





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

**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, Rev

**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).
  - e. 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
- h.

- 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

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 90-3 is consistent







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
3	Amortized Cost	if shown or	Amortized Cost if No Rate Available
4	Amortized Cost	A.V.	
5	Amortized Cost	if No Rate	
6	The lesser of the Market Value Amount or Amortized Cost	shown in VOS Manual	Lower of Amortized Cost or Par Value times Market Rate



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

## 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.<sup>e</sup>

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 te

**ISSUE**

Collateralized mortgage obligations and certain participating interests in real estate mortgage investment conduits (REMICs) (hereinafter collectiv

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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





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

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, whessictivus7 (us98 on undisco

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

- 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



## 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





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:

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



**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		
<i>At conclusion:</i>		
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

### **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