

Final version of the
Interim Reporting Instructions for the Year Ending December 31, 2009

For Use in Reporting
Residential Mortgage Backed Securities

Valuation of Securities (E) Task Force
Of the
Financial Conditions (E) Committee
Of the

National Association of Insurance Commissioners

1. Background

This document contains instructions on the process to be used by insurers to determine an NAIC Designation and the reporting for residential mortgage backed securities (RMBS)¹ for the 12/31/2009 annual statement filing.

RMBS securities were placed under regulatory review by the NAIC on December 6, 2009. The regulatory review process is discussed in Part Two, Section 3 (e) of the Purposes and Procedures of the NAIC Securities Valuation Office (SVO) (referred to in this document as the Purposes and Procedures Manual). For your convenience, the text of Section 3 (e) is attached.

The NAIC procedure to place a security or asset class under regulatory review was developed to enable the NAIC to publicly communicate to industry and interested capital market participants a possible change in: regulatory policy for a specific security or asset class, analytical methodology used to determine regulatory treatment, or both. The NAIC began to discuss the possibility of a change in policy and methodology for RMBS in May of this year. The decision to place RMBS under regulatory review formally acknowledges and observes an established NAIC procedure.

The decision to place RMBS under regulatory review means:

- That for year end 2009 reporting purposes the NAIC will not use NAIC ARO credit ratings to determine risk based capital (RBC) for RMBS but instead will utilize a financial model for that purpose.
- Under the regulatory review procedure, insurers are now required to identify RMBS on their financial statements by appending the suffix **Z***. This permits identification of insurer holdings of this asset class and also facilitates necessary changes to NAIC computer systems used to track insurer holdings.
- That the filing exemption applicable to RMBS securities rated by NAIC AROs is suspended for this asset class for 2009 reporting purposes and until further notice. The exception to this is a small number of RMBS which cannot be modeled. Instructions for determining an NAIC Designation for that small population of securities is provided in this document.
- Because NAIC Designations for RMBS will be determined by a vendor run model, and not directly by the SVO, the normal process by which an insurer appeals decisions of the SVO will not apply for RMBS for 2009 reporting purposes and until further notice.

¹ For purposes of these instructions, RMBS refers to and includes non-agency residential mortgage-backed securities, where the collateral consists of loans pertaining to non-multi-family homes. That includes prime, subprime, Alt-A mortgages, as well as home equity loans and home equity lines of credit. See section 2d for further details on specific asset classes that are included following an analytical review during the valuation process. Excluded from these instructions are agency RMBS where the mortgages are guaranteed by federal and federally sponsored agencies such as GNMA (Government National Mortgage Association, FNMA (Federal National Mortgage Association), or FHLMC (Federal Home Loan Mortgage Corporation). The exclusion covers both bonds issued and guaranteed by, or only guaranteed by the agency. Also not included are loans guaranteed by the United States Department of Veteran Affairs or the Rural Housing Services.

2. Overview of the Modeling Process

a. **What the Model Does** - The decision to use a model reflects regulatory concern that credit ratings for RMBS do not properly reflect the expected total loss from the securities. Accordingly, the NAIC decided to engage an independent third party firm to model losses of RMBS securities held by the insurance industry.

The modeling is to be conducted on a security level basis and use assumptions generally accepted by market participants for prepayments, home price levels, expected defaults, severities of loss, and performance of loans in good standing, along with other assumptions, including interest rates.

b. **The Model Output** - For each RMBS, the model determines the price at which the expected loss² equals the midpoint between the RBC charges for each NAIC designation, i.e. each price point, if exceeded, changes the NAIC designation. Because of the difference in RBC charge, the deliverable is 5 prices for Life and 5 for P&C (and Health, as RBC is the same for P&C and Health) for each RMBS.

RBC charge / NAIC designation (pre-tax)		
P&C	RBC	Midpoint
1	0.3%	0.65%
2	1.0%	1.50%
3	2.0%	3.25%
4	4.5%	7.25%
5	10.0%	20.00%
6	30.0%	
Life	RBC	Midpoint
1	0.4%	0.85%
2	1.3%	2.95%
3	4.6%	7.30%
4	10.0%	16.50%
5	23.0%	26.50%
6	30.0%	

c. **How to Use the Model Output** – The NAIC designation for RMBS is determined by where the insurer’s carrying value (divided by remaining par value) matches the price ranges provided by the model for each NAIC designation.

This is discussed in greater detail and examples are given below.

d. **Securities that Cannot be Modeled** - Some RMBS owned by insurers will not be subject to modeling because the data is not available for modeling (e.g. private placements). Of these, many will be subject to utilization of the existing ARO ratings along with the carrying value to determine the NAIC designation and the resulting RBC factor more accurately. Here are the details of the methodology to be used by insurers:

² Expected Loss is defined as the net present value of principal losses, discounted using the security’s Coupon rate. Security (adjusted in case of original issue discount securities to book yield at original issue, and in case of floating rate securities, discounted using LIBOR curve + Origination spread).

The Lock Down List - On November 20, 2009, the SVO staff agreed that PIMCO Advisory should begin its assignment using a list of 21,000 CUSIPs believed to be insurer owned US RMBS (the lock down list). The staff has continued to identify additional CUSIPs that could be US owned RMBS and these additional CUSIPs will be analyzed by PIMCO Advisory during the second part of their assignment after January 2010.

Not Everything on the Lock Down List was US RMBS - Of the 21,000 CUSIPs, on the lock down list, PIMCO Advisory has the necessary data to model about 20,000. About 1,000 of the securities could not be modeled.

The SVO determined that a significant portion of the 1,000 securities are not RMBS. What follows provides guidance on what was discovered and what this means for the 2009 year-end reporting process.

Agency RMBS - RMBS that are 100% guaranteed by the agencies are not within the scope of this project and continue to be subject to the filing exemption process. Agency label RMBS that are not 100% guaranteed by the agency are within the scope of the project.

Manufactured Housing - Manufactured housing was initially identified as being within the scope of the project. Manufactured housing is not treated as RMBS and cannot be modeled using the process applicable to RMBS. Rated manufactured housing transactions are eligible for the filing exemption.

Foreign RMBS – Foreign RMBS have unique characteristics that reflect the legal and business environment of the country in which the mortgage is originated and may include other embedded risks, such as currency risk. In the opinion of the staff these features would require additional analytical processes. However, given the small number of these securities, the Chair of the Task Force has asked that they be included within the scope for the project and the staff has agreed. Foreign RMBS would be evaluated with a modified FE approach, similar to US RMBS that are rated but not modeled.

CDO – CDOs are excluded from the scope of the project due to the wide range of underlying collateral which cannot necessarily be verified as residential real estate. CDOs continue to be subject to the filing exempt process.

Securities with missing underlying data – PIMCO has highlighted some securities that cannot be modeled due to unavailability of the underlying data. The final treatment will be governed by the underlying collateral, e.g. those that are found to be manufactured housing will be treated as non RMBS, while rated Foreign RMBS will follow the modified FE approach.

For **securities that are rated but not modeled**, please use the table below for the Intrinsic Price to calculate the break points as described in the examples:

P&C	Implied Intrinsic price
AAA-A	99.35
BBB	98.50
BB	96.75
B	92.75
CCC-C	80.00

Life	Implied Intrinsic price
AAA-A	99.15
BBB	97.05
BB	92.70
B	83.50
CCC-C	73.50

All D rated securities will have an NAIC designation of 6.

The remaining RMBS with no ARO ratings and which cannot be modeled will follow the existing ‘Not Rated’ or ‘NR’ process, requiring subsequent filing with the NAIC’s Securities Valuation Office, or be subjected to the ‘5*/6* process’ (‘five-star/six-star process’).

Re-securitization of Real Estate Mortgage Investment Conduits (Re-REMICs) are also subject to be analyzed by the model.

3. Example

a. Intrinsic Price calculation

In order to calculate the desired output, it will be necessary to calculate a price that reflects the credit loss expectations for each CUSIP. This price is different from the market price and is termed as the Intrinsic Price.

Intrinsic price is defined as difference between Remaining Par Value and Expected Loss
The example below works through the steps and calculations for a single RMBS: Subprime RMBS security BSABS 2007-AQ1, class A2 (CUSIP 07389VAB3) modeled using market observer assumptions on Conditional Default Rate, Prepayment rates, Severity and other parameters applied to the securitization waterfall structure. In this example the Discounted Expected Loss is equal to 24%.

Discounted Expected Loss (% of Remaining Par)	24%
Intrinsic Price	76

b. Carrying Price ranges for NAIC ratings

Carrying Price is defined as the insurer’s Carrying Value divided by the security’s remaining Par Value, multiplied by 100. To translate the Expected Loss ranges into Carrying Price breakpoint, divide the Intrinsic Price by 1 minus the Expected Loss at each breakpoint:

$$\text{Carrying Price} = \frac{\text{Intrinsic Price}}{(1 - \text{Expected Loss})}$$

“Expected Loss” refers to the Midpoint loss for a given NAIC RBC category.

The example below works through the steps and calculation of break points for the Intrinsic Price calculated in the previous section

Calculate Carrying Price break point for each NAIC designation based on expected loss at break point, e.g.

$$\text{Minimum Carrying Price (NAIC Designation 4 Life)} = \frac{\text{Intrinsic Price}}{(1 - \text{Expected Loss})} = \frac{76}{(1 - 7.30\%)} = 81.98$$

The following tables expand this calculation to all NAIC designations

**Example Carrying Price range calculations - Life
Intrinsic Price = 76**

NAIC designation	RBC charge	Midpoint	Break point
1	0.40%	0.85%	0.00
2	1.30%	2.95%	76.65
3	4.60%	7.30%	78.31
4	10.00%	16.50%	81.98
5	23.00%	26.50%	91.02
6	30.00%		103.40

← Example calculated above

**Example Carrying Price range calculations – P&C and Health
Intrinsic Price = 76**

NAIC designation	RBC charge	Midpoint	Break point
1	0.30%	0.65%	0.00

2	1.00%	1.50%	76.50
3	2.00%	3.25%	77.16
4	4.50%	7.25%	78.55
5	10.00%	20.00%	81.94
6	30.00%		95.00

4. Illustration of How To Use the Model Output

Overview of the process:

- I. Determine initial NAIC designation based on break points using Amortized Cost
- II. Determine whether security is to be held at Amortized Cost or Fair Value
 - A. For Life companies
 1. Securities with NAIC designation 1-5 are held at Amortized Cost
 2. Securities with NAIC designation 6 are held at Fair Value
 - B. For P&C and Health companies
 1. Securities with NAIC designation 1-2 are held at Amortized Cost
 2. Securities with NAIC designation 3-6 are held at Fair Value
- III. Determine the final NAIC designation
 - A. For securities held at Amortized Cost, keep the initial designation
 - B. For securities held at Fair Value, determine final NAIC designation based on break points using Fair Value

Illustrative Price Table using the example security above.

	Maximum price for each NAIC designation				
	1	2	3	4	5
Life	76.65	78.31	81.98	91.02	103.40
P&C	76.50	77.16	78.55	81.94	95.00

Step I: Determine, using the company's Amortized Cost (divided by remaining par value), and the Price Table, what the Initial Designation is at Amortized Cost (divided by remaining par value). A user would determine the correct Initial Designation by comparing the Amortized Cost with the maximum price for each NAIC category. The relevant Initial Designation is the designation where the Amortized Cost (divided by remaining par value) **is less than the Maximum Price** for such category. For the example security, a Life company that has an Amortized Cost (divided by remaining par value) of 79 would net an Initial Designation of 3. For a P&C company, the relevant designation would be 4 for the same security.

Step II: Determine whether, in accordance with SSAP43, Paragraphs 25-26, the company should carry the security at Amortized Cost or Fair Value.

Step III: If under Step 2 it is determined that Amortized Cost is used, the process is complete and the initial designation is used as the final designation. If under Step 2 it is determined that Fair Value is used, the process used to determine the final designation is the same as Step I, except Fair Values are used in place of Amortized Cost.

5. Accounting (SSAP43R)

Based upon the following accounting guidance in SSAP No. 43R, the company will need to follow the steps below in determining the value it would report in its financial statements.

25. Loan-backed securities shall be valued and reported in accordance with this statement, the *NAIC Purposes and Procedures of the Securities Valuation Office* manual, and the designation assigned in the NAIC Valuations of Securities product prepared by the NAIC Securities Valuation Office. For reporting entities that maintain an Asset Valuation Reserve (AVR), 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 fair value. For reporting entities that do not maintain an AVR, loan-backed securities designated highest-quality and high-quality (NAIC designations 1 and 2, respectively) shall be reported at amortized cost; loan-backed securities that are designated medium quality, low quality, lowest quality and in or near default (NAIC designations 3 to 6, respectively) shall be reported at the lower of amortized cost or fair value.

26. The *NAIC Purposes and Procedures of the Securities Valuation Office manual* identifies which method loan-backed securities are subject to in determining NAIC designation. Securities within the scope of this statement will determine the NAIC designation as follows:

- a. For loan-backed securities subject to a single designation:
The NAIC designation is the single designation assigned to a particular CUSIP in the Valuation of Securities product (either assigned by the NAIC Securities Valuation Office, or determined by the Filing Exempt process). This designation establishes the carrying value method as described in paragraph 25 and is reported in Schedule D. or
- b. For loan-backed securities subject to multiple designations:
Securities subject to multiple designations shall use a two-step process for determining the carrying value method and final NAIC designation;
 - i. Step 1: The current amortized cost of a loan-backed security is compared to the range of values assigned to the six (6) NAIC designations for each CUSIP to establish the **initial** NAIC designation. The carrying value method, either the amortized cost or the lower of amortized cost or fair value, is then determined as described in paragraph 25 based upon the **initial** NAIC designation.
 - ii. Step 2: The final NAIC designation that shall be used for reporting is determined by comparing the carrying value of a security (based on paragraph 26 b.i.) to the range of values assigned to the six (6) NAIC designations for each CUSIP. This final NAIC designation shall be applicable for all statutory accounting and reporting purposes (including establishing the AVR charges), except for establishing the appropriate carrying value method in Step 1(paragraph 26 b.i.).

27. For reporting entities required to maintain an AVR, the accounting for unrealized gains and losses shall be in accordance with SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve (SSAP No. 7). For reporting entities not required to maintain an AVR, unrealized gains and losses shall be recorded as a direct credit or charge to unassigned funds (surplus).

6. Further Detailed Illustrations

For Entities that DO NOT maintain an AVR (e.g. P&C and Health companies)

The following is information available from company records.

CUSIP	Amortized Cost	Fair Value
55265KVV7	95.47	27.32
12669GL33	90.64	93.04

The following illustrative Price Table will be made available to the user:

CUSIP	PC & Health				
	1	2	3	4	5
55265KVV7	92.99	93.83	95.56	99.52	112.14
12669GL33	90.30	91.14	92.88	96.84	109.46

1. Compare the current Amortized Cost to the range of values from the Price Table and determine the Initial Designation that will indicate what valuation method will be used for the current reporting period.

So, for CUSIP 55265KVV7, the Amortized Cost is 95.47, which is greater than 93.83 but less than 95.56, therefore an Initial Designation of 3 should be used for valuation purposes only.

For CUSIP 12669GL33, the amortized cost is 90.64, which is greater than 90.30 but less than 91.14, therefore an initial NAIC designation of 2 should be used for valuation purposes only.

2. Compare the Initial Designation used to indicate the valuation method with the new SSAP 43R paragraph for securities indentified as available to use the new SVO filing criteria.

a. If the current Amortized Cost indicates a designation 1-2 (Non-AVR) then Amortized cost is the carrying value method for the current reporting period.

i. The current amortized cost will be reported in the Book/Adjusted Carrying Value column of Schedule D; and

For CUSIP 12669GL33, the Initial Designation calculated above is 2, and the entity would report the current amortized cost of 90.64 in the book/adjusted carrying value column of Schedule D.

ii. The designation associated with the current amortized cost is reported in Schedule D (in this case it will be the same as the initial designation used to indicate the valuation method).

For CUSIP 12669GL33, the Initial Designation is final and a NAIC designation of 2 would be reported in Schedule D.

The reporting entity would now need to determine the designation associated with the current fair value that is reporting in Schedule D.

b. If the current Amortized Cost indicates a designation 3-6 (Non-AVR), then Fair Value is the carrying value method for the current reporting period.

i. The current Fair Value will be reported in the Book/Adjusted Carrying Value column of Schedule D; and

For CUSIP 55265KWV7, Initial Designation is 3 and Fair Value must be used for reporting purposes. For CUSIP 55265KWV7, the entity would report the current fair value of 27.32 in the book/adjusted carrying value column of Schedule D.

ii. The designation associated with the current Fair Value is reported in Schedule D (NOT the Initial Designation established by the Amortized Cost comparison that generates the valuation method for the current reporting period).

The procedure for determining the NAIC designation for Fair Values is the same as the Amortized Cost. The Fair Value is compared with the Maximum Prices from the Price Table. The best designation where the Fair Value is less than the Maximum Price is used.

For CUSIP 55265KWV7, Initial Designation is 3 and Fair Value must be used to calculate the Final Designation. The fair value is 27.32, which is less than 92.99, and is therefore a Final NAIC Designation of 1, which would be reported in Schedule D.

For Entities that DO maintain an AVR (e.g. Life or Fraternal entity)

The following is information available from company records.

CUSIP	Amortized Cost	Fair Value
65535YAA0	100.78	58.57
126671F84	89.48	21.53

The following illustrative Price Table will be made available to the user:

CUSIP	LIFE				
	1	2	3	4	5
65535YAA0	70.96	73.04	77.35	86.45	96.35
126671F84	98.43	100.51	104.81	113.92	123.82

1. Compare the current Amortized Cost to the range of values from the Price Table and determine the Initial Designation that will indicate what valuation method will be used for the current reporting period.

So, for CUSIP 65535YAA0, the Amortized Cost is 100.78, which is greater than 96.35, an Initial Designation of 6 should be used for valuation purposes only.

For CUSIP 126671F84, the Amortized Cost is 89.48, which is less than 98.43, an Initial Designation of 1 should be used for valuation purposes only.

2. Compare the initial designation used to indicate the valuation method with the new SSAP 43R paragraph for securities indentified as available to use the new SVO filing criteria.

a. If the current Amortized Cost indicates a designation 1-5 (AVR), then Amortized Cost is the carrying value method for the current reporting period.

i. The current amortized cost will be reported in the Book/Adjusted Carrying Value column of Schedule D; and

For CUSIP 126671F84, Initial Designation is 1 and the entity would report the current amortized cost of 89.48 in the book/adjusted carrying value column of Schedule D.

ii. The designation associated with the current amortized cost is reported in Schedule D (in this case it will be the same as the initial designation used to indicate the valuation method).

For CUSIP 126671F84, the amortized cost is 89.48, the Initial Designation is final and a NAIC designation of 1 would be reported in Schedule D.

The reporting entity would now need to determine the designation associated with the current Fair Value that is reporting in Schedule D.

b. If the current Amortized Cost indicates a designation 6 (AVR), then Fair Value is the carrying value method for the current reporting period.

i. The current Fair Value will be reported in the Book/Adjusted Carrying Value column of Schedule D; and

For CUSIP 65535YAA0, Initial Designation is 6 and Fair Value must be used for reporting purposes. The entity would report the current fair value of 58.57 in the book/adjusted carrying value column of Schedule D.

iii. The designation associated with the current Fair Value is reported in Schedule D (NOT the Initial Designation established by the Amortized Cost comparison that generates the valuation method for the current reporting period).

The procedure for determining the NAIC designation for Fair Values is the same as the Amortized Cost. The Fair Value is compared with the Maximum Prices from the Price Table. The best designation where the Fair Value is less than the Maximum Price is used.

For CUSIP 65535YAA0, the Initial Designation is 6 and Fair Value must be used to calculate the Final Designation. The Fair Value is 58.57, which is less than 70.96, and is therefore an Final NAIC Designation 1, which would be reported in Schedule D.

7. Schedule D Reporting

For Entities that DO NOT maintain an AVR (e.g. property and casualty or health entity)

SCHEDULE D – PART 1

Showing All Long-Term **BONDS** Owned December 31 of Current Year

1 CUSIP Identification	6 NAIC Designation	Fair Value		10 Par Value	11 Book / Adjusted Carrying Value
		8 Rate Used To Obtain Fair Value	9 Fair Value		
55265KWV7	1Z*	27.32	27,320	100,000	27,320
12669GL33	2Z*	93.04	93,040	100,000	90,640

For Entities that DO maintain an AVR (e.g. Life or Fraternal entity)

SCHEDULE D – PART 1

Showing All Long-Term **BONDS** Owned December 31 of Current Year

1 CUSIP Identification	6 NAIC Designation	Fair Value		10 Par Value	11 Book / Adjusted Carrying Value
		8 Rate Used To Obtain Fair Value	9 Fair Value		
65535YAA0	1Z*	58.57	58,570	100,000	58,570
126671F84	1Z*	21.53	21,530	100,000	89,480

8. AVR and IMR Reporting

The final NAIC designation reported in Schedule D as determined in the guidance above would be used in determining whether a realized gain or loss for an RMBS security is interest-related or credit-related. The determination is completed just as any other security; with the rating at purchase being compared to the rating at sale.

If the rating changed by more than one NAIC designation from purchase, the realized gain or loss would be considered credit-related and go into the AVR. Otherwise the realized gain or loss would be considered interest-related and go into the IMR if the rating did not change by more than one NAIC rating class when comparing the ratings at purchase and sale. All unrealized gains or losses as the result of valuing the securities at fair value would go into the AVR.

The AVR or IMR treatment for RMBS realized losses for other-than-temporary impairments would be determined according to the provisions of paragraph 27 of SSAP No. 43R. The book-adjusted carrying value of RMBS securities that is used in the AVR calculation would be the same as that calculated for Schedule D reporting as determined in the guidance above.

9. Risk-Based Capital Reporting

No special guidance for RMBS securities is needed for RBC reporting. The book-adjusted carrying value and final NAIC designation of RMBS securities as reported in Schedule D of the annual statement and as calculated in the guidance above would be used for Risk-Based Capital calculation. The above process must be used by all insurers, even if the insurer is not subject to RBC.