Statutory Issue Paper No. 26

Amortized Cost

7. Amortization of bond premium or discount shall be calculated using the scientific (constant yield) interest method taking into consideration specified interest and principal provisions over the life of the bond. Bonds containing call provisions (where the issuer can be called away from the reporting entity at the issuer's discretion) shall be amortized to the call or maturity value/date which produces the lowest asset value (yield to worst).

Balance Sheet Amount

8. Bonds shall be valued and reported in accordance with the NAIC Valuations of Securities manual prepared by the Securities Valuation Office (Valuations of Securities manual). For reporting entities that maintain an Asset Valuation Reserve (AVR), the bonds 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 market value. For reporting entities that do not maintain an AVR, bonds that are designated highest-quality and high-quality (NAIC designations 1 and 2, respectively) shall be reported at amortized cost; all other bonds (NAIC designations 3 to 6) shall be reported at the lower of amortized cost or fair market value.

Impairment

9. If it is determined that a decline in the fair market value of a bond is other than temporary, the cost basis of the bond shall be written down to fair market value as a new cost basis and the amount of the write down shall be accounted for as a realized loss. The new cost basis shall not be changed for subsequent recoveries in fair market value. Future declines in market value which are determined to be other than temporary, shall be recorded as realized losses. An impairment shall be considered to have occurred if it is probable that the reporting entity will be unable to collect all amounts due according to the contractual terms of a debt security in effect at the date of acquisition. A decline in fair market value which is other than temporary includes situations where a reporting entity has made a decision to sell a security prior to its maturity at an amount below its carrying value (i.e., amortized cost). This is consistent with Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets.

Income

10. Interest income for any period consists of interest collected during the period, the change in the due and accrued interest between the beginning and end of the period as well as reductions for premium amortization and interest paid on acquisition of bonds, and the addition of discount accrual. In accordance with Issue Paper No. 34—Investment Income Due and Accrued, investment income shall be reduced for amounts which have been determined to be uncollectible. Contingent interest may be accrued if the applicable provisions of the underlying contract and the prerequisite conditions have been met.

11. A bond may provide for a prepayment penalty or acceleration fee in the event the bond is liquidated prior to its scheduled termination date. Such fees shall be reported as investment income when received.

Origination Fees

12. Origination fees represent fees charged to the borrower in connection with the process of originating or restructuring a transaction such as the private placement of bonds. The fees include, but are not limited to, points, management, arrangement, placement, application, underwriting, and other fees pursuant to such a transaction. Origination fees shall not be recorded until received in cash. Origination fees intended to compensate the reporting entity for interest rate risks (e.g., points), shall be amortized into income over the term of the bond consistent with paragraph 7 of this issue paper. Other origination fees shall be recorded in income immediately.

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Origination, Acquisition, and Commitment Costs

13. Costs related to origination when paid in the form of brokerage and other related fees shall be capitalized as part of the cost of the bond, consistent with paragraph 5 of this issue paper. All other costs, including internal costs or costs paid to an affiliated entity related to origination, purchase or commitment to purchase bonds shall be charged to expense when incurred.

Commitment Fees

14. Commitment fees are fees paid to the reporting entity that obligate the reporting entity to make available funds for future borrowing under a specified condition. A fee paid to the reporting entity to obtain a commitment to make funds available at some time in the future, generally, is refundable only if the bond is issued. If the bond is not issued then the fees shall be recorded as investment income by the reporting entity when the commitment expires. A fee paid to the reporting entity to obtain a commitment to be able to borrow funds at a specified rate and with specified terms quoted in the commitment agreement, generally, is not refundable unless the commitment is refused by the reporting entity. This type of fee shall be deferred, and amortization shall depend on whether or not the commitment is exercised. If the commitment is exercised, then the fee shall be amortized in accordance with paragraph 7 of this issue paper over the life of the bond as an adjustment to the investment income on the bond. If the commitment expires unexercised, the commitment fee shall be recognized in income on the commitment expiration date.

Loaned Bonds

15. When bonds are loaned, they remain assets of the reporting entity and are not removed from the accounting records as the reporting entity remains the owner of the bonds. When collateral is provided for the general use of the reporting entity, the asset is recorded and the admissibility of the asset is determined as if the reporting entity owned the collateral asset. A liability for the return of that collateral must be established. When collateral not available for the general use of the reporting entity is provided, it should not be recognized as an asset of the reporting entity. When non-cash collateral is provided, the current market value of that collateral must be used to determine adequacy of the collateral held relative to the current market value of the loaned bonds/securities.

Wash Sales

16. When a bond is sold and the proceeds are reinvested within 30 days in the same or substantially the same security, such transfers shall be considered to be wash sales, and shall be accounted for as sales and disclosed as required by paragraph 19. Unless there is a concurrent contract to repurchase or redeem the transferred bond from the transferee, the transferor does not maintain effective control over the bond.

17. For the securities to be substantially the same, the criteria set forth in paragraph 28 of FASB Statement No. 125, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities (FAS 125) must be met.

Exchanges and Conversions

18. If a bond is exchanged or converted into other securities, the fair value of the bond surrendered at the date of the exchange or conversion shall become the cost basis for the new securities with any gain or loss realized at the time of the exchange or conversion. If the fair value of the securities received in an exchange or conversion is more clearly evident than the fair value of the bond surrendered then it shall become the cost basis for the new securities. This is consistent with Issue Paper No. 73—Nonmonetary Transactions

Disclosures

19. The following disclosures shall be made for bonds in the notes to the financial statements:

- Fair values in accordance with Issue Paper No. 33—Disclosures about Fair Value of Financial Instruments;

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- Concentrations of credit risk in accordance with Issue Paper No. 27—Disclosures of Information about Financial Instruments with Concentrations of Credit; Risk
- The basis at which the bonds are stated;
- Amortization method;
  Description of any loaned bonds, including the amount, description of the collateral and whether or not the collateral is restricted;
- Reporting entities shall disclose the following information for wash sales, as defined in paragraph 16, involving transactions for securities with a NAIC designation of 3 or below, or unrated:
  a. A description of the reporting entity's objectives regarding these transactions;
  b. An aggregation of transactions by NAIC Designation 3 or below, or unrated;
  c. The number of transactions involved during the reporting period;
  d. The book value of securities sold;
  e. The cost of securities repurchased;
  f. The realized gains/losses associated with the securities involved.

DISCUSSION

20. The statutory accounting principles described in the summary conclusion section are consistent with current statutory accounting guidance for bonds, except as follows:

- Paragraphs 5 and 6 require bond acquisitions and dispositions to be recorded on the trade date, whereas current statutory guidance is silent.

- Paragraph 9 contains an impairment test that is not contained in the current statutory whether or not th[(liq is ns by)-72(ntne tt)]TJ 0.0009pc 0r theiionclusion tade ed2(f.)-2442unrated: e

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- GAAP does not require reporting of AVR or IMR and requires that realized gains and losses be included in income when realized.

- FAS 91 generally requires amortization of the security premium or discount over the remaining life of the security.

- FAS 91 allows deferral of certain origination costs.

22. This paper is consistent with Issue Paper No. 45—Repurchase Agreements, Reverse Repurchase Agreements and Dollar Repurchase Agreements (Issue Paper No. 45), in defining what criteria must be met in order for securities to be considered substantially the same. Issue Paper No. 45 adopts paragraph 28 of FAS 125 and AICPA Statement of Position 90-3, Definition of the Term Substantially the Same for Holders of Debt Instruments, as Used in Certain Audit Guides and a Statement of Position (SOP 90-3).

23. The statutory accounting principles established in this issue paper, attempt to smooth the effect upon a reporting entity's surplus of fair market value fluctuation of investments held by the reporting entity. This is consistent with the Statement of Concepts which states "conservative valuation procedures provide protection to policyholders against adverse fluctuations in financial condition or operating results." Statutory accounting principles for life insurance companies also use the concept of AVR and IMR adjustments to compensate for fair market value fluctuations over time.

Drafting Notes/Comments

- Loan-backed and structured securities are addressed in Issue Paper No. 43—Loan-Backed and Structured Securities
- Repurchase and reverse repurchase agreements are addressed in Issue Paper No. 45—Repurchase Agreements, Reverse Repurchase Agreements and Dollar Repurchase Agreements
- AVR and IMR are addressed in Issue Paper No. 7—Asset Valuation Reserve and Interest Maintenance Reserve.
- Short-term investments are addressed in Issue Paper No. 28—Short-Term Investments
- The value of a CMO special purpose subsidiary is addressed in Issue Paper No. 86 - Securitization.
- Investment income due and accrued is addressed in Issue Paper No. 34—Investment Income Due and Accrued
- Securities not yet valued by the SVO will follow SVO procedures for valuing such securities as being drafted by the SVO as directed by the Invested Asset Working Group of the Valuation of Securities (EX4) Task Force.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

24. The Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 1, Bonds and Loan-backed and Structured Securities, states:

> Bonds are obligations issued by business units, governmental units, and certain nonprofit units, and having a fixed schedule for one or more future

For bonds purchased at a discount, where cost is less than par value, there is to be an annual accrual of this discount to increase the ledger value to par value at maturity. The annual accrual of discount is generally accounted for as an addition to interest that has been collected during the year.

For bonds secured by U.S. governmental entities, amortization of premium and accrual of discount may require special handling, and the Valuations of Securities manual should be consulted.

Interest Income

If interest (including contingent interest) on a bond is recorded when received, an adjustment must be made to recognize due and accrued interest as of the reporting date. Interest income for any period consists of interest collected during the period and the change in the due and accrued interest between the beginning and end of the period, plus the adjustments for the accrual of discount, minus adjustment for the amortization of premium, and minus adjustment for interest paid on acquisition of bonds.

Contingent interest represents bondholder income generated through the occurrence of specific economic events in relation to the issuer. For example, contingent interest may become payable upon the attainment by the issuer of a given level of cash flow or income. In may respects, bonds with contingent interest provisions are similar to income bonds. Due and unpaid contingent interest may be recorded as income. The proper accrual of such income does, however, require an analysis of the applicable provisions in the underlying agreement and the verification that the prerequisite conditions have been met.

Commitment and Other Origination Fees

Commitment and other origination fees may arise from the private placement of bonds. Commitment fees are charged by the company to the borrower for promising to make available funds for future borrowing at currently specified interest rates. If the fee is not returnable to the borrower and the bond is not issued, the fee should be taken into income immediately. If the fee is returnable only if the bond is issued, it should not be considered income until it is determined that the bond will not be placed. If it is determined that the bond will be issued, the fee should be deferred and amortized using the interest method over the life of the loan. Other fees intended to compensate the company for interest rate risks associated with the commitment may be built into the interest rates specified and thus, if collected, would be amortized into income over the term of the bond.

Fees charged to borrowers for providing services related to the origination of a private placement should be taken into income immediately only if no portion of the loan is retained by the company. Otherwise, recognition of any fees related to the portion of the loan retained for investment purposes should be deferred until issue and amortized into income using the interest method over the life of the loan. Deferred fee income related to loans originated and retained for resale should be recognized upon sale.

Loaned Bonds or Bonds Subject to Reverse Repurchase Agreements

Where the state of domicile permits such activity, bonds may be loaned or placed under reverse repurchase arrangements with authorized brokers or dealers in securities.

When a bond is loaned, collateral consisting of cash and/or cash equivalent is pledged. The pledged collateral is maintained in an escrow account. The statement will continue to report the insurance company as owner of the bond.

The valuation of this bond will remain unaffected by the loan as long as the amount of the collateral is at least equal to the required amount specified in the Valuations of Securities manual. Failure to hold sufficient collateral may result in the admitted asset value being decreased.

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25. The Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies contains similar guidance.

26. The Purposes and Procedures Manual of the NAIC Securities Valuation Office contains the following guidance:

> (B) Corporate Bonds--General Procedure. The analysis to determine an NAIC designation will be made in one of two ways. The first will be the direct use of ratings performed by other recognized rating agencies or organizations. The second will be the use of various security analysis techniques, both quantitative and subjective in nature.

well as the issuer's management/sponsorship, marketing capabilities, and cost structure to determine the extent of the issuer's competitive edge, if any. These characteristics, when viewed in context with the issuer's financial profile, will determine the ability of the company to respond to varying economic scenarios.

The result of the first two foregoing steps will be a judgment by the SVO analyst of the issuer's implied senior unsecured debt paying ability or rating expressed as an NAIC Designation. The ratings of all other securities of the same issuer (including preferred stocks) can be scaled either upwards or downwards based on that securities' relationship to senior unsecured debt in the capital structure as well as the strength of the credit.

(3) The final part of the analysis will focus on factors that are specific to the security under review as opposed to those relevant to the issuer. This will include a

(6) Equipment Trust Certificates will be reviewed first on the basis of an annually submitted SVO collateral valuation form and if that is not submitted then on the credit standing of the certificate issuer.

(7) Certificates of Deposit (negotiable and non-negotiable) will be considered under the general provisions of Section 2(B).

(8) Repurchase Agreements. Securities subject to repurchase agreements will have an NAIC Designation determined in accordance with Section 2(B).

(9) Reverse Repurchase Agreements. Securities subject to reverse repurchase agreements will have an NAIC Designation determined in accordance with Section 2(B) if the cash and/or cash equivalents pledged as collateral is equal to 100% or more of the market value of the financed securities as of the date of the statement. If other than identical securities are returned, the transaction is to be treated as an ordinary purchase and sale.

(10) Commercial Paper will be valued under the general procedures of Section 2(B).

(11) Convertible Bonds. Bonds eligible for amortized value will be so valued while bonds not eligible will be valued at the lower of market value or the then existing amortized value.

(12) New Enterprises created either as startup companies or as business combinations of pre-existing business units will be evaluated on the basis of projected income statements and balance sheets since prior figures are either not available or not meaningful. Insurers must submit such projections in order to justify ratings higher than the lowest quality category.

(13) Loaned Securities. Where permitted by an insurer's state of domicile, bonds loaned to others shall be valued in accordance with Section 2(B) if (i) Acceptable Collateral, as hereinafter defined, is pledged as security for the loan and (ii) except as set forth in the following sentence, the Acceptable Collateral pledged as security is, at the inception of the loan, in an amount equal to 102% of the market value of the loaned bonds. In the event that foreign bonds are the subject of the loan and the denomination of the cuc

collateral coverage, cash flow coverage of debt service and other strengths inherent in the structural factors unique to the DIP lending process.

(15) Bonds of Liquidating Corporations. Securities of such entities will be marked to market by all insurers and accorded on NAIC rating of "6". In the absence of an active market or a reliable quotation, the value of such securities will be analytically determined by the SVO staff, or the SVO, at its discretion, may accept a value determined by an independent organization approved by the SVO.

(16) Distressed Bonds trading at less than 25% of par at the date of valuation and which are not original issue deep discount bonds. Such securities will be marked to market by all insurers regardless of whether they are current as to all contractual provisions at the date of valuation.

(17) Pricing of Privately Placed and Illiquid Publicly Traded Bonds In or Near Default. The pricing of privately placed and illiquid publicly traded bonds will be analytically determined by the SVO staff, or the SVO, at its discretion, may accept a value determined by an independent organization approved by the SVO. The pricing of these securities will be dependent on three primary factors: (1) the ultimate recovery value in cents per dollar of par value expected to be received net of all reasonable costs of a workout or bankruptcy proceeding such as fees for accountants, lawyers, bankers, etc. (2) the expected timing of the receipt of such recovery value and (3) a discount rate to be applied to factors one and two that reflects market rates of discount for defaulted bonds in general adjusted for the current degree of uncertainty existing in the recovery amount.

Four states of recovery are generally recognized by the SVO and different discount rates reflecting more or less uncertainty will be used for securities in each state. These rates will vary with market conditions. The states are:

(a) Newly defaulted bonds where maximum uncertainty as to recovery exists.

(b) Defaulted securities where a preliminary plan of reorganization has been put forth for discussion.

(c) Defaulted securities where a generally agreed to but unsigned plan is on the table.

(d) Defaulted securities where a plan has been agreed to by all parties and a payout date has been set. This is the only case in which estimated value close to 100% of par will be achievable.

(18) Loan-backed and Structured Securities. The SVO encourages insurers to obtain ratings for loan-backed and structured securities submitted for an NAIC designation from an NAIC approved NRSRO. For unrated structured securities acquired by conversion i.e., securitization, refer to Section 6(B)(g)(i) for instructions.

(E) Instructions for Completing Schedule D of the NAIC Annual Statement

The following table indicates the appropriate entries to be made in Schedule D of the NAIC Annual Statement for all bonds except income bonds (see Section 2(C)(1)) and perpetual bonds and demand notes (see Section 2(C)(2)).

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(1) For Insurers Maintaining an Asset Valuation Reserve (AVR) (see Section 6)

NAIC DESIGNATION	AMORTIZED OR INVESTMENT

2. Basis of Valuation of Invested Assets

a. Provide a statement of the valuation basis for invested assets, including bonds,

ancillary activities related to establishing and monitoring credit policies, supervision, and administration, shall be charged to expense as incurred. Employees' compensation and fringe benefits related to those activities, unsuccessful loan origination efforts, and idle time shall be charged to expense as incurred. Administrative costs, rent, depreciation, and all other occupancy and equipment costs are considered indirect costs and shall be charged to expense as incurred.

Commitment Fees and Costs

8. Except as set forth in subparagraphs (a) and (b) below, fees received for a commitment to originate or purchase a loan or group of loans shall be deferred and, if the commitment is exercised, recognized over the life of the loan as an adjustment of yield or, if the commitment expires unexercised, recognized in income upon expiration of the commitment

 a. If the enterprise's experience with similar arrangements indicates that the likelihood that the commitment will be exercised is remote,[3] the commitment fee shall be recognized over the commitment period on a straight-line basis as service fee income. If the commitment is subsequently exercised during the commitment period, the remaining unamortized commitment fee at the time of exercise shall be recognized over the life of the loan as an adjustment of yield.

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[3] The term remote is used here, consistent with its use in FASB Statement No. 5, Accounting for Contingencies, to mean that the likelihood is slight that a loan commitment will be exercised prior to its expiration.

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 b. If the amount of the commitment fee is determined retrospectively as a percentage of the line of credit available but unused in a previous period, if that percentage nominal in relation to the stated interest rate on any related borrowing, and if that borrowing will bear a market interest rate at the date the loan is made, the commitment fee shall be recognized as service fee income as of the determination date.

9. Direct loan origination costs (described in paragraph 6) incurred to make a commitment to originate a loan shall be offset against any related commitment fee and the net amount recognized as set forth in paragraph 8.

Purchase of a Loan or Group of Loans

15. The initial investment in a purchased loan or group of loans shall include the amount paid to the seller plus any fees paid or less any fees received. The initial investment frequently differs from the related loan's principal amount at the date of purchase. This difference shall be recognized as an adjustment of yield over the life of the loan. All other costs incurred in connection with acquiring purchased loans or committing to purchase loans shall be charged to expense as incurred.

Other

17. Deferred net fees or costs shall not be amortized during periods in which interest income on a loan is not being recognized because of concerns about the realization of loan principal or interest.

Application of the Interest Method and Other Amortization Matters

18. Net fees or costs that are required to be recognized as yield adjustments over the life of the related loan(s) shall be recognized by the interest method except as set forth in

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paragraph 20. The objective of the interest method is to arrive at periodic interest income

estimates. The practice of recognizing net fees over the estimated average life of a group of loans shall no longer be acceptable. (Refer to Appendix B.)

20. Certain loan agreements provide no scheduled payment terms (demand loans); others provide the borrower with the option to make multiple borrowings up to a specified maximum amount, to repay portions of previous borrowings, and then reborrow under the same contract (revolving lines of credit).

a. For a loan that is payable at the lender's demand, any net fees or costs may be recognized as an adjustment of yield on a straight-line basis over a period that is consistent with (1) the understanding between the borrower and lender or (2) if no understanding exists, the lender's estimate of the period of time over which the loan will remain outstanding; any unamortized amount shall be recognized when the loan is paid in full.

b. For revolving lines of credit (or similar loan arrangements), the net fees or costs shall be recognized in income on a straight-line basis over the period the revolving line of credit is active, assuming that borrowings are outstanding for the maximum term provided in the loan contract.

If the borrower pays all borrowings and cannot reborrow under the contract, any unamortized net fees or costs shall be recognized in income upon payment. The interest method shall be applied to recognize net unamortized fees or costs when the loan agreement provides a schedule for payment and no additional borrowings are provided for under the agreement.[8]

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[8] For example, if the loan agreement provides the borrower with the option to convert a one-year revolving line of credit to a five-year term loan, during the term of the revolving line of credit the lender would recognize the net fees or costs as income on a straight-line basis using the combined life of the revolving line of credit and term loan. If the borrower elects to convert the line of credit to a term loan, the lender would recognize the unamortized net fees or costs as an adjustment of yield using the interest method. If the revolving line of credit expires and borrowings are extinguished, the unamortized net fees or costs would be recognized in income upon payment.

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30. FAS 125 provides the following guidance:

28. To be substantially the same,[9] the asset that was transferred and the asset that is to be repurchased or redeemed need to have all of the following characteristics:

a. The same primary obligor (except for debt guaranteed by a sovereign government, central bank, government-sponsored enterprise or agency thereof, in which case the guarantor and the terms of the guarantee must be the same)
b. Identical form and type so as to provide the same risks and rights
c. The same maturity (or in the case of mortgage-backed pass-through and pay-through securities have similar remaining weighted-average maturities that result in approximately the same market yield)
d. Identical contractual interest rates
e. Similar assets as collateral
f. The same aggregate unpaid principal amount or principal amounts within accepted “good delivery” standards for the type of security involved.

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[9] In this Statement, the term substantially the same is used consistently with the usage of that term in the AICPA Statement of Position 90-3, Definition of the Term Substantially the Same for Holders of Debt Instruments, as Used in Certain Audit Guides and a Statement of Position.

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31. AICPA Statement of Position 90-3, Definition of the Term Substantially the Same for Holders of Debt Instruments, as Used in Certain Audit Guides and a Statement of Position (SOP 90-3) provides the following guidance:

> .13 To minimize diversity in practice, the AICPA Banking Committee, Savings and Loan Associations Committee, and Stockbrokerage and Investment Banking Committee believe the definition of substantially the same should be narrow. Therefore, the committees have concluded that for debt instruments, including mortgage-backed securities, to be substantially the same, all the following criteria must be met:
>
> a. The debt instruments must

[4] Participants in the mortgage-backed securities market have established parameters for what is considered acceptable delivery. These specific standards are defined by the Public Securities Association (PSA) and can be found in Uniform Practices for the Clearance and Settlement of Mortgage-Backed Securities and Other Related Securities, which is published by PSA.

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 1, Bonds and Loaned Backed and Structured Securities
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapter 1, Bonds and Loan Backed and Structured Securities
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