Introduction

Exchange traded funds (“ETFs”) have helped transform the way investors access the corporate and government bond markets by reducing transaction costs, increasing price transparency, and deepening market liquidity. As of March 31, 2023, there was approximately $1.3 trillion in US fixed income ETF assets under management (“AUM”) - an increase of nearly 150% since 2017.¹ This growth in AUM is one indicator of how integral fixed income ETFs have become to bond markets.

Global regulators have long sought to facilitate bond markets that provide investors with liquidity and price transparency.² Fixed income ETFs serve to directly address this by offering liquid exchange trading and real-time, executable intraday pricing. Moreover, most US fixed income ETFs provide daily disclosure of portfolio holdings. These qualities are further discussed in this paper.

Fixed income investors of all types utilize fixed income ETFs as a direct alternative to individual bonds. The ability to buy and sell portfolios of bonds on exchange through ETFs helps investors navigate liquidity challenges, particularly in times of market stress.³

However, notwithstanding the continued growth in fixed income ETF AUM, a substantive accounting asymmetry exists under US Generally Accepted Accounting Principles (“GAAP”) between bonds held through fixed income ETFs and bonds held in a separately managed account (“SMA”) that does not recognize the substantially similar economic exposure between two such investments.

We believe the accounting standards should be modified so that investors are not faced with a trade-off in adopting fixed income ETFs and can instead make investment decisions based on their investment objectives rather than an accounting asymmetry.

In fact, some standard setters, such as the National Association of Insurance Commissioners (“NAIC”), have made recent policy changes (see page 4 for more information) to better reflect the substance of the economic and risk profiles of fixed income ETFs.

To that end, we recommend policymakers permit a reporting entity that invests in certain eligible fixed income ETFs (e.g., index-based) the option to fair value such instruments through other comprehensive income (“FVTOCI”)—an option that is currently permitted for economically similar products (e.g., a similar underlying bond portfolio in an SMA).

BlackRock has long advocated for the modernization of global bond markets for the benefit of investors.⁴ This paper is a continuation of those efforts and is aimed at raising awareness of these accounting asymmetries that exist between investment products that provide substantially similar economic exposures.

The rise of fixed income ETFs

Unlike equities, which generally trade on registered exchanges, most bonds are traded in the over-the-counter (“OTC”) market due to the dozens, or even hundreds, of unique securities that can be issued by the same entity, each with differing coupon levels, seniority, call features, and maturity dates. Additionally, relative to equities, most bonds trade infrequently, so there is rarely a continuous two-way market of buyers and sellers with respect to an individual bond, which may present certain liquidity and price discovery challenges for investors.

Improvements and modernizations to bond markets have been in play since the Global Financial Crisis (“GFC”). Alongside those efforts, investors have also increasingly turned to fixed income ETFs in the post-GFC era given a number of attractive qualities, such as:⁵

1. ETFs trade on exchanges where investors can buy or sell shares intraday in the “secondary” market as opposed to relying on OTC trading (as is the case with most individual bonds).

The opinions expressed are as of September 2023 and may change as subsequent conditions vary. All source information can be found in the Endnotes section.

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2. The vast majority of fixed income ETFs (by AUM) are index-based, which means they are designed to track specific, rules-based indexes. Most index-based fixed income ETFs are “fully transparent” in that each ETF publicly discloses information about its holdings (e.g., identifier and face amount of each bond owned by the ETF) each business day.

3. Fixed income ETFs can enhance an institutional investor’s ability to construct portfolios and help manage risk by reducing execution costs, increasing price transparency (through continuously available on-exchange market prices) and providing additional liquidity (through the ability to transact on exchange).

4. Also important to many institutional investors are the “in-kind” creation and redemption features of most fixed income ETFs, which do not require bonds to be purchased or sold by the ETF. These mechanisms are critical in facilitating an ETF’s investment objective and keeping the price of the ETF aligned with the value of its underlying securities.

5. Finally, fixed income ETFs have become an important component of the evolution of the bond market ecosystem. Broker-dealers and other market participants are increasingly using fixed income ETFs to manage bond inventory, facilitate large client bond portfolio transactions, hedge derivatives books, and to help price individual and portfolios of fixed income securities.

An emerging GAAP accounting hurdle

Today, individual bonds and portfolios of bonds are treated as debt securities for GAAP accounting purposes and are permitted to be classified as either 1) available-for-sale, with changes in fair value recognized in other comprehensive income (FVTOCI), 2) trading, with subsequent changes in fair value recognized in the income statement, or 3) held-to-maturity, where they are held at amortized cost until they mature.

Each share of an ETF generally represents a pro rata interest in the underlying bond portfolio and assets of the ETF. However, shares of fixed income ETFs are currently being treated as equity securities for GAAP accounting purposes (even if the underlying portfolio is predominantly comprised of bonds and tracks a bond index). As a result, the available-for-sale classification (FVTOCI option) is not available to index-based fixed income ETFs and changes in fair value must be recognized in the income statement. As discussed further below, this differing accounting treatment does not recognize that index-based fixed income ETFs can offer investors substantially similar economic exposure to a portfolio of individual bonds or a fixed income SMA.

We believe that the structure and mechanics of a fixed income ETF have been shown to be an effective transmission mechanism to pass on the economics of the underlying portfolio of bonds to the investor, whereby any differences in performance can be de minimis over time.

The benefits of fixed income ETFs during market volatility

The utility and benefits of index-based fixed income ETFs to investors and other market participants have been demonstrated during many periods of market uncertainty, including the COVID-19-induced market volatility in March 2020, as well as the interest-rate volatility caused by stress in the global banking sector in March 2023. While liquidity conditions in the OTC bond market sharply deteriorated during these periods, many fixed income ETFs traded on exchanges with generally tight bid–ask spreads. In addition, most fixed income ETFs provided deep liquidity, continuous price transparency and lower transaction costs than were available in individual bonds during these periods of market stress.

Furthermore, the ability to buy and sell portfolios of bonds on an exchange through ETFs helped investors navigate challenging bond market conditions. Many types of market participants used fixed income ETFs during these periods of volatility to help acquire targeted bond exposures, manage interest rate risk, support liquidity in the corporate credit markets, reposition portfolios, and obtain real-time price transparency when liquidity was significantly degraded in individual bonds.

To address the challenges of 2020’s COVID-19-induced market volatility, the U.S. Federal Reserve (the “Fed”) established the Secondary Market Corporate Credit Facility (“SMCCF”) to support companies by providing liquidity to the market for outstanding corporate bonds. The SMCCF supported bond market liquidity by allowing the Fed to purchase investment grade corporate bonds as well as U.S. listed ETFs whose investment objective is to provide broad exposure to the U.S. market for corporate bonds.

Investors, particularly institutions, have recognized the potential benefits of using fixed income ETFs to reduce transaction costs, improve liquidity and facilitate price discovery. We believe that the Fed’s decision to include index-based fixed income ETFs alongside individual bonds in the SMCCF is consistent with these trends.
The accounting differences between fixed income ETFs and portfolios of bonds do not reflect this. Critically, the present inability to use the FVTOCI option for shares of an index-based ETF creates unintended consequences on investor decision making. For example, investors that are sensitive to earnings volatility, like public insurance companies and other public companies, may choose to hold portfolios of individual bonds instead of fixed income ETFs because they prefer the FVTOCI accounting treatment of the former (i.e., unrealized gains and losses are not included in earnings immediately), despite the numerous advantages that fixed income ETFs can offer over holding a portfolio of individual bonds.

To this point, recent research from S&P analyzing NAIC data has shown a difference in reported equity ETF and fixed income ETF holdings in the last few years between mutual (i.e., nonpublic) insurers that file under the NAIC’s statutory accounting framework and public insurers that file under both statutory and GAAP accounting. For instance, total ETFs as a percentage of invested assets were substantially higher for mutual insurance companies (approximately 0.7%) than for public insurance companies (approximately 0.3%) in 2022. Since fixed income ETF use cases are largely the same between the two types of insurers, we believe it is reasonable to characterize the fixed income ETF accounting asymmetry as a contributor to these divergent investment patterns.

An accounting asymmetry: Inconsistent treatment for substantially similar economic exposure

While gaining exposure to fixed income securities through an ETF or through an SMA can present different legal, operational and regulatory requirements, both structures present investors with similar risk/return profiles and economic experiences. The discussions in this section are focused on those similarities. We illustrate below how an investor could hypothetically obtain substantially similar economic exposure to an identical bond portfolio via an index-based fixed income ETF or through an index-based SMA (Figure 1).

An index-based fixed income SMA contains a portfolio of individual bonds that is managed on behalf of an investor. The professional asset management firm purchases a bond portfolio in accordance with agreed upon investment guidelines, and the securities are held on the investor’s behalf in an account at a duly appointed custodian (typically a third-party).

As an alternative to using an SMA, an investor could instead gain economic exposure to the same or similar bond portfolio by purchasing shares of an index-based fixed income ETF on an exchange. In that case, the professional asset management firm manages a bond portfolio in accordance with the ETF’s disclosed investment

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**Figure 1: Attributes of index-based fixed income ETFs and fixed income SMAs**

<table>
<thead>
<tr>
<th>Attribute</th>
<th>Index-based fixed income ETF</th>
<th>Index-based fixed income SMA</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment objective</td>
<td>Track relevant bond index</td>
<td>Track relevant bond index</td>
</tr>
<tr>
<td>Ownership of securities</td>
<td>Pro rata interest in bonds via ownership of ETF shares; certain investors (typically institutions) may, via an AP, access the underlying securities through the in-kind redemption mechanism</td>
<td>Direct ownership of bonds</td>
</tr>
<tr>
<td>Management fee</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Bonds held at third party custodian</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Underlying assets</td>
<td>Bonds</td>
<td>Bonds</td>
</tr>
<tr>
<td>Portfolio transparency</td>
<td>Typically full daily transparency</td>
<td>Full transparency through custody account statement daily</td>
</tr>
<tr>
<td>Payments of interest from bond portfolio holdings</td>
<td>Delivered to ETF custody account and distributed to investor</td>
<td>Delivered to custody account and paid to investor</td>
</tr>
<tr>
<td>Repayments of principal from bond portfolio holdings</td>
<td>Delivered to ETF custody account and reinvested</td>
<td>Delivered to custody account and reinvested</td>
</tr>
<tr>
<td>Exit Strategy</td>
<td>1) Sell ETF shares on exchange (applicable to all investors) or 2) engage an AP to execute an in-kind redemption and take possession of bonds to hold bonds to maturity or sell in OTC bond market (applicable to certain investors, generally institutions)</td>
<td>Hold bonds to maturity or sell in OTC bond market</td>
</tr>
</tbody>
</table>
guidelines. The investor would own shares of the ETF that represent a pro rata interest of the same or similar investment portfolio as the SMA. The investor would also typically be able to view a list of every bond owned by the ETF (through the daily disclosure transparency provided by most ETFs).

Importantly, institutional investors are also often able to work with an AP who can use the ETF’s in-kind redemption mechanism to take ownership of the basket of the ETF’s underlying bonds in exchange for the ETF’s shares, achieving a similar economic benefit to those who invested directly in bonds through an SMA. In other words, the investor could, through the AP, exchange shares of the ETF for a slice of the ETF’s underlying bonds, and thus hold those bonds in the same exact manner as an investor in an SMA.

Despite the differences in legal forms and governance structures, index-based SMAs and index-based fixed income ETFs can have nearly identical returns and risk attributes. However, the two products could be treated differently under GAAP accounting policy because shares of an ETF are not permitted to FVTOCI. It should be noted that some recent policy changes have been made by the SEC, NAIC, the Chicago Mercantile Exchange Clearing (“CME”), and the Depository Trust & Clearing Corporation (“DTCC”) to better reflect the substance of the economic and risk profiles of fixed income ETFs and how investors are increasingly using them for bond exposure (i.e., that index-based fixed income ETFs are more equivalent to debt securities than equity securities for certain purposes).20

**Impacts on investor behavior**

We believe that the differing accounting treatment of index-based fixed income ETFs and portfolios of bonds does not accurately reflect the exposure to a portfolio of bonds that an index-based fixed income ETF provides. As a result, some investors continue to rely on the less liquid, more opaque and more costly OTC markets to access individual bonds.21

From an economic perspective, an index-based fixed income ETF can be viewed as transforming a portfolio of bonds into a single security that can then be traded on an exchange. The fixed income ETF allows an investor to obtain exposure to the entire portfolio of bonds in a potentially more cost-efficient, liquid and transparent way. In some ways, we believe fixed income ETFs are helping to effectively “standardize” an otherwise fragmented OTC bond market.22 Minimizing the accounting asymmetry across these products would remove the trade-off investors currently face between investing in a product that has these benefits but is not permitted to FVTOCI, or investing in individual bonds that are permitted to FVTOCI but may not have the same benefits.

Current guidance under the Financial Accounting Standards Board (“FASB”) could also create confusion among users of GAAP financial statements when analyzing the earnings and risk profiles of reporting entities holding products with nearly identical substance, yet are treated differently from an accounting perspective. As an example, an asset manager evaluating life insurance companies for investment might use GAAP financial statements to review the investment holdings of each entity. The asset manager could come to differing conclusions about the risk profile of

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**Recent actions of the NAIC relating to fixed income ETFs**

Accounting asymmetry around fixed income ETFs has not been limited to GAAP. Specifically, the NAIC in recent years has issued guidance and substantively revised an existing Statement of Statutory Accounting Principles (“SSAP”) to address the appropriate treatment of fixed income ETFs with respect to insurance company statutory accounting and regulatory risk-based capital. The NAIC considered whether fixed income ETFs should be accounted for as “equity” (covered by SSAP No. 30) or as “bonds” (covered by SSAP No. 26). In evaluating the appropriate categorization of fixed income ETFs, the NAIC recognized that while shares of an ETF are legal form common stock, the “common stock” presumption could be overcome where the fixed income ETF is registered under the 1940 Act, the portfolio of the ETF is predominantly bonds, and a qualitative and quantitative look-through evaluation into the holdings of its portfolio can be conducted. The NAIC noted that the classification of fixed income ETFs as “debt like” for statutory accounting and regulatory capital purposes reflects, amongst other things, “the fact that the fund does not, nor does it intend to, invest in common stock or any material holdings incompatible with debt-like treatment.”23

As a result of the updated guidance, ETFs that are reviewed by the NAIC’s Securities Valuation Office (“SVO”) and are deemed to qualify under the specific assessment are referred to as “SVO-Identified Bond ETFs.” These ETFs are then reported separately on the “long-term bond” reporting schedule. In addition, the guidance enables insurers to elect to use a statutory accounting measurement method akin to a modified amortized cost accounting calculation (“systematic value”)24 instead of being reported at fair value.
each entity if those entities hold products that are similar in substance but accounted for differently. Permitting FVTOCI treatment for index-based fixed income ETFs would provide significant benefits to those users who rely on GAAP financial statements to evaluate entities and make investment decisions.

Conclusion
To date, the FASB has considered and provided guidance on the accounting treatment of fixed income investment products such as individual corporate and government bonds held in third-party SMAs, but it has not yet provided specific guidance or commentary on products with the structural and economic features present in certain fixed income ETFs (e.g., index-based, in-kind redemption), despite the integral role fixed income ETFs now play in bond markets.

Given the economic similarities between index-based fixed income ETFs and other products that are treated as debt for GAAP purposes, as well as the evolving role of fixed income ETFs within portfolio management, we believe that GAAP should permit holders of a clearly defined, limited subset of fixed income ETFs (e.g., transparent, index-based fixed income ETFs) to have the FVTOCI option – like what is available to debt securities. Doing so would update GAAP requirements to more accurately reflect the economic substance of index-based fixed income ETFs, allow investors to more fully recognize the benefits of fixed income ETFs, (including the ability to access the bond market in a cost-efficient, liquid and transparent manner), and align FASB guidance with the evolving nature of the bond market.
Endnotes

2. For example, see the US Securities and Exchange Commission’s (“SEC”) establishment of the Fixed Income Market Structure Advisory Committee (“FIMSAC”) in 2017 to “provide the Commission with diverse perspectives on the structure and operations of the U.S. fixed income markets, as well as advice and recommendations on matters related to fixed income market structure” and the SEC’s Release No. 34-90019: Regulation ATS for ATSs that Trade U.S. Government Securities, NMS Stock, and Other Securities; Regulation SCI for ATSs that Trade U.S. Treasury Securities and Agency Securities; and Electronic Corporate Bond and Municipal Securities Markets.
3. For more color on ETFs during the COVID-19 market shock, see Lessons from COVID-19: ETFs as a Source of Stability.
4. For example, see BlackRock’s response to the International Organization of Securities Commissions (“IOSCO”) Consultation on the corporate bond market here.
5. For information on increased fixed income ETF adoption, see All Systems Go.
6. As of March 31, 2023, 95.7% of all US fixed income ETF AUM was in index strategies. Source: BlackRock.
7. Rule 6c-11 under the Investment Company Act of 1940, as amended (the “1940 Act”) requires ETFs relying on the Rule to publicly disclose their holdings as of the end of each business day.
8. In an in-kind creation, an authorized participant (“AP”) will present a basket of securities to the ETF in exchange for ETF shares and a cash balancing amount (if any). In an in-kind redemption, an AP will deliver ETF shares to the ETF in exchange for a basket of securities (i.e., in this case, bonds) and a cash balancing amount (if any).
9. For more information on the creation and redemption mechanisms, and, in particular, how the primary market process supports a robust and durable ETF market ecosystem under a variety of market conditions, see New data behind the bond ETF primary process.
10. Source: BlackRock.
11. Generalized examples of how classification impacts when changes in fair value are reported: Unrealized gains and losses for available-for-sale securities are included in accumulated other comprehensive income (“AOCI”), net of tax effect, on the balance sheet until realized. Unrealized gains and losses for trading securities are included in earnings immediately.
12. For example, the bid-ask spread on the iShares 20+ Year Treasury Bond ETF (TLT) remained in a 1 basis point range throughout March 2023, while the bid-ask spreads in the underlying U.S. Treasuries widened to 30 basis points, up from the two-year average of 18 basis points. Source: Bloomberg, BlackRock, as of March 17, 2023.
14. For example, trading volumes spiked across iShares U.S. Treasury exposures as investors turned to Treasury ETFs to navigate volatile market conditions in March 2023 with trading volumes more than 300% higher than their averages over the prior three years. Source: BlackRock, Bloomberg as of March 17, 2023.
15. For more information on ETF performance through COVID-19, see Lessons from COVID-19: ETFs as a Source of Stability.
16. The SMICF was established by the Fed under the authority of Section 1.3(3) of the Federal Reserve Act, with approval of the Treasury Secretary. Source: US Federal Reserve (as of February 2021).
17. The Board of IOSCO published a report on its findings of ETF behavior during the COVID-19 market stress. A notable takeaway was that the ETF structure was relatively resilient throughout the period, which “highlighted that the pricing of ETFs could be different when the liquidity of their underlying assets deteriorated significantly and deepened the industry’s understanding of fixed income ETFs’ potential role in providing additional pricing information for the underlying bond markets.” Source: IOSCO, Exchange Traded Funds: Thematic Note – Finding and Observations during COVID-19 induced market stress August 2021.
19. For example, as detailed in iShares fixed income ETF prospectuses: “Dividends and other distributions on shares of the Fund are distributed on a pro rata basis to beneficial owners of such shares. Dividend payments are made through DTC participants and indirect participants to beneficial owners then of record on the distribution date.”
20. Examples of such modifications include the following: 1) The SEC issued no-action relief with respect to certain ETF-related broker/dealer net capital rules in June 2022. This no-action relief provides for broker-dealer capital charges on US Treasury ETFs that are similar to the capital charges on the ETF’s underlying portfolio holdings of certain US Treasury ETFs. See Net Capital Treatment of Certain U.S. Treasury Exchange-Traded Funds: 2) In September 2022, the CME made changes to its margin rules regarding the acceptability and margin haircut for certain ETFs, granting US Treasury-like haircut to US Treasury ETFs used as margin for futures contracts and cleared interest rate swap. See Advisory Notice 22-292. 3) The CME’s regulator, the US Commodity Futures Trading Commission (“CFTC”) permitted CME’s futures and interest rate swap clearinghouses to accept certain Treasury ETFs as margin with reduced haircuts. 4) In September 2022, the CME updated its ETF dividend reporting practices relating to certain 1940 Act fixed income ETFs. With this reporting update, US withholding tax treatment of dividend distributions to non-US investors from such fixed income ETFs will be treated similarly to interest distributions with respect to individual bonds and loans; 5) Efforts by the NAIC, which are discussed more fully below.
22. Similar to the pattern of transformation that took place in the equity markets roughly two decades ago, increased adoption of fixed income ETFs and other fixed income index exposures has rapidly accelerated changes in global bond markets for investors. Broker-dealers and market makers have become required to rapidly price and trade entire portfolios of bonds to facilitate ETF primary market activity, thus driving the rise of algorithmic bond pricing and further accelerating the adoption of electronic trading and alternative bond trading architecture. These improvements in bond market technology and operating platforms are helping market participants to organize and navigate the opaque and fragmented OTC markets.
23. NAIC Statutory Issue Paper No. 156 (as of April 8, 2017).
24. Systematic value is only permitted to be designated as the measurement method for asset valuation reserve (AVR) filers acquiring qualifying investments that have an NAIC designation of 1 to 5, and for non-AVR filers acquiring investments with an NAIC designation of 1 or 2. Further details of systematic value for SVO-identified investments can be found in paragraph 25 of SSAP 26R. If an insurer does not elect for systematic value, these specific ETFs are still required to be reported at fair value (with changes reflected as unrealized gains/losses), similar to other ETF or mutual fund investments. Source: Accounting Practices and Procedures Manual, NAIC.

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