Why are fixed income ETFs becoming more prevalent?

*Kelly Sweppenhiser:* To best understand the investment environment for fixed income ETFs, it’s most appropriate to look back about seven years and that’s when the NAIC began allowing NAIC designations for fixed income ETFs and therefore bond-like capital treatment for these vehicles. This was a major decision for bond ETFs and since then we’ve seen usage of bond ETFs within insurance portfolios grow significantly. And although media sources would point most frequently to the low-cost and diversification benefits of bond ETFs, I more commonly hear two other reasons from the insurance companies that I work with. The first of which is liquidity and lots of it in the areas that they need it most. Insurers can now trade a portfolio of hundreds or even thousands of bonds with greater efficiency than they can traditionally trade just one cash bond.

And secondarily, my personal favorite, is that bond ETFs are emotionless. If an insurance company needs cash you sell the bond ETF. If you have excess cash you buy a bond ETF. There’s no monthly calls with the manager, no quarterly discussions with the board about performance, it is a very straightforward way to get the emotionless exposure you need in the areas that the portfolio has the greatest need for.

How do bonds earn NAIC designations?

*Kelly Sweppenhiser:* We’re often asked by insurance companies, how do bond ETFs earn NAIC designations? The process is relatively straightforward. Every first quarter of each year bond sponsors like Vanguard are able to submit their portfolios to the NAIC Security Valuation Office for review. The SVO does a deep dive into the underlying holdings and grants that bond ETF a preliminary NAIC designation. Once an insurance company buys and files that fixed income ETF, the SVO takes yet again another look at the underlying holdings and grants that bond ETF a standard NAIC designation. Then at this time the insurance company can file it on Schedule D Part One.

What’s the NAIC’s view on bond ETF accounting?

*Kelly Sweppenhiser:* At first, NAIC guidance on accounting for bond ETFs was the original cost methodology. Upon further review, the NAIC didn’t necessarily feel that this was the most consistent methodology with other principles of their bond treatment. So, through working with interested parties, the systematic value accounting methodology for bond ETFs was born. I’m going to leave it to my colleague Jeff Sparling, former actuary, to tell you a little bit more about the two options insurers will have for filing their fixed income ETFs in 2018 and beyond.
What is systematic value accounting?

Jeff Sparling: In 2013 the NAIC identified inconsistent filings when insurers were reporting their designated fixed income ETF investments. For example, many insurers were reporting these investments at cost which over time may overstate their asset valuation. Therefore, the Statutory Account Principles Working Group, the NAIC staff, and the interested parties began working on an accounting resolution. In April of 2017, the Working Group passed a revision to SAP 26 which allows insurers to report their designated fixed income ETF investments at either fair value or a new methodology called systematic value.

Systematic value is an accounting methodology which allows insurers to report these designated fixed income ETF investments in a bond-like manner, as these investments can be amortized from quarter-to-quarter on the NAIC filing. In other words, it allows insurers to maintain a lower volatility when reporting these assets for fixed income ETFs as compared to the fair value method.

What do insurers need to know?

Jeff Sparling: There are three things you should know. Number one, you will no longer be able to report designated fixed income ETFs at cost. Number two, if you do hold a designated fixed income ETF investment and would like to use systematic value, there will be a box to check for systematic value on the December 31, 2017 NAIC filing. If you leave that box blank, the default will be the fair value method for this investment. And number three, if you do choose systematic value going forward, the new accounting methodology will go into effect January 1, 2018. This is when investment managers like Vanguard will be providing the aggregate cash flows for the underlying ETF investments, which serves as the backbone for the systematic value calculation.