Statutory Accounting Principles (E) Working Group

**Maintenance Agenda Submission Form**

**Form A**

## **Issue:** SSAP No. 43R – CLO Financial Modeling

**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 proposes revisions to *SSAP No. 43R—Loan-Backed and Structured Securities* to incorporate edits to reflect changes adopted by the Valuation of Securities (E) Task Force on Feb. 21, 2023, to include collateralized loan obligations (CLOs) in the SVO financial modeling process.

This agenda item has been drafted to ensure the financial modeling guidance summarized in *SSAP No. 43R—Loan-Backed and Structured Securities* reflects the practices as directed by the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (P&P Manual). (Note, while the *Accounting Practices and Procedures Manual* is higher than the P&P manual in the statutory hierarchy, the primary source of authoritative guidance for financial modeling is the P&P manual. Only a general description of the modeling process is included in SSAP No. 43R). The methodology to model CLOs is still being developed, but guidance that permits the SVO to model CLOs has been adopted and should be followed once CLOs begin to be financially modeled.

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 or the NAIC designation assigned by the NAIC Securities Valuation Office. The P&P Manual provides detailed guidance. A general description of the processes is as follows:
2. Financial Modeling: Pursuant to the P&P Manual, theNAICidentifies select securities where financial modeling must be used to determine the NAIC designation. For a modeled legacy security, meaning one which closed prior to January 1, 2013, the NAIC designation is based on financial modeling incorporating the insurers’ carrying value. For a modeled non-legacy security, meaning one which closed after December 31, 2012, the NAIC designation and NAIC designation category assigned by the NAIC Securities Valuation Office must be used. For those legacy 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. As specified in the P&P Manual, a modeled legacy security RMBS or CMBS tranche that has no expected loss, as compiled and published by the NAIC Securities Valuation Office, under any of the selected modeling scenarios would be assigned an NAIC 1 designation and NAIC 1.A designation category regardless of the insurer’s book/adjusted carrying value. The three-step process for modeled legacy 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 each NAIC designation and NAIC designation category 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 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 NAIC designation and NAIC designation category for each CUSIP or is mapped to an NAIC designation category, according to the instructions in the P&P Manual. This final NAIC designation shall be applicable for statutory accounting and reporting purposes and the NAIC designation category will be used for 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 securities not subject to paragraph 27.a. (financial modeling) follow the established designation procedures according to the appropriate section of the P&P Manual. 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.

### 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).

## **SSAP No. 43R - EXHIBIT A – Question and Answer Implementation Guide**

## **Index to Questions**

|  |
| --- |
| Questions 8-10 are specific to securities subject to the financial modeling process. (This process is limited to qualifying RMBS/CMBS securities reviewed by the NAIC Structured Securities Group.) The guidance in questions 8-10 shall not be inferred to other securities in scope of SSAP No. 43R. |
| 8 | Do LBSS purchased in different lots result in a different NAIC designation for the same CUSIP? Can reporting entities use a weighted average method determined on a legal entity basis? |
| 9 | The NAIC Designation process for LBSS may incorporate loss expectations that differ from the reporting entity’s expectations related to OTTI conclusions. Should the reporting entities be required to incorporate recovery values obtained from data provided by the service provider used for the NAIC Designation process for impairment analysis as required by SSAP No. 43R? |
| 10 | For companies that have separate accounts, can the NAIC designation be assigned based upon the total legal entity or whether it needs to be calculated separately for the general account and the total separate account? |

**8. *Question*** – Do LBSS purchased in different lots result in a different NAIC designation for the same CUSIP? Can reporting entities use a weighted average method determined on a legal entity basis?

8.1 Under the financial modeling process (applicable to qualifying RMBS/CMBS reviewed by the NAIC Structured Securities Group), the amortized cost of the security impacts the “final” NAIC designation used for reporting and RBC purposes. As such, securities subject to the financial modeling process acquired in different lots can result in a different NAIC designation for the same CUSIP. In accordance with the current instructions for calculating AVR and IMR, reporting entities are required to keep track of the different lots separately, which means reporting the different designations. For reporting purposes, 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. (For example, all acquisitions of the identical CUSIP resulting with an NAIC 1 designation may be aggregated, and all acquisitions of the identical CUSIP resulting with an NAIC 3 designation may be aggregated.)

**9. *Question*** – The NAIC Designation process for LBSS subject to the financial modeling process may incorporate loss expectations that differ from the reporting entity’s expectations related to OTTI conclusions. Should the reporting entities be required to incorporate recovery values obtained from data provided by the service provider used for the NAIC Designation process for impairment analysis as required by SSAP No. 43R?

9.1 In accordance with *INT 06-07: Definition of Phrase “Other Than Temporary*,” reporting entities are expected to “consider all available evidence” at their disposal, including the information that can be derived from the NAIC designation.

**10. *Question*** - For companies that have separate accounts, can the NAIC designation be assigned based upon the total legal entity or whether it needs to be calculated separately for the general account and the total separate account?

10.1 The financial modeling process for qualifying RMBS/CMBS securities is required for applicable securities held in either the general or separate account.

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):

The following edits have previously been reflected in the financial modeling guidance:

* Agenda Item 2018-19: To be consistent with the prior SVO P&P Manual revisions, 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 Credit Rating Provider (CRP) rating without adjustment based on carrying value.
* Agenda Item 2018-03: 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 are not expected to be prevalent, but could still occur with the financial modeling process for residential mortgage backed securities (RMBS) and commercial mortgage backed securities (CMBS).
* Agenda Item 2020-21: Edits incorporated adopted guidance to the P&P manual detailing the use and mapping of NAIC designations to NAIC designation categories. Reporting entities were to then utilize the new NAIC designation categories for accounting and reporting purposes.
* Agenda Item 2021-23: Adopted changes to summarize the financial modeling guidance in SSAP No. 43R This guidance continues to refer users to the detailed financial modeling guidance in the P&P Manual.

**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 a SAP clarification, and expose revisions to *SSAP No. 43R—Loan-backed and Structured Securities* to incorporate changes to add CLOs to the financial modeling guidance and to clarify that CLOs are not captured as legacy securities. These revisions reflect the guidance adopted for the P&P Manual in February 2023.**

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

### Designation Guidance

1. For Residential Mortgage-Backed Securities (RMBS), Commercial Mortgage-Backed Securities (CMBS) and Collateralized Loan Obligations (CLOs), 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 or the NAIC designation assigned by the NAIC Securities Valuation Office. The P&P Manual provides detailed guidance. A general description of the processes is as follows:
2. Financial Modeling: Pursuant to the P&P Manual, theNAICidentifies select securities where financial modeling must be used to determine the NAIC designation. For a modeled RMBS/CMBS legacy security, meaning one which closed prior to January 1, 2013, the NAIC designation is based on financial modeling incorporating the insurers’ carrying value. For a modeled RMBS/CMBS non-legacy security, meaning one which closed after December 31, 2012, or modeled CLO the NAIC designation and NAIC designation category assigned by the NAIC Securities Valuation Office must be used. For those RMBS/CMBS legacy 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. As specified in the P&P Manual, a modeled legacy security RMBS or CMBS tranche that has no expected loss, as compiled and published by the NAIC Securities Valuation Office, under any of the selected modeling scenarios would be assigned an NAIC 1 designation and NAIC 1.A designation category regardless of the insurer’s book/adjusted carrying value. The three-step process for modeled RMBS/CMBS legacy 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 each NAIC designation and NAIC designation category 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 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 NAIC designation and NAIC designation category for each CUSIP or is mapped to an NAIC designation category, according to the instructions in the P&P Manual. This final NAIC designation shall be applicable for statutory accounting and reporting purposes and the NAIC designation category will be used for 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 securities not subject to paragraph 27.a. (financial modeling) follow the established designation procedures according to the appropriate section of the P&P Manual. 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.

### 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) until the current year financial modeling information becomes available and then follow the procedures for financially modeled securities (paragraph 27.a, 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) until the current year financial modeling information becomes available and then follow the procedures for financially modeled securities (paragraph 27.a, as appropriate).

Staff Review Completed by: Julie Gann, NAIC Staff – February 2023

Status:

On March 22, 2023, the Statutory Accounting Principles (E) Working Group moved this agenda item to the active listing, categorized as a SAP clarification, and exposed revisions to SSAP No. 43R to incorporate changes to add CLOs to the financial modeling guidance and to clarify that CLOs are not captured as legacy securities.

https://naiconline.sharepoint.com/teams/FRSStatutoryAccounting/National Meetings/A. National Meeting Materials/2023/3-22-23 - Spring/Exposures/23-02 - 43R - CLO FM.docx