

# Statutory Issue Paper No. 43

## Loan-Backed and Structured Securities

### STATUS

Finalized March 16, 1998

**Original SSAP: SSAP No. 43; Current Authoritative Guidance: SSAP No. 43R**

*This issue paper may not be directly related to the current authoritative statement.*

### Type of Issue:

Common Area

### SUMMARY OF ISSUE

1. Current statutory accounting guidance for investments in loan-backed and structured securities is contained in the Accounting Practices and Procedures Manuals for Life and Accident and Health and for Property and Casualty Insurance Companies. That guidance also establishes the NAIC's Securities Valuation Office (SVO) as the primary authority for the valuation of such investments.
2. The purpose of this issue paper is to establish statutory accounting principles for investments in loan-backed and structured securities that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

### SUMMARY CONCLUSION

3. Loan-backed securities shall be defined as pass-through certificates, collateralized mortgage obligations (CMOs) and other "securitized" loans not included in structured securities, as defined below, for which the payment of interest and/or principal is directly proportional to the interest and/or principal received by the issuer from the mortgage pool or other underlying securities. Structured securities shall be defined as loan-backed securities which have been divided into two or more classes for which the payment of interest and/or principal of any class of securities has been allocated in a manner which is not proportional to interest and/or principal received by the issuer from the mortgage pool or other underlying securities. Loan-backed securities and structured securities are collectively referred to as loan-backed securities in this issue paper.
4. Loan-backed securities meet the definition of assets as defined in *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets* and are admitted assets to the extent they conform to the requirements of this issue paper.
5. The acquisitions and dispositions of loan-backed securities shall be recorded on the trade date. At acquisition, loan-backed securities shall be reported at their cost, including brokerage and related fees. For securities where all information is not known as of the trade date (i.e., actual payment factors, specific pools, etc.), a reporting entity shall make its best estimate based on known facts.
6. For reporting entities required to maintain an Interest Maintenance Reserve (IMR), the accounting for realized capital gains and losses on sales of loan-backed securities shall be in accordance with *Issue Paper No. 7—Asset Valuation Reserve and Interest Maintenance Reserve*. For reporting entities not required to maintain an IMR, realized gains and losses on sales of loan-backed securities shall be recorded on the trade date, and shall be reported on the net realized gains or losses line of the Investment Income section of the Statement of Operations.

**Origination Fees**

7. Origination fees represent fees charged to the borrower in connection with the process of originating or restructuring a transaction. The fees include, but are not limited to, points, management, arrangement, placement, application, underwriting, and other fees pursuant to such a transaction. Origination fees shall not be recorded until received in cash. Origination fees intended to compensate the reporting entity for interest rate risks (e.g., points), shall be amortized into income over the term of the loan-backed security consistent with paragraph 11 of this issue paper. Other origination fees shall be recorded as income upon receipt.

**Origination, Acquisition, and Commitment Costs**

8. Costs related to origination when paid in the form of brokerage and other related fees shall be capitalized as part of the cost of the loan-backed security, consistent with paragraph 5 of this issue paper. All other costs, including internal costs or costs paid to an affiliated entity related to origination, purchase, or commitment to purchase loan-backed securities, shall be charged to expense when incurred.

**Commitment Fees**

9. Commitment fees are fees paid to the reporting entity that obligate the reporting entity to make available funds for future borrowing under a specified condition. A fee paid to the reporting entity to obtain a commitment to make funds available at some time in the future, generally, is refundable only if the loan-backed security is issued. If the loan-backed security is not issued then the fees shall be recorded as investment income by the reporting entity when the commitment expires.

10. A fee paid to the reporting entity to obtain a commitment to borrow funds at a specified rate and with specified terms quoted in the commitment agreement, generally, is not refundable unless the commitment is refused by the reporting entity. This type of fee shall be deferred, and amortization shall depend on whether or not the commitment is exercised. If the commitment is exercised, then the fee shall be amortized in accordance with paragraph 11 of this issue paper over the life of the loan-backed security as an adjustment to the investment income on the loan-backed security. If the commitment expires unexercised, the commitment fee shall be recognized in income on the commitment expiration date.

**Amortized Cost**

11. The purchase discount or premium shall be amortized using the interest method as an adjustment to investment income. The interest method results in a constant effective yield equal to the prevailing rate at the time of purchase or at the time of subsequent adjustments to book value. The amortization period shall reflect estimates of the period over which redemption of the loan-backed securities is expected to occur, not the stated maturity period.

**Balance Sheet Amount**

12. Loan-backed securities shall be valued and reported in accordance with the NAIC Valuations of Securities manual prepared by the Securities Valuation Office. For reporting entities that maintain an Asset Valuation Reserve (AVR), the loan-backed 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 market value. For reporting entities that do not maintain an AVR, loan-backed securities that are designated highest-quality and high-quality (NAIC designations 1 and 2, respectively) shall be reported at amortized cost; with all other loan-backed securities (NAIC designations 3 to 6) reported at the lower of amortized cost or market value.

**Changes in Valuation**

13. Changes in prepayment assumptions and the resulting cash flows shall be reviewed periodically. For securities that have the potential for loss of a portion of the original investment due to changes in interest rates or prepayments, such review shall be performed quarterly. Examples of securities that have the potential for loss of a portion of the original investment include CMO residuals and mortgage-backed interest-only certificates. For such securities, an effective yield or internal rate of return

is calculated at acquisition based on the purchase price and anticipated future cash flows. For other investments, such review may be performed annually. The prepayment rates of the underlying loans shall be used to determine prepayment assumptions. Prepayment assumptions should be applied consistently across portfolios to all securities backed by similar collateral (similar with respect to coupon, issuer, and age of collateral). Reporting entities should also use consistent assumptions across portfolios for similar collateral within controlled affiliated groups. Since each reporting entity may have a unique method for determining the prepayment assumptions, it is impractical to set standard assumptions for the industry. Relevant sources and rationale used to determine prepayment assumptions should be documented by the reporting entity.

14. Loan-backed securities shall be revalued using the new prepayment assumptions using either the prospective or retrospective adjustment methodologies, as defined in paragraph 31, consistently applied by type of securities. 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 this 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 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.

### **Impairment**

15. 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 (undiscounted estimated future cash flows are less than the current book value), an other than temporary impairment shall be considered to have occurred. Accordingly, the cost basis of the loan-backed 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 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.

### **Income**

16. Interest shall be accrued using the interest method using the redemption prices and redemption dates used for amortizing premiums and discounts. Interest income for any period consists of interest collected during the period, the change in the due and accrued interest between the beginning and end of the period as well as reductions for premium amortization and interest paid on acquisition of loan-backed securities, and the addition of discount accrual. Contingent interest may be accrued if the applicable provisions of the underlying contract and the prerequisite conditions have been met.

17. A loan-backed security may provide for a prepayment penalty or acceleration fee in the event the investment is liquidated prior to its scheduled termination date. Such fees shall be reported as investment income when received.

**Loaned Loan-Backed Securities**

18. When loan-backed securities are loaned, they remain either admitted or nonadmitted assets of the reporting entity and are not removed from the accounting records as the reporting entity remains the owner of the securities. When collateral is provided and it is deposited for the general use of the reporting entity, it becomes either an admitted or nonadmitted asset of the reporting entity based on its characteristics, and a liability for the return of that collateral must be established. When collateral not available for the general use of the reporting entity is provided, it should not be recognized as an asset of the reporting entity. When non-cash collateral is provided, the current market value of that collateral must be used to determine adequacy of the collateral held relative to the current market value of the loaned securities.

**Wash Sales**

19. When investments in loan-backed securities are sold and the proceeds are reinvested within 30 days in the same or substantially the same security, such transfers shall be considered to be wash sales, and shall be accounted for as sales and disclosed as required by paragraph 25. Unless there is a concurrent contract to repurchase or redeem the transferred security from the transferee, the transferor does not maintain effective control over the security.

**Giantization/Megatization of FHLMC or FNMA Mortgage-Backed Securities**

20. Giantization/megatization of mortgage-backed securities is defined as existing pools of FHLMC or FNMA mortgage-backed securities (MBS) with like coupon and prefix which are repooled together by the issuing agency creating a new larger security. The new Fannie Mae “Mega” or Freddie Mac “Giant” is a guaranteed MBS pass-through representing an undivided interest in the underlying pools of loans.

21. The benefits derived from giantization/megatization include:

- a. Increased liquidity: Smaller MBS pools (particularly those with current face of less than \$1 million) are less liquid than mortgage pools with current faces exceeding \$5 million. Repooling smaller MBS pools into one, larger pool improves the marketability for the aggregate package;
- b. Geographic diversity: Regrouping of multiple pools generally will create greater geographic pool loan diversity resulting in less prepayment variation due to regional economic factors;
- c. Reduced administrative expenses: The reduced number of pools lowers bank custodial fees, pricing/factor service fees, and increases efficiency for the accounting and investment departments.

22. Repooled FHLMC and FNMA securities meet the definition of substantially the same as defined in *Issue Paper No. 45—Repurchase Agreements, Reverse Repurchase Agreements and Dollar Repurchase Agreements* (Issue Paper No. 45). The transaction shall not be considered a sale/purchase and no gain or loss shall be recognized. To properly document the repooling, the transaction shall be reported through Schedule D of the Annual Statement as a disposition and an acquisition.

23. Transaction fees charged by the issuing agencies shall be capitalized and amortized over the life of the repooled security.

**Disclosures**

24. In addition to the disclosures required for invested assets in general, reporting entities shall disclose the following about their loan-backed securities in the notes to the financial statements:

- a. Fair values in accordance with *Issue Paper No. 33—Disclosures about Fair Value of Financial Instruments*
  - b. Concentrations of credit risk in accordance with *Issue Paper No. 27—Disclosure of Information about Financial Instruments with Concentration of Credit Risk*
  - c. Basis at which the loan-backed securities are stated
  - d. The adjustment methodology used for each type of security (prospective or retrospective)
  - e. Changes from the retrospective to the prospective adjustment methodology due to negative yield on specific securities.
  - f. If a reporting entity elects to use book value as of January 1, 1994 as the cost, for securities purchased prior to January 1, 1994 where historical cash flows are not readily available for applying the retrospective method, that fact shall be disclosed.
  - g. Descriptions of sources used to determine prepayment assumptions
  - h. Market value sources (The following sources shall be applied consistently 1) public market quotes, 2) fair value provided by the broker, 3) management estimate, 4) pricing service, 5) pricing matrix).
  - i. If the reporting entity has entered into securities lending transactions, its policy for requiring collateral and a description, including the amount, of loaned securities.
25. Reporting entities shall disclose the following information for wash sales, as defined in paragraph 19, involving transactions for securities with a NAIC designation of 3 or below, or unrated:
- a. A description of the reporting entity's objectives regarding these transactions;
  - b. An aggregation of transactions by NAIC Designation 3 or below, or unrated;
  - c. The number of transactions involved during the reporting period;
  - d. The book value of securities sold;
  - e. The cost of securities repurchased;
  - f. The realized gains/losses associated with the securities involved.

**DISCUSSION**

26. The statutory accounting principles described in the summary conclusion section adopt current statutory accounting guidance, for loan-backed securities, contained in paragraph 32 (which becomes fully effective for 1995), except as follows:

- a. Paragraph 5 requires loan-backed securities acquisitions and dispositions to be recorded on the trade date, whereas current statutory guidance is silent.

- b. Paragraph 19 provides guidance on wash sales of loan-backed securities.
- c. Paragraph 40 provides guidance concerning the criteria which constitutes what are the same or substantially the same investments as defined in conjunction with dollar repurchase agreements. Due to the similarities between the investments discussed herein and the investments which underlie dollar repurchase agreements, the utilization of the same criteria to define “the same and substantially the same” investments appears reasonable and consistent.

27. This issue paper rejects the GAAP guidance for loan-backed securities, which is contained in *FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities* (FAS 115), *FASB Statement No. 91, Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases* (FAS 91), *FASB Emerging Issues Task Force No. 89-4, Accounting for a Purchased Investment in a Collateralized Mortgage Obligation Instrument or in a Mortgage-Backed Interest-Only Certificate*, *FASB Emerging Issues Task Force No. 90-2, Exchange of Interest-Only and Principal-Only Securities for a Mortgage-Backed Security*, *FASB Emerging Issues Task Force No. 93-18, Recognition of Impairment for an Investment in a Collateralized Mortgage Obligation Instrument or in a Mortgage-Backed Interest-Only Certificate*, and *FASB Emerging Issues Task Force No. 96-12, Recognition of Interest Income and Balance Sheet Classification of Structured Notes*. The primary differences between the statutory accounting principles established in this issue paper and GAAP are as follows:

- a. FAS 115 requires investments in debt securities to be classified into three categories: held-to-maturity, available-for-sale and trading. Held-to-maturity securities are reported at amortized cost. Available-for-sale are reported at fair value, with unrealized gains or losses reported as a separate component of shareholders' equity. Trading securities are reported at fair value, with unrealized gains or losses included in earnings.
- b. GAAP does not require reporting of AVR.
- c. FAS 91 and EITF 89-4 require that (1) for other than high-risk loan-backed securities, adjustments to the effective yield be for changes in prepayment assumptions be made on a retrospective basis; (2) for high-risk CMOs, such adjustments be made on a prospective basis.
- d. FAS 91 allows deferral of certain origination costs.
- e. Under this issue paper, impairment is measured based on nondiscounted estimated cash flows. *Emerging Issues Task Force Issue No. FASB 93-18, Recognition of Impairment for an Investment in a Collateralized Mortgage Obligation Instrument or in a Mortgage-Backed Interest-Only Certificate*. (EITF 93-18) requires that impairment be measured based on discounted cash flows.

28. This issue paper adopts paragraphs 9-12, 15, 17, 23-31 and 61-65 of *FASB Statement No. 125, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (FAS 125) as they relate to loan-backed securities. Paragraph 14 is rejected as it relates to the classifications of securities under FAS 115. FAS 115 was rejected in *Issue Paper No. 26—Bonds, Excluding Loan-Backed and Structured Securities*.

29. The guidance on loaned securities in this issue paper is drafted under the general rule that securities lending transactions do not meet the criteria for surrender of control necessary to classify the

transaction as a sale. If the criteria in paragraph 9 of FAS 125 regarding surrender of control are met, the transaction shall be accounted for by the transferor as a sale of the “loaned” securities.

30. *AICPA Statement of Position 90-3, Definition of the Term Substantially the Same for Holders of Debt Instruments, as Used in Certain Audit Guides and a Statement of Position (SOP 90-3)* is consistent with paragraph 35 of this issue paper and has been adopted in Issue Paper No. 45.

31. The statutory accounting principles established in this issue paper attempt to smooth the effect upon a reporting entity’s surplus of fair value fluctuation of investments held by the reporting entity. This is consistent with the Statement of Concepts which states that “*conservative valuation procedures provide protection to policyholders against adverse fluctuations in financial condition or operating results.*” Statutory accounting principles for life insurance companies also use the concept of AVR and Interest Maintenance Reserve (IMR) adjustments to compensate for fair value fluctuations over time.

#### **Drafting Notes/Comments**

- Investment income due and accrued is addressed in *Issue Paper No. 34—Investment Income Due and Accrued*.
- Accounting for AVR and IMR is addressed in *Issue Paper No. 7—Asset Valuation Reserve and Interest Maintenance Reserve*.
- *Issue Paper No. 26—Bonds, Excluding Loan-Backed and Structured Securities* addresses accounting for bonds.
- Special purpose subsidiaries used to securitize loans are addressed in *Issue Paper No. 86—Securitization*. That issue paper addresses the situation whereby a reporting entity securitizes loans through the special purpose entity, and then purchases the resultant securities as investments

### **RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE**

#### **Statutory Accounting**

32. Chapter 1, *Bonds and Loan Backed and Structured Securities*, in the Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies contains the following guidance relating to loan-backed and structured securities:

#### **ACCOUNTING FOR LOAN-BACKED AND STRUCTURED SECURITIES (CMOs)**

##### **Description**

Loan-backed and structured securities are financial instruments designed to channel funds from capital markets to mortgage borrowers. The investments are structured so that all or substantially all of the collections of principal and interest from the underlying collateral are paid through to the investor.

Loan-backed securities are defined as pass-through certificates, collateralized mortgage obligations (CMOs) and other securitized loans not included in structured securities as defined in the next paragraph. The payment of interest and/or principal on loan-backed securities is directly proportional to the interest and/or principal received by the issuer from the mortgage pool or other underlying securities.

Structured securities are defined as loan-backed securities which have been divided into two or more classes, where the payment of interest and/or principal of any class of the securities has been allocated in a manner which is not proportional to interest and/or principal received by the issuer from the mortgage pool or underlying securities. Structured securities have been further

defined as collateralized mortgage obligations and other structured securities for Schedule D reporting and disclosures.

These investments are issued by special-purpose corporations or trusts (issuer) established by a sponsoring parent organization. Mortgage loans or other securities securing the loan-backed obligation are acquired by the issuer and pledged to an independent trustee until the issuer's obligation has been fully satisfied. The investor can look only to the issuer's assets (primarily the trustee assets or third parties such as insurers or guarantors) for repayment of the obligation. As a result, the sponsor and its other affiliates may have no financial obligation under the instrument, although one of those entities may retain the responsibility for servicing the underlying mortgage loans. Some sponsors do guarantee the performance of the underlying loans.

At purchase, loan-backed and structured securities are recorded at purchase cost. Discount or premium is recorded for the difference between the purchase price and the principal amount. The discount or premium is amortized using the interest method and is recorded as an adjustment to investment income. The interest method results in the recognition of a constant rate of return on the investment equal to the prevailing rate at the time of purchase or at the time of subsequent adjustments of book value.

#### Prepayment Assumptions

Prepayments are a significant variable element in the cash flow of the investment because they affect the yield and determine the expected maturity against which the yield is evaluated. Falling interest rates generate faster prepayment of the mortgages underlying the security, shortening its duration. This causes the insurance company to reinvest assets much sooner than expected at potentially less advantageous rates. This is called prepayment risk. Extension risk is created by rising interest rates which slow repayment and can significantly lengthen the duration of the security.

Because performance of these securities is highly sensitive to prepayment rates, assumptions must be reviewed at least annually. Assumptions used for securities that have the potential for loss of a portion of the original investment due to changes in interest rates or prepayments should be reviewed quarterly. Changes in prepayment assumptions and the resulting cash flows must be considered when determining the carrying value of the security in periods after purchase.

Securities should be revalued using the new prepayment assumptions resulting from the annual or quarterly review. The effective yield is calculated using anticipated cash flows of the security based on an assumption of prepayment rates of the underlying loans. Variable rate securities or floaters, should use a constant rate of interest determined at the date of the calculation.

Prepayment assumptions should be applied consistently across portfolios to all securities backed by similar collateral (similar with respect to coupon, issuer, and age of collateral). Companies should also use consistent assumptions across portfolios for similar collateral within controlled affiliated groups. Since each company may have a unique method for determining the prepayment assumptions, it is impractical to set standard assumptions for the industry.

Relevant sources and rationale used to determine prepayment assumptions should be documented by the company.

#### Adjustment Methodologies

Both the prospective and retrospective adjustment methodologies are acceptable when revaluing these investments. The methods require that the effective yield be recalculated at each reporting date if there has been a change in the underlying assumptions. A company or a controlled affiliated group must choose a method for each type of security and consistently apply it to the



security type. A security type describes the principal payment and interest payment characteristics of the security. For structured securities, the issuing agencies have developed a set of standard definitions for REMIC and CMO bonds describing principal and interest payment types.

#### Prospective Method

The prospective approach recognizes, through the recalculation of the effective yield to be applied to future periods, the effects of all past cash flows whose amounts differ from those estimated earlier and the effects and changes in projected cash flows. Under this method, the recalculated effective yield will equate the carrying amount of the investment to the present value of anticipated future cash flows. The recalculated yield is then used to accrue income on the investment balance for the subsequent accounting period. No change in the carrying amount is required to be recognized unless the undiscounted anticipated cash flow is less than the carrying amount of the investment.

#### Retrospective Method

The retrospective method 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 of the investment is 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.

Under this method, the adjustment to book value to recognize premium or discount on payments that differed from estimates is called a true-up. Since it is an adjustment to yield, the offset to the book value is a charge or credit to investment income.

#### Negative Yield

Using either the prospective or retrospective method, if the revaluation based on new prepayment assumptions results in a negative effective yield (estimated future cash flows are less than the current book value), the security should be valued at the undiscounted estimate of anticipated future cash flows. Writedowns representing a loss in value should be treated as a realized capital loss and included in the IMR. The loss should be amortized over the weighted average life consistent with the valuation of the security at the time of the loss recognition.

At the time of recognition, a new cost basis should be established for the security. In future periods, the security cannot be written up and therefore the prospective adjustment methodology must be used for periods subsequent to the loss recognition.

A company should be able to identify those securities for which a negative yield adjustment was taken.

#### Investment Limitations

Loan-backed securities including CMOs and other structured securities may be subject to limitations established by the state of domicile.

Effective Date

The guidance in this chapter is effective for the year ending December 31, 1994 for loan-backed and structured securities that have the potential for loss of a portion of the original investment, such as losses arising from changes in interest rates or prepayments rates. (These securities should include, but are not limited to, interest-only structured securities and structured securities purchased at a significant premium over par value.) These accounting and reporting principles are effective for all loan-backed and structured securities for the year ending December 31, 1995. Companies may adopt compliance earlier, if desired.

For securities purchased prior to January 1, 1994 where historical cash flows are not readily available for applying the retrospective method, the company may use January 1, 1994 as the acquisition date and the then book value as the cost for purposes of determining yield adjustments in future periods. If this option is selected, a company should disclose that fact in the footnote where it presents the amortization methods used.

33. The Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies contains similar guidance.

34. The *Purposes and Procedures Manual of the NAIC Securities Valuation Office - Section 2 - Procedures for Determining NAIC Designations for Bonds* contains guidance on loan-backed securities. Pertinent excerpts are as follows:

(1) Collateralized Obligations. The ability of any type of collateral to enhance or fully support the contractual provisions of any security will be taken into account by the SVO only if acceptable documentary evidence is provided. This might include, but is not limited to the filing of the SVO's Collateral Loan form where appropriate, the original due diligence package, appraisal reports, valuations of business entities reports or any other relevant supporting information.

(18) Loan-backed and Structured Securities. The SVO encourages insurers to obtain ratings for loan-backed and structured securities submitted for an NAIC designation from an NAIC approved NRSRO. For unrated structured securities acquired by conversion i.e., securitization, refer to Section 6(B)(g)(i) for instructions.

(E) Instructions for Completing Schedule D of the NAIC Annual Statement

The following table indicates the appropriate entries to be made in Schedule D of the NAIC Annual Statement for all bonds except income bonds (see Section 2(C)(1)) and perpetual bonds and demand notes (see Section 2(C)(2)).

(1) For Insurers Maintaining an Asset Valuation Reserve (AVR) (see Section 6)

NAIC DESIGNATION COLUMN	AMORTIZED OR INVESTMENT VALUE COLUMN	MARKET VALUE COLUMNS	
		RATE	AMOUNT
1	Amortized Cost	SVO	
2	Amortized Cost	Market Rate	Par Value X Rate or Amortized Cost if No Rate Available
3	Amortized Cost	if shown or A.V.	
4	Amortized Cost	if No Rate	
5	Amortized Cost	shown in	
6	The lesser of the Market Value Amount or Amortized Cost	VOS Manual	Lower of Amortized Cost or Par Value times Market Rate

A.V. = Bond has been valued at amortized value and that value should appear in the Market Value Amount Column.

(2) For Property and Casualty Insurers and All Other Insurers Not Maintaining an Asset Valuation Reserve (AVR)

NAIC DESIGNATION COLUMN	AMORTIZED OR INVESTMENT VALUE COLUMN	MARKET VALUE COLUMNS	
		RATE	MARKET VALUE
1	Amortized Cost		Par Value X Rate
2	Amortized Cost	SVO Market Rate if shown	or A.V. if no rate available
3	The lesser of the Market Value Amount Or the Amortized Cost	or A.V. if No	Lower of Amortized Cost or Par Value X Rate
4	The lesser of the Market Value Amount or the Amortized Cost	Rate shown In VOS	Lower of Amortized Cost or Par Value X Rate
5	The lesser of the Market Value Amount or the Amortized Cost	Manual	Lower of Amortized Cost or Par Value X Rate
6	The lesser of the Market Value Amount or the Amortized Cost		Lower of Amortized Cost or Par Value X Rate

A.V. = Bond has been valued at amortized value and that value should appear in the Market Value Amount Column.

35. Chapter 1, Bonds and Loan Backed and Structured Securities, of the Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, contains the following guidance concerning the criteria which constitutes investments which are “the same or substantially the same” for dollar repurchase agreements:

- a. The mortgage-backed securities must have the same primary obligor, except for securities guaranteed by the United States or an agency, thereof, in which case the guarantor must be the same.
- b. The mortgage-backed securities must be identical in form and type. For example, the exchange of GNMA I securities for GNMA II securities would not meet the criterion.
- c. The mortgage-backed securities must bear the identical contractual interest rate.
- d. The mortgage-backed securities must be similar with respect to maturities (expected remaining lives) resulting in approximately the same market yield.
- e. The mortgage-backed securities must be collateralized by a similar pool of mortgages, such as single-family residential mortgages.
- f. The aggregate principal amounts of the mortgage-backed securities sold and repurchased must be substantially the same. For mortgage-backed securities to meet this criterion, the principal amount of the certificates repurchased must be within 2.5

percent (plus or minus) of the principal amount of the original certificates. For example, if the principal amount of mortgage-backed securities sold is \$1,000,000, the principal amount of mortgage-backed securities reacquired must be between \$1,025,000 and \$975,000 to qualify under this criterion.

### Generally Accepted Accounting Principles

36. GAAP guidance is promulgated by FAS 115. Pertinent excerpts are as follows:

#### Accounting for Certain Investments in Debt and Equity Securities

6. At acquisition, an enterprise shall classify debt and equity securities into one of three categories: held-to-maturity, available-for-sale, or trading. At each reporting date, the appropriateness of the classification shall be reassessed.

#### Held-to-Maturity Securities

7. Investments in debt securities shall be classified as held-to-maturity and measured at amortized cost in the statement of financial position only if the reporting enterprise has the positive intent and ability to hold those securities to maturity.

#### Trading Securities and Available-for-Sale Securities

12. Investments in debt securities that are not classified as held-to-maturity and equity securities that have readily determinable fair values shall be classified in one of the following categories and measured at fair value in the statement of financial position:

- a. Trading securities. Securities that are bought and held principally for the purpose of selling them in the near term (thus held for only a short period of time) shall be classified as trading securities. Trading generally reflects active and frequent buying and selling, and trading securities are generally used with the objective of generating profits on short-term differences in price. Mortgage-backed securities that are held for sale in conjunction with mortgage banking activities, as described in *FASB Statement No. 65, Accounting for Certain Mortgage Banking Activities*, shall be classified as trading securities. (Other mortgage-backed securities not held for sale in conjunction with mortgage banking activities shall be classified based on the criteria in this paragraph and paragraph 7.)
- b. Available-for-sale securities. Investments not classified as trading securities (nor as held-to-maturity securities) shall be classified as available-for-sale securities.

#### Reporting Changes in Fair Value

13. Unrealized holding gains and losses for trading securities shall be included in earnings. Unrealized holding gains and losses for available-for-sale securities (including those classified as current assets) shall be excluded from earnings and reported as a net amount in a separate component of shareholders' equity until realized. Paragraph 36 of *FASB Statement No. 109, Accounting for Income Taxes*, provides guidance on reporting the tax effects of unrealized holding gains and losses reported in a separate component of shareholders' equity.

14. Dividend and interest income, including amortization of the premium and discount arising at acquisition, for all three categories of investments in securities shall continue to be included in earnings. This Statement does not affect the methods used for recognizing and measuring the amount of dividend and interest income. Realized gains and losses for securities classified as either available-for-sale or held-to-maturity also shall continue to be reported in earnings.

## Impairment of Securities

16. For individual securities classified as either available-for-sale or held-to-maturity, an enterprise shall determine whether a decline in fair value below the amortized cost basis is other than temporary. For example, if it is probable that the investor will be unable to collect all amounts due according to the contractual terms of a debt security not impaired at acquisition, an other-than-temporary impairment shall be considered to have occurred.<sup>4</sup> If the decline in fair value is judged to be other than temporary, the cost basis of the individual security shall be written down to fair value as a new cost basis and the amount of the write-down shall be included in earnings (that is, accounted for as a realized loss). The new cost basis shall not be changed for subsequent recoveries in fair value. Subsequent increases in the fair value of available-for-sale securities shall be included in the separate component of equity pursuant to paragraph 13; subsequent decreases in fair value, if not an other-than-temporary impairment, also shall be included in the separate component of equity.

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<sup>4</sup>A decline in the value of a security that is other than temporary is also discussed in AICPA Auditing Interpretation, Evidential Matter for the Carrying Amount of Marketable Securities, which was issued in 1975 and incorporated in Statement on Auditing Standards No. 1, Codification of Auditing Standards and Procedures, as Interpretation 20, and in SEC Staff Accounting Bulletin No. 59, Accounting for Noncurrent Marketable Equity Securities.  
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## 37. FAS 91 provides the following guidance:

## Purchase of a Loan or Group of Loans

15. The initial investment in a purchased loan or group of loans shall include the amount paid to the seller plus any fees paid or less any fees received. The initial investment frequently differs from the related loan's principal amount at the date of purchase. This difference shall be recognized as an adjustment of yield over the life of the loan. All other costs incurred in connection with acquiring purchased loans or committing to purchase loans shall be charged to expense as incurred.

## Application of the Interest Method and Other Amortization Matters

18. Net fees or costs that are required to be recognized as yield adjustments over the life of the related loan(s) shall be recognized by the interest method except as set forth in paragraph 20. The objective of the interest method is to arrive at periodic interest income (including recognition of fees and costs) at a constant effective yield on the net investment in the receivable (that is, the principal amount of the receivable adjusted by unamortized fees or costs and purchase premium or discount). The difference between the periodic interest income so determined and the stated interest on the outstanding principal amount of the receivable is the amount of periodic amortization.<sup>6</sup> Under the provisions of this Statement, the interest method shall be applied as follows when the stated interest rate is not constant throughout the term of the loan:

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<sup>6</sup> The "interest" method is also described in paragraph 16 of APB Opinion No. 12, Omnibus Opinion--1967, in the first sentence of paragraph 15 of *APB Opinion No. 21, Interest on Receivables and Payables*, and in paragraphs 235-239 of *FASB Concepts Statement No. 6, Elements of Financial Statements*.  
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- a. If the loan's stated interest rate increases during the term of the loan (so that interest accrued under the interest method in early periods would exceed interest at the stated rate), interest income shall not be recognized to the extent that the

net investment in the loan would increase to an amount greater than the amount at which the borrower could settle the obligation. Prepayment penalties shall be considered in determining the amount at which the borrower could settle the obligation only to the extent that such penalties are imposed throughout the loan term. (Refer to Appendix B.)

- b. If the loan's stated interest rate decreases during the term of the loan, the stated periodic interest received early in the term of the loan would exceed the periodic interest income that is calculated under the interest method. In that circumstance, the excess shall be deferred and recognized in those future periods when the constant effective yield under the interest method exceeds the stated interest rate. (Refer to Appendix B.)
- c. The loan's stated interest rate varies based on future changes in an independent factor, such as an index or rate (for example, the prime rate, the London Interbank Offered Rate (LIBOR), or the U.S. Treasury bill weekly average rate), the calculation of the constant effective yield necessary to recognize fees and costs shall be based either on the factor (the index or rate) that is in effect at the inception of the loan or on the factor as it changes over the life of the loan.<sup>7</sup> (Refer to Appendix B.)

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<sup>7</sup> A variable rate loan whose initial rate differs from the rate its base factor would produce is also subject to the provisions of paragraphs 18.a. and 18.b.

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19. Except as stated in the following sentence, the calculation of the constant effective yield necessary to apply the interest method shall use the payment terms required by the loan contract, and prepayments of principal shall not be anticipated to shorten the loan term. If the enterprise holds a large number of similar loans for which prepayments are probable and the timing and amount of prepayments can be reasonably estimated, the enterprise may consider estimates of future principal prepayments in the calculation of the constant effective yield necessary to apply the interest method. If the enterprise anticipates prepayments in applying the interest method and a difference arises between the prepayments anticipated and actual prepayments received, the enterprise shall recalculate the effective yield to reflect actual payments to date and anticipated future payments. The net investment in the loans shall be adjusted to the amount that would have existed had the new effective yield been applied since the acquisition of the loans. The investment in the loans shall be adjusted to the amount that would have existed had the new effective yield been applied since the acquisition of the loans. The investment in the loans shall be adjusted to the new balance with a corresponding charge or credit to interest income. Enterprises that anticipate prepayments shall disclose that policy and the significant assumptions underlying the prepayment estimates. The practice of recognizing net fees over the estimated average life of a group of loans shall no longer be acceptable. (Refer to Appendix B.)

38. EITF 89-4 provides the following guidance:

*Emerging Issues Task Force No. 89-4, Accounting for a Purchased Investment in a Collateralized Mortgage Obligation Instrument or in a Mortgage-Backed Interest-only Certificate*

## ISSUE

Collateralized mortgage obligations and certain participating interests in real estate mortgage investment conduits (REMICs) (hereinafter collectively referred to as CMOs) are typically issued by a special-purpose entity (the issuer). The issuer may be organized in a variety of legal forms, such as a trust, a corporation, or a partnership. Accordingly, an investor may purchase a CMO instrument in equity form (for example, trust interests, stock, or partnership interests) or nonequity form (for example, participating debt securities). CMOs are collateralized by mortgage loans or mortgage-backed securities that are transferred to the CMO trust or pool by a sponsor. The issuer is structured so that collections from the underlying collateral provide the cash flow to make principal and interest payments on the obligations, or tranches, of the issuer.

Some CMO instruments, regardless of legal form, are most like debt instruments because those CMO instruments have stated principal amounts and traditional defined interest rate terms. Purchasers of certain other CMO instruments are entitled to the excess, if any, of the issuer's cash inflows, including reinvestment earnings, over the cash outflows for debt service and administrative expenses. Those CMO instruments, regardless of legal form, may include instruments designated as residual interests and are "high-risk" in that these CMO instruments could result in the loss of a portion of the original investment.

When accounting for a purchased investment in a CMO, the issues are:

1. Which factors (legal form, economic substance, or other factors) should be considered in determining whether to account for CMO instruments as equity or nonequity
2. What attribute(s) of nonequity high-risk CMO instruments and mortgage-backed interest-only certificates distinguishes them as a group of instruments that should be accounted for similarly
3. How an investment in a nonequity high-risk CMO instrument or in a mortgage-backed interest-only certificate should be accounted for in subsequent periods; specifically, how current and expected future cash flows should be allocated between income and return of investment in each accounting period.

## EITF DISCUSSION

The Task Force reached a consensus as follows:

### Issue 1

The Task Force reached a consensus that the accounting for a purchased investment in a CMO instrument should generally be consistent with the form of the investment. However, some CMO instruments issued in the form of equity represent solely the purchase of a stream of future cash flows to be collected under preset terms and conditions. Consequently, a purchased investment in a CMO instrument in equity form meeting all of the following criteria is required to be accounted for as a nonequity investment regardless of the legal form of the instrument (for example, beneficial interest in a trust, common stock, or partnership interest):

1. The assets in the special-purpose entity were not transferred to the special-purpose entity by the purchaser of the CMO instrument. <sup>1</sup>

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<sup>1</sup> An investor in a CMO instrument who transferred assets to the related special-purpose entity should follow the accounting established by Statement 77 or Technical Bulletin 85-2, as applicable.

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2. The assets of the special-purpose entity consist solely of a large number of similar high-credit-quality monetary assets <sup>2</sup> (or one or more high-credit-quality mortgage-backed securities that provide an undivided interest in a large number of similar mortgage loans) for which prepayments are probable and the timing and amounts of prepayments can be reasonably estimated.

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<sup>2</sup> High-credit-quality monetary assets as used herein include only (1) assets guaranteed by the U.S. government, its agencies, or other creditworthy guarantors and (2) mortgage loans or mortgage-backed securities sufficiently collateralized to ensure that the possibility of credit loss is remote.

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3. The special-purpose entity is self-liquidating, that is, it will terminate when the existing assets are fully collected and the existing obligations of the special-purpose entity are fully paid.

4. Assets collateralizing the obligations of the special-purpose entity may not be exchanged, sold, or otherwise managed as a portfolio, and the purchaser has neither the right nor the obligation to substitute assets that collateralize the entity's obligations.

5. There is no more than a remote possibility that the purchaser would be required to contribute funds to the special-purpose entity to pay administrative expenses or other costs.

6. No other obligee of the special-purpose entity has recourse to the purchaser of the investment.

The ability of a purchaser of a CMO instrument to call other CMO tranches of the special-purpose entity generally will not preclude treatment of the purchaser's investment as a nonequity instrument provided all the above criteria are met.

CMO instruments issued in the form of equity that do not meet the above criteria should be accounted for under the provisions of Opinion 18 or ARB 51, as amended by Statement 94.

## Issue 2

The Task Force reached a consensus that nonequity CMO instruments that have potential for loss of a significant portion of the original investment due to changes in (1) interest rates, (2) the prepayment rate of the assets of the CMO structure, or (3) earnings from the temporary reinvestment of cash collected by the CMO structure but not yet distributed to the holders of its obligations (reinvestment earnings) are high-risk CMO instruments and should be accounted for as described in Issue 3 below. Nonequity CMO instruments include all CMO instruments issued in debt form and those CMO instruments issued in equity form that meet all six criteria listed in Issue 1.

For example, most issuers of CMO obligations have excess cash flows each period after required bond payments and administrative costs have been paid. Typically, the excess cash flows arise primarily from the spread between the interest rate paid on the CMO obligations and the interest rate received on the issuer's assets. The issuer may sell nonequity instruments (often called



CMO residuals) that entitle the purchaser to these excess cash flows. These instruments often have little or no principal component. If mortgage prepayments increase or if the interest rate paid on variable-rate obligations of the issuer increases, or both, the total cash flow to the investor in the CMO residual would significantly decline, possibly leaving the investor unable to recover a significant portion of the initial purchase price. Therefore, these types of CMO instruments are high-risk CMO instruments.

Other mortgage-related instruments entitle an investor to receive cash flows designated as interest from specified mortgages or mortgage-backed securities. These instruments are often called interest-only certificates and are similar to high-risk nonequity CMO instruments due to the potential for loss related to prepayment risk. The Task Force also reached a consensus that mortgage-backed interest-only certificates should be accounted for in the same manner as high-risk nonequity CMO instruments (see Issue 3 below).

Nonequity CMO instruments that do not have the potential for loss of a significant portion of the original investment due to the factors enumerated above, such as principal-only certificates, are not high-risk CMO instruments. Premiums and discounts arising from the purchase of CMO instruments that are not high risk should be amortized in accordance with the provisions of Statement 91.

### Issue 3

The Task Force reached a consensus that in accounting for each purchased high-risk nonequity CMO instrument for which it is appropriate to use amortized cost, the investor should allocate the total cash flows expected to be received over the estimated life of the investment between principal and interest in the following manner. [Note: See STATUS section.] At the date of purchase, an effective yield is calculated based on the purchase price and anticipated future cash flows. In the initial accounting period, interest income is accrued on the investment balance using that rate. Cash received on the investment is first applied to accrued interest with any excess reducing the recorded investment balance. At each reporting date, the effective yield is recalculated based on the amortized cost of the investment and the then-current estimate of future cash flows. This recalculated yield is then used to accrue interest income on the investment balance in the subsequent accounting period. This procedure continues until all cash flows from the investment have been received.

The amortized balance of the investment at the end of each period will equal the present value of the estimated future cash flows discounted at the newly calculated effective yield.

The estimated future cash flows at each reporting date should reflect the most current estimate of future prepayments. Prepayment estimates should be made using assumptions that are consistent with assumptions used by marketplace participants for similar instruments, which the Task Force understands may require the use of an estimate of future interest rates implied by the current yield curve. In addition, if future cash flows will be directly affected by changes in interest rates, current interest rates at or near the balance sheet date should be used to estimate those cash flows.<sup>3</sup> Estimates of cash flows from reinvestment earnings also should be based on rates that are not in excess of current interest rates for eligible investments as defined in the CMO instrument.

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<sup>3</sup> For example, some CMO instruments have cash flows that are impacted by the interest paid to variable-rate tranche holders in the same CMO structure. Current rates should be used to estimate the amounts to be paid to the variable rate tranche holders and in turn the amount of future cash flows to be collected from the CMO instruments.

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Investors in high-risk CMO instruments should evaluate each CMO instrument separately to determine whether expected future cash flows are adequate to recover the recorded investment balance. The recorded balance for each investment should not exceed the undiscounted estimated future cash flows; that is, the effective yield cannot be negative. Any write-down establishes a new cost, which then is used for purposes of calculating effective yields in subsequent periods.

If investments in high-risk CMO instruments are significant, the effective yield calculated at the reporting date, which will be used to accrue income in the following period, should be disclosed in the annual financial statements. Either the effective yield for each CMO instrument or the effective yield for the portfolio of CMO instruments may be disclosed. If significant, the carrying amount and fair value of investments in high-risk CMO instruments also should be disclosed in the annual financial statements. When market quotations are not available for these investments, estimates should be made.

The application of this consensus is limited to circumstances in which the CMO or similar instrument represents an interest in a pool of high-credit-quality monetary assets for which prepayments are probable and the timing and amounts of prepayments can be reasonably estimated.

This consensus supersedes the conclusions expressed by the Task Force in Issue No. 86-38, "Implications of Mortgage Prepayments on Amortization of Servicing Rights," Subissue C, "Unanticipated Prepayments and Interest-Only Certificates," with respect to interest-only certificates.

#### General Comments

The SEC Observer noted that the method of adopting the consensus should be disclosed. If adoption of the consensus materially affects comparability, the nature and effect of adoption (including a quantification of the effects, if practicable) also should be disclosed in the notes to the financial statements.

The SEC Observer expressed concern that the accounting prescribed by these consensus might be analogized to similar investments in collateralized borrowing structures when (1) the underlying collateral is of a lesser credit quality than that defined in this consensus or (2) the cash flow from the underlying collateral cannot be reasonably estimated. The SEC staff believes that such investments should be accounted for following a conservative method that adequately reflects the nature of those high-risk structures.

The Task Force noted that some CMO instruments and interest-only certificates are economically similar to excess servicing receivables and other mortgage-related investments. Diverse accounting methods for amortizing investments in the various types of mortgage-related instruments have been established in accounting literature. In addition, different interpretations of existing literature have resulted in further diversity in practice. The Task Force acknowledged the need for more comprehensive guidance in this area and authorized the working group to submit a letter to the FASB encouraging the Board to establish uniform guidance through a short-term project separate from the financial instruments project. [Note: See STATUS section.]

#### STATUS

The methodologies for amortizing and adjusting the carrying value of excess servicing fee assets and investments in interest-only securities or other similar financial instruments will be considered by the FASB staff as part of the project on present-value-based measurements.

In May 1993, the FASB issued Statement 115, which addresses accounting for certain investments in debt and equity securities and supersedes Statement 12. Under Statement 115, a positive intent and ability to hold a debt security to maturity is a prerequisite for using amortized cost. A financial institution must consider whether it has the ability to hold a high-risk CMO instrument to maturity under existing regulatory requirements. (See Topic No. D-39 in Appendix D.)

Paragraph 16 of Statement 115 states that if the decline in fair value of a security is judged to be other than temporary, the cost basis of the individual security should be written down to fair value. That measure of impairment differs from the measure in Issue 3 of the Task Force's consensus. In Issue No. 93-18, "Recognition of Impairment for an Investment in a Collateralized Mortgage Obligation Instrument or in a Mortgage-Backed Interest-Only Certificate," the Task Force reached a consensus that Statement 115 changes the measure of impairment of the instruments addressed in Issue 89-4 from undiscounted cash flows to fair value.

Issue 93-18 also addresses whether Statement 115 changes the consensus on Issue 89-4 with respect to the timing of recognizing impairment of investments in high-risk nonequity collateralized mortgage obligation instruments and interest-only certificates. The Task Force decided to supersede that aspect of the consensus on Issue 89-4 with a new consensus that if the present value of estimated future cash flows discounted at a risk-free rate is less than the amortized cost basis of the instrument, an impairment loss should be recognized.

No further EITF discussion is planned.

39. EITF 93-18 provides the following guidance:

*Emerging Issued Task Force No. 93-18 Impairment Recognition for a purchased Investment in a Collateralized Mortgage obligation Instrument or in a Mortgage-Bond Interest-only Certificate*

#### ISSUE

Paragraph 16 of Statement 115 requires that if a decline in fair value of an individual security classified as either available-for-sale or held-to-maturity is judged to be other than temporary, the cost basis shall be written down to fair value. The measure of an impairment loss for the securities discussed in Issue No. 89-4, "Accounting for a Purchased Investment in a Collateralized Mortgage Obligation Instrument or in a Mortgage-Backed Interest-Only Certificate," was based on undiscounted future cash flows. The recognition of an impairment loss under Issue 89-4 occurs when the recalculated effective yield turns negative (that is, when the sum of the newly estimated undiscounted future cash inflows is less than the security's recorded balance) and the impairment recognized was a write-down such that the recalculated effective yield was zero.

The issues are (1) whether Statement 115 changes the measure of an impairment loss for those instruments addressed in Issue 89-4 (that is, investments in high-risk nonequity collateralized mortgage obligation instruments and interest-only certificates), (2) whether Statement 115 changes the consensus on Issue 89-4 about the timing for recognition of an impairment loss for those instruments, and (3) whether previously recognized impairment losses for those instruments should be remeasured at fair value for purposes of determining the cumulative catch-up adjustment upon initial adoption of Statement 115.

#### EITF DISCUSSION

The Task Force reached a consensus that Statement 115 changes the measure of impairment of the instruments addressed in Issue 89-4 from undiscounted cash flows to fair value.

The Task Force also reached a consensus that if the present value of estimated future cash flows discounted at a risk-free rate (that is, the rate on monetary assets that are essentially risk free, as described in paragraph 4 of Statement 76) is less than the amortized cost basis of the instrument, an impairment loss should be recognized. That comparison should be made at each reporting date. The excess of the amortized cost basis over the instrument's fair value should be recognized as a realized loss in the income statement, thereby establishing a new cost basis for the security. The rate to be used to determine the present value amount is the risk-free rate for instruments with duration consistent with the security's estimated future cash flows at the time the instrument is tested for impairment. The term duration is used in its technical sense to mean the weighted-average time to receive all cash flows (interest, dividends, and principal), where the weights reflect the relative present values of the cash flows.

The Task Force reiterated the guidance in Issue 89-4 that the estimated future cash flows at each reporting date should reflect the most current estimate of future prepayments and use the same assumptions that are specified by the consensus in Issue 89-4.

The Task Force also reached a consensus that the amortized cost basis of those instruments that are determined to have an other-than-temporary impairment loss at the time of initial adoption of Statement 115 should be written down to fair value. The amount of the write-down should be included as part of the cumulative catch-up adjustment. If an enterprise has initially adopted Statement 115 in a reporting period prior to the period in which this consensus was reached (that is, the reporting period that includes March 24, 1994), an additional adjustment may be necessary to comply with this consensus. That adjustment, which also would be determined as of the date of initial adoption, should be reported as an additional cumulative catch-up adjustment in the reporting period that includes March 24, 1994.

These consensuses are limited to those instruments that are within the scope of Issue 89-4.

## STATUS

No further EITF discussion is planned.

40. *AICPA Statement of Position 90-3, Definition of the Term Substantially the Same for Holders of Debt Instruments, as Used in Certain Audit Guides and a Statement of Position (SOP 90-3)* provides the following guidance:

13 To minimize diversity in practice, the AICPA Banking Committee, Savings and Loan Associations Committee, and Stockbrokerage and Investment Banking Committee believe the definition of substantially the same should be narrow. Therefore, the committees have concluded that for debt instruments, including mortgage-backed securities, to be substantially the same, all the following criteria must be met:

- a. The debt instruments must have the same primary obligor, except for debt instruments guaranteed by a sovereign government, central bank, government-sponsored enterprise or agency thereof, in which case the guarantor and terms of the guarantee must be the same.<sup>1</sup>

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<sup>1</sup> The exchange of pools of single-family loans would not meet this criterion because the mortgages comprising the pool do not have the same primary obligor, and would therefore not be considered substantially the same.

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- b. The debt instruments must be identical in form and type so as to give the same risks and rights to the holder.<sup>2</sup>

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<sup>2</sup> For example, the following exchanges would not meet this criterion: GNMA I securities for GNMA II securities; loans to foreign debtors that are otherwise the same except for different U.S. foreign tax credit benefits (because such differences in the tax receipts associated with the loans result in instruments that vary “in form and type”); commercial paper for redeemable preferred stock.

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- c. The debt instruments must bear the identical contractual interest rate.
- d. The debt instruments must have the same maturity except for mortgage-backed pass-through and pay-through securities for which the mortgages collateralizing the securities must have similar remaining weighted average maturities (WAMs) that result in approximately the same market yield.<sup>3</sup>

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<sup>3</sup> For example, the exchange of a “fast-pay” GNMA certificate (that is, a certificate with underlying mortgage loans that have a high prepayment record) for a “slow-pay” GNMA certificate would not meet this criterion because differences in the expected remaining lives of the certificates result in different market yields.

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- e. Mortgage-backed pass-through and pay through securities must be collateralized by a similar pool of mortgages, such as single-family residential mortgages.
- f. The debt instruments must have the same aggregate unpaid principal amounts, except for mortgage-backed pass-through and pay-through securities, where the aggregate principal amounts of the mortgage-backed securities given up and the mortgage-backed securities reacquired must be within the accepted “good delivery” standard for the type of mortgage-backed security involved.<sup>4</sup>

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<sup>4</sup> Participants in the mortgage-backed securities market have established parameters for what is considered acceptable delivery. These specific standards are defined by the Public Securities Association (PSA) and can be found in Uniform Practices for the Clearance and Settlement of Mortgage-Backed Securities and Other Related Securities, which is published by PSA.

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41. FAS 125 provides the following guidance:

#### Accounting for Transfers and Servicing of Financial Assets

9. A transfer of financial assets (or all or a portion of a financial asset) in which the transferor surrenders control over those financial assets shall be accounted for as a sale to the extent that consideration other than beneficial interests in the transferred assets is received in exchange. The transferor has surrendered control over transferred assets if and only if all of the following conditions are met:

- a. The transferred assets have been isolated from the transferor—put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership (paragraphs 23 and 24).

- b. Either (1) each transferee obtains the right—free of conditions that constrain it from taking advantage of that right (paragraph 25)—to pledge or exchange the transferred assets or (2) the transferee is a qualifying special-purpose entity (paragraph 26) and the holders of beneficial interests in that entity have the right—free of conditions that constrain them from taking advantage of that right (paragraph 25)—to pledge or exchange those interests.
  - c. The transferor does not maintain effective control over the transferred assets through (1) an agreement that both entitles and obligates the transferor to repurchase or redeem them before their maturity (paragraphs 27-29) or (2) an agreement that entitles the transferor to repurchase or redeem transferred assets that are not readily obtainable (paragraph 30).
10. Upon completion of any transfer of financial assets, the transferor shall:
- a. Continue to carry in its statement of financial position any retained interest in the transferred assets, including, if applicable, servicing assets (paragraphs 35-41), beneficial interests in assets transferred to a qualifying special-purpose entity in a securitization (paragraphs 47-58), and retained undivided interests (paragraph 33)
  - b. Allocate the previous carrying amount between the assets sold, if any, and the retained interests, if any, based on their relative fair values at the date of transfer (paragraphs 31-34).

11. Upon completion<sup>3</sup> of a transfer of assets that satisfies the conditions to be accounted for as a sale (paragraph 9), the transferor (seller) shall:

- a. Derecognize all assets sold
- b. Recognize all assets obtained and liabilities incurred in consideration as proceeds of the sale, including cash, put or call options held or written (for example, guarantee or recourse obligations), forward commitments (for example, commitments to deliver additional receivables during the revolving periods of some securitizations), swaps (for example, provisions that convert interest rates from fixed to variable), and servicing liabilities, if applicable (paragraphs 31, 32, and 35-41)
- c. Initially measure at fair value assets obtained and liabilities incurred in a sale (paragraphs 42-44) or, if it is not practicable to estimate the fair value of an asset or a liability, apply alternative measures (paragraphs 45 and 46)
- d. Recognize in earnings any gain or loss on the sale.

The transferee shall recognize all assets obtained and any liabilities incurred and initially measure them at fair value (in aggregate, presumptively the price paid).

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<sup>3</sup> Although a transfer of securities may not be considered to have reached completion until the settlement date, this Statement does not modify other generally accepted accounting principles, including *FASB Statement No. 35, Accounting and Reporting by Defined Benefit Pension Plans*, and AICPA Statements of Position and audit and accounting Guides for certain industries, that require accounting at the trade date for certain contracts to purchase or sell securities.

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12. If a transfer of financial assets in exchange for cash or other consideration (other than beneficial interests in the transferred assets) does not meet the criteria for a sale in paragraph 9, the transferor and transferee shall account for the transfer as a secured borrowing with pledge of collateral (paragraph 15).

## Secured Borrowings and Collateral

15. A debtor may grant a security interest in certain assets to a lender (the secured party) to serve as collateral for its obligation under a borrowing, with or without recourse to other assets of the debtor. An obligor under other kinds of current or potential obligations, for example, interest rate swaps, also may grant a security interest in certain assets to a secured party. If collateral is transferred to the secured party, the custodial arrangement is commonly referred to as a pledge. Secured parties sometimes are permitted to sell or repledge (or otherwise transfer) collateral held under a pledge. The same relationships occur, under different names, in transfers documented as sales that are accounted for as secured borrowings (paragraph 12). The accounting for collateral by the debtor (or obligor) and the secured party depends on whether the secured party has taken control over the collateral and on the rights and obligations that result from the collateral arrangement:

- a. If (1) the secured party is permitted by contract or custom to sell or repledge the collateral and (2) the debtor does not have the right and ability to redeem the collateral on short notice, for example, by substituting other collateral or terminating the contract, then
  - (i) The debtor shall reclassify that asset and report that asset in its statement of financial position separately (for example, as securities receivable from broker) from other assets not so encumbered.
  - (ii) The secured party shall recognize that collateral as its asset, initially measure it at fair value, and also recognize its obligation to return it.
- b. If the secured party sells or repledges collateral on terms that do not give it the right and ability to repurchase or redeem the collateral from the transferee on short notice and thus may impair the debtor's right to redeem it, the secured party shall recognize the proceeds from the sale or the asset repledged and its obligation to return the asset to the extent that it has not already recognized them. The sale or repledging of the asset is a transfer subject to the provisions of this Statement.
- c. If the debtor defaults under the terms of the secured contract and is no longer entitled to redeem the collateral, it shall derecognize the collateral, and the secured party shall recognize the collateral as its asset to the extent it has not already recognized it and initially measure it at fair value.
- d. Otherwise, the debtor shall continue to carry the collateral as its asset, and the secured party shall not recognize the pledged asset.

## Disclosures

17. An entity shall disclose the following:
- a. If the entity has entered into repurchase agreements or securities lending transactions, its policy for requiring collateral or other security
  - b. If debt was considered to be extinguished by in-substance defeasance under the provisions of FASB Statement No. 76, Extinguishment of Debt, prior to the effective date of this Statement, a general description of the transaction and the amount of debt that is considered extinguished at the end of the period so long as that debt remains outstanding

- c. If assets are set aside after the effective date of this Statement solely for satisfying scheduled payments of a specific obligation, a description of the nature of restrictions placed on those assets
- d. If it is not practicable to estimate the fair value of certain assets obtained or liabilities incurred in transfers of financial assets during the period, a description of those items and the reasons why it is not practicable to estimate their fair value
- e. For all servicing assets and servicing liabilities:
  - (1) The amounts of servicing assets or liabilities recognized and amortized during the period
  - (2) The fair value of recognized servicing assets and liabilities for which it is practicable to estimate that value and the method and significant assumptions used to estimate the fair value
  - (3) The risk characteristics of the underlying financial assets used to stratify recognized servicing assets for purposes of measuring impairment in accordance with paragraph 37
  - (4) The activity in any valuation allowance for impairment of recognized servicing assets—including beginning and ending balances, aggregate additions charged and reductions credited to operations, and aggregate direct write-downs charged against the allowances—for each period for which results of operations are presented.

#### Isolation beyond the Reach of the Transferor and Its Creditors

23. The nature and extent of supporting evidence required for an assertion in financial statements that transferred financial assets have been isolated—put presumptively beyond the reach of the transferor and its creditors, either by a single transaction or a series of transactions taken as a whole—depend on the facts and circumstances. All available evidence that either supports or questions an assertion shall be considered. That consideration includes making judgments about whether the contract or circumstances permit the transferor to revoke the transfer. It also may include making judgments about the kind of bankruptcy or other receivership into which a transferor or special-purpose entity might be placed, whether a transfer of financial assets would likely be deemed a true sale at law, whether the transferor is affiliated with the transferee, and other factors pertinent under applicable law. Derecognition of transferred assets is appropriate only if the available evidence provides reasonable assurance that the transferred assets would be beyond the reach of the powers of a bankruptcy trustee or other receiver for the transferor or any of its affiliates, except for an affiliate that is a qualifying special-purpose entity designed to make remote the possibility that it would enter bankruptcy or other receivership (paragraph 57.c.).

24. Whether securitizations isolate transferred assets may depend on such factors as whether the securitization is accomplished in one step or two steps (paragraphs 54-58). Many common financial transactions, for example, typical repurchase agreements and securities lending transactions, isolate transferred assets from the transferor, although they may not meet the other criteria for surrender of control.

#### Conditions That Constrain a Transferee

25. Many transferor-imposed or other conditions on a transferee's contractual right to pledge or exchange a transferred asset constrain a transferee from taking advantage of that right. However, a transferor's right of first refusal on a bona fide offer from a third party, a requirement to obtain the transferor's permission to sell or pledge that shall not be unreasonably withheld, or a



prohibition on sale to the transferor's competitor generally does not constrain a transferee from pledging or exchanging the asset and, therefore, presumptively does not preclude a transfer containing such a condition from being accounted for as a sale. For example, a prohibition on sale to the transferor's competitor would not constrain the transferee if it were able to sell the transferred assets to a number of other parties; however, it would be a constraint if that competitor were the only potential willing buyer.

#### Qualifying Special-Purpose Entity

26. A qualifying special-purpose entity<sup>7</sup> must meet both of the following conditions:
- a. It is a trust, corporation, or other legal vehicle whose activities are permanently limited by the legal documents establishing the special-purpose entity to:
    - (1) Holding title to transferred financial assets
    - (2) Issuing beneficial interests (If some of the beneficial interests are in the form of debt securities or equity securities, the transfer of assets is a securitization.)
    - (3) Collecting cash proceeds from assets held, reinvesting proceeds in financial instruments pending distribution to holders of beneficial interests, and otherwise servicing the assets held
    - (4) Distributing proceeds to the holders of its beneficial interests.
  - b. It has standing at law distinct from the transferor. Having standing at law depends in part on the nature of the special-purpose entity. For example, generally, under U.S. law, if a transferor of assets to a special-purpose trust holds all of the beneficial interests, it can unilaterally dissolve the trust and thereby reassume control over the individual assets held in the trust, and the transferor "can effectively assign his interest and his creditors can reach it."<sup>8</sup> In that circumstance, the trust has no standing at law, is not distinct, and thus is not a qualifying special-purpose entity.

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<sup>7</sup> The description of a special-purpose entity is restrictive. The accounting for transfers of financial assets to special-purpose entities should not be extended to any entity that does not satisfy all of the conditions articulated in this paragraph.

<sup>8</sup> *Scott's Abridgment of the Law on Trusts*, §156 (Little, Brown and Company, 1960), 296.

#### Agreements That Maintain Effective Control over Transferred Assets

27. An agreement that both entitles and obligates the transferor to repurchase or redeem transferred assets from the transferee maintains the transferor's effective control over those assets, and the transfer is therefore to be accounted for as a secured borrowing, if and only if all of the following conditions are met:

- a. The assets to be repurchased or redeemed are the same or substantially the same as those transferred (paragraph 28).
- b. The transferor is able to repurchase or redeem them on substantially the agreed terms, even in the event of default by the transferee (paragraph 29).
- c. The agreement is to repurchase or redeem them before maturity, at a fixed or determinable price.

- d. The agreement is entered into concurrently with the transfer.

28. To be substantially the same,<sup>9</sup> the asset that was transferred and the asset that is to be repurchased or redeemed need to have all of the following characteristics:

- a. The same primary obligor (except for debt guaranteed by a sovereign government, central bank, government-sponsored enterprise or agency thereof, in which case the guarantor and the terms of the guarantee must be the same)
- b. Identical form and type so as to provide the same risks and rights
- c. The same maturity (or in the case of mortgage-backed pass-through and pay-through securities have similar remaining weighted-average maturities that result in approximately the same market yield)
- d. Identical contractual interest rates
- e. Similar assets as collateral
- f. The same aggregate unpaid principal amount or principal amounts within accepted “good delivery” standards for the type of security involved.

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<sup>9</sup> In this Statement, the term *substantially the same* is used consistently with the usage of that term in the AICPA Statement of Position 90-3, *Definition of the Term Substantially the Same for Holders of Debt Instruments, as Used in Certain Audit Guides and a Statement of Position*.

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29. To be able to repurchase or redeem assets on substantially the agreed terms, even in the event of default by the transferee, a transferor must at all times during the contract term have obtained cash or other collateral sufficient to fund substantially all of the cost of purchasing replacement assets from others.

30. A call option or forward contract that entitles the transferor to repurchase, prior to maturity, transferred assets not readily obtainable elsewhere maintains the transferor's effective control, because it would constrain the transferee from exchanging those assets, unless it is only a cleanup call.

#### Measurement of Interests Held after a Transfer of Financial Assets

##### Assets Obtained and Liabilities Incurred as Proceeds

31. The proceeds from a sale of financial assets consist of the cash and any other assets obtained in the transfer less any liabilities incurred. Any asset obtained that is not an interest in the transferred asset is part of the proceeds from the sale. Any liability incurred, even if it is related to the transferred assets, is a reduction of the proceeds. Any derivative financial instrument entered into concurrently with a transfer of financial assets is either an asset obtained or a liability incurred and part of the proceeds received in the transfer. All proceeds and reductions of proceeds from a sale shall be initially measured at fair value, if practicable.

#### Securities Lending Transactions

61. Securities lending transactions are initiated by broker-dealers and other financial institutions that need specific securities to cover a short sale or a customer's failure to deliver securities sold. Transferees (“borrowers”) of securities generally are required to provide “collateral” to the transferor (“lender”) of securities, commonly cash but sometimes other securities or standby letters of credit, with a value slightly higher than that of the securities “borrowed.” If the “collateral” is cash, the transferor typically earns a return by investing that cash at rates higher than the rate paid or “rebated” to the transferee. If the “collateral” is other than cash, the transferor typically receives a fee. Securities custodians or other agents commonly

carry out securities lending activities on behalf of clients. Because of the protection of “collateral” (typically valued daily and adjusted frequently for changes in the market price of the securities transferred) and the short terms of the transactions, most securities lending transactions in themselves do not impose significant credit risks on either party. Other risks arise from what the parties to the transaction do with the assets they receive. For example, investments made with cash “collateral” impose market and credit risks on the transferor.

62. In some securities lending transactions, the criteria in paragraph 9 are met, including the third criterion. Those transactions shall be accounted for (a) by the transferor as a sale of the “loaned” securities for proceeds consisting of the “collateral”<sup>11</sup> and a forward repurchase commitment and (b) by the transferee as a purchase of the “borrowed” securities in exchange for the “collateral” and a forward resale commitment. During the term of that agreement, the transferor has surrendered control over the securities transferred and the transferee has obtained control over those securities with the ability to sell or transfer them at will. In that case, creditors of the transferor have a claim only to the “collateral” and the forward repurchase commitment.

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<sup>11</sup>If the “collateral” is a financial asset that the holder is permitted by contract or custom to sell or repledge and the debtor does not have the right and ability to redeem the collateral on short notice, for example, by substituting other collateral or terminating the contract, that financial asset is proceeds of the sale of the “loaned” securities. To the extent that the “collateral” consists of letters of credit or other financial instruments that the holder is not permitted by contract or custom to sell or pledge, a securities lending does not satisfy the sale criteria and is accounted for as a loan of securities by the transferor to the transferee

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63. However, many securities lending transactions are accompanied by an agreement that entitles and obligates the transferor to repurchase or redeem the transferred assets before their maturity under which the transferor maintains effective control over those assets (paragraphs 27-30). Those transactions shall be accounted for as secured borrowings, in which cash (or securities that the holder is permitted by contract or custom to sell or repledge) received as “collateral” is considered the amount borrowed, the securities “loaned” are considered pledged as collateral against the cash borrowed, and any “rebate” paid to the transferee of securities is interest on the cash the transferor is considered to have borrowed. Collateral provided in securities lending transactions that are accounted for as secured borrowings shall be reported in the statement of financial position like other collateral, as set forth in paragraph 15.

64. The transferor of securities being “loaned” accounts for cash received (or for securities received that may be sold or repledged and were obtained under agreements that are not subject to repurchase or redemption on short notice, for example, by substitution of other collateral or termination of the contract) in the same way whether the transfer is accounted for as a sale or a secured borrowing. The cash (or securities) received shall be recognized as the transferor’s asset—as shall investments made with that cash, even if made by agents or in pools with other securities lenders—along with the obligation to return the cash (or securities).

**Illustration—Securities Lending Transaction Treated as a Secured Borrowing**

65. Accounting for a securities lending transaction treated as a secured borrowing:

**Facts**

Transferor’s carrying amount and fair value of security loaned	\$1,000
Cash “collateral”	1,020
Transferor’s return from investing cash collateral at a 5 percent annual rate	5
Transferor’s rebate to the borrower at a 4 percent annual rate	4

The loaned securities cannot be redeemed on short notice, for example, by substitution of other collateral. For simplicity, the fair value of the security is assumed not to change during the 35-day term of the transaction.

**Journal Entries for the Transferor***At inception:*

Cash	1,020	
Payable under securities loan agreements		1,020
To record the receipt of cash collateral		
Securities loaned to broker	1,000	
Securities		1,000
To reclassify loaned securities that cannot be redeemed on short notice		
Money market instrument	1,020	
Cash		1,020
To record investment of cash collateral		

*At conclusion:*

Cash	1,025	
Interest		5
Money market instrument		1,020
To record results of investment		
Securities	1,000	
Securities loaned to broker		1,000
To record return of security		
Payable under securities loan agreements	1,020	
Interest ("rebate")	4	
Cash		1,024
To record repayment of cash collateral plus interest		

**Journal Entries for the Transferee***At inception:*

Receivable under securities loan agreements	1,020	
Cash		1,020
To record transfer of cash collateral		
Securities	1,000	
Obligation to return borrowed securities		1,000
To record receipt of borrowed securities that cannot be redeemed on short notice		

*At conclusion:*

Obligation to return borrowed securities	1,000	
Securities		1,000
To record the return of securities		

Cash	1,024	
Receivable under securities loan agreements		1,020
Interest revenue (“rebate”)		4
To record the receipt of cash collateral and rebate interest		

### Repurchase Agreements and “Wash Sales”

69. Furthermore, “wash sales” that previously were not recognized if the same financial asset was purchased soon before or after the sale shall be accounted for as sales under this Statement. Unless there is a concurrent contract to repurchase or redeem the transferred financial assets from the transferee, the transferor does not maintain effective control over the transferred assets.

## RELEVANT LITERATURE

### Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 1, *Bonds and Loan Backed and Structured Securities*
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapter 1, *Bonds and Loan Backed and Structured Securities*
- *Purposes and Procedures Manual of the NAIC Securities Valuation Office*
- *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets*
- *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets*
- *Issue Paper No. 7—Asset Valuation Reserve and Interest Maintenance Reserve*
- *Issue Paper No. 27—Disclosure of Information about Financial Instruments with Concentrations of Credit Risk*
- *Issue Paper No. 33—Disclosures about Fair Value of Financial Instruments*
- *Issue Paper No. 45—Repurchase Agreements, Reverse Repurchase Agreements and Dollar Repurchase Agreements*

### Generally Accepted Accounting Principles

- *FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities*
- *FASB Statement No. 91, Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*
- *FASB Statement No. 125, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*
- *EITF 89-4, Accounting for a Purchased Investment in a Collateralized Mortgage Obligation Instrument or in a Mortgage-Backed Interest-Only Certificate*
- *FASB Emerging Issues Task Force No. 90-2, Exchange of Interest-Only and Principal-Only Securities for a Mortgage-Backed Security*
- *EITF 93-18, Recognition of Impairment for an Investment in a Collateralized Mortgage Obligation Instrument or in a Mortgage-Backed Interest-Only Certificate*
- *FASB Emerging Issues Task Force No. 96-12, Recognition of Interest Income and Balance Sheet Classification of Structured Notes*
- *AICPA Statement of Position 90-3, Definition of the Term Substantially the Same for Holders of Debt Instruments, as Used in Certain Audit Guides and a Statement of Position*

### State Regulations

- No additional guidance obtained from state statutes or regulations.