Statutory Issue Paper No. 32

Investments in Preferred Stock (excluding investments in preferred stock of subsidiary, controlled, or affiliated entities)

STATUS
Finalized March 16, 1998

Original SSAP and Current Authoritative Guidance: SSAP No. 32

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Current statutory guidance pertaining to the valuation of and accounting for preferred stock 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 established the NAIC's Securities Valuation Office (SVO) as the primary authority for the valuation of preferred stocks. The purpose of this issue paper is to establish statutory accounting principles for preferred stocks, including those loaned under a securities lending agreement, which are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

2. Accounting for investments in preferred stock of subsidiaries, controlled or affiliated entities (investments in affiliates) will be addressed in *Issue Paper No. 46—Accounting for Investments in Subsidiary, Controlled and Affiliated Entities.*

SUMMARY CONCLUSION

3. For purposes of statutory accounting, preferred stocks (excluding investments in affiliates), which may or may not be publicly traded and may include shares against which exchange traded call options are outstanding, shall include:

   a. Redeemable preferred stocks (including mandatory sinking fund preferred stocks and preferred stocks redeemable at the option of the holder).

   b. Perpetual preferred stocks including nonredeemable preferred stocks and preferred stock redeemable at the option of the issuer.

Redeemable preferred stock shall be defined as preferred stock that by its terms must be redeemed by the issuing enterprise or is redeemable at the option of the investor. They include mandatory sinking fund preferred stock and payment-in-kind (PIK) preferred stock. Mandatory sinking fund preferred stocks shall be defined as redeemable preferred stock subject to a 100% mandatory sinking fund, annual installments of which will (1) commence not more than 10 years from the date of issue or December 31, 1978, if outstanding on that date; (2) be not less than 2% of the number of shares issued (or outstanding on December 31, 1978, if issued prior to that date); (3) provide for the redemption of the entire issue over a period not longer than 40 years from the date of issue, or December 31, 1978, if outstanding on that date. Redeemable preferred stock which is subject to a 100% mandatory sinking fund, but which do not at date of issue, or December 31, 1978 if outstanding at that time, meet one or more of the other requirements above, shall be considered as mandatory sinking fund preferred stock at the time the deficiency is cured through the passage of time or otherwise. Payment-in-kind (PIK) preferred stocks shall be defined as redeemable preferred stocks on which dividends can be paid in additional securities rather than cash at the option of the issuer. Perpetual preferred stock shall be defined as preferred stock with no redemption or sinking fund features and preferred stock redeemable at the option of the issuer.

4. Preferred stock meets the definition of an asset as defined in *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets* and is an admitted asset to the extent it conforms to the requirements of this paper.

5. At acquisition, preferred stocks shall be reported at their cost, including brokerage and other related fees. Cost shall not exceed market value. Preferred stock acquisitions and dispositions shall be recorded on the trade date, not the settlement date except for private placement preferred stocks which shall be recorded on the funding date.

6. Redeemable preferred stock purchased at a premium shall be amortized to reduce the carrying value to the call or redemption value over the period to the call or earliest redemption date, whichever produces the lowest asset value. Redeemable preferred stock purchased at a discount shall be amortized to increase the carrying value to par value over the period to maturity or the latest redemption date. Amortization shall be calculated using the interest method and shall be reported as increases or decreases in dividends collected during the year.

7. Dividends on preferred stock (whether cumulative or noncumulative) other than mandatorily redeemable preferred stock shall be recorded as investment income on the ex-dividend date with a corresponding receivable to be extinguished upon receipt of cash (i.e., dividend income shall be recorded on preferred stocks declared to be ex-dividend on or prior to the statement date). Dividends on mandatorily redeemable preferred stock shall be accrued, even if not declared, using the interest method to the redemption price over the period ending on the redemption date.

8. For purposes of statutory accounting, preferred stocks shall be valued based on a) the underlying characteristics of the security, b) the quality rating of the security as defined in the *Purposes and Procedures Manual of the NAIC Securities Valuation Office* (SVO Purposes and Procedures) and reported in the Valuations of Securities manual published by the NAIC's Valuation of Securities Task Force at the end of each year and c) whether an Asset Valuation Reserve (AVR) is maintained by the reporting entity.

Reporting Entities That Do Not Maintain An AVR

9. Highest-quality or high-quality redeemable preferred stocks (which have characteristics of a debt security) shall be valued at cost or amortized cost. Other redeemable preferred stocks shall be valued at the lower of cost, amortized cost or market value. Highest-quality or high-quality perpetual preferred stocks (which have characteristics of an equity security) shall be valued at market value as reported in Valuations of Securities manual. Other perpetual preferred stock shall be valued at lower of cost or market value.

Reporting Entities That Do Maintain An AVR

10. Highest-quality, high-quality or medium quality redeemable preferred stocks (which have characteristics of a debt security) shall be valued at cost or amortized cost. Other redeemable preferred stocks shall be valued at the lower of cost, amortized cost or market value. Highest-quality, high-quality or medium quality perpetual preferred stocks (which have characteristics of an equity security) shall be valued at cost. Other perpetual preferred stock shall be valued at the lower of cost or market value.

Additional Valuation Guidance Applicable To All Reporting Entities

11. The SVO Purposes and Procedures classifies preferred stocks into six redeemable preferred stock quality categories and into six perpetual preferred stock quality categories. Preferred stocks shall be classified in accordance with the Valuations of Securities manual published by the NAIC's Valuation of Securities Task Force each reporting date. Unrealized gains and losses on perpetual preferred stocks shall be included as a direct credit or charge to surplus.

12. Restricted preferred stock shall be defined as a security for which sale is restricted by governmental or contractual requirement (other than in connection with being pledged as collateral) except where that requirement terminates within one year or if the holder has the power by contract or otherwise to cause the requirement to be met within one year. Any portion of the security that can be reasonable expected to qualify for sale within one year is not considered restricted.

13. PIK preferred stocks are considered redeemable preferred stock and shall be recorded initially at cost and accreted to the lower of (1) the call price or (2) par value, measured in either case at the end of the stock dividend period and based on all of the shares expected to be held at the end of that period, including those received as dividends. PIK stocks received as dividends should be recorded at market value. Any cash dividends paid during the stock dividend period on PIK stocks shall be accounted for as a reduction in the investment.

14. For any decline in the fair value of a preferred stock which is determined to be other than temporary, the cost basis of the preferred stock shall be written down to fair market value as the new cost basis and the amount of the write down shall be accounted for as a realized loss. For those reporting entities required to maintain an AVR, realized losses shall be accounted for in accordance with *Issue Paper No. 7—Asset Valuation Reserve and Interest Maintenance Reserve*. For perpetual preferred stock, subsequent fluctuations in market value shall be recorded as unrealized gains or losses. Subsequent fluctuations in market value shall be recorded as unrealized gains and losses to the extent that they do not bring the investment above its new cost basis. Future declines in market value which are determined to be other than temporary, shall be recorded as realized losses. For perpetual preferred stock, a decline in fair value which is other than temporary includes situations where an investor has made a decision to sell a security at an amount below its carrying value. This is consistent with *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets.* For redeemable preferred stock, when a decline in fair value is determined to be other than temporary, the investment should be written down to fair value as the new cost basis and the amount of the write down shall be accounted for as a realized loss. For redeemable preferred stock, an impairment shall be considered to have occurred if it is probable that the investor will be unable to collect all amounts due according to the contractual terms of the security in effect at the date of acquisition. A decline in fair value which is other than temporary includes situations where an investor has made a decision to sell a security prior to its maturity at an amount below its carrying value (i.e., amortized cost).

15. A reporting entity can subscribe for the purchase of stock, but not be required to make payment until a later time. Transactions of this nature are common in the formation of corporations. Preferred stock acquired under a subscription represents a conditional transaction in a security authorized for issuance but not yet actually issued. Such transactions are settled if and when the actual security is issued and the exchange or National Association of Securities Dealers (NASD) rules that the transactions are to be settled. Preferred stock acquired under a subscription shall be recorded as an admitted asset when the reporting entity or its designated custodian or transfer agent takes delivery of the security and the security is recorded in the name of the reporting entity or its nominee, (i.e., the accounting for such preferred stock acquisitions shall be on the settlement date).

Loaned Preferred Stock

16. When preferred stocks 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 stocks. 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 stocks/securities.

Wash Sales

17. When preferred stock 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 20. Unless there is a concurrent contract to repurchase or redeem the transferred preferred stock from the transferee, the transferor does not maintain effective control over the preferred stock.

18. 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

19. If preferred stock is exchanged or converted into other securities, the fair value of the preferred stock 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 preferred stock surrendered then it shall become the cost basis for the new securities. This treatment is consistent with *Issue Paper No. 73—Nonmonetary Transactions*.

Disclosures

20. The following disclosures shall be made for all preferred stocks in the notes to the financial statements:

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

b. Concentrations of credit risk in accordance with *Issue Paper No. 27—Disclosure of Information about Financial Instruments with Concentrations of Credit Risk*;

c. Basis at which the preferred stocks are stated;

d. Description of any loaned preferred stock, including the amount, description of the collateral and whether or not the collateral is restricted;

e. A description, as well as the amount, of preferred stock that is restricted and the nature of the restriction.

f. Reporting entities shall disclose the following information for wash sales, as defined in paragraph 17, involving transactions for securities with a NAIC designation of 3 or below, or unrated:

1. A description of the reporting entity's objectives regarding these transactions;
2. An aggregation of transactions by NAIC Designation 3 or below, or unrated;
3. The number of transactions involved during the reporting period;
4. The book value of securities sold;
5. The cost of securities repurchased;
6. The realized gains/losses associated with the securities involved.

DISCUSSION

21. The statutory accounting principles described above do not recognize the GAAP accounting principles for valuation set forth in *FASB Statement No. 115*, *Accounting for Certain Investments in Debt and Equity Securities* (FAS 115); therefore, this issue paper rejects FAS 115.

22. The statutory accounting principles described above are consistent with current statutory accounting guidance for preferred stocks except as follows:

a. Specific guidelines for PIK preferred stocks are not included in current statutory guidance.

b. Specific guidelines for stock subscriptions are not included in current statutory guidance.

c. Specific guidelines for collateral deposited related to restricted stock that has been loaned are not included in current statutory guidance.

d. Specific guidelines for wash sales, other than transactions between affiliates, are not included in current statutory guidance.

23. This issue paper adopts paragraphs 9-12, 15, 17, 23-31 and 61-65 of *FASB Statement No. 125*, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (FAS 125*)* as they relate to preferred stock. The guidance on loaned securities in this issue paper is drafted under the general rule that securities lending transactions do not meet the criteria for surrender of control necessary to classify the transaction as a sale. If the criteria in paragraph 9 of FAS 125 regarding surrender of control are met, the transaction shall be accounted for by the transferor as a sale of the "loaned" securities.

24. Paragraph 14 of FAS 125 is rejected as it relates to classifications of securities under FAS 115. FAS 115 was rejected in *Issue Paper No. 26—Bonds, excluding Loan-Backed and Structured Securities* (Issue Paper No. 26). This issue paper rejects *FASB Emerging Issues Task Force No. 86-32, Early Extinguishment of a Subsidiary's Mandatorily Redeemable Preferred Stock.*

25. The statutory accounting principle outlined in the conclusion above accounts for preferred stocks based on the underlying characteristics of the securities and takes into consideration whether an Asset Valuation Reserve is maintained. This is consistent with the statutory accounting principles established in Issue Paper No. 26 and *Issue Paper No. 30—Investments in Common Stock (excluding investments in common stock of subsidiary, controlled, or affiliated entities)*. Under the statutory principles outlined in the conclusion above, preferred stocks with underlying characteristics of a debt security are valued similar to bonds and preferred stocks with underlying characteristics of an equity instrument are valued similar to common stocks (except for reporting entities that maintain an AVR, where they are valued at cost). This is consistent with the Statement of Concepts which states that *"The regulator's need for meaningful,*

comparable financial information to determine an insurer's financial condition requires consistency in the development and application of statutory accounting principles."

Drafting Notes/Comments

- Accounting for preferred stock holdings of subsidiary, controlled and affiliated companies is addressed in *Issue Paper No. 46—Accounting for Investments in Subsidiary, Controlled and Affiliated Entities*.
- Investment income due and accrued is addressed in *Issue Paper No. 34—Investment Income Due and Accrued*.
- Accounting for the Asset Valuation Reserve (AVR) default component required for preferred stock holdings is addressed in *Issue Paper No. 7—Asset Valuation Reserve and Interest Maintenance Reserve*.
- 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

26. The Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies provides guidance with respect to preferred stock (similar guidance is also in the Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies). Pertinent excerpts are as follows:

> Shares of capital stock represent units of ownership in a corporation, including common and preferred stock, mutual fund shares, transferable savings and loan association shares, warrants, and options to purchase stock. A return on stock held for investment is generally in the form of cash dividends which are paid to the owner. Occasionally, dividends are paid in the form of additional shares of stock. Liquidation of stock investments may give rise to capital gains or losses. (Investment in stock of parents, subsidiaries or affiliates is discussed in Chapter 6.)
>
> Common stockholders are the residual owners of the corporation and assume the ultimate risk associated with ownership up to the limit of their investment. They are usually entitled to voting powers of ownership. At liquidation, their claim to assets is after those of creditors and preferred stockholders. Common stockholders may liquidate their ownership rights in a corporation by selling their shares in the secondary market.
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> Preferred stock is a corporate financing method embodying features of common stock and debt. Preferred stockholders have a prior claim to common stockholders on income and assets, but rank below creditors. Ownership of preferred stock usually does not include voting privileges. Numerous options may be designed into the issue including call features, cumulative dividend entitlements, and earnings participation. Generally the dividend rate on preferred stock is determined at issue and does not reflect variations in earnings of the issuer.
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> Valuation
> Common and preferred stocks are generally required to be reported at the value published in the Valuations of Securities manual published by the NAIC's Valuation of Securities Task Force at the end of each year. This value is the subcommittee's determination of "market" for each listed stock.
>
> Preferred stocks in good standing subject to a 100% mandatory sinking fund shall be carried at cost, unless the company owned the preferred stock on Dec, 31, 1964, in which case the company may have the option of reporting them either at the association value on that date or at company cost. Preferred stock that is not in good standing is to be reported at the lower of cost or association value.

The valuation of stock purchase warrants, stock purchase options that may be exercised on December 31 of the year for which the annual statement is being prepared, loaned securities, and investments in subsidiaries shall be in accordance with the practices and procedures prescribed by the NAIC and the state of domicile.

Securities not listed in the manual, securities listed with no value because insufficient information for valuation was submitted to the Valuation of Securities Task Force, and restricted stock require the determination of an acceptable value. Insurance companies are required to submit sufficient information on these securities to the NAIC Securities Valuation Office to permit them to determine market value.

Dividends

Dividends are usually recorded in the general ledger on a cash basis. Dividends receivable on qualified shares of stock are generally permitted as admitted assets to the extent that the dividend has been excluded from the determination of the market price of the holding (i.e., on stock selling ex-dividend). Dividends receivable are included in "Investment Income Due and Accrued" in the annual statement. The asset is developed by a determination of the dividend status of each stock investment at the balance sheet date. Thus, dividend income on stock for any period consists of dividends collected during the year and the change in the declared but unpaid dividends between the beginning and end of the period.

The *Valuation of Securities* manual has a complete listing of all stocks that are traded "ex-dividend" at the end of the year. An ex-dividend stock is one in which the issuing company has closed its stock ledger on a certain date and has declared a dividend payable to the stockholder of record, even though the stock may have been sold after the record date but prior to the payment date. The association value of ex-dividend stock includes no value for the dividend since the unpaid dividend does not transfer with ownership of the stock. The listing of ex-dividend stock contains the declared dividend rate for calculating the declared but unpaid dividends that are allowable for each stock owned by the company on the dividend record date.

Loaned Stock

Where the law or regulation of the insurer's state of domicile does not prohibit such activity, stock may be loaned to authorized securities broker/dealers or to authorized financial institutions.

Securities lending is conducted through open-ended agreements, which may be terminated on short notice by the lender or borrower. Securities loans are collateralized by cash and/or cash equivalents, and securities issued by the U.S. Government or its agencies. Securities lending transactions may be negotiated directly between an insurer and a borrower, or indirectly through an insurer's custodian/agent and a borrower.

When stocks are loaned, they remain assets of the insurance company and are not removed from the accounting records as the insurance company remains the owner of the stocks. When cash collateral is provided and it is deposited for the general use of the company, it becomes an asset of the company, and a liability for the return of that collateral must be established.

When non-cash collateral not available for the general use of the company is provided, it should not be recognized as an asset of the company. If balance sheet accounts are used for non-cash collateral control purposes, a contra account should be used to neutralize or zero out the balance sheet account so that no net asset value is reported in the assets of the insurance company. When non-cash collateral is used, 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 stocks/securities.

As stated in the NAIC Valuations of Securities manual, the minimum collateral on securities loaned is 102% of the market value of loaned stocks. The value of collateral will at times exceed or go below 102% of the market value of securities loaned due to daily market fluctuations in both the stocks loaned and collateral. A daily "mark to market" or valuation procedure must be in place to ensure that the market value of the collateral never goes below 100% of the market value of securities loaned and that calls for additional collateral to maintain the 102% minimum which should be made on a timely basis.

If the collateral on stocks is denominated in a different currency than the stocks being loaned, the minimum collateral on these securities loaned is 105% of the market value of loaned stocks as noted in the NAIC Valuations of Securities manual. Again, the same daily valuation procedures noted above must be in place to ensure adequate collateral for stocks loaned.

The valuation of the stocks remain unaffected by the loan as long as the amount of collateral is at least equal to the minimum amounts specified above. Failure to hold sufficient collateral may result in the admitted assets value being decreased by the amount of insufficient collateral.

27. The *Purposes and Procedures Manual of the NAIC Securities Valuation Office* - Section 3 - Procedures for Determining NAIC Designations for Preferred Stocks contains the following guidance:

(A) **Purpose** The purpose of assigning an NAIC Designations P1-6 and PSF 1-6 is to determine the appropriate values to be entered in Schedule D and the AVR.

(B) **General Procedures** For the purpose of analysis, preferred stocks are divided into two categories, perpetual and mandatory sinking fund preferred stocks. Perpetual preferreds are those which do not have any sinking fund provisions. Mandatory sinking fund preferred stock shall include those issues subject to a 100% mandatory sinking fund, annual installments of which will: (1) commence not more than 10 years from the date of issue or December 31, 1978, if outstanding on that date; (2) be not less than 2½% of the number of shares issued (or outstanding on December 31, 1978, if issued prior to that date); (3) provide for the redemption of the entire issue over a period not longer than 40 years from the date of issue, or December 31, 1978, if outstanding on that date. "Mandatory sinking fund preferred stock" that is subject to a 100% mandatory sinking fund, but that does not at date of issue, or December 31, 1978 if outstanding at that time, meet one or more of the other requirements of this Section, may qualify at such time as the deficiency is cured through the passage of time, or otherwise.

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 Which Have Securities Rated by Other Recognized Rating Agencies or Organizations.

Ratings of other recognized 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 rating into NAIC Designations is presented in Appendix B. To become an NAIC approved rating organization the candidate must apply to the NAIC's Securities Valuation Office and file written documentation similar to that detailed in Section 2(B)(1) and an explanation of how their rating scale translates into the NAIC rating system.

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

The implied senior unsecured debt rating of any issuer will be used to determine how an issuer's preferred stock will be rated. Preferreds will in general be given a rating grade equal to that of the real or implied most junior level of debt. For example, if senior unsecured debt is rated or has an implied rating of 3 then the subordinated debt of this issuer would be rated 4 and the preferred stock would also be rated a 4. Whether a preferred will be rated high quality or not will depend upon how much debt precedes it in the capital structure and how well both interest and preferred dividends are covered by earnings. All preferred dividends and sinking fund requirements must have been paid for the last three years for any preferred to be rated P-5, PSF-5 or higher.

(C) Special Factors.

(1) Market Values for Privately Placed Preferred Stock. In determining a price for a directly placed preferred, the SVO staff will first look for a publicly traded comparable preferred stock. (i.e. one with similar basic characteristics) of the same issuer and use the yield from that issue to price the private issue. If no comparable issues are available, the staff will use the yields from Moody's Investors Services indices of preferred yields as of the close of the week preceding December 31.

(2) Preferred stocks of 100% owned insurance subsidiaries will be valued in the same manner as common stock of subsidiaries.

(3) Loaned Securities.

Where permitted by law or regulation of an insurer's state of domicile, preferred stocks loaned to others shall be valued in accordance with Section 3(B) at date of statement if the Acceptable Collateral, as hereinafter defined, is pledged as security for the loan and 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 shares. In event that foreign shares 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 shares, the amount of Acceptable Collateral which shall be pledged shall be an amount equal to 105% of the market value of the loaned shares. A decline in value of the Acceptable Collateral or an increase in the value of the loaned shares during the term of the loan shall not result in disqualification from valuation in accordance with the above 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 shares (or 102% of the market value or the loaned shares 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% or 105% initially required to be posted and 100% or 102%, respectively. For purpose of this provision, Acceptable Collateral shall mean cash and cash equivalents and shall include securities issued by the U.S. Government or its agencies. 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.

(4) Other Limited Life Preferred Shares.

Some examples of these are: Dutch Auction Rate Preferred Shares (DARTS), Fixed Rate Adjustable Preferred Stock (FRAPS), Stated Term Auction Preferred Shares (STRAPS), Fixed Rate Exchangeable Preferred Stock (FREPS), Marketed Auction Preferred Shares (MAPS), Stated Rate Auction Preferred

Shares (STAR), Share Adjusted Broker Remarketed Shares (SABRES). These shares will qualify to be valued at cost for companies maintaining an Asset Valuation Reserve and cost or amortized cost for all others as long as an "PSF 1 or 2," "High Quality" designation, is maintained in both cases.

(D) Instructions for Completing Schedule D of the NAIC Year End Annual Statement.

The following tables indicate the appropriate entries to be entered in Schedule D Part 2-Section 1 of the NAIC Annual Statement for all preferred stocks.

(1) For Insurers Maintaining an Asset Valuation Reserve (AVR) (See Section 5)

NAIC DESIGNATION COLUMN	STATEMENT VALUE COLUMN	MARKET VALUE COLUMNS	
		RATE	AMOUNT
PSF-1 Thru PSF-3	Cost or Amortized Cost	SVO Market Rate	Par Value X Rate
PSF-4 Thru PSF6	Lower of Cost, Amortized Cost, or Market Value	SVO Market Rate	Par Value X Rate
P-1 Thru P-3	Cost	SVO Market Rate	Par Value X Rate
P-4 Thru P-6	Lower of Cost or Market Value	SVO Market Rate	Par Value X Rate

(2) For Insurers Not Maintaining an Asset Valuation Reserve (AVR)

NAIC DESIGNATION COLUMN	STATEMENT VALUE COLUMN	MARKET VALUE COLUMNS	
		RATE	AMOUNT
PSF-1 Thru PSF-2	Cost or Amortized Cost	SVO Market Rate	Par Value X Rate
PSF-3 Thru PSF6	Lower of Cost, Amortized Cost, or Market Value	SVO Market Rate	Par Value X Rate
P-1 Thru P-2	Market Value	SVO Market Rate	Par Value X Rate
P-3 Thru P-6	Lower of Cost or Market Value	SVO Market Rate	Par Value X Rate

Note: The quality ratings are defined in the SVO Purpose and Procedures as follows:

P-1 Highest quality perpetual preferred stock
P-2 High quality perpetual preferred stock
P-3 Medium quality perpetual preferred stock
P-4 Low quality perpetual preferred stock
P-5 Lower quality perpetual preferred stock
P-6 Lowest quality perpetual preferred stock

PSF1 Highest quality sinking fund or limited life preferred stock
PSF2 High quality sinking fund or limited life preferred stock
PSF3 Medium quality sinking fund or limited life preferred stock
PSF4 Low quality sinking fund or limited life preferred stock
PSF5 Lower quality sinking fund or limited life preferred stock
PSF6 Lowest quality sinking fund or limited life preferred stock

28. Several states have statutes that address valuation of preferred stocks. See excerpts below:

- Utah Regulations - Utah Administrative Rules, Insurance, R590 Administration, Rule R590-116--Valuation of Assets

  5. Preferred and Guaranteed Stocks.

     a. Preferred or guaranteed stocks in good standing are to be valued at cost by companies which are maintaining a mandatory securities valuation reserve. Companies not maintaining a mandatory securities valuation reserve shall value such stocks at market value.

     b. Preferred or guaranteed stocks not in good standing are to be valued at market value.

     c. Market value as used for valuation of preferred or guaranteed stocks means in accordance with the values listed in "Valuation of Securities." For securities which are traded on a registered national securities exchange, but are not listed in that publication, market value may be established at the most recent published trade value. Securities not listed and not actively traded on a major stock exchange shall have a market value in an amount that the insurer can justify to the commissioner.

     d. Preferred or guaranteed stocks of insurance subsidiaries are to be valued in accordance with the requirements of Section 31A-17-401(3)(a), U.C.A., and Section (4)(B) of this rule.

- Massachusetts Statutes - Insurance Laws, PART I. -- Administration of the Government, TITLE XXII-- Corporations, Chapter 175 -- INSURANCE, Powers and Duties of Commissioner of Insurance, 175:11A - Valuation of securities and other investments

  (A)(1) Investments, shall be valued in accordance with the published valuation standards of the National Association of Insurance Commissioners. Securities investments as to which the National Association of Insurance Commissioners has not published valuation standards in its Valuation of Securities Manual or its successor publication shall be valued as follows:

  (a) All obligations having a fixed term and rate shall, if not in default as to principal and interest, be valued as follows: (I) if purchased at par, at par value; (ii) if purchased above or below par, on the basis of the purchase price adjusted so as to bring the value to par at maturity and so as to yield in the meantime the effective rate of interest at which the purchase was made; or in lieu of such method, according to such accepted method of valuation as is approved by the commissioner, but no such method shall be inconsistent with valuation methods used by insurers in general, or any method currently formulated or approved by the National Association of Insurance Commissioners.

  (b) Purchase price shall in no case be taken at a higher figure than the actual market value at the time of purchase, plus actual brokerage, transfer, postage or express charges paid in the acquisition of such securities.

  (c) Common, preferred or guaranteed stocks shall be valued at their market value or at the option of the company, they may be valued at purchase price if purchase price is less than market value.

- Florida Statutes - Insurance Laws, TITLE XXXVII-- INSURANCE, Chapter 625 -- Accounting, Investments, and Deposits by Insurers, Part I. Assets and Liabilities, 625.151- Securities valuation

(1) Securities, other than those referred to in º 625.141, held by an insurer shall be valued, in the discretion of the department, at their market value, or at their appraised value, or at prices determined by it as representing their fair market value.

- Georgia Regulations, Rules and Regulations of the State of Georgia, TITLE 120. -- Rules of the Comptroller General, 120-2. Insurance Department, Chapter 120-2-5 -- Valuation Procedures and Instructions for Bonds and Stocks, 120-2-5-.01 Establishing Values

  (1) Each insurer reporting stocks and bonds as admitted assets in its annual statement shall be responsible for establishing a value for such securities. Except as otherwise provided by law, the procedures for establishing such values where applicable shall be as follows:

  (a) Other than the nonadmissible exceptions listed in paragraph 2 of this Rule, values must comply with the rules for valuation contained in the National Association of Insurance Commissioners' Valuation of Securities Task Force publication, Valuation of Securities, for the applicable year.

  (b) Securities not listed in the National Association of Insurance Commissioners' Committee on Valuation of Securities publication Valuation of Securities shall have no value, unless, upon application to such Committee on Valuation of Securities and submission of all relevant material required by the committee, and such committee establishes a value for the securities.

Generally Accepted Accounting Principles

29. 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.

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. (Note: remainder of paragraph not reproduced as not applicable to preferred stock)

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.

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.

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 accounting to the contractual terms of a debt security not impaired at acquisition, an other-than-temporary impairment shall be considered to have occurred.[4] If the decline in the 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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[4]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.

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30. FAS 125 provides the following guidance:

Accounting for Transfers and Servicing of Financial Assets

9. A transfer of financial assets (or all or a portion of a financial asset) in which the transferor surrenders control over those financial assets shall be accounted for as a sale to the extent that consideration other than beneficial interests in the transferred assets is received in exchange. The transferor has surrendered control over transferred assets if and only if all of the following conditions are met:

a. The transferred assets have been isolated from the transferor—put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership (paragraphs 23 and 24).
b. Either (1) each transferee obtains the right—free of conditions that constrain it from taking advantage of that right (paragraph 25)—to pledge or exchange the transferred assets or (2) the transferee is a qualifying special-purpose entity (paragraph 26) and the holders of beneficial interests in that entity have the right—free of conditions that constrain them from taking advantage of that right (paragraph 25)—to pledge or exchange those interests.
c. The transferor does not maintain effective control over the transferred assets through (1) an agreement that both entitles and obligates the transferor to repurchase or redeem them before their maturity (paragraphs 27-29) or (2) an agreement that entitles the transferor to repurchase or redeem transferred assets that are not readily obtainable (paragraph 30).

10. Upon completion of any transfer of financial assets, the transferor shall:

a. Continue to carry in its statement of financial position any retained interest in the transferred assets, including, if applicable, servicing assets (paragraphs 35-41), beneficial interests in assets transferred to a qualifying special-purpose entity in a securitization (paragraphs 47-58), and retained undivided interests (paragraph 33)

b. Allocate the previous carrying amount between the assets sold, if any, and the retained interests, if any, based on their relative fair values at the date of transfer (paragraphs 31-34).

11. Upon completion[3] of a transfer of assets that satisfies the conditions to be accounted for as a sale (paragraph 9), the transferor (seller) shall:

a. Derecognize all assets sold

b. Recognize all assets obtained and liabilities incurred in consideration as proceeds of the sale, including cash, put or call options held or written (for example, guarantee or recourse obligations), forward commitments (for example, commitments to deliver additional receivables during the revolving periods of some securitizations), swaps (for example, provisions that convert interest rates from fixed to variable), and servicing liabilities, if applicable (paragraphs 31, 32, and 35-41)

c. Initially measure at fair value assets obtained and liabilities incurred in a sale (paragraphs 42-44) or, if it is not practicable to estimate the fair value of an asset or a liability, apply alternative measures (paragraphs 45 and 46)

d . Recognize in earnings any gain or loss on the sale.

The transferee shall recognize all assets obtained and any liabilities incurred and initially measure them at fair value (in aggregate, presumptively the price paid).

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[3]Although a transfer of securities may not be considered to have reached completion until the settlement date, this Statement does not modify other generally accepted accounting principles, including *FASB Statement No. 35, Accounting and Reporting by Defined Benefit Pension Plans*, and AICPA Statements of Position and audit and accounting Guides for certain industries, that require accounting at the trade date for certain contracts to purchase or sell securities.

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12. If a transfer of financial assets in exchange for cash or other consideration (other than beneficial interests in the transferred assets) does not meet the criteria for a sale in paragraph 9, the transferor and transferee shall account for the transfer as a secured borrowing with pledge of collateral (paragraph 15).

Secured Borrowings and Collateral

15. A debtor may grant a security interest in certain assets to a lender (the secured party) to serve as collateral for its obligation under a borrowing, with or without recourse to other assets of the debtor. An obligor under other kinds of current or potential obligations, for example, interest rate swaps, also may grant a security interest in certain assets to a secured party. If collateral is transferred to the secured party, the custodial arrangement is commonly referred to as a pledge. Secured parties sometimes are permitted to sell or repledge (or otherwise transfer) collateral held under a pledge. The same relationships occur, under different names, in transfers documented as sales that are accounted for as secured borrowings (paragraph 12). The accounting for collateral by the debtor (or obligor) and the secured party depends on whether the secured party has taken control over the collateral and on the rights and obligations that result from the collateral arrangement:

a. If (1) the secured party is permitted by contract or custom to sell or repledge the collateral and (2) the debtor does not have the right and ability to redeem the collateral on short notice, for example, by substituting other collateral or terminating the contract, then

(i) The debtor shall reclassify that asset and report that asset in its statement of financial position separately (for example, as securities receivable from broker) from other assets not so encumbered.

(ii) The secured party shall recognize that collateral as its asset, initially measure it at fair value, and also recognize its obligation to return it.

b. If the secured party sells or repledges collateral on terms that do not give it the right and ability to repurchase or redeem the collateral from the transferee on short notice and thus may impair the debtor's right to redeem it, the secured party shall recognize the proceeds from the sale or the asset repledged and its obligation to return the asset to the extent that it has not already recognized them. The sale or repledging of the asset is a transfer subject to the provisions of this Statement.

c. If the debtor defaults under the terms of the secured contract and is no longer entitled to redeem the collateral, it shall derecognize the collateral, and the secured party shall recognize the collateral as its asset to the extent it has not already recognized it and initially measure it at fair value.

d. Otherwise, the debtor shall continue to carry the collateral as its asset, and the secured party shall not recognize the pledged asset.

Disclosures

17. An entity shall disclose the following:

a. If the entity has entered into repurchase agreements or securities lending transactions, its policy for requiring collateral or other security

b. If debt was considered to be extinguished by in-substance defeasance under the provisions of FASB Statement No. 76, Extinguishment of Debt, prior to the effective date of this Statement, a general description of the transaction and the amount of debt that is considered extinguished at the end of the period so long as that debt remains outstanding

c. If assets are set aside after the effective date of this Statement solely for satisfying scheduled payments of a specific obligation, a description of the nature of restrictions placed on those assets

d. If it is not practicable to estimate the fair value of certain assets obtained or liabilities incurred in transfers of financial assets during the period, a description of those items and the reasons why it is not practicable to estimate their fair value

e. For all servicing assets and servicing liabilities:

(1) The amounts of servicing assets or liabilities recognized and amortized during the period

(2) The fair value of recognized servicing assets and liabilities for which it is practicable to estimate that value and the method and significant assumptions used to estimate the fair value

(3) The risk characteristics of the underlying financial assets used to stratify recognized servicing assets for purposes of measuring impairment in accordance with paragraph 37

(4) The activity in any valuation allowance for impairment of recognized servicing assets—including beginning and ending balances, aggregate additions charged and reductions credited to operations, and aggregate direct write-downs charged against the allowances—for each period for which results of operations are presented.

Isolation beyond the Reach of the Transferor and Its Creditors

23. The nature and extent of supporting evidence required for an assertion in financial statements that transferred financial assets have been isolated—put presumptively beyond the reach of the transferor and its creditors, either by a single transaction or a series of transactions taken as a whole—depend on the facts and circumstances. All available evidence that either supports or questions an assertion shall be considered. That consideration includes making judgments about whether the contract or circumstances permit the transferor to revoke the transfer. It also may include making judgments about the kind of bankruptcy or other receivership into which a transferor or special-purpose entity might be placed, whether a transfer of financial assets would likely be deemed a true sale at law, whether the transferor is affiliated with the transferee, and other factors pertinent under applicable law. Derecognition of transferred assets is appropriate only if the available evidence provides reasonable assurance that the transferred assets would be beyond the reach of the powers of a bankruptcy trustee or other receiver for the

transferor or any of its affiliates, except for an affiliate that is a qualifying special-purpose entity designed to make remote the possibility that it would enter bankruptcy or other receivership (paragraph 57.c.).

24. Whether securitizations isolate transferred assets may depend on such factors as whether the securitization is accomplished in one step or two steps (paragraphs 54-58). Many common financial transactions, for example, typical repurchase agreements and securities lending transactions, isolate transferred assets from the transferor, although they may not meet the other criteria for surrender of control.

Conditions That Constrain a Transferee

25. Many transferor-imposed or other conditions on a transferee's contractual right to pledge or exchange a transferred asset constrain a transferee from taking advantage of that right. However, a transferor's right of first refusal on a bona fide offer from a third party, a requirement to obtain the transferor's permission to sell or pledge that shall not be unreasonably withheld, or a prohibition on sale to the transferor's competitor generally does not constrain a transferee from pledging or exchanging the asset and, therefore, presumptively does not preclude a transfer containing such a condition from being accounted for as a sale. For example, a prohibition on sale to the transferor’s competitor would not constrain the transferee if it were able to sell the transferred assets to a number of other parties; however, it would be a constraint if that competitor were the only potential willing buyer.

Qualifying Special-Purpose Entity

26. A qualifying special-purpose entity[7] must meet both of the following conditions:

a. It is a trust, corporation, or other legal vehicle whose activities are permanently limited by the legal documents establishing the special-purpose entity to:
   (1) Holding title to transferred financial assets
   (2) Issuing beneficial interests (If some of the beneficial interests are in the form of debt securities or equity securities, the transfer of assets is a securitization.)
   (3) Collecting cash proceeds from assets held, reinvesting proceeds in financial instruments pending distribution to holders of beneficial interests, and otherwise servicing the assets held
   (4) Distributing proceeds to the holders of its beneficial interests.

b. It has standing at law distinct from the transferor. Having standing at law depends in part on the nature of the special-purpose entity. For example, generally, under U.S. law, if a transferor of assets to a special-purpose trust holds all of the beneficial interests, it can unilaterally dissolve the trust and thereby reassume control over the individual assets held in the trust, and the transferor "can effectively assign his interest and his creditors can reach it."[8] In that circumstance, the trust has no standing at law, is not distinct, and thus is not a qualifying special-purpose entity.

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[7]The description of a special-purpose entity is restrictive. The accounting for transfers of financial assets to special-purpose entities should not be extended to any entity that does not satisfy all of the conditions articulated in this paragraph.

[8]*Scott’s Abridgment of the Law on Trusts,* §156 (Little, Brown and Company, 1960), 296.

Agreements That Maintain Effective Control over Transferred Assets

27. An agreement that both entitles and obligates the transferor to repurchase or redeem transferred assets from the transferee maintains the transferor’s effective control over those

assets, and the transfer is therefore to be accounted for as a secured borrowing, if and only if all of the following conditions are met:

a. The assets to be repurchased or redeemed are the same or substantially the same as those transferred (paragraph 28).
b. The transferor is able to repurchase or redeem them on substantially the agreed terms, even in the event of default by the transferee (paragraph 29).
c. The agreement is to repurchase or redeem them before maturity, at a fixed or determinable price.
d. The agreement is entered into concurrently with the transfer.

28. To be substantially the same,[9] 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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[9] 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.*

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29. To be able to repurchase or redeem assets on substantially the agreed terms, even in the event of default by the transferee, a transferor must at all times during the contract term have obtained cash or other collateral sufficient to fund substantially all of the cost of purchasing replacement assets from others.

30. A call option or forward contract that entitles the transferor to repurchase, prior to maturity, transferred assets not readily obtainable elsewhere maintains the transferor's effective control, because it would constrain the transferee from exchanging those assets, unless it is only a cleanup call.

Measurement of Interests Held after a Transfer of Financial Assets

Assets Obtained and Liabilities Incurred as Proceeds

31. The proceeds from a sale of financial assets consist of the cash and any other assets obtained in the transfer less any liabilities incurred. Any asset obtained that is not an interest in the transferred asset is part of the proceeds from the sale. Any liability incurred, even if it is related to the transferred assets, is a reduction of the proceeds. Any derivative financial instrument entered into concurrently with a transfer of financial assets is either an asset obtained or a liability incurred and part of the proceeds received in the transfer. All proceeds and reductions of proceeds from a sale shall be initially measured at fair value, if practicable.

Securities Lending Transactions

61. Securities lending transactions are initiated by broker-dealers and other financial institutions that need specific securities to cover a short sale or a customer's failure to deliver

securities sold. Transferees ("borrowers") of securities generally are required to provide "collateral" to the transferor ("lender") of securities, commonly cash but sometimes other securities or standby letters of credit, with a value slightly higher than that of the securities "borrowed." If the "collateral" is cash, the transferor typically earns a return by investing that cash at rates higher than the rate paid or "rebated" to the transferee. If the "collateral" is other than cash, the transferor typically receives a fee. Securities custodians or other agents commonly carry out securities lending activities on behalf of clients. Because of the protection of "collateral" (typically valued daily and adjusted frequently for changes in the market price of the securities transferred) and the short terms of the transactions, most securities lending transactions in themselves do not impose significant credit risks on either party. Other risks arise from what the parties to the transaction do with the assets they receive. For example, investments made with cash "collateral" impose market and credit risks on the transferor.

62. In some securities lending transactions, the criteria in paragraph 9 are met, including the third criterion. Those transactions shall be accounted for (a) by the transferor as a sale of the "loaned" securities for proceeds consisting of the "collateral"[11] and a forward repurchase commitment and (b) by the transferee as a purchase of the "borrowed" securities in exchange for the "collateral" and a forward resale commitment. During the term of that agreement, the transferor has surrendered control over the securities transferred and the transferee has obtained control over those securities with the ability to sell or transfer them at will. In that case, creditors of the transferor have a claim only to the "collateral" and the forward repurchase commitment.

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[11]If the “collateral” is a financial asset that the holder is permitted by contract or custom to sell or repledge and the debtor does not have the right and ability to redeem the collateral on short notice, for example, by substituting other collateral or terminating the contract, that financial asset is proceeds of the sale of the “loaned” securities. To the extent that the “collateral” consists of letters of credit or other financial instruments that the holder is not permitted by contract or custom to sell or pledge, a securities lending does not satisfy the sale criteria and is accounted for as a loan of securities by the transferor to the transferee

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63. However, many securities lending transactions are accompanied by an agreement that entitles and obligates the transferor to repurchase or redeem the transferred assets before their maturity under which the transferor maintains effective control over those assets (paragraphs 27-30). Those transactions shall be accounted for as secured borrowings, in which cash (or securities that the holder is permitted by contract or custom to sell or repledge) received as "collateral" is considered the amount borrowed, the securities "loaned" are considered pledged as collateral against the cash borrowed, and any "rebate" paid to the transferee of securities is interest on the cash the transferor is considered to have borrowed. Collateral provided in securities lending transactions that are accounted for as secured borrowings shall be reported in the statement of financial position like other collateral, as set forth in paragraph 15.

64. The transferor of securities being “loaned” accounts for cash received (or for securities received that may be sold or repledged and were obtained under agreements that are not subject to repurchase or redemption on short notice, for example, by substitution of other collateral or termination of the contract) in the same way whether the transfer is accounted for as a sale or a secured borrowing. The cash (or securities) received shall be recognized as the transferor's asset—as shall investments made with that cash, even if made by agents or in pools with other securities lenders—along with the obligation to return the cash (or securities).

Illustration—Securities Lending Transaction Treated as a Secured Borrowing

65. Accounting for a securities lending transaction treated as a secured borrowing:

<u>Facts</u>

Transferor's carrying amount and fair value of security loaned	$1,000
Cash "collateral"	1,020
Transferor's return from investing cash collateral at a 5 percent annual rate	5
Transferor's rebate to the borrower at a 4 percent annual rate	4

The loaned securities cannot be redeemed on short notice, for example, by substitution of other collateral. For simplicity, the fair value of the security is assumed not to change during the 35-day term of the transaction.

<u>Journal Entries for the Transferor</u>

At inception:

Cash	1,020	
Payable under securities loan agreements		1,020
To record the receipt of cash collateral		

Securities loaned to broker	1,000	
Securities		1,000
To reclassify loaned securities that cannot be redeemed on short notice		

Money market instrument	1,020	
Cash		1,020
To record investment of cash collateral		

At conclusion:

Cash	1,025	
Interest		5
Money market instrument		1,020
To record results of investment		

Securities	1,000	
Securities loaned to broker		1,000
To record return of security		

Payable under securities loan agreements	1,020	
Interest ("rebate")	4	
Cash		1,024
To record repayment of cash collateral plus interest		

<u>Journal Entries for the Transferee</u>

At inception:

Receivable under securities loan agreements	1,020	
Cash		1,020
To record transfer of cash collateral		

Securities	1,000	
Obligation to return borrowed securities		1,000

To record receipt of borrowed securities that cannot be redeemed on short notice

At conclusion:

Obligation to return borrowed securities	1,000	
Securities		1,000

To record the return of securities

Cash	1,024	
Receivable under securities loan agreements		1,020
Interest revenue ("rebate")		4

To record the receipt of cash collateral and rebate interest

Repurchase Agreements and "Wash Sales"

69. Furthermore, "wash sales" that previously were not recognized if the same financial asset was purchased soon before or after the sale shall be accounted for as sales under this Statement. Unless there is a concurrent contract to repurchase or redeem the transferred financial assets from the transferee, the transferor does not maintain effective control over the transferred assets.

OTHER SOURCES OF INFORMATION:

31. Accounting for Paid in Kind (PIK) Preferred Stocks (a form of redeemable preferred stock) is addressed in the NAIC Technical Resource Group Proposed Draft Life Codification:

> PIK stocks are redeemable issues of preferred stock which have been used frequently in the financing of leveraged acquisitions because the dividends are payable either in cash or in additional shares of the identical securities for a specified period, typically three to five years (the "stock dividend period"). The choice of paying cash or securities is the election of the issuer; however, it is assumed that in most instances dividends will be paid in securities as a means of preserving cash after the leveraged acquisition. PIKs are redeemable after a fixed period, typically, 15 to 20 years, and a sinking fund may be used to fund redemption after the tenth. PIKs are typically callable; however, the call provisions vary. Some issues are callable at any time at par; others have call protection under which the issues are not callable until the fifth year, either at par or at a premium. PIKs typically are exchangeable at the issuer's election, either immediately or after a stated period, into junior subordinated debt or other securities of the issuer.
>
> PIK bonds typically have the option at each interest payment date of making interest payments in cash or in additional debt securities. These additional debt securities are referred to as baby or bunny bonds. Baby bonds generally have the same terms, including maturity dates and interest rates, as the original bonds. Interest on baby bonds may also be paid in cash or in additional like-kind debt securities at the option of the issuer.
>
> The method used by investors to account for investments in PIKs stocks and bonds should conform with the method used for investments in bonds and redeemable preferred stock. Therefore, the bond accounting method is appropriate because it is anticipated that dividends on PIKs will be paid in additional securities rather than cash (PIKs resemble zero coupon bonds). Accordingly, a form of level yield accounting similar to that used for zero coupons bonds is the preferable approach to recording income. Income under the level yield method is recognized by multiplying the level yield implicit in the PIK by the most recent balance sheet carrying amount.
>
> Specifically, investments in PIK stocks should be recorded initially at cost and accreted to the lower of (1) the call price or (2) par value, measured in either case at the end of the stock

dividend period and based on all of the shares expected to be held at the end of that period, including those received as dividends.

Investments in PIK bonds should be recorded initially at cost and accreted to the lower of (1) the call price or (2) par value so that at final maturity the bond's carrying amount will be equal to the aggregate principal amount of the original bonds and all baby bonds received.

Any cash dividends paid during the stock dividend period on PIK stocks are accounted for as a reduction in the investment. Any interest paid on PIK bonds are accounted for as a reduction in the investment.

At no time should PIK securities be carried on the balance sheet in excess of the current call price. In addition, in the event of impairment in the value of the PIK, losses should be recognized immediately to the extent of the impairment.

If the PIKs are exchanged for other securities of the issuer, the carrying amount of the PIKs at the date of exchange becomes the cost basis of the new securities.

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, Accounting for Assets Transferred Between Affiliates and Chapter 2, Stocks
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Accounting for Assets Transferred Between Affiliates and Chapter 2, Stocks
- *Purposes and Procedures Manual of the NAIC Securities Valuation Office*, Section 3 - Procedures for Determining NAIC Designations for Preferred Stocks
- *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets*
- *Issue Paper No. 5—Definition of Liability, Loss Contingencies and Impairments of Assets*
- *Issue Paper No. 7—Asset Valuation Reserve and Interest Maintenance Reserve*
- *Issue Paper No. 26—Bonds, excluding Loan-backed and Structured Securities*
- *Issue Paper No. 45—Repurchase Agreements, Reverse Repurchase Agreements and Dollar Repurchase Agreements*
- *Issue Paper No. 73—Nonmonetary Transactions*

Generally Accepted Accounting Principles

- *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*
- *Accounting Principles Board Opinion No. 29, Accounting for Nonmonetary Transactions*
- *FASB Emerging Issues Task Force No. 86-32, Early Extinguishment of a Subsidiary's Mandatorily Redeemable Preferred Stock*

State Regulations

- Delaware Statutes - Insurance Laws, Title 18 Insurance Code, Part I, Chapter 13 - Investments, Section 1311
- Utah Regulations - Utah Administrative Rules, Insurance, R590 Administration, Rule R590-116--Valuation of Assets
- Massachusetts Statutes - Insurance Laws, PART I. -- Administration of the Government, TITLE Xxii-- Corporations, Chapter 175 -- INSURANCE, Powers and Duties of Commissioner of Insurance, 175:11A - Valuation of securities and other investments
- Florida Statutes - Insurance Laws, TITLE XXXVII-- INSURANCE, Chapter 625 -- Accounting, Investments, and Deposits by Insurers, Part I. Assets and Liabilities, 625.151- Securities valuation

- Georgia Regulations, Rules and Regulations of the State of Georgia, TITLE 120. -- Rules of the Comptroller General, 120-2. Insurance Department, Chapter 120-2-5 -- Valuation Procedures and Instructions for Bonds and Stocks, 120-2-5-.01 Establishing Values

Other Sources of Information

- NAIC Technical Resource Group Proposed Draft Life Codification, Chapter 1, Bonds