Statutory Issue Paper No. 41

Surplus Notes

STATUS
Finalized March 16, 1998

Original SSAP: SSAP No. 41; Current Authoritative Guidance: SSAP No. 41R

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Reporting entities sometimes issue instruments that have the characteristics of both debt and equity. These instruments are commonly referred to as surplus notes, the term used herein, but are also referred to as surplus debentures or contribution certificates. These instruments are used for various reasons, including but not limited to:

   a. Providing regulators with flexibility in dealing with problem situations to attract capital to reporting entities whose surplus levels are deemed inadequate to support their operations.

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Objectives of Statutory Financial Reporting

> The primary responsibility of each state insurance department is to regulate insurance companies in accordance with state laws with an emphasis on solvency for the protection of policyholders. The ultimate objective of solvency regulation is to ensure that policyholder, contractholder and other legal obligations are met when they come due and that companies maintain capital and surplus at all times and in such forms as required by statute to provide an adequate margin of safety. The cornerstone of solvency measurement is financial reporting. Therefore, the regulator's ability to effectively determine relative financial condition using financial statements is of paramount importance to the protection of policyholders. An accounting model based on the concepts of conservatism, consistency, and recognition is essential to useful statutory financial reporting.

Existing statutory guidance has been expanded by this issue paper to address the accounting for issuance costs of these instruments and to require the disclosure of unapproved principal, principal paid in the current year and total principal paid on surplus notes. These disclosures are parallel to disclosures required for interest.

13. The conclusions reached in this issue paper vary from GAAP which requires all debt instruments, including surplus notes, to be recorded as liabilities. GAAP does not have the concept of surplus but rather has the concept of stockholders' equity. Stockholders' equity is a measure of the amount of net assets available to stockholders after all other obligations have been satisfied. As a contrast to features of surplus notes that make them policyholders' surplus, certain preferred stocks issued by entities have redemption features or liquidation preferences that provide

information: date issued, interest rate, amount of note, carrying value (lower of amortized cost or market value), interest paid current year, total interest paid, accrued interest and date of maturity.

f. For each surplus debenture or similar obligation included in 6e, other than a surplus debenture which is issued in an offering registered under the Securities Act of 1933 or distributed in an underwritten offering pursuant to Rule 144A under the Securities Act of 1933, furnish:

the name of the holder (indicate if parent or affiliate);
description of the assets received; and
the repayment conditions and restrictions.

For each surplus debenture or similar obligation included in 6e which is issued in an offering registered under the Securities Act of 1933 or distributed in an underwritten offering pursuant to Rule 144A under the Securities Act of 1933, furnish:

the name of the underwriters (indicate if parent or affiliate);
the name of the registrar/paying agent (indicate if parent or affiliate);
the description of the assets received; and
the repayment conditions and restrictions.

In addition to the above, identify all affiliates that hold any portion of a surplus debenture or similar obligation (including an offering registered under the Securities Act of 1933 or distributed pursuant to Rule 144A under the Securities Act of 1933), and any holder of ten percent (10%) or more of the outstanding amount of any surplus debenture registered under the Securities Act of 1933 or distributed pursuant to Rule 144A under the Securities Act of 1933.

Holders

17. The SVO Purposes and Procedures provides the following guidance with respect to investments in surplus notes:

Section 7: Procedures for Valuing Surplus Debentures

(A) An insurance company that owns surplus debenture(s) (notes) issued by another insurance company shall value the surplus debenture(s) as follows:

1. At amortized cost if the notes have been rated by a Nationally Recognized Statistical Rating Organization (NRSRO) and have a NAIC rating equivalent designation of 1. If the notes have been rated by more than one NRSRO, the lowest rating equivalent shall be used for purposes of this valuation procedure.

2. Notes that are not rated or have a NAIC rating equivalent designation of 2 through 6 shall be valued as follows:

   a. At its outstanding face value, notwithstanding the payment of interest and/or principal, when the notes were issued by an insurer whose capital and surplus (excluding the Asset Valuation Reserve and all surplus notes) is greater than or equal to the greater of 5% of its admitted assets (excluding separate accounts) or $6,000,000. The valuation should be calculated using the most recently filed statutory financial statement of the insurer that issued the notes;

surplus (excluding the Asset Valuation Reserve and all surplus notes) is less than the greater of 5% of admitted assets (excluding separate accounts) or $6,000,000. The statement value factor is equal to total capital and surplus, including surplus notes, less the greater of 5% of admitted assets (excluding separate accounts) or $6,000,000 divided by the surplus notes. The valuation should be calculated using the most recently filed statutory financial statement of the insurer that issued the notes;

3. At zero, notwithstanding any previous payments of interest and/or principal, when the notes are issued by an insurer which is subject to any order of liquidation, conservation, rehabilitation or a company action level event based on its risk-based capital.

Issuers of surplus debentures must obtain the latest rating letters from the NRSROs who rate their notes and file them with the Executive Director of the SVO semiannually on June I and December 1 of each year. If there is a c also subject to regulatory approval. Where such approval conditions exist, insurers should report these instruments as admitted assets only in

RELEVANT LITERATURE

Statutory Accounting

- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies
- NAIC Annual Statement instructions
- *Purposes and Procedures Manual of the NAIC Securities Valuation Office*
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Minutes of the Financial Condition (EX4) Subcommittee meeting of June 7, 1995.
- *Issue Paper No. 26—Bonds, Excluding Loan-Backed and Structured Securities*

Generally Accepted Accounting Principles

- *FASB Statement of Financial Accounting Concepts No. 6, Elements of Financial Statements*
- *FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities*

State Regulations

- No additional guidance obtained from state statutes or regulations.

Other Sources of Information

- Article 5 of Regulation S-X of the Securities and Exchange Commission

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