AllianceBernstein

When Is a Bond a Bond?

Applying the NAIC's Principles-Based Bond Definition Guidance

The NAIC's principles-based bond-definition guidance goes into effect January 1, 2025, so time is running short for insurers and asset managers to adapt. We've collaborated to develop a classification framework that leads our investment process, enabling investors to make timely decisions in an increasingly dynamic marketplace.

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Matthew Kearns
Portfolio Manager
Insurance Portfolio Management

Deanna Leighton
Lead Portfolio Manager
Insurance Portfolio Management

William Moretti
Lead Portfolio Manager
Public and Private
Structured Finance—Equitable

Rosemarie Albrizio
Lead Director
Account Policy—Equitable

Philip M. Slaughter
Head of Insurance and
Alternatives Accounting

Executive Summary

Working closely together, AB and Equitable have developed a framework and process for applying the NAIC's bond-classification guidance—retooling the investment process and strengthening integration from front to back office.

- Adopting the National Association of Insurance Commissioners' (NAIC's) principles-based bond-definition guidance is a major effort that requires both insurers and their asset managers to renovate their investment operations and processes.
- Time is running out—the new regulation goes into effect January 1, 2025, and insurers must classify their year-end 2024 investment portfolios to ensure compliance by day one.
- Making sound investment decisions requires a full understanding of an opportunity's investment implications—and under the guidance, its accounting implications.
- Bond investors are familiar with fundamental analysis for both public and private securities, but the guidance now requires a similar application of that mindset through a statutory accounting lens.
- Our approach to navigating the new requirements leverages relationships within AB and Equitable as well as with industry peers to better inform insights and cascade them throughout our organizations.
- We've developed a bond-classification framework that leads our investment process, providing investors and accountants with timely access to critical decision-making inputs—regardless of a security's complexity.

A Regulatory Approach to an Evolving Market

Adopting the NAIC's principles-based bond-definition guidance has proven to be among the most significant efforts for the insurance community since the NAIC codified statutory accounting principles in 2001. The guidance marks a major shift from the regulator's previous prescriptive approach. It places responsibility on insurers to assess a security's composition, focusing on the substance of an investment over its legal form, to substantiate whether it qualifies to be reported as a bond.

It takes a deep understanding of the NAIC's guidance to complete a classification and fulfill the associated reporting and documentation requirements. The concepts within these criteria are likely familiar to insurance investors, but applying them through the lens of the bond-definition guidance is a far more novel concept. To do this effectively, insurers and their asset-management partners must make significant renovations to their investment operations and processes.

Several motives underly the NAIC's guidance. Perhaps the most evident is the association's desire to address approaches to structuring securities that seek favorable capital treatment, which results in higher equity exposure on insurers' balance sheets. In seeking to curtail this activity, the NAIC hasn't been shy about broadcasting its desire for principles-based guidance and application. Such an approach brings a level of interpretation and subjectivity to any issue, and classifying investments through that lens is no different. It poses challenges—some controllable, others less so—based on an insurer's proximity to the development of the guidance and the insight it gains from partnering with peers in similar situations.

The insurance industry has been in active discussions with the NAIC in an effort to gain clarity on the association's guidance and develop an approach to applying the guidance that's as consistent as possible. These engagements have been productive, but it's challenging to reach consensus on such a large scale. Inevitably, different interpretations of the guidance and different approaches to applying it will be adopted across the industry, and these different approaches will ultimately face scrutiny from regulators. That's why it's vital for insurance investors to capitalize on this opportunity to develop sound processes and avoid challenges down the road.

Time is running out for insurance investors and asset managers to adapt to the new guidance. The regulation goes into effect January 1, 2025, and insurers must classify their year-end 2024 investment portfolios to ensure compliance by day one.

Determining When a Bond Is Really a Bond

A bond classification requires a security structure, a representation of a creditor relationship, and an attestation as to whether a security is an issuer credit obligation (ICO) or an asset-backed security (ABS).

Structure: The criteria for defining a security's structure will continue to follow the definitions based on generally accepted accounting principles (GAAP) in the US.

Creditor Relationship: When assessing whether a creditor relationship exists, only the substance of a security's structure matters—its legal form isn't relevant. For example, a security with equity-like characteristics or that represents an ownership interest in the issuer does not signify a creditor relationship.

The filing entity that owns the security can rebut this presumption only through significant analysis and by applying its own judgment. For example, a debt instrument could be a creditor relationship if the characteristics of the underlying equity interests produce predictable cash flows, and if the underlying equity risks have been redistributed throughout the capital structure.

For the characteristics of the underlying equity interests to support the transformation of equity risk to bond risk, the guidance requires that these characteristics reduce the inherent reliance on equity valuation risk. The greater the reliance of the debt instrument on the sale of underlying equity interests or refinancing at maturity, the more compelling other factors must be to overcome the presumption that there is not a creditor relationship.

DISPLAY 1: CLASSIFICATION STARTS WITH DEFINING A BOND AS AN ICO OR ABS

Example Security

Issuer Credit Obligation (ICO)

- Repayment is supported by the general creditworthiness of an operating entity or entities, consisting of direct or indirect recourse to those entities.
- There may be secondary recourse to collateral, but 100% of repayment must be derived from operating-entity cash flows.
- Reported on Schedule D-1-1

Asset-Backed Securities (ABS)

- A security issued by an entity created primarily to raise debt capital, backed by financial assets or cash-generating nonfinancial assets owned by the ABS issuer.
- Repayment is primarily derived from the cash flows associated with the underlying collateral.
- Reported on Schedule D-1-2

Financial ABS

- Primarily backed by self-liquidating collateral (i.e., loans)
- No future performance obligation outside of default risk that could impact the ability to generate cash flows to service debt
- Requires **substantive credit enhancement** for bond classification
- Reported on Schedule D-1-2

Nonfinancial ABS

- Primarily backed by non-self-liquidating collateral (i.e., leases)
- Depends on the completion of a performance obligation, including the sale of underlying collateral at maturity, before all cash flows are generated
- Requires both **substantive credit enhancement** and **meaningful cash flows** for bond classification
- Reported on Schedule D-1-2

For illustrative purposes only.

As of September 30, 2024 | **Source:** National Association of Insurance Commissioners (NAIC) and AllianceBernstein (AB)

ICO or ABS? Once it's determined that a security structure and a creditor relationship exist, the next question is which type of creditor relationship exists: Is it an ICO or an ABS? The answer (*Display 1*) focuses on the security's primary source of repayment and drives the reporting location on Schedule D. If a creditor relationship exists and a security meets the criteria for an ICO, an insurer can classify that security as a bond and report it on Schedule D-1-1.

If a security is an ABS, an evaluator must look through its structure at the underlying collateral to determine whether it's a financial or nonfinancial asset. Financial and nonfinancial ABS require overlapping, but separate, criteria to support their classification as bonds (*Display 2, page 3*). Nonfinancial ABS require both substantive credit enhancement and meaningful cash flows to be classifed as bonds; financial ABS only require substantive credit enhancement.

To substantiate these criteria, it's necessary to deeply understand security structures, repayment sources and expected collateral performance. Much of this analysis is inherent in the credit-underwriting process, but it's nonetheless essential to classify securities properly. This analysis may be familiar to bond investors with expertise in underwriting investments, but the scope and necessary timeliness within the trading lifecycle magnify the need to develop processes that emphasize scale.

DISPLAY 2: CRITERIA FOR FINANCIAL AND NONFINANCIAL ABS

Substantive Credit Enhancement

- The intent of the criteria requiring the investor to be in a different economic position than if they owned the underlying collateral directly
- Ensures sufficient economic substance exists to support the transformation of underlying collateral risk to bond risk
- Forms of credit enhancement can include subordination, guarantees, overcollateralization, etc.
- Required for all ABS

Meaningful Cash Flows

- Criteria intended to demonstrate that the nonfinancial assets underlying an ABS encompass a level of cash generation conducive to servicing bond-like cash flows
- Ensures that a meaningful level of cash flow exists for debt servicing, other than through the sale or refinancing of the underlying assets
- Attestable by either a practical expedient (100% of interest and less than 50% of principal reliant on sale or refinancing) or a full analysis of bond cash flows
- Only required for nonfinancial ABS

For illustrative purposes only.

As of September 30, 2024 | **Source:** NAIC and AB

Wanted: Transparency, Flexibility and Efficiency in Dynamic Markets

To make sound investment decisions, it's imperative to fully understand an investment's implications. In a traditional sense, this understanding includes factors such as risk-reward trade-offs and cash-flow profiles. But as the NAIC guidance reinforces, insurance investing also requires understanding accounting implications. With the bond-definition guidance now a critical driver of accounting treatment, fully transparent classifications are critical to the investment decision-making process for insurers.

Given the substantial size and scope of existing insurance portfolios, the average insurer is likely up to the task of classifying thousands, if not tens of thousands, of securities in accordance with the NAIC guidance. But that's only the first step: starting January 1, 2025, insurers will need to classify each new investment and maintain enough documentation to support their classifications. The processes for doing this will need to be flexible enough to adapt to the innovative, changeable nature of financial markets. What asset classes will be hot tomorrow? What new structures will arise?

Collateralized loan obligations (CLOs), for instance, are healthy allocations in insurance portfolios today, but were once uncharted territory for insurance investors. Inevitably, the market's next iteration of financial engineering will become as commonplace for insurers as CLOs are today. An insurer's ability to take advantage of that next new opportunity will be as contingent on understanding and applying the bond-definition guidance as it is on understanding and applying any other part of the investment process. Thus, as insurers begin to contemplate the bond-definition guidance, it is not only critical to develop processes that can address the state of financial markets today, but also adjust to the opportunities of tomorrow.

Under the Hood: Viewing Fundamental Analysis Through a Statutory Accounting Lens

The NAIC's bond-definition guidance requires insurance investors to assess every security in their universe, regardless of where a security sits on the continuum, from plain vanilla to highly esoteric. Even securities that seem straightforward on the surface may have intricate underlying structures that influence their classification.

Some bond market veterans may feel confident in saying that a security is a bond "because it's a bond." But in the new world the NAIC has created, the precedent supporting that judgment will be replaced by in-depth fundamental analysis. And although bond investors are certainly no stranger to fundamental analysis for both public and private securities, the guidance breaks new ground in requiring a similar application of that mindset viewed through a statutory accounting lens.

Many public securities benefit from readily available reference data to aid classification, but not all public—or private—securities have such data available. Still, the NAIC's guidance applies to all investments, regardless of a manager's ability to access the required data. That means investment managers must establish and maintain strong controls and coordination across their investment and accounting teams. Without them, they may struggle to satisfy the bond-definition requirements—and to capitalize on investment opportunities.

More than ever, teamwork is essential to bolstering insurers' investment processes, and we think integrating expertise in fundamental analysis and statutory accounting should be the first step. We brought together experts in these disciplines from both insurance and asset-management groups to work through the NAIC's evolving classification guidance. In the process, we gained insight into a variety of security types—from cost-recovery bonds to sports-related private placements, and from credit-linked notes to diamond ABS. And we developed workflows flexible enough to account for their idiosyncrasies.

A New Dimension of Front- to Back-Office Integration

To effectively integrate the NAIC's principles-based guidance into the investment process, it's essential for insurers to equip themselves with a sizable toolkit to do the heavy lifting. By fortifying the investment process, investment teams should be better able to stay in front of market opportunities.

Insurance investors are used to dealing with big numbers: expansive portfolios, heavy transaction volumes to satisfy investment objectives, and the plethora of data points needed to inform decisions. Making sense of all these numbers demands deeply integrated front-, middle- and back-office functions, empowering investors to leverage operational integrity as they navigate markets.

In a traditional sense, this integration is driven by the timely and efficient transmission of quantitative information. Yet, there's much less precedent for transmitting the type of qualitative data points that stem from the subjective answers to the nuanced questions inherent in the bond-definition guidance. This underscores the need for insurers and their asset-manager partners to adapt. Specifically, they need to extend the established pillars of their vertical integration to a broader audience and institute the ability to transmit the subjective, qualitative information required to support the bond-definition guidance.

AB and Equitable: A Collaborative Effort to Revamp Processes

Our approach to navigating the new bond-definition requirements starts with leveraging the relationships within AB and Equitable as well as with our industry peers to ensure that our collective insights are better informed and cascade throughout our organizations.

A key part of this effort has been our involvement in a variety of industry working groups. These engagements give our accounting and investment professionals the real-time transparency they need to adapt to the guidance's evolving nature. With this input, we've developed a robust toolkit of expertise, processes and controls that we believe strongly positions us to satisfy the bond-definition requirements. This toolkit capitalizes on the deep, familiar relationships across the investment and accounting teams that back our operational integration, but it also extends that integration to a group that's essential to the investment process but until now was removed from statutory-accounting practices—fundamental research.

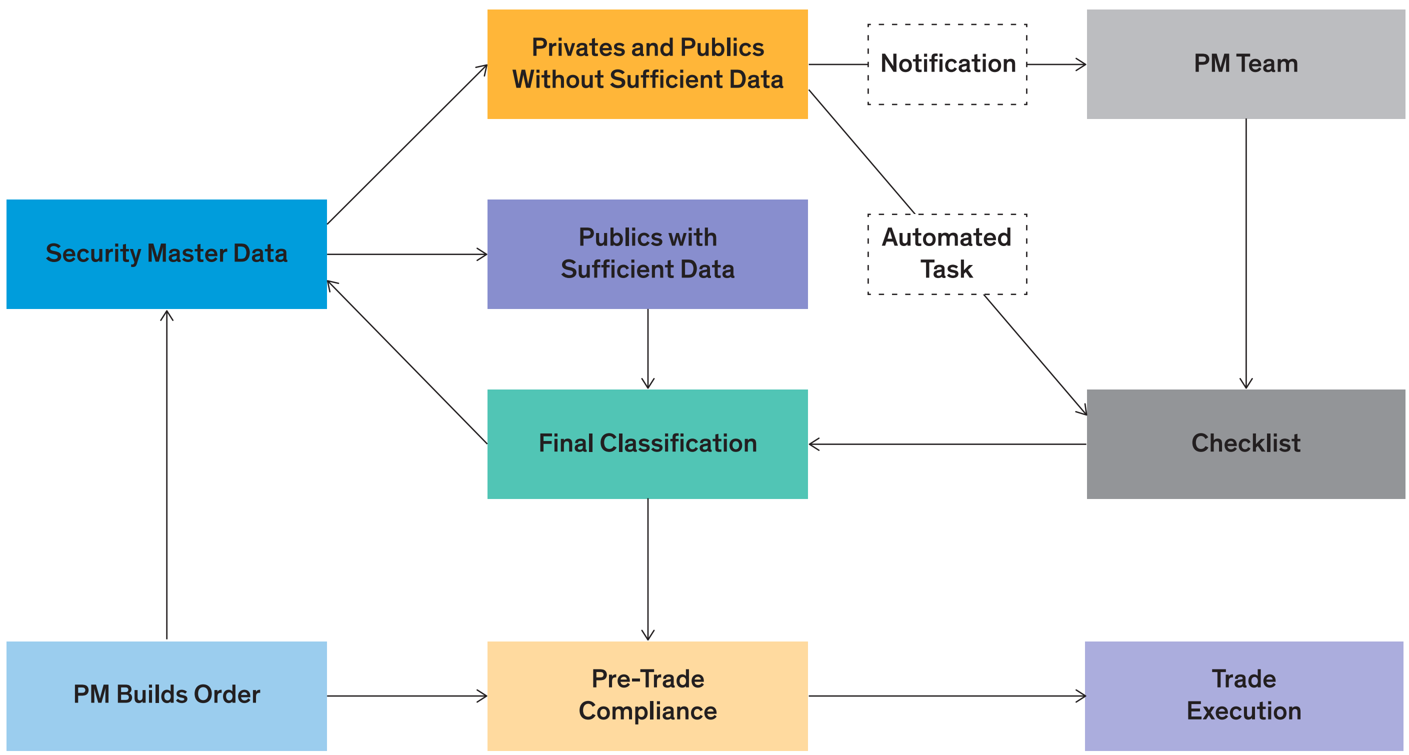
Fundamental research has always been a core pillar of our investment process. Just as its insights drive credit-underwriting and surveillance processes, those same inputs can be adapted to complete a security's classification and support its documentation requirements. We think the ability to do this efficiently in the fast-paced nature of financial markets will differentiate asset managers in this pursuit.

Timeliness is paramount to integrating the NAIC guidance. Investment opportunities can be ethereal—they come and go quickly in a dynamic marketplace. Investors must be ready to rapidly assess and understand all the factors that can influence an investment decision—including satisfying bond-definition requirements.

With that in mind, we've developed a bond-classification framework—positioned at the beginning of the investment flow—that provides portfolio managers and accounting professionals with timely access to these critical decision-making inputs (*Display 3, page 5*). In this manner, bond classification leads the way and its requirements don't obstruct our ability to access investment opportunities.

Based on structures and underlying risk profiles, our framework groups securities with similar characteristics into asset categories. Each category is defined by both a qualitative description and a set

DISPLAY 3: A MULTIFACETED PROCESS REQUIRES DIVERSE EXPERTISE



For illustrative purposes only.

As of September 30, 2024 | **Source:** NAIC and AB

of security reference data, or requirements from a checklist, which support a bond classification.

Most public securities have enough reference data to be assigned to an asset category and ensure the category's compliance with the NAIC guidance. They can be classified by reference data alone, well ahead of investment decision-making.

But what about private and (some) public securities for which reference data isn't enough to assign a classification? These cases require intervention from human experts. We've embedded controls into our order-management process to flag these securities, routing portfolio managers or research analysts to a checklist, where investors can attest to the bond-definition criteria and provide enough documentation to quickly support a classification.

The design of this framework and its mechanisms ensures that all securities within our investment universe are classified in a timely manner, thus equipping investment teams to make fully educated decisions on the wide universe of opportunities they're accustomed to assessing in the absence of bond-definition requirements. This is true regardless of a security's complexity or access to widely available security-reference data.

Conclusion

By leveraging the collective insights of diverse disciplines across the asset-management and insurance fields, we've developed a framework and process for applying the NAIC's bond-classification guidance. The collaborative efforts to retool our investment process have also strengthened our integration from front to back office.

We've placed our classification framework at the front of the investment process, which we believe ensures timely access to decision-making inputs across an expansive universe of securities—from simple to esoteric. The framework also accommodates a dynamic investing landscape, enabling investors to classify new security types that will emerge as opportunities for insurers.

As we see it, this puts our best foot forward in integrating the NAIC's principles-based guidance into our investment processes.

Nashville
501 Commerce Street
Nashville, TN 37203
United States
(212) 969 1000

New York
66 Hudson Boulevard East
New York, NY 10001
United States
(212) 969 1000

London
60 London Wall
London EC2M 5SJ
United Kingdom
+44 20 7470 0100

Singapore
One Raffles Quay
#27-11 South Tower
Singapore 048583
+65 6230 4600

Tokyo
Hibiya Parkfront 14F
2-1-6 Uchisaiwaicho,
Chiyoda-ku
Tokyo, 100-0011, Japan
+81 3 5962 9000

Toronto
200 Bay Street, North Tower
Suite 1203
Toronto, Ontario M5J 2J2,
Canada
(647) 375 2803

Sydney
Level 32, Aurora Place
88 Phillip Street
Sydney NSW 2000
Australia
+61 02 9255 1200

Hong Kong
39th Floor, One Island East,
Taikoo Place
18 Westlands Road
Quarry Bay, Hong Kong
+852 2918 7888

ICN20241778
USI–8493–1124
alliancebernstein.com