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.

   b. Providing a source of capital to mutual and other types of non-stock reporting entities who do not have access to traditional equity markets for capital needs.

   c. Providing alternative source of capital to stock reporting entities, although not for the purpose of initially capitalizing the reporting entity.

Common attributes of surplus notes are that they are only allowable pursuant to the approval of the domiciliary state, the form and content require regulatory approval and interest may be paid and principal may be repaid only with the prior approval of the commissioner of the state of domicile.

2. Current statutory guidance allows that surplus notes may be reported as surplus and not as debt of the reporting entity. Statutory guidance for issuers of surplus notes is found in Chapter 27, Paid-in or Contributed Capital and Organizational Surplus*,* of the Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies (Life/A&H Accounting Practices and Procedures Manual) and Chapter 24, Paid-in or Contributed Capital and Organizational Surplus of the Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies (P&C Accounting Practices and Procedures Manual). Statutory guidance for holders of surplus notes is provided in the *Purposes and Procedures Manual of the NAIC Securities Valuation Office* (SVO Purposes and Procedures). GAAP does not distinguish surplus notes from other types of subordinated notes and requires them to be recorded as liabilities.

3. The purpose of this issue paper is to establish statutory accounting principles for issuers of surplus notes and holders of surplus notes that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

Issuers of Surplus Notes

4. Surplus notes issued by a reporting entity that are subject to strict control by the commissioner of the reporting entity's state of domicile and have been approved as to form and content shall be reported as surplus and not as debt only if the surplus note contains the following provisions:

a. Subordination to policyholders;

b. Subordination to claimant and beneficiary claims;

c. Subordination to all other classes of creditors other than surplus note holders; and

d. Interest payments and principal repayments require prior approval of the commissioner of the state of domicile.

The proceeds received by the issuer must be in the form of cash or other admitted assets having readily determinable values and liquidity satisfactory to the commissioner of the state of domicile.

5. Costs of issuing surplus notes (i.e., loan fees, legal fees, etc.) do not meet the definition of an asset as defined in *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets* (Issue Paper No. 4). Accordingly, such costs shall be charged to operations when incurred.

6. Discount or premium, if any, shall be reported in the balance sheet as a direct deduction from or addition to the face amount of the note. Such discount or premium shall be charged or credited to the statement of operations concurrent with approved interest payments on the surplus note and in the same proportion or percentage as the approved interest payment is to the total estimated interest to be paid on the surplus note.

7. Interest shall be not be recorded as a liability nor an expense until approval for payment of such interest has been granted by the commissioner of the state of domicile. All interest, including interest in arrears, shall be expensed in the statement of operations when approved for payment. Unapproved interest:

a. Shall not be reported through operations;

b. Shall not be represented as an addition to the principal or notional amount of the instrument; and

c. Shall not accrue further interest, i.e., interest on interest.

8. As of the date of approval of principal repayment by the commissioner of the state of domicile, the issuer shall reclassify such approved payments from surplus to liabilities.

Disclosures

9. The notes to the financial statements of a reporting entity that issues surplus notes shall disclose the following as long as the surplus notes are outstanding:

a. Date issued,

b. Description of the assets received,

c. Holder of the note or if public the names of the underwriter and trustee,

d. Amount of note,

e. Carrying value of note,

f. The rate at which interest accrues,

g. Maturity dates or repayment schedules, if stated,

h. Unapproved interest and/or principal,

i. Interest and/or principal paid in the current year,

j. Total interest and/or principal paid on surplus notes,

k. Subordination terms,

l. Liquidation preference to the reporting entity's common and preferred shareholders and

m. The repayment conditions and restrictions.

In addition to the above a reporting entity shall 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 10% or more of the outstanding amount of any surplus note registered under the Securities Act of 1933 or distributed pursuant to Rule 144A under the Securities Act of 1933.

Holders of Surplus Notes

10. Surplus notes meet the definition of an asset as defined in Issue Paper No. 4. Holders of surplus notes shall follow SVO valuation procedures. The valuation procedures documented in the SVO Purposes and Procedures are detailed in paragraph 17 of this issue paper. Surplus notes shall be accounted for in accordance with *Issue Paper No. 26—Bonds, Excluding Loan-Backed and Structured Securities* (Issue Paper No. 26). The admitted asset value of a 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 surplus note. Only interest that has been approved by the issuer's domiciliary commissioner shall be accrued as income by a holder of surplus notes in a manner consistent with Issue Paper No. 26.

DISCUSSION

11. The primary concern of regulators is the ability of a reporting entity to meet its obligations to its policyholders. Additionally, surplus notes are subordinated to policyholder, claimant and beneficiary claims, as well as debts owed to all other classes of creditors (other than surplus note holders). For these reasons, they are viewed as surplus by regulators. A reporting entity's ability to pay interest and repay principal on surplus notes is more restrictive than its ability to pay dividends on common stock since most states permit some level of dividends to be paid without prior approval of the commissioner. The restrictive nature and the level of regulatory control over surplus notes coupled with the requirement of surplus notes to be reviewed as to form and content (including approval of the assets received for the surplus notes) provides assurances that adequate surplus exists to meet policyholder obligations.

12. The conclusions reached in this issue paper are consistent with current statutory guidance which requires surplus notes to be reported as surplus. Reporting surplus notes as surplus is consistent with the objectives of statutory financial reporting outlined in the Statement of Concepts which states:

> 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 their holders more favorable treatment than is provided to holders of common stock. GAAP has tended to focus on disclosure of those features and liquidation preferences. The Securities and Exchange Commission has issued guidance that requires equity securities with debt like features, such as mandatorily redeemable preferred stock to be recorded outside of the equity section of the balance sheet because of their liability-like characteristics.

14. Under GAAP, holders of surplus notes are required to account for such investments either at amortized cost or market value depending on their ability and intent with respect to holding the securities to maturity. *FASB Statement No. 115*, *Accounting for Certain Investments in Debt and Equity Securities (FAS 115)* has been rejected in its entirety in Issue Paper No. 26, *Issue Paper No. 28—Short-Term Investments*, *Issue Paper No. 30—Investments in Common Stock (excluding investments in common stock of subsidiary, controlled, or affiliated entities)*, *Issue Paper No. 32—Investments in Preferred Stock (including investments in preferred stock of subsidiary, controlled, or affiliated entities)* and *Issue Paper No. 43—Loan-Backed and Structured Securities*.

Drafting Notes/Comments
None

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting
Issuers
15. Chapter 24 of the P&C Accounting Practices and Procedures Manual and Chapter 27 of the Life/A&H Accounting Practices and Procedures manual provide the following guidance:

> Subordinated Surplus Debentures and Other Similar Instruments
>
> Insurers sometimes issue instruments that have the characteristics of both debt and equity. These instruments resemble debt inasmuch as they are repayable at interest and sometimes, dependent on the requirements of the domiciliary jurisdiction, include maturity dates and/or schedules of repayment. However, key provisions make these instruments tantamount to equity. These provisions are that they are allowable pursuant to the domiciliary jurisdiction's statutory, or

other regulatory provisions, approval requirements as to form and content and most importantly, interest may be paid and principal may be repaid only with the prior approval of the commissioner of the domiciliary jurisdiction. These instruments are sometimes referred to by other names including “surplus debentures”, “contribution certificates”, or “capital notes”.

This type of funding shall not be used to initially capitalize an insurer other than a mutual or reciprocal insurer. However, this type of instrument provides regulators with flexibility in dealing with problem situations to attract capital to companies whose surplus levels are deemed inadequate to support an insurer’s operations. It is noted that various jurisdictions’ dividend limitations based on “earned surplus” inhibit possible investors from providing necessary surplus funding. Additionally, mutual and other types of non-stock insurers do not have access to the other forms of capital equity markets.

As noted in the various states’ statutes that specifically provide for these types of instruments, these instruments may be reported as surplus and not as debt. This is due to the strict control which inures to the commissioners of those jurisdictions regarding the form and content of the instrument and the payment of interest and the repayment of principal.

The proceeds from this type of surplus acquisition must be in the form of cash, cash equivalents, or other assets having a readily determinable value satisfactory to the domiciliary commissioner. Insurers must clearly report the transaction in its “Notes to the Financial Statements” including the fact that payment of interest and repayment of principal is subject to the domiciliary jurisdiction’s approval.

Interest on such instruments is to be reported as an expense and a liability only after payment has been approved. Accrued interest that has not been approved for payment:

1. should <u>not</u> be reported through operations;

2. should <u>not</u> be represented as an addition to the instrument; and,

3. may <u>not</u> accrue further interest, i.e., “interest on interest”.

The amount of the accrued unapproved interest should be reflected in the “Notes to the Financial Statements”.

When a domiciliary jurisdiction grants an insurer permission to report a surplus note instrument as a component of its surplus account, the surplus note document shall provide that in the event of liquidation, the claims under the instrument are subordinated to policyholder, claimant and beneficiary claims as well as debts owed to all other classes of creditors (creditors other than surplus note holder) and that all payment of principal and interest are not payable and shall not be paid until approved by the domiciliary commissioner. The claims of the holder of a surplus note may be superior to claims of the issuer’s common and preferred shareholders if so provided in the instrument itself and duly authorized by the issuer. Such conditions shall also be clearly reported in the “Notes to the Financial Statements”.

This section applies to all such above described instruments issued after the date of adoption (December 12, 1991).

16. NAIC Annual Statement Instructions contain the following guidance with respect to disclosure of surplus notes:

6. Capital and Surplus and Shareholders’ and Policyholders’ Dividend Restrictions

<u>Instruction:</u>

e. For each surplus debenture or similar obligation, except those surplus notes required or which are a prerequisite for purchasing an insurance policy and are held by the policyholder, included on Page 3, Line 24A, furnish the following 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;

   b. By applying the statement value factor to the outstanding face amount of the surplus notes, 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 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 l and December 1 of each year. If there is a change in the rating, the SVO should be notified immediately.

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 in Schedule BA of the annual statement as other invested assets. For life insurers, the NRSRO rating equivalent may be used to report the surplus note statement value in the fixed income category of the other invested assets maximum reserve calculation. The maximum reserve factor should be the factors used for preferred-stocks not bonds. If no rating from a NRSRO exists, the surplus notes should be reserved on line 43 of the other invested asset maximum reserve calculation. This procedure is effective for all financial statements filed as of December 31, 1994, and thereafter.

(B) Issuers whose Surplus Notes are eligible for amortized value accounting by Holders pursuant to Section 7 (A). To be included on this list insurer holders or issuers must request listing and supply copies of appropriate NRSRO rating documents.

- Farmers Insurance Exchange
- General American Life Ins. Co.
- John Hancock Mutual Life Ins. Co.
- Massachusetts Mutual Life Ins. Co.
- Liberty Mutual Ins. Co.
- Metropolitan Life Ins. Co.
- National Life Ins. Co.
- Nationwide Mutual Ins. Co.
- New England Mutual Life Ins. Co.
- New York Life Ins. Co.
- Ohio National Life Ins. Co.
- Pacific Mutual Life Ins. Co.
- Principal Mutual Life Ins. Co.
- Prudential Insurance Company of America

18. Chapter 9 of the Life/A&H Accounting Practices and Procedures Manual provides the following guidance for holders of surplus notes:

Surplus Notes:

Insurers sometimes make subordinated surplus contributions to other insurers via an instrument variously referred to as “surplus notes”, “surplus debentures”, “contribution certificates”, “capital notes”, etc. Generally, these instruments allow for payment of interest and repayment of principal only with the approval of the commissioner of the domiciliary jurisdiction of the insurer receiving the surplus infusion and issuing the instrument. The form and content of such instruments are also subject to regulatory approval. Where such approval conditions exist, insurers should report these instruments as admitted assets only in an amount as determined by the Securities Valuation Office (SVO) of the National Association of Insurance Commissioners. The holders of such instruments should never be allowed an admitted asset value more than that which would be allowed by considering the instruments as equity instruments and adding same to any other equity investments in the issuer held directly or indirectly by the holder of the instruments. In addition, such instruments shall be considered in the limitations on investments in affiliates. Investment income on these instruments shall not be reported as accrued until payment by the issuer has been approved by the insurer's domiciliary commissioner.

Generally Accepted Accounting Principles

19. The distinction between a liability and equity instrument in GAAP is found in *FASB Statement of Financial Accounting Concepts No. 6*, *Elements of Financial Statements* (only pertinent excerpts are included):

> 55. Although the line between equity and liabilities is clear in concept, it may be obscured in practice. Applying the definitions to particular situations may involve practical problems because several kinds of securities issued by business enterprises seem to have characteristics of both liabilities and equity in varying degrees or because the names given some securities may not accurately describe their essential characteristics. For example, convertible debt instruments have both liability and residual-interest characteristics, which may create problems in accounting for them. (*APB Opinion No. 14, Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants*, and *APB Opinion No. 15, Earnings per Share*, both discuss problems of that kind.) Preferred stock also often has both debt and equity characteristics, and some preferred stocks may effectively have maturity amounts and dates at which they must be redeemed for cash.

20. FAS 115 provides the following guidance with respect to investments in surplus notes:

> FAS 115 Summary
> Summary
>
> This Statement addresses the accounting and reporting for investments in equity securities that have readily determinable fair values and for all investments in debt securities. Those investments are to be classified in three categories and accounted for as follows:
>
> - Debt securities that the enterprise has the positive intent and ability to hold to maturity are classified as held-to-maturity securities and reported at amortized cost.
> - Debt and equity securities that are bought and held principally for the purpose of selling them in the near term are classified as trading securities and reported at fair value, with unrealized gains and losses included in earnings.
> - Debt and equity securities not classified as either held-to-maturity securities or trading securities are classified as available-for-sale securities and reported at fair value, with unrealized gains and losses excluded from earnings and reported in a separate component of shareholders' equity.
>
> This Statement does not apply to unsecuritized loans. However, after mortgage loans are converted to mortgage-backed securities, they are subject to its provisions. This Statement supersedes *FASB Statement No. 12, Accounting for Certain Marketable Securities*, and related Interpretations and amends *FASB Statement No. 65, Accounting for Certain Mortgage Banking Activities*, to eliminate mortgage-backed securities from its scope.

OTHER SOURCES OF INFORMATION

21. Article 5 of Regulation S-X of the Securities and Exchange Commission provides the following pertinent guidance:

Redeemable Preferred Stocks

28. Preferred stocks subject to mandatory redemption requirements or whose redemption is outside the control of the issuer. (a) Include under this caption amounts applicable to any class of stock which has any of the following characteristics: (1) it is redeemable at a fixed or determinable price on a fixed or determinable date or dates whether by operation of a sinking fund or otherwise; (2) it is redeemable at the option of the holder; or (3) it has conditions for redemption which are not solely within the control of the issuer, such as stocks which must be redeemed out of future earnings. Amounts attributable to preferred stock which is not redeemable or is redeemable solely at the option of the issuer shall be included under §210.5-02.29 unless it meets one or more of the above criteria.

(b) State on the face of the balance sheet the title of each issue, the carrying amounts and redemption amount. (If there is more than one issue, these amounts may be aggregated on the face of the balance sheet and details concerning each issue may be presented in the note required by paragraph (c) below.) Show also the dollar amount of any shares subscribed but unissued, and show the deduction of subscriptions receivable therefrom. If the carrying value is different from the redemption amount, describe the accounting treatment for such difference in the note required by paragraph (c) below. Also state in this note or on the face of the balance sheet, for each issue, the number of shares authorized and the number of shares issued or outstanding, as appropriate [See §210.4-071]

(c) State in a separate note captioned "Redeemable Preferred Stocks" (1) a general description of each issue, including its redemption features (e.g. sinking fund, at option of holders, out of future earnings) and the rights, if any, of holders in the event of default, including the effect, if any, on junior securities in the event a required dividend, sinking fund, or other redemption payment(s) is not made; (2) the combined aggregate amount of redemption requirements for all issues each year for the five years following the date of the latest balance sheet; and (3) the changes in each issue for each period for which an income statement is required to be filed. [See also § 210.4-08(d).]

(d) Securities reported under this caption are not to be included under a general heading "stockholders' equity" or combined in a total with items described in captions 29, 30 or 31 which follow.

Non-Redeemable Preferred Stocks

29. Preferred stocks which are not redeemable or are redeemable solely at the option of the issuer. State on the face of the balance sheet, or if more than one issue is outstanding state in a note, the title of each issue and the dollar amount thereof. Show also the dollar amount of any shares subscribed but unissued, and show the deduction of subscriptions receivable therefrom. State on the face of the balance sheet or in a note, for each issue, the number of shares authorized and the number of shares issued or outstanding as appropriate [See § 210.4-07l. Show in a note or separate statement the changes in each class of preferred shares reported under this caption for each period for which an income statement is required to be filed. [See also § 210.4-08(d).

Common Stocks

30. Common stocks. For each class of common shares state, on the face of the balance sheet, the number of shares issued or outstanding, as appropriate [see §210.4 07] and the dollar amount thereof. If convertible, this fact should be indicated on the face of the balance sheet. For each class of common shares state, on the face of the balance sheet or in a note, the title of the issue, the number of shares authorized, and, if convertible, the basis of conversion [see also § 210.4-08(d)]. Show also the dollar amount of any common shares subscribed but unissued, and show the deduction of subscriptions receivable therefrom. Show in a note or statement the changes in each class of common shares for each period for which an income statement is required to be filed.

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