

The Fall NAIC meeting was held September 14-17 in Washington D.C. Of particular attention was the ACLI proposal for an upward notching of Residential Mortgage Backed Securities (RMBS) and the likely potential for a new process for assigning NAIC Designations of non-agency CMOs. In addition, SSAP 43R was adopted, giving companies the ability to take impairment write-downs equal to the credit loss amount and not to fair market value on structured securities where the Discounted Cash Flows is less than book value.

Securities Valuation Task Force (VOS Task Force)

The VOS Task Force is discussing a change in the way Residential Mortgage Backed Securities (RMBS) are rated. This change would consider both the likelihood and the severity of loss. An ACLI study found the potential impact of downgrades by the rating agencies would be significant as approximately 50% of the non-agency RMBS designated securities that were rated a NAIC 1 at December 31, 2008 are below that rating at June 30, 2009. The impact to the (RBC) C-1 factor would result in an increase in the charge from \$2 billion at year-end 2008 to \$11 billion at June 30, 2009. Given this increase and the fact that rating agencies will continue to assign ratings based on the likelihood of the loss rather than the severity, a new process for non-agency RMBS is necessary. The VOS Task Force was sympathetic and is looking into having a third party evaluate these securities. This third party would assign a factor that would also include “price points” that companies would then use to calculate the NAIC designation. The factor assignment would be based on the underlying cash flows of that RMBS and the current “book value/price” of the investment on the insurers’ books. For example, assume three different companies held the same RMBS at different book values:

	Book Price	NAIC Designation
Company 1	100	NAIC 3
Company 2	75	NAIC 2
Company 3	60	NAIC 1

Under the proposed third-party solution, Company 3 can report the investment as a NAIC 1 because they are recording the investment at a lower book value; therefore, it has a smaller risk of loss. At a meeting on October 14, both the VOS Task Force and the Financial Condition (E) Committee adopted this resolution for year-end 2009. A third-party vendor has yet to be announced.

Effective December 31, 2009, the VOS Task Force voted to accept RealPoint LLC onto the NAIC Acceptable Rating Organization (ARO) list, bringing the number of approved AROs to six. RealPoint’s acceptance was based on its position as a CMBS specialist, its monthly evaluation of each security (resulting in more timely adjustments) and the fact that only a small portion of its fees are paid from new issues/issuers.

The SVO is reviewing a plan to translate information from all six of the rating agencies into NAIC designations using the same rules that insurers use to assign a FE (Filing Exempt) designation. This would allow companies to utilize the SVO for designations instead of the current system where each company solicits the data and assigns FE

designations themselves. In the fourth quarter of 2009, the Securities Valuation Office will look into the cost and feasibility of obtaining the “full universe of cusips” and translating them into the appropriate NAIC designations. *So it would appear that in the not-too-distant future, companies once again will be using SVO-supplied NAIC designations.*

The Reorganized Purposes and Procedures manual was adopted and will be released on 12/31/09. Many of the sections have been combined to allow more fluency and consistency within subject matter.

The Invested Assets Working Group will take a look at Hybrid securities with regard to the “deferral risk” associated with securities. This evaluation is expected to occur over the next six months.

Emerging Accounting Issues Working Group (EAIWG)

Similar to the VOS Task Force discussions on rating RMBS, this Working Group discussed the reporting of ReREMICs (INT 09-07). ReREMICs are done to repackage an existing structured security which currently includes a small percentage of non-performing loans into a new deal. Because rating agencies look at the likelihood of default (not severity), they will downgrade a REMIC to CCC or B if even 1% of the underlying loans is not performing. This has resulted in insurers holding high-quality structured securities with a NAIC Designation of a 4 or 5. By entering into a ReREMIC transaction, a company can carve out the nonperforming pieces and end up with two securities, one fully paying (rated AAA), while the non-performing piece would be rated CCC or worse.

The EAIWG is addressing whether these securities should fall under SSAP 25 (non-economic transaction recorded at the lower of book or market value) or SSAP 91R (recorded at book value). It appears that the answer may depend on how much of the original REMIC the insurer holds after the “re-packaging.” If the insurer holds all of the securities, then the deal would be recorded at book value. However, if a portion (maybe some threshold will be given, 10% was referenced during the discussion) of the original deal is sold to some outside party, then the transaction would be recorded at the lower of book or market value.

Industry has argued that these deals should be treated simply as a re-rating of an existing security with no corresponding accounting of the security as a sale. This would have been consistent with the economics of the transaction and would have provided the correct capital charge commensurate with the underlying risk. Further, the riskier non-performing or equity tranche was most often the portion of the deal that was disposed of. However, the Working Group was uncomfortable saying that the economics did not change in instances where a portion of the original deal was sold.

The Working Group and the SAPWG voted to change the requirements for admission of Deferred Tax Assets (DTA) under SSAP 10. This was a very contentious topic (approved by a narrow margin and sure to be discussed again at future meetings). Under the proposal, DTAs would

be admitted if they were expected to be recovered within three years (an increase from one year) on the balance sheet and would also increase the total dollar amount of admissible DTAs from 10% to 15% of adjusted capital & surplus. The Working Group will allow this arrangement for 2009/10 and will look at it in more detail to determine a reasonable longer term solution. The insurance industry was strongly in favor of this change, citing the fact that because this is a permitted practice in many states, it causes an inequity of application in states where it is not permitted. Regulators favor this proposal, stating that this provision would benefit stronger companies who pay the most in taxes. Weaker companies, who already are not paying many taxes, would be less likely to benefit. And, because companies would file three year pro-forma statements to justify the admissibility of DTA, regulators also would have another tool to evaluate insurance companies. Some regulators opposed this proposal, stating this “funny money” on the balance sheet creates surplus amounts that are based on risky and unreliable projections.

Statutory Accounting Principles Working Group (SAPWG)

Prior to the meeting, the SAPWG adopted SSAP 43R which applies to the recognition of an impairment loss. This new standard is effective September 30, 2009 and applies to loan-backed and structured securities. In the case of a credit-related impairment that the entity does not intend to sell and also has the ability to hold to recovery of the cost basis, the entity would only recognize a realized loss attributable to the credit loss and not the “interest-related loss.” This is good news, especially after last year’s lengthy discussion about the merits of companies’ recognized losses being charged down to fair market value in a distressed marketplace (under those conditions a large portion of the loss may have been “interest-related”). However, the Working Group will require a new series of disclosures for impaired structured securities (see the Blanks Working Group section below for details).

Work continues with the Fair Value Subgroup. For the most part, it appears that the final language will mirror the GAAP fair market value language. This was intended “to minimize situations in which fair value is calculated differently and that assets reported at fair value therefore will not vary between GAAP and Statutory financial statements.” One area where there WILL be differences has to do with the determination of fair value of liabilities. Because the concept of considering a company’s own credit risk has been rejected for statutory accounting, there will be some instances of fair market value differences for liabilities. The Working Group continues to endorse fair market value footnote disclosures, similar to GAAP, for those securities valued at market value.

Industry had concerns about including some of these disclosures, stating that in the instance of bonds, most are reported at amortized cost. Therefore, these tables would be incomplete and only relevant for a small number of investments. The same could be said for the Level 3 roll forward reconciliation (only a small fraction of securities are valued using Level 3 inputs). The Working Group was inclined to keep these footnotes, although a member of the NAIC staff said that in the Preamble of the Accounting Practices and Procedures Manual there is a paragraph (No. 44) that applies to materiality. Therefore, many companies may find it appropriate not to include this information based on the immateriality of the disclosure.

Illustrative Fair Value Disclosure (Non Life Company)

Assets at Fair Value on a Recurring Basis

	Level 1	Level 2	Level 3
Pref. stk (Perpetual rated NAIC 1 or 2)	500	100	25
Common stk	900	50	50
Derivative assets	50	----	5
Separate account assets	700	200	15
Total assets at fair value	2,150	350	95

Assets at Fair Value on a Recurring Basis

using significant unobservable inputs (Level 3)

	Equities	Sep Accts	Derivatives
Balance at 1/1/2009	900	805	50
Total gains/losses (realized/unrealized)			
Included in net income	(20)	30	5
Included in surplus	70	20	----
Purchases, issuance and sales	20	50	----
Transfers in/out of Level 3	30	10	
Balance at 12/31/2009	1,000	915	55
Total gains (losses) included in income attributable to instruments held at the reporting date	50	35	5

Assets at Fair Value on a Nonrecurring Basis

	Level 1	Level 2	Level 3	Total Unrealized (Loss)
Bonds	1,500	100	10	
Preferred Stock (All Redeemables and Perpetuals rated 3–6)	20	----	5	

Blanks Working Group

One investment-related change was discussed at the meeting. The Blanks Instruction Manual will be updated for Life Companies to include language that companies can use to record impairments with elements of either a credit or interest rate loss. Therefore, impairment losses potentially can be recorded as either AVR or IMR. This would primarily occur when a company has the current intention to sell a security at a loss. In those situations, companies should write the security down to fair market value regardless, even if there may not be an anticipated credit loss.

After the meeting, the Blanks Working Group moved ahead to propose and potentially adopt the following additional quarterly and annual statement footnote disclosures relating to SSAP 43R (Applies to Impairment of Structure Securities only), effective September 30, 2009. While this proposal was adopted on October 9, it was unclear whether companies would be required to report on Footnote Number 5 – D(5) all impaired securities currently held or just those impaired during the third quarter. This issue is expected to be resolved for year end. Here are the proposed footnote disclosures for structured securities:

Footnote Number 5–D(4)

	1	2	3	4
Amortized Cost Basis Before OTTI		OTTI		
		Recog in Loss	Non-Interest Amount	Fair Value (C1-C2-C3)
Aggregate Intent to Sell	\$ _____	\$ _____	\$ _____	\$ _____
Aggregate Intent & Ability	\$ _____	\$ _____	\$ _____	\$ _____

The Aggregate Intent to Sell line would include those structured securities that the company intends to sell or does not have the intent

to hold to recovery (write-down to FMV).

The Aggregate Intent & Ability line would include those structured securities that the company intends to hold but where the discounted cash flows are less than the current book value (write-down to the discounted cash flow/credit loss amount).

Footnote Number 5 – D(5)

CUSIP	Book/Adj	Projected	Recognized	Amortized	Fair value
	carrying value			cost after	
	amortized	cash flows	OTTI	OTTI	
	cost before				
	current period				
	OTTI				
#####	\$ _____	\$ _____	\$ _____	\$ _____	\$ _____

Include Footnote Number 5-D(5) as shown above for each security with a recognized other-than-temporary impairment, currently held by the reporting entity, where the present value of cash flows expected to be collected is less than the amortized cost basis of the security. It should be noted that columns 3 and 5 should be equal since the book value after the OTTI should equal the projected cash flows.

Since Footnote Number 5 – D(5) is new for this quarter (3Q09), companies would need to show the net projected cash flows for ALL securities where impairments were taken for credit-loss-only amounts, including those securities where impairments were restated as a result of the transition provisions of SSAP 43R.

Reminder – Year-end Schedule D Annual Statement – “Public Utilities” and “Banks Trust and Insurance Companies” no longer exist as Schedule D categories. A new category, “Hybrids,” has been added.

NAIC/AICPA Working Group

All states have adopted “The Annual Financial Reporting Model Regulation” (commonly referred to as the Model Audit Rule) to incorporate best practices relating to auditor independence, corporate governance and internal controls over financial reporting (similar to SOX). Companies with \$500 million or more in direct and assumed premiums must prepare an annual management assessment of internal controls over financial reporting. **This regulation is effective January 1, 2010.**

Principles-Based Reserving Educational Session

The NAIC adopted a revised version of the Model Standard Valuation Law (SVL). Currently, SVL requires companies to use static formulas for life and annuity reserves with prescribed mortality and interest rates. The new SVL would permit companies to derive minimum required reserves based on modern principles of risk analysis, a company’s own experience and stochastic modelling. Before this standard can go into effect, it must be adopted by 42 of the 55 NAIC jurisdictions. A January 1, 2012 effective date seems likely. ♦

**The next quarterly meeting will be held
in San Francisco, December 5–8, 2009.**

David W. Chellgren, Vice President, is responsible for communicating GAAP/STAT/Tax accounting policies to Conning’s Investment Accounting & Reporting Group and to clients. Prior to joining Conning, he spent 22 years in accounting positions at Aetna, working in a number of areas, including corporate, property-casualty and securities, where he served as head of securities accounting. Mr. Chellgren received his undergraduate degree from Fairfield University and holds an MBA in Finance from the University of Hartford.

Pamela DelCiampo, Assistant Vice President, is responsible for managing the SVO filing process for Conning’s Investment Accounting & Reporting clients. Prior to joining Conning in 2001, Ms. DelCiampo was employed by the Phoenix Life Insurance Company as an Investment Accounting Manager.

NAIC NOTES is published by Conning and may not be reproduced or disseminated in any form without the express permission of Conning. This publication is intended only to inform readers about general developments of interest and does not constitute investment advice. While every effort has been made to ensure the accuracy of the information contained herein, Conning does not guarantee such accuracy and cannot be held liable for any errors in or any reliance upon this information. Conning does not guarantee that this publication is complete. Opinions expressed herein are subject to change without notice. Past performance is no indication of future results. Conning is a portfolio company of the funds managed by Aquiline Capital Partners LLC (“Aquiline”), a New York-based private equity firm. Conning has offices in Hartford, New York, Dublin and London.

Copyright 2009 Conning & Company, All rights reserved.

About Conning:

As a knowledge leader for the insurance industry, Conning serves clients with a unique combination of asset management, strategic consulting and insurance research.

CONNING
One Financial Plaza, Hartford, CT 06103-2627
860-299-2000, www.conning.com

