Statutory Issue Paper No. 140

Substantive Revisions to SSAP No. 43—Loan-Backed and Structured Securities

STATUS
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Original SSAP and Current Authoritative Guidance: SSAP No. 43R

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. The purpose of this issue paper is to retain for historical purposes the statutory guidance superseded with the issuance of *SSAP No. 43R—Loan-Backed and Structured Securities – Revised* (SSAP No. 43R):

   a. *SSAP No. 43—Loan-Backed and Structured Securities* (SSAP No. 43);

   b. *SSAP No. 98—Treatment of Cash Flows When Quantifying Changes in Valuation and Impairments, an Amendment of SSAP No. 43—Loan-Backed and Structured Securities* (SSAP No. 98);

   c. Paragraph 13 of *SSAP No. 99—Accounting for Certain Securities to an Other-Than-Temporary Impairment* (SSAP No. 99)

2. This Issue Paper also details SSAP No. 43R as initially adopted in September 2009. The substantive revisions adopted within SSAP No. 43R include accounting guidance for securities acquired in a transfer, beneficial interests, recognition of impairment and disclosures.

3. SSAP No. 43R supersedes SSAP No. 98 (impairment to fair value) and revises valuation and impairment requirements based on the cash flows expected to be collected for the securities, rather than fair value. Since the impairment requirements are based upon expected cash flows, most impairment charges recognized will be based upon cash flows that the reporting entity does NOT expect to collect (credit related). Reporting entities would only impair to fair value if there is intent to sell the security, or the reporting entity cannot assert that they have the intent and ability to retain the investment for a period of time sufficient to recover the amortized cost basis. No. 43R provides differences in impairment recognition for situations when: 1) there is an intent to sell; 2) the entity does not have the intent and ability to hold the security; and 3) there is a non-interest related decline, when there is no intent to sell and when the entity has the intent and ability to hold the security.

4. For historical record, the guidance within SSAP No. 43, SSAP No. 98, and paragraph 13 of SSAP No. 99, which has been superseded by SSAP No. 43R, has been included as the 'Relevant Statutory Accounting' guidance within paragraphs 7, 8 and 9.

5. The adopted guidance within SSAP No. 43R has been included below:

   1. This statement establishes statutory accounting principles for investments in loan-backed securities and structured securities. In accordance with *SSAP No. 91R—Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (SSAP No. 91R), retained

beneficial interests from the sale of loan-backed securities and structured securities are accounted for in accordance with this statement. In this statement loan-backed securities and structured securities are collectively referred to as loan-backed securities.

SUMMARY CONCLUSION

2. Loan-backed securities are defined as pass-through certificates, collateralized mortgage obligations (CMOs), and other securitized loans not included in structured securities, as defined below, for which the payment of interest and/or principal is directly proportional to the interest and/or principal received by the issuer from the mortgage pool or other underlying securities.

3. 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 interest and/or principal received by the issuer from the mortgage pool or other underlying securities.

4. Loan-backed securities are issued by special-purpose corporations or trusts (issuer) established by a sponsoring parent organization. Mortgage loans or other securities 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 can look only to the issuer's assets (primarily the trusteed assets or third parties such as insurers or guarantors) 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 mortgage loans or other securities. Some sponsors do guarantee the performance of the underlying loans.

5. Loan-backed 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.

6. The scope of this statement encompasses all types of loan-backed and structured securities, including, but not limited to, the following:

a. Loan-backed and structured securities acquired at origination,

b. Loan-backed and structured securities acquired subsequent to origination for which it is probable, at acquisition, that the reporting entity will be **able** to collect all contractually required payments receivable, and are accounted for at acquisition under SSAP No. 91R,

c. Loan-backed and structured securities for which it is probable, either known at acquisition or identified during the holding period[1], that the reporting entity will be **unable** to collect all contractually required payments receivable, and

d. Beneficial interests that continue to be held by a reporting entity (transferor) in securitization transactions that are accounted for as sales under SSAP No. 91R and purchased beneficial interests in securitized financial assets[2].

7. At acquisition, loan-backed securities, except for loan-backed or structured securities that are beneficial interests that are not of high credit quality or can contractually be prepaid or otherwise settled in such a way that the reporting entity would not recover substantially all of its

[1] Securities classified within the type of paragraph 6.a. or 6.b. may be required to change classification to type 6.c. when it becomes probable that the reporting entity will be unable to collect all contractually required payments receivable.

[2] The accounting requirements related to these type of securities included in paragraphs 20-24 shall be determined at acquisition or initial transfer.

recorded amount[3] (see paragraphs 20-24), shall be reported at cost, including brokerage and related fees. Cost shall not exceed fair value. Acquisitions and dispositions shall be recorded on the trade date, not the settlement date, except for the acquisition of private placement loan-backed securities which shall be recorded on the funding date. For securities where all information is not known as of the trade date (e.g., actual payment factors and specific pools), a reporting entity shall make its best estimate based on known facts.

8. Amortization of premium or discount shall be calculated using the scientific (constant yield) interest method and shall be recorded as an adjustment to investment income. The interest method results in a constant effective yield equal to the prevailing rate at the time of purchase or at the time of subsequent adjustments to book value. The amortization period shall reflect estimates of the period over which repayment of principal of the loan-backed securities is expected to occur, not the stated maturity period.

9. Interest shall be accrued using the effective-yield method using the redemption prices and redemption dates used for amortizing premiums and discounts. Interest income consists of interest collected during the period, the change in the due and accrued interest between the beginning and end of the period as well as reductions for premium amortization and interest paid on acquisition of loan-backed securities, and the addition of discount accrual. Contingent interest may be accrued if the applicable provisions of the underlying contract and the prerequisite conditions have been met.

10. For reporting entities required to maintain an IMR, the accounting for realized capital gains and losses on sales of loan-backed securities shall be in accordance with *SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve*. For reporting entities not required to maintain an IMR, realized gains and losses on sales of loan-backed securities shall be recorded on the trade date and shall be reported as net realized capital gains or losses in the Statement of Income.

11. A loan-backed security may provide for a prepayment penalty or acceleration fee in the event the investment is liquidated prior to its scheduled termination date. These fees shall be reported as investment income when received.

Collection of All Contractual Cashflows is Probable

12. The following guidance applies to loan-backed and structured securities for which it is probable that the investor will be able to collect all contractually required payments receivable. (Paragraphs 17-19 provide guidance for securities in which collection of all contractual cash flows is not probable and paragraphs 20-24 provide guidance for beneficial interests.) Prepayments are a significant variable element in the cash flow of loan-backed securities because they affect the yield and determine the expected maturity against which the yield is evaluated. Falling interest rates generate faster prepayment of the mortgages underlying the security, shortening its duration. This causes the reporting entity to reinvest assets sooner than expected at potentially less advantageous rates. This is called prepayment risk. Extension risk is created by rising interest rates which slow repayment and can significantly lengthen the duration of the security. Differences in cash flows can also result from other changes in the cash flows from the underlying assets. If assets are delinquent or otherwise not generating cash flow, which should be reflected in the cash flow analysis through diminishing security cash flows, even if assets have not been liquidated and gain/losses have not been booked.

13. Changes in currently estimated cash flows, including the effect of prepayment assumptions, on loan-backed securities shall be reviewed periodically, at least quarterly. The prepayment rates of the underlying loans shall be used to determine prepayment assumptions. Prepayment assumptions shall be applied consistently across portfolios to all securities backed by similar collateral (similar with respect to coupon, issuer, and age of collateral). Reporting entities shall use consistent assumptions across portfolios for similar collateral within controlled

[3] As referenced in the Relevant Literature section, this Statement adopts EITF 99-20, including the scope requirements of that guidance.

affiliated groups. Since each reporting entity may have a unique method for determining the prepayment assumptions, it is impractical to set standard assumptions for the industry. Relevant sources and rationale used to determine each prepayment assumption shall be documented by the reporting entity.

14. Loan-backed securities shall be revalued using the currently estimated cash flows, including new prepayment assumptions, using either the prospective or retrospective adjustment methodologies, consistently applied by type of securities. However, if at anytime during the holding period, the reporting entity determines it is no longer probable that they will collect all contractual cashflows, the reporting entity shall apply the accounting requirements in paragraphs 17-19.

15. The prospective approach recognizes, through the recalculation of the effective yield to be applied to future periods, the effects of all cash flows whose amounts differ from those estimated earlier and the effects and changes in projected cash flows. Under the prospective method, the recalculated effective yield will equate the carrying amount of the investment to the present value of the anticipated future cash flows. The recalculated yield is then used to accrue income on the investment balance for subsequent accounting periods. There are no accounting changes in the current period unless the security is determined to be other than temporarily impaired.

16. The retrospective methodology changes both the yield and the asset balance so that expected future cash flows produce a return on the investment equal to the return now expected over the life of the investment as measured from the date of acquisition. Under the retrospective method, the recalculated effective yield will equate the present value of the actual and anticipated cash flows with the original cost of the investment. The current balance is then increased or decreased to the amount that would have resulted had the revised yield been applied since inception, and investment income is correspondingly decreased or increased.

Collection of All Contractual Cashflows is Not Probable

17. The following guidance applies to loan-backed and structured securities with evidence of deterioration of credit quality since origination for which it is probable, either known at acquisition or identified during the holding period, that the investor will be unable to collect all contractually required payments receivable, except for those beneficial interests that are not of high credit quality or can contractually be prepaid or otherwise settled in such a way that the reporting entity would not recover substantially all of its recorded amount determined at acquisition (see paragraphs 20-24).

18. The reporting entity shall recognize the excess of all cash flows expected at acquisition over the investor's initial investment in the loan-backed or structured security as interest income on an effective-yield basis over the life of the loan-backed or structured security (accretable yield).[4] Any excess of contractually required cash flows over the cash flows expected to be collected is the nonaccretable difference. Expected prepayments shall be treated consistently for determining cash flows expected to be collected and projections of contractual cash flows such that the nonaccretable difference is not affected. Similarly, the difference between actual prepayments and expected prepayments shall not affect the nonaccretable difference.

19. An investor shall continue to estimate cash flows expected to be collected over the life of the loan-backed or structured security. If, upon subsequent evaluation:

a. The fair value of the loan-backed or structured security has declined below its amortized cost basis, an entity shall determine whether the decline is other than temporary. For example, if, based on current information and events, there is a

[4] A loan-backed or structured security may be acquired at a discount because of a change in credit quality or rate or both. When a loan-backed or structured security is acquired at a discount that relates, at least in part, to the security's credit quality, the effective interest rate is the discount rate that equates the present value of the investor's estimate of the security's future cash flows with the purchase price of the loan-backed or structured security.

decrease in cash flows expected to be collected (that is, the investor is unable to collect all cash flows expected at acquisition plus any additional cash flows expected to be collected arising from changes in estimate after acquisition (in accordance with paragraph 19.b.), an other-than-temporary impairment shall be considered to have occurred. The investor shall consider both the timing and amount of cash flows expected to be collected in making a determination about whether there has been a decrease in cash flows expected to be collected.

b. Based on current information and events, if there is a significant increase in cash flows previously expected to be collected or if actual cash flows are significantly greater than cash flows previously expected, the investor shall recalculate the amount of accretable yield for the loan-backed or structured security as the excess of the revised cash flows expected to be collected over the sum of (1) the initial investment less (2) cash collected less (3) other-than-temporary impairments plus (4) amount of yield accreted to date. The investor shall adjust the amount of accretable yield by reclassification from nonaccretable difference. The adjustment shall be accounted for as a change in estimate in conformity with SSAP No. 3—Accounting Changes and Corrections of Errors (SSAP No. 3), with the amount of periodic accretion adjusted over the remaining life of the loan-backed or structured security (prospective method).

Beneficial Interests

20. The following paragraphs provide statutory accounting guidance for interest income and impairment for a reporting entity that continues to hold an interest in securitized financial assets accounted for as sales under SSAP No. 91R, or that purchases a beneficial interest in securitized financial assets that are not of high credit quality or can contractually be prepaid or otherwise settled in such a way that the reporting entity would not recover substantially all of its recorded amount, determined at acquisition or the date of transfer[5]. Beneficial interests that are of high credit quality and cannot contractually be prepaid or otherwise settled in such a way that the reporting entity would not recover substantially all of its recorded investment, shall be accounted for in accordance with paragraphs 12-16.

21. The reporting entity shall recognize the excess of all cash flows attributable to the beneficial interest estimated at the acquisition/transaction date (referred to herein as the transaction date) over the initial investment (the accretable yield) as interest income over the life of the beneficial interest using the effective yield method. If the holder of the beneficial interest is the reporting entity that transferred the financial assets for securitization, the initial investment would be the allocated carrying amount after application of the relative fair value allocation method required by SSAP No. 91R. The amount of accretable yield shall not be displayed in the balance sheet.

22. The reporting entity that holds a beneficial interest shall continue to update the estimate of cash flows over the life of the beneficial interest. If upon evaluation:

a. Based on current information and events it is probable that there is a favorable (or an adverse) change in estimated cash flows from the cash flows previously projected, then the investor shall recalculate the amount of accretable yield for the beneficial interest on the date of evaluation as the excess of estimated cash flows over the beneficial interest's reference amount (the reference amount is equal to (1) the initial investment less (2) cash received to date less (3) other-than-temporary impairments recognized to date [as described in paragraph 22.b.] plus (4) the yield accreted to date. The adjustment shall be accounted for prospectively as a change in estimate in conformity with SSAP No. 3, with the amount of periodic accretion adjusted over the remaining life of the beneficial

[5] The accounting requirements related to these type of securities included in paragraphs 20-24 shall be determined at acquisition or initial transfer. As referenced in the Relevant Literature section, this Statement adopts EITF 99-20, including the scope requirements of that guidance.

interest. Based on estimated cash flows, interest income may be recognized on a beneficial interest even if the net investment in the beneficial interest is accreted to an amount greater than the amount at which the beneficial interest could be settled if prepaid immediately in its entirety.

b. The fair value of the beneficial interest has declined below its reference amount; a reporting entity shall determine whether the decline is other-than-temporary. If, based on current information and events it is probable that there has been an adverse change in estimated cash flows (in accordance with paragraph 22.a. above), then (1) an other-than-temporary impairment shall be considered to have occurred and (2) the beneficial interest shall be written down to the current estimate of cash flows at the financial reporting date discounted at a rate equal to the current yield used to accrete the beneficial interest with the resulting change being recognized as a realized loss. Determining whether there has been a favorable (or an adverse) change in estimated cash flows from the cash flows previously projected (taking into consideration both the timing and amount of the estimated cash flows) involves comparing the present value of the remaining cash flows as estimated at the initial transaction date (or at the last date previously revised) against the present value of the cash flows estimated at the current financial reporting date. The cash flows shall be discounted at a rate equal to the current yield used to accrete the beneficial interest. If the present value of the original cash flows estimated at the initial transaction date (or the last date previously revised) is less than the present value of the current estimate of cash flows expected to be collected, the change is considered favorable (that is, an other-than-temporary impairment shall be considered to have not occurred). If the present value of the original cash flows estimated at the initial transaction date (or the last date previously revised) is greater than the present value of the current estimated cash flows, the change is considered adverse (that is, an other-than-temporary impairment shall be considered to have occurred). However, absent any other factors that indicate an other-than-temporary impairment has occurred, changes in the interest rate of a "plain-vanilla," variable-rate beneficial interest generally shall not result in the recognition of an other-than-temporary impairment[6] (a plain-vanilla, variable-rate beneficial interest does not include those variable-rate beneficial interests with interest rate reset formulas that involve either leverage or an inverse floater).

23. All cash flows estimated at the transaction date are defined as the holder's estimate of the amount and timing of estimated future principal and interest cash flows used in determining the purchase price or the holder's fair value determination for purposes of determining a gain or loss under SSAP No. 91R. Subsequent to the transaction date, estimated cash flows are defined as the holder's estimate of the amount and timing of estimated principal and interest cash flows based on the holder's best estimate of current information and events. A change in estimated cash flows is considered in the context of both timing and amount of the estimated cash flows.

24. In situations in which it is not practicable for a transferor to estimate the fair value of the beneficial interest at the initial transfer date, interest income shall not be recognized using the interest method. For these beneficial interests (that is, those beneficial interests that continue to be held by a transferor that are recorded at $0 pursuant to SSAP No. 91R), the transferor shall use the cash basis for recognizing interest income because the beneficial interest will have an allocated carrying amount of zero.

[6] Changes in the interest rate of a "plain-vanilla," variable-rate beneficial interest (a plain-vanilla, variable-rate beneficial interest does not include those variable-rate beneficial interests with interest rate reset formulas that involve either leverage or an inverse floater) generally should not result in the recognition of an other-than-temporary impairment. For plain-vanilla, variable-rate beneficial interests, the yield is changed to reflect the revised interest rate based on the contractual interest rate reset formula. For example, if a beneficial interest pays interest quarterly at a rate equal to LIBOR plus 2 percent, the yield of that beneficial interest is changed prospectively to reflect changes in LIBOR. However, changes in the fair value of a plain-vanilla, variable-rate beneficial interest due to credit events should be considered when evaluating whether there has been an other-than-temporary impairment.

Reporting and Impairment Guidance for All Loan-Backed and Structured Securities

25. Loan-backed securities shall be valued and reported in accordance with this statement, the *Purposes and Procedures Manual of the NAIC Securities Valuation Office*, and the designation assigned in the NAIC Valuations of Securities product prepared by the NAIC Securities Valuation Office. For reporting entities that maintain an Asset Valuation Reserve (AVR), loan-backed securities shall be reported at amortized cost, except for those with an NAIC designation of 6, which shall be reported at the lower of amortized cost or fair value. For reporting entities that do not maintain an AVR, loan-backed securities designated highest-quality and high-quality (NAIC designations 1 and 2, respectively) shall be reported at amortized cost; loan-backed securities that are designated medium quality, low quality, lowest quality and in or near default (NAIC designations 3 to 6, respectively) shall be reported at the lower of amortized cost or fair value.

26. For reporting entities required to maintain an AVR, the accounting for unrealized gains and losses shall be in accordance *with SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve* (SSAP No. 7). For reporting entities not required to maintain an AVR, unrealized gains and losses shall be recorded as a direct credit or charge to unassigned funds (surplus).

27. The application of this reporting requirement resulting from NAIC designation (i.e., lower of cost or fair value) is not a substitute for other-than-temporary impairment recognition (paragraphs 32-36). For securities reported at fair value where an other-than-temporary impairment has been determined to have occurred, the realized loss recognized from the other-than-temporary impairment shall first be applied towards the realization of any unrealized losses previously recorded as a result of fluctuations in the security's fair value due to the reporting requirements. After the recognition of the other-than-temporary impairment, the security shall continue to report unrealized gains and losses as a result of fluctuations in fair value.

28. If the fair value of a loan-backed or structured security is less than its amortized cost basis at the balance sheet date, an entity shall assess whether the impairment is other than temporary. Amortized cost basis includes adjustments made to the cost of an investment for accretion, amortization, collection of cash, previous other-than-temporary impairments recognized as a realized loss (including any cumulative-effect adjustments recognized in accordance with paragraphs 55-57 of this Statement).

29. If an entity intends to sell the loan-backed or structured security (that is, it has decided to sell the security), an other-than-temporary impairment shall be considered to have occurred.

30. If an entity does not intend to sell the loan-backed or structured security, the entity shall assess whether it has the intent and ability[7] to retain the investment in the security for a period of time sufficient to recover the amortized cost basis. If the entity does not have the intent and ability to retain the investment for the time sufficient to recover the amortized cost basis, an other-than-temporary impairment shall be considered to have occurred.

31. If the entity does not expect to recover the entire amortized cost basis of the security, the entity would be unable to assert that it will recover its amortized cost basis even if it does not intend to sell the security and the entity has the intent and ability to hold. Therefore, in those situations, an other-than temporary impairment shall be considered to have occurred. In assessing whether the entire amortized cost basis of the security will be recovered, an entity shall compare the present value of cash flows expected to be collected from the security with the amortized cost basis of the security. If present value of cash flows expected to be collected is less than the amortized cost basis of the security, the entire amortized cost basis of the security will

[7] This assessment shall be considered a high standard due to the accounting measurement method established for the securities within the scope of this Statement (amortized cost).

not be recovered (that is, a non-interest related decline[8] exists), and an other-than-temporary impairment shall be considered to have occurred. A decrease in cashflows expected to be collected on a loaned-backed or structured security that results from an increase in prepayments on the underlying assets shall be considered in the estimate of the present value of cashflows expected to be collected.

32. In determining whether a non-interest related decline exists, an entity shall calculate the present value of cash flows expected to be collected based on an estimate of the expected future cash flows of the impaired loan-backed or structured security, discounted at the security's effective interest rate.

a. For securities accounted for under paragraphs 12-16 – the effective interest rate of the loan-backed or structured security is the rate of return implicit in the security (that is, the contractual interest rate adjusted for any net deferred fees or costs, premium, or discount existing at the origination or acquisition of the security).[9]

b. For securities accounted for under paragraphs 17-19 – the effective interest rate is the rate implicit immediately prior to the recognition of the other-than-temporary impairment.

c. For securities accounted for under paragraphs 20-24 – the reporting entity shall apply the guidance in paragraph 22.b.

33. When an other-than-temporary impairment has occurred because the entity intends to sell the security or has assessed that that they do not have the intent and ability to retain the investments in the security for a period of time sufficient to recover the amortized cost basis, the amount of the other-than-temporary impairment recognized in earnings as a realized loss shall equal the entire difference between the investment's amortized cost basis and its fair value at the balance sheet date. (This guidance includes loan-backed securities previously held at lower of cost or market. For these securities, upon recognition of an other-than-temporary impairment, unrealized losses would be considered realized.)

34. When an other-than-temporary impairment has occurred because the entity does not expect to recover the entire amortized cost basis of the security even if the entity has no intent to sell and the entity has the intent and ability to hold, the amount of the other-than-temporary impairment recognized as a realized loss shall equal the difference between the investment's amortized cost basis and the present value of cash flows expected to be collected, discounted at the loan-backed or structured security's effective interest rate in accordance with paragraph 32. (This guidance includes loan-backed securities previously held at lower of cost or market. For these securities, upon recognition of an other-than-temporary impairment, unrealized losses would be considered realized for the non-interest related decline. Hence, unrealized losses could continue to be reflected for these securities due to the reporting requirements.)

35. For reporting entities required to maintain an AVR or IMR, the accounting for the other-than-temporary impairment shall be in accordance with *SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve*. Non-interest related other-than-temporary impairment losses shall be recorded through the AVR. If the reporting entity wrote the security down to fair value due to the intent to sell or does not have the intent and ability to retain the investment in the security for a period of time sufficient to recover the amortized cost basis, the non-interest related portion of the other-than-temporary impairment losses shall be recorded through the AVR; the interest related other-than-temporary impairment losses shall be recorded through the IMR.

[8] A non-interest related decline is a decline in value due to fundamental credit problems of the issuer. Fundamental credit problems exist with the issuer when there is evidence of financial difficulty that may result in the issuer being unable to pay principal or interest when due. An interest related decline in value may be due to both increases in the risk-free interest rate and general credit spread widening.

[9] See Footnote 1.

36. For situations where an other-than-temporary impairment is recognized pursuant to paragraphs 33 and 34 of this Statement, the previous amortized cost basis less the other-than-temporary impairment recognized as a realized loss shall become the new amortized cost basis of the investment. That new amortized cost basis shall not be adjusted for subsequent recoveries in fair value. Therefore, the prospective adjustment method shall be used for periods subsequent to loss recognition.

37. In periods subsequent to the recognition of an other than temporary impairment loss for a loan-backed or structured security, the reporting entity shall account for the other-than-temporarily impaired security as if the security had been purchased on the measurement date of the other-than-temporary impairment at an amortized cost basis equal to the previous amortized cost basis less the other-than-temporary impairment recognized as a realized loss. The difference between the new amortized cost basis and the cash flows expected to be collected shall be accreted as interest income. A reporting entity shall continue to estimate the present value of cash flows expected to be collected over the life of the loan-backed or structured security.

a. For securities accounted for under paragraphs 12-19, if upon subsequent evaluation, there is a significant increase in the cash flows expected to be collected or if actual cash flows are significantly greater than cash flows previously expected, such changes shall be accounted for as a prospective adjustment to the accretable yield in accordance with paragraphs 17-19. The security shall continue to be subject to impairment analysis for each subsequent reporting period. The new amortized cost basis shall not be changed for subsequent recoveries in fair value. Future declines in fair value which are determined to be other-than-temporary shall be recorded as realized losses.

b. For beneficial interests accounted for under paragraphs 20-24, a reporting entity shall apply the guidance in paragraphs 21-22 to account for changes in cash flows expected to be collected.

38. It is inappropriate to automatically conclude that a security is not other-than-temporarily impaired because all of the scheduled payments to date have been received. However, it also is inappropriate to automatically conclude that every decline in fair value represents an other-than-temporary impairment. Further analysis and judgment are required to assess whether a decline in fair value indicates that it is probable that the holder will not collect all of the contractual or estimated cash flows from the security. In addition, the length of time and extent to which the fair value has been less than cost can indicate a decline is other than temporary. The longer and/or the more severe the decline in fair value, the more persuasive the evidence that is needed to overcome the premise that it is probable that the holder will not collect all of the contractual or estimated cash flows from the issuer of the security.

39. In making its other-than-temporary impairment assessment, the holder shall consider all available information relevant to the collectibility of the security, including information about past events, current conditions, and reasonable and supportable forecasts, when developing the estimate of future cash flows. Such information generally shall include the remaining payment terms of the security, prepayment speeds, the financial condition of the issuer(s), expected defaults, and the value of any underlying collateral. To achieve that objective, the holder shall consider, for example, industry analyst reports and forecasts, sector credit ratings, and other market data that are relevant to the collectibility of the security. The holder also shall consider how other credit enhancements affect the expected performance of the security, including consideration of the current financial condition of the guarantor of a security (if the guarantee is not a separate contract) and/or whether any subordinated interests are capable of absorbing estimated losses on the loans underlying the security. The remaining payment terms of the security could be significantly different from the payment terms in prior periods (such as for some securities backed by "nontraditional loans"[10]). Thus, the holder shall consider whether a security

[10] A nontraditional loan may have features such as (a) terms that permit principal payment deferral or payments smaller than interest accruals (negative amortization), (b) a high loan-to-value ratio, (c) multiple loans on the same collateral that when combined result in a high loan-to value ratio, (d) option adjustable-rate mortgages (option ARMs) or similar products that may expose the borrower to

backed by currently performing loans will continue to perform when required payments increase in the future (including "balloon" payments). The holder also shall consider how the value of any collateral would affect the expected performance of the security. If the fair value of the collateral has declined, the holder needs to assess the effect of that decline on the ability of the holder to collect the balloon payment.

Origination Fees

40. Origination fees represent fees charged to the borrower in connection with the process of originating or restructuring a transaction. The fees include, but are not limited to, points, management, arrangement, placement, application, underwriting, and other fees pursuant to such a transaction. Origination fees shall not be recorded until received in cash. Origination fees intended to compensate the reporting entity for interest rate risks (e.g., points), shall be amortized into income over the term of the loan-backed security consistent with paragraph 8 of this statement. Other origination fees shall be recorded as income upon receipt.

Origination, Acquisition, and Commitment Costs

41. Costs related to origination when paid in the form of brokerage and other related fees shall be capitalized as part of the cost of the loan-backed security, consistent with paragraph 7 of this statement. All other costs, including internal costs or costs paid to an affiliated entity related to origination, purchase, or commitment to purchase loan-backed securities, shall be charged to expense when incurred.

Commitment Fees

42. Commitment fees are fees paid to the reporting entity that obligate the reporting entity to make available funds for future borrowing under a specified condition. A fee paid to the reporting entity to obtain a commitment to make funds available at some time in the future, generally, is refundable only if the loan-backed security is issued. If the loan-backed security is not issued, then the fees shall be recorded as investment income by the reporting entity when the commitment expires.

43. A fee paid to the reporting entity to obtain a commitment to borrow funds at a specified rate and with specified terms quoted in the commitment agreement, generally, is not refundable unless the commitment is refused by the reporting entity. This type of fee shall be deferred, and amortization shall depend on whether or not the commitment is exercised. If the commitment is exercised, then the fee shall be amortized in accordance with paragraph 8 of this statement over the life of the loan-backed security as an adjustment to the investment income on the loan-backed security. If the commitment expires unexercised, the commitment fee shall be recognized in income on the commitment expiration date.

Giantization/Megatization of FHLMC or FNMA Mortgage Backed Securities

44. Giantization/megatization of mortgage backed securities is defined as existing pools of FHLMC or FNMA mortgage-backed securities (MBS) with like coupon and prefix which are repooled together by the issuing agency creating a new larger security. The new Fannie Mae "Mega" or Freddie Mac "Giant" is a guaranteed MBS pass-through representing an undivided interest in the underlying pools of loans.

45. The benefits derived from giantization/megatization include:

a. Increased liquidity: Smaller MBS pools (particularly those with current face of less than $1 million) are less liquid than mortgage pools with current faces

future increases in repayments in excess of increases that result solely from increases in the market interest rate (for example, once negative amortization results in the loan reaching a maximum principal accrual limit), (e) an initial interest rate that is below the market interest rate for the initial period of the loan term and that may increase significantly when that period ends, and (f) interest-only loans that should be considered in developing an estimate of future cash flows.

exceeding $5 million. Repooling smaller MBS pools into one larger pool improves the marketability for the aggregate package;

b. Geographic diversity: Regrouping of multiple pools generally will create greater geographic pool loan diversity resulting in less prepayment variation due to regional economic factors;

c. Reduced administrative expenses: The reduced number of pools lowers bank custodial fees, pricing/factor service fees, and increases efficiency for the accounting and investment departments.

46. Repooled FHLMC and FNMA securities meet the definition of substantially the same as defined in *SSAP No. 91R—Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. The transaction shall not be considered a sale/purchase and no gain or loss shall be recognized. To properly document the repooling, the transaction shall be reported through Schedule D of the Annual Statement as a disposition and an acquisition.

47. Transaction fees charged by the issuing agencies shall be capitalized and amortized over the life of the repooled security.

Disclosures

48. In addition to the disclosures required for invested assets in general, the following disclosures regarding loan-backed securities shall be made in the financial statements. Regardless of the allowances within paragraph 59 of the Preamble, the disclosures in paragraph 48.f., 48.g. and 48.h. are required in separate, distinct notes to the financial statements:

a. Fair values in accordance with *SSAP No. 27—Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk, Financial Instruments with Concentrations of Credit Risk and Disclosures about Fair Value of Financial Instruments* (SSAP No. 27);

b. Concentrations of credit risk in accordance with SSAP No. 27;

c. Basis at which the loan-backed securities are stated;

d. The adjustment methodology used for each type of security (prospective or retrospective);

e. Descriptions of sources used to determine prepayment assumptions.

f. All securities within the scope of this statement with a recognized other-than-temporary impairment, disclosed in the aggregate, classified on the basis for the other-than-temporary impairment: (1) intent to sell, (2) inability or lack of intent to retain the investment in the security for a period of time sufficient to recover the amortized cost basis, or (3) present value of cash flows expected to be collected is less than the amortized cost basis of the security.

g. For each security with a recognized other-than-temporary impairment, currently held by the reporting entity, as the present value of cash flows expected to be collected is less than the amortized cost basis of the securities:

i. The amortized cost basis, prior to any current-period other-than-temporary impairment.

ii. The other-than-temporary impairment recognized in earnings as a realized loss.

iii. The fair value of the security.

iv. The amortized cost basis after the current-period other-than-temporary impairment.

h. All impaired securities (fair value is less than cost or amortized cost) for which an other-than-temporary impairment has not been recognized in earnings as a realized loss (including securities with a recognized other-than-temporary impairment for non-interest related declines when a non-recognized interest related impairment remains):

i. The aggregate amount of unrealized losses (that is, the amount by which cost or amortized cost exceeds fair value) and

ii. The aggregate related fair value of securities with unrealized losses.

i. The disclosures in (i) and (ii) above should be segregated by those securities that have been in a continuous unrealized loss position for less than 12 months and those that have been in a continuous unrealized loss position for 12 months or longer using fair values determined in accordance with SSAP No. 27.

j. Additional information should be included describing the general categories of information that the investor considered in reaching the conclusion that the impairments are not other-than-temporary.

k. When it is not practicable to estimate fair value in accordance with SSAP No. 27, the investor should disclose the following additional information, if applicable:

i. The aggregate carrying value of the investments not evaluated for impairment, and

ii. The circumstances that may have a significant adverse effect on the fair value.

49. Refer to the preamble for further discussion regarding disclosure requirements. All disclosures within this Statement shall be included within the interim and annual statutory financial statements.

Relevant Literature

50. This statement adopts *FASB Emerging Issues Task Force No. 99-20*, *Exchange of Interest-Only and Principal-Only Securities for a Mortgage-Backed Security and FASB Staff Position EITF 99-20-1, Amendments to the Impairment Guidance of EITF Issue No. 99-20.* This statement adopts paragraphs 5, 7 and 9 of AICPA *Statement of Position 03-03, Accounting for Certain Loans or Debt Securities Acquired in a Transfer* (SOP 03-03) for loan-backed and structured securities only. With the exception of this specific adoption, consideration of SOP 03-03 is still pending consideration for statutory accounting.

51. This statement rejects *FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities* and *FASB Statement No. 91, Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*.

52. This statement also rejects *FASB Emerging Issues Task Force No. 89-4, Accounting for a Purchased Investment in a Collateralized Mortgage Obligation Instrument or in a Mortgage-Backed Interest-Only Certificate, FASB Emerging Issues Task Force No. 90-2, Exchange of Interest-Only and Principal-Only Securities for a Mortgage-Backed Security, FASB Emerging Issues Task Force No. 93-18, Recognition of Impairment for an Investment in a Collateralized Mortgage Obligation Instrument or in a Mortgage-Backed Interest-Only Certificate*, and *FASB Emerging Issues Task Force No. 96-12, Recognition of Interest Income and Balance Sheet Classification of Structured Notes*.

Effective Date and Transition

53. This statement is effective for years beginning January 1, 2001. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with *SSAP No. 3—Accounting Changes and Corrections of Errors*.

54. For securities purchased prior to January 1, 1994, where historical cash flows are not readily available for applying the retrospective method, the reporting entity may use January 1, 1994 as the acquisition date and the then book value as the cost for purposes of determining yield adjustments in future periods.

55. This revised statement supersedes SSAP No. 98 and paragraph 13 of SSAP No. 99 effective September 30, 2009. For reporting entities that either early adopted the requirements of SSAP No. 98 or previously adopted a statutory accounting policy that was in accord with the prescriptions of SSAP No. 98, for which an other-than-temporary impairment was previously recognized, and if such reporting entities do not intend to sell the security, and have the intent and ability to retain the investment in the security for a period of time sufficient to recover the amortized cost basis, those reporting entities shall recognize the cumulative effect of reversing the impact of the adoption of SSAP No. 98, or an equivalent statutory accounting policy, and paragraph 13 of SSAP No. 99 as an adjustment to the opening balance of unassigned funds (surplus) as of July 1, 2009, with a corresponding adjustment to applicable financial statement elements.

56. The accounting and reporting requirements of this revised statement shall be applied to existing and new investments held by a reporting entity on or after September 30, 2009. For loan-backed and structured securities held at the beginning of the interim period of adoption (July 1, 2009) and continue to be held as of September 30, 2009, for which an other-than-temporary impairment was previously recognized under SSAP No. 43, if a reporting entity does not intend to sell the security, and has the intent and ability to retain the investment in the security for a period of time sufficient to recover the amortized cost basis, the reporting entity shall recognize the cumulative effect of initially applying this revised statement as an adjustment to the opening balance of unassigned funds (surplus) as of July 1, 2009, with a corresponding adjustment to applicable financial statement elements. The cumulative effect on unassigned funds (surplus) shall be calculated by comparing the present value of the cash flows expected to be collected determined in accordance with the methodology in paragraph 32, as applicable, with the amortized cost basis of the loan-backed and structured security as of the beginning of the interim period in which this revised statement is adopted (July 1, 2009). The cumulative-effect adjustment shall include related tax effects. The discount rate used to calculate the present value of the cash flows expected to be collected shall be the rate in effect before recognizing any other-than-temporary impairments and not a rate that has been adjusted to reflect those impairments.

57. The amortized cost basis of a security for which an other-than-temporary impairment was previously recognized shall be adjusted by the amount of the cumulative-effect adjustment before taxes. The difference between the new amortized cost basis and the cash flows expected to be collected shall be accreted as interest income (see paragraph 37).

58. In the period of adoption, an entity shall provide the disclosures required by SSAP No. 3 for changes in accounting principles.

AUTHORITATIVE LITERATURE

Statutory Accounting

- *Purposes and Procedures Manual of the NAIC Securities Valuation Office*
- NAIC *Valuations of Securities* manual prepared by the Securities Valuation Office

RELEVANT ISSUE PAPERS

- *Issue Paper No. 43—Loan-Backed and Structured Securities*
- *Issue Paper No. 140—Substantive Revisions to SSAP No. 43—Loan-Backed and Structured Securities*, Revised September, 2009

DISCUSSION

6. This Issue Paper is intended to provide a historical reference of SSAP No. 43, SSAP No. 98 and SSAP No. 99 prior to the adoption of SSAP No. 43R. SSAP No. 43R was adopted in September 2009 with an effective date of September 30, 2009.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

7. Statutory accounting principles for loan-backed and structured securities was included within *SSAP No. 43—Loan-Backed and Structured Securities* (SSAP No. 43). This guidance has been superseded by SSAP No. 43R:

> SCOPE OF STATEMENT
>
> 1. This statement establishes statutory accounting principles for investments in loan-backed securities and structured securities. In accordance with SSAP No. 91R, retained beneficial interests from the sale of loan-backed securities and structured securities are accounted for in accordance with this statement. In this statement loan-backed securities and structured securities are collectively referred to as loan-backed securities.
>
> SUMMARY CONCLUSION
>
> 2. Loan-backed securities are defined as pass-through certificates, collateralized mortgage obligations (CMOs), and other securitized loans not included in structured securities, as defined below, for which the payment of interest and/or principal is directly proportional to the interest and/or principal received by the issuer from the mortgage pool or other underlying securities.
>
> 3. 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 interest and/or principal received by the issuer from the mortgage pool or other underlying securities.
>
> 4. Loan-backed securities are issued by special-purpose corporations or trusts (issuer) established by a sponsoring parent organization. Mortgage loans or other securities 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 can look only to the issuer's assets (primarily the trusteed assets or third parties such as insurers or guarantors) 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 mortgage loans. Some sponsors do guarantee the performance of the underlying loans.
>
> 5. Loan-backed 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.

Acquisitions and Sales

6. At acquisition, loan-backed securities shall be reported at cost, including brokerage and related fees. Cost shall not exceed fair value. Acquisitions and dispositions shall be recorded on the trade date, not the settlement date, except for the acquisition of private placement loan-backed securities which shall be recorded on the funding date. For securities where all information is not known as of the trade date (e.g., actual payment factors and specific pools), a reporting entity shall make its best estimate based on known facts.

Amortization

7. Amortization of premium or discount shall be calculated using the scientific (constant yield) interest method and shall be recorded as an adjustment to investment income. The interest method results in a constant effective yield equal to the prevailing rate at the time of purchase or at the time of subsequent adjustments to book value. The amortization period shall reflect estimates of the period over which repayment of principal of the loan-backed securities is expected to occur, not the stated maturity period.

Balance Sheet Amount

8. Loan-backed securities shall be valued and reported in accordance with this statement, the *Purposes and Procedures Manual of the NAIC Securities Valuation Office*, and the designation assigned in the NAIC *Valuations of Securities* product prepared by the NAIC Securities Valuation Office. For reporting entities that maintain an Asset Valuation Reserve (AVR), loan-backed securities shall be reported at amortized cost, except for those with an NAIC designation of 6, which shall be reported at the lower of amortized cost or fair value. For reporting entities that do not maintain an AVR, loan-backed securities designated highest-quality and high-quality (NAIC designations 1 and 2, respectively) shall be reported at amortized cost; loan-backed securities that are designated medium quality, low quality, lowest quality and in or near default (NAIC designations 3 to 6, respectively) shall be reported at the lower of amortized cost or fair value.

9. For reporting entities required to maintain an AVR, the accounting for unrealized gains and losses shall be in accordance with *SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve* (SSAP No. 7). For reporting entities not required to maintain an AVR, unrealized gains and losses shall be recorded as a direct credit or charge to unassigned funds (surplus).

Changes in Valuation

10. Prepayments are a significant variable element in the cash flow of loan-backed securities because they affect the yield and determine the expected maturity against which the yield is evaluated. Falling interest rates generate faster prepayment of the mortgages underlying the security, shortening its duration. This causes the reporting entity to reinvest assets sooner than expected at potentially less advantageous rates. This is called prepayment risk. Extension risk is created by rising interest rates which slow repayment and can significantly lengthen the duration of the security. Differences in cash flows can also result from other changes in the cash flows from the underlying assets. If assets are delinquent or otherwise not generating cash flow, that should be reflected in the cash flow analysis through diminishing security cash flows, even if assets have not been liquidated and gain/losses have not been booked.

11. Changes in currently estimated cash flows, including the effect of prepayment assumptions, on loan-backed securities shall be reviewed periodically. For securities that have the potential for loss of a portion of the original investment, the review shall be performed at least quarterly. For other securities, the review shall be performed at least annually. In addition to assets that are delinquent or otherwise not generating cash flows, other examples of securities that have the potential for loss of a portion of the original investment include CMO residuals and mortgage-backed interest-only certificates. For these securities, an effective yield or internal rate

of return is calculated at acquisition based on the purchase price and anticipated future cash flows.

12. The prepayment rates of the underlying loans shall be used to determine prepayment assumptions. Prepayment assumptions shall be applied consistently across portfolios to all securities backed by similar collateral (similar with respect to coupon, issuer, and age of collateral). Reporting entities shall use consistent assumptions across portfolios for similar collateral within controlled affiliated groups. Since each reporting entity may have a unique method for determining the prepayment assumptions, it is impractical to set standard assumptions for the industry. Relevant sources and rationale used to determine each prepayment assumption shall be documented by the reporting entity.

13. Loan-backed securities shall be revalued using the currently estimated cash flows, including new prepayment assumptions, using either the prospective or retrospective adjustment methodologies, consistently applied by type of securities.

14. The prospective approach recognizes, through the recalculation of the effective yield to be applied to future periods, the effects of all cash flows whose amounts differ from those estimated earlier and the effects and changes in projected cash flows. Under the prospective method, the recalculated effective yield will equate the carrying amount of the investment to the present value of the anticipated future cash flows. The recalculated yield is then used to accrue income on the investment balance for subsequent accounting periods. There are no accounting changes in the current period unless the undiscounted anticipated cash flow is less than the carrying amount of the investment.

15. The retrospective methodology changes both the yield and the asset balance so that expected future cash flows produce a return on the investment equal to the return now expected over the life of the investment as measured from the date of acquisition. Under the retrospective method, the recalculated effective yield will equate the present value of the actual and anticipated cash flows with the original cost of the investment. The current balance is then increased or decreased to the amount that would have resulted had the revised yield been applied since inception, and investment income is correspondingly decreased or increased.

Impairment

16. Regardless of whether a reporting entity is using a prospective or retrospective method, if the revaluation based on new currently estimated cash flows results in a negative yield (i.e., undiscounted estimated future cash flows are less than the current book value), an other than temporary impairment shall be considered to have occurred. If it is determined an other than temporary impairment has occurred, the cost basis of the security shall be written down to the undiscounted estimated future cash flows and the amount of the write down shall be accounted for as a realized loss. For reporting entities required to maintain an AVR/IMR, the accounting for the entire amount of the realized capital loss shall be in accordance with *SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve*. The new cost basis shall not be changed for subsequent recoveries in fair value. Therefore, the prospective adjustment method must be utilized for periods subsequent to the loss recognition.

17. NOTE: This paragraph is added by *SSAP No. 99—Accounting for Certain Securities Subsequent to an Other-Than-Temporary Impairment.* Remaining paragraphs are renumbered.

In periods subsequent to the recognition of an other than temporary impairment loss for a loan-backed or structured security, the reporting entity shall account for the other-than-temporarily impaired security as if the security had been purchased on the measurement date of the other-than-temporary impairment. The fair value of the security on the measurement date shall become the new cost basis. The discount or reduced premium recorded for the security, based on the new cost basis, shall be amortized in the prospective manner over the remaining period in which repayment of principal is expected to occur. The security shall continue to be subject to impairment analysis for each subsequent reporting period. The new cost basis shall not be changed for subsequent recoveries in fair value. Therefore, the prospective adjustment method must be utilized for periods subsequent to the impairment loss recognition. Future declines in fair value which are determined to be other-than-temporary shall be recorded as realized losses.

Income

18. Interest shall be accrued using the interest method using the redemption prices and redemption dates used for amortizing premiums and discounts. Interest income consists of interest collected during the period, the change in the due and accrued interest between the beginning and end of the period as well as reductions for premium amortization and interest paid on acquisition of loan-backed securities, and the addition of discount accrual. Contingent interest may be accrued if the applicable provisions of the underlying contract and the prerequisite conditions have been met.

19. For reporting entities required to maintain an IMR, the accounting for realized capital gains and losses on sales of loan-backed securities shall be in accordance with *SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve*. For reporting entities not required to maintain an IMR, realized gains and losses on sales of loan-backed securities shall be recorded on the trade date and shall be reported as net realized capital gains or losses in the Statement of Income.

20. A loan-backed security may provide for a prepayment penalty or acceleration fee in the event the investment is liquidated prior to its scheduled termination date. These fees shall be reported as investment income when received.

Beneficial Interests

21. A holder of a beneficial interest in securitized financial assets should recognize the excess of all cash flows attributable to the beneficial interest estimated at the acquisition/transaction date over the initial investment as interest income over the life of the beneficial interest using the effective yield method.

22. The holder of a beneficial interest should continue to update the estimate of cash flows over the life of the beneficial interest. Based on current information and events, if a favorable or adverse change in estimated cash flows is projected, the holder should recalculate the amount of interest income for the beneficial interest on the date of evaluation. The recalculated yield should be used to recognize interest income as a prospective change over the remaining life of the beneficial interest. Impairment for beneficial interests shall be determined in accordance with paragraph 16.

Origination Fees

23. Origination fees represent fees charged to the borrower in connection with the process of originating or restructuring a transaction. The fees include, but are not limited to, points, management, arrangement, placement, application, underwriting, and other fees pursuant to such a transaction. Origination fees shall not be recorded until received in cash. Origination fees intended to compensate the reporting entity for interest rate risks (e.g., points), shall be amortized into income over the term of the loan-backed security consistent with paragraph 7 of this statement. Other origination fees shall be recorded as income upon receipt.

Origination, Acquisition, and Commitment Costs

24. Costs related to origination when paid in the form of brokerage and other related fees shall be capitalized as part of the cost of the loan-backed security, consistent with paragraph 6 of this statement. All other costs, including internal costs or costs paid to an affiliated entity related to origination, purchase, or commitment to purchase loan-backed securities, shall be charged to expense when incurred.

Commitment Fees

25. Commitment fees are fees paid to the reporting entity that obligate the reporting entity to make available funds for future borrowing under a specified condition. A fee paid to the reporting entity to obtain a commitment to make funds available at some time in the future, generally, is refundable only if the loan-backed security is issued. If the loan-backed security is not issued, then the fees shall be recorded as investment income by the reporting entity when the commitment expires.

26. A fee paid to the reporting entity to obtain a commitment to borrow funds at a specified rate and with specified terms quoted in the commitment agreement, generally, is not refundable unless the commitment is refused by the reporting entity. This type of fee shall be deferred, and amortization shall depend on whether or not the commitment is exercised. If the commitment is exercised, then the fee shall be amortized in accordance with paragraph 7 of this statement over the life of the loan-backed security as an adjustment to the investment income on the loan-backed security. If the commitment expires unexercised, the commitment fee shall be recognized in income on the commitment expiration date.

Giantization/Megatization of FHLMC or FNMA Mortgage Backed Securities

27. Giantization/megatization of mortgage backed securities is defined as existing pools of FHLMC or FNMA mortgage-backed securities (MBS) with like coupon and prefix which are repooled together by the issuing agency creating a new larger security. The new Fannie Mae “Mega” or Freddie Mac “Giant” is a guaranteed MBS pass-through representing an undivided interest in the underlying pools of loans.

28. The benefits derived from giantization/megatization include:

a. Increased liquidity: Smaller MBS pools (particularly those with current face of less than $1 million) are less liquid than mortgage pools with current faces exceeding $5 million. Repooling smaller MBS pools into one larger pool improves the marketability for the aggregate package;

b. Geographic diversity: Regrouping of multiple pools generally will create greater geographic pool loan diversity resulting in less prepayment variation due to regional economic factors;

c. Reduced administrative expenses: The reduced number of pools lowers bank custodial fees, pricing/factor service fees, and increases efficiency for the accounting and investment departments.

29. Repooled FHLMC and FNMA securities meet the definition of substantially the same as defined in *SSAP No. 91R—Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. The transaction shall not be considered a sale/purchase and no gain or loss shall be recognized. To properly document the repooling, the transaction shall be reported through Schedule D of the Annual Statement as a disposition and an acquisition.

30. Transaction fees charged by the issuing agencies shall be capitalized and amortized over the life of the repooled security.

Disclosures

31. In addition to the disclosures required for invested assets in general, the following disclosures regarding loan-backed securities shall be made in the financial statements:

a. Fair values in accordance with SSAP No. 27—Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk, Financial Instruments with Concentrations of Credit Risk and Disclosures about Fair Value of Financial Instruments (SSAP No. 27);

b. Concentrations of credit risk in accordance with SSAP No. 27;

c. Basis at which the loan-backed securities are stated;

d. The adjustment methodology used for each type of security (prospective or retrospective);

e. Changes from the retrospective to the prospective adjustment methodology due to negative yield on specific securities;

f. If, for applying the retrospective method, the reporting entity has elected to use book value as of January 1, 1994 as the cost for securities purchased prior to January 1, 1994 where historical cash flows are not readily available; and

g. Descriptions of sources used to determine prepayment assumptions.

h. For each balance sheet presented, all securities in an unrealized loss position for which other-than-temporary declines in value have not been recognized

   i. The aggregate amount of unrealized losses (that is, the amount by which cost or amortized cost exceeds fair value) and

   ii. The aggregate related fair value of securities with unrealized losses.

i. The disclosures in (i) and (ii) above should be segregated by those securities that have been in a continuous unrealized loss position for less than 12 months and those that have been in a continuous unrealized loss position for 12 months or longer using fair values determined in accordance with SSAP No. 27.

j. As of the date of the most recent balance sheet presented, additional information should be included describing the general categories of information that the investor considered in reaching the conclusion that the impairments are not other-than-temporary.

k. When it is not practicable to estimate fair value in accordance with SSAP No. 27, the investor should disclose the following additional information, if applicable, as of each date for which a statement of financial position is presented in its annual financial statements:

   i. The aggregate carrying value of the investments not evaluated for impairment, and

   ii. The circumstances that may have a significant adverse effect on the fair value.

32. Refer to the preamble for further discussion regarding disclosure requirements. The disclosures in paragraphs 31.a., 31.b., 31.h., 31.i., 31.j., and 31.k. above shall be included in the annual audited statutory financial reports only.

Relevant Literature

33. This statement rejects *FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities* and *FASB Statement No. 91, Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*.

34. This statement also rejects FASB Emerging Issues Task Force No. 89-4, *Accounting for a Purchased Investment in a Collateralized Mortgage Obligation Instrument or in a Mortgage-Backed Interest-Only Certificate,* FASB Emerging Issues Task Force No. 90-2, *Exchange of Interest-Only and Principal-Only Securities for a Mortgage-Backed Security,* FASB Emerging

Issues Task Force No. 93-18, *Recognition of Impairment for an Investment in a Collateralized Mortgage Obligation Instrument or in a Mortgage-Backed Interest-Only Certificate, and FASB Emerging Issues Task Force No. 96-12, Recognition of Interest Income and Balance Sheet Classification of Structured Notes, and FASB Emerging Issues Task Force No. 99-20, Recognition of Interest Income and Impairment on Purchased and Retained Beneficial Interests in Securitized Financial Assets.*

Effective Date and Transition

35. This statement is effective for years beginning January 1, 2001. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with *SSAP No. 3—Accounting Changes and Corrections of Errors.*

36. For securities purchased prior to January 1, 1994, where historical cash flows are not readily available for applying the retrospective method, the reporting entity may use January 1, 1994 as the acquisition date and the then book value as the cost for purposes of determining yield adjustments in future periods.

8. *SSAP No. 98—Treatment of Cash Flows When Quantifying Changes in Valuation and Impairments, an Amendment of SSAP No. 43—Loan-Backed and Structured Securities* (SSAP No. 98) amended paragraphs 14-16 of SSAP No. 43. This guidance was superseded with the issuance of SSAP No. 43R:

SCOPE OF STATEMENT

1. This statement establishes statutory accounting principles for impairment analysis and subsequent valuation of loan-backed and structured securities.

SUMMARY CONCLUSION

2. This statement amends paragraphs 14-16 of SSAP No. 43—*Loan-Backed and Structured Securities* to the following:

14. The prospective approach recognizes, through the recalculation of the effective yield to be applied to future periods, the effects of all cash flows whose amounts differ from those estimated earlier and the effects and changes in projected cash flows. Under the prospective method, the recalculated effective yield will equate the carrying amount of the investment to the present value of the anticipated future cash flows. The recalculated yield is then used to accrue income on the investment balance for subsequent accounting periods. There are no accounting changes in the current period unless the security is determined to be other than temporarily impaired.

15. The retrospective methodology changes both the yield and the asset balance so that expected future cash flows produce a return on the investment equal to the return now expected over the life of the investment as measured from the date of acquisition. Under the retrospective method, the recalculated effective yield will equate the present value of the actual and anticipated cash flows with the original cost of the investment. The current balance is then increased or decreased to the amount that would have resulted had the revised yield been applied since inception, and investment income is correspondingly decreased or increased.

Impairment

16. If it is determined that the decline in fair value of the security is other than temporary, then the cost basis of the security shall be written down to fair value. The amount of the write down shall be accounted for as a realized loss. An interest related decline in value shall be considered other than temporary only when a reporting entity has the intent to sell the investment, at the reporting date, before recovery of the cost of

the investment. For reporting entities required to maintain an AVR/IMR, the accounting for the entire amount of the realized capital loss shall be in accordance with *SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve*. Credit related other than temporary impairment losses shall be recorded through the AVR; interest related other than temporary impairment losses shall be recorded through the IMR. The new cost basis shall not be changed for subsequent recoveries in fair value. Therefore, the prospective adjustment method must be utilized for periods subsequent to the loss recognition.

Disclosures

3. This statement requires no additional disclosures.

Effective Date and Transition

4. This statement is effective for quarterly and annual reporting periods beginning on or after January 1, 2009, with early adoption permitted and encouraged. A change resulting from the adoption of this statement shall be accounted for prospectively. No cumulative effect adjustments or application of the new guidance to prior events or periods are required, similar to a change in accounting estimate.

9. *SSAP No. 99—Accounting for Certain Securities Subsequent to an Other-Than-Temporary Impairment* (SSAP No. 99) establishes statutory accounting principles for the treatment of premium or discount applicable to certain securities subsequent to the recognition of an other-than-temporary impairment. Paragraph 13 of SSAP No. 99 inserted a new paragraph into SSAP No. 43. Consistent with the superseding of SSAP No. 43 by SSAP No. 43R, paragraph 13 of SSAP No. 99 (and the new paragraph inserted within SSAP No. 43) have also been superseded:

Loan-Backed and Structured Securities

13. This statement shall insert the following new paragraph 17 into SSAP No. 43, with subsequent paragraphs of SSAP No. 43 to be renumbered accordingly:

17. In periods subsequent to the recognition of an other than temporary impairment loss for a loan-backed or structured security, the reporting entity shall account for the other-than-temporarily impaired security as if the security had been purchased on the measurement date of the other-than-temporary impairment. The fair value of the security on the measurement date shall become the new cost basis. The discount or reduced premium recorded for the security, based on the new cost basis, shall be amortized in the prospective manner over the remaining period in which repayment of principal is expected to occur. The security shall continue to be subject to impairment analysis for each subsequent reporting period. The new cost basis shall not be changed for subsequent recoveries in fair value. Therefore, the prospective adjustment method must be utilized for periods subsequent to the impairment loss recognition. Future declines in fair value which are determined to be other-than-temporary shall be recorded as realized losses.

Disclosures

14. This statement requires no additional disclosures.

Generally Accepted Accounting Principles

10. The adoption of SSAP No. 43R did not adopt or reject any GAAP standards.

RELEVANT LITERATURE

Statutory Accounting

- *SSAP No. 43—Loan-Backed and Structured Securities*
- *SSAP No. 98—Treatment of Cash Flows When Quantifying Changes in Valuation and Impairments, an Amendment of SSAP No. 43—Loan-Backed and Structured Securities*
- *SSAP No. 99—Accounting for Certain Securities Subsequent to an Other-Than-Temporary Impairment*
- *Issue Paper No. 43—Loan-Backed and Structured Securities*
- *Issue Paper No. 124—Treatment of Cash Flows When Quantifying Changes in Valuation and Impairments: An Amendment to SSAP No. 43—Loan-Backed and Structured Securities*
- *Issue Paper No. 131—Accounting for Certain Securities Subsequent to an Other-Than-Temporary Impairment*

Generally Accepted Accounting Principles

- None

State Regulations

- No additional guidance obtained from state statutes or regulations.