

Statutory Issue Paper No. 131

Accounting for Certain Securities Subsequent to an Other-Than-Temporary Impairment

STATUS

Finalized March 29, 2008

Current Authoritative Guidance for Certain Securities Subsequent to an Other-Than-Temporary Impairment: SSAP No. 26, SSAP No. 32 and SSAP No. 34

This issue paper may not be directly related to the current authoritative impairment guidance in SSAP No. 43R.

Original SSAP from Issue Paper: SSAP No. 99

Type of Issue:

Common Area

SUMMARY OF ISSUE

1. In November of 2005, the FASB issued *FSP FAS 115-1/124-1: The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments* (FSP FAS 115-1/124-1) to address several issues related other-than-temporary impairment for investments. In December of 2006, the Emerging Accounting Issues Working Group of the NAIC released *INT 06-07: Definition of Phrase "Other Than Temporary"* (INT 06-07), which addressed all but two issues contained within FSP FAS 115-1/124-1. The purpose of this issue paper is to address one of those remaining issues, specifically the guidance provided in paragraph 16 of FSP FAS 115-1/124-1 regarding treatment of premium or discount for a debt security subsequent to other-than-temporary impairment recognition.
2. Current statutory guidance on accounting for impairment of debt securities, amortization of premium and accrual of discount is provided in *SSAP No. 26—Bonds, excluding Loan-backed and Structured Securities* (SSAP No. 26), *SSAP No. 32—Investments in Preferred Stock (including investments in preferred stock of subsidiary, controlled, or affiliated entities)* (SSAP No. 32), *SSAP No. 34—Investment Income Due and Accrued* (SSAP No. 34), and *SSAP No. 43—Loan-backed and Structured Securities* (SSAP No. 43).
3. Subsequent to recognition of an other-than-temporary impairment for a debt security, the GAAP guidance in FSP FAS 115-1/124-1 requires that a reporting entity account for the security as if the security had been purchased on the measurement date of the other-than-temporary impairment. As such, the recorded discount or reduced premium should be amortized over the remaining life of the security in a prospective manner based on the amount and timing of future estimated cash flows. Statutory accounting statements currently contain no explicit guidance on the issue of whether to continue amortization of premium or accrual of discount subsequent to other-than-temporary impairment recognition.

SUMMARY CONCLUSION

4. This issue paper adopts the guidance in paragraph 16 of FSP FAS 115-1/124-1, with modification to the applicable statutory accounting statements to be consistent with the statutory language in each respective statement as indicated in the following paragraphs.

Bonds, excluding Loan-backed and Structured Securities

5. The guidance in paragraphs 6 and 7 of this issue paper shall supersede the guidance in paragraph 9 of SSAP No. 26.

Impairment

6. An other-than-temporary 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. If it is determined that a decline in the fair value of a bond is other-than-temporary, an impairment loss shall be recognized as a realized loss equal to the entire difference between the bonds 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/IMR, the accounting for the entire amount of the realized capital loss shall be in accordance with *SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve*. Credit related other-than-temporary impairment losses shall be recorded through the AVR; interest related other-than-temporary impairment losses shall be recorded through the IMR.

7. In periods subsequent to the recognition of an other-than-temporary impairment loss for a bond, 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. The fair value of the bond on the measurement date shall become the new cost basis of the bond 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.

Preferred Stock

8. The guidance in paragraphs 9-12 of this issue paper shall supersede the guidance in paragraphs 22-24 of SSAP No. 32.

Impairment of Redeemable Preferred Stock

9. An other-than-temporary 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 security prior to its maturity at an amount below its carrying value (i.e., amortized cost). If it is determined that a decline in the fair value of a redeemable preferred stock 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 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 Reserves*.

10. In periods subsequent to the recognition of other-than-temporary impairment loss for a redeemable 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 18 or paragraph 20 of SSAP No. 32, as applicable. The fair

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-than-temporary impairment. The fair value of the security on the measurement date shall become the new cost basis. The discount or reduced premium recorded for the security, based on the new cost basis, shall be amortized in the prospective manner over the remaining period in which repayment of principal is expected to occur. The security shall continue to be subject to impairment analysis for each subsequent reporting period. The new cost basis shall not be changed for subsequent recoveries in fair value. Therefore, the prospective adjustment method

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 evaluation, measurement and subsequent accounting treatment related to impairment of debt securities. FSP FAS 115-1 / 124-1, footnote 2 to paragraph 7, defines cost to include adjustments made to the cost basis of an investment for accretion, amortization, previous other-than-temporary impairments, and hedging. Based on this definition, cost for GAAP purposes would be the equivalent of the book adjusted carrying value relevant to statutory accounting.

21. The guidance adopted by this issue paper requires that subsequent to impairment recognition, a debt security be accounted for as if the security had been purchased on the measurement date of the other-than-temporary impairment. For debt securities carried with unamortized premium, the impairment loss is first applied to any unamortized premium, and the reduced premium is amortized over the remaining life of the security in a prospective manner based on the amount and timing of future estimated cash flows. If an impairment loss is so significant that the unamortized premium is fully expensed upon recognition of the realized loss, any remaining impairment loss is applied to the cost of the security and amortization would no longer be applicable.

22. For securities carried with unaccrued discount, the impairment loss is recorded as a reduction of cost, with no effect on the unaccrued discount. The sum of the new cost basis plus the unaccrued discount

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 security prior to its maturity at an amount below its carrying value (i.e., amortized cost).

28. Statutory guidance in SSAP No. 34 provides items to be included in gross investment income:

SCOPE OF STATEMENT

1. This statement establishes statutory accounting principles for investment income due and accrued.

SUMMARY CONCLUSION

2. Investment income due shall be defined as investment income earned and legally due to be paid to the reporting entity (i.e., receivable) as of the reporting date. Investment income accrued shall be defined as investment income earned as of the reporting date but not legally due to be paid to the reporting entity until subsequent to the reporting date.

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.).

4. Investment income due and accrued shall be recorded as an asset in accordance with SSAP No. 4—Assets and Nonadmitted Assets (SSAP No. 4). An evaluation shall be made of such assets in accordance with SSAP No. 5—Liabilities, Contingencies and Impairments of Assets (SSAP No. 5), to determine whether an impairment exists. Amounts determined to be uncollectible shall be written off through the statement of operations. Then an evaluation shall be made to determine nonadmitted amounts.

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:

Amortization

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 over which repayment of principal of the loan-backed securities is expected to occur, not the stated maturity period.

Impairment

16. Regardless of whether a reporting entity is using a prospective or retrospective method, if the revaluation based on new currently estimated cash flows results in a negative yield (i.e., undiscounted estimated future cash flows are less than the current book value), an other than temporary impairment shall be considered to have occurred. If it is determined an other than temporary impairment has occurred, the cost basis of the security shall be written down to the undiscounted estimated future cash flows and the amount of the write down shall be accounted for as a realized loss. For reporting entities required to maintain an AVR/IMR, the accounting for the entire amount of the realized capital loss shall be in accordance with SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve. The new cost basis shall not be changed for subsequent recoveries in fair value. Therefore, the prospective adjustment method must be utilized for periods subsequent to the loss recognition.

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.