

Interpretation of the Emerging Accounting Issues Working Group

INT 04-02: Surplus Notes Issued by Entities Under Regulatory Action

ISSUE NULLIFIED BY SSAP NO. 41

INT 04-02 Dates Discussed

March 14, 2004; June 13, 2004

INT 04-02 References

SSAP No. 41—Surplus Notes (SSAP No. 41)

INT 04-02 Issue

1. SSAP No. 41 provides accounting guidance for surplus notes issued by an entity under regulatory action.
2. The following is excerpted from SSAP No. 41, with bolding added for emphasis:
 10. Surplus notes shall be accounted for in accordance with *SSAP No. 26—Bonds, excluding Loan-Backed and Structured Securities* (SSAP No. 26). Holders of surplus notes shall value their investment in surplus notes as follows:
 - a. **Rated Notes**
 - i. If the notes have been rated by an NAIC ~~Acceptable Rating Organization (ARO)~~ credit rating provider (CRP) and have a designation equivalent of NAIC 1, then amortized cost shall be used. If the notes are rated and monitored by two NAIC ~~AROs~~ CRPs, the lowest of the ratings shall be assigned. In case of notes rated and monitored by three or more NAIC ~~AROs~~ CRPs, the NAIC ~~ARO~~ CRP ratings will be ordered according to their NAIC equivalents and the rating falling second lowest will be selected, even if that rating is equal to that of the first lowest.
 - ii. The *Purposes and Procedures Manual of the NAIC Securities Valuation Office* contains a listing of NAIC equivalent ~~ARO~~ CRP designations as well as a listing of insurers that meet the requirements of i. above.
 - b. **Non-Rated Notes**
 - i. If the notes are not ~~ARO~~ CRP rated or have an NAIC designation equivalent of NAIC 2 through 6, then value as follows:
 - (a) At its outstanding face value, notwithstanding the payment of interest and/or principal, when the notes were issued by a reporting entity whose capital and surplus (excluding surplus notes included therein) is greater than or equal to the greater of 5% of its admitted assets (excluding separate accounts) or \$6,000,000. The valuation shall be calculated using the most recently filed statutory financial statements of the entity that issued the notes;

- (b) By applying a "statement factor" to the outstanding face amount of the capital or surplus notes, notwithstanding the payment of interest and/or principal when the notes were issued by a reporting entity whose capital and surplus (excluding surplus notes included therein) is less than or equal to the greater of 5% of its admitted assets (excluding separate accounts) or \$6,000,000. The "statement factor" is equal to the 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 capital or surplus notes. The valuation should be calculated using the most recently filed statutory financial statements of the entity that issued the notes. Should the result of the "statement factor" yield a product less than zero, the surplus notes shall be carried at zero and not a negative amount.

Capital or surplus debenture(s) must not be valued in excess of the lesser of the value determined above or amortized cost and are to be reported as other invested assets. **If the notes are issued by an entity which is subject to any order of liquidation, conservation, rehabilitation or a company action level event based on its risk-based capital, then the valuation is at zero, notwithstanding any previous payments of interest and/or principal.** The admitted asset value of a capital or surplus note shall not exceed the amount that would be admitted if the instrument was considered an equity instrument and added to any other equity investments in the issuer held directly or indirectly by the holder of the capital or surplus note. If the calculated value (after application of paragraph 10.b.i.(b)) is less than the outstanding face value, then that amount shall be accounted for as a nonadmitted asset.

3. The intent of the bolded sentence above in SSAP No. 41, paragraph 10 is not entirely clear, due to ambiguity surrounding the word "issued." Does "issued" refer simply to the identity of the issuing company, or does "issued" also carry a temporal implication, referring to the time of issue?
4. Two possibilities for the intent of the sentence are as follows:

View A: A holder of a surplus note must value the note at zero in any period in which the issuer of the note is under regulatory action. Once the issuer is no longer under regulatory action, the holder values the note according to the guidance in paragraph 10.a. or 10.b. as appropriate.

View B: If an issuer of a surplus note is under regulatory action at the time the note is issued, then the holder must value the note at zero in all future periods, regardless of whether or not the issuer remains under regulatory action.

INT 04-02 Discussion

5. The working group reached a consensus that View A is appropriate. A holder of a surplus note must value the note at zero in any period in which the issuer of the note is under regulatory action. Once the issuer is no longer under regulatory action, the holder values the note according to the guidance in SSAP No. 41, paragraph 10.a. or 10.b. as appropriate.

INT 04-02 Status

6. No further discussion is planned.