DIFFICULTIES OF SSAP NO. 43R TO AN INSURANCE RECEIVER

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Prior to the adoption of Statements of Statutory Accounting Principles ("SSAP") No. 43R—*Loan-backed and Structured Securities – Revised*, the valuation of loan-backed and structured securities was governed by SSAP No. 43—*Loan-backed and Structured Securities*, SSAP No. 98—*Treatment of Cash Flows When Quantifying Changes in Valuations and Impairments*, and SSAP No. 99—*Accounting for Certain Securities Subsequent to an Other-Than-Temporary Impairment*. On September 14, 2009, SSAP Nos. 98 and 99 were replaced with SSAP No. 43R. SSAP No. 43R provided updated guidance on recording other-than-temporary impairments ("OTTI") on loan-backed and structured securities. SSAP No. 43R became effective for September 30, 2009, financial reporting. Under SSAP No. 43R, loan-backed securities are defined as pass-through certificates (*e.g.*, asset-backed or mortgage-backed securities), collateralized mortgage obligations, and other securitized loans where the payment of principal and interest is proportional to principal and interest received from the underlying securities. Structured securities (*e.g.,* collateralized debt obligations ("CDOs")), on the other hand, are defined as loan-backed securities which have been divided into two or more classes for which payment of principal and interest is paid sequentially, rather than being allocated and paid in proportion to principal and interest received from the underlying investment securities.

For simplicity in this article, loan-backed and structured securities will both be referred to as loan-backed securities.

The recently adopted SSAP No. 43R may require insurers to recognize a loss on loan-backed securities even if such insurers have the intent and ability to hold such securities to maturity. Under SSAP No. 43R, a loan-backed security is valued at amortized cost, unless the security is rated by the National Association of Insurance Commissioners ("NAIC") Securities Valuation Office as NAIC 3 through 6 (non-life companies) or NAIC 6 (life companies), and in this event, the security is valued at the lower of amortized cost or fair (market) value. In addition to the valuation requirements above, for any security whose fair value is less than its amortized cost, the insurer must determine whether the impairment (decline) is "other than temporary." If the impairment is considered to be an OTTI (in other words, the insurer does not expect to collect the entire amortized cost of the security), then the insurer must recognize a loss on that security. If the OTTI is caused as a result of the insurer's intent to sell (or lack of ability to hold) the security before it recovers the loss in value, then the insurer must write the security down to fair value and recognize a loss for the amount of the write-down.

The difficulty in applying SSAP No. 43R comes when trying to apply the OTTI requirements to those securities that the insurer has the intent and ability to hold, but which have impaired fair values. Unless it is very clear that the insurer will receive all cash flows as structured, the insurer will likely be required to perform cash-flow modeling for the security to determine whether the impairment is credit related (in other words, whether the insurer will receive all contracted cash flows). If

the results of the cash-flow modeling (present value of the expected cash flows) are lower than the amortized cost of the security, then the insurer will need to value the security at the amount of the discounted cash flows and recognize a loss for the amount of the write-down.

The required SSAP No. 43R analysis may require a write-down of the investment securities that were held at higher values under the previous guideline of SSAP No. 98. Conversely, if a loan-backed security had been treated as an OTTI investment under the previous guideline of SSAP No. 98, SSAP No. 43R may provide for a "write-up" in value of the investment, which is certainly unique under statutory accounting principles. SSAP No. 43R is unusual in that the previous accounting rules provided that once a company took an OTTI write-down, it could not typically "write-up" the value of the securities unless it sold the same. The complexities of SSAP No. 43R are apparent and become more complex as determining the impairment status of certain securities may require extensive analysis.

As will be discussed more thoroughly in this article, the requirement to determine the future cash flows and market values is not a simple task. Specifically, the requirement to determine future discounted cash flows and market values for structured security products, such as CDOs, is a complex endeavor which many insurance entities are not equipped to develop. Even some Wall Street firms will have difficulty in analyzing the underlying securities that may comprise certain loan-backed securities. The use of outside Wall Street firms to analyze loan-backed securities, on behalf of an insurance receiver, may be an expensive process. The process will involve a discounted cash flow analysis of projected future cash flows for all loan-backed securities where there is uncertainty as to cash flows, and it will also require a market value analysis for NAIC 6 (life companies) and NAIC 3 through 6 (non-life companies) rated investment securities, both of which must be performed for each statutorily mandated financial reporting period. The process of accurately depicting the value of loan-backed securities is also vital for other reasons, such as a sale of the company and representations of financial condition, audits, and determining the availability of funds for policy payments or other financial transactions.

The complexity of determining market values for loan-backed securities is compounded by the current state of the capital markets. When determining the market value for a typical common or preferred stock, it entails a simple process of receiving a quote from one of many standard services. The process of determining market values for loan-backed securities may pose other challenges. In late 2007, the loan-backed market became illiquid and severely distressed. The market for these once high and mighty securities became almost nonexistent. The lack of a "normal" market was the impetus for the cash-flow modeling changes to SSAP No. 43R. The liquidity and market for some of the loan-backed securities have since come back, albeit to an extent. However, this market is not as liquid or robust as it once was, leading to valuation and inefficient investment trading problems, while severe illiquidity and depressed prices persist for some securities. To be sure, there is a lack of a true market for some loan-backed securities that may be considered distressed or under price pressure, meaning that difficulties arise in pricing these securities and price quotes

may reflect unrealistic market values. For example, there may be significant discrepancies in offer and bid prices. In addition, sales that do occur may be in response to liquidity concerns, "fire sales," or other distressed scenarios which artificially depress values and create further material valuation differences. Furthermore, the actual price of trades may not be disclosed, and those that are disclosed may not reflect the right value to assign to those securities. In order to combat this problem of taking past offers or sales as true market values, an insurance receiver (or an ongoing company) may need to do additional analysis to find the proper market price.

Specifically, for distressed loan-backed securities, mid-market pricing tends to provide more reliable pricing information for current market values of distressed and illiquid securities. This process collects data from several sources including actual recent trading activity, market bids and offers, and general market intelligence from broker dealers and trading desks. The data is analyzed where trades based on forced sales or liquidations are not considered so that prices are not skewed downward unfairly. The other trades must be carefully analyzed to determine the cash flow and required rates of return assumptions that market participants may have used in determining their offer prices. Once all pricing information is gathered and accurate data is compiled, the mid-point between the bid and offer levels is used. This mid-market pricing process tends to be more representative of the current market value for each security and should provide a more realistic price for some of these illiquid securities. The insurance receiver must make sure that good and "auditable" records are prepared, as valuations may be reviewed during an audit. In general, the insurance receiver will also want "auditable" records of determined values for support of any future policy payments, reinsurance, or other transactions that may involve estimates of assets available, assets to be transferred in a financial transaction, or as support for any rehabilitation plan.

To determine the expected future cash flows of these loan-backed securities, some of the original underwriters provide discounted cash flow information to investors. However, their approach may be flawed. Many of these underwriters have advisory divisions which either owned or advised customers on purchasing these assets or have other close relationships with an underwriter that tend to encourage more optimistic cash flow scenarios. Many of these underwriters may no longer be doing any real or in depth analysis of their own to support the cash flow estimates for these securities or may have significant differences in perspectives on the future performance of the assets. In a recent experience, we noted that the underwriter's values (based on their cash flow assumptions and expected losses for structured securities) for certain loan-backed securities were up to 50% higher than the value determined by the receivership team of expert consultants that evaluated updated information on discounted cash flows for each structured security. The potential conflict of interest may encourage underwriters to present a much better scenario than what a conservative and realistic analysis may have shown. The original underwriter may be the only source available for discounted cash flows, unless the insurance company has internal resources available to develop the cash flow analysis, which is unlikely in most instances. For expediency, many insurance companies may simply rely on

the rosier cash flow assumptions of the original underwriter rather than obtaining or performing any other cash flow analysis; thus, the insurance receiver should be wary as to whether such analysis is flawed.

Even where companies have the internal resources to develop the cash flow analysis, difficulties arise simply as a result of the complexity of these securities. For example, most CDOs consist of large pools of bonds, loans and other assets. In a typical asset-backed CDO, the portfolio may consist of more than 100 individual securities. To determine the proper discounted cash flow analysis, each security must be analyzed and various assumptions must be implemented in the model including length of the security (some securities can have 30-year maturities), uncertainty in future interest rates, assumed default rates for underlying collateral, and prepayment assumptions in an uncertain economy. The sheer number of companies or securities that make up the underlying collateral pools for some of the investment securities also complicates the analysis. This is a time-consuming process where a lot of the data can be difficult to acquire, and the end result is far from an exact science. Even companies that have extensive financial resources to perform this analysis may find the required process to be cumbersome, and they may not want to dedicate internal resources to this valuation process. Data can also be sparse for some underlying securities that are either privately or foreignly held, making a cash flow or market value analysis exceedingly difficult.

Most internal investment departments at insurance companies are not equipped with a team of experienced analysts that have the capabilities or resources to perform such research. Bear in mind that many insurance companies, even before receivership, did not have an extensive team of investment analysts, choosing instead to rely on the ratings of nationally recognized rating agencies before making investment purchases. Many insurance companies have since determined that heavy reliance on rating agencies may have been particularly harmful to their investment portfolios.

Another type of structured security product that can pose additional problems to an insurer is a synthetic CDO. Synthetic CDOs are CDOs in which the underlying credit exposures are taken on by using a credit default swap rather than by having a vehicle invest in actual cash securities. Certain synthetic CDOs are essentially "light switch" investments in that if the insurer's tranche or risk class is affected before the maturity date (*i.e.*, by too many defaults in the underlying assets), the insurer will lose the entire value of its investment, meaning that the "light switch" turns off. Alternatively, if the insurer's tranche or risk class is not affected before the maturity date, the insurer will obtain a complete payoff on its investment. In these types of investments, the insurer must take an educated guess on whether the investment will be paid in full or become worthless prior to the maturity date. The insurer must also assess counterparty risk for the swap counterparty for potential signs of default. To an insurance receiver, these educated guesses and assessments can be difficult, and the stakes are high to make the right decision. For synthetic CDOs, the insurance receiver must make an educated guess about whether greater value will ultimately be recognized for the estate (albeit by selling the synthetic CDO for what may be a distressed price), or will the synthetic CDO have few enough defaults of underlying assets where the investment will

pay off at maturity. Can you spell the words "crystal ball"? Insurance receivers may find themselves tempted to sell synthetic CDOs when distressed offers to purchase are being made. There continues to be a plethora of negative news about investment securities that would affect the value of the synthetic CDO, so the retention of these investments is not for the faint of heart. A question arises—should the insurance receiver "play for an all or nothing bet" that the synthetic CDO will pay off many years down the road, or should the insurance receiver sell now, take significant investment losses, and remove the investment risk? While the tendency may be to sell such a security to remove the market risk, the receiver must weigh not only the loss taken on the sale of the investment, but also the likelihood that a security purchased with the proceeds from the sale will likely not produce investment returns equal to the investment that was sold. Such investment returns may be critical in matching the liabilities of the insurer.

The difficulty in properly valuing these types of assets will directly impact an insurer's ability to provide accurate information for tax returns and other publicly filed documents. Any change in the valuation of an asset (*e.g.*, write-down) will have a direct impact on reported surplus, which can immediately impact options for rehabilitation efforts. Additionally, surplus write-downs can continue to strain the financial health of the insurer.

Further issues for these types of securities will involve their tax treatment. Loan-backed securities have very unique attributes which can also play a vital role in tax liabilities. Specifically, the Internal Revenue Code provides that a taxpayer who has realized losses on securities can deduct those realized losses as capital losses, but only up to the amount of capital gains. However, the Internal Revenue Code provides that any ordinary loss, in contrast to a capital loss, can be entirely deducted from the taxpayer's income which effectively lowers the taxpayer's taxable income. Therefore, a decision to sell any security at a loss should be assessed against investment gains. Incurring investment losses in excess of investment gains might result in the loss of very valuable tax benefits.

An insurance receiver should analyze whether loan-backed securities are debt obligations rather than investment securities for tax purposes. The difference in this tax categorization may allow an insurer, which may have realized losses on loan-backed securities, to deduct those losses from income as ordinary losses rather than capital losses, providing the receivership estate with significant tax benefits. However, it is important to remember that the tax and statutory rules for write-downs of securities as losses are different. Just because a security is written down for statutory purposes, it does not necessarily mean that the security is written down for tax purposes. Therefore, a receiver should be cautioned when believing that by simply writing down a security for statutory purposes they will also experience potential benefits under the tax code. However, if conditions exist to meet both requirements, the receiver may find benefit in being more aggressive with write-downs if there is a corresponding and more immediate tax benefit (*i.e.*, security losses being treated as ordinary versus capital).

In summary, SSAP No. 43R provides some benefits to an insurance receiver, as the

ability to write up securities in certain circumstances is a new feature that may enhance asset values. Further, the process of performing the SSAP No. 43R valuation will present a number of issues that require careful attention. SSAP No. 43R may assist in rehabilitation efforts as the financial markets continue to improve, but acquiring and analyzing the necessary cash flow data may be daunting. Moreover, the discounted cash flow values may be materially greater than the values realized from the forced or quick sale of the loan-backed securities. In the end, the valuation of loan-backed securities under SSAP No. 43R may present difficult decisions and challenges for insurance receivers.

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