

Statutory 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

STATUS

Finalized December 2, 2007

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

Type of Issue:

Common Area

SUMMARY OF ISSUE

1. *SSAP No. 43—Loan-Backed and Structured Securities* (SSAP No. 43) requires that loan-backed and structured securities shall be revalued using new prepayment assumptions by utilizing either the prospective or retrospective adjustment methodologies. When calculating these new prepayment assumptions, SSAP No. 43 states that undiscounted cash flows should be utilized.
2. Concerns have been raised that an undiscounted cash flows approach for impairment analysis does not properly evaluate certain asset-backed or structured securities. These securities are subject to other than temporary impairment due to deterioration in the credit quality of the underlying securities which serve as the source of cash flow for the payment of interest, and, depending upon the structure of the security, in some cases may also serve as the source for a substantial portion of the return of principal. The issue is that other than temporarily impaired securities are not accurately identified or reported under SSAP No. 43 impairment analysis.
3. The purpose of this issue paper is to amend SSAP No. 43 to require the use of fair value for impairment analysis and subsequent valuation of loan-backed and structured securities, and remain consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy.

SUMMARY CONCLUSION

4. This issue paper amends paragraphs 14 through 16 of SSAP No. 43 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 undiscounted anticipated cash flow is less than the carrying amount of the investment 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.

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 that the decline in fair value of the security is an other than temporary, impairment has occurred, then the cost basis of the security shall be written down to fair value. The undiscounted estimated future cash flows and~~ 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.

Effective Date and Transition

5. Upon adoption of this issue paper, the NAIC will release a Statement of Statutory Accounting Principle (SSAP) for comment. The SSAP will contain the adopted Summary Conclusion of this issue paper. Users of the Accounting Practices and Procedures Manual should note that issue papers are not represented in the Statutory Hierarchy (see Section IV of the Preamble) and therefore the conclusions reached in this issue paper should not be applied until the corresponding SSAP has been adopted by the Plenary of the NAIC. It is expected that the SSAP will be effective for reporting periods beginning on or after January 1, 2009. A change resulting from the adoption of the finalized SSAP shall be accounted for prospectively.

DISCUSSION

6. Two forms of asset-backed or structured securities, commonly referred to as principal protected securities and combination notes, pose a significant risk of credit related impairment. A typical principal protected security is structured such that cash and securities are deposited in a trust, with the trust issuing new securities on the basis of the deposited assets. The cash is used to purchase a zero coupon U.S. government strip (or similar low risk security) with the intent that it will accrete to an amount equal to the original principal of the structured security at maturity. The deposited higher risk securities support the payment of interest. In dynamically hedged structures, the allocation to the low risk securities varies throughout the life of the structured security based on the performance of the higher risk assets. In this type of structure, the higher risk assets may be supporting the interest payments as well as providing for a substantial portion, or potentially all, of the return of principal.

7. The allocation to the low risk strip is used as a hedge to advocate the position that the security is “principal protected” since the intent is for the investor to be “guaranteed” a return of principal at maturity. This position ignores the economic reality that in some structured security arrangements, particularly those that are dynamically hedged or leveraged, the initial value of the low risk strip may be a very small percentage of the principal value of the assets in the trust, with the balance being in residual tranches of higher risk securities.

8. Recently there have been a large number of residual tranches used in principal protected securities that have experienced significant declines in value purely as a result of the crystallization of credit risk. When the value of the residual securities in these structures is diminished, the market value of

the structured security moves toward the present value of the low risk strip. Though the value of the structured securities has often been significantly impaired, in many cases, other than temporary impairment recognition would not be required in the financial statements under an undiscounted cash flows approach to impairment analysis.

9. From an admitted asset perspective, in such an instance, a reporting entity with solvency or liquidity problems could only sell such an investment, or force the trust to unwind, for an amount that would be substantially less than the original value of the security. Thus, the fair value of the investment is the amount that would be available to the reporting entity to meet its current and future obligations, and is the amount that should be reflected in the financial statements.

10. SSAP No. 43 impairment guidance does not properly identify these securities as other than temporarily impaired. The use of undiscounted cash flows causes concern among regulators because it ignores the credit dynamic described in paragraphs 6 through 9, and does not provide for proper analysis or valuation of these securities. The fair value of the security in such a situation is what remains of the principal at the measurement date, and it is a substantially diminished value. In order to provide for conservative, consistent and accurate financial statements, an impairment approach that utilizes fair value is necessary to properly analyze and value this class of securities.

11. During discussion of this issue, concerns were raised regarding the impact of the proposed changes to SSAP No. 43 on certain high quality loan-backed securities, such as those issued by the Government National Mortgage Association (GNMA) which are backed by the full faith and credit of the U.S. Government, or those issued by the Federal National Mortgage Association (FNMA) and the Federal Home Loan Mortgage Corporation (FHLMC) which are generally considered to be of extremely high credit quality. The primary concern was that under a fair value impairment approach, these securities would be considered other than temporarily impaired when in an unrealized loss position due to the general fluctuation of market interest rates, though a reporting entity had the intent to hold such a security to maturity.

12. In 2006, the Emerging Accounting Issues Working Group (EAIWG) of the NAIC released *INT 06-07: Definition of Phrase "Other Than Temporary"* (INT 06-07), to address the GAAP guidance issued by the FASB in *FSP FAS 115-1/124-1: The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments* (FSP FAS 115-1/124-1). Within INT 06-07, the EAIWG concluded that interest related declines in value should only be considered other than temporary impairments when a reporting entity has the intent to sell the security at the reporting date, before recovery of the cost of the investment. When evaluating for interest related impairment, a reporting entity should consider whether its cash or working capital requirements and contractual or regulatory obligations indicate that an investment may need to be sold before the forecasted recovery occurs.

13. Given this interpretation by the EAIWG, and considering that the primary motivation of regulators in proposing revisions to SSAP No. 43 impairment guidance was the proper recognition of credit quality related impairment, the Statutory Accounting Principles Working Group (SAPWG) included language in the exposure draft to specify that interest related declines in value should be considered other than temporary only when the reporting entity has the intent to sell the security, at the reporting date, before recovery of the cost of the investment. This additional guidance is consistent with the statutory accounting interpretation provided in INT 06-07.

14. For clarification purposes, the SAPWG also added language relevant to reporting entities required to maintain an Asset Valuation Reserve (AVR) and an Interest Maintenance Reserve (IMR). The additional guidance specifies that, for companies required to maintain such reserves, credit related other than temporary impairment losses are to be recorded through the AVR, while interest related other than temporary impairment losses are to be recorded through the IMR.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE**Statutory Accounting**

15. SSAP No. 43, paragraphs 14 through 16:

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.

16. Regardless of whether a reporting entity is using a prospective or retrospective method, if the revaluation based on new prepayment assumptions 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 that a decline in the fair value of a loan-backed security is other than temporary, 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 (which shall be included in Interest Maintenance Reserve (IMR), if applicable). 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.

16. INT 06-07, paragraphs 1 through 8:

1. The Accounting Practices and Procedures Manual contains guidance for determining when an investment is considered impaired within each of the above identified statements. Those statements should also be used to determine the measurement of an impairment loss. Each of the above statements also makes reference to an "other than temporary" decline in fair value. This interpretation is designed to address questions related to that phrase, as well as summarize the statutory accounting process for determining when an investment is considered impaired.

Step 1: Determine Whether an Investment Is Impaired

2. The decision for determining when an investment is considered impaired is dictated by the applicable SSAP and the respective impairment indicators included in each of the SSAPs. If an impairment indicator is present, the determination of an impairment shall be assessed at the individual security or investment level as reported in the annual statement and supporting schedules. For those SSAPs that require the reporting entity to use the fair value to determine if an impairment has occurred, the determination of that value shall be consistent with how the term fair value is defined within the Glossary of the Accounting Practices and Procedures Manual. Once a reporting entity has determined that an impairment indicator is present, the reporting entity shall continue to evaluate whether the investment is impaired each subsequent reporting period until either (a) the investment experiences a recovery of the fair value up to (or beyond) its carrying value or (b) the investor recognizes an other-than-temporary impairment loss.

Step 2: Evaluate Whether an Impairment Is Other Than Temporary

3. There are numerous factors to be considered when determining whether an impairment is other than temporary and their relative significance will vary from case to case. The Emerging Accounting Issues Working Group (working group) has been asked if the phrase “other than temporary” should be interpreted to mean “permanent”. The working group¹ believes the Statutory Accounting Principles Working Group consciously chose the phrase “other than temporary” as the analysis was not intended to determine whether an individual security or investment was “permanently impaired.” The fair value of assets may decline for various reasons. The market price may be affected by general market conditions, which reflect prospects for the economy as a whole, or by specific information pertaining to an industry or an individual company. Such declines require further investigation by management. Acting upon the premise that a write-down may be required, management should consider all available evidence to evaluate the fair value of its investment.

4. The working group believes that the following items are only a few examples of the factors, which, individually or in combination, indicate that a security’s decline in value is specific to an issuer’s fundamental credit difficulties, or that a non-interest related decline is other than temporary and that a write-down of the carrying value is required:

- a. The length of time and the extent to which the fair value has been less than cost;
- b. The financial condition and short-term prospects of the issuer, including any specific events that may influence the operations of the issuer, such as changes in technology, that may impair the earnings potential of the asset or the discontinuance of a segment of the business that may affect the future earnings potential; or
- c. The intent and ability of the holder to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in value.

5. An interest related impairment should be deemed other-than-temporary when an investor has the intent to sell an investment, at the reporting date, before recovery of the cost of the investment. The investor should consider whether its cash or working capital requirements and contractual or regulatory obligations indicate that the investment may need to be sold before the forecasted recovery occurs. The term “interest related” includes a declining value due to both increases in the risk free interest rate and general credit spread widening. Credit spreads can widen or contract for a variety of reasons, including supply/demand imbalances in the marketplace or perceived higher/lower risk of an entire sector. If the declining value is caused, in whole or in part, due to credit spreads widening, but not due to fundamental credit problems of the issuer, the change in credit spreads is deemed to be interest related. 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.

6. Unless evidence exists to support the assertion that the decline in fair value below carrying value is temporary, a write-down, accounted for as a realized loss, should be recorded. In accordance with the guidance of the SSAPs, such loss should be recognized in income for the period in which other than temporary impairment is determined to have occurred. The adjusted carrying value reflecting the impairment loss of the individual security or investment shall be the new cost basis of the individual security or investment.

7. The working group has also been asked if it is appropriate for reporting entities, independent auditors or state examiners to apply predefined thresholds to the phrase “other than temporary”? The working group is aware that certain insurers, independent auditors and state examiners, over time, have developed quantitative thresholds as “rules of thumb” to assist in the evaluation of asset impairment. One rule of thumb in particular suggests that if the fair value is less than its carrying value by 20 percent or more, then it is considered to be other than temporarily impaired. Another suggests that an asset is other than temporarily impaired if the fair value has been less than cost for more than 6 months. The use of a numerical threshold may

provide the basis for a preliminary assumption that – without considering all relevant circumstances – an impairment may have occurred. Identifying the impairment is only the beginning of the analysis; it cannot appropriately be used as a substitute for a full analysis of all relevant qualitative considerations. Exclusive reliance on such thresholds removes the ability of management to apply its judgment, a concept inherent to the impairment model.

Step 3: If the Impairment is Other Than Temporary, the Cost Basis of the Individual Asset Shall Be Written Down to a New Cost Basis and the Amount of the Write-Down Is Accounted for as a Realized Loss

8. If an impairment is considered other than temporary, the cost or carrying value of the asset should be written down to reflect its value in accordance with the relevant SSAP. A company's management should follow the impairment guidance in the SSAP pertaining to that particular asset class while considering various factors on a case-by-case basis in determining the amount of the realized loss that should be recorded.

Generally Accepted Accounting Principles

- No additional guidance obtained from GAAP.

OTHER SOURCES OF INFORMATION

- No additional guidance obtained from state statutes or regulations.

RELEVANT LITERATURE

Statutory Accounting

- *Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy*
- *SSAP No. 43—Loan-Backed and Structured Securities*
- *SSAP No. 3—Accounting Changes*
- *SSAP No. 4—Definition of Assets and Nonadmitted Assets*
- *SSAP No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets*
- *SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve*
- *INT 06-07: Definition of Phrase “Other Than Temporary”*

Generally Accepted Accounting Principles

- *FASB Statement No. 115: Accounting for Certain Investments in Debt and Equity Securities*
- *FASB Statement No. 125: Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*
- *FASB Emerging Issues Task Force No. 99-20: Recognition of Interest Income and Impairment on Purchased and Retained Beneficial Interests in Securitized Financial Assets*

State Regulations

- No additional guidance obtained from state statutes or regulations.

Other Sources of Information

No additional guidance obtained from other sources of information.