

VALUATION OF SECURITIES (E) TASK FORCE

Valuation of Securities (E) Task Force Minutes, Dec. 6, 2009

Valuation of Securities (E) Task Force Nov. 30, 2009, Conference Call Minutes (Attachment One)

Disclosure of Model and Assumptions to be used to Determine Risk for RMBS, dated Nov. 24, 2009
(Attachment One-A)

American Council of Life Insurers Assumptions for Modeling RMBS Future Defaults Cover Letter
(Attachment One-A1)

Modeling RMBS Future Defaults (Attachment One-A2)

Center for Economic Justice and the Consumer Federation of America Questions and Comments
(Attachment One-A3)

American Academy of Actuaries Comment Letter for RMS (Attachment One-A4)

Valuation of Securities (E) Task Force Dec. 2, 2009, Conference Call Minutes (Attachment Two)

Proposed Assumptions for use in RMBS Assessment for the Reporting Year, dated Dec. 2, 2009
(Attachment Two-A)

Responses to Questions and Comments Regarding RMBS Assessment for the Reporting Year
(Attachment Two-A1)

Reference to the Purposes and Procedures Manual in SSAP No. 43, dated Nov. 18, 2009 (Attachment Three)

Interim Reporting Instructions for the Year Ending Dec. 31, 2009 (Attachment Four)

Proposal to Redefine the Mission and Role of the Invested Asset (E) Working Group, dated Sept. 1, 2009
(Attachment Five)

North American Securities Valuation Association Defines 6* Designation, dated Oct. 20, 2009 (Attachment Six)

Information on Valuation Technique Utilized, dated Oct. 1, 2009 (Attachment Seven)

Valuation of Securities (E) Task Force
San Francisco, CA
December 6, 2009

The Valuation of Securities (E) Task Force met in San Francisco, CA, Dec. 6, 2009. The following Task Force members participated: James J. Wrynn, Chair, represented by Matti Peltonen (NY); Thomas R. Sullivan, Vice Chair, represented by Kathy Belfi (CT); Steve Poizner represented by Tomoko Stock (CA); Karen Weldin-Stewart represented by Alfred Franz (DE); Kevin M. McCarty represented Ray Spudeck (FL); Susan E. Voss represented by Jim Armstrong (IA); Michael T. McRaith represented by Jim Hanson (IL); Sandy Praeger represented by Linda Shephard (KS); James J. Donelon represented by Stewart Guerin (LA); Ralph S. Tyler, III, represented by Lester Schott (MD); Glenn Wilson represented by Blaine Shepherd (MN); Ann Frohman represented by Jim Nixon (NE); Roger Seigny represented by Paul Kropp (NH); Kim Holland represented by John McCarter (OK); Joel Ario represented by Dave DelBiondo (PA); Alfred W. Gross represented by Van Tompkins (VA); Mike Kreidler represented by Pat McNaughton (WA); and Sean Dilweg represented by Kim Shaul (WI). Also participating was: Mike Moriarty (NY).

1. Residential Mortgage-Backed Securities Assumptions

Mr. Peltonen said that on Nov. 24 the Task Force released the assumptions that PIMCO Advisory would use in its analysis of residential mortgage-backed securities (RMBS) for comment. The Task Force then held a conference call on Nov. 30 to take comments from interested persons. The Task Force held a second conference call on Dec. 2 to finalize and adopt the assumptions that would be used to model RMBS securities for year-end 2009 reporting purposes. Mr. Peltonen asked for a motion to adopt the report (Attachments One and Two) of the chair. Ms. Shaul moved and Mr. Shepherd seconded the motion. The motion passed.

2. The RMBS Project

a. Clarification of the Application of the Short-term Solution

Mr. Peltonen said that, as the Task Force has the charge to work on the long-term solution for structured securities, and the adopted decision is only effective for year-end 2009, he would take a motion to extend the current RMBS solution until the long-term solution is in place. Ms. Belfi moved and Ms. Stock seconded the motion. The motion passed.

b. Status Report on the RMBS Project

Mr. Peltonen said that PIMCO Advisory has been provided with the assumptions to be used to run its financial model. PIMCO Advisory also has most of the CUSIP identifiers for the population of insurer-owned RMBS to be modeled. The SVO staff will conduct a quality assurance and validation process and publish and distribute the results in the form of an Excel spreadsheet through NAIC systems, where insurers can obtain the results for year-end reporting on Schedule D. It is anticipated that the spreadsheets will be available prior to year-end.

Ed Stephenson (Barnert Associates, representing Jackson National Life) asked the source of the fee information posted on the NAIC Web site. Chris Evangel (NAIC) said the fee process was developed by the NAIC, acting through the Executive (EX) Committee. Mr. Stephenson said that the process outlined on the Web site will cause an administrative burden on companies trying to receive this data by year-end. He asked the Task Force to review the process. Mr. Stephenson said he was particularly concerned that that insurers would be asked to prove they paid the assessment before they receive access to the data. Mr. Evangel said the NAIC will get the data Dec. 18 and will release it to the companies by Dec. 28, but only after they have paid their bill. Insurers can dispute the fee after the process is complete.

c. Placing RMBS under Regulatory Review – Interim Instructions for Year-end Reporting

Mr. Peltonen said that the NAIC has held a number of public meetings relative to the modeling process to be used for 2009 reporting of RMBS securities, but that the Task Force needed to formally place the asset class under regulatory review. Robert Carcano (NAIC) said that Part Two of the *Purposes and Procedures Manual of the Securities Valuation Office* (Purposes and Procedures Manual) specifies a procedure in paragraph 3 Section (e) and that the procedure calls for a formal statement at a public meeting. The staff recommends a formal vote to ensure compliance with this procedure, despite significant and public NAIC activity on this issue. Mr. Peltonen asked for a motion to place RMBS securities under regulatory review. Ms. Shaul moved and Mr. Shepherd seconded the motion. The motion passed.

d. Statement Regarding References to the Purposes and Procedures Manual in SSAP No. 43R

Mr. Carcano said that the Purposes and Procedures Manual envisions that interim guidance would be provided to insurers when securities are placed under regulatory review. This reflects that the procedure is triggered by the need for new policy or new methodology to drive regulatory treatment. *SSAP No. 43—Loan-Backed and Structured Securities – Revised* (SSAP No. 43R) refers insurers to the Purposes and Procedures Manual for instructions related to filing RMBS and other structured securities. The proposed statement (Attachment Three) interprets which sections of the Purposes and Procedures Manual are being referenced by SSAP No. 43R. SVO staff also have drafted an interim instructions document (Attachment Four), which is attached to the statement and which are the interim instructions envisioned by the securities under regulatory review procedure. This document specifies the ramifications of RMBS being placed under regulatory review, including that RMBS are no longer eligible for the filing exempt (FE) rule and that NAIC acceptable rating organization (ARO) rating cannot be used to derive risk-based capital (RBC). Mr. Peltonen asked for a motion to adopt the statement and the interim instructions document. Ms. Shaul moved and Mr. Shepherd seconded the motion. The motion passed.

3. Report of the Invested Asset (E) Working Group

Mr. Peltonen said the Working Group had not met since the Fall National Meeting. Mr. Peltonen asked NAIC staff to review the proposed expanded charge of the Working Group for 2010 (Attachment Five). Mr. Carcano said that the Working Group was initially designed to be an ad hoc group that would be activated to make recommendations for regulatory treatment of new financial products. However, the Working Group and NAIC staff have concluded that if the NAIC is to provide quick, effective, timely and comprehensive guidance to the industry and to capital markets, it must be actively engaged in monitoring market developments. The proposed charge envisions a more active role for the Invested Asset (E) Working Group and an interactive process between the Working Group and the SVO that would permit regulators to more effectively respond to new capital market developments. As such, the staff requests that the proposed expanded charge be adopted. Mr. Peltonen asked for a motion to adopt the expanded charge of the Working Group. Mr. Shepherd moved and Ms. Stock seconded the motion. The motion passed.

4. Proposal to Revise the Requirement to File Certain 6* Securities with the SVO

Mr. Peltonen said that there was a discrepancy in the general valuation instructions that permit insurers to use any source to report a value and an instruction that requires insurers to file 6* securities with the SVO if the company wants to use a value higher than zero (0). Cathy Cahoon (Babson Capital, representing the North American Securities Valuation Association — NASVA) said NASVA proposes that the text in Part Four, Section 3 (g) of the Purposes and procedures Manual be deleted so that companies can use their own value (Attachment Six). Mr. Carcano said the staff opposes the proposal, because the 5*/6* process was designed for a different kind of security than the general valuation procedures in Part Six. The proposal assumes it is possible for the industry to make two simultaneous statements: 1) that the insurer does not have documents for the transaction (implying an inability to discuss the terms and characteristics of the securities with the market in general); 2) but that it can nevertheless have good price discovery. The staff is also concerned that while not many transactions are reported under this section, those that are reported tend to be large. Ms. Cahoon said from her company's perspective a lot of the transactions are small private placements issues, where the book value is lower than the actual filing fee on some of these. The pricing is from a company valuation, she explained, because — as there are no public sources of prices for these securities — companies do not have anything to price the issue other than internal company sources. Ms. Shaul asked if the document had been released for comment. Mr. Carcano said that the document had not been previously released for comment. Mr. Peltonen asked for a motion to release the proposal for a 30-day comment period. Ms. Shaul moved and Mr. Shepherd seconded the motion. The motion passed.

5. Implementation of RealPoint, LLC, Credit Ratings for Commercial Mortgage-backed Securities

Mr. Evangel said that the staff has incorporated RealPoint credit ratings into NAIC systems and SVO products. However, RealPoint does not have a ratings delivery service like the other AROs, so insurers that want to include RealPoint in their internal processes have to create a data-transfer procedure.

6. Assigning an NAIC Designation to Hybrid Securities Not Rated by an ARO

Mr. Peltonen said that insurers owned a small group of unrated hybrid securities and the question is what methodology options exist to designate the quality of these securities. One option would be to draft a new regulatory rule. Another option is to permit the industry to self rate or to use the 5*/6* rule. Mr. Carcano said the decision of the Financial Condition (E) Committee that classification analysis was no longer warranted to determine the reporting status of hybrids means the SVO lacks authority to assess the quality of these instruments. The SVO also would not apply the rating agency methodology to hybrids. Mr. Peltonen asked the SVO to further outline options and make a recommendation on how the Task Force should go forward on this issue. Chris Anderson (Anderson Insights) said the adopted decision is that hybrids are to be classified as bonds. Therefore, he said, if the SVO is going to rate unrated hybrids, they should be classified as bonds and additional risk should be reflected in the NAIC designation assigned. Mr. Peltonen said there would be further discussion on this issue.

7. Referral from the Statutory Accounting Principles (E) Working Group

Mr. Carcano said the referral (Attachment Seven) involves the adoption of Issue Paper No. 138, Fair Value Measurements, which requires insurers to disclose information on the valuation technique utilized by the insurer. The SVO products calculate fair value in ways that do not identify the valuation technique utilized. The Task Force is being asked to consider whether the SVO can provide transparency as to valuation technique and whether it is appropriate for insurers to use the SVO determination as their own determination. Mr. Carcano reported that the SVO staff has not studied the issue and proposed to report back to the Task Force not later than the 2010 Spring National Meeting.

8. Definition of First Lien on RMBS and CMBS securities that Incorporate Mixed Collateral

Mr. Peltonen said the issue is what amount of second-lien mortgages could be permitted in RMBS and CMBS issues so they can still be considered to fit into the defined RMBS or CMBS categories. Mr. Carcano said the SVO staff has been studying this issue, but had not yet completed its analysis. Mr. Peltonen asked the staff to draft something on the issue and to report back to the Task Force at the next meeting.

Having no further business, the Valuation of Securities (E) Task Force adjourned.

W:\Dec09\TF\VOS\12-vostf.doc

Valuation of Securities (E) Task Force
Conference Call
November 30, 2009

The Valuation of Securities (E) Task Force met via conference call on Nov. 30, 2009. The following Task Force members participated: James J. Wrynn, Chair, represented by Mike Moriarty (NY); Steve Poizner represented by Tomoko Stock (CA); Karen Welden-Stewart represented by Alfred Franz (DE); Kevin McCarty represented by Ray Spudeck (FL); Susan E. Voss represented by Allen Harder (IA); Michael McRaith represented by Kevin Fry (IL); Sandy Praeger represented by Ken Abitz (KS); James J. Donelon represented by Stewart Guerin (LA); Glenn Wilson represented by Blaine Shepherd (MN); Ann Frohman represented by Bruce Bornman (NE); Kim Holland represented by Frank Stone (OK); Joel Ario represented by Dave DelBiondo (PA); Alfred Gross represented by Van Tompkins (VA); Mike Kreidler represented by Pat McNaughton (WA); and Sean Dilweg (WI). Matti Peltonen (NY) also participated on the call.

1. The NAIC Residential Mortgage - Backed Securities Project

Mr. Moriarty said the purpose of the call was to take comments from industry and interested persons on the assumptions that will be used in the modeling process by PIMCO Advisory to calculate the intrinsic value of insurer owned Residential Mortgage Backed Securities (RMBS) and map those results back to NAIC designations for year-end 2009 reporting. Mr. Moriarty said that the staff has developed instructions for reporting of RMBS securities at year-end 2009 and posted this to the NAIC web site. The staff has also developed and distributed a November 24, 2009 Memorandum (Attachment One) summarizing the model and the proposed assumptions. Final recommendations are expected to be presented to the Task Force during a call scheduled for Dec. 2, 2009. The memorandum is the basis for today's discussion. Written comments were received from the American Council of Life Insurers (ACLI), the American Academy of Actuaries, the Center for Economic Justice, the Consumer Federation of America and Beneficial Life Insurance Company.

Robert Carcano (NAIC) summarized the Nov. 24 memorandum. Eric Kolchinski (NAIC) provided a more detailed explanation. Mr. Kolchinsky said the first step is a macro-economic model that projects an economic future. The output from that model is used in a mortgage credit model which applies the assumptions on a loan by loan level. The outputs from the mortgage credit model are things like prepayment rates, default rates and losses. Those are then input into a capital structure model. RMBS typically have very complex and intertwining cash flows where principal, interest, excess interest and losses have to be allocated separately. The capital structure model allocates projected payments and losses among the various tranches. Finally there is a valuation process which is a separate process where we assign some sort of meaning to the cash flows produced for each tranche from the capital structure model. Mr. Kolchinsky said the key assumptions to be determined by regulators are primarily in steps one and four.

The first recommended assumption is that the Task Force use the PIMCO Advisory standard base case home price appreciation model. PIMCO Advisory uses home price appreciation curves created by a leading third party economic consultancy. These curves are mapped to each individual loan in each security. Therefore, we have a home price appreciation curve on each security in the pool. The SVO recommends that interest rate and other macroeconomic projections be based on PIMCO Advisory's internal interest rate model which projects mortgage rates and future interest rates based on current interest rate markets. The NAIC assessed PIMCO's proprietary mortgage credit model as part of the vendor selection process. The cash flow software tool is the market standard cash flow or waterfall modeling tool used. The SVO therefore recommends the NAIC use that model. The last of the key assumptions relate to the valuation process. The SVO has chosen and recommends a multiple scenario analysis for each tranche. Many RMBS tranches are thin meaning that they consist of only one or two percent of the total capital structure. This makes the security sensitive to the assumptions used in the initial run of the mortgage credit model. Running multiple scenarios ensures a more reliable valuation. The scenarios will be prepared by a PIMCO Advisory time series model. It uses historic home price appreciation price volatility as its basis and creates home price appreciation curves which can then be allocated to a certain probability. We are using five curves in total with a base curve having a 50 percent probability two other curves an aggressive and conservative curve each having a 22.5 percent probability and finally a most aggressive and most conservative curve each with a 2.5 percent probability. Each scenario is weighted by their respective probabilities to determine the final valuation. The process by which the valuation is mapped back to an NAIC Designation is explained in the instructions document that has been posted on the NAIC website.

Mr. Kolchinski said that the SVO will conduct a quality assurance process in addition to the one that PIMCO Advisory will run. The NAIC will have two separate tracks and tasks in the quality assurance process. One is a macro level statistical analysis of all of the results. The goal here is to find outliers as well as discrepancies in the process. The second is a random sampling of individual CUSIP numbers. Some will be completely at random while others will be follow-ups on outliers. The

NAIC will review month by month payments and loan level tranche level information for each security randomly sampled and compare them to both the governing documents and the latest remittance reports to ensure that the modeling process is consistent with those governing documents and that the data used is correct and of the highest quality.

Mr. Dilweg asked if the five scenarios cross reference with PIMCO Advisory as the base case. Mr. Kolchinski agreed saying the intention is to capture tranches that may be okay in the median scenario but may be susceptible to loss in more aggravated economic scenarios.

Mr. Moriarty asked the ACLI to present their comments.

Mani Sabapathi and Nancy Mueller Handal (both of Prudential, representing the ACLI) said the ACLI documents (Attachments Two and Three) were provided to illustrate the challenges modelers face in developing expectations for RMBS collateral. The focus needs to be on identifying the key drivers of default in the current economic environment. These include housing price declines and unemployment. Typically default is caused by a loss of employment but in the current environment significant housing price declines are precipitating default. The NAIC memorandum is not clear about how housing declines are to be translated into a default projection. The base case expectation of 38 percent is in line with major economic research but there is uncertainty and variability in terms of what that means for mortgage performance and future defaults. Trading prices and market implied models suggest future defaults of two to three times that in the pipeline - as many as 15 to 20 million more defaults in addition to the six or seven million have already been seen so far. This approach would end up with severities running close to 70 percent. What would such a result imply for an unemployment rate? The key point is the need for a transparent matrix for future defaults.

Ms Mueller Handal said new jobless claims were correlated to unemployment to separate the negative equity from job loss. A rough estimate of a base scenario of 11 percent unemployment over the next 12 months assuming a recovery down to about 400,000 – 450,000 new claims per week and then over the next four years a steady state of 325,000 per week we mean six to ten percent of people losing their homes in prime, 10-15 percent in Alt As and 25 – 30 percent in sub-prime. A market implied model would project roughly 25 percent of prime borrowers, 50 percent for Alt-A borrowers and 75 percent for sub-prime borrowers and those are new defaults from borrowers that have paid throughout the crisis. This shows the need for caution with the assumptions. ACLI requests that the modeler discuss what its model would project as to how many people are going to default and what percentage of the population would lose their homes. ACLI also asked what that implies as unemployment. ACLI made other comments and requests for information or clarification. Mr. Kolchinski replied to some of the questions and Mr. Carcano indicated all questions were being noted and a more detailed response would be provided after consultation with the Task Force.

Birny Birnbaum of the Center for Economic Justice and the Consumer Federation of America said he included a number of questions in his comment letter (Attachment Four) and asked if he should go through them. Mr. Carcano said that the staff initial comments were structured to address his questions but that if there was anything that was not addressed in the initial comments we would be happy to go over anything he felt was missed. Mr. Birnbaum questioned the transparency of the process. He questioned the relevancy of historical volatility in the model given recent financial turmoil. He also questioned whether the future can be captured in any kind of historical time series. Mr. Birnbaum said that no information has been provided as to the assumptions that are going into the model. Mr. Birnbaum asked how PIMCO Advisory handled conflicts of interest. He also questioned why the adoption of the assumptions needs to be done in private.

Mr. Kolchinski said the memorandum distributed for this meeting (Attachment Five) shows the spread between the most aggressive and the most conservative being nearly a 30 point difference in home pricing appreciation between the most conservative and the most aggressive. There is quite a large part of the probability sphere and is intended to make sure we are capturing potential downside on the market as well as potential upside. The key assumptions that go into the mortgage credit model are home price appreciation and interest rates as well as the mortgage rates. The home price appreciation is the dependant variable and the result of the unemployment and other economic conditions that affects mortgages. The base case scenario provided by the third party consultants has an unemployment rate and other economic conditions associated with it

Mr. Carcano said it is very important for everyone on the call to be aware of the nature of the process. We are trying to look into a very complex future and identify variables that will give us some sense of how this asset class will perform. There are a number of ways this can be done and each has benefits and drawbacks. With respect to the level of transparency it may not be fully appreciated that the NAIC is a private company and this specific project is a technical project being conducted as such. It is not a regulatory project at this stage but a technical project being conducted by technical staff under the process set up to conduct technical projects.

Therese Vaughan (NAIC) said that she would agree with the expectation that we are transparent as possible in this project and she does not think it is enough to say that we are a private association and we are not going to exercise transparency so she is going to disagree with Mr. Carcano here. She thinks we need to be transparent and we are trying to work with the vendors so that we can be as transparent as we can on the bidding process but also the intent of this Working Group as she understands it is to be very transparent in the process of setting the assumptions and what assumptions are used. We have been very open about putting them on our web site and what is the final version will be perfectly available publicly. She has a problem with us as an organization saying the NAIC is a private association and therefore we are not going to be transparent in this project and does not want to use that argument.

Mr. Carcano said he did not mean to suggest that the NAIC would be anything but fully transparent. His point was that certain stages of this project up to now have been conducted by the staff and it is very technical work - it is not necessarily true that our regulators have had access to each and every aspect of those technical processes until we report back to them which is what we are doing on this call.

Mr. Carcano said that conflicts are managed in a number of related ways. The first is a physical segregation process. Specific staff is identified to work on the project by the vendor and this staff is taken off other assignments and put into a separate room with restricted access both in terms of who can access that area as well as who can access project information. The overall effect is to create a cocoon in which information can flow into the cocoon where the team members are working but cannot flow out. Other physical controls include separate computer systems and other lines of communication. There are ethical barriers, special compliance procedures. No one on the vendor's staff have any responsibility whatsoever for trading. There is no compensation link and no reporting link to those groups as well. PIMCO Advisory has two very highly visible public mandates with the Federal Reserve Bank. We reviewed the conflicts management process for those mandate. From all of this analysis we derived a high sense of confidence that PIMCO Advisory employs best practices to manage potential conflicts of interest.

Mr. Dilweg said that he and Mr. Birnbaum had discussed models in the past and that as the NAIC has gone into this project he is very comfortable with where the process has ended up. He has been through his other regulatory companies looking at RMBS for over a year and the modeling that is done on them and it is important that as we roll into this we have a very good choice of vendors. The one we settled on is very well qualified across a wide range of criteria. We are running a loan level analysis with five stress cases running through it. I think you have to think back to the initial ACLI proposal which said lets just kick this up two NAIC levels and not worry about any of the detailed analysis. We spent this past summer going back and forth winnowing it down to this. He agrees it is not perfect this is not rocket science either. It is important to note that although the HPA is really driver of the valuation model our macro economic models do take into consideration the unemployment rate, CPI, household income a number of those issues. He thinks it is a very good process that has gotten us here today and we are just trying to work through these assumptions so we have a back view of these assets. He appreciates all of the questions and has looked at them closely.

Nancy Bennett of the American Academy of Actuaries (AAA) said she thinks that there have been a number of good questions that have been previously discussed. AAA would encourage the continued disclosure and documentation of the assumptions. Everyone needs to understand how the assumptions have been set and what the basis for the assumptions is and how they will monitor in the future.

Kirby Brown of Beneficial Life said he would echo the general need for transparency on the assumptions. He thinks it is important to have transparency on these issues on things such as the time horizon associated with the peak to trough assumptions what the expectations is following those time frames going forward through the various underlying loans.

Mr. Moriarty said that the questions and issues raised on the call would be covered in a follow up question and answers document. To a large extent we are dependent on our experts. We have hired not just PIMCO Advisory but also Oliver Wyman to provide a second layer of opinion.

Phillip Slaughter of ING said the structured model was referred to as an industry standard and asked if the modeler was Intex. Mr. Kolchinski said it was. Mr. Slaughter asked how the discount rates arrived at for floating rate bonds or hybrid coupon bonds. Does PIMCO Advisory have a proprietary cash forecast model or does it just use forward curves. Mr. Kolchinski said it was based on the forward rate plus the coupon. Mr. Slaughter asked how loan modifications were addressed in the model. Mr. Kolchinski said we would provide a more narrative description on how it was done. Mr. Slaughter asked if a complete list of the sub-models that Prime, Sub-Prime, Alt- A had been mentioned does the list go deeper by collateral or product type. Mr. Kolchinski said the matrix is derived is based on all of these properties rather than based on a sub-model.

Bart Simon of the Federal Reserve Bank of Boston asked what the definition of an effective coupon rate was. Mr. Kolchinski said it includes the benchmark and the spread and any discount that occurs at issue. Mr. Simon asked about the distribution used on the HPA scenarios. It was a real distribution from the time series models and the corresponding probabilities is that an accurate representation. Mr. Kolchinski said that the way this was done is that the base case comes from the third party consultancy the other scenarios were determined through this model. The probability that you see there correspond to those HP paths from that. Mr. Simon asked if it was fair to say that the valuation that is going to be coming out of the model at the very end discounted back is an expected loss or intrinsic value. Mr. Kolchinski said that those definitions are very broad and used in many different ways so the goal here is to have in the statistical sense of expected loss that we have a number of discrete paths and we will weight them by their probabilities. Mr. Simon asked how these valuations are going to be transferred into actual capital charges. Mr. Kolchinski said that the mapping process is explained in detail in the RMBS Instructions posted to the NAIC web site at several locations. Mr. Simon asked if the monoline wraps would the current CDS performance is used to predict default and the probability of receiving payment. Mr. Kolchinski said the staff would follow up on that question.

Jay Muska from Travelers asked if the model output would provide the current market value. Mr. Peltonen said what we expect from the model does not contemplate what the current market value is because there are more factors that go into market value. It is just the net present value of the expected loss and that is mapped back to the appropriate NAIC Designation.

Mr. Simon asked if there will be future guidance for reporting for the institutions not RBC reporting specifically to get some consistency between companies on their 10-K's. Mr. Moriarty said that the NAIC does not get involved in providing guidance on how a company should report their GAAP reporting or anything to the SEC.

Mike Garley of Deutsche Asset Management asked if any timelines had been set out in terms of when this information is going to be released so companies can record proper journal entries on their books. Chris Evangel (NAIC) said that the plan was to have them out by year-end at least by Dec. 28. Mr. Garley asked if they would be based on the data that relates to the underlying securities will that be based on a Nov. 30 month end. Mr. Kolchinski said that we are using the Oct. remittance reports, we are running the HPA curves as of Nov. and right now we are running the rate curves as of Nov. 20.

Having no further business, the meeting of the Valuation of Securities (E) Task Force was adjourned.

W:\Dec09\TF\VOS\VOSTFConfCall11.30.09.doc

To: Industry and Interested Persons
From: Mike Moriarty (NY), Chair of the Valuation of Securities (E) Task Force
Members of the Valuation of Securities Task Force
Re: Disclosure of Model and Assumptions to be used to Determine Risk - Based Capital for Residential Mortgage Backed Securities (RMBS) for the Year Ending 2009
Date: November 24, 2009

1. Introduction – On October 14, 2009 the Valuation of Securities Task Force adopted a proposal that for year end 2009 reporting purposes, risk-based capital (RBC) for residential mortgage securities (RMBS) would be determined using a financial model instead of NAIC ARO credit ratings (the RMBS proposal). The RMBS proposal was adopted by the Financial Conditions (E) Committee on October 14, 2009 and adopted in turn by the NAIC Executive Committee and Plenary on November 5, 2009. On October 20, the NAIC Executive Committee authorized the NAIC staff to initiate a request for proposal process to identify financial modeling firms who could perform the assessment of insurer owned RMBS securities. The staff concluded this assignment and on November 17, 2009 recommended to the NAIC Executive Committee the selection of PIMCO Advisory to conduct the 2009 year end valuation of RMBS securities (the NAIC engagement). This recommendation was accepted. The Task Force held a regulator to regulator call on November 24, 2009 to hear a presentation from the SVO staff, PIMCO Advisory and NAIC consultants on the RFP process, PIMCO Advisory's non-agency mortgage model and the assumptions that drive that model. This document summarizes the presentation made by PIMCO Advisory and the SVO staff to the Task Force and is released **in anticipation of a public meeting to be held November 30, 2009** at which time the Task Force will present the detailed proposal to industry representatives and other interested persons.

2. The Model – The NAIC engagement requires PIMCO Advisory to conduct a loan level analysis of US RMBS using their proprietary non-agency mortgage model. The PIMCO Advisory analytical process actually refers to and consists of four sub-steps: a macroeconomic model, a mortgage loan credit model, a capital structure model, (often referred to as a waterfall model) and a final valuation. This final valuation is used to map securities to the current RBC process. This section provides an overview of the modeling process and identifies the kind of underlying assumptions that drive it.

a. The macroeconomic model projects future macroeconomic variables, specifically home price appreciation/depreciation (HPA/HPD) and interest rates. PIMCO Advisory's HPA/HPD median -case scenarios are derived from a market standard regional and national HPA/HPD forecast. PIMCO Advisory also projects multiple HPA/HPD scenarios around this median using a proprietary time series model. While many macroeconomic assumptions, such as employment are embedded in the market standard HPA/HPD forecast to which the model is calibrated, they are not explicit variables utilized by PIMCO Advisory's model. Forward-looking interest rates are another primary dynamic variable. Future interest rate paths are based on implied forward money market and mortgage interest rates. The projected mortgage rate curve is a function of 5- and 10-year swap rates and credit spreads.

b. The mortgage loan credit model projects loan performance based on macroeconomic variables (HPA and interest rate forecasts) and qualitative loan characteristics. Qualitative loan characteristics include static variables such as FICO, original loan to value ratio (LTV) and property type, as well as dynamic variables such as current loan to value mortgage rate resets and others.

Mortgage prepayment, delinquency and default are modeled using a transition rate methodology. Each loan underlying the RMBS is initially classified as performing or non-performing, then projected forward as it transitions between current and delinquent states or terminates through prepayment or default. This projection is done on an individual-loan basis. The probability of a loan transitioning among these states is estimated based on historical patterns, loan-level characteristics and macroeconomic variables. These transition probabilities are calculated using sub-models segmented by collateral type (sub-prime, Alt-A, jumbo etc.) and product type (fixed rate, adjustable rate) to capture the different behavior of these mortgage types. Once the probabilities are calculated, a Monte-Carlo simulation is used in which a random drawing against these calculated probabilities determines how the loan transitions or terminates each month.

The loss severity of defaulted loans is projected based on collateral deficiency (unpaid balance less REO sales price), lost interest (accrued as servicer advances), expenses (legal, property taxes, brokerage fees), and mortgage insurance considerations. Severity is driven by the projected HPA through the current marked-to-market cumulative LTV, as well as historical severity, mortgage rates, credit profile and loan types.

The severity, prepayment and default rates are used to calculate loan-level cash flows, which are aggregated into mortgage pool-level cash flows.

- c. Once generated, pool-level cash flows are passed through the capital structure model to calculate the specific security's principal losses. The model captures the set of rules that determine which bonds get paid principal and interest as mortgages pay off and which bonds take losses as mortgages default. The rules are determined by a deal's legal documents.
- d. A discount rate is applied to each bond's losses to arrive at a net present value. The interest rate used to discount the bond flow will be the bond's effective coupon rate.

Valuations are calculated under multiple scenarios because many bonds are highly non-linear and may have low or zero losses under the median scenario but suffer large losses under a more stressful scenario. In the multiple scenario approach used, the mortgage credit model and capital structure model are used to calculate the present value of losses under each HPA/HPD scenario, each of which has an associated probability. The final valuation is the probability weighted present value of losses.

3. Assumptions - The Task Force, in consultation with PIMCO Advisory, consultants and SVO staff has determined that the following assumptions will be used to value RMBS:

- a. The median HPA scenario will be PIMCO Advisory's standard base case scenario.
- b. PIMCO Advisory will use its internal model to calculate four additional HPA paths (two more conservative and two more aggressive). The running of the additional paths is necessary to capture the credit convexity or "cuspidity" of the bonds.
- c. The additional HPA paths will be constructed such that the median case scenario has a 50% probability of occurring, the aggressive and the conservative scenarios each have a 22.5% probability of occurring and the most aggressive and most conservative have a 2.5% chance.
- d. The final valuation will be the probability weighted average of the present values of all losses under each HPA scenario.
- e. All losses will be discounted at the bond's effective coupon rate.

The following table summarizes the relevant probability weights for the HPA scenarios:

Scenario	Probability	Peak to Trough HPA
Most Aggressive	2.5%	-33%
Aggressive	22.5%	-35%
Base Case	50.0%	-38%
Conservative	22.5%	-41%
Most Conservative	2.5%	-61%

4. Quality Assurance/Control

In addition to PIMCO Advisory's extensive internal quality control process, the SVO and consultants will conduct quality control checks of the valuation process. These checks will help to ensure that the valuation process is of the quality required. The SVO will run both aggregate quality analytics and randomly sampled CUSIP-specific bottoms-up assessments. Additionally, the SVO has confirmed that PIMCO has appropriate procedures in place to ensure that the analysis is free from conflicts of interest.

W:\Dec09\TF\VOS\RMBS\DisclosureOfModelAssumptions11.24.09.doc



Andrew Melnyk, Ph.D.
Managing Director, Research

November 10, 2009

Mr. Matti Peltonen
Valuation of Securities Task Force
National Association of Insurance
Commissioners
c/o State of New York Insurance
Department
25 Beaver Street
New York, New York 10004

Mr. Michael Moriarty
Valuation of Securities Task Force
National Association of Insurance
Commissioners
c/o State of New York Insurance
Department
25 Beaver Street
New York, New York 10004

Re: Assumptions for Modeling Residential Mortgage-Backed Securities (RMBS)
Future Defaults

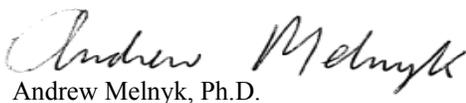
Dear Messrs. Peltonen and Moriarty:

ACLI member companies have been examining various challenges that modelers are likely to face when forecasting non-agency RMBS performance.¹ Our efforts have resulted in the attached presentation, entitled *Modeling RMBS Future Defaults*.

ACLI feels that industry participation and cooperation are important throughout the entire modeling process, particularly during the early stages when modeling assumptions are first determined. For this reason, we would like to request a public, in-person meeting with appropriate NAIC and SVO staff as well as representatives from the firm chosen to assess RMBS. Such a meeting would serve as an appropriate public venue for ACLI to present and discuss various issues in the attached document. It would also provide an opportunity for industry to answer any questions the modeler may have. Ideally, we would like such a meeting to take place during the week of November 16th.

Thank for undertaking this important effort and for considering our request.

Sincerely,


Andrew Melnyk, Ph.D.

¹ The ACLI represents three hundred forty (340) member companies operating in the United States, of which three hundred thirty two (332) are legal reserve life insurance companies, and eight (8) are fraternal benefit societies. These 340 member companies account for 93 percent of total assets, 93 percent of the life insurance premiums, and 94 percent of annuity considerations in the United States.

Modeling RMBS Future Defaults



Modelers face significant challenges in forecasting non-agency RMBS performance



- ◆ Nearly simultaneous presence of weak housing and labor markets makes attribution of performance drivers difficult.
- ◆ Changes in collateral composition due to prepayments and defaults requires loan level analysis to project future defaults.
- ◆ Regulators should ensure that model projections are consistent with the potential range of macroeconomic scenarios (unemployment, home prices, interest rates) expected.
- ◆ The most difficult model projection is the rate at which currently performing loans will default in the future; that is the primary focus of this presentation..

Assumptions used for projected defaults for performing borrowers could imply that 40% - 50% of mortgagors will lose their homes

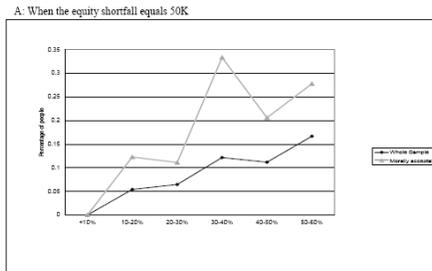
- ◆ Certain models assume that future defaults (where the home is liquidated) on currently performing borrowers will be substantially higher than delinquencies experienced to date. A sample model's default expectations across a variety of transactions are shown in the Appendix A.
- ◆ Even for the cleanest mortgage pools (<5% seriously delinquent), such models projects an additional 20% of performing loans to default. For transactions with over 40% of loans seriously delinquent, projections are for about 75% of performing loans to default.
- ◆ Such models project, on average, additional home liquidations of roughly 2 ½ - 3 times the current delinquency pipeline, or about 15 - 18 million more homes liquidated. Adding this to the 6 million homes currently in the delinquency pipeline, implies about 20 - 25 million of 50 million mortgagors will lose their home.
- ◆ This is often the result of attributing significant weight to housing markets (due to negative equity) as the key driver of defaults or in extrapolating recent delinquency trends, which have been impacted by severe weakness in both labor and housing markets.
- ◆ Cumulative future defaults on performing loans provides a useful metric to ensure that future default rates are consistent with projected macroeconomic conditions.

Models should be cautious about being overly reliant on home prices in predicting defaults

Evidence of true "strategic" default remains largely anecdotal and likely accounts for a limited portion of defaults

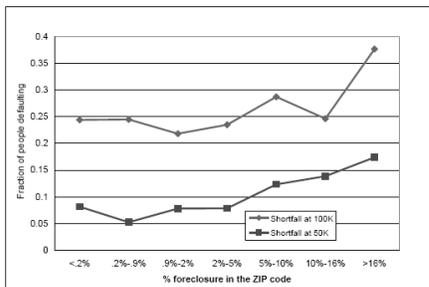
- ◆ Since behavioral evidence of strategic defaults is limited, studies by researchers provide insight into potential behavior. One such study (figures below) ¹ suggests that of those who believe it is morally acceptable to default on their home, less than a third would do so, even if their negative equity position is in excess of 50%; amongst all respondents, less than 20% would default. Increased foreclosure activity can also result in "strategic defaults".
- ◆ These estimates indicate about 1.25 million borrowers (50mm mortgage borrowers * 25% in negative equity position * 10% assumed to strategically default) have defaulted due to negative equity (which is about 20% of total defaults to date).

Figure 3: Percentage of homeowners willing to default as a function of the equity shortfall
 On the y-axis there is the fraction of homeowners who claim they will default if the equity in their house was equal to -50K (-100K). On the x-axis the ratio between the negative equity amount (-50K-100K) and the self-reported value of the house of that person. Source: www.financialmarkets.org



¹ "Moral and Social Constraints to Strategic Default on Mortgages", by Guiso, et al

Figure 4: Percentage of homeowners willing to default as a function of the foreclosures in the area
 On the y-axis there is the fraction of homeowners who claim they will default if the equity in their house was equal to -50K (-100K). Source: www.financialmarkets.org. On the x-axis the percentage of initiated foreclosures as a fraction of the total number of outstanding mortgages in the ZIP code in which the homeowner lives. Source: www.realtor.com and Equifax.



Loans originated with weak underwriting or fraud are likely already delinquent or liquidated.

- ◆ Unqualified borrowers would not have been able to meet 24+ months of mortgage payments. These accounts are now seriously delinquent or already foreclosed and liquidated.
- ◆ Remaining borrowers display much stronger credit characteristics than delinquent borrowers.
- ◆ Remaining borrowers have displayed an ability to pay mortgage debt over a long-period of significant economic distress. This is an indicator of positive selection and lower risk in the remaining pool of borrowers.

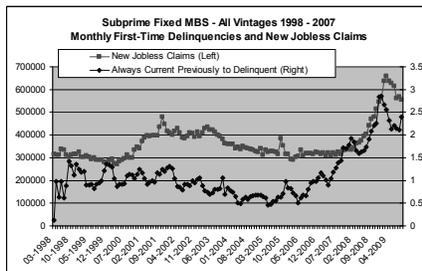
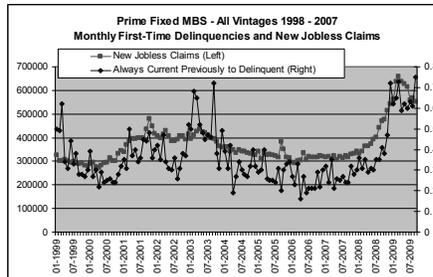
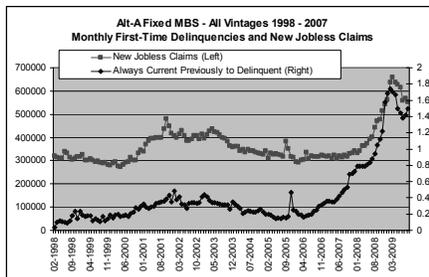
Prime Loans	Current Accounts	60+ Delinquent Accounts	Subprime Loans	Current Accounts	60+ Delinquent Accounts
FICO	741	717	FICO	630	624
Adjusted LTV	77.0	91.4	Adjusted LTV	86.1	95.4
Original LTV	70.8	75.6	Original LTV	78.9	77.9

Alt-A Loans	Current Accounts	60+ Delinquent Accounts
FICO	716	695
Adjusted LTV	86.7	101.4
Original LTV	73.7	77.9

Data based on Intex universe for deals originated in 2006

5

Data shows that job losses drive new delinquencies
Lack of equity is a secondary factor that pushes a loan from delinquency to default



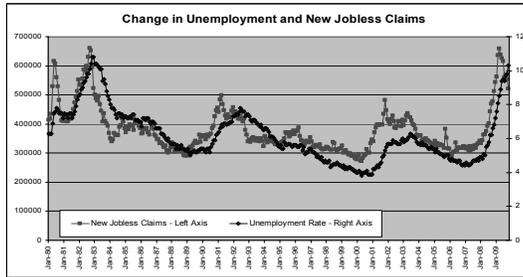
Correlations with New Jobless Claims

- Alt-A = 0.85**
- Prime = 0.74**
- Subprime = 0.61**

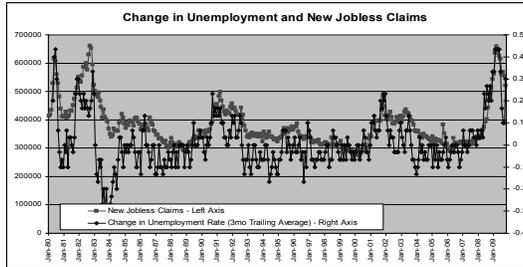
Roll Rates from early delinquency to late delinquency and default are then highly dependent on home primes (see appendix)

6

Initial Jobless Claims is a leading indicator of unemployment rates
 We are already seeing improvement in this metric.

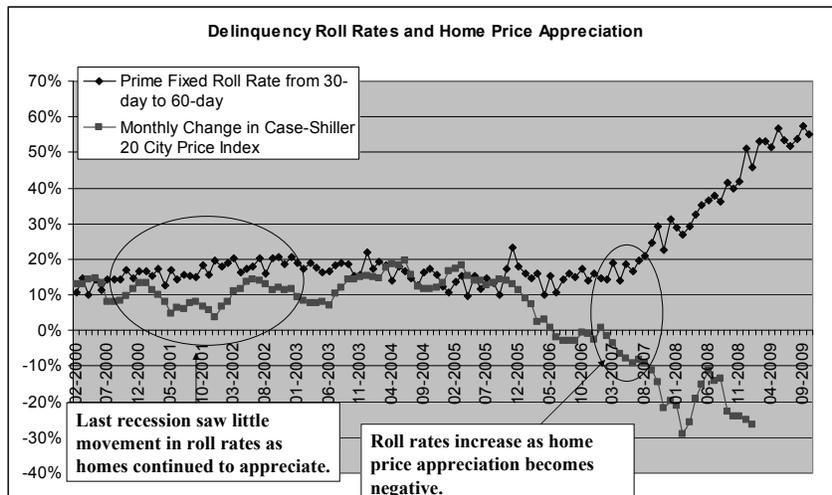


Jobless claims have led unemployment in past cycles in moving downward. Claims have dropped to around 525K per week – a drop to ~450K per week is likely as unemployment stops increasing.



“Steady-state” claims are around 325K per week after the economy recovers.

Home price declines are a secondary contributor to defaults by eliminating an equity safety net for borrowers.



Models should consider declining job losses

Caution should be exercised in evaluating and using roll rates based on the rapid economic deterioration of the last 12 months

Economic forecasts and links to mortgage delinquencies can help develop future default projections. We provided below two examples of macroeconomic conditions and projected defaults based on the relationships shown in previous slides (calculations in Appendix B).

- ◆ **Base Scenario**
 - ◆ 11% Unemployment over the next 12 months = ~400K to 450K new jobless claims per week
 - ◆ Recovery to steady state unemployment levels over next 4 years = ~325K new claims per week
 - ◆ Weak housing market for next 12 months followed by slow price appreciation
 - ◆ Prime Fixed 5yr Defaults for Currently Performing Loans = 6%
 - ◆ Alt-A Fixed 5yr Defaults for Currently Performing Loans = 11%
 - ◆ Subprime Fixed 5yr Defaults for Currently Performing Loans = 23%
- ◆ **Pessimistic Economic Conditions – representative of base case expectation for certain models**
 - ◆ 17% Unemployment over the next 24 months = ~550K new jobless claims per week for 24 months
 - ◆ Prolonged, slow recovery with high unemployment for next 3 years = ~400K new claims per week
 - ◆ Continued, significant housing declines; little appreciation in out years.
 - ◆ Prime Fixed 5yr Defaults for Currently Performing Loans = 11%
 - ◆ Alt-A Fixed 5yr Defaults for Currently Performing Loans = 24%
 - ◆ Subprime Fixed 5yr Defaults for Currently Performing Loans = 44%

9

Government loan modification programs are dramatically changing the types and impacts of modifications

- ◆ Modification activity is ramping up significantly as there is broad political support for modifications as a means to reduce distressed housing supply and thus stabilize housing markets.
- ◆ Available modification performance data reflect historical modifications that recapitalized the balance and resulted in increased payments to the borrower. Recent modifications are tending toward rate and principal reductions and providing significant reductions in payments (charts below).

Modifications and Payment Effects: Alt-A Loans

Chart 50: Modification Type Monthly Breakdown (%)

Source: LoanPerformance, BofA Merrill Lynch Global Research

Chart 66: Relative Payment Reduction Monthly Breakdown (%)

Source: LoanPerformance, BofA Merrill Lynch Global Research

10

Modifications that significantly lower monthly payments have shown much lower re-default behavior than traditional re-capitalizations

- ◆ Assumptions for modifications should take into account:
 - the significant incentives to servicers and borrowers being provided by the Treasury
 - the meaningful payment reductions that borrowers are receiving
 - after-tax monthly payments (after modification) vs rental alternatives
- ◆ OCC Mortgage Metrics Report shows significant differences in performance for modifications as a function of payment reduction:

Table 5. Re-Default Rates of Loans Modified in 2008 by Changes in Payment (60 or More Days Delinquent)

	Three Months after Modification	Six Months after Modification	Nine Months after Modification	12 Months after Modification
Decreased by 20% or More	15.0%	24.6%	30.4%	34.1%
Decreased by 10% to Less than 20%	16.7%	29.3%	36.9%	43.0%
Decreased by Less than 10%	18.8%	36.1%	45.4%	50.8%
Unchanged	47.2%	57.0%	62.8%	63.4%
Increased	30.3%	50.9%	60.6%	64.7%

◆ Source: OCC and OTS Mortgage Metrics Report -Second Quarter 2009, September 2009

Projected defaults for performing loans should conform to expected economic conditions and observed default relationships with employment

- ◆ Results produced by a mortgage modeler should be consistent with expected macro economic scenarios.
- ◆ Key macro inputs are labor market and housing market expectations
- ◆ However, given the broad range of sensitivity that models assign to these variables, cumulative future defaults should be considered as a key metric in ensuring future default projections are in-line with projected macroeconomic conditions.
 - Recent economic weakness has resulted in over 6 million delinquent borrowers; macroeconomic projections can be utilized to estimate a range of reasonable default expectations for the mortgage universe.
 - For example, to experience an additional 6 million defaults over the next 3 – 5 years would suggest a repeat of the labor market and housing market conditions we have faced over the last 3 years.

Appendix

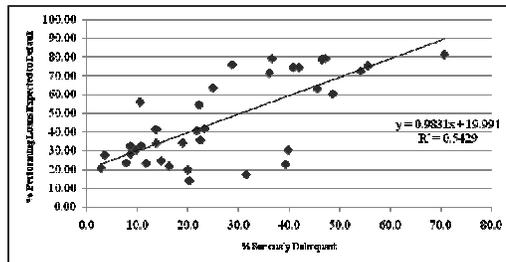


Appendix A
Performing Borrowers Expected to Default relative to Current Delinquency Pipeline



- Default expectations on performing borrowers are plotted below against delinquency pipeline for a variety of transactions (Prime, Alt A and subprime).
- Illustrates that for most transactions, future defaults on performing loans are expected to be substantially higher than delinquencies experienced to date

Sample Mortgage model's future projected defaults for performing loans and current delinquency pipeline



Appendix B: Base Economic Scenario

Continued Economic Weakness with Flat to Slightly Higher Unemployment, 12-Month Period

Collateral	Average New Jobless Claims	Implied Rate of New Delinquencies	Roll Rate from 30-day to Default	12-Mo Default Rate
Prime - Fixed	450,000	0.50%	35%	2.10%
Alt-A - Fixed	450,000	1.00%	40%	4.80%
Subprime - Fixed	450,000	2.00%	45%	10.80%

Recovery and Long-Term Outlook - Lower Unemployment, HPA (Real + Inflation)

Collateral	Average New Jobless Claims	Implied Rate of New Delinquencies	Roll Rate from 30-day to Default	Annual Default Rate
Prime - Fixed	325,000	0.30%	25%	0.90%
Alt-A - Fixed	325,000	0.40%	30%	1.44%
Subprime - Fixed	325,000	0.70%	35%	2.94%

Collateral	5-Yr Defaults
Prime - Fixed	5.7%
Alt-A - Fixed	10.6%
Subprime - Fixed	22.6%

15

Appendix B: Pessimistic Economic Scenario

Significant, Pro-Longed Economic Weakness with Unemployment Pushing going to 17% over a 24-Month Period

Collateral	Average New Jobless Claims	Implied Rate of New Delinquencies	Roll Rate from 30-day to Default	24-Mo Default Rate
Prime - Fixed	550,000	0.65%	40%	6.24%
Alt-A - Fixed	550,000	1.50%	45%	16.20%
Subprime - Fixed	550,000	2.00%	50%	24.00%

Moderate Recovery - Elevated Jobless Claims and Delinquencies Continue for years 3 - 5

Collateral	Average New Jobless Claims	Implied Rate of New Delinquencies	Roll Rate from 30-day to Default	Annual Default Rate
Prime - Fixed	400,000	0.40%	35%	1.68%
Alt-A - Fixed	400,000	0.55%	40%	2.64%
Subprime - Fixed	400,000	1.25%	45%	6.75%

Collateral	5-Yr Defaults
Prime - Fixed	11.3%
Alt-A - Fixed	24.1%
Subprime - Fixed	44.3%

W:\Dec09\TFVOS Modeling\RMBS\Future Defaults.doc

16

**Comments of the
Center for Economic Justice and the Consumer Federation of America**

Questions and Comments for Valuation of Securities Task Force

November 30, 2009 Conference Call

In a November 25, 2009 BestWire article about the release of the memorandum “

Disclosure of Model and Assumptions to be used to Determine Risk - Based Capital for Residential Mortgage Backed Securities (RMBS) for the Year Ending 2009,” Scott Holeman is identified as an NAIC spokesman and is reported to state, “We’re trying to make this process as transparent as possible.”

Given that the process has been totally non-transparent to date, it’s scary to imagine what the process would look like if the NAIC was trying to keep the process opaque.

The latest episode in the life insurer capital relief bonanza demonstrates, yet again, state regulators taking unnecessarily hasty action to provide – by the regulators’ own statements – unneeded capital gifts to insurers. The memo was released on November 25, 2009 – the last business day before the public meeting to discuss the assumptions. Comments on the memo are due November 27, 2009 – the Friday after Thanksgiving and a day that many state insurance departments are closed.

The memo regarding assumptions in the RMBS modeling to be performed by PIMCO is missing a critical piece of information – any description of the assumptions to be used PIMCO. The rush to change accounting, reserving and risk-based capital rules to relieve insurer of holding capital and reserves for consumer protection has morphed into a slapstick routine that would make the Three Stooges envious.

This week’s economic reports show new record highs in mortgage delinquency and foreclosure and in unemployment rates. The Mortgage Bankers Association reports 1 in 7 mortgages delinquent or in foreclosure. The national unemployment rate has crested 10% and 15 states now have unemployment rates over 10%. As state regulators fall over themselves with capital relief for insurers, regulators give consumers a poke in the eye by saying that regulators need a third year to study the impact of the subprime crisis and recession on insurance scoring for personal lines insurance.

The memo describes yet another non-public meeting among regulators in which regulators, PIMCO and unnamed consultants heard about the PIMCO model and its assumptions. The memo describes the mechanics of the PIMCO exercise, but fails to describe any of the key economic assumptions going into any of the models. There is nothing in the memo about assumptions or output for future interest rates, future unemployment rates, home price values, loan principal versus home value, the impact of foreclosure prevention and loan modification programs, the level of geographic detail in economic analysis (county, state, nation), how various economic conditions translate into mortgage delinquencies or default and many others.

For all their weaknesses, the rating methodologies of the credit rating agencies are explicit and transparent. In contrast, the NAIC has now turned to a black box methodology with a host of proprietary technologies for purposes of solvency regulation.

We ask that the NAIC or PIMCO provide answers to the following questions during the November 30, 2009 call.

1. What conflicts of interest or potential conflicts of interest has PIMCO disclosed in its proposal to the NAIC?
2. What actions has PIMCO taken or will PIMCO take to prevent the conflicts of interest from compromising the valuations? What is the basis for the statement that the SVO has confirmed that PIMCO has appropriate procedures in place to ensure the analysis is free from conflict of interest?
3. Who are the consultants, other than PIMCO, involved in the RMBS project, including consultant involved in the request for proposal, the evaluation of proposals, the award of contract for RMBS valuations and any ongoing assistance in the RBMS valuations?
4. What due diligence has the NAIC performed to identify any conflicts of interest or potential conflicts of interest among the consultants it item 3? What actions have these consultants taken to prevent the conflicts of interest from compromising the valuations of RMBS or the capital requirements of any insurers?
5. What are all the assumptions and inputs into the PIMCO Advisory standard base case scenario?

6. What does “non-agency” refer to in PIMCO’s non-agency mortgage model?
7. What information about the “proprietary non-agency mortgage model” will be withheld from regulators? What information about the model will be withheld from the public?
8. What is the degree of geographic detail in the macroeconomic model? Is the analysis of the macroeconomic model performed at a census tract, ZIP Code, country, metropolitan area, state or national level? Are the outputs from the macroeconomic model at a census tract, ZIP Code, metropolitan area, state or national level? How will local economic conditions – unemployment, wage growth, existing housing supply, existing foreclosures, for example – be incorporated into the macroeconomic model?
9. What are the base case assumptions / outputs for home price appreciation, interest rates, unemployment, wage growth, new delinquencies and new defaults?
10. How will the existence of mortgage modification and foreclosure prevention programs be included in the valuations?
11. What is the source of information on current home price values and current outstanding principal amounts for each loan?
12. What are the actual inputs into the macroeconomic model? What key economic indicators are generated by the model either as an intermediary step or final output?
13. What assumptions are utilized about the likelihood of loan default regarding home price appreciation, interest rates, original loan to value ratio, current loan to value ratio, property type, original FICO and current FICO? How do these assumptions vary by collateral type and product type?
14. What is meant by Peak to Trough HPA? How were the five Peak to Trough HPA values in the memo determined or selected?
15. Why were five HPA scenarios selected – as opposed to a probability-weighted average of all possible scenarios?
16. What are the characteristics – in terms of economic indicators and loan default occurrence of the additional scenarios (HPA paths)? What is the basis for determining the probability of occurrence of each of the five paths?
17. What exactly will the SVO be doing when it runs aggregate quality analytics and bottom-up assessments of randomly sampled CUSIPs?
18. What is included in PIMCO’s internal quality control process?

W:\Dec09\TF\VOS\CenterforEconomicJusticeQ&AConfCall11.30.09.doc



AMERICAN ACADEMY *of* ACTUARIES

November 17, 2009

Mr. Michael Moriarty, Chair
Valuation of Securities Task Force
National Association of Insurance Commissioners

Mr. Lou Felice, Chair
Capital Adequacy Task Force
National Association of Insurance Commissioners

Dear Michael and Lou,

The American Academy of Actuaries¹ Invested Asset Working Group (IAWG) offers the following comment on the American Council of Life Insurance (ACLI) Residential Mortgage Backed Securities (RMBS) proposal, passed by the NAIC Executive Committee/Plenary in October.

The IAWG supports a change to the framework for establishing capital requirements for RMBS securities based on both the probability and severity of loss. However, we feel there are several outstanding issues that have not been included in the ACLI's September 10, 2009, letter with the revised proposal to modify the risk-based capital for RMBS. In this letter, we have outlined certain issues with the RMBS short-term solution. We request written guidance be released to the public before year-end 2009 to facilitate proper implementation and understanding of the RBC change.

We understand that the RMBS change will be effective for December 31, 2009, risk-based capital (RBC) calculations. Further, the change to classifying RMBS securities is considered a short term solution for 2009 only. The ACLI has outlined an approach to classify RMBS into the NAIC designations; these new designations may yield a significant reduction to minimum capital requirements.

In the following section, we have outlined our concerns.

1. Assumption Set:

Assumptions are obviously a critical component to this effort and will impact the overall result. Who will be responsible for setting assumptions? We recommend the process for establishing assumptions to be transparent, and disclosed to all interested parties.

The short term solution will likely include inconsistent assumptions between the models used to classify securities and the models used to derive the current capital factors. If a long-term solution maintains separate mapping exercises for classification and RBC factor determination, we recommend the use of consistent assumptions between the two models.

2. Classification Mapping:

¹ The American Academy of Actuaries is a 16,000-member professional association whose mission is to serve the public on behalf of the U.S. actuarial profession. The Academy assists public policymakers on all levels by providing leadership, objective expertise, and actuarial advice on risk and financial security issues. The Academy also sets qualification, practice, and professionalism standards for actuaries in the United States.

The ACLI's September 10, 2009, letter does not fully explain the method for aligning each security with the NAIC class. Without complete details, it is not possible to anticipate the impact of or further understand the ACLI's method. We have formulated these comments with a presumption that the classification is based on aligning expected losses with an NAIC class.

There are multiple definitions of expected loss. If expected loss represents a mean level of loss, we have concern with using expected losses in determining capital requirements. In general, the NAIC RBC formula establishes minimum capital requirements to cover losses under extreme or adverse conditions. These capital requirements are established in recognition of reserve levels designed to cover losses under moderately adverse conditions.

Any long term solution must ensure that the capital requirements are set to cover losses under moderately adverse conditions.

3. Implementation Details

- What is the definition of RMBS? What types of securities will be included or excluded from this proposal?
- What date will the securities be valued? What happens to securities that have been purchased after the valuation date, if sooner than 12/31/09?
- When will companies have access to information about securities that were modeled and those securities that were not modeled?
- What is the dispute or appeal process in the event a company disagrees with the results produced by the modeler?
- What data/information will be provided to individual companies for use in their RBC filing?
- The ACLI proposal addresses the Life and P&C RBC filings, but there is no mention of the Health RBC filing. Does the RMBS change apply to health insurers?

Publication of guidance on these concerns, as soon as possible, would help greatly facilitate timely implementation.

To reiterate, we support capital requirements based on the probability and severity of loss. In light of the change in capital requirements for RMBS for 2009, we further support a more methodical and transparent process and evaluation for revising capital requirements for RMBS, as well as other asset types, to be implemented over the long term. Our future efforts will focus on participation in the development of a long-term solution for determining capital requirements for investment risks.

Please contact us with any questions you may have on these comments. We are happy to discuss these issues in further detail with you.

Sincerely,

David Berger, Chair, Invested Asset Work Group
Nancy Bennett, Chair, Life Capital Adequacy Subcommittee

cc: Matti Peltonen, NYID
Chris Evangel, SVO
Richard Newman, NAIC
Dan Swanson, NAIC

W:\Dec09\TF\VOS\RMBSAAACommentLetter11.17.09.doc

Valuation of Securities (E) Task Force
Conference Call
December 2, 2009

The Valuation of Securities (E) Task Force met via conference call Dec. 2, 2009. The following Task Force members participated: James J. Wrynn, Chair, represented by Mike Moriarty (NY); Steve Poizner represented by Tomoko Stock (CA); Kevin M. McCarty represented by Ray Spudeck (FL); Susan E. Voss represented by Allen Harder (IA); Michael T. McRaith represented by Kevin Fry (IL); Sandy Praeger represented by Ken Abitz (KS); James J. Donelon represented by Stewart Guerin (LA); Ralph S. Tyler, III, represented by Alex Hart (MD); Glenn Wilson represented by Constance Peterson (MN); Ann Frohman represented by Bruce Bornman (NE); Kim Holland represented by Frank Stone (OK); Alfred W. Gross represented by Van Tompkins (VA); Mike Kreidler represented by Tim Hayes (WA); and Sean Dilweg (WI). Also participating were: Matti Peltonen (NY); and Peter Medley (WI).

1. NAIC Residential Mortgage-Backed Securities Project

Mr. Moriarty said the purpose of the call was to adopt the proposed assumptions that will be used by the NAIC to model residential mortgage-backed securities (RMBS) for year-end 2009. Two documents were distributed for this call. One is a memorandum (Attachment One) from the chair and the Task Force to industry representatives and interested persons containing the SVO recommendation as to the assumptions that should be used in the modeling effort. The other document is a question-and-answer (Q&A) document (Attachment Two), which responds to the questions raised during the Nov. 30 conference call held by the Task Force. Pursuant to the NAIC Policy Statement on Open Meetings, Mr. Moriarty said the Task Force had met in regulator-to-regulator session to consult with NAIC staff on the assumptions and on the Q&A documents prior to convening this meeting. Mr. Moriarty noted that, in addition to regulators and SVO staff, representatives from Oliver Wyman and PIMCO Advisory were on the call should they be needed to address technical questions or issues.

Mr. Moriarty said that one individual asked what regulators expect interested persons to do with the information that was distributed. Mr. Moriarty said that regulators do not expect anything specific from interested persons. The Q&A document is intended to provide guidance and clarification to the extent that is possible, given project objectives and time frame. He explained that a decision on the assumptions needs to be made today so that the project can proceed.

Eric Kolchinsky (NAIC) summarized the proposed assumptions. Mr. Kolchinsky said that the comments received by the SVO did not suggest a need to modify the original proposal. The proposal is to use the medium-base case scenario with four additional home price appreciation (HPA) paths: two aggressive and two conservative. This will measure credit convexity or “cuspidity” of the bonds. Each scenario will be assigned a probability, with the two outward probabilities assigned a 2.5% probability, the medium a 50% probability and the conservative scenarios a 22.5% probability. The valuation will be the probability weighted average of all five scenarios, and the discount will be the effective coupon at that time.

Mr. Kolchinsky said the questions were divided into four general categories: 1) fundamental questions about the methodology and approach; 2) more detailed questions on technical issues, such as dates; 3) questions about conflicts of interest; and 4) data requests. Mr. Kolchinsky said that many of the questions ask if the SVO was ignoring the unemployment rate or asked whether, given that HPA is the main variable, the focus of the model was primarily on strategic defaults. Mr. Kolchinsky explained that kind of question — i.e., what variables are to be used and what it means to use a certain variable in a financial model — goes to the use of financial models in general. Financial models are statistical in nature and the calibration of financial models is statistical in nature. In statistics, two variables can be found to be statistically related without implying any sort of causality. For example, if you took a survey of children and found those with coughs and those with fevers, you would find a great statistical relationship between children with coughs and children with fevers — but that does not imply that a fever causes a cough or that a cough causes a fever. We know that both of those are simultaneously caused by a third factor we call “illness.” By the same token, he said, in a financial model, sometimes the best variable to use as an input variable to describe some of the desired output variables might be caused by another, third, unexplained variable and, in this case, the input variable is HPA. What regulators are saying by using HPA is not that HPA caused mortgage defaults or vice versa. What regulators are saying is that HPA is the most robust variable that can be used to explain default. Mr. Kolchinsky then reviewed each of the questions and provided the associated response.

Mr. Moriarty asked for a motion to adopt the assumptions as recommended by the SVO and as set forth in the Dec. 2 memorandum and to authorize the SVO to release on its Web site the final assumptions and the Q&A document. Commissioner Dilweg moved and Ms Peterson seconded the motion.

Mr. Moriarty asked how the model used by PIMCO Advisory relates to broader discussions about losses in market indicators or market prices. Mr. Kolchinsky said that market prices are severely dislodged because of the absence of liquidity in the markets. The fundamental value of assets, and especially of structured assets compared to market prices, has become a function of available liquidity in the markets and available leverage. Mr. Kolchinsky explained that, in looking at market prices over the past year, there would be a “U shape” form, where the bottom of the U shape occurs in March as the Federal Reserve provided liquidity to the markets through the Term Asset Loan Facility (TALF) program. Most market prices are a function of credit, he said, but a significant function of the current lack of liquidity is the lack of leverage for investors in buying bank-owned properties. This is why the regulators’ objective has been to create a valuation methodology that provided a “bottoms up” fundamental review of how these mortgages will perform, instead of basing it on market prices.

Ed Stephenson (Barnert Associates, representing Jackson National Life) asked that the industry be given a sample of the model output, perhaps limited to 50 CUSIPs, that would permit the industry to compare the output with internal models. Companies have to make decisions with regard to their capital positions at year-end. The sample would also provide the basis for questions for PIMCO Advisory and the SVO regarding discrepancies. The sample should be provided with PIMCO Advisory’s own validation process, so PIMCO Advisory can make adjustments to the model based on industry concerns. Mr. Moriarty asked what would it mean if a sample was provided and it was not comparable to an internal model. Ratings are not comparable to what comes out of the internal model, especially given that there would be no appeal process. Clearly the model is proprietary, Mr. Moriarty said, and some of it is a “black box” — but he said he has to believe that some of the larger institutions have a fairly good sense of the modeling process and can estimate where the securities are going to come out. Mr. Moriarty emphasized that, while both the rating agencies and the SVO publish methodologies, it would be strange to say that, armed with these methodologies, an outside insurance company could predict where a particular security would be rated.

Rick Smith (Nationwide Insurance) said that a sample would help insurers calibrate the statutory information to GAAP conclusions.

Carrie Cazolas (Allstate) asked what methodology would be used to determine the benefit given to monoline insurers. Mr. Kolchinsky said the SVO would use the monoline’s credit default swaps to determine their ability to pay. Typically, he said, you run a model assuming no support and then go back and see what is the probability of having support for the given tranche.

Mr. Moriarty said there was a motion on the table to ask for a vote to adopt the assumptions as recommended in the Dec. 2 memorandum and to instruct the SVO to place the Q&A and the final list of assumptions on the Web site. The motion passed.

Having no further business, the Valuation of Securities (E) Task Force adjourned.

W:\Dec09\TF\VOS\VOSTFConfCall12.02.09.doc

**Valuation of Securities (E) Task Force
Final Assumptions for Financial Model to be Used to Determine Risk Based Capital for Insurer Owned RMBS
Adopted on December 2, 2009**

To: Industry Representatives and Interested Persons
From: Mike Moriarty (NY), Chair of the Valuation of Securities (E) Task Force
Members of the Valuation of Securities Task Force
Re: Proposed Assumptions for use in RMBS assessment for the reporting year ending December 31, 2009
Date: December 2, 2009

1. Statement – After considering the comments and questions from interested persons received during the conference call held November 30, 2009, the recommendation of the SVO is that the Task Force adopt the assumptions originally presented in the November 24th memorandum and discussed on the November 30, 2009 conference call. **The SVO recommendation will be discussed on today’s conference call.**

- 2. Proposed Assumptions** - The assumptions are reproduced below for your convenience.
- a. The median HPA scenario will be PIMCO Advisory’s standard base case scenario.
 - b. PIMCO Advisory will use its internal model to calculate four additional HPA paths (two more conservative and two more aggressive). The running of the additional paths is necessary to capture the credit convexity or “cuspidity” of the bonds.
 - c. The additional HPA paths will be constructed such that the median case scenario has a 50% probability of occurring, the aggressive and the conservative scenarios each have a 22.5% probability of occurring and the most aggressive and most conservative have a 2.5% chance.
 - d. The final valuation will be the probability weighted average of the present values of all losses under each HPA scenario.
 - e. All losses will be discounted at the bond’s effective coupon rate.

The following table summarizes the relevant probability weights for the HPA scenarios:

Scenario	Probability	Peak to Trough HPA
Most Aggressive	2.5%	-33%
Aggressive	22.5%	-35%
Base Case	50.0%	-38%
Conservative	22.5%	-41%
Most Conservative	2.5%	-61%

W:\Dec09\TF\VOS\AssumptionsforRMBSYearEndReporting12.02.09.doc

Responses to Questions and Comments

The following responds to the comment letters received from interested persons as well as the questions and comments received on the November 30th open call. A separate document will be posted on the NAIC website to cover detailed instructions for implementing the new methodology, the timing of delivery of results and the treatment of securities which cannot be modeled.

a) Fundamental assumptions and methodology questions

a.1. Are you ignoring the unemployment rate in your mortgage model? Does the use of HPA as your primary variable imply that you only concerned about “strategic defaults”?

The model does not ignore unemployment as a driver or consider only 'strategic defaults'. HPA is a metric for statistical analysis that corresponds to an outlook on the economy and comprises of a variety of other variables including unemployment, GDP growth, CPI, etc. Therefore, the use of HPA as the primary independent variable by PIMCO Advisory does not mean that the assumption is that HPA causes or is the primary driver of mortgage defaults. Rather, both HPA and defaults are closely related to other macroeconomic conditions including unemployment. However, future HPA is used because statistically it is a single variable which helps to explain the number of future defaults.

From a statistical standpoint, it is important to recognize that a strong relationship does not necessarily imply causation since related effects may both be caused by other untested variables.

Practically, future HPA has the benefit of being a widely accepted and commonly projected variable. Furthermore, economists feel comfortable enough to project future HPA on an MSA and county level which allows a more granular approach to modeling.

a.2. Please provide more information on the median-case scenario.

The national median-case scenario represents the base-case outlook on the economy, as provided by a market-standard 3rd party forecast. This scenario includes factors such as GDP, unemployment, inflation, and household income as well as HPA. As discussed above, the HPA assumption can be treated as a proxy for the broader economic conditions, with all other macroeconomic factors implicit in the HPA assumption.

Further details on the static variables included in the median-case economic projection are included below:

Factor	Forecast		
	2010	2011	2012
Unemployment	10.6%	9.6%	7.4%
GDP growth	2.2%	5.0%	4.9%
CPI growth	1.4%	2.0%	2.0%

a.3. Please provide more information on the timing of the home price “troughs” for the five HPA scenarios.

Timing of trough and shape of recovery varies by scenario. The baseline and two aggressive scenarios are in line with the market expectations of a trough in the middle of 2010 with a recovery following thereafter. The conservative scenario assumes an additional year of house price decline with a slower recovery. The most conservative scenario assumes a very long period of continued decline through the next decade. Further information on the projected HPA troughs is included below:

HPA scenario parameters

Scenario	Probability	Timing of Trough	Peak to Trough HPA
Most Aggressive	2.5%	Q2 2010	-33%
Aggressive	22.5%	Q2 2010	-35%
Median Case	50.0%	Q2 2010	-38%
Conservative	22.5%	Q2 2011	-41%
Most Conservative	2.5%	Q2 2020	-61%

a.4. What level of conservatism is embedded in the analysis?

Instead of focusing on creating scenarios which are explicitly conservative or aggressive, the NAIC has sought to create robust valuations. They accomplished this via several methods including using a well respected market standard HPA projection as the base case scenario and having 5 scenarios to capture the convexity of “cuspy” bonds

a.5. What geographic granularity is used for HPA data assumptions?

HPA is applied at the lowest granularity possible given data and projection availability. Where possible, this means that historical HPA is applied at the ZIP Code-level, and projected HPA is applied at the County-level. However, in some cases complete addresses are not available for each loan, or the loan maps to a county for which projections are not available. In these cases the loan is mapped to the lowest-level data or projection possible, according to the following hierarchy:

- ZIP Code
- County
- MSA
- State
- Census Division
- U.S.

a.6. What sub-models are used for different collateral and mortgage types?

Key drivers for difference in performance of loans are included in the model as segmentation factors and sub-models or as parameters within the model. The sub-models are split by collateral type, mortgage type, and loan age while drivers such as FICO, mark-to-market LTV, documentation level, and previous delinquency are included as parameters. Loss expectations account for difference in performance driven by each of the factors above.

Collateral type	Mortgage type
Prime-Jumbo	<ul style="list-style-type: none"> ▪ Fixed-rate ▪ Adjustable-rate
Subprime	<ul style="list-style-type: none"> ▪ Fixed-rate ▪ Adjustable-rate
Alt-A	<ul style="list-style-type: none"> ▪ Fixed-rate ▪ Adjustable-rate
Payment-Option ARM	<ul style="list-style-type: none"> ▪ Adjustable-rate
Second Lien	<ul style="list-style-type: none"> ▪ Fixed-rate ▪ Adjustable-rate

a.7. How do market prices factor into the valuation analysis?

The quantitative valuation methodology used in the modeling process does not include market prices of RMBS securities at any point, and the model is not considered to be a “market implied” model. Specifically, the methodology is based on a fundamental analysis of expected losses, and does not include factors implicit in market prices such as liquidity premium. However, please note that while the model estimates are independent of market prices, market prices are one of several tools used in the quality assurance review.

b) Technical questions

b.1. What are the “as of dates” for modeling data and assumptions?

Dates for assumptions and data sets are as follows:

- Collateral remittance reports: October 2009
- Median case HPA projection: November 2009
- Interest rate curves: November 20th, 2009

b.2. Are loan modifications taken into account in the Mortgage Credit Model?

Loan modifications are indirectly taken into account in the calibration of the Mortgage Credit Model, and impacts both default rates and severity rates. For example, if a delinquent loan cures due to a loan modification, we will capture this in our loan level model through a higher default probability relative to a loan that has never been delinquent. Also, we may show impact via loss severities to the extent a failed modification results in longer timeframe until the property can be foreclosed and any value recovered. Also, with the HAMP loan modification moratorium, there is backlog of delinquencies. Our model effectively purges the delinquencies, resulting in a default spike.

We also recognize that loan modifications have several offsetting impacts that may negate each other. Very high redefault rates, big fallout from trial mods and big coupon reductions may offset lower redefault for successful mods. This lead us to the conclusion that the inclusion of a more direct loan modification adjustment to the model was not justified.

b.3. How are monoline insurance “wraps” taken into account?

Securities with wraps are first modeled assuming no wrap support. Expected losses are then modified according to the monoline insurer’s perceived ability to pay. Ability to pay is derived from CDS spreads. CDS spreads are adjusted to allow for other risk premia that are not related to ability to pay, e.g., liquidity risk premia.

b.4. Are ARM re-sets and other loan-specific features taken into account?

Yes. Each loan is modeled individually based on its characteristics and features. If loans have significant near-term interest rate step-ups or other changes in loan characteristics, these changes will be reflected in projected prepayment, delinquency and default rates.

b.5. How are discount rates calculated for ARMs

Losses for all securities will be discounted using the effective coupon rate for that security. For ARMs, this is equal to the forward curve for the appropriate index (e.g. LIBOR) plus the stated margin. Interest rate indices are projected based on implied money market and mortgage interest rates.

b.6. Are the disclosed HPA scenario parameters comparable to a publicly available index?

The disclosed parameters for the HPA scenarios (e.g. peak-to-trough HPA) are in reference to the Case Shiller Home Price Index.

c) Clarifications on conflicts of interest

c.1. What potential conflicts of interest were disclosed by PIMCO? How are these potential conflicts being mitigated?

Management of potential conflicts of interest was a key consideration of the NAIC in the vendor selection process. PIMCO Advisory is a distinct group within Pacific Investment Management Company, and was established specifically to manage these types of assignments. PIMCO Advisory will classify as restricted persons those employees assigned to provide services to the NAIC (or otherwise provided with confidential information). Restricted persons, when required due to the nature of their services, will work in a physical location that is in a separate building from general portfolio management. Due to the sensitive nature of the information obtained as a result of the engagement with the NAIC and the potential for conflicts of interest, all involved personnel will be prohibited from trading U.S. non-agency residential mortgage-backed securities and the securities of U.S. Life or Property & Casualty companies regulated by the NAIC.

The staff working on this project have only been provided with the comprehensive list of individual CUSIPS to be analyzed; they have not been provided with specific insurer holdings details. Within PIMCO, no confidential NAIC information would be shared outside of restricted persons. The information barriers in place at PIMCO Advisory are subject to periodic review by its compliance department to monitor compliance with, and effectiveness of, information barriers to maintain confidentiality and mitigate potential conflicts of interest.

Potential issues with conflict of interest were carefully and satisfactorily addressed as part of the selection and contracting processes and appropriate conflicts management procedures will be included in the contract that is currently being finalized. We are comfortable that very restrictive physical, ethical and contractual barriers are in place.

d) Data requests

A number of data requests were made for further analysis, including:

1. Detailed results for a sample of 500 CUSIPs
2. The number of homes which are projected to default under the median-case scenario
3. HPA in the five best and five worst MSAs under each of the HPA scenarios

Due to the strenuous timeframes for completing the analysis and the proprietary nature of PIMCO Advisory's models, we will not be able to meet these requests. SVO will be conducting detailed validation of the results and results will be reviewed with the regulators.

W:\Dec09\TF\VOS\Q&AfromRMBSYearEndReporting.doc

To: Industry and Interested Persons
From: Mike Moriarty, Chair of the Valuation of Securities (E) Task Force
Members of the Valuation of Securities Task Force
Re: References to the Purposes and Procedures Manual in SSAP No 43
Date: November 18, 2009

- 1. Revised Statutory Accounting Guidance for RMBS** - The Statutory Accounting Principles (E) Working Group recently released a revision to Statement of Statutory Accounting Principle (SSAP) No. 43R for a comment period ending Thursday, November 19, 2009. The revisions to SSAP No. 43R relate to an NAIC regulatory decision initiated by the Valuation of Securities (E) Task Force that for year end 2009 reporting purposes, risk based capital (RBC) for residential mortgage backed securities (RMBS)¹ would be determined using a financial model instead of NAIC ARO credit ratings.
- 2. The Financial Model Output** - The financial model will calculate 10 prices for every RMBS (5 for Life and 5 for P&C/Health, reflecting the difference in RBC). Each price represents the point at which the expected loss for any given RMBS equals the midpoint between the RBC charges for each NAIC designation; i.e., each price point, if exceeded by the insurer's carrying value, changes the NAIC designation. An insurance company will compare its carrying value for an RMBS to the list of price points to obtain the appropriate NAIC Designation for the RMBS. The procedure is fully discussed below.
- 3. Statutory Guidance Refers to the P&P Manual** - Paragraph 26 of the exposure draft refers insurance companies to the *Purposes & Procedures Manual of the NAIC Securities Valuation Office* (the "P&P Manual") as the source for the method to be used to determine an NAIC Designation for loan-backed securities for 2009 year end reporting.
- 4. Clarification** - For purposes of reporting loan backed securities other than RMBS references in SSAP No. 43R to the P&P Manual is to the filing exemption discussed in Part Four, Section 2 (d). Loan-backed securities *other than RMBS* are not affected by the NAIC decision to determine RBC for RMBS using a financial model instead of NAIC ARO ratings. For purposes of reporting RMBS, references in SSAP No. 43R to the P&P Manual is to Part Two, Section 3 (e), i.e., the NAIC procedure for placing a security or asset class under regulatory review. Because the regulatory review process contemplates the need to develop new regulatory policy or new methodology to drive regulatory objectives it envisions that the NAIC would provide interim reporting instructions to insurance companies. The applicable interim instructions for year end reporting of RMBS are attached to this Statement and have also been posted to the NAIC website. All insurers that maintain non-agency, private label RMBS must comply with the interim instructions for the 2009 statutory annual statement filing.

W:\Dec09\TF\VOS\TaskForceStatementonPPSSAP43 11.18.09.doc

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, home equity lines of credit and loans against manufactured or mobile homes. 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.

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.

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.

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, home equity lines of credit and loans against manufactured or mobile homes. 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.

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 depends on the insurer’s carrying value of each RMBS, whether that carrying value, in accordance with SSAP 43R paragraphs 25-26 is the amortized cost or fair value, and where the carrying value matches the price ranges provided in the model output for each NAIC designation.

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

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.

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-REMIC) 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

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)

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 part value), and the Price Table, what the Initial Designation is at Amortized Cost. 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 is less than the Maximum Price for such category. For the example security, a Life company that has an Amortized Cost 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:

- i. 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;

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.

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
55265KWV7	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
55265KWV7	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 55265KWV7, 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.

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 Identificati on	6 NAIC Designation	Fair Value		10 Par Value	11 Book / Adjuste d Carryin g Value
		8 Rate Used To Obtain Fair Value	9 Fair Value		
55265KW V7	1Z*	27.32	27,320	100,000	27,320
12669GL3 3	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 Identificati on	6 NAIC Designation	Fair Value		10 Par Value	11 Book / Adjuste d Carryin g Value
		8 Rate Used To Obtain Fair Value	9 Fair Value		
65535YAA 0	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.

W:\Dec09\TF\VOS\ReportingInstructionsonYearEnding12.31.09.doc

To: Michael Moriarty, Chair of the Valuation of Securities (E) Task Force
Members of the Valuation of Securities (E) Task Force
From: Kevin Fry, Chair of the Invested Asset (E) Working Group
Matti Peltonen, Vice Chair of the Invested Asset (E) Working Group
Bob Carcano, Senior Counsel, SVO
Re: Proposal to Redefine the Mission and Role of the Invested Asset (E) Working Group
Date: September 1, 2009

1. Introduction - The Invested Asset (E) Working Group (“IAWG” or “Working Group”) was re-created in 2006¹ to serve as a forum for regulators to address new investment structures and to propose regulatory rules to address them. The IAWG functions as a contact point into the regulatory process for insurance companies and members of the investment advisory community. As we approach the completion of our current charge we are concerned that the operating pattern of the IAWG is inappropriate to its role and function. The IAWG was conceived as an ad hoc group, operating only when convened by the Task Force to respond to a specific assignment and disbanding immediately thereafter.² This memorandum proposes an alternative organizational pattern and charge for the IAWG and explains our reasoning.

2. Background – Immediately after its formation, the IAWG was assigned to review Constant Proportion Debt Obligations. This assignment convinced the Working Group that if the NAIC was to attain its transparency objective, the IAWG would have to be able to provide comprehensive, one-stop regulatory guidance in as timely a manner as the complexity of the new instrument permitted. As a result, we requested an expanded charge to consider improvements to the process by which risks in investments are evaluated, regulatory rules are made and guidance is communicated to insurance companies, market participants and the regulatory community.³ We recognized and articulated that:

- Improving transparency would require insurance companies, their trade representatives, investment advisors and market participants to identify new securities and to work with regulators to highlight actual and potential risks and translate analytical insights into appropriate regulatory rules. Our first priority therefore was to facilitate this interaction by developing the specific procedures that would apply in a technical review of a new security.⁴
- The expression of regulatory concerns about risks in securities that have already been purchased by insurance companies runs a great risk of creating market turmoil. Accordingly, we have focused considerable attention on identifying the kinds of investment risks (other than credit) that are associated with fixed-income securities in order to create a more comprehensive regulatory framework. We are now evaluating the best ways to regulate those risks. The investment risk framework we are developing provides the primary background against which regulators will develop rules for investments.
- A risk focused approach to regulation requires regulators to understand investment risks and that they and the SVO as their primary advisor have the tools and systems necessary to conduct thorough financial solvency monitoring. Accordingly, we have worked with NAIC staff to identify where changes are necessary to investment schedules and reporting instructions, create a dynamic electronic system to identify risk attributes of securities owned by insurers, identify analytical tools and concepts for development that will assist regulators understand investment issues and expand SVO capabilities.

¹ The Invested Asset (E) Working Group was re-formed as part of NAIC transparency initiative, whose components are identified below:

- The SVO should report all of its determinations involving publicly traded securities on the SVO Web site;
- Broker-dealers could have direct access to the SVO to obtain SVO opinions before bringing new securities to the market;
- The SVO would explain its determinations as required through research articles;
- Clarifying amendments could be made to portions of the *Purposes and Procedures Manual*; and
- The Invested Asset Working Group should be reestablished and tasked with reviewing new investment vehicles as and when so directed by the Valuation of Securities (E) Task Force.

² *Invested Asset (E) Working Group – Charge adopted December 10, 2006*. From time to time, the Valuation of Securities (E) Task Force may determine that the technical nature of some matter before it would be best advanced by convening the Invested Asset Working Group and transferring to it a specific regulatory assignment or assignments. The assignment or assignments thus transferred to the Invested Asset Working Group by the Valuation of Securities Task Force shall be within that charge of the Task Force related to development of a regulatory framework for new or evolving investments or the consideration of refinements for an existing regulatory framework applicable to an existing class of securities. The phrase regulatory framework refers collectively to and means the following regulatory mechanisms or processes: statutory accounting guidance, annual statement instructions, blanks reporting instructions, asset valuation reserves, interest maintenance reserves, risk based capital charges, valuation procedures for invested assets, credit assessment procedures for invested assets or any other aspect of the NAIC financial solvency framework within the scope of the charge of the Task Force. The Invested Asset Working Group is charged with the review of matters in the priority established by the Task Force.

³ The Invested Asset Working Group is charged with considering improvements to the process by which risks in new invested assets are evaluated, communicated and monitored, and how the annual statement investment schedules could be made more transparent to better reflect non-credit risks, such as various structural risks embedded in new and existing securities. (*Charge adopted June 3, 2007*.)

⁴ The role of the IAWG and the process for reviewing securities is explained at http://www.naic.org/committees_e_vos_iawg.htm

If the IAWG is disbanded after completing its current charge, the infrastructure we have just described would quickly erode. Our opinion is that the function of the IAWG should be to proactively manage the NAIC transparency objective and the infrastructure described above. The members of the IAWG, supported by the SVO, must develop the background, knowledge, expertise, legitimacy and infrastructure necessary to quickly and efficiently represent the NAIC regulatory community in discussions on investment risk issues with investment professionals representing the insurance industry and other capital market participants. This can only happen if the IAWG evolves into the regulatory partner of the SVO. The IAWG should:

- Ensure that its members develop and maintain expertise about investment risks in general and SVO operations in particular;
- Serve the SVO as a base of knowledge about regulatory practices and procedures;
- Provide the SVO with direction and guidance to assist the SVO identify those market signals and information that have immediate regulatory significance;
- Be the chief representative of the regulatory community to the SVO analytical staff;
- Assist the SVO to identify regulatory needs;
- Ensure proper dissemination of investment know-how to the regulatory community;
- Provide guidance in the completion and implementation of system projects commenced during its current charge;⁵ and
- Have a role in identifying technology platform characteristics that would most effectively assist the regulatory mission and assist the management and evolution of these systems.

We believe the recommended charge (Attachment One) would accomplish the objectives identified.

Attachment One
Proposed 2010 Charge for the Invested Asset (E) Working Group

The Invested Asset (E) Working Group (IAWG) is established as a standing NAIC Working Group. The mission of the IAWG is to provide continuity in and manage NAIC processes related to the development of regulatory rules to address new investment structures. The IAWG shall fulfill this charge by:

- Serving as the primary NAIC contact point into the regulatory process for insurance companies, their investment advisors and other market participants;
- Creating and maintaining a framework and the necessary procedures and processes to conduct technical assessments of investment risks in investment products eligible for purchase by insurance companies;

⁵ A summary of these projects and the issues they present for regulators and the staff is set forth below:

- A) Database Symmetry
 - i. Development of risk attribute granularity and implication for the Investment Schedule project
 - ii. Other than credit risks that can be monitored by this process
- B) Enhanced SVO Monitoring Process and Role
 - i. Priority Coding
 - ii. Pricing Information
 - iii. Greater Reporting on Exposures
- 3) Implementation of Phases 1, 2 and 3 of the Investment Schedule Project.

- Developing and maintaining knowledge and expertise about investment risks and issues as well as SVO operations and capabilities;
- Guiding the development of the technology platform of the SVO to ensure the development, implementation and evolution of systems and tools that adequately support NAIC financial solvency objectives;
- Serving as the primary NAIC regulatory resource to alert the NAIC regulatory community of the identification of regulatory issues and concerns in specific investments or in investments generally;
- Ensuring that the process by which risks in invested assets are evaluated, communicated and monitored is updated as necessary to permit a timely and comprehensive response to requests for regulatory guidance;
- Ensuring that the NAIC framework for investment risks in all annual statement investment schedules and reporting instructions capture relevant information of investment risks in insurer owned securities; and
- Performing or conducting such other ancillary or related activity that are consistent with its mission and charge.

In its fulfillment of this charge, the IAWG shall meet with the SVO on a regular basis. in sessions which are either open or closed to the public, in accordance with, and within the parameters of, the requirements of the NAIC Open Meetings Policy. During these sessions the IAWG shall consult on:

- SVO operations;
- Risks in investment or investment trends identified by the SVO;
- Regulatory practices and regulatory sensitivities that should serve as inputs in the conduct of SVO analytical responsibilities; and
- Market signals and information that warrant scrutiny for possible regulatory relevance.

W:\Dec09\TF\VOS\RedefineMission&RoleofIAWG09.01.09.doc

To: Matti Peltonen, Chair of Valuation of Securities (E) Task Force
From: North American Securities Valuation Association (NASVA)
Date: October 20, 2009

As we discussed during the July Interim NASVA meeting in New York, there appears to be a disconnect between the 6* language in Part 4, Section 3 (g) and Part 6 – Valuation of Unaffiliated Investments. The current 6* language in Part 4 requires insurance companies to file a Principal & Interest Certification for a security with the Securities Valuation Office if they intend to carry it on the annual statement with a value greater zero. Part 6 grants insurance companies (in Sec 2(b) the right to use their GAAP price sources or the SVO prices for all securities in their portfolio, regardless of designation. We feel that there is no longer a need for the SVO to continue to assign a price to 6* securities.

The 5*/6* policy was designed to encourage insurance companies' compliance with the requirements outlined in the P&P for filing with the SVO in a timely manner. By requiring companies to carry a 6* on their annual statement, the cost for non-compliance is the highest RBC Charge. The possibility of a lower RBC charge is the strongest motivator for an insurance company during these times of economic uncertainty. Higher RBC charges, as an enterprise overall, put pressure on an insurance company's ability to raise capital and general business. One of the criteria uses to determine an NRSRO's financial strength rating of an insurance company is the risk based capital charges.

The purpose of the 2008 changes to Part 6 was to improve accuracy, to reflect market practices in the pricing process, and to eliminate any discrepancies between a company's statutory and GAAP prices. Pricing a 6* at zero is not a true representation of the fair value of security. The 6* is merely an administrative symbol to indicate that full documentation was not available for the SVO to do a complete review of the security. We propose that insurance companies no longer be required to file a 6* to get a price of greater than zero. Companies should be allowed to use their own GAAP sources as the price would be more indicative of the true inherent value of the security.

Accordingly, here are our proposed amendments to the *Purposes and Procedures Manual* to codify this change:

Current Language

(f) Use of NAIC 6* Designation

An insurer may assign an NAIC 6* Designation to corporate and municipal securities and to structured securities that have never been rated by an NAIC ARO.

The insurer shall assign an NAIC 6* Designation to a security when:

- (i) The documentation necessary to permit a full credit analysis of a security does not exist;
- (ii) The insurer cannot certify that the issuer or obligor is current on all required interest and principal payments; and
- (iii) The insurer cannot certify that it expects ultimate payment of all interest and principal.

The SVO may assign a security an NAIC 6* Designation when the security was assigned an NAIC 5* Designation in a previous year but no Subsequent Report has been received by the SVO.

(g) Unit Price of NAIC 6* Securities

An insurer that intends to report a security on its annual or quarterly financial statement (NAIC Financial Statement Blank) with an NAIC 6* Designation and a Unit Price not greater than zero is not obligated to file a Principal and Interest Certification Form for the security with the SVO. An insurer that intends to report a security on its annual or quarterly financial statement (NAIC Financial Statement Blank) with an NAIC 6* Designation and a Unit Price greater than zero shall file a Principal and Interest Certification Form for the security with the SVO.

Proposed Language

(f) Use of NAIC 6* Designation

An insurer may assign an **NAIC 6*** Designation to corporate and municipal securities and to structured securities that have never been rated by an NAIC ARO.

The insurer shall assign an **NAIC 6*** Designation to a security when:

- (i) The documentation necessary to permit a full credit analysis of a security does not exist;
- (ii) The insurer cannot certify that the issuer or obligor is current on all required interest and principal payments; and
- (iii) The insurer cannot certify that it expects ultimate payment of all interest and principal.

The SVO may assign a security an **NAIC 6*** Designation when the security was assigned an **NAIC 5*** Designation in a previous year but no Subsequent Report has been received by the SVO.

(f) Unit Price of NAIC 6* Securities

For determining the fair value, the insurer should refer to Part 6 for instructions.

W:\Dec09\TF\VOS\NASVA6StarLetter10.20.09.doc



To: Valuation of Securities (E) Task Force
Superintendent James J. Wrynn (NY), Chair

From: Statutory Accounting Principles Working Group
Joe Fritsch (NY), Chair

Date: October 1, 2009

RE: Referral – Information on Valuation Technique Utilized

During the Fall National Meeting, the Statutory Accounting Principles Working Group adopted *Issue Paper No. 138, Fair Value Measurements* (Issue Paper No. 138) and directed staff to draft and expose a new SSAP on fair value. Issue Paper No. 138 adopts with modification *FAS 157, Fair Value Measurements* (FAS 157) and defines fair value, establishes a framework for measuring fair value, and establishes disclosure requirements about fair value.

Pursuant to the guidance within FAS 157, and adopted within Issue Paper No. 138, fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Although the objective of this fair value definition (exit price) remains the same, different techniques can be utilized to determine fair value. Pursuant to the guidance, entities must classify fair value measurements into one of three broad hierarchy levels. The fair value hierarchy prioritizes the inputs to valuation techniques used to measure fair value and gives the highest priority to quoted prices in active markets and the lowest priority to unobservable inputs. The following provides a summary of the fair value hierarchy levels:

- Level 1 – Quoted prices (unadjusted) in active markets for identical assets and liabilities that the entity has the ability to access at the measurement date.
- Level 2 – Inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly.
- Level 3 – Unobservable inputs for the asset or liability. Unobservable inputs shall be used to measure fair value to the extent that relevant observable inputs are not available, thereby allowing for situations in which there is little, if any, market activity, for the asset or liability at the measurement date. (As noted, the fair value objective remains the same, thus unobservable inputs shall reflect the entity’s own assumptions about the assumptions that market participants would use in pricing the asset or liability—including assumptions about risk.)

In 2009, the Financial Accounting Standards Board (FASB) adopted modifications to FAS 157 in the form of *FSP FAS 157-4, Determining the Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly* (FSP FAS 157-4). The Working Group also adopted this guidance within Issue Paper No. 138. This guidance addressed questions on the use of pricing services or brokers in determining fair value:

When estimating fair value, this issue paper does not preclude the use of quoted prices provided by third parties, such as pricing services or brokers, when the reporting entity has determined that the quoted prices provided by those parties are determined in accordance with this issue paper. However, when there has been a significant decrease in the volume or level of activity for the asset or liability, the reporting entity should evaluate whether those quoted prices are based on current information that reflects orderly transactions or a valuation technique that reflects market participant assumptions (including assumptions about risks). In weighting a quoted price as an input to a fair value measurement, the reporting entity should place less weight (when compared with other indications of fair value that are based on transactions)

EXECUTIVE OFFICE	444 N. Capitol Street, NW, Suite 701	Washington, DC 20001-1509	p 202 471 3990	f 816 460 7493
CENTRAL OFFICE	2301 McGee Street, Suite 800	Kansas City, MO 64108-2662	p 816 842 3600	f 816 783 8175
SECURITIES VALUATION OFFICE	48 Wall Street, 6th Floor	New York, NY 10005-2906	p 212 398 9000	f 212 382 4207

on quotes that do not reflect the result of transactions. Furthermore, the nature of the quote (for example, whether the quote is an indicative price or a binding offer) should be considered when weighting the available evidence, with more weight given to quotes based on binding offers.

When discussing the fair value guidance within Issue Paper No. 138, it was identified that the information provided within the current NAIC Securities Valuation Office (SVO) product may not provide the detail necessary for entities to determine whether the pricing information (“fair value”) has been determined in accordance with the parameters of Issue Paper No. 138. Although recent SVO revisions allow entities to utilize various sources for determining fair value, it was noted that entities that continue to utilize the NAIC SVO product might not have the means to properly classify valuations within the fair value hierarchy, or assert that the information received has been determined in accordance with Issue Paper No. 138.

Please accept this memorandum as notification from the Statutory Accounting Principles (E) Working Group on anticipated changes to fair value measurements and classifications, as well as to advise of the need to incorporate information on the valuation techniques utilized when the NAIC SVO provides pricing information.

(Although issue papers adopted by the Statutory Accounting Principles (E) Working Group are not considered authoritative statutory accounting guidance, during the Fall National Meeting the Working Group directed staff to proceed with drafting and exposing a new SSAP on fair value measurements, reflecting the guidance adopted within Issue Paper No. 138. It is expected that this SSAP will be discussed and potentially adopted during the Winter National Meeting. The effective date of this new SSAP is currently proposed for 2010 annual financial statements, with interim and annual financial statement reporting thereafter. Allowance for early adoption within 2009 annual financial statements is also provided within the proposed SSAP.)

Thank you for your consideration of this memorandum. Any of the Statutory Accounting Principles (E) Working Group staff can provide assistance as needed.

cc: Matti Peltonen; Mike Moriarty; Chris Evangel; Richard Newman; Julie Gann; John Tittle; Robin Marcotte

W:\Dec09\TF\VOS\ValuationTechniqueUtilized10.01.09.doc