Statutory Accounting Principles (E) Working Group

**Maintenance Agenda Submission Form**

**Form A**

## **Issue:** Eliminating Financial Modeling Process

**Check (applicable entity):**

 P/C Life Health

Modification of Existing SSAP [x]  [x]  [x]

New Issue or SSAP [ ]  [ ]  [ ]

Interpretation [ ]  [ ]  [ ]

Description of Issue: In coordination with a Valuation of Securities (E) Task Force and the Blanks (E) Working Group, this agenda item proposes elimination of the multi-step modeling process (i.e. incorporating breakpoints) to determine final NAIC designations on RMBS and CMBS securities.

Current guidance allows the amortized cost basis to be used in determining the “final” NAIC designation for statutory accounting and reporting - including the assessment of AVR and for risk-based capital (RBC) purposes. By design, this practice allows for reporting diversity as identical securities, purchased a different price points (thus having different amortized/carrying values) may have differing reported NAIC designations. Thus, two identical reporting entities possessing the same security, may have differing NAIC designations.

The current RMBS/CMBS multi-step modeling practice is the only remaining approach that utilizes breakpoints to determine final NAIC designations. In March 2019, agenda item 2018-19 removed the multi-step modeling approach for modified filing exempt (MFE) securities. This change removed the carrying value from the designation determination analysis and accordingly now utilizes the original NAIC designation, without adjustment, to determine the measurement method under SSAP No. 43R and corresponding RBC charges. With this change, identical securities have an identical NAIC designation.

The implemented change for MFE securities is being proposed for expansion to RMBS and CMBS securities for several reasons. In conjunction with the upcoming designation granularity expansion, the cost, complexity and technical issues to maintain the multi-step modeling process will be substantial for reporting entities. Each individual security will be required to develop an additional 19 price breakpoints to correspond with designation granularity reporting; insurance companies will need to substantially modify their investment accounting software to determine designations and designation categories. It is important to note that the current multi-step modeling approach has the potential to increase/improve a security’s NAIC designation – thus reducing RBC and AVR charges, however, could also work in an opposite manner decreasing NAIC designation. Despite the proposal to cease the multi-step model usage, industry appears supportive of the change as the cost and usage in both today’s environment and with the upcoming granularization reporting, does not adequately justify any potential benefit. A RMBS/CMBS security can be appropriately modeled, regardless of the amortized carrying value and will provide a single, nonadjustable NAIC designation. This will provide regulators with increased efficiency of oversight and improved comparability between various reporting entities carrying identical investments.

Existing Authoritative Literature:

***SSAP No. 43R—Loan-backed and Structured Securities***

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

1. Loan-backed and structured securities shall be valued and reported in accordance with this statement, the *Purposes and Procedures Manual of the NAIC Investment Analysis Office*, and the designation assigned in the *NAIC Valuations of Securities* product prepared by the NAIC Securities Valuation Office or equivalent specified procedure. The carrying value method shall be determined as follows:

a. For reporting entities that maintain an Asset Valuation Reserve (AVR), loan-backed and structured 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.

b. For reporting entities that do not maintain an AVR, loan-backed and structured securities designated highest-quality and high-quality (NAIC designations 1 and 2, respectively) shall be reported at amortized cost; loan-backed and structured 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.

### Designation Guidance

1. For RMBS/CMBS securities within the scope of this statement, the initial NAIC designation used to determine the carrying value method and the final NAIC designation for reporting purposes is determined using a multi-step process. The *Purposes and Procedures Manual of the NAIC Investment Analysis Office* provides detailed guidance. A general description of the processes is as follows:
2. Financial Modeling: TheNAICidentifies securities where financial modeling must be used to determine the NAIC designation. NAIC designation based on financial modeling incorporates the insurers’ carrying value for the security. For those securities that are financially modeled, the insurer must use NAIC CUSIP specific modeled breakpoints provided by the modelers in determining initial and final designation for these identified securities. Securities where modeling results in zero expected loss in all scenarios are automatically considered to have a final NAIC designation of NAIC 1, regardless of the carrying value. The three-step process for modeled securities is as follows:

i. Step 1: Determine Initial Designation –The current amortized cost (divided by remaining par amount) of a loan-backed or structured security is compared to the modeled breakpoint values assigned to the six (6) NAIC designations for each CUSIP to establish the **initial** NAIC designation.

ii. Step 2: Determine Carrying Value Method – The carrying value method, either the amortized cost method or the lower of amortized cost or fair value method, is then determined as described in paragraph 26 based upon the initial NAIC designation from Step 1.

iii. Step 3: Determine Final Designation –The final NAIC designation that shall be used for investment schedule reporting is determined by comparing the carrying value (divided by remaining par amount) of a security (based on paragraph 27.a.ii.) to the NAIC CUSIP specific modeled breakpoint values assigned to the six (6) NAIC designations for each CUSIP. This final NAIC designation shall be applicable for statutory accounting and reporting purposes (including establishing the AVR charges). The final designation is not used for establishing the appropriate carrying value method in Step 2 (paragraph 27.a.ii.).

1. All Other Loan-Backed and Structured Securities: For loan-backed and structured securities not subject to paragraphs 27.a. (financial modeling) follow the established designation procedures according to the appropriate section of the *Purposes and Procedures Manual of the NAIC Investment Analysis Office*. The NAIC designation shall be applicable for statutory accounting and reporting purposes (including determining the carrying value method and establishing the AVR charges). The carrying value method is established as described in paragraph26. Examples of these securities include, but are not limited to, mortgage-referenced securities, equipment trust certificates, credit tenant loans (CTL), 5\*/6\* securities, interest only (IO) securities, securities with CRP ratings (excluding RMBS/CMBS), and loan-backed and structured securities with SVO assigned NAIC designations.

Activity to Date (issues previously addressed by the Working Group, Emerging Accounting Issues (E) Working Group, SEC, FASB, other State Departments of Insurance or other NAIC groups): In accordance with a Valuation of Securities (E) Task Force referral, agenda item 2018-19 eliminated the multi-step designation guidance, utilizing amortized cost basis and breakpoints for the determination of final NAIC designations of MFE securities. The revisions were adopted with an effective date of March 31, 2019, with early adoption permitted for year-end 2018.

**Information or issues (included in *Description of Issue*) not previously contemplated by the Working Group:**

None

**Convergence with International Financial Reporting Standards (IFRS):** Not Applicable

Staff Recommendation:

NAIC Staff recommends that the Working Group move this item to the active listing, categorized as nonsubstantive and expose revisions to *SSAP No. 43R—Loan-backed and Structured Securities* to eliminate the multi-step financial modeling designation guidance in determining final NAIC designations for RMBS/CMBS securities.

Although the Working Group is recommended to proceed with exposure on this agenda item and solicit comments for consideration, final action will not occur on this item until revisions eliminating the RMBS/CMBS multi-step modeling approach has been adopted by the Valuation of Securities (E) Task Force. NAIC SAPWG staff will coordinate with the VOSTF staff to stay current on their discussion and action on this item.

**Proposed Revisions to *SSAP No. 43R—Loan-backed and Structured Securities***

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

1. Loan-backed and structured securities shall be valued and reported in accordance with this statement, the *Purposes and Procedures Manual of the NAIC Investment Analysis Office*, and the designation assigned in the *NAIC Valuations of Securities* product prepared by the NAIC Securities Valuation Office or equivalent specified procedure[[1]](#footnote-1). The carrying value method shall be determined as follows:

a. For reporting entities that maintain an Asset Valuation Reserve (AVR), loan-backed and structured 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.

b. For reporting entities that do not maintain an AVR, loan-backed and structured securities designated highest-quality and high-quality (NAIC designations 1 and 2, respectively) shall be reported at amortized cost; loan-backed and structured 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.

For brevity, the remaining SSAP has been omitted, however remaining paragraphs will be renumbered accordingly.

## ***EXHIBIT A – Question and Answer Implementation Guide***

This exhibit addresses common questions regarding the valuation and impairment guidance detailed in SSAP No. 43R.

**Index to Questions**

| **No.** | **Question** |
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| 1 | Are reporting entities permitted to establish an accounting policy to write down a SSAP No. 43R other-than-temporarily impaired security, for which a “non-interest” related decline exists, to fair-value regardless of whether the reporting entity intends to sell, or has the intent and ability to hold? |
| 2 | Can a reporting entity avoid completing a cash-flow assessment or testing for a specific other-than-temporarily impaired security when the entity believes there is a clear cash-flow shortage (i.e., non-interest related impairment) and elect to recognize a full impairment for the SSAP No. 43R security (no impairment bifurcation), with fair value becoming the new amortized cost basis, and recognition of the full other-than-temporary impairment as a realized loss?  |
| 3 | Can reporting entities change their “intend to sell” or “unable to hold” assertions and recover previously recognized other-than-temporary impairments?  |
| 4 | How do the regulators intend the phrase “intent and ability to hold” as used within SSAP No. 43R to be interpreted?  |
| 5 | How do contractual prepayments affect the determination of credit losses?  |
| 6 | Are the disclosure requirements within paragraphs 51.f. and 51.g. of SSAP No. 43R required to be completed for the current reporting quarter only, or as a year-to-date cumulative disclosures?  |
| 7 | If an impairment loss is recognized based on the "present value of projected cash flows" in one period is the entity required to get new cash flows every reporting period subsequent or just in the periods where there has been a significant change in the actual cash flows from projected cash flows? |
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Staff Review Completed by:

Jim Pinegar, NAIC Staff – September 2019

**Status:**

On December 7, 2019, the Statutory Accounting Principles (E) Working Group moved this agenda item to the active listing, categorized as nonsubstantive, and exposed revisions to *SSAP No. 43R—Loan-backed and Structured Securities*, as illustrated above, to eliminate the multi-step financial modeling designation guidance in determining final NAIC designations for residential mortgage-backed securities (RMBS) / commercial mortgage-backed securities (CMBS) securities. Exposure was contingent upon the Valuation of Securities (E) Task Force’s concurrent exposure, which occurred on December 8, 2019. The Working Group noted that final action on this would not be taken until the Valuation of Securities (E) Task Force takes action on their related item.

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1. Securities within scope of this statement shall be reported with NAIC designations. The process to determine the NAIC designation may vary based on type of underlying investment and is directed in accordance with the *Purposes and Procedures Manual of the NAIC Investment Analysis Office*. For example, certain investments may use CRP ratings in determining the equivalent NAIC designation, whereas other investments, including, but not limited to, mortgage-referenced securities, equipment trust certificates, credit tenant loans (CTL), and interest only (IO) securities, may be required to obtain the NAIC designation directly from the *NAIC Valuation of Securities* product. For interim reporting instructions, refer to the *Purposes and Procedures Manual of the NAIC Investment Analysis Office.* [↑](#footnote-ref-1)