in preferred stock of subsidiaries, controlled or affiliated entities, including preferred stock interests of certified capital companies (CAPCO) per *INT 06-02: Accounting and Reporting for Investments in a Certified Capital Company (CAPCO)* are included within the scope of this statement. In addition to the provisions of this statement, preferred stock investments in SCA are also subject to the provisions of SSAP No. 25 and SSAP No. 97.

9. Preferred stocks 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, SSAP No. 25 and SSAP No. 97.

Proposed Revisions to *SSAP No. 43R—Loan-backed and Structured Securities:*

1. Loan-backed securities are defined as securitized assets not included in structured securities, as defined below, for which the payment of interest and/or principal is directly proportional to the payments received by the issuer from the underlying assets, including but not limited to pass-through securities, lease-backed securities, and equipment trust certificates.
2. Structured securities are defined as loan-backed securities which have been divided into two or more classes for which the payment of interest and/or principal of any class of securities has been allocated in a manner which is not proportional to payments received by the issuer from the underlying assets.
3. Loan-backed securities are issued by special-purpose corporations or trusts (issuer) established by a sponsoring organization. The assets securing the loan-backed obligation are acquired by the issuer and pledged to an independent trustee until the issuer’s obligation has been fully satisfied. The investor only has direct recourse to the issuer’s assets, but may have secondary recourse to third parties through insurance or guarantee for repayment of the obligation. As a result, the sponsor and its other affiliates may have no financial obligation under the instrument, although one of those entities may retain the responsibility for servicing the underlying assets. Some sponsors do guarantee the performance of the underlying assets.
	1. In determining whether a loan-backed structured is an affiliated investment, consideration shall be given to the substance of the transaction, and the parties whose action or performance materially impacts the insurance reporting entity holding the security. For example, although a loan-backed security may be acquired from a non-related issuer, if the assets held in trust predominantlyFN reflect assets issued by affiliates of the insurance reporting entity, and the insurance reporting entity only has direct recourse to the assets held in trust, the transaction shall be considered an affiliated investment, and the transaction shall also subject to the accounting and reporting provisions in SSAP No. 25.

New Footnote: In applying this guidance, a reporting entity is not required to complete a detailed review of the assets held in trust to determine the extent, if any, the assets were issued by related parties. Rather, this guidance is a principle concept intended to prevent situations in which affiliated debt is knowingly captured in a SSAP No. 43R structure and recorded as a “non-affiliated” investment because of the involvement of a non-related trustee or SSAP No. 43R security issuer. As identified in SSAP No. 25, it is erroneous to conclude that the inclusion of a non-related intermediary, or the presence of non-related assets in a structure predominantly comprised of related party investments, eliminates the requirement to identify and assess the investment transaction as a related party / affiliated arrangement.

5. Investments within the scope of this statement are also subject to the provisions and disclosure requirements of *SSAP No. 25—Affiliates and Other Related Parties* if the SSAP No. 43R transaction is a related party / affiliated entity arrangementFN. Loan-backed and structured securities 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 and SSAP No. 25.

New Footnote: As discussed in paragraph 4a, a SSAP No. 43R security may still be considered a related party transaction even if the asset trustee or security issuer is a non-related party.

Proposed Revisions to *SSAP No. 48—Joint Ventures, Partnerships and Limited Liability Companies*

5. Investments in the ventures defined in paragraphs 2-4 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. Investments in joint ventures, partnerships, and limited liability companies shall be reported in Other Invested Assets in the financial statements.

6. Investments in these ventures, except for joint ventures, partnerships and limited liability companies with a minor ownership interestFN, shall be reported using an equity method as defined in *SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities* (SSAP No. 97), paragraphs 8.b.i. through 8.b.iv. A reporting entity whose shares of losses in a SSAP No. 48 entity exceeds its investment in the SSAP No. 48 entity shall disclose the information required by SSAP No. 97, paragraph 35.a.

New Footnote: With the identification of whether the reporting entity has a minor ownership interest, reporting entities must also identify whether the investment is an affiliate transaction. Pursuant to the concepts reflected in SSAP No. 25, consideration shall be given to the substance of the transaction, and the parties whose action or performance materially impacts the insurance reporting entity holding the security. For example, if the underlying assets within a SSAP No. 48 entity represent assets issued by an affiliate, then the SSAP No. 48 entity shall be considered an affiliate investment, with the transaction subject to the accounting and reporting provisions of SSAP No. 25. As identified in SSAP No. 25, it is erroneous to conclude that the inclusion of a non-related intermediary, or the presence of non-related assets in a structure predominantly comprised of related party investments, eliminates the requirement to identify and assess the investment transaction as a related party / affiliated arrangement.

Staff Review Completed by:

Julie Gann, NAIC Staff – December 2018

Status:

On April 6, 2019, the Statutory Accounting Principles (E) Working Group moved this item to the active listing, categorized as nonsubstantive, and exposed the above revisions to *SSAP No. 25—Affiliates and Other Related Parties, SSAP No. 26R—Bonds, SSAP No. 32—Preferred Stock, SSAP No. 43R—Loan-backed and Structured Securities,* and *SSAP No. 48—Joint Ventures, Partnerships and Limited Liability Companies* to clarify the application of SSAP No. 25, as well as an “affiliated” classification, when a transaction is in substance a related party transaction, even if the transaction is conducted through a non-related intermediary.

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