

Interpretation of the Emerging Accounting Issues Working Group

INT 99-29: Classification of Step-up Preferred Stock

ISSUE NULLIFIED BY SSAP NO. 32

INT 99-29 Dates Discussed

October 4, 1999; December 6, 1999

INT 99-29 References

SSAP No. 32—Investments in Preferred Stock (including investments in preferred stock of subsidiary, controlled, or affiliated entities) (SSAP No. 32)

INT 99-29 Issue

1. A step-up preferred stock is a security with the structure of a preferred stock that has the cash flow characteristics of a debt instrument. Typically, it is structured as a perpetual preferred stock, but includes in its terms a call option that may be exercised at the option of the issuer at a time certain. The terms of the option are such that it is economically certain that the issuer will call the security. For example, the call option might provide that the issuer be required to pay 10 times LIBOR after the option date.

2. Per SSAP No. 32, redeemable preferred stock is defined as preferred stock that must be redeemed by the issuing enterprise or is redeemable at the option of the reporting entity. Perpetual preferred stock is defined as preferred stock with no redemption or sinking fund features and preferred stock redeemable at the option of the issuer.

3. It does not appear that step-up preferred stock meets the definition of a redeemable preferred stock. With respect to the “must” provision, while it is economically certain that the issuer will redeem the stock, the issuer is not legally obligated to do so. As the reporting entity has no rights in the option, it does not qualify in the second part of the definition. Therefore, step-up preferred stock is not considered redeemable preferred stock as defined in SSAP No. 32.

4. A strict reading of the perpetual preferred stock definition further complicates the issue in that step-ups do not have redemption features: thus, they meet the definition of perpetual preferred stock. The valuation of step-up preferred stock would not be consistent with the economic substance of the security if it were valued at fair value.

5. Review of SVO guidance in the *Purposes and Procedures Manual of the NAIC Securities Valuation Office* indicates that these securities have more characteristics of debt securities, thus they would be more consistent with the valuation of redeemable preferred stocks. In fact, the SVO office has recently revised its classification of certain securities because the characteristics of the step-up preferred shares are so “debt-like.”

6. Should step-up preferred stock be classified as redeemable preferred stock or perpetual preferred stock?

INT 99-29 Discussion

7. The working group reached a consensus that when securities have characteristics of both debt and equity, the accounting and valuation of such securities should be consistent with SVO guidelines as stipulated in the *Purposes and Procedures Manual of the NAIC Securities Valuation Office*.

INT 99-29 Status

8. No further discussion is planned.