Accounting and Reporting Treatment for Repurchase/Reverse Repurchase Agreements Over 1 Year in Duration

May 2014
Agenda

• Executive Summary
• Background on Repo Agreements
• What is a Repo Agreement?
• Use of Repos within the Insurance Industry
• Repo and Capital Market Risks
• FASB Topic 860 vs SSAP 103
• ACLI Proposed Guidance for Long Duration Repos
Executive Summary

• The Repurchase and Reverse Repurchase Agreement (collectively, “Repo Agreement”) market is one of the largest sectors of the credit markets and provides an important source of liquidity to both investors and dealers

• The insurance industry currently participates in the Short Duration (tenor of one year or less) repo market. Long Duration Reverse Repos (tenors greater than one year) can meet portfolio needs for longer term investments

• SSAP Nos. 2 and 103 do not address the accounting and reporting requirements for Long Duration Repos or Reverse Repos

• ACLI strongly favors consistent accounting and reporting treatment for Short Duration and Long Duration Repo Agreements concurrent with FASB’s expected accounting guidance

• ACLI respectfully requests the NAIC to provide guidance
Background on Repo Agreements

- Repo Agreement market estimated to be $2.5 trillion for US Tri-Party Repo Agreements

- Used by investors, as short-term investments and by dealers as a key source of collateralized funding
- Repo Agreements possess the economic equivalent of a secured loan, but are legally characterized as the purchase and sale of securities
What is a Repo Agreement?

- A Repo Agreement is a contractual arrangement between two parties whereby one party sells securities (borrower of cash) to an investor (lender of cash) with a simultaneous contractual obligation to buy such securities back at a later date at the same price, plus interest on the sale proceeds.

- Three types of Repo Agreements:
  - Deliverable: underlying securities are delivered to the investor’s clearing bank
  - Held-In-Custody: underlying securities are held by the seller in a segregated account or at one of the seller’s clearing banks
  - Tri-Party: mostly used method; both parties establish separate accounts at a third party (“Tri-Party”) custodian bank, where both underlying securities and cash are delivered from each party, simultaneously

- Typical Terms of Repo Agreements:

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<tr>
<th>Haircut &amp; Variation Margin</th>
<th>Collateral Types</th>
<th>Collateral Eligibility &amp; Substitution</th>
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<tbody>
<tr>
<td>Repo Rate</td>
<td>Tenor</td>
<td>Interest Payment Frequency</td>
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Use of Repos within the Insurance Industry

Well-structured, long-dated Repos can be attractive assets for insurers for the following reasons:

- Long Duration Repos are well suited investments for an insurer to match against its long-term liabilities
- Many insurers already participate in the repo market and have legal documents in place with several counterparties
- Proven Structure: Master Repurchase Agreement provisions provide for
  - Overcollateralization
  - Daily mark-to-market and margining
  - Netting and immediate close-out given at EOD
  - Full counterparty recourse for any shortfall not covered by the sale of collateral
- Bankruptcy “safe harbor” under Sections 555 and 559 of the US Bankruptcy Code, allows these transactions to be terminated and liquidated immediately upon the declaration of bankruptcy or insolvency by one of the parties to the transaction
- Demand from banks for longer tenor financing has increased the availability of long term repos with attractive terms and spreads in the market
Repo and Capital Market Risks

• Risks associated with Repo can be minimized if managed prudently
  – Careful selection of creditworthy counterparties
  – Conservative haircuts and prudent assessment of collateral liquidity
  – Efficient collateral valuation, delivery and management systems
  – Diligence on legal certainty regarding underlying securities

• Risks are not unique to Repo Agreements, but common to all capital markets transactions
  – Counterparty Credit Risk
  – Collateral Value Risk
  – Interest Rate Risk
  – Operational Risk
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<th>FASB Topic 860</th>
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| **Existing Guidance**     | Currently, **defined accounting guidance** for Repo Agreements among all tenors | • Generally adopts ASC 860  
• Specifies that Reverse Repurchase Agreements are to be reported as “Short-Term Investments” |
| **Guidance for Long Duration Repos** | **No distinction** for Repo Agreements based on tenor                        | **No guidance** for Long Duration Repos.  
Classified as non-admitted assets for Reverse Repo                                               |
# ACLI Proposed Accounting Guidance for Long Duration Repos

## Current Accounting for Short Duration Repos

| SSAP Guidance for Reverse Repurchase Agreements | Reverse Repurchase Agreements accounted as “Short-term Investments” under SSAP No.103, par. 103.; tenors of one year or less classified as “Short-Term Investments” or “Cash Equivalents” under SSAP No. 2, par. 3 and par. 10 | ACLI Proposed Accounting for Long Duration Repos | Reverse Repurchase Agreements classified as “Long-term Bonds” or “Other Long-term Invested Assets” |
| SSAP Guidance for Repurchase Agreements | Repurchase Agreements is recorded as a liability under SSAP No. 103, par. 94 | Same as current accounting |

## NAIC Annual Instructions for Reverse Repurchase Agreements

| Schedule E, Part 2 “Cash Equivalents” for maturities of three months or less (NAIC Annual Instructions) | Schedule D “Long-term Bonds” for maturities greater than 1 year OR Schedule BA “Other Long-term Invested Assets” |
| Schedule DA, Part 2 “Short-term Investments” for maturities of 1 year or less, but greater than three months (NAIC Annual Instructions) |

## NAIC Annual Instructions for Repurchase Agreements

| Repurchase Agreements reported in line 25 “aggregate write-ins for liabilities” within the “Liabilities, Surplus and Other Funds” Section | Same as current accounting |