National Association of Insurance Commissioners
The Center for Insurance Policy and Research

MEMORANDUM

TO: Kevin Fry, Chair, Valuation of Securities (E) Task Force
Members of the Valuation of Securities (E) Task Force

FROM: Charles A. Therriault, Director, NAIC Securities Valuation Office

CC: Eric Kolchinsky, Director, NAIC Structured Securities Group

DATE: July 2, 2019

RE: Proposed Amendment to the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (P&P Manual) to Update the Definition and Instructions for Principal Protected Notes

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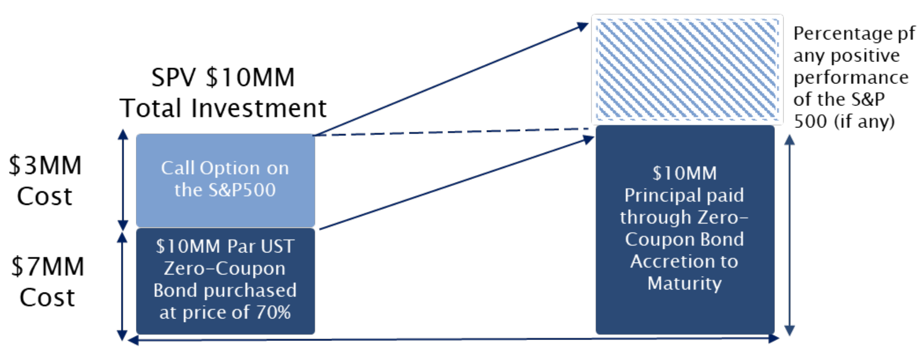
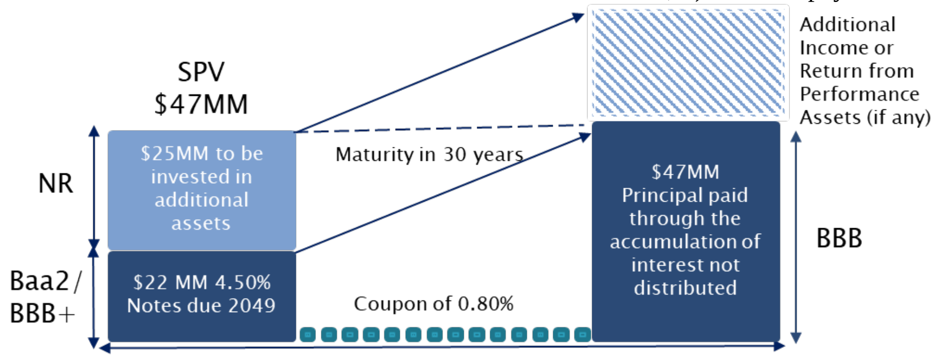
1. **Introduction** – The SVO proposes a substantive amendment to the P&P Manual to update guidance in Part Three under the Procedure Application to Filing Exempt (FE) Securities and Private Letter (PL) Rating Securities, Specific Populations of Securities Not Eligible for Filing Exemption. The SVO has become aware of a class of structured securities, known as Principal Protected Notes, that mixes a traditional bond or bonds with additional assets that may possess any characteristic. These additional assets are intended to generate an excess return, we call them the "performance assets;" such as, derivatives, common stock, commodities, equity indices, etc. … essentially any asset. The performance assets may include undisclosed assets and are typically not securities that would otherwise be permitted on Schedule D, Part 1 as a bond

2. **Analytical Concern** – The SVO has reviewed a dozen or more of these securities. They share a consistent theme; the external credit rating provider (CRP) rating is based solely on the component dedicated to the repayment of principal and ignores the risks and statutory prohibitions of reporting the performance asset on Schedule D, Part 1. There are many potential variants of this structure, for simplicity I have included examples of two common forms below. While the transactions details have been changed to maintain confidentiality the examples accurately reflect the risks and assets embedded within these structures.

    a. In this initial example there are only two components: 1) a $10 MM par UST zero-coupon bond sold at discount (ex. $70) from par ($100) that will pay par ($100) at maturity and 2) a return linked to any positive performance of call options on the S&P 500 Index (if the S&P 500 Index has a negative performance, investors will only receive an amount equal to their initial investment). The external rating would be AAA, based solely on the risk of the UST security.



b. In the second example there are multiple components: 1) a $22MM corporate bond paying a fixed coupon (ex. 4.50%) with a stated maturity date (ex 9/30/2049), 2) the corporate bond has two NRSRO ratings (Moody's Baa2, S&P BBB+), 3) the SPV invests $25MM in additional undisclosed and unrated assets, 4) the SPV pays a semi-annual coupon of 0.80%, 5) the excess coupon difference (4.50% - 0.80% = 3.70%) is used to accumulate into the required principal to pay at maturity and 6) a different NRSRO rated the PPN a BBB, again based solely on the corporate bonds that represent less than 50% of the total investment in this example.



In both examples, assets that would otherwise be ineligible for reporting on Schedule D are making their way onto that schedule through financial structuring. Significant risks are being obscured by focusing only risk associated with the repayment of principal. The source of the assets being transferred into this structured security and their relationship to the insurer is also not transparent. In addition, assets affiliated with the insurance company may be included in the additional asset tranche.

3. **Recommendation** –The SVO proposes removing this class of securities from eligibility for Filing Exemption. The SVO has existing methodologies that can applied to assess the overall risk of these structures and, to the extent that the SVO identifies possible affiliated assets, the SVO would alert regulators. The SVO also recommends referring this memorandum to the Statutory Accounting Principles (E) Working Group to consider the treatment of the asset transformations described above.

4. **Proposed Amendment** – The proposed amendment is shown below in red-underline.

Part Three SVO Procedures and Methodology for Production of NAIC Designations

PROCEDURE APPLICABLE TO FILING EXEMPT (FE) SECURITIES AND PRIVATE LETTER (PL) RATING SECURITIES

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Specific Populations of Securities Not Eligible for Filing Exemption

4. The filing exemption procedure does not apply to:

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- Principal Protected Notes (PPN) – PPN (sometime called "Principal Protected Securities," "Principal Protected Loans," or "Combo Notes") are a type of structured security where a portion of the underlying assets are dedicated to ensure the repayment of principal at maturity or a third party may guarantee the repayment of principal at maturity. The remaining assets in the structure, the performance assets, are intended to generate additional returns and may be of a type (ex. derivatives, equities, commodities, non-CRP rated debt, loans, funds, private equity, real estate, affiliated, undisclosed, etc.) that would not be eligible for reporting on Schedule D. Investments in PPNs must be submitted to the SVO for analysis.

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