Statutory Accounting Principles (E) Working Group

**Maintenance Agenda Submission Form**

**Form A**

## **Issue:** SSAP No. 43R - Designation Categories for RMBS/CMBS Investments

**Check (applicable entity):**

 P/C Life Health

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

New Issue or SSAP [ ]  [ ]  [ ]

Interpretation [ ]  [ ]  [ ]

Description of Issue: This agenda item reflects updated NAIC designation guidance recently adopted by the Valuation of Securities (E) Task Force (VOSTF) for the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (P&P Manual), for residential mortgage-backed securities (RMBS) / commercial mortgage-backed securities (CMBS).

As adopted by the VOSTF, a new designation category will be utilized when reporting RMBS/CMBS investments. The current financial modeling process remains unaffected, however the NAIC designations, as produced by the financial model (and as previously used for reporting), will now be mapped to a final NAIC designation category. Reporting entities will then utilize the new NAIC designation category for accounting and reporting purposes. The edits proposed in this agenda item update the NAIC designation category mapping instructions in *SSAP No. 43R—Loan-Backed and Structured Securities* for RMBS/CMBS investments.

For historical reference, the VOSTF originally proposed to eliminate the multi-step modeling (“financial modeling”) practice for RMBS/CMBS investments – primarily in response to the implementation of NAIC designation categories, which would have required 19 additional price breakpoints for RMBS/CMBS investments. The multi-step modeling practice for these instruments is the only remaining approach that utilizes breakpoints to determine NAIC designations. Since its original exposure, the VOSTF modified its proposal and on May 14, adopted revised guidance to the *P&P Manual,* continuing the financial modeling practice, but in lieu of implementing additional price breakpoints, the output of the financial model will be mapped to a specific NAIC designation category. As an example, the prior modeled NAIC 1 with risk of loss will be mapped to a NAIC 1.D and a NAIC 2 will be mapped to a NAIC 2.B.

Existing Authoritative Literature:

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

### 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 for modified filing exempt (MFE) securities. The elimination of MFE was effective March 31, 2019, with early application permitted for year-end 2018. With the elimination of MFE, for securities that are filing exempt, the NAIC designation reported will correspond to the CRP rating without adjustment based on carrying value. Also, in agenda item 2018-03, the Working Group clarified that securities acquired in lots shall not be reported with weighted average designations. With the adopted guidance, If a SSAP No. 43R security (by CUSIP) has different NAIC designations by lot, the reporting entity shall either 1) report the aggregate investment with the lowest applicable NAIC designation or 2) report the investment separately by purchase lot on the investment schedule. If reporting separately, the investment may be aggregated by NAIC designation. With the elimination of MFE, the instances of different designations by lot is not expected to be prevalent, but it could still occur with the financial modeling process for RMBS and CMBS securities.

**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 reflect the updated final designation guidance for RMBS/CMBS securities. This update will reflect the guidance recently adopted for the *Purposes and Procedures Manual of the NAIC Investment Analysis Office*.

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

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

### 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, as determined by the modeled price range, 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. These six (6) NAIC designations are mapped to NAIC designation categories as shown in the *Purposes and Procedures Manual of the NAIC Investment Analysis Office,* along with instructions for tranches that have no expected loss under any of the selected modeling scenarios and instructions for non-modeled securities. This final NAIC designation and NAIC designation category shall be applicable for statutory accounting and reporting purposes (including investment schedule reporting and establishing RBC and AVR charges). The final NAIC 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 paragraph 26. 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.

Staff Review Completed by: Jim Pinegar, NAIC Staff – June 2020

Status:

On July 30, 2020, the Statutory Accounting Principles (E) Working Group moved this item to the active listing, categorized as nonsubstantive, and exposed revisions to *SSAP No. 43R—Loan-backed and Structured Securities*, as shown above, to reflect the updated final designation guidance for RMBS/CMBS securities. This update will reflect the guidance recently adopted for the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (P&P manual).

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