Statutory Accounting Principles (E) Working Group

**Maintenance Agenda Submission Form**

**Form A**

## **Issue:** Accounting for Bond Tender Offers

**Check (applicable entity):**

P/C Life Health

Modification of Existing SSAP

New Issue or SSAP

Interpretation

Description of Issue: Questions have arisen regarding the accounting treatment for when a held bond is retired early through the acceptance of a “bond tender offer.” A bond tender offer occurs when the bond issuer repurchases some, or all, of a particular bond issuance prior to its scheduled maturity date. These offers are generally an attempt to retire a substantial amount of outstanding debt by making a one-time, special offer to bond holders. Generally, the purpose of a tender offer is to retire bonds that were originally issued at higher interest rates; however, some tender offers have occurred as a mechanism for capital restructuring. As expected, these activities are most common in a decreasing or depressed interest rate environment.

Tender offers typically share similar characteristics in that the offer is: 1) for a predetermined (finite) number of bonds, 2) a specified, nonnegotiable price, 3) available to the market as a whole – generally advertised through a press release, 4) only available for a limited period of time, and 5) contingent upon acceptance by a substantial percentage of debt holders – generally accepted by at least 25% of those eligible for early buyout.

From a bond holder’s perspective, the only material difference between a called and tendered bond is that with the tender offer, the bond holder must elect to accept the repurchase offer. If the tender offer is not accepted, the bond’s terms (including scheduled maturity date) remain unchanged. Bond tender offers are generally offered at rates slightly above market value, as an economic enticement for the holder to “sell” the bond. This increased compensation is reflective of prepayment penalties and/or acceleration fees noted in called bonds. The reinvestment risk assumed by holding a bond with a call option is generally compensation through a higher yield or a known prepayment penalty. Similarly, through a bond tender offer, increased compensation comes in the form of additional termination payout as compared to current market value.

Specific guidance for the reporting and allocation of investment income and/or capital gain/loss associated with callable bonds (where the issuer, at its sole discretion, can redeem a bond before it scheduled maturity date) is noted in *SSAP No. 26R—Bonds;* however guidance is not reflected for when a bond is retired early through a tender offer. As previously discussed, called bonds and bond tender offers are similar in the fact that the issuer can retire a bond early, however with a bond tender offer, the *holder* must elect to accept the offer. If the offer is not accepted, the original terms of the bond are not modified.

Existing Authoritative Literature:

The reporting of prepayment penalties or acceleration fees in the event a bond is liquidated prior to its scheduled termination date are detailed in *SSAP No. 26R—Bonds.*

**Income**

1. 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 *SSAP 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.
2. 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.**
3. The amount of prepayment penalty and/or acceleration fees to be reported as investment income or loss shall be calculated as follows:
4. For called bonds in which the total proceeds (consideration) received exceeds par:

i. The amount of investment income reported is equal to the consideration received less the par value of the investment; and

ii. Any difference between the book adjusted carrying value (BACV) and the par value at the time of disposal shall be reported as realized capital gains and losses, subject to the authoritative literature in SSAP No. 7.

1. For called bonds in which the consideration received is less than par[[1]](#footnote-1):
2. To the extent an entity has in place a process to identify explicit prepayment penalty or acceleration fees, these should be reported as investment income. (An entity shall consistently apply their process. Once a process is in place, an entity is required to maintain a process to identify prepayment penalties for called bonds in which consideration received is less than par.)
3. After determining any explicit prepayment penalty or acceleration fees, the reporting entity shall calculate the resulting realized gain as the difference between the remaining consideration and the BACV, which shall be reported as realized capital gain, subject to the authoritative literature in SSAP No. 7.

Activity to Date (issues previously addressed by the Working Group, Emerging Accounting Issues (E) Working Group, SEC, FASB, other State Departments of Insurance or other NAIC groups): None

**Information or issues (included in *Description of Issue*) not previously contemplated by the Working Group:**

While bond tenders were not specifically discussed, the accounting and reporting of revenues as a result of early termination, was addressed in agenda item 2018-32: SSAP No. 26R—Prepayment Penalties. In this agenda item, authoritative guidance was adopted detailing the breakout of revenues between investment income and capital gains when the called bond consideration was less than par.

**Convergence with International Financial Reporting Standards (IFRS): N/A**

Staff Recommendation: NAIC Staff recommends that the Working Group move this item to the active listing, categorized as nonsubstantive and expose revisions to *SSAP No. 26R—Bonds* to clarify that the accounting and reporting of investment income and capital gain/loss, due to the early liquidation either through a call or a tender offer, shall be similarly applied. NAIC staff believes this is in line with original intent as the initial SSAP No. 26 codification guidance (still reflected in paragraph 16 of SSAP No. 26R) is not specific to called bonds. Rather, the guidance refers to “prepayment penalties or acceleration fees in the event the bond is liquidated prior to its scheduled termination date.” This guidance would seemingly include all dynamics in which an issuer provides a penalty / fee to the holder to terminate the bond.

A bond retired early through either a call or tender offer are functionally equivalent to a bond holder. The only potential additional consideration for the bond holder is that the yield-to-worst concept was likely not applied in relation to the bond tender offer (as the tender offer amount and date were not known/expected at the time of acquisition). However, this concern is negated as bond tender offers are generally at or above market value and the holder must elect to participate. If a bond tender offer is not economically beneficial to the holder, the holder would simply not participate.

SSAP No. 26R – Proposed Updates

1. 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.
2. The amount of prepayment penalty and/or acceleration fees to be reported as investment income or loss shall be calculated as follows:
3. For called or tendered bonds in which the total proceeds (consideration) received exceeds par:

i. The amount of investment income reported is equal to the consideration received less the par value of the investment; and

ii. Any difference between the book adjusted carrying value (BACV) and the par value at the time of disposal shall be reported as realized capital gains and losses, subject to the authoritative literature in SSAP No. 7.

1. For called or tendered bonds in which the consideration received is less than par[[2]](#footnote-2):
2. To the extent an entity has in place a process to identify explicit prepayment penalty or acceleration fees, these should be reported as investment income. (An entity shall consistently apply their process. Once a process is in place, an entity is required to maintain a process to identify prepayment penalties for called bonds in which consideration received is less than par.)
3. After determining any explicit prepayment penalty or acceleration fees, the reporting entity shall calculate the resulting realized gain as the difference between the remaining consideration and the BACV, which shall be reported as realized capital gain, subject to the authoritative literature in SSAP No. 7.

Staff Review Completed by: Jim Pinegar, NAIC Staff – January 2020

**Status:**

On March 18, 2020, the Statutory Accounting Principles (E) Working Group moved this item to the active listing, categorized as nonsubstantive, and exposed revisions to *SSAP No. 26R—Bonds*, to clarify that the accounting and reporting of investment income and capital gain/loss, due to the early liquidation either through a call or a tender offer, shall be similarly applied. The current guidance refers to “prepayment penalties or acceleration fees in the event the bond is liquidated prior to its schedule termination date,” and includes all dynamics in which an issuer provides a penalty/fee to the holder to terminate the bond. This item has a comment period deadline ending May 29, 2020.

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1. This guidance applies to situations in which consideration received is less than par but greater than the book adjusted carrying value (BACV). Pursuant to the yield-to-worst concept, bonds shall be amortized to the call or maturity date that produces the lowest asset value. In the event a bond has not been amortized to the lowest value prior to the call (BACV is greater than the consideration received), the entire difference between consideration received and the BACV shall be reported to investment income. [↑](#footnote-ref-1)
2. This guidance applies to situations in which consideration received is less than par but greater than the book adjusted carrying value (BACV). Pursuant to the yield-to-worst concept, bonds shall be amortized to the call or maturity date that produces the lowest asset value. In the event a bond has not been amortized to the lowest value prior to the call, or in cases of an accepted tender bond offer (BACV is greater than the consideration received), the entire difference between consideration received and the BACV shall be reported to investment income. [↑](#footnote-ref-2)