Statutory Accounting Principles (E) Working Group

**Maintenance Agenda Submission Form**

**Form A**

## **Issue:** Accounting for Perpetual Bonds

**Check (applicable entity):**

P/C Life Health

Modification of Existing SSAP

New Issue or SSAP

Interpretation

Description of Issue: Questions have arisen regarding accounting treatment for perpetual bonds held as investments within scope of *SSAP No. 26R—Bonds.* A perpetual bond is a fixed income security, representing a creditor relationship, with a fixed schedule of future payments, however it does not contain a maturity date - thus yielding the definitional term “perpetual.” These bonds are typically not redeemable at the option of the holder but likely possess call options for the benefit of the issuer.

Perpetual bonds possess characteristics very similar to that of perpetual preferred stock in that both offer a projected return for an indefinite of time. The similarities of these two securities extend beyond both having indefinite lives and receiving periodic, scheduled income cash flows (i.e. interest for perpetual bonds and dividends for perpetual preferred stock). Both investments 1) have a higher than average duration from their perpetual cashflows reflecting a greater market value sensitivity, up and down, to interest rate movements, 2) generally are subject to issuer call provisions, and 3) do not possess voting rights. The only primary cashflow difference between perpetual bonds and perpetual preferred stock is seniority in the event of a liquidation (bond typically place higher in the liquidation hierarchy) – which is why perpetual preferred stock may warrant a higher yield to compensate for seniority risk.

Existing Authoritative Literature:

SSAP No. 26R does not contain specific or differing valuation and reporting guidance for perpetual bonds. These investments would be captured in the existing valuation and reporting guidance for bonds that are not mandatory convertible, which anticipate a scheduled maturity date. Under this existing guidance, bonds are held at amortized cost *or* lower of amortized cost or fair value, depending on NAIC designation of the bond. Due to perpetual bonds lacking a maturity date (and possessing indefinite lives), they are unable to experience accretion or amortization to yield an amortized cost basis.

### SSAP No. 26R—Bonds

11. Bonds, as defined in paragraph 3, shall be valued and reported in accordance with this statement, the *Purposes and Procedures Manual of the NAIC Investment Analysis Office*, and the designation assigned in the NAIC *Valuations of Securities* product prepared by the NAIC Securities Valuation Office (SVO).

1. Bonds, except for mandatory convertible bonds: For reporting entities that maintain an asset valuation reserve (AVR), the bondsshall 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 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 value.**
2. Mandatory convertible bonds: Mandatory convertible bonds are subject to special reporting instructions and are not assigned NAIC designations or unit prices by the SVO. **The balance sheet amount for mandatory convertible bonds shall be reported at the lower of amortized cost or fair value during the period prior to conversion.** This reporting method is not impacted by NAIC designation or information received from credit rating providers (CRPs). Upon conversion, these securities will be subject to the accounting guidance of the statement that reflects their revised characteristics. (For example, if converted to common stock, the security will be in scope of *SSAP No. 30R—Unaffiliated Common Stock*, if converted to preferred stock, the security will be in scope of *SSAP No. 32—Preferred Stocks*.)

### Due to the numerous payment similarities between perpetual bonds and perpetual preferred stock, the accounting and reporting guidance for perpetual preferred stock is below. (Note: guidance below is from agenda item 2019-04: SSAP No. 32 – Investment Classification Project.) This agenda item substantially revises *SSAP No. 32—Preferred Stock* as a part of the Investment Classification Project. This guidance is anticipated for adoption during the Summer 2020 National Meeting)

### SSAP No 32R—Preferred Stock

1. Preferred stock shall be valued based on (a) the underlying characteristics (redeemable, **perpetual** or mandatory convertible), (b) the quality rating expressed as an NAIC designation, and (c) whether an asset valuation reserve (AVR) is maintained by the reporting entity:
   1. **For reporting entities that do not maintain an AVR:**
      1. Highest-quality or high-quality redeemable preferred stocks (NAIC designations 1 and 2) shall be valued at amortized cost. All other redeemable preferred stocks (NAIC designations 3 to 6) shall be reported at the lower of amortized cost or fair value.
      2. **Perpetual preferred stocks shall be reported at fair value, not to exceed any currently effective call price.**
      3. Mandatory convertible preferred stocks (regardless if the preferred stock is redeemable or perpetual) shall be reported at fair value, not to exceed any currently effective call price, in the periods prior to conversion. Upon conversion to common stock, these securities shall be in scope of SSAP No. 30R.
      4. For preferred stocks reported at fair value, unrealized gains and losses shall be recorded as a direct credit or charge to unassigned funds (surplus).
   2. **For reporting entities that maintain an AVR**:
      1. Highest-quality, high-quality or medium quality redeemable preferred stocks (NAIC designations 1 to 3) shall be valued at amortized cost. All other redeemable preferred stocks (NAIC designations 4 to 6) shall be reported at the lower of amortized cost or fair value.
      2. **Perpetual preferred stocks shall be valued at fair value, not to exceed any currently effective call price.**
      3. Mandatory convertible preferred stocks (regardless if the preferred stock is redeemable or perpetual) shall be reported at fair value, not to exceed any currently effective call price, in the periods prior to conversion. Upon conversion to common stock, these securities shall be in scope of SSAP No. 30R.
      4. For preferred stocks reported at fair value, 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).

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): While not specific to perpetual bonds, in agenda item 2019-04: SSAP No. 32 – Investment Classification Project, the Working Group has agreed in principle with the accounting for perpetual preferred stock, which from an investor perspective, is materially similar to perpetual bonds.

**Information or issues (included in *Description of Issue*) not previously contemplated by the Working Group:** None

**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 perpetual bonds shall be reported at fair value, not to exceed any current effective call price. Although this is considered a nonsubstantive change, if a stated effective date is preferred (instead of immediately upon adoption), NAIC staff recommends an effective date of Jan. 1, 2021, with early application permitted. (Although these bonds cannot amortize without a maturity date, NAIC staff notes that the specific reference to fair value may cause a change for reporting entities immediately before year-end. However, it is also noted that these types of bonds are not believed to be overly prevalent.)

SSAP No. 26R – Proposed Updates

**Balance Sheet Amount**

11. Bonds, as defined in paragraph 3, shall be valued and reported in accordance with this statement, the *Purposes and Procedures Manual of the NAIC Investment Analysis Office*, and the designation assigned in the NAIC *Valuations of Securities* product prepared by the NAIC Securities Valuation Office (SVO).

1. Bonds, except for mandatory convertible bonds: 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 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 value. For perpetual bonds, the bonds shall be reported at fair value regardless of NAIC designation, not to exceed any current effective call price.
2. Mandatory convertible bonds: Mandatory convertible bonds are subject to special reporting instructions and are not assigned NAIC designations or unit prices by the SVO. The balance sheet amount for mandatory convertible bonds shall be reported at the lower of amortized cost or fair value during the period prior to conversion. This reporting method is not impacted by NAIC designation or information received from credit rating providers (CRPs). Upon conversion, these securities will be subject to the accounting guidance of the statement that reflects their revised characteristics. (For example, if converted to common stock, the security will be in scope of *SSAP No. 30R—Unaffiliated Common Stock*, if converted to preferred stock, the security will be in scope of *SSAP No. 32—Preferred Stocks*.)

### Effective Date and Transition

1. Revisions adopted April 2019, to explicitly exclude securities for which the contract amount of the instrument to be paid at maturity (or the original investment) is at risk for other than failure of the borrower to pay the contractual amount due, are effective December 31, 2019.
2. The reporting of perpetual bonds at fair value shall be effective January 1, 2021, with early adoption permitted.

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

**Status:**

On July 30, 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*, as illustrated above,to clarify that perpetual bonds shall be reported at fair value, not to exceed any current effective call price. Although this is considered a nonsubstantive change, a stated effective date of Jan. 1, 2021, with early application permitted, has been proposed to allow time for reporting entities to make measurement changes as needed.

On November 12, 2020, the Statutory Accounting Principles (E) Working Group exposed revisions to *SSAP No. 26R—Bonds*, as illustrated below, to clarify that perpetual bonds are within scope as a “bond,” and shall apply the yield-to-worst concept. Additionally, for perpetual bonds that do not possess or no longer possess a call feature shall follow fair value reporting.

SSAP No. 26R – Proposed Updates for the November 12th Interim Meeting:

In conjunction with the NAIC staff recommendation to retain bond accounting (i.e. amortized cost) for perpetual bonds that possess a future call date, however to require fair value accounting for those that do not (or no longer) possess a future call date, the following edits are recommended. All items below are new and have not previously been exposed.

### Amortized Cost

1. 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 FN. Bonds containing call provisions (where the issue can be called away from the reporting entity at the issuer’s discretion), except “make-whole” call provisions, shall be amortized to the call or maturity value/date which produces the lowest asset value (yield-to-worst). Although the concept for yield-to-worst shall be followed for all callable bonds, make-whole call provisions, which allow the bond to be callable at any time, shall not be considered in determining the timeframe for amortizing bond premium or discount unless information is known by the reporting entity indicating that the issuer is expected to invoke the make-whole call provision.

New Footnote: For perpetual bonds with an effective call option, any applicable premium shall be amortized to the next effective call date. For perpetual bonds purchased at a discount, any applicable discount shall be accreted utilizing the yield-to-worst concept.

**Balance Sheet Amount**

11. Bonds, as defined in paragraph 3, shall be valued and reported in accordance with this statement, the *Purposes and Procedures Manual of the NAIC Investment Analysis Office*, and the designation assigned in the NAIC *Valuations of Securities* product prepared by the NAIC Securities Valuation Office (SVO).

1. Bonds, except for mandatory convertible bonds: 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 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 value. For perpetual bonds in which do not possess or no longer possess an effective call option, the bond shall be reported at fair value regardless of NAIC designation.

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