Statutory Issue Paper No. 151

Valuation for Holders of Surplus Notes

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Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Current statutory accounting guidance for holders of surplus notes is in *SSAP No. 41—Surplus Notes* (SSAP No. 41). Pursuant to this guidance, capital or surplus notes shall be accounted for in accordance with *SSAP No. 26—Bonds*, with valuation determined on the basis of the NAIC equivalent designation to a CRP rating. Under that guidance, for surplus notes that have a designation equivalent to NAIC 1, the surplus note shall be valued at amortized cost. For surplus notes that are not rated, or have an NAIC designation equivalent below NAIC 1, the value is either the outstanding face value, or a specific calculation of the outstanding face value based on a "statement factor" depending on the size of the reporting entity that issued the surplus note.

2. An agenda item to review the guidance for holders of surplus notes was drafted to address questions on guidance previously included within paragraph 10 of SSAP No. 41. Particularly, the agenda item proposed to clarify the application of the guidance in paragraphs 10a and 10b to the paragraph 10 "hanging paragraph" guidance. Additionally, the agenda item posed questions on whether the valuation methods should be reviewed, with consideration of a "lower of amortized cost or fair value" approach, or if the thresholds for applying the "statement factor" should be reviewed and if different parameters should be established for determining the value of those surplus notes.

3. After considering the agenda item, the Working Group directed NAIC staff to prepare this Issue Paper to detail substantive revisions to SSAP No. 41, which proposes revisions and documenting discussions regarding the measurement methods, and resulting valuation, for holders of surplus notes.

SUMMARY CONCLUSION

4. This issue paper substantively revises the measurement guidance for the holders of surplus notes in SSAP No. 41. This issue paper proposes that these revisions be subsequently reflected in a substantively revised SSAP No. 41R.

Substantive Revisions to SSAP No. 41:

Holders of Capital or Surplus Notes

<u>9.</u> Investments in capital or surplus notes meet the definition of assets as defined in *SSAP No. 4—Assets and Nonadmitted Assets* and are admitted assets to the extent they conform to the requirements of this statement. <u>Additionally, the amount admitted is specifically limited to the following two provisions:</u>

a. <u>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 instruments in the issuer held directly or indirectly by the holder of the capital or surplus note.</u>

b. The surplus note shall be nonadmitted if issued by an entity that is subject to any order of liquidation, conservation, rehabilitation or any company action level event based on its risk-based capital. Subsequent to this nonadmittance, if any of the conditions described ceased to exist, the holder may admit the surplus note at the value determined under paragraph 11. If a surplus note was nonadmitted pursuant to this paragraph, and the surplus note was ultimately determined to be other-than-temporarily impaired, the reporting entity shall recognize a realized loss for the portion of the surplus note determined to be other-than-temporarily impaired, with elimination of a corresponding amount of the previously nonadmitted assets.

10. Capital or surplus notes shall be valued~~accounted for in accordance with *SSAP No. 26—Bonds, Excluding Loan-Backed and Structured Securities* (SSAP No. 26). Holders of capital or surplus notes shall value their investment as follows:~~ in accordance with paragraph 11. Pursuant to that paragraph, the value is determined by CRP ratings. Part 6, Section 4 – Capital and Surplus Debentures of the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* provides guidance in determining the NAIC designation for these investments.

11. If the capital or surplus note has been rated by an NAIC credit rating provider (CRP) and has a designation equivalent of NAIC 1 or NAIC 2[1], then it shall be reported at amortized cost. If the capital or surplus note is not CRP rated or has an NAIC designation equivalent of NAIC 3 through 6, then the balance sheet amount shall be reported at the lesser of amortized cost or fair value, with fluctuations in value reflected as unrealized valuation changes.

~~a. Rated Notes~~

~~b. If the notes have been rated by an NAIC 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 CRPs, the lowest of the ratings shall be assigned. In case of notes rated and monitored by three or more NAIC CRPs, the NAIC 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.~~

~~c. The *Purposes and Procedures Manual of the NAIC Securities Valuation Office* contains a listing of NAIC equivalent CRP designations as well as a listing of insurers that meet the requirements of paragraph 10.a.i.~~

~~d. Non-Rated Notes~~

~~e. If the notes are not CRP rated or have an NAIC designation equivalent of NAIC 2 through 6, then value as follows:~~

~~f. 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;~~

[1] The *Purposes and Procedures Manual of the NAIC Securities Valuation Office* contains a listing of NAIC equivalent CRP designations as well as a listing of insurers that meet the requirements of paragraph 11.

~~g. 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 capital or 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 any 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.~~

~~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.~~

Income

12. For reporting entities required to maintain an AVR, the accounting for unrealized gains and losses shall be in accordance with *SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve* (SSAP No. 7). For reporting entities not required to maintain an AVR, unrealized gains and losses shall be recorded as a direct credit or charge to unassigned funds (surplus).

13. 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 SSAP No. 26~~. Interest income for any period consists of interest collected during the period, the change in the due and accrued interest between the beginning and end of the period approved by the issuer's domiciliary commissioner.

14. Except for the specific limitations on recognizing interest income in paragraph 13, investment income, and the recognition of uncollectible accrued interest, shall follow the guidance in *SSAP No. 34—Investment Income Due and Accrued*.

Impairment

15. An other-than-temporary impairment[(INT 06-07)] 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 surplus note. Pursuant to the terms of a surplus note, payments of principal and interest may be delayed if the issuer's domiciliary commissioner does not approve payment. Extended delays of either principal or interest shall trigger an evaluation for an other-than-temporary impairment. An other-than-temporary impairment shall be recognized in situations when the reporting entity has made a decision to sell a surplus note prior to its maturity at an amount below its carrying value. If it is determined that a decline in fair value is other-–than-temporary, an impairment loss shall be recognized as a realized loss equal to the difference between the surplus note's carrying value and the fair value at the balance sheet date of the

reporting period for which the assessment is made. The measurement of impairment 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.

16. In periods subsequent to the recognition of an other-than-temporary impairment loss for a surplus note, the holder of the surplus note shall account for the other-than-temporarily impaired surplus note as if the surplus note had been purchased on the measurement date of the other-than-temporary impairment. The fair value of the surplus note on the measurement date shall become the new cost basis of the surplus note and the new cost basis shall not be adjusted for subsequent recoveries in fair value. The discount or reduced premium recorded for the surplus note, based on the new cost basis, shall be amortized over the remaining life of the surplus note in the prospective manner based on the amount and timing of future estimated cash flows. The surplus note 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.

Relevant Literature

19.~~15.~~ ~~This statement adopts the *Purposes and Procedures Manual of the NAIC Investment Analysis Office*, "Procedures for Valuing Surplus Debentures."~~ This statement rejects *AICPA Practice Bulletin No. 15, Accounting by the Issuer of Surplus Notes*, which requires surplus notes to be accounted for as debt and that interest be accrued over the life of the surplus note, irrespective of the approval of interest and principal payments by the insurance commissioner.

Effective Date and Transition

20. 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 provisions of paragraph 3, which are required for an instrument to qualify as a surplus note, apply to all surplus notes issued or amended after December 12, 1991. Surplus notes issued on or before December 12, 1991, shall not be required to meet the provisions of paragraph 3 in order to be accounted for as a surplus note. Guidance reflected in paragraph 11, incorporated from *INT 04-02: Surplus Notes Issued by Entities Under Regulatory Action*, was originally effective June 13, 2004.

21. In April 2016, substantive revisions were adopted to change the valuation method for holders of surplus notes. With the adopted substantive revisions, surplus notes with a designation equivalent to NAIC 1 or NAIC 2 shall be reported at amortized cost. All other surplus notes are required to be reported at the lesser of amortized cost or fair value. The substantive revisions also incorporated guidance to clarify when surplus notes shall be nonadmitted, have an unrealized loss, and undergo an other-than-temporary impairment assessment. The substantive revisions, detailed for historical purposes in Issue Paper No. 151, are effective January 1, 2017 and shall be accounted for as a change in accounting principle in accordance with *SSAP No. 3—Accounting Changes and Corrections of Errors*.

DISCUSSION

5. In August 2014, an agenda item was presented to the Statutory Accounting Principles (E) Working Group to address questions on the application of the guidance in paragraph 10.a. and 10.b. to the paragraph 10 "hanging paragraph" guidance. This agenda item was exposed with a request for comments on whether to revise the thresholds when applying a statement factor and on the issues noted below.

a. For surplus notes acquired at a premium, whether the valuation method used for NAIC 1 designation surplus notes should always be amortized cost, or if the hanging paragraph guidance for a "lower of value" threshold intended to reduce amortized cost if the outstanding face value was less.

b. For surplus notes reported at outstanding face value, whether the difference between outstanding face value and amortized cost should be reported as a non-admitted asset or an unrealized loss.

c. For surplus notes in which amortized cost was less than the calculated value from use of the statement factor, the determination of the amount that should be nonadmitted.

d. For surplus notes in which amortized cost was greater than the calculated value from use of the statement factor, clarification that the difference between the calculated amount and the outstanding face value would be nonadmitted.

e. For surplus notes in which amortized cost was greater than the face amount and the calculated amount from use of the statement factor, clarification that the nonadmitted portion would be the difference between the calculated amount and the outstanding face value.

6. In November 2014, the Working Group reviewed comments received from the exposure and directed staff to draft revisions to clarify existing guidance related to non-rated surplus notes and surplus notes with a CRP rating below an equivalent NAIC 1 designation. In addition, the Working Group affirmed that surplus notes with a CRP rating equivalent to an NAIC 1 designation should be carried at amortized cost, and not the lessor of amortized cost or the outstanding face value. As a result of this direction, in March 2015, the Working Group exposed proposed revisions to illustrate the following:

a. Surplus notes with a CRP rating equivalent to an NAIC 1 shall be reported at amortized cost.

b. Surplus notes that are not rated by a CRP or have a CRP rating that is anything other than NAIC 1 shall be reported at the lower of amortized cost or fair value. (This would eliminate the concept of reporting the surplus note at "outstanding face value" or a calculated amount determined based on a "statement factor".)

c. Valuation changes (e.g., fair value fluctuations, movement from amortized cost to fair value) would result in unrealized changes. The other aspects that impact the value of surplus notes (e.g., issuer is under regulatory action) would result in nonadmittance.

7. In June 2015, the Working Group considered comments on the March 2015 proposed revisions, with identification that no comments were received objecting to the concepts reflected in the exposure. However, it was identified that the comments received recommended consideration of whether surplus notes with a CRP rating equivalent to an NAIC 2 designation should receive amortized cost accounting treatment. As a result of these comments, and as the proposed revisions would result in substantive changes, the Working Group directed the preparation of an issue paper detailing the revisions based on the concepts previously exposed and to include research and discussion on the comments received suggesting amortized cost for surplus notes with CRP ratings equivalent to NAIC 2 designations. It was also noted that discussion of proposals to include impairment guidance, as well as whether to duplicate guidance from the P&P Manual, would be included in the issue paper.

Use of Outstanding Face Value / Statement Factor

8. In reviewing *Issue Paper No. 41—Surplus Notes* (finalized in 1998), the threshold guidance for 5% and $6,000,000 of admitted assets, reflected in paragraphs 10.b.i(a) and 10.b.i(b) of SSAP No. 41, was originally pulled from Section 7: Procedures for Vesting Surplus Debentures of the *Purposes and Procedures Manual of NAIC Securities Valuation Office*. This guidance was subsequently removed from the P&P Manual, and retained only within SSAP No. 41. In reviewing the history of this guidance, it has been 16 years since the outstanding face value / statement factor guidance was revised.

9. In reviewing the reporting schedule for surplus notes (Schedule BA), it was identified that the reporting process does not encompass the concepts to reflect outstanding face value or a calculated amount based on a statement factor. Particularly, there are no current columns on Schedule BA for par or outstanding face value. Additionally, if the statement factor is used, it is not possible on Schedule BA to identify the use of a calculation and the resulting amount.

10. The guidance in SSAP No. 41 identifies that capital or surplus notes shall be accounted for in accordance with *SSAP No. 26—Bonds*, but is inconsistent with SSAP No. 26 as it has specific valuation guidance for notes that are non-rated or are rated by a CRP that is equivalent to an NAIC designation between 2-6. By revising the valuation guidance to the lower of amortized cost or fair value for surplus notes that do not have a CRP rating equivalent to an NAIC 1, the measurement method in SSAP No. 41 will be more consistent with the statutory accounting method for lower-quality instruments captured within SSAP No. 26, which are reported at a lower of amortized cost of fair value measurement method. Additionally, the highest possible value reported (lower of amortized cost or fair value) would seemingly reflect an amount no greater than what the reporting entity would be able to obtain if they had to sell the surplus note in an orderly transaction between market participants.

11. In considering proposed revisions to the valuation of surplus notes, it was recognized that it could be possible for amounts reported for surplus notes to be increased. Such situations are expected to be limited to instances in which a statement factor was previously used to calculate the valuation amount, and the previous calculated amount was less than fair value. With the proposed process to require the lower of amortized cost or fair value, and as fair value is defined in *SSAP No. 100—Fair Value* to reflect the amount that would be received to sell the asset in an orderly transaction between market participants, a resulting increase from the proposed change has not been identified as a regulatory concern.

Recognition of Nonadmitted Amounts / Unrealized Losses / Impairment Consideration

12. Prior guidance in SSAP No. 41 seemed to commingle when changes in the value for surplus notes should impact unrealized losses or be nonadmitted. Per the proposed revisions in this issue paper, valuation changes (e.g., fair value fluctuations, or moving from amortized cost to fair value) would result in unrealized gains or losses. The other aspects that impact the value of surplus notes (e.g., investment limitations, or if the issuer is under regulatory action) are proposed to result in nonadmission of the surplus notes.

13. The proposal for revisions to require valuation fluctuations to be recognized as unrealized gains or losses is consistent with existing statutory accounting principles for both debt and equity instruments that are measured at fair value, or that move between the lower of amortized cost or fair value.

14. The proposed revisions to nonadmit surplus notes in accordance with investment limitations when the issuer is under regulatory action is intended to only clarify the prior SSAP No. 41 guidance without incorporating significant changes. The prior guidance in SSAP No. 41 specifically highlighted the equity investment limitation, and previously noted that the holder should report a "zero" value in any period in which the issuer is under regulatory action. This guidance was explicit that the zero value would be revised to reflect the guidance under SSAP No. 41 once the insurer was no longer under regulatory action. As reporting a "zero" value appears to be synonymous with nonadmittance, this issue paper proposes revisions to ensure consistency with reporting in such situations.

15. It was identified that there is no explicit guidance in SSAP No. 41 for the recognition of other-than-temporarily impaired surplus notes. As discussed above, prior SSAP No. 41 guidance stipulated that surplus notes should be reported at a "zero" value when the issuer is under regulatory action, however, that guidance allows for the zero value to be revised once the issuer is no longer subject to the regulatory action. Pursuant to existing statutory accounting principles on the recognition of other-than-temporary impairment (OTTI), generally, once an OTTI is recognized, the recognized realized loss is not permitted to be revised for subsequent recoveries. As it is possible for the performance of a surplus note to be other-

than-temporarily impaired beyond situations in which the issuer is subject to regulatory action, it was proposed that explicit impairment guidance, using the concepts of existing OTTI guidance in other SSAPs be included within SSAP No. 41. Pursuant to the direction provided by the Working Group during the 2015 Fall National Meeting, OTTI guidance has been included within the proposed revisions detailed within this issue paper.

16. With the inclusion of proposed impairment guidance in this issue paper, additional revisions were also included to prescribe the recognition of realized losses as a result of OTTI recognition, and the elimination of nonadmitted assets, if the surplus note had previously been nonadmitted.

NAIC Designations for Recognizing Surplus Notes at Amortized Cost

17. In response to the March 2015 exposure, comments were received that both surplus notes with NAIC 1 and NAIC 2 equivalent designations should be carried at amortized cost, not just the surplus notes with an NAIC 1 equivalent CRP rating. These comments highlighted that surplus notes with NAIC 2 equivalent CRP ratings are considered high-quality investment grade securities and should be afforded the same measurement guidance as other high-quality investments in statutory accounting. Particularly, bonds with NAIC 2 designations (or equivalents) and preferred stocks with NAIC 2 designations (or equivalents) are permitted to be reported at amortized cost. These comments further identify that surplus notes are predominantly issued by mutual companies and represent an efficient way for those companies to access capital. Lastly, the comments identified that companies that issue surplus notes, nor the insurers that purchase surplus notes with high-quality CRP ratings should be penalized by requiring a measurement consistent with lower-quality investments.

18. Pursuant to the December 2014 *Purposes and Procedures Manual of the NAIC Investment Analysis Office*, the NAIC designations are proprietary symbols that the NAIC SVO uses to denote a category or band or credit risk. The definitions of the designations (detailed below) do not fluctuate based on the type of investment and are used uniformly for all investments:

a. **NAIC 1** is assigned to obligations exhibiting the highest quality. Credit risk is at its lowest and the issuer's credit profile is stable. This means that interest, principal or both will be paid in accordance with the contractual agreement and that repayment of principal is well protected. An **NAIC 1** obligation should be eligible for the most favorable treatment provided under the NAIC Financial Conditions Framework.

b. **NAIC 2** is assigned to obligations of high quality. Credit risk is low but may increase in the intermediate future and the issuer's credit profile is reasonably stable. This means that for the present, the obligation's protective elements suggest a high likelihood that interest, principal or both will be paid in accordance with the contractual agreement, but there are suggestions that an adverse change in circumstances or economic, financial or business conditions will affect the degree of protection and lead to a weakened capacity to pay. An **NAIC 2** obligation should be eligible for relatively favorable treatment under the NAIC Financial Conditions Framework.

c. **NAIC 3** is assigned to obligations of medium quality. Credit risk is intermediate and the issuer's credit profile has elements of instability. These obligations exhibit speculative elements. This means that the likelihood that interest, principal or both will be paid in accordance with the contractual agreement is reasonable for the present, but an exposure to an adverse change in circumstances or economic, financial or business conditions would create an uncertainty about the issuer's capacity to make timely payments. An **NAIC 3** obligation should be eligible for less favorable treatment under the NAIC Financial Conditions Framework.

d. **NAIC 4** is assigned to obligations of low quality. Credit risk is high and the issuer's credit profile is volatile. These obligations are highly speculative, but currently the issuer has the capacity to meet its obligations. This means that the likelihood that interest, principal or both will be paid in accordance with the contractual agreement is low and that an adverse change in circumstances or business, financial or economic conditions would accelerate credit risk, leading to a significant impairment in the issuer's capacity to make timely payments. An **NAIC 4** obligation should be accorded stringent treatment under the NAIC Financial Conditions Framework.

e. **NAIC 5** is assigned to obligations of the lowest credit quality, which are not in or near default. Credit risk is at its highest and the issuer's credit profile is highly volatile, but currently the issuer has the capacity to meet its obligations. This means that the likelihood that interest, principal or both will be paid in accordance with the contractual agreement is significantly impaired given any adverse business, financial or economic conditions. An **NAIC 5** Designation suggests a very high probability of default. An **NAIC 5** obligation should incur more stringent treatment under the NAIC Financial Conditions Framework.

f. **NAIC 6** is assigned to obligations that are in or near default. This means that payment of interest, principal or both is not being made, or will not be made, in accordance with the contractual agreement. An **NAIC 6** obligation should incur the most severe treatment under the NAIC Financial Conditions Framework.

19. Pursuant to the identified expected elements of a review of a surplus note by a CRP (noted below), the process to review surplus notes is specific to the type of instrument. As such, it is presumed that the rating received has taken into consideration the specific elements (e.g., debt and equity) reflected within the surplus note. Expected elements of surplus note review by a CRP:

a. Review of specific terms and conditions of the surplus note, including whether the surplus note has characteristics of debt or equity.

b. Regulatory assessment, including whether regulatory approval was obtained before issuance, the amount of surplus notes allowed as policyholders surplus, and provisions for regulatory approval of interest and principal.

c. Review of management intent and the intended use of funds in evaluating surplus notes.

d. In addition to evaluating the terms of the surplus note, review issuer (insurer) for financial performance, business profile and risk management.

20. The SVO does not currently have a process to review surplus notes, and although surplus notes are filed with the SVO, these submissions do not result with assessments or classifications of the underlying investment or a credit quality designation. Under current guidelines, the SVO function for filed surplus notes includes:

a. The SVO verifies that the CRP rating is equivalent to an NAIC 1 designation and compiles a list of surplus notes reported to the SVO that have CRP ratings equivalent to NAIC 1 designations.

b. For surplus notes that are not rated by CRPs, or have CRP ratings equivalent to an NAIC 2-6 designations, the SVO is to review the issuer's statutory financial statements solely to identify whether the issuers admitted assets and surplus amounts allow the holder to use the outstanding face value or if the holder shall value the surplus note based on the product of outstanding face value and the statement factor pursuant to the current requirements in SSAP No. 41.

21. From a review of the 2013 and 2014 statutory financial statements, the following NAIC designations were identified for surplus notes:

<u>2013 – 149 Surplus Notes</u>

a. Equivalent to NAIC 1 = 96 Surplus Notes (1, 1FE, 1Z)

b. Equivalent to NAIC 2 = 42 Surplus Notes (2, 2FE, 2Z)

c. Equivalent to NAIC 3 = 1 (3FE)

d. Equivalent to NAIC 4 = 1 (4FE)

e. Equivalent to NAIC 6 = 1 (6FE)

f. Other Designations = 8 (None "0", A and NR)

<u>2014 – 136 Surplus Notes</u>

g. Equivalent to NAIC 1 = 88 Surplus Notes (1, 1FE)

h. Equivalent to NAIC 2 = 38 Surplus Notes (2, 2FE, 2Z)

i. Equivalent to NAIC 3 = 1 (3)

j. Equivalent to NAIC 4 = 1 (4FE)

k. Equivalent to NAIC 6 = 1 (6FE)

l. Other Designations = 7 ("0", K, P1A and NR)

22. After considering the comments received from interested parties, as well as the information regarding designation definitions, and the expected process to review surplus notes by CRPs, during the 2015 Fall National Meeting, the Working Group directed NAIC staff to revise the issue paper to specify an amortized cost measurement method to surplus notes with CRP ratings equivalent to either NAIC 1 or NAIC 2. All other surplus notes (rated or non-rated) shall be reported at the lower of amortized cost or fair value.

23. With the direction to expand amortized cost treatment to NAIC 2 designated surplus notes, the Working Group identified that revisions would also be needed to the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* to include the listing of these NAIC 2 surplus notes along with surplus notes designated NAIC 1. The Working Group noted that a referral would be submitted to request these modifications.

24. In review of the November 15, 2006, memo from Michael Moriarty, Chair of the Valuation of Securities (E) Task Force, to Chris Evangel, Managing Director SVO, the purpose to file all surplus notes with the SVO was for the SVO to review the issuer's statutory financial statements and determine whether holders of non-rated / non-NAIC 1 designation equivalent surplus notes should be the outstanding face value or the product of the outstanding face value and a statement factor method. If adopted revisions result with all surplus notes being valued at amortized cost or fair value based on NAIC designation equivalent, the original intent of filing surplus notes would no longer exist.

25. Regardless of the original filing purpose, it is noted that the SVO listing of surplus notes held by insurers, and their corresponding NAIC designation equivalent, has been beneficial in reviewing surplus notes, and it is recommended that the referral support the continuation of filings to occur with the SVO for assessment of CRP equivalence to NAIC designations.

Duplication of Guidance in SSAP No. 41 and the Purposes and Procedures Manual

26. In response to the November 2014 exposure, comments were received suggesting removal of guidance from SSAP No. 41, paragraph 10a.i and instead refer to the duplicate guidance contained within the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (P&P Manual). The comments suggested that deleting the guidance would be consistent with SSAP No. 26, SSAP No. 30, SSAP No. 32, and SSAP No. 43R where there is reference to the P&P Manual rather than duplicating the guidance in the SSAPs. The comments identified that this approach would eliminate the need to modify the SSAPs when the Valuation of Securities (E) Task Force adopts changes to the P&P Manual.

27. In reviewing these comments, it was identified that in May 8, 2008, the Valuation of Securities (E) Task Force recommended revisions to the Statutory Accounting Principles (E) Working Group to revise the guidance in SSAP No. 41, paragraph 10a.i to mirror the guidance from the P&P Manual. Prior to this referral the language did not agree between the two publications, therefore revisions were needed to make the language consistent. The 2008 revisions adopted to SSAP No. 41, paragraph 10 as a result of this correspondence are shown below:

a. Rated Notes

i. If the notes have been rated by a NAIC ~~Nationally Recognized Statistical~~ Acceptable Rating Organization ~~(NRSRO)~~(ARO) 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~~there is more than one NRSRO rating~~, the lowest of the ratings shall be assigned. In case of notes rated and monitored by three or more NAIC AROs, the NAIC ARO 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. ~~equivalent shall be used for purposes of this valuation procedure;~~

28. The guidance in the P&P Manual is detailed in Part Two, Section 4. Reporting Exceptions:

d) Filing Exemption for Certain NAIC CRP Rated Securities

NOTE: This Section sets forth filing exemptions for certain securities that are rated by an NAIC CRP in the equivalent of the NAIC 1 through NAIC 6 Designation categories. Because these securities will not be filed with the SVO, the SVO will not be able to monitor any innovation or regulatory risk in these securities.

The SVO does not have responsibility for determining whether specific securities should be filing exempt. An insurer who is uncertain whether a specific security qualifies for exemption should not contact the SVO for guidance, but should either file the security with the SVO or use the EIV Regulatory Treatment Analysis Service process described in Part Four, Section 3 of this Manual and obtain an opinion on exemption for that security.

Because these filing exemption provisions are set forth without any compliance mechanism, the SVO will not be able to verify whether insurers have filed all securities that are required to be filed with the SVO. State insurance department regulators may wish to create their own compliance mechanisms to protect any interests they may have relative to their domiciliary insurers.

(i) An insurance company must file all securities with the SVO except those securities that meet, and continue to meet, the conditions of either Paragraph (A), (B) or (C) below. Any security that at one time met the conditions of Paragraphs (A), (B) or (C) below, but does not continue to meet such conditions must be filed with the SVO within 120 days of such failure, as if the security had never been filing exempt.

These filing exemptions do not apply to investments required to be filed pursuant to Part Five, Section 2 of this Manual. Catastrophe-Linked Bonds are filing exempt provided the credit rating assigned to them by a CRP was derived in a specified manner. Please refer to Part Four, Section 4 of this Manual.

(A) Bonds

Bonds, *excluding RMBS and CMBS, (please refer to Section 4 (e), below),* assigned an Eligible NAIC CRP Rating, as defined in Part One, Section 4 (c) (ii) (B) of this Manual, are exempt from filing with the SVO. Bonds assigned Eligible NAIC CRP Ratings will be assigned the equivalent NAIC Designation. If two Eligible NAIC CRP Ratings have been assigned, then the lowest rating will be assigned. In case of a security assigned three or more Eligible NAIC CRP Ratings, the Eligible NAIC CRP Ratings for the security 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.

(B) Preferred Stock

Preferred Stock assigned Eligible NAIC CRP Ratings, as defined in Part One, Section 4 (c) (ii) (B) of this Manual, are exempt from filing with the SVO. Preferred Stock assigned Eligible NAIC CRP Ratings will be assigned the equivalent NAIC Designation. If two Eligible NAIC CRP Ratings have been assigned, then the lowest rating will be assigned. In the case of a security assigned three or more Eligible NAIC CRP Ratings, the Eligible NAIC CRP Ratings for the security 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.

(C) Public Common Stock that is not restricted as to transferability.

(i) SVO Authority to Require Filing of Filing Exempt Securities

The filing exemptions described above do not limit the authority of the SVO to require filings with respect to any security that is otherwise filing exempt at any time for the purpose of reviewing the provisions, terms, covenants or structural features of the security and designating the quality of the security. Upon completion of such review, the SVO is authorized to report its findings and recommendations to the VOS/TF.

29. With regards to this discussion, during the 2015 Fall National Meeting, the Working Group was requested to provide their preference for the continued duplication and/or if only reference to the P&P Manual should be included in SSAP No. 41. It was noted that there are other instances in which such duplication exists, and it is generally a matter of the need to easily access the guidance and the significance in application for reporting entities that determine whether guidance should be duplicated. As part of the interested parties' comments, it was noted that since surplus notes are private placement securities there is typically no incentive for insurers to obtain more than one credit rating. If reference is included to the P&P Manual within SSAP No. 41 (rather than the actual language), that it would be proposed for the specific section citation of the P&P Manual to be included to assist reporting entities with quickly locating the guidance.

30. In considering the proposal to remove duplicate language between publications, during the 2015 Fall National Meeting, the Working Group noted their preference not to have the language on determining the appropriate rating within the SSAP. The Working Group noted that this is instructional ("how to") language that is best suited within the *Purposes and Procedures Manual of the NAIC Investment Analysis Office*. However, it was noted that the current language in the P&P Manual was specific to bonds, and there is no specific reference to surplus notes. To ensure appropriate guidance continues, the Working Group directed NAIC staff to send a referral to the Task Force requesting that they incorporate explicit reference for determining the designation of surplus notes, and once this guidance is included, to remove the designation guidance instruction from the substantively revised SSAP No. 41R. In making this direction, the Working Group noted that if the language is included as a modification to the P&P Manual prior to the adoption of SSAP No. 41R, then the language would be removed as a result of this agenda item. However, if the guidance in the P&P Manual is not updated prior to the adoption of this issue paper, and the substantively revised SSAP No. 41R, then the language currently in SSAP No. 41 would be retained and would be considered for deletion as part of a subsequent agenda item.

31. As a result of the referral response dated March 17, 2016 from the Valuation of Securities (E) Task Force, identifying the adoption of guidance for inclusion in the P&P Manual, the Working Group agreed to remove the guidance on determining the NAIC designation from this issue paper, and the corresponding substantively revised SSAP, and instead refer to the location of the guidance in the P&P Manual.

Reference to Adopted Guidance

32. In reviewing the guidance in SSAP No. 41, it was identified that language currently exists that references the "adoption" of the *Purposes and Procedures Manual of the NAIC Investment Office* "Procedures for Valuing Surplus Debentures" as part of the statutory relevant literature. As SSAPs are the highest level in the SAP hierarchy for accounting guidance, it is recommended that this adoption

reference be removed from the SSAP. Furthermore, the guidance in the P&P Manual references the guidance in SSAP No. 41, therefore, this reference to the P&P Manual results in a circular reference between the two publications.

33. In reviewing the SSAPs, there does not appear to be any other references to the adoption of the P&P Manual guidance as "relevant literature". Furthermore, such "adoptions" are limited to the actions on GAAP guidance reviewed as part of the statutory accounting maintenance process. As such, revisions are detailed within this issue paper to remove the reference of the adoption to the *Purposes and Procedures Manual of the NAIC Investment Analysis Office*.

Effective Date

34. Upon adoption of this issue paper, the NAIC will release a substantively revised Statement of Statutory Accounting Principles (SSAP) for comment. 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. It is expected that the SSAP will contain an effective date of reporting periods after January 1, 2017.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

- *SSAP No. 41R—Surplus Notes*

Generally Accepted Accounting Principles

- SSAP No. 41R rejects AICPA Practice Bulletin 15, Accounting by the Issuer of Surplus Notes. This GAAP guidance requires surplus notes to be accounted for as debt, with interest accruing over the life of the surplus note. This treatment is contrary to the guidance in SSAP No. 41R.

