

# Statutory Issue Paper No. 26

## Bonds, Excluding Loan-Backed and Structured Securities

### STATUS

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Original SSAP and Current Authoritative Guidance: SSAP No. 26

### Type of Issue:

Common Area

### SUMMARY OF ISSUE

1. Current statutory guidance for bonds is contained in the Accounting Practices and Procedures Manuals for Life and Accident and Health and for Property and Casualty Insurance Companies. That guidance also establishes the NAIC's Securities Valuation Office (SVO) as an authority for the valuation of bonds.
2. The purpose of this paper is to establish statutory accounting principles for bonds, excluding loan-backed and structured securities (which are covered in *Issue Paper No. 43—Loan-Backed and Structured Securities* (Issue Paper No. 43)) that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

### SUMMARY CONCLUSION

3. Bonds shall be defined as any securities representing a creditor relationship, whereby there is a fixed schedule for one or more future payments. This definition includes U.S. Treasury securities, U.S. government agency securities, municipal securities, corporate bonds, bank participations, convertible debt, certificates of deposit and commercial paper that have a fixed schedule of payments and a maturity date in excess of one year from the date of acquisition. Loan-backed and structured securities meet this definition, but are excluded from the scope of this issue paper, and are addressed in Issue Paper No. 43. Securities which meet the definition above, but have a maturity date of one year or less from the date of acquisition are addressed in *Issue Paper No. 28—Short-term Investments*. Mortgage loans and other real estate lending activities made in the ordinary course of business meet the definition above, but are not addressed in this issue paper. These types of transactions are addressed in issue papers 37 and 39.
4. Bonds meet the definition of assets as defined in *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets*, and are admitted assets to the extent they conform to the requirements of this paper.

### Acquisitions and Sales

5. A bond acquisition or disposal shall be recorded on the trade date, not the settlement date except for the acquisition of private placement bonds which shall be recorded on the funding date. At acquisition, bonds shall be reported at their cost, including brokerage and other related fees, which cannot exceed the fair market value at the date of acquisition.
6. For reporting entities required to maintain an Interest Maintenance Reserve (IMR), the accounting for realized capital gains and losses on sales of bonds shall be in accordance with *Issue Paper No. 7—Asset Valuation Reserve and Interest Maintenance Reserve*. For reporting entities not required to maintain an IMR, realized gains and losses on sales of bonds shall be recorded on the trade date, and shall be reported on the net realized capital gains or losses line of the Investment Income section of the Underwriting and Investment Exhibit.

**Amortized Cost**

7. 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).

**Balance Sheet Amount**

8. Bonds shall be valued and reported in accordance with the NAIC Valuations of Securities manual prepared by the Securities Valuation Office (Valuations of Securities manual). For reporting entities that maintain an Asset Valuation Reserve (AVR), the bonds shall be reported at amortized cost, except for those with an NAIC designation of 6, which shall be reported at the lower of amortized cost or fair market value. For reporting entities that do not maintain an AVR, bonds that are designated highest-quality and high-quality (NAIC designations 1 and 2, respectively) shall be reported at amortized cost; all other bonds (NAIC designations 3 to 6) shall be reported at the lower of amortized cost or fair market value.

**Impairment**

9. If it is determined that a decline in the fair market value of a bond is other than temporary, the cost basis of the bond shall be written down to fair market 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 market value. Future declines in market 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 market 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 (i.e., amortized cost). This is consistent with *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets*.

**Income**

10. 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 as well as reductions for premium amortization and interest paid on acquisition of bonds, and the addition of discount accrual. In accordance with *Issue Paper No. 34—Investment Income Due and Accrued*, investment income shall be reduced for amounts which have been determined to be uncollectible. Contingent interest may be accrued if the applicable provisions of the underlying contract and the prerequisite conditions have been met.

11. A bond may provide for a prepayment penalty or acceleration fee in the event the bond is liquidated prior to its scheduled termination date. Such fees shall be reported as investment income when received.

**Origination Fees**

12. Origination fees represent fees charged to the borrower in connection with the process of originating or restructuring a transaction such as the private placement of bonds. The fees include, but are not limited to, points, management, arrangement, placement, application, underwriting, and other fees pursuant to such a transaction. Origination fees shall not be recorded until received in cash. Origination fees intended to compensate the reporting entity for interest rate risks (e.g., points), shall be amortized into income over the term of the bond consistent with paragraph 7 of this issue paper. Other origination fees shall be recorded in income immediately.

**Origination, Acquisition, and Commitment Costs**

13. Costs related to origination when paid in the form of brokerage and other related fees shall be capitalized as part of the cost of the bond, consistent with paragraph 5 of this issue paper. All other costs, including internal costs or costs paid to an affiliated entity related to origination, purchase or commitment to purchase bonds shall be charged to expense when incurred.

**Commitment Fees**

14. Commitment fees are fees paid to the reporting entity that obligate the reporting entity to make available funds for future borrowing under a specified condition. A fee paid to the reporting entity to obtain a commitment to make funds available at some time in the future, generally, is refundable only if the bond is issued. If the bond is not issued then the fees shall be recorded as investment income by the reporting entity when the commitment expires. A fee paid to the reporting entity to obtain a commitment to be able to borrow funds at a specified rate and with specified terms quoted in the commitment agreement, generally, is not refundable unless the commitment is refused by the reporting entity. This type of fee shall be deferred, and amortization shall depend on whether or not the commitment is exercised. If the commitment is exercised, then the fee shall be amortized in accordance with paragraph 7 of this issue paper over the life of the bond as an adjustment to the investment income on the bond. If the commitment expires unexercised, the commitment fee shall be recognized in income on the commitment expiration date.

**Loaned Bonds**

15. When bonds are loaned, they remain assets of the reporting entity and are not removed from the accounting records as the reporting entity remains the owner of the bonds. When collateral is provided for the general use of the reporting entity, the asset is recorded and the admissibility of the asset is determined as if the reporting entity owned the collateral asset. A liability for the return of that collateral must be established. When collateral not available for the general use of the reporting entity is provided, it should not be recognized as an asset of the reporting entity. When non-cash collateral is provided, the current market value of that collateral must be used to determine adequacy of the collateral held relative to the current market value of the loaned bonds/securities.

**Wash Sales**

16. When a bond is sold and the proceeds are reinvested within 30 days in the same or substantially the same security, such transfers shall be considered to be wash sales, and shall be accounted for as sales and disclosed as required by paragraph 19. Unless there is a concurrent contract to repurchase or redeem the transferred bond from the transferee, the transferor does not maintain effective control over the bond.

17. For the securities to be substantially the same, the criteria set forth in paragraph 28 of *FASB Statement No. 125, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (FAS 125) must be met.

**Exchanges and Conversions**

18. If a bond is exchanged or converted into other securities, the fair value of the bond surrendered at the date of the exchange or conversion shall become the cost basis for the new securities with any gain or loss realized at the time of the exchange or conversion. If the fair value of the securities received in an exchange or conversion is more clearly evident than the fair value of the bond surrendered then it shall become the cost basis for the new securities. This is consistent with *Issue Paper No. 73—Nonmonetary Transactions*.

**Disclosures**

19. The following disclosures shall be made for bonds in the notes to the financial statements:

- Fair values in accordance with *Issue Paper No. 33—Disclosures about Fair Value of Financial Instruments*;

- Concentrations of credit risk in accordance with *Issue Paper No. 27—Disclosures of Information about Financial Instruments with Concentrations of Credit Risk*;
- The basis at which the bonds are stated;
- Amortization method;
- Description of any loaned bonds, including the amount, description of the collateral and whether or not the collateral is restricted;
- Reporting entities shall disclose the following information for wash sales, as defined in paragraph 16, involving transactions for securities with a NAIC designation of 3 or below, or unrated:
  - a. A description of the reporting entity’s objectives regarding these transactions;
  - b. An aggregation of transactions by NAIC Designation 3 or below, or unrated;
  - c. The number of transactions involved during the reporting period;
  - d. The book value of securities sold;
  - e. The cost of securities repurchased;
  - f. The realized gains/losses associated with the securities involved.

## DISCUSSION

20. The statutory accounting principles described in the summary conclusion section are consistent with current statutory accounting guidance for bonds, except as follows:

- Paragraphs 5 and 6 require bond acquisitions and dispositions to be recorded on the trade date, whereas current statutory guidance is silent.
- Paragraph 9 contains an impairment test that is not contained in the current statutory guidance, but which is considered consistent with the conservatism concept in the Statement of Concepts.
- Paragraph 11 requires that prepayment penalties and acceleration fees received from the liquidation of an investment prior to its maturity date be recorded as investment income. Current statutory accounting guidance allows for prepayment penalties and acceleration fees to be recorded as either capital gains or investment income.
- Paragraph 16 provides guidance on sales and subsequent repurchases of bonds which is intended to prevent “window dressing.”

21. This issue paper adopts *AICPA Statement of Position 90-11, Disclosure of Certain Information by Financial Institutions About Debt Securities Held as Assets* and *AICPA Practice Bulletin No. 4, Accounting for Foreign Debt/Equity Swaps*. This issue paper rejects the GAAP guidance for debt securities, which is contained in *FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities* (FAS 115), *FASB Statement No. 91, Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases* (FAS 91), *FASB Emerging Issues Task Force No. 89-18, Divestitures of Certain Investment Securities to an Unregulated Commonly Controlled Entity under FIRREA*, and *FASB Emerging Issues Task Force No. 96-10, Impact of Certain Transactions on Held-to-Maturity Classifications Under FASB Statement No. 115*. The primary differences between the statutory accounting principles established in this issue paper and GAAP are as follows:

- FAS 115 requires investments in debt securities to be classified into three categories: held-to-maturity, available-for-sale and trading. Held-to-maturity securities are reported at amortized cost. Available-for-sale are reported at fair value, with unrealized gains or losses reported as a separate component of shareholders' equity. Trading securities are reported at fair value, with unrealized gains or losses included in earnings.

- GAAP does not require reporting of AVR or IMR and requires that realized gains and losses be included in income when realized.
- FAS 91 generally requires amortization of the security premium or discount over the remaining life of the security.
- FAS 91 allows deferral of certain origination costs.

22. This paper is consistent with *Issue Paper No. 45—Repurchase Agreements, Reverse Repurchase Agreements and Dollar Repurchase Agreements* (Issue Paper No. 45), in defining what criteria must be met in order for securities to be considered substantially the same. Issue Paper No. 45 adopts paragraph 28 of FAS 125 and *AICPA Statement of Position 90-3, Definition of the Term Substantially the Same for Holders of Debt Instruments, as Used in Certain Audit Guides and a Statement of Position* (SOP 90-3).

23. The statutory accounting principles established in this issue paper, attempt to smooth the effect upon a reporting entity's surplus of fair market value fluctuation of investments held by the reporting entity. This is consistent with the Statement of Concepts which states "*conservative valuation procedures provide protection to policyholders against adverse fluctuations in financial condition or operating results.*" Statutory accounting principles for life insurance companies also use the concept of AVR and IMR adjustments to compensate for fair market value fluctuations over time.

#### **Drafting Notes/Comments**

- Loan-backed and structured securities are addressed in *Issue Paper No. 43—Loan-Backed and Structured Securities*.
- Repurchase and reverse repurchase agreements are addressed in *Issue Paper No. 45—Repurchase Agreements, Reverse Repurchase Agreements and Dollar Repurchase Agreements*.
- AVR and IMR are addressed in *Issue Paper No. 7—Asset Valuation Reserve and Interest Maintenance Reserve*.
- Short-term investments are addressed in *Issue Paper No. 28—Short-Term Investments*.
- The value of a CMO special purpose subsidiary is addressed in Issue Paper No. 86 - Securitization.
- Investment income due and accrued is addressed in *Issue Paper No. 34—Investment Income Due and Accrued*.
- Securities not yet valued by the SVO will follow SVO procedures for valuing such securities as being drafted by the SVO as directed by the Invested Asset Working Group of the Valuation of Securities (EX4) Task Force.

### **RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE**

#### **Statutory Accounting**

24. The Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 1, Bonds and Loan Backed and Structured Securities, states:

Bonds are obligations issued by business units, governmental units, and certain nonprofit units, and having a fixed schedule for one or more future payments of money. This definition includes commercial paper, negotiable certificates of deposit, repurchase agreements, collateralized mortgage obligations (CMOs), mortgage participation certificates (MPCs), interest-only and principal-only certificates (IOs and POs), and equipment trust certificates. Governmental bonds may be classified as general obligation bonds secured by revenue from a restricted source. Corporate bonds are either secured by a claim to mortgage assets or other specific collateral, or by the general credit of the corporation, i.e., debentures. Such investments may be public issues or private placements. Bonds held for investment generate interest income to the investor. Their sale may result in capital gain or loss.

Bonds that pay interest at a rate greater than that which the market requires of similarly rated securities will sell at a "premium" above the face amount of the bond. Bonds with interest rates below the current market will sell at a "discount" from the face amount.

#### Authorizations and Limitations

Bonds may be subject to qualitative limitations determined by state regulations. For example, a U.S. Treasury Note may have no investment limitations while a railroad bond may have stringent restrictions, both individual (one particular railroad corporation) and in the aggregate (all railroad bonds).

#### Valuation

Bonds are generally valued at cost adjusted, i.e., amortized, to bring the value to par at maturity. Except for privately placed issues, cost cannot exceed the market value at the date of acquisition, including brokerage and other related fees. Carrying value should not exceed the call price for any particular issue.

Most bond holdings are subject to amortization under the valuation standards of the National Association of Insurance Commissioners and are to be carried at amortized cost. Bonds that do not qualify for amortization according to the NAIC Valuations of Securities manual are to be carried at the value contained in the manual or at book value, whichever is lower. Bonds not listed in the manual, or obligations listed with no value, require the determination of an acceptable value that can be justified to the appropriate regulatory agency.

The Valuation of Securities Task Force has classified bonds into six categories according to whether the bond can be amortized for establishing the investment value to be used in financial statements. A complete description of the NAIC's classification system, valuation bases to be applied, and the requirements and tests used in the classification of bonds may be obtained by reference to the Valuations of Securities manual, produced by the NAIC.

Most regulatory agencies reserve the privilege of directing the valuation of a specific obligation either not listed in the Valuations of Securities manual or affected by a material financial disclosure subsequent to the annual publication. Investments in foreign securities are accounted for in much the same manner. Procedures for valuation and conversion into U.S. currency are prescribed in the Valuations of Securities manual.

#### Nonadmitted Bonds

Bond classification as admitted assets varies at the discretion of the states. A bond may be classified as a nonadmitted asset to the extent that it fails a qualitative or quantitative limitation test or is otherwise unauthorized as outlined by the applicable state code. A certain percentage of such investments otherwise not qualifying for investment is commonly permitted by the state codes under a blanket clause or "basket provision" limiting the total quantity of these and other similar investments as a function of net admitted assets or surplus, or both.

For bonds not eligible for amortization, the difference between the amortized (book) value and the association (market) value is treated as a nonadmitted asset.

#### Premium and Discount

On acquisition, bonds are recorded in the general ledger at their cost. For bonds purchased at a premium, there is to be an annual amortization to reduce the recorded cost to par value. In the case of a bond with a call privilege, the amortized value used should be the lowest value produced by using the maturity date or the call features. The annual amortization of premium is normally accounted for as reduction to interest that has been collected during the year.

For bonds purchased at a discount, where cost is less than par value, there is to be an annual accrual of this discount to increase the ledger value to par value at maturity. The annual accrual of discount is generally accounted for as an addition to interest that has been collected during the year.

For bonds secured by U.S. governmental entities, amortization of premium and accrual of discount may require special handling, and the Valuations of Securities manual should be consulted.

#### Interest Income

If interest (including contingent interest) on a bond is recorded when received, an adjustment must be made to recognize due and accrued interest as of the reporting date. Interest income for any period consists of interest collected during the period and the change in the due and accrued interest between the beginning and end of the period, plus the adjustments for the accrual of discount, minus adjustment for the amortization of premium, and minus adjustment for interest paid on acquisition of bonds.

Contingent interest represents bondholder income generated through the occurrence of specific economic events in relation to the issuer. For example, contingent interest may become payable upon the attainment by the issuer of a given level of cash flow or income. In many respects, bonds with contingent interest provisions are similar to income bonds. Due and unpaid contingent interest may be recorded as income. The proper accrual of such income does, however, require an analysis of the applicable provisions in the underlying agreement and the verification that the prerequisite conditions have been met.

#### Commitment and Other Origination Fees

Commitment and other origination fees may arise from the private placement of bonds. Commitment fees are charged by the company to the borrower for promising to make available funds for future borrowing at currently specified interest rates. If the fee is not returnable to the borrower and the bond is not issued, the fee should be taken into income immediately. If the fee is returnable only if the bond is issued, it should not be considered income until it is determined that the bond will not be placed. If it is determined that the bond will be issued, the fee should be deferred and amortized using the interest method over the life of the loan. Other fees intended to compensate the company for interest rate risks associated with the commitment may be built into the interest rates specified and thus, if collected, would be amortized into income over the term of the bond.

Fees charged to borrowers for providing services related to the origination of a private placement should be taken into income immediately only if no portion of the loan is retained by the company. Otherwise, recognition of any fees related to the portion of the loan retained for investment purposes should be deferred until issue and amortized into income using the interest method over the life of the loan. Deferred fee income related to loans originated and retained for resale should be recognized upon sale.

#### Loaned Bonds or Bonds Subject to Reverse Repurchase Agreements

Where the state of domicile permits such activity, bonds may be loaned or placed under reverse repurchase arrangements with authorized brokers or dealers in securities.

When a bond is loaned, collateral consisting of cash and/or cash equivalent is pledged. The pledged collateral is maintained in an escrow account. The statement will continue to report the insurance company as owner of the bond.

The valuation of this bond will remain unaffected by the loan as long as the amount of the collateral is at least equal to the required amount specified in the Valuations of Securities manual. Failure to hold sufficient collateral may result in the admitted asset value being decreased.

25. The Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies contains similar guidance.

26. The *Purposes and Procedures Manual of the NAIC Securities Valuation Office* contains the following guidance:

(B) Corporate Bonds--General Procedure. The analysis to determine an NAIC designation will be made in one of two ways. The first will be the direct use of ratings performed by other recognized rating agencies or organizations. The second will be the use of various security analysis techniques, both quantitative and subjective in nature.

(1) Issuers That Have Securities Rated by Other Recognized Rating Agencies or Organizations.

Ratings of other recognized rating organizations will be translated directly into an NAIC Designation. The SVO staff will have discretionary authority to downgrade ratings of other organizations but not to upgrade. If there are multiple differing ratings the SVO may use the highest rating but may also go lower where indicated. Where one issue of an issuer has a rating, this rating will be used as a benchmark in determining the ratings of other non-rated issues of the same issuer.

A list of the approved agencies and the translation of their ratings into NAIC Designations is presented in Appendix B. To become an NAIC approved rating organization the candidate must submit to the NAIC's Securities Valuation Office proof that it has been designated a "Nationally Recognized Statistical Rating Organization" (NRSRO) by the Securities and Exchange Commission (SEC) of the Government of the United States of America. Such proof will be acceptable to the NAIC for designation as an NAIC approved rating organization. Rating organizations not so recognized by the SEC may be used by the SVO in its day to day operation when rated entities are not rated by an NAIC approved NRSRO and the quality of such ratings is determined to be substantially similar in quality to those of an NAIC approved NRSRO by SVO staff. The SVO may request whatever documentation deemed necessary to make such a determination. Such rating organizations will not, however, be granted NAIC approved rating organization status.

(2) Issuers of Securities That are Not Rated by Any Other Recognized Rating Organization.

The analysis to determine an NAIC Designation will generally be made up of three segments.

(1) The SVO will apply a quantitative financial model to current and past financial statement data to determine a preliminary measure of the relative financial soundness of the issuer. The result should be expressed as a numeric score which can be ranked against other similar scores and these then related to the various NAIC Designations. It is important to emphasize that the result obtained from the model will not be the sole determinant of an NAIC Designation which determination will be subject to the second and third parts of the analysis which follow.

(2) In the second segment of its analysis the SVO staff will review five years of historical financial data (when available), and any projected data made available to it. This review will cover the balance sheet, the income statement, and the statement of cash flows as obtained from the issuer's financial statements as well as the notes thereto. The staff will also review various standard financial ratios. In addition, the analyst will review the auditors opinion. Furthermore, the SVO analyst is expected to review any news media articles relating to the issuer or research reports that are available. The analysis would also include but is not limited to, a detailed review of the issuer's industry and operating environment as



well as the issuer's management/sponsorship, marketing capabilities, and cost structure to determine the extent of the issuer's competitive edge, if any. These characteristics, when viewed in context with the issuer's financial profile, will determine the ability of the company to respond to varying economic scenarios.

The result of the first two foregoing steps will be a judgment by the SVO analyst of the issuer's implied senior unsecured debt paying ability or rating expressed as an NAIC Designation. The ratings of all other securities of the same issuer (including preferred stocks) can be scaled either upwards or downwards based on that securities' relationship to senior unsecured debt in the capital structure as well as the strength of the credit.

- (3) The final part of the analysis will focus on factors that are specific to the security under review as opposed to those relevant to the issuer. This will include a review of:
  - (a) Covenants
  - (b) Structure
  - (c) Collateral
  - (d) Third party financial support or other credit enhancements
  - (e) Any other factor specific to the security under review

At all times during the analysis the SVO analyst will have complete discretion to extend the investigation to whatever extent deemed necessary in order to arrive at an appropriate NAIC Designation

- (C) Corporate Bonds--Special Factors. All bonds of the following types will be subject to the review procedures of Section 2(B), but the following special factors and statement value considerations will be addressed additionally as indicated.
  - (1) Collateralized Obligations. The ability of any type of collateral to enhance or fully support the contractual provisions of any security will be taken into account by the SVO only if acceptable documentary evidence is provided. This might include, but is not limited to the filing of the SVO's Collateral Loan form where appropriate, the original due diligence package, appraisal reports, valuations of business entities reports or any other relevant supporting information.
  - (2) Income Bonds that have paid contingent interest in full for the three most recent years and otherwise meeting the standards of review of Section 2(B) shall be valued on the Annual Statement at amortized cost. The method of amortization shall be straight line. Income bonds not meeting these requirements shall be valued on the Annual Statement at market value.
  - (3) Perpetual Bonds and Demand Notes not in default and otherwise meeting the requirements of Section 2(B) shall be valued on the Annual Statement at original cost by those insurers maintaining an AVR (see Section 6). All other insurers must value these bonds at market value. Any such bond or note will have its normal NAIC Designation followed by the letter C if the security is eligible for cost treatment.
  - (4) Church Bonds secured by a mortgage on the church property will have an NAIC Designation determined based on the requirements of Section 2(B) and the appraised value of such property. All others will be reviewed on the basis of sufficient cash flow to meet obligations as they mature.
  - (5) Oil and Gas Loans. Loans made on the basis of collateralized oil and gas revenues will be reviewed taking into account a reputable petroleum engineer's or geologist's estimates of existing reserves and the related oil and gas pay out and loan payment schedules.

- (6) Equipment Trust Certificates will be reviewed first on the basis of an annually submitted SVO collateral valuation form and if that is not submitted then on the credit standing of the certificate issuer.
- (7) Certificates of Deposit (negotiable and non-negotiable) will be considered under the general provisions of Section 2(B).
- (8) Repurchase Agreements. Securities subject to repurchase agreements will have an NAIC Designation determined in accordance with Section 2(B).
- (9) Reverse Repurchase Agreements. Securities subject to reverse repurchase agreements will have an NAIC Designation determined in accordance with Section 2(B) if the cash and/or cash equivalents pledged as collateral is equal to 100% or more of the market value of the financed securities as of the date of the statement. If other than identical securities are returned, the transaction is to be treated as an ordinary purchase and sale.
- (10) Commercial Paper will be valued under the general procedures of Section 2(B).
- (11) Convertible Bonds. Bonds eligible for amortized value will be so valued while bonds not eligible will be valued at the lower of market value or the then existing amortized value.
- (12) New Enterprises created either as startup companies or as business combinations of pre-existing business units will be evaluated on the basis of projected income statements and balance sheets since prior figures are either not available or not meaningful. Insurers must submit such projections in order to justify ratings higher than the lowest quality category.
- (13) Loaned Securities. Where permitted by an insurer's state of domicile, bonds loaned to others shall be valued in accordance with Section 2(B) if (i) Acceptable Collateral, as hereinafter defined, is pledged as security for the loan and (ii) except as set forth in the following sentence, the Acceptable Collateral pledged as security is, at the inception of the loan, in an amount equal to 102% of the market value of the loaned bonds. In the event that foreign bonds are the subject of the loan and the denomination of the currency of the Acceptable Collateral is other than the denomination of the currency of the loaned foreign bonds, the amount of Acceptable Collateral that shall be pledged shall be an amount equal to 105% of the market value of the loaned bonds. A decline in value of the acceptable collateral or an increase in the value of the loaned bonds during the term of the loan shall not result in the disqualification from valuation in accordance with Section 2(B) if, during the term the loan is outstanding, additional Acceptable Collateral is posted any time the amount of Acceptable Collateral declines to 100% of the market value of the loaned bonds (or 102% of the market value of the loaned bonds if Acceptable Collateral in an amount equal to 105% was required to be posted at the inception of the loan) in an amount equal to the difference between the 102% and 105%, respectively. For purposes of this provision, Acceptable Collateral shall mean cash and cash equivalents and shall also include securities issued by the U.S. Government or its agencies. The market value of loaned bonds shall include accrued interest on such loaned bonds. Any shortfall in the amount of the actual Acceptable Collateral posted and the required 102% or 105%, as applicable, shall be deducted from the otherwise determined statement value.
- (14) Debtor in Possession (DIP) Financing. Such financing will not be considered to be equivalent to the prior existing debt of a bankrupt and reorganizing entity. Instead it will be considered for valuation based on its superior claim position,

collateral coverage, cash flow coverage of debt service and other strengths inherent in the structural factors unique to the DIP lending process.

- (15) Bonds of Liquidating Corporations. Securities of such entities will be marked to market by all insurers and accorded on NAIC rating of "6". In the absence of an active market or a reliable quotation, the value of such securities will be analytically determined by the SVO staff, or the SVO, at its discretion, may accept a value determined by an independent organization approved by the SVO.
- (16) Distressed Bonds trading at less than 25% of par at the date of valuation and which are not original issue deep discount bonds. Such securities will be marked to market by all insurers regardless of whether they are current as to all contractual provisions at the date of valuation.
- (17) Pricing of Privately Placed and Illiquid Publicly Traded Bonds In or Near Default. The pricing of privately placed and illiquid publicly traded bonds will be analytically determined by the SVO staff, or the SVO, at its discretion, may accept a value determined by an independent organization approved by the SVO. The pricing of these securities will be dependent on three primary factors: (1) the ultimate recovery value in cents per dollar of par value expected to be received net of all reasonable costs of a workout or bankruptcy proceeding such as fees for accountants, lawyers, bankers, etc. (2) the expected timing of the receipt of such recovery value and (3) a discount rate to be applied to factors one and two that reflects market rates of discount for defaulted bonds in general adjusted for the current degree of uncertainty existing in the recovery amount.

Four states of recovery are generally recognized by the SVO and different discount rates reflecting more or less uncertainty will be used for securities in each state. These rates will vary with market conditions. The states are:

- (a) Newly defaulted bonds where maximum uncertainty as to recovery exists.
  - (b) Defaulted securities where a preliminary plan of reorganization has been put forth for discussion.
  - (c) Defaulted securities where a generally agreed to but unsigned plan is on the table.
  - (d) Defaulted securities where a plan has been agreed to by all parties and a payout date has been set. This is the only case in which estimated value close to 100% of par will be achievable.
- (18) Loan-backed and Structured Securities. The SVO encourages insurers to obtain ratings for loan-backed and structured securities submitted for an NAIC designation from an NAIC approved NRSRO. For unrated structured securities acquired by conversion i.e., securitization, refer to Section 6(B)(g)(i) for instructions.

(E) Instructions for Completing Schedule D of the NAIC Annual Statement

The following table indicates the appropriate entries to be made in Schedule D of the NAIC Annual Statement for all bonds except income bonds (see Section 2(C)(1)) and perpetual bonds and demand notes (see Section 2(C)(2)).

(1) For Insurers Maintaining an Asset Valuation Reserve (AVR) (see Section 6)

NAIC DESIGNATION COLUMN	AMORTIZED OR INVESTMENT VALUE COLUMN	MARKET VALUE COLUMNS	
		RATE	AMOUNT
1	Amortized Cost	SVO	
2	Amortized Cost	Market Rate	Par Value X Rate or
3	Amortized Cost	if shown or	Amortized Cost if No Rate
4	Amortized Cost	A.V.	Available
5	Amortized Cost	if No Rate	
6	The lesser of the Market Value Amount or Amortized Cost	shown in VOS Manual	Lower of Amortized Cost or Par Value times Market Rate

A.V. = Bond has been valued at amortized value and that value should appear in the Market Value Amount Column.

(2) For Property and Casualty Insurers and All Other Insurers Not Maintaining an Asset Valuation Reserve (AVR)

NAIC DESIGNATION COLUMN	AMORTIZED OR INVESTMENT VALUE COLUMN	MARKET VALUE COLUMNS	
		RATE	MARKET VALUE
1	Amortized Cost	SVO Market Rate	Par Value X Rate or A.V. if no rate available
2	Amortized Cost	if shown	
3	The lesser of the Market Value Amount or the Amortized Cost	or A.V. if	Lower of Amortized Cost or Par Value X Rate
4	The lesser of the Market Value Amount or the Amortized Cost	No Rate shown	Lower of Amortized Cost or Par Value X Rate
5	The lesser of the Market Value Amount or the Amortized Cost	In VOS Manual	Lower of Amortized Cost or Par Value X Rate
6	The lesser of the Market Value Amount or the Amortized Cost		Lower of Amortized Cost or Par Value X Rate

A.V. = Bond has been valued at amortized value and that value should appear in the Market Value Amount Column.

27. The NAIC Annual Statement Instructions require that the notes to the financial statements of the Annual Statements include the following information to be disclosed about invested assets:

2. Basis of Valuation of Invested Assets
  - a. Provide a statement of the valuation basis for invested assets, including bonds, stocks, derivative instruments, etc. State the method of amortization of bonds not backed by other loans, loan-backed bonds and structured securities.

### Generally Accepted Accounting Principles

28. GAAP guidance is promulgated by FAS 115. Pertinent excerpts are as follows:

#### Accounting for Certain Investments in Debt and Equity Securities

6. At acquisition, an enterprise shall classify debt and equity securities into one of three categories: held-to-maturity, available-for-sale, or trading. At each reporting date, the appropriateness of the classification shall be reassessed.

#### Held-to-Maturity Securities

7. Investments in debt securities shall be classified as held-to-maturity and measured at amortized cost in the statement of financial position only if the reporting enterprise has the positive intent and ability to hold those securities to maturity.

#### Trading Securities and Available-for-Sale Securities

12. Investments in debt securities that are not classified as held-to-maturity and equity securities that have readily determinable fair values shall be classified in one of the following categories and measured at fair value in the statement of financial position:
  - a. Trading securities. Securities that are bought and held principally for the purpose of selling them in the near term (thus held for only a short period of time) shall be classified as trading securities. Trading generally reflects active and frequent buying and selling, and trading securities are generally used with the objective of generating profits on short-term differences in price. Mortgage-backed securities that are held for sale in conjunction with mortgage banking activities, as described in FASB Statement No. 65, Accounting for Certain Mortgage Banking Activities, shall be classified as trading securities. (Other mortgage-backed securities not held for sale in conjunction with mortgage banking activities shall be classified based on the criteria in this paragraph and paragraph 7.)
  - b. Available-for-sale securities. Investments not classified as trading securities (nor as held-to-maturity securities) shall be classified as available-for-sale securities.

#### Reporting Changes in Fair Value

13. Unrealized holding gains and losses for trading securities shall be included in earnings. Unrealized holding gains and losses for available-for-sale securities (including those classified as current assets) shall be excluded from earnings and reported as a net amount in a separate component of shareholders' equity until realized. Paragraph 36 of FASB Statement No. 109, Accounting for Income Taxes, provides guidance on reporting the tax effects of unrealized holding gains and losses reported in a separate component of shareholders' equity.
14. Dividend and interest income, including amortization of the premium and discount arising at acquisition, for all three categories of investments in securities shall continue to be included in earnings. This Statement does not affect the methods used for recognizing and measuring the amount of dividend and interest income. Realized gains and losses for securities classified as either available-for-sale or held-to-maturity also shall continue to be reported in earnings.

## Impairment of Securities

16. For individual securities classified as either available-for-sale or held-to-maturity, an enterprise shall determine whether a decline in fair value below the amortized cost basis is other than temporary. For example, if it is probable that the investor will be unable to collect all amounts due according to the contractual terms of a debt security not impaired at acquisition, an other-than-temporary impairment shall be considered to have occurred.<sup>4</sup> If the decline in fair value is judged to be other than temporary, the cost basis of the individual security shall be written down to fair value as a new cost basis and the amount of the write-down shall be included in earnings (that is, accounted for as a realized loss). The new cost basis shall not be changed for subsequent recoveries in fair value. Subsequent increases in the fair value of available-for-sale securities shall be included in the separate component of equity pursuant to paragraph 13; subsequent decreases in fair value, if not an other-than-temporary impairment, also shall be included in the separate component of equity.

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<sup>4</sup> A decline in the value of a security that is other than temporary is also discussed in AICPA Auditing Interpretation, Evidential Matter for the Carrying Amount of Marketable Securities, which was issued in 1975 and incorporated in Statement on Auditing Standards No. 1, Codification of Auditing Standards and Procedures, as Interpretation 20, and in SEC Staff Accounting Bulletin No.59, Accounting for Noncurrent Marketable Equity Securities.

29. The guidance for the accounting for loan origination costs and commitment fees is contained in FAS 91. Pertinent excerpts are as follows:

## Loan Origination Fees and Costs

5. Loan origination fees shall be deferred and recognized over the life of the loan as an adjustment of yield<sup>2</sup> (interest income). Likewise, direct loan origination costs defined in paragraph 6 shall be deferred and recognized as a reduction in the yield of the loan except as set forth in paragraph 14 (for a troubled debt restructuring). Loan origination fees and related direct loan origination costs for a given loan shall be offset and only the net amount shall be deferred and amortized. The practice of recognizing a portion of loan origination fees as revenue in a period to offset all or part of the costs of origination shall no longer be acceptable.

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<sup>2</sup> Methods for recognition of deferred fees and direct loan origination costs over the life of the loan as an adjustment of yield are set forth in paragraphs 18-20.

6. Direct loan origination costs of a completed loan shall include only (a) incremental direct costs of loan origination incurred in transactions with independent third parties for that loan and (b) certain costs directly related to specified activities performed by the lender for that loan. Those activities are: evaluating the prospective borrower's financial condition; evaluating and recording guarantees, collateral, and other security arrangements; negotiating loan terms; preparing and processing loan documents; and closing the transaction. The costs directly related to those activities shall include only that portion of the employees' total compensation and payroll-related fringe benefits directly related to time spent performing those activities for that loan and other costs related to those activities that would not have been incurred but for that loan.
7. All other lending-related costs, including costs related to activities performed by the lender for advertising, soliciting potential borrowers, servicing existing loans, and other

ancillary activities related to establishing and monitoring credit policies, supervision, and administration, shall be charged to expense as incurred. Employees' compensation and fringe benefits related to those activities, unsuccessful loan origination efforts, and idle time shall be charged to expense as incurred. Administrative costs, rent, depreciation, and all other occupancy and equipment costs are considered indirect costs and shall be charged to expense as incurred.

#### Commitment Fees and Costs

8. Except as set forth in subparagraphs (a) and (b) below, fees received for a commitment to originate or purchase a loan or group of loans shall be deferred and, if the commitment is exercised, recognized over the life of the loan as an adjustment of yield or, if the commitment expires unexercised, recognized in income upon expiration of the commitment
    - a. If the enterprise's experience with similar arrangements indicates that the likelihood that the commitment will be exercised is remote,<sup>3</sup> the commitment fee shall be recognized over the commitment period on a straight-line basis as service fee income. If the commitment is subsequently exercised during the commitment period, the remaining unamortized commitment fee at the time of exercise shall be recognized over the life of the loan as an adjustment of yield.
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- <sup>3</sup> The term remote is used here, consistent with its use in *FASB Statement No. 5, Accounting for Contingencies*, to mean that the likelihood is slight that a loan commitment will be exercised prior to its expiration.
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- b. If the amount of the commitment fee is determined retrospectively as a percentage of the line of credit available but unused in a previous period, if that percentage nominal in relation to the stated interest rate on any related borrowing, and if that borrowing will bear a market interest rate at the date the loan is made, the commitment fee shall be recognized as service fee income as of the determination date.
9. Direct loan origination costs (described in paragraph 6) incurred to make a commitment to originate a loan shall be offset against any related commitment fee and the net amount recognized as set forth in paragraph 8.

#### Purchase of a Loan or Group of Loans

15. The initial investment in a purchased loan or group of loans shall include the amount paid to the seller plus any fees paid or less any fees received. The initial investment frequently differs from the related loan's principal amount at the date of purchase. This difference shall be recognized as an adjustment of yield over the life of the loan. All other costs incurred in connection with acquiring purchased loans or committing to purchase loans shall be charged to expense as incurred.

#### Other

17. Deferred net fees or costs shall not be amortized during periods in which interest income on a loan is not being recognized because of concerns about the realization of loan principal or interest.

#### Application of the Interest Method and Other Amortization Matters

18. Net fees or costs that are required to be recognized as yield adjustments over the life of the related loan(s) shall be recognized by the interest method except as set forth in

paragraph 20. The objective of the interest method is to arrive at periodic interest income (including recognition of fees and costs) at a constant effective yield on the net investment in the receivable (that is, the principal amount of the receivable adjusted by unamortized fees or costs and purchase premium or discount). The difference between the periodic interest income so determined and the stated interest on the outstanding principal amount of the receivable is the amount of periodic amortization.<sup>6</sup> Under the provisions of this statement, the interest method shall be applied as follows when the stated interest rate is not constant throughout the term of the loan:

- a. If the loan's stated interest rate increases during the term of the loan (so that interest accrued under the interest method in early periods would exceed interest at the stated rate), interest income shall not be recognized to the extent that the net investment in the loan would increase to an amount greater than the amount at which the borrower could settle the obligation. Prepayment penalties shall be considered in determining the amount at which the borrower could settle the obligation only to the extent that such penalties are imposed throughout the loan term. (Refer to Appendix B.)
- b. If the loan's stated interest rate decreases during the term of the loan, the stated periodic interest received early in the term of the loan would exceed the periodic interest income that is calculated under the interest method. In that circumstance, the excess shall be deferred and recognized in those future periods when the constant effective yield under the interest method exceeds the stated interest rate. (Refer to Appendix B.)
- c. If the loan's stated interest rate varies based on future changes in an independent factor, such as an index or rate (for example, the prime rate, the London Interbank Offered Rate (LIBOR), or the U.S. Treasury bill weekly average rate), the calculation of the constant effective yield necessary to recognize fees and costs shall be based either on the factor (the index or rate) that is in effect at the inception of the loan or on the factor as it changes over the life of the loan.<sup>7</sup> (Refer to Appendix B.)

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<sup>6</sup> The "interest" method is also described in paragraph 16 of *APB Opinion No. 12, Omnibus Opinion--1967*, in the first sentence of paragraph 15 of *APB Opinion No. 21, Interest on Receivables and Payables*, and in paragraphs 235-239 of FASB Concepts Statement No. 6, Elements of Financial Statements.

<sup>7</sup> A variable rate loan whose initial rate differs from the rate its base factor would produce is also subject to the provisions of paragraphs 18(a) and (b).

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19. Except as stated in the following sentence, the calculation of the constant effective yield necessary to apply the interest method shall use the payment terms required by the loan contract, and prepayments of principal shall not be anticipated to shorten the loan term. If the enterprise holds a large number of similar loans for which prepayments are probable and the timing and amount of prepayments can be reasonably estimated, the enterprise may consider estimates of future principal prepayments in the calculation of the constant effective yield necessary to apply the interest method. If the enterprise anticipates prepayments in applying the interest method and a difference arises between the prepayments anticipated and actual prepayments received, the enterprise shall recalculate the effective yield to reflect actual payments to date and anticipated future payments. The net investment in the loans shall be adjusted to the amount that would have existed had the new effective yield been applied since the acquisition of the loans. The investment in the loans shall be adjusted to the new balance with a corresponding charge or credit to interest income. Enterprises that anticipate prepayments shall disclose that policy and the significant assumptions underlying the prepayment



estimates. The practice of recognizing net fees over the estimated average life of a group of loans shall no longer be acceptable. (Refer to Appendix B.)

20. Certain loan agreements provide no scheduled payment terms (demand loans); others provide the borrower with the option to make multiple borrowings up to a specified maximum amount, to repay portions of previous borrowings, and then reborrow under the same contract (revolving lines of credit).
- a. For a loan that is payable at the lender's demand, any net fees or costs may be recognized as an adjustment of yield on a straight-line basis over a period that is consistent with (1) the understanding between the borrower and lender or (2) if no understanding exists, the lender's estimate of the period of time over which the loan will remain outstanding; any unamortized amount shall be recognized when the loan is paid in full.
  - b. For revolving lines of credit (or similar loan arrangements), the net fees or costs shall be recognized in income on a straight-line basis over the period the revolving line of credit is active, assuming that borrowings are outstanding for the maximum term provided in the loan contract.

If the borrower pays all borrowings and cannot reborrow under the contract, any unamortized net fees or costs shall be recognized in income upon payment. The interest method shall be applied to recognize net unamortized fees or costs when the loan agreement provides a schedule for payment and no additional borrowings are provided for under the agreement.<sup>8</sup>

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<sup>8</sup> For example, if the loan agreement provides the borrower with the option to convert a one-year revolving line of credit to a five-year term loan, during the term of the revolving line of credit the lender would recognize the net fees or costs as income on a straight-line basis using the combined life of the revolving line of credit and term loan. If the borrower elects to convert the line of credit to a term loan, the lender would recognize the unamortized net fees or costs as an adjustment of yield using the interest method. If the revolving line of credit expires and borrowings are extinguished, the unamortized net fees or costs would be recognized in income upon payment.

30. FAS 125 provides the following guidance:

28. To be substantially the same,<sup>9</sup> the asset that was transferred and the asset that is to be repurchased or redeemed need to have all of the following characteristics:
- a. The same primary obligor (except for debt guaranteed by a sovereign government, central bank, government-sponsored enterprise or agency thereof, in which case the guarantor and the terms of the guarantee must be the same)
  - b. Identical form and type so as to provide the same risks and rights
  - c. The same maturity (or in the case of mortgage-backed pass-through and pay-through securities have similar remaining weighted-average maturities that result in approximately the same market yield)
  - d. Identical contractual interest rates
  - e. Similar assets as collateral
  - f. The same aggregate unpaid principal amount or principal amounts within accepted "good delivery" standards for the type of security involved.

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<sup>9</sup> In this Statement, the term substantially the same is used consistently with the usage of that term in the *AICPA Statement of Position 90-3, Definition of the Term Substantially the Same for Holders of Debt Instruments, as Used in Certain Audit Guides and a Statement of Position*.

31. *AICPA Statement of Position 90-3, Definition of the Term Substantially the Same for Holders of Debt Instruments, as Used in Certain Audit Guides and a Statement of Position (SOP 90-3)* provides the following guidance:

.13 To minimize diversity in practice, the AICPA Banking Committee, Savings and Loan Associations Committee, and Stockbrokerage and Investment Banking Committee believe the definition of substantially the same should be narrow. Therefore, the committees have concluded that for debt instruments, including mortgage-backed securities, to be substantially the same, all the following criteria must be met:

- a. The debt instruments must have the same primary obligor, except for debt instruments guaranteed by a sovereign government, central bank, government-sponsored enterprise or agency thereof, in which case the guarantor and terms of the guarantee must be the same.<sup>1</sup>

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<sup>1</sup> The exchange of pools of single-family loans would not meet this criterion because the mortgages comprising the pool do not have the same primary obligor, and would therefore not be considered substantially the same.

- b. The debt instruments must be identical in form and type so as to give the same risks and rights to the holder.<sup>2</sup>

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<sup>2</sup> For example, the following exchanges would not meet this criterion: GNMA I securities for GNMA II securities; loans to foreign debtors that are otherwise the same except for different U.S. foreign tax credit benefits (because such differences in the tax receipts associated with the loans result in instruments that vary "in form and type"); commercial paper for redeemable preferred stock.

- c. The debt instruments must bear the identical contractual interest rate.

- d. The debt instruments must have the same maturity except for mortgage-backed pass-through and pay-through securities for which the mortgages collateralizing the securities must have similar remaining weighted average maturities (WAMs) that result in approximately the same market yield.<sup>3</sup>

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<sup>3</sup> For example, the exchange of a "fast-pay" GNMA certificate (that is, a certificate with underlying mortgage loans that have a high prepayment record) for a "slow-pay" GNMA certificate would not meet this criterion because differences in the expected remaining lives of the certificates result in different market yields.

- e. Mortgage-backed pass-through and pay through securities must be collateralized by a similar pool of mortgages, such as single-family residential mortgages.

- f. The debt instruments must have the same aggregate unpaid principal amounts, except for mortgage-backed pass-through and pay-through securities, where the aggregate principal amounts of the mortgage-backed securities given up and the mortgage-backed securities reacquired must be within the accepted "good delivery" standard for the type of mortgage-backed security involved.<sup>4</sup>

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<sup>4</sup> Participants in the mortgage-backed securities market have established parameters for what is considered acceptable delivery. These specific standards are defined by the Public Securities Association (PSA) and can be found in Uniform Practices for the Clearance and Settlement of Mortgage-Backed Securities and Other Related Securities, which is published by PSA.

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## RELEVANT LITERATURE

### Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- *Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies*, Chapter 1, Bonds and Loan Backed and Structured Securities
- *Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies*, Chapter 1, Bonds and Loan Backed and Structured Securities
- *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets*
- *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets*
- *Issue Paper No. 73—Nonmonetary Transactions*
- *Issue Paper No. 45—Repurchase Agreements, Reverse Repurchase Agreements and Dollar Repurchase Agreements*
- *Purposes and Procedures Manual of the NAIC Securities Valuation Office*

### Generally Accepted Accounting Principles

- *FASB Statement No. 91, Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*
- *FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities*
- *FASB Statement No. 125, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*
- *AICPA SOP 90-3, Definition of the Term Substantially the Same for Holders of Debt Instruments, as used In Certain Audit Guides and a Statement of Position*
- *AICPA SOP 90-11, Disclosure of Certain Information by Financial Institutions About Debt Securities Held as Assets*
- *AICPA Practice Bulletin No. 4, Accounting for Foreign Debt/Equity Swaps*
- *FASB Emerging Issues Task Force No. 89-18, Divestitures of Certain Investment Securities to an Unregulated Commonly Controlled Entity under FIRREA*
- *FASB Emerging Issues Task Force No. 96-10, Impact of Certain Transactions on Held-to-Maturity Classifications Under FASB Statement No. 115*

### State Regulations

- No additional guidance obtained from state statutes or regulations.

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