

Statutory Issue Paper No. 164

Preferred Stock

STATUS

Finalized July 30, 2020

- b. FASB Codification: A security that has preferential rights compared to common stock.

5. Comments received from interested parties in October 2019 indicated that the term “security” is not interchangeable as it pertains to preferred stock. Interested parties requested all references be changed to “interest” or directly reference the type of stock under consideration. In review of the use of the term “security” in the issue paper, most instances represent existing references carried over from SSAP No. 32. NAIC staff recognizes that preferred stock is a “security,” as demonstrated by the definitions from both the NASDAQ and FASB, but NAIC staff has proposed some revisions to limit the generic use of the term. The use of the term “security” in paragraph 8, paragraphs 10-13 and in Exhibit A (as it pertains to defining specific types of preferred stock) has been revised to “preferred stock.” The use of the term “security” in paragraph 3 has been retained as this usage mirrors the FASB definition for preferred stock.

6. NAIC staff’s original intent was to align various investment definitions with common industry definitions or those specified by U.S. GAAP. As part of the investment reclassification project, this practice began with unaffiliated common stock (SSAP 30R) and now has expanded into preferred stock (SSAP No. 32). The definition proposed by NAIC staff was made with the understanding that preferred stock is either redeemable or perpetual. While this issue paper does mention some stock labeled as “redeemable perpetual preferred stock,” distinctions are made in the prospectus as to its true underlying characteristics (thus being redeemable or perpetual). Generally, NAIC staff continue to believe that for a majority of preferred stock issuances, a share which is redeemable at the option of the holder is by definition redeemable outside (or not solely within) the control of the issuer – thus the actions are mutually exclusive. However, interested parties cite guidance for additional circumstances in which, through legal technicalities, could create a third class of preferred shares – those redeemable outside the control of the issuer and holder. Since the definition refers to “solely within the control of the issuer” as a determination for classifying a preferred share as redeemable (reported at amortized cost), certain circumstances which are technically “not solely within the issuer’s control” could cause shares to be reclassified to redeemable which were originally categorized as perpetual (reported at fair value). ASC 480-10 provides a few of these examples as: change in state law, the issuer fails to achieve certain project milestones, the issuer fails to pay specified dividends, the issuer experiences a change in credit rating, etc. As such, NAIC staff are supportive of the changes suggested by interested parties as they align with the original objective of preferred stock classification and reflect the expected economics of the investment.

7. Although the historical definition of preferred stock in SSAP No. 32 is comparable to current market terms, this issue paper recommends revisions incorporate the NASDAQ definition as it is more encompassing of the characteristics of preferred stocks.

Definitions and Classification as Redeemable or Perpetual Preferred Stock

8. The accounting guidance of SSAP No. 32 varies based on whether preferred stock is considered to be “redeemable” or “perpetual.” The historical definitions of redeemable and perpetual within SSAP No. 32R reflected the following:

- a. 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. It includes mandatory sinking fund

- a. Preferred Stock Subject to Mandatory Redemption Requirements or Whose Redemption is Outside the Control of the Issuer ("Redeemable Preferred Stock"). The term means any stock which (i) the issuer undertakes to redeem at a fixed or determinable price on the fixed or determinable date or dates, whether by operation of a sinking fund or otherwise; (ii) is redeemable at the option of the holders; (iii) has conditions for redemption which are not solely within the control of the issuer; or (iv) has stocks which must be redeemed out of future earnings. Under this definition, preferred stock which meet one or more of the above criteria would be classified as redeemable preferred stock regardless of their other attributes such as voting rights, dividend rights or conversion features. (FASB ASC 480-10-S99)
- b. Preferred Stocks Which Are Not Redeemable or Are Redeemable Solely at the Option of the Issuer ("Non-Redeemable Preferred Stock"). The term means any preferred stock which does not meet the criteria for classification as a "redeemable preferred stock." (FASB ASC 480-10-S99)

10. In reviewing these definitions, and preferred stock components that permit payment of dividends in stock instead of cash (known as payment-in-kind (PIK) stock), it was identified that preferred stock that incorporates PIK dividends is not limited to redeemable preferred stock as implied in the prior SSAP No. 32 definition for redeemable preferred stock.

11. To ensure classification of redeemable and perpetual preferred stock consistently with U.S. GAAP, the definitions from the FASB ASC have been incorporated into the revised SSAP No. 32.

Definition of Restricted Stock:

12. The historical accounting guidance in SSAP No. 32 included a definition of restricted stock as "a security for which sale is restricted by governmental or contractual requirement (other than in connection

determined to preclude the ability to consider asset as available for policyholder claims. In such situations, the restricted asset would be considered nonadmitted.

Definitions or Preferred Stock Components / Characteristics

15. The historical guidance in SSAP No. 32 included definitions for a couple of preferred stock terms, including “mandatory sinking fund” and “step-up preferred stock,” but did not include definitions of other common preferred stock components or terms. Furthermore, in reviewing the previously included terms, it was identified that they were no longer current and should be revised or removed from SSAP No. 32. For example, the definition of “mandatory sinking fund” included references to preferred stock outstanding in 1978, and the definition of “step-up preferred stock” referred to the Purposes and Procedures Manual of the NAIC Investment Analysis Office and there is no current accounting or valuation guidance for step-up preferred stock in that Manual.

16. Rather than include a variety of terms in the body of the SSAP, particularly as components may not impact overall accounting and reporting of the preferred stock, a new exhibit has been included to include a glossary of key preferred stock terms. The definitions intend to capture current market-terms for the noted components.

Accounting and Reporting of Preferred Stock

17. The historical guidance in SSAP No. 32 captured different accounting and reporting provisions based on whether the preferred stock was classified as redeemable or perpetual, and whether the reporting entity maintained an Asset Valuation Reserve (AVR). Although these classifications are still considered appropriate, it has been noted that additional guidance is needed for mandatory convertible preferred stock, and that a review of the various measurement methods permitted (by classification) should occur to ensure appropriate measurement in the financial statements. Specifically, the prior guidance in SSAP No. 32 explicitly permitted “cost” as an acceptable measurement method, even for perpetual preferred stock. Consistent with prior conclusions from U.S. GAAP, as well as the Statutory Accounting Principles (E) Working Group, “historical cost” is generally not an acceptable measurement method. Particularly, this measurement method is not acceptable when liquidation of an asset would generally occur at market prices, such as a non-redeemable (perpetual) preferred stock.

18. The changes reflected in the revised SSAP No. 32 continue to differentiate accounting and reporting guidance by whether a reporting entity maintains an AVR on the type of preferred stock (redeemable or perpetual). However, revisions have been incorporated to clarify the accounting and reporting of mandatory convertible preferred stock and to update the measurement basis for each type of preferred stock:

- a. For redeemable preferred stock, the revisions continue to use NAIC designations in determining the measurement method. There is no change proposed to the measurement basis per designation. However, the revisions clarify that the measurement basis shall be either amortized cost or fair value based on NAIC designation, eliminating reference to “cost” as an measurement method that could be used by a reporting entity. For the amortization of redeemable preferred stock, revisions have also been incorporated to clarify that amortization (or accretion) of any discount or premium is reported through investment income, instead of impacting dividends collected. Recognizing this amortization through investment income is consistent with U.S. GAAP.
- b. For perpetual preferred stock, the revisions have eliminated use of NAIC designations in determining measurement method and the guidance requires use of fair value, not to exceed any stated call price from the prospectus of the preferred stock. As there are no requirements for an issuer to redeem these securities, these securities can continue indefinitely until the issuing entity reacquires the preferred stock at current market rates or elects to buy-back the preferred stock in accordance with rates established in the preferred

stock prospectus. In order to prevent overstatement of the securities in the financial statements, the measurement of these preferred stocks reflects fair value, not to exceed any currently effective buy-back rates (call prices) that the issuer can utilize to redeem the stock. This measurement guidance is not impacted by the type of reporting entity (AVR or non-AVR filer) and is not impacted by NAIC designation. Although not impacted by NAIC designation, this guidance does not change the requirement to report the NAIC designation as the NAIC designation impacts the risk-based capital (RBC) charge attributed to the preferred stock.

- c. For mandatory convertible preferred stock, guidance has been incorporated to require measurement at fair value, not to exceed stated call price, in the periods prior to conversion. This guidance is applicable regardless if the preferred stock would be classified as redeemable or perpetual and is applicable regardless of NAIC designation. This guidance requires the preferred stock to be measured at the same measurement basis that would be required once converted to common stock. This prevents overstatement in the financial statements at the time of conversion.
- d. For exchange traded funds which qualify for preferred stock treatment from the NAIC SVO, the revisions clarify that these investments shall always be treated as perpetual preferred stock. This classification is appropriate as the fund would not qualify as a redeemable preferred stock with a structure that allows for amortization.

Impairment of Preferred Stock

19. The prior guidance in SSAP No. 32 included different guidance for determining other-than-temporary impairment (OTTI) based on whether the preferred stock was redeemable or perpetual. Although this division has been retained, modifications have been reflected as follows:

- a. For redeemable preferred stock, guidance has been captured to require assessment of OTTI whenever mandatory redemption rights or sinking fund requirements do not occur. Although preferred stock may indicate “required” elements, failing to provide dividends, or contribute to a sinking fund, may not be considered an act of default or require liability recognition from the issuer. Not receiving preferred stock provisions does not turn the holder of preferred stock into a creditor, and a redemption right cannot force a company to redeem shares. However, if an issuer fails to comply with “required” components, reporting

Preferred Stock Income / Redemption

20. The guidance in this issue paper incorporates ~~examples~~ ^{examples} to clarify the reporting of dividend income from preferred stock. This guidance clarifies that divi

EXHIBIT A - REVISIONS TO SSAP No. 32—Preferred Stock

Preferred Stock

SCOPE OF STATEMENT

1. This statement establishes statutory accounting principles for preferred stock.
2. Investments in preferred stock ~~of entities captured in SSAP No. 97—Investments in Subsidiaries, Controlled or Affiliated Entities or SSAP No. 48—Joint Ventures, Partnerships and Limited Liability Companies, including as well as~~ preferred stock interests of certified capital companies (CAPCO) per INT 06-02: Accounting and Reporting for Investments in a Certified Capital Company (CAPCO) included within the scope of this statement. The requirement to file investments in preferred stock of certain subsidiaries, controlled or affiliated entities with the NAIC pursuant to SSAP No. 97 does not affect the application of the accounting, valuation

4. The definition of preferred stock, as defined in paragraph 3, does not include fund investments. However, the following types of SVO-identified investments are captured within scope of this statement.

e.a. Exchange Traded Funds, which qualify for preferred stock treatment, as identified in Part Three of the Purposes and Procedures Manual of the NAIC Investment Analysis Office published on the SVO's web page at www.naic.org. SVO-identified preferred stock ETFs shall follow the accounting provisions for perpetual preferred stock.

~~4. 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. It includes mandatory sinking fund preferred stock and payment-in-kind (PIK) preferred stock.~~

~~5. Mandatory sinking fund preferred stock is defined as redeemable preferred stock subject to a 100% mandatory sinking fund, annual payments of which will (a) commence not more than 10 years from the date of issue or December 31, 1978, if outstanding on that date; (b) be not less than 2% of the number of shares issued (or outstanding on December 31, 1978, if issued prior to that date); (c) provide for the redemption of the entire issue over a period longer than 40 years from the date of issue, or December 31, 1978, if outstanding on that date. Redeemable preferred stock which is subject to a 100% mandatory sinking fund, but which does not, at date of issue or December 31, 1978, if outstanding at that time, meet one or more of the other requirements above, shall be considered as mandatory sinking fund preferred stock at the time the deficiency is cured through the passage of time or otherwise.~~

~~6. PIK preferred stock is defined as redeemable preferred stock on which, at the option of the issuer, dividends can be paid in additional securities rather than cash.~~

~~7. Perpetual preferred stock is defined as preferred stock with no redemption or sinking fund features or preferred stock redeemable at the option of the issuer.~~

8.5. Restricted preferred stock is defined as a security either redeemable or perpetual preferred stock that must be traded in compliance with special Securities Exchange Commission (SEC) regulations concerning its purchase and resale. These restrictions usually result from affiliate ownership, merger and acquisition (M&A) activity and underwriting activity. Pursuant to the SEC, restricted securities are securities acquired in an unregistered, private sale from the issuing company or from an affiliate of the issuer. They typically bear a "restrictive" legend stating that the holding may not resell the stock in the public marketplace unless the sale is exempt from the SEC's registration requirements. Restricted preferred stock is generally coded as an admitted asset; however, admittance may be limited based on the degree of restriction in accordance with SAP No. 4—Assets and Nonadmitted Assets. Restricted preferred stock shall be coded as restricted in the investment scheme.

Acquisitions and Sales

~~10.7.~~ At acquisition, preferred stock shall be reported at cost, including brokerage and other related fees. ~~PIK Preferred~~ stock received as dividends shall be recorded at fair value. Acquisitions and dispositions shall be recorded on the trade date. Private placement stock transactions shall be recorded on the funding date.

~~11.8.~~ A reporting entity can subscribe for the purchase of stock, but not be required to make payment until a later time. Transactions of this nature are common in the formation of corporations. Preferred stock acquired under a subscription represents a conditional transaction ~~in which a security preferred stock is~~ authorized for issuance but not yet actually issued. Such transactions are settled if and when the actual ~~security preferred stock~~ is issued and the exchange or National Association of Securities Dealers (NASD) rules that the transactions are to be settled. Preferred stock acquired under a subscription shall be recorded as an admitted asset when the reporting entity or its designated custodian or transfer agent takes delivery of the ~~security preferred stock~~ and the ~~security preferred stock~~ is recorded in the name of the reporting entity or its nominee, (i.e., the accounting for such preferred stock acquisitions shall be on the settlement date).

Amortization

~~12.9.~~ 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 call or earliest redemption date, whichever produces the lowest asset value (yield worst). Redeemable preferred stock purchased at a discount shall be ~~amortized~~ accreted to increase the carrying value ~~par value~~ the redemption price over the period to maturity or the latest redemption date.

~~13.~~ ~~PIK preferred stock shall be amortized to three 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.~~

~~14.10.~~ Amortization (and accretion) of the premium and discount arising at acquisition shall be calculated using the interest method and shall be reported through investment income ~~as increases or decreases in dividends collected during the year.~~

Balance Sheet Amount

~~15.~~ ~~The NAIC Securities Valuation Office assigns preferred stocks NAIC designations (NAIC designation 1 through 6) accordance with the Purposes and Procedures Manual of the NAIC Investment Analysis Office and that NAIC designation is published in accordance with the SVO compilation instructions in the Purposes and Procedures Manual~~

~~16.11.~~ Preferred stock shall be valued based on (a) the underlying characteristics ~~of the security~~ (redeemable ~~or perpetual~~ or mandatory convertible) (b) the quality rating ~~of the security~~ expressed as an NAIC designation ~~pursuant to paragraph 15~~ and (c) whether an asset valuation reserve (AVR) is maintained by the reporting entity:

a. For reporting entities that do not maintain an AVR:

~~17.~~ ~~Step-up preferred stock (a security with the structure of a preferred stock, that has the cash flow characteristics of a debt instrument) is considered a security with characteristics of both debt and equity,~~

~~Reporting Entities That Do Not Maintain An AVR~~

~~19.i.~~ 19.i. Highest-quality or high-quality redeemable preferred stocks (NAIC designations 1

is other-than-temporary, an impairment loss shall be recognized as a realized loss equal to the entire difference between the redeemable preferred stock's carrying value and its fair value not to exceed any currently effective call price,

- iii. The aggregate carrying value of the investments not evaluated for impairment, and
- iv. The circumstances that may have a significant adverse effect on the fair value.

~~32.19.~~ Refer to the Preamble for further discussion regarding disclosure requirements. The disclosure requirements of paragraphs ~~34.18b.~~, ~~34.18e.~~, ~~34.18f.~~, ~~34.18g.~~ and ~~34.18h.~~ shall be included in the annual audited statutory financial reports only.

Relevant Literature

~~33.20.~~ This statement rejects ASU 2018-03, Recognition and Measurement of Financial Assets and Financial Liabilities, ASU 2016-01, Financial Instruments – Overfunded Statement No. 115, accounting for Certain Investments in Debt and Equity Securities and FASB Emerging Issues Task Force No. 86-32, Early Extinguishment of a Subsidiary’s Mandatorily Redeemable Preferred Stock statement adopts FASB Staff Position 115-1/124-1, The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments, paragraph 16, with modification to be consistent with statutory language in the respective statutory accounting statements.

Effective Date and Transition

~~34.21.~~ This statement is effective for years beginning January 1, 2001. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with SSAP No. 3—Accounting Changes and Corrections of Errors. The guidance in paragraphs 23-26 was previously included within SSAP No. 99—Accounting for Securities Subsequent to an Other-Than-Temporary Impairment and was effective for reporting periods beginning on January 1, 2009, and thereafter, with early adoption permitted. In 2010, guidance from SSAP No. 99 was incorporated within the impacted standards, with SSAP No. 99 superseding the original impairment guidance included in this standard, and the substantive revisions reflected in SSAP No. 99 are retained for historical purposes within Issue Paper No. 131. The guidance in paragraphs 27 and 28 of SSAP No. 32 was originally superseded January 1, 2005, by guidance included in SSAP No. 88—Investments in Subsidiaries, Controlled and Affiliated Entities, A replacement of SSAP No. 46, and then subsequently reflected in SSAP No. 97. In 2007, the guidance related to preferred stock of SCAs from SSAP No. 97 was incorporated into this statement and revised to reflect a definition of preferred stock. The original guidance included in this statement, and the substantive revisions reflected in SSAP No. 88 and SSAP No. 97 (including the title change already reflected in SSAP No. 32) are retained for historical purposes within Issue Paper Nos. 32 and 118. Guidance in paragraph 17 was originally contained in NT 99-29: Classification of Step-Up Preferred Stock and was effective December 6, 1999.

22. On July 30, 2020, substantive revisions, as detailed in Issue Paper No. 164—Preferred Stock, were adopted. These revisions, effective January 1, 2021, update definitions of preferred stock and reporting values based on characteristics of the preferred stock.

REFERENCES

Other

- x Purposes and Procedures Manual of the NAIC Investment Analysis Office
- x NAIC Valuation of Securities product prepared by the Securities Valuation Office

Relevant Issue Papers

- x Issue Paper No. 32—Investments in Preferred Stock (excluding investments in preferred stock of subsidiary, controlled, or affiliated companies)
- x Issue Paper No. 131—Accounting for Certain Securities Subsequent to an Other-Than-Temporary Impairment
- x [Issue Paper No. 164—Preferred Stock](#)

EXHIBIT A – GLOSSARY

Callable Preferred Stock – A preferred stock in which the issuer has the right to call or redeem the stock at a preset price after a defined date. Callable preferred stock can be either redeemable preferred stock or perpetual preferred stock depending on the characteristics of the preferred stock. For example, callable preferred stock with a maturity or a specific buyback date would be redeemable preferred stock, whereas callable preferred stock electable at the discretion of the issuer is perpetual preferred stock.

Convertible Preferred Stock – A preferred stock that is convertible into another security based on a conversion rate. For example, convertible preferred stock that is convertible into common stock on a two-

