Statutory Issue Paper No. 131

value of the redeemable preferred stock on the measurement date shall become the new cost basis of the redeemable preferred stock and the new cost basis shall not be adjusted for subsequent recoveries in fair value. The discount or reduced premium recorded for the security, based on the new cost basis, shall be amortized over the remaining life of the security in the prospective manner based on the amount and timing of future estimated cash flows. The security shall continue to be subject to impairment analysis for each subsequent reporting period. Future declines in fair value which are determined to be other-than-temporary shall be recorded as realized losses.

Impairment of Perpetual Preferred Stock

11. If it is determined that a decline in the fair value of a perpetual preferred stock is other-than-temporary, an impairment loss shall be recognized as a realized loss equal to the entire difference between the perpetual preferred stock's carrying value and its fair value at the balance sheet date of the reporting period for which the assessment is made. The measurement of the impairment loss shall not include partial recoveries of fair value subsequent to the balance sheet date. For reporting entities required to maintain an AVR, realized losses shall be accounted for in accordance with *SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve*.

12. In periods subsequent to the recognition of an other-than-temporary impairment loss for a perpetual preferred stock, the reporting entity shall account for the other-than-temporarily impaired security as if the security had been purchased on the measurement date of the other-than-temporary impairment, and in accordance with paragraph 19 or paragraph 21 of SSAP No. 32, as applicable. The fair value of the perpetual preferred stock on the measurement date shall become the new cost basis of the perpetual preferred stock and the new cost basis shall not be adjusted for subsequent recoveries in fair value. Future declines in fair value which are determined to be other-than-temporary, shall be recorded as realized losses.

Investment Income Due and Accrued

13. The guidance in SSAP No. 34, paragraph 3, shall be modified by this issue paper as follows:

> 3. In general, gross investment income shall be recorded as earned and shall include investment income collected during the period, the change in investment income due and accrued, the change in unearned investment income plus any amortization (e.g., discounts or premiums on bonds, origination fees on mortgage loans, etc.) Immediate amortization of premium which occurs upon recognition of an other-than-temporary impairment loss for a debt security with a recorded premium shall be reported as a realized loss and shall not be included in investment income.

Loan-backed and Structured Securities

14. This issue paper shall insert the following new paragraph 17 into SSAP No. 43, with subsequent paragraphs of SSAP No. 43 to be renumbered accordingly:

> 17. In periods subsequent to the recognition of an other than temporary impairment loss for a loan-backed or structured security, the reporting entity shall account for the other-than-temporarily impaired security as if the security had been purchased on the measurement date of the other-thaon n-tempo5e dete[y i)-5(m)8(paicab)-7(le .147 TD[valas if the(occurity as me5(m)8(e)2(a)-3

must be utilized for periods subsequent to the impairment loss recognition. Future declines in fair value which are determined to be other-than-temporary shall be recorded as realized losses.

Disclosures

15. This issue paper requires no additional disclosures.

Relevant Literature

16. This issue paper adopts FSP FAS 115-1/124-1, paragraph 16, with modification to be consistent with statutory language in the respective statutory accounting statements.

Effective Date and Transition

17. After adoption of this issue paper, it is expected that the NAIC will release a Statement of Statutory Accounting Principle (SSAP) for comment. The initial draft of the SSAP will contain the adopted Summary Conclusion of this issue paper. Users of the Accounting Practices and Procedures Manual should note that issue papers are not represented in the Statutory Hierarchy (see Section IV of the Preamble) and therefore the conclusions reached in this issue paper should not be applied until the corresponding SSAP has been adopted by the Plenary of the NAIC. To allow time for any necessary system related changes, it is expected that the SSAP will be effective for reporting periods ending on or after December 31, 2008.

DISCUSSION

18. Though statutory accounting statements include instructions on accounting for impaired debt securities, guidance is currently silent regarding the treatment of premium or discount subsequent to recognition of an other-than-temporary impairment loss. Prior to issuance of FSP FAS 115-1/124-1, GAAP guidance was also silent on the issue. This has led to inconsistent accounting practices.

19. The FASB guidance requires that amortization of premium or accrual of discount continues in periods subsequent to other-than-temporary impairment recognition. Statutory accounting guidance should provide for consistent accounting treatment in this subsequent period, and there appears to be no compelling reason for statutory guidance to diverge from GAAP on this issue. As such, this issue paper adopts the GAAP guidance contained in FSP FAS 115-1/124-1, paragraph 16, with modifications to be consistent with existing statutory accounting language.

20. The term “cost” is used in GAAP for ev

becomes the maximum amortized value, or the maximum value to which the security is allowed to be accreted. The unaccrued discount is then accrued over the remaining life of the security based on the amount and timing of future estimated cash flows. As the carrying value shall not be adjusted for subsequent recoveries in fair value, the book adjusted carrying value shall not exceed the maximum amortized value during the remaining life of the security.

23. This exposure draft also includes clarifying guidance for SSAP No. 26 regarding the proper recording of impairment losses for reporting entities required to maintain an Asset Valuation Reserve (AVR) and an Interest Maintenance Reserve (IMR). The language was added to paragraph 6 of this issue paper to clarify that for reporting entities required to maintain such reserves, credit related other-than-temporary impairment losses are to be recorded through the AVR, while interest related other-than-temporary impairment losses are to be recorded through the IMR.

24. The guidance adopted by this issue paper is consistent with the concepts of statutory accounting.

Drafting Notes/Comments

25. None

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

26. Statutory guidance for amortization of premium, accrual of discount, and impairment for bonds, excluding loan-backed and structured securities, is provided in SSAP No. 26:

> Amortized Cost
>
> 6. 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 issue 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).
>
> Impairment
>
> 9. If it is determined that a decline in the fair value of a bond is other than temporary, the cost basis of the bond shall be written down to fair 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 value. Future declines in fair 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 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.

27. Statutory guidance for amortization of premium, accrual of discount, and impairment for preferred stock is provided in SSAP No. 32:

> Amortization
>
> 12. Redeemable preferred stock purchased at a premium shall be amortized to reduce the carrying value to the call or redemption value over the period to the call or earliest redemption date, whichever produces the lowest asset value (yield to worst). Redeemable preferred stock

purchased at a discount shall be amortized to increase the carrying value to par value over the period to maturity or the latest redemption date.

13. PIK preferred stock shall be amortized to the lower of the call price or par value, measured in either case at the end of the stock dividend period and based on all of the shares expected to be held at the end of that period, including those received as dividends.

14. Amortization shall be calculated using the interest method and shall be reported as increases or decreases in dividends collected during the year.

Impairment

22. If it is determined that a decline in the fair value of a preferred stock is other than temporary, the preferred stock shall be written down to fair value as a new cost basis and the amount of the write down shall be accounted for as a realized loss. For those reporting entities required to maintain an AVR, realized losses shall be accounted for in accordance with SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve.

23. Perpetual preferred stock shall be accounted for in accordance with paragraph 19 or paragraph 21, as applicable, subsequent to the recognition of an other than temporary impairment. Future declines in fair value which are determined to be other than temporary, shall be recorded as realized losses. A decline in fair value which is other than temporary includes situations where the reporting entity has made a decision to sell a security at an amount below its carrying value.

24. Redeemable preferred stock shall be accounted for in accordance with paragraph 18 or paragraph 20, as applicable, subsequent to the recognition of an other than temporary impairment. Future declines in fair 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 the security in effect at the date of acquisition. A decline in fair value which is other than temporary includes situations where the reporting entity has made a decision to sell a

5. This two-step process is set forth below.

   a. Investment income due and accrued shall be assessed for collectibility. If, in accordance with SSAP No. 5, it is probable the investment income due and accrued balance is uncollectible, the amount shall be written off and shall be charged against investment income in the period such determination is made;

   b. Any remaining investment income due and accrued (i.e., amounts considered probable of collection) representing either (1) amounts that are over 90 days past due (generated by any invested asset except mortgage loans in default), or (2) amounts designated elsewhere in the Accounting Practices and Procedures Manual as nonadmitted shall be considered nonadmitted assets and recognized through a direct charge to surplus in accordance with SSAP No. 4. These nonadmitted amounts shall be subject to continuing assessments of collectibility and, if determined to be uncollectible, a write-off shall be recorded in the period such determination is made in accordance with subparagraph a. above.

6. Accrued interest on mortgage loans that are in default (as defined in SSAP No. 37—Mortgage Loans) shall be recorded as Investment Income Due and Accrued when such interest is deemed collectible. Interest can be accrued on mortgage loans in default if deemed collectible; if interest is deemed uncollectible, it shall not be accrued and any previously accrued amounts are to be written off in accordance with the guidelines in paragraph 5.a. above. If a mortgage loan in default has interest 180 days past due which has been assessed as collectible, all interest shall be considered a nonadmitted asset and recognized through a direct charge to surplus as outlined in paragraph 5.b. above.

29. Statutory guidance for amortization of premium, accrual of discount, and impairment for loan-backed and structured securities is provided in SSAP No. 43:

<u>Amortization</u>

7. Amortization of premium or discount shall be calculated using the scientific (constant yield) interest method and shall be recorded as an adjustment to investment income. The interest method results in a constant effective yield equal to the prevailing rate at the time of purchase or at the time of subsequent adjustments to book value. The amortization period shall reflect estimates of the period y30 Td6(d Accrut5paystmenofha)]T0.0004 Tc 096601 Tw 23.641 0 Tdof inc30

Generally Accepted Accounting Principles

30. FSP FAS 115-1/124-1, paragraph 16 contains the GAAP guidance which is addressed by this issue paper:

> Accounting for Debt Securities Subsequent to an Other-Than-Temporary Impairment
>
> 16. In periods subsequent to the recognition of an other-than-temporary impairment loss for debt securities, an investor shall account for the other-than-temporarily impaired debt security as if the debt security had been purchased on the measurement date of the other-than-temporary impairment. That is, the discount or reduced premium recorded for the debt security, based on the new cost basis, would be amortized over the remaining life of the debt security in a prospective manner based on the amount and timing of future estimated cash flows.

31. Footnote 2 to paragraph 7 of FSP FAS 115-1/124-1, provides the GAAP definition of cost, which is used in impairment evaluation:

> Cost includes adjustments made to the cost basis of an investment for accretion, amortization, previous other-than-temporary impairments, and hedging.

RELEVANT LITERATURE

Statutory Accounting

- SSAP No. 26—*Bonds, excluding Loan-Backed and Structured Securities*
- SSAP No. 32—*Investments in Preferred Stock (including investments in preferred stock of subsidiary, controlled, or affiliated entities)*
- SSAP No. 43—*Loan-Backed and Structured Securities*

Generally Accepted Accounting Principles

- FASB Staff Position FAS 115-1/124-1

State Regulations

- No additional guidance obtained from state statutes or regulations.

