Statutory Accounting Principles (E) Working Group

**Maintenance Agenda Submission Form**

**Form A**

## **Issue:** SSAP No. 43R – Government-Sponsored Enterprises – Credit Risk Transfer Transactions.

**Check (applicable entity):**

 P/C Life Health

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

New Issue or SSAP [ ]  [ ]  [ ]

Interpretation [ ]  [ ]  [ ]

**Description of Issue:**

During the 2019 Spring National Meeting, the Working Group adopted agenda item 2018-18: Structured Notes, which expanded the scope of *SSAP No. 43R—Loan-Backed and Structures Securities* to include certain Government-Sponsored Enterprises (GSE) – Credit Risk Transfer (CRT) Transactions.

Credit risk transfer securities are mortgage-referenced securities issued by government sponsored entities that are tied to a referenced pool of mortgages. These are instruments in which the payments received are linked to the interest and principal repayment of underlying mortgage loans from those identified in a particular pool of mortgages. For these instruments, investors may not receive a full return of principal as principal repayment is contingent on the ultimate repayment by the mortgage loan borrowers (as credit risk has been transferred to the investor). The program naming convention for CRT’s was identified as Structured Agency Credit Risk (STACR) for Freddie Mac and Connecticut Avenue Securities (CAS) for Fannie Mae.

This agenda item has been drafted to reflect recent changes to the Freddie Mac STACR and Fannie Mae CAS programs. It is anticipated that future Freddie Mac STACR and Fannie Mae CAS issuances will be solely conducted through a Real Estate Mortgage Investment Conduit (REMIC) trust. The REMIC is functionally equivalent to the original Freddie Mac STACR and Fannie Mae CAS programs, in that the trusts will pay interest and principal to investors on a monthly basis. All other material characteristics also remain unaffected as the investment represents a large, diversified reference pool, multiple tranches are available to accommodate various risk appetites, and the notes are highly liquid with an estimated $2 billion in buy/sale trades occurring each month. Also unchanged is that the STACR notes are not guaranteed by Freddie Mac (i.e. credit risk has been transferred) and Freddie Mac, and both entities maintain the senior risk tranche, which is unfunded and not issued for public investors.

The primary difference in the use of a REMIC trust is that counterparty risk exposure to Freddie Mac and Fannie Mae is reduced as the trust is designed to stand on its own. The trust’s assets are intended to fund interest and principal payments on the notes, thus insulating investors from a possible Freddie Mac or Fannie Mae insolvency. While several other benefits are touted, the use of a REMIC will also not subject international investors to U.S. withholding tax requirements, likely resulting in higher international investor participation.

In collaboration with NAIC Securities Valuation Office (SVO) staff, SAPWG support staff has confirmed that the anticipated use of a REMIC trust remains functionally equivalent and retains the same material risk structure as the original STACR and CAS programs. Additionally, investment in securities issued by a GSE REMIC trust remains within the review scope of the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (P&P Manual). Per part 4 of the P&P Manual, Mortgage Referenced Securities are not eligible for filing exemption and are subject to assessment by the Structures Securities Group.

This agenda item proposes to 1) include STACR and CAS REMIC’s into the scope of SSAP No. 43R and, 2) align SSAP No. 43R guidance regarding the financial modeling of mortgage referenced securities to the requirements as directed in the P&P Manual.

Existing Authoritative Literature:

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

The inclusion GSE CRT securities into the scope of SSAP No. 43R is referenced in paragraph 5:

1. Mortgage-referenced securities do not meet the definition of a loan-backed or structured security but are explicitly captured in scope of this statement. In order to qualify as a mortgage-referenced security, the **security must be issued by a government sponsored enterprise[[1]](#footnote-1) in the form of a “credit risk transfer” in which the issued security is tied to a referenced pool of mortgages**. These securities do not qualify as “loan-backed securities” as the pool of mortgages are not held in trust and the amounts due under the investment are not backed or secured by the mortgage loans. **Rather, these items reflect instruments in which the payments received are linked to the credit and principal payment risk of the underlying mortgage loan borrowers captured in the referenced pool of mortgages. For these instruments, reporting entity holders may not receive a return of their full principal as principal repayment is contingent on repayment by the mortgage loan borrowers in the referenced pool of mortgages.** Unless specifically noted, the provisions for loan-backed securities within this standard apply to mortgage-referenced securities.

**Financial modeling of CRT Securities is referenced in paragraph 27:**

### 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 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.

### Specific Interim Reporting Guidance for RMBS/CMBS Securities

1. The guidance in this paragraph shall be applied in determining the reporting method for residential mortgage-backed securities (RMBS) and commercial mortgage-backed securities (CMBS) acquired in the current year for quarterly financial statements. Securities reported as of the prior-year end shall continue to be reported under the prior-year end methodology for the current-year quarterly financial statements. For year-end reporting, securities shall be reported in accordance with paragraph 27, regardless of the quarterly methodology used.
2. Reporting entities that acquired the entire financial modeling database for the prior-year end are required to follow the financial modeling methodology (paragraph 27.a.) for all securities acquired in the subsequent year that were included in the financial modeling data acquired for the prior year-end.
3. Reporting entities that acquired identical securities (identical CUSIP) to those held and financially modeled for the prior year-end are required to follow the prior year-end financial modeling methodology (paragraph 27.a.) for these securities acquired subsequent to year-end.
4. Reporting entities that do not acquire the prior-year financial modeling information for current-year acquired individual CUSIPS, and are not captured within paragraphs 28.a. or 28.b., are required to follow the analytical procedures for non-financially modeled securities (paragraph 27.b. as appropriate). Reporting entities that do acquire the individual CUSIP information from the prior-year financial modeling database shall use that information for interim reporting.
5. Reporting entities that acquire securities not previously modeled at the prior year-end are required to follow the analytical procedures for non-financially modeled securities (paragraph 27.b. as appropriate).

***Purposes and Procedures Manual of the NAIC Investment Analysis Office* (P&P Manual); Part 4 –Mortgage Reference Securities:**

**Definition**

29. A Mortgage Referenced Security has the following characteristics: A Mortgage Referenced Security’s coupon and/or principal payments are linked, in whole or in part, to prices of, or payment streams from, real estate, index or indices related to real estate, or assets deriving their value from instruments related to real estate, including, but not limited to, mortgage loans.

**Not Filing Exempt**

30. A Mortgage Referenced Security is not eligible for filing exemption but is subject to the filing requirement.

**NAIC Risk Assessment**

31. In determining the NAIC Designation of a Mortgage Referenced Security, **the SSG may use the financial modeling methodology discussed in this Part, adjusted (if and as necessary) to the specific reporting and accounting requirements applicable to Mortgage Referenced Securities.**

**Quarterly Reporting for Mortgage Reference Securities**

32. To determine the NAIC Designation to be used for quarterly financial statement reporting for a Mortgage Reference Security purchased subsequent to the annual surveillance described in this Part, the insurer uses the prior year-end modeling data for that CUSIP (which can be obtained from the NAIC) until the annual surveillance data is published for the current year. For a Mortgage Reference Security that is not in the prior year-end modeling data for that CUSIP, the insurer may follow the instructions in Part Two of this manual for the assignment of the SVO Administrative Symbol “Z” provided the insurer owned security meets the criteria for a security that is in transition in reporting or filing

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): None

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

Relevant background from agenda item 2018-18 was included in the ‘Description of Issue’ section.

**Convergence with International Financial Reporting Standards (IFRS): N/A**

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 Structures Securities*, incorporating minor scope modifications to reflect recent changes to the STACR and CAS programs. The proposed edits would allow credit risk transfer securities from Freddie Mac and Fannie Mae to remain in scope when a REMIC structure is used in the STACR program or CAS program.

1. Mortgage-referenced securities do not meet the definition of a loan-backed or structured security but are explicitly captured in scope of this statement. In order to qualify as a mortgage-referenced security, the security must be issued by a government sponsored enterprise[[2]](#footnote-2) or by a special purpose trust in a transaction sponsored by a government sponsored enterprise in the form of a “credit risk transfer” in which the issued security is tied to a referenced pool of mortgages and. the payments received are linked to the credit and principal payment risk of the underlying mortgage loan borrowers captured in the referenced pool of mortgages. For these instruments, reporting entity holders may not receive a return of their full principal as principal repayment is contingent on repayment by the mortgage loan borrowers in the referenced pool of mortgages. Unless specifically noted, the provisions for loan-backed securities within this standard apply to mortgage-referenced securities.
2. 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:
3. Financial Modeling: Pursuant to the P&P manual, theNAICidentifies select 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 securities not subject to paragraph 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 equipment trust certificates, credit tenant loans (CTL), 5\*/6\* securities, interest only (IO) securities, securities with CRP ratings (excluding RMBS/CMBS), loan-backed and structured securities and mortgage-referenced securities with SVO assigned NAIC designations.

### Specific Interim Reporting Guidance Financially Modeled Securities

1. For securities that will be financially modeled under paragraph 27, the guidance in this paragraph shall be applied in determining the reporting method for such securities acquired in the current year for quarterly financial statements. Securities reported as of the prior-year end shall continue to be reported under the prior-year end methodology for the current-year quarterly financial statements. For year-end reporting, securities shall be reported in accordance with paragraph 27, regardless of the quarterly methodology used.
2. Reporting entities that acquired the entire financial modeling database for the prior-year end are required to follow the financial modeling methodology (paragraph 27.a.) for all securities acquired in the subsequent year that were included in the financial modeling data acquired for the prior year-end.
3. Reporting entities that acquired identical securities (identical CUSIP) to those held and financially modeled for the prior year-end are required to follow the prior year-end financial modeling methodology (paragraph 27.a.) for these securities acquired subsequent to year-end.
4. Reporting entities that do not acquire the prior-year financial modeling information for current-year acquired individual CUSIPS, and are not captured within paragraphs 28.a. or 28.b., are required to follow the analytical procedures for non-financially modeled securities (paragraph 27.b. as appropriate). Reporting entities that do acquire the individual CUSIP information from the prior-year financial modeling database shall use that information for interim reporting.
5. Reporting entities that acquire securities not previously modeled at the prior year-end are required to follow the analytical procedures for non-financially modeled securities (paragraph 27.b. as appropriate).

Staff Review Completed by:

Jim Pinegar –August 2020

NAIC Staff

**Status:**

On November 12, 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 Structures Securities*, as illustrated above, to incorporate minor scope modifications to reflect recent changes to the STACR and CAS programs. The proposed edits would allow credit risk transfer securities from Freddie Mac and Fannie Mae to remain in scope of SSAP No. 43R when a REMIC structure is used in the STACR program or CAS program.

G:\FRS\DATA\Stat Acctg\3. National Meetings\A. National Meeting Materials\2020\11-12-20 (Fall)\Exposures\C - 20-34 - SSAP No. 43R - GSE CRT Program.docx

1. **Currently, only Fannie Mae and Freddie Mac are the government sponsored entities that issue qualifying mortgage-referenced securities. However, this guidance would apply to mortgage-referenced securities issued by any other government sponsored entity that subsequently engages in the transfer of residential mortgage credit risk.** [↑](#footnote-ref-1)
2. Currently, only Fannie Mae and Freddie Mac are the government sponsored entities that either directly issue qualifying mortgage-referenced securities or sponsor transactions in which special purpose trust issues qualifying mortgage-reference securities. However, this guidance would apply to mortgage-referenced securities issued by any other government sponsored entity that subsequently engages in the transfer of mortgage credit risk [↑](#footnote-ref-2)