Statutory Accounting Principles (E) Working Group

**Maintenance Agenda Submission Form**

**Form A**

## **Issue:** Surplus Note Accounting - Referral from the Reinsurance (E) Task Force

**Check (applicable entity):**

P/C Life Health

Modification of existing SSAP

New Issue or SSAP

Interpretation

Description of Issue:

Surplus notes are unique statutory accounting items, which have the characteristics of both debt and equity. Surplus notes are issued debt instruments required to be subordinated to the policyholders, claimants and all other creditors. The strict control of form, terms and repayment by the issuing entity’s state of domicile and subordination to all other claimants, give the surplus notes equity-like characteristics. Under statutory accounting, surplus notes are reported in the equity section of the issuer’s balance sheet. (Surplus notes are reported as debt under U.S. GAAP.)

The Reinsurance (E) Task Force was asked to review an investment product that appeared to be a surplus note but included multi-layered / linked transactions that “embed” the risk of the domiciliary state regulator not approving payment of the surplus note’s stipulated principal and interest. It was identified that the statutory accounting provisions to allow equity reporting (rather than debt reporting) may not fully consider the possibility for subsequent, complex transactions that could influence whether the note continues to be in compliance with the strict provisions of *SSAP No. 41R—Surplus Notes*.

Although the specific components of the investment reviewed by the Subgroup were considered proprietary, it was identified that the guidance in SSAP No. 41R did not address “linked” transactions in determining whether an insurer’s issued debt instrument should qualify as a surplus note. For example, if payments made by an insurer under a surplus note influences whether the insurer would receive payment under a separate note held by the insurer (shown as an asset), or if payments “approved” under a surplus note (owed by the insurer) would be netted against other amounts due to the insurer, it was identified that the surplus note may not be actually subordinate to policyholders and other claimants. If this issued debt instrument is not considered subordinate, then it should not be considered a surplus note, and reported by the issuing insurer as equity.

The investment model and its underlying transactions were reviewed by the Reinsurance Investment Security (E) Subgroup, and a referral was sent from the Reinsurance (E) Task Force and Reinsurance Investment Security (E) Subgroup to the Statutory Accounting Principles (E) Working Group with a suggestion to review the guidance in SSAP No. 41R and to make any updates to the language necessary to clarify the treatment of this and similar investment products. This agenda item intends to clarify the guidance in SSAP No. 41R to exclude investments that include multi-layered / linked transactions from the definition of surplus notes under SSAP No. 41R.

*Referral:* Per the Subgroup’s requested review of an investment product, and possible multi-layer transactions that “embed” the risk that the domiciliary state regulator will ultimately approval payment of stipulated principal and interest payments on a surplus note, it was identified that the provisions to allow surplus note accounting (rather than debt accounting) may not fully consider the possibility for subsequent, complex transactions that could influence whether the note continues to be in compliance with the strict provisions of SSAP No. 41R. For example, if an insurer was to engage in a subsequent transaction that “linked” the principal/interest payments of a surplus note to the obligations under a separate and distinct debt instrument or to an “investment” product, concerns exist on whether the issued surplus note in substance remains subordinate to policyholders, claimants, and beneficiaries and/or whether the unaffiliated investor might be incentivized to try to unduly influence decisions to deny payment of interest and/or principal on the surplus note.

This referral recommends that the Working Group consider revisions to SSAP No. 41R to further elaborate the principle intent of the standard, and to address situations involving subsequent transactions (with both affiliates and non-affiliates) that may be linked to an issued (or acquired / sold) surplus note.

Although not part of the referral to the Working Group, the final recommendation adopted by the Task Force reflects the following with regards to “primary security:”

Recommends that NO SECURITY be considered “Primary Security” when the receipt of cash flows from the issuer of the investment is impacted by the financial condition, actions, assets or obligations of the investment’s holder, the holder’s affiliates or the holder’s overall holding company group, or creates a right of recourse or reimbursement against any such person or its property. This recommendation is intended to include ALL arrangements where cash flows due from the investment issuer could be countered / netted / offset (even if it is not an exact match) with a cash flow out from the holder of the investment, the holder’s affiliates or the holder’s overall holding company group. The Subgroup agreed that these securities shall be considered part of a “Regulatory Transaction” and shall not be considered SVO-Listed securities or assets qualifying for use as Primary Security. Furthermore, such transactions must not be considered individually (simply as an investment at the reporting entity level), but must be considered collectively with all other transactions involving affiliates, the overall holding company group, as well as with unaffiliated companies used as intermediaries between the insurance reporting entity, and affiliated entities or the overall holding company group.

With regards to surplus notes, NAIC staff recommends the above conclusion should also be captured when determining whether an issued debt instrument qualifies for surplus note treatment.

Existing Authoritative Literature: Authoritative guidance for surplus notes is in SSAP No. 41R as well as *SSAP No. 15—Debt and Holding Company Obligations*. Current guidance does not provide enough information to effectively prevent a state from approving a note with underlying multi-layered transactions.

SSAP No. 41R:

### Issuers of Surplus Notes

1. Reporting entities sometimes issue instruments that have the characteristics of both debt and equity. These instruments are commonly referred to as surplus notes, the term used herein, but are also referred to as surplus debentures or contribution certificates. These instruments are used for various reasons, including but not limited to:
2. Providing regulators with flexibility in dealing with problem situations to attract capital to reporting entities whose surplus levels are deemed inadequate to support their operations;
3. Providing a source of capital to mutual and other types of non-stock reporting entities who do not have access to traditional equity markets for capital needs;
4. Providing an alternative source of capital to stock reporting entities, although not for the purpose of initially capitalizing the reporting entity.
5. Surplus notes issued by a reporting entity that are subject to strict control by the commissioner of the reporting entity’s state of domicile and have been approved as to form and content shall be reported as surplus and not as debt only if the surplus note contains the following provisions:
6. Subordination to policyholders;
7. Subordination to claimant and beneficiary claims;
8. Subordination to all other classes of creditors other than surplus note holders; and
9. Interest payments and principal repayments require prior approval of the commissioner of the state of domicile.
10. Proceeds received by the issuer must be in the form of cash or other admitted assets having readily determinable values and liquidity satisfactory to the commissioner of the state of domicile.
11. Interest shall not be recorded as a liability nor an expense until approval for payment of such interest has been granted by the commissioner of the state of domicile. All interest, including interest in arrears, shall be expensed in the statement of operations when approved for payment. Unapproved interest shall not be reported through operations, shall not be represented as an addition to the principal or notional amount of the instrument, and shall not accrue further interest, i.e., interest on interest.
12. As of the date of approval of principal repayment by the commissioner of the state of domicile, the issuer shall reclassify such approved payments from surplus to liabilities.
13. Costs of issuing surplus notes (e.g., loan fees and legal fees) shall be charged to operations when incurred.
14. Discount or premium, if any, shall be reported in the balance sheet as a direct deduction from or addition to the face amount of the note. Such discount or premium shall be charged or credited to the statement of operations concurrent with approved interest payments on the surplus note and in the same proportion or percentage as the approved interest payment is to the total estimated interest to be paid on the surplus note.

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:** None.

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

Staff Review Completed by:

Jake Stultz, NAIC Staff – January 2018

Staff Recommendation:

Staff recommends that the Working Group move this item to the active listing, categorized as nonsubstantive and expose revisions to *SSAP No. 41R—Surplus Notes* to provide clear guidance that “surplus notes” that are linked to other structures are not subordinate and do not qualify for surplus note accounting.

Proposed Revisions to SSAP No. 41R: *(New paragraphs all other paragraphs to be renumbered.)*

1. Debt instruments that appear to be similar to surplus notes but are linked (directly or indirectly) to other products or transactions that embed a risk that a domiciliary state regulator will ultimately approve payment of stipulated principal and interest on the surplus note do not qualify to be reported in the equity section of the issuer’s balance sheet. These instruments shall be accounted for as debt under *SSAP No. 15—Debt and Holding Company Obligations.*
2. If an issued debt instrument has been approved as a surplus note, state regulators shall continue to evaluate subsequent transactions that could impact whether the instrument continues to be in compliance with the provisions of this statement. If a surplus note is subsequently identified to be “linked” to another productFN, the note will no longer qualify to be reported as a surplus note and shall be accounted for under SSAP No. 15. Examples of “linked” transactions:
   1. When the approval of cash flows under a surplus note impact whether cash flows due to the insurer will be received. This restriction is intended to encompass all scenarios in which the insurer ultimately assumes the risk of non-payment under a surplus note, regardless if the linked transaction is with an affiliate or a non-affiliate. As a simple example, if the non-approval of principle / interest of a surplus note results with the insurer not receiving the full amount due from an instrument held by the insurer, the debt instrument does not qualify as a surplus note.
   2. Arrangements where cash flows due from the insurer under the surplus note could be countered / netted / offset (even if it is not an exact match) with a cash flow due to the insurer from a held instrument. This restriction is intended to encompass all scenarios in which the amounts owed under a surplus note can be offset with amounts due from instruments reported as assets.

*Staff Note: If a surplus note can be offset against the cash flows of a reported asset, the insurer has inflated both assets and surplus in the financial statements. At the time of maturity, the surplus note and linked asset would both be eliminated from the financial statements without assets being received that can be used for policyholder claims. In these scenarios, it would be expected that the surplus note and related asset would continue to be renewed to allow the assets and equity to continue to be reported without any expected inflow or outflow of cash or assets.*

New Footnote: An instrument reported as an asset by an insurer that is “linked” to a debt instrument issued by the insurer is considered to have economic value other than which can be used to fulfill policyholder obligations, and reflects an asset that is unavailable due to the encumbrances or other third party interests, and shall be nonadmitted pursuant to SSAP No. 4, paragraph 3.

*SSAP No. 4—Assets and Nonadmitted Assets: (No revisions proposed, included for reference purposes.)*

1. For purposes of statutory accounting, an asset shall be defined as: probable[[1]](#footnote-1) future economic benefits obtained or controlled by a particular entity as a result of past transactions or events. An asset has three essential characteristics: (a) it embodies a probable future benefit that involves a capacity, singly or in combination with other assets, to contribute directly or indirectly to future net cash inflows, (b) a particular entity can obtain the benefit and control others’ access to it[[2]](#footnote-2), and (c) the transaction or other event giving rise to the entity’s right to or control of the benefit has already occurred. These assets shall then be evaluated to determine whether they are admitted. The criteria used is outlined in paragraph 3.
2. As stated in the Statement of Concepts, "The ability to meet policyholder obligations is predicated on the existence of readily marketable assets available when both current and future obligations are due. Assets having economic value other than those which can be used to fulfill policyholder obligations, or those assets which are unavailable due to encumbrances or other third party interests should not be recognized on the balance sheet," and are, therefore, considered nonadmitted. For purposes of statutory accounting principles, a nonadmitted asset shall be defined as an asset meeting the criteria in paragraph 2, which is accorded limited or no value in statutory reporting, and is one which is:
   1. Specifically identified within the *Accounting Practices and Procedures Manual* as a nonadmitted asset; or
   2. Not specifically identified as an admitted asset within the *Accounting Practices and Procedures Manual*.

If an asset meets one of these criteria, the asset shall be reported as a nonadmitted asset and charged against surplus unless otherwise specifically addressed within the *Accounting Practices and Procedures Manual*. The asset shall be depreciated or amortized against net income as the estimated economic benefit expires. In accordance with the reporting entity's written capitalization policy, amounts less than a predefined threshold of furniture, fixtures, equipment, or supplies, shall be expensed when purchased.

1. Transactions which do not give rise to assets as defined in paragraph 2 shall be charged to operations in the period the transactions occur. Those transactions which result in amounts which may meet the definition of assets, but are specifically identified within the *Accounting Practices and Procedures Manual* as not giving rise to assets (e.g., policy acquisition costs), shall also be charged to operations in the period the transactions occur.
2. The reporting entity shall maintain a capitalization policy containing the predefined thresholds for each asset class to be made available for the department(s) of insurance.

**Status:**

On March 24, 2018, the Statutory Accounting Principles (E) Working Group moved this agenda item to the active listing, categorized as nonsubstantive, and exposed proposed revisions, as illustrated above, to *SSAP No. 41R—Surplus Notes* to indicate that surplus notes linked to other structures are not subordinate and do not qualify for reporting as statutory equity by the issuer. Furthermore, the revisions indicate that assets linked to issued surplus notes are not available for policyholder claims and shall be nonadmitted.

On August 4, 2018, the Statutory Accounting Principles (E) Working Group exposed revisions to *SSAP No. 41R—Surplus Notes,* modified from the prior exposure, to incorporate accounting guidance that prevents situations in which an issued surplus note can be linked to a reported asset or agreement and still qualify for surplus note reporting. The paragraph exposed, as shown below, focuses on the principal intent of the guidance. (Due to the extent of changes, this exposure does not identify revisions from the past exposure.)

### Issuers of Surplus Notes

1. Reporting entities sometimes issue instruments that have the characteristics of both debt and equity. These instruments are commonly referred to as surplus notes, the term used herein, but are also referred to as surplus debentures or contribution certificates. These instruments are used for various reasons, including but not limited to:
2. Providing regulators with flexibility in dealing with problem situations to attract capital to reporting entities whose surplus levels are deemed inadequate to support their operations;
3. Providing a source of capital to mutual and other types of non-stock reporting entities who do not have access to traditional equity markets for capital needs;
4. Providing an alternative source of capital to stock reporting entities, although not for the purpose of initially capitalizing the reporting entity.
5. Surplus notes issued by a reporting entity that are subject to strict control by the commissioner of the reporting entity’s state of domicile and have been approved as to form and content shall be reported as surplus and not as debt only if the surplus note contains the following provisions:
6. Subordination to policyholders;
7. Subordination to claimant and beneficiary claims;
8. Subordination to all other classes of creditors other than surplus note holders; and
9. Interest payments and principal repayments require prior approval of the commissioner of the state of domicile.
10. The fundamental concept of paragraph 3 is that all surplus notes must be subordinate to all policyholders and all other creditors and that the domiciliary commissioner has control of payments made under a surplus note. Any dynamic, either when issuing a surplus note or through a subsequent transaction, that ultimately results with a surplus note that is not fully subordinate or that circumvents the commissioner control, disqualifies the instrument from “surplus note” treatment and the reporting entity shall report the issued instrument as debt under *SSAP No. 15—Debt and Holding Company Obligations.* Under the fundamental concept requiring subordination and commissioner control, surplus note accounting is prohibited in any situation in which a reporting entity has “linked” the cash flows payable from an issued surplus note with cash flows receivable under any other agreement or held asset. Such dynamics include, but are not limited to, situations in which terms negate or reduce cash flow exchanges, and/or when amounts payable under surplus notes and amounts receivable under other agreements or assets can be netted or offset (partially or in full) eliminating or reducing the exchange of cash or assets that would normally occur throughout the duration, or at maturity, of the agreement, asset or surplus note.

*(Remaining paragraphs to be renumbered accordingly.)*

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1. 1 *FASB Statement of Financial Accounting Concepts No. 6, Elements of Financial Statements*, states:

   Probable is used with its usual general meaning, rather than in a specific accounting or technical sense (such as that in *FASB Statement No. 5, Accounting for Contingencies*, paragraph 3), and refers to that which can reasonably be expected or believed on the basis of available evidence or logic but is neither certain nor proved. [↑](#footnote-ref-1)
2. If assets of an insurance entity are pledged or otherwise restricted by the action of a related party, the assets are not under the exclusive control of the insurance entity and are not available to satisfy policyholder obligations due to these encumbrances or other third party interests. Thus, pursuant to paragraph 2(c), such assets shall not be recognized as an admitted asset on the balance sheet. Additional guidance for assets pledged as collateral is included in INT 01-31. [↑](#footnote-ref-2)