



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
Marc Perlman, Investment Counsel, NAIC Securities Valuation Office

DATE: January 27, 2020

RE: Updated - 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. **Summary** –The Task Force on the Oct. 31 call directed NAIC staff to work with industry on the definition for Principal Protected Securities. NAIC staff reported at the Fall National Meeting that it had met with industry representatives on Dec. 3, Nov. 22, Nov. 15 and Nov. 8. The attached updated amendment reflects the discussions to date and staff’s recommendation for a definition of this security; including, expanding this to a new P&P Manual section that provides examples. The update is consistent with the general framework that was outlined at the Fall National Meeting.
 2. **Recommendation** – NAIC staff recommends exposing this updated amendment for comment (new text is identified in red).

PART ONE
POLICIES OF THE NAIC VALUATION OF SECURITIES (E) TASK
FORCE

POLICIES APPLICABLE TO SPECIFIC ASSET CLASSES

PRINCIPAL PROTECTED NOTES

Defined

115. Principal Protected Notes (PPNs) are a type of security that repackages one or more underlying investments and for which contractually promised payments according to a fixed schedule are satisfied by proceeds from an underlying bond(s) but for which the repackaged security generates potential additional returns as described in the detail criteria for PPNs, along with examples, in Part Three of this Manual.

Intent

116. Transactions meeting the criteria of a PPN as defined this Manual may possess Other Non-Payment Risks and must be submitted to the SVO for review under its Subscript S authority.

PART THREE
SVO PROCEDURES AND METHODOLOGY FOR PRODUCTION
OF NAIC DESIGNATIONS

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

FE SECURITIES

Filing Exemption

3. Bonds, within the scope of SSAP No. 26R and SSAP No. 43R (excluding RMBS and CMBS subject to financial modeling) and Preferred Stock within scope of SSAP No. 32, that have been assigned an Eligible NAIC CRP Rating, as described in this Manual, are exempt from filing with the SVO (FE securities) with the exception of Bonds and or Preferred Stock explicitly excluded below.

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)** - Transactions meeting the criteria of a PPN as specified in this Manual may possess Other Non-Payment Risks and must be submitted to the SVO for review under its Subscript S authority.

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PRINCIPAL PROTECTED NOTES

Definition

324. Principal Protected Notes (PPNs) are a type of security that repackages one or more underlying investments and for which contractually promised payments according to a fixed schedule are satisfied by proceeds from an underlying bond(s) (including principal and, if applicable, interest, make whole payments and fees thereon) that if purchased by an insurance company on a stand-alone basis would be eligible for Filing Exemption, but for which:

(i)

a. the repackaged security structure enables potential returns from the underlying investments in addition to the contractually promised cash flows paid to such repackaged security according to a fixed schedule;

OR

b. the contractual interest rate paid by the PPN is zero, below market or, in any case, equal to or below the comparable risk-free rate;

AND

(ii) the insurer would obtain a more favorable Risk Based Capital charge or regulatory treatment for the PPN through Filing Exemption than it would were it to separately file the underlying investments in accordance with the policies in this Manual.

Exclusions

325. For the avoidance of doubt, PPNs shall not include defeased or pre-refunded securities which have separate instructions in this Manual; broadly syndicated securitizations, such as collateralized loan obligations (CLOs) (including middle market CLOs) and asset backed securities (ABS), except as described in the examples in this section; or CLO or ABS issuances held for purposes of risk retention as required by a governing law or regulation.

Filing Requirements

326. Investments in PPNs must be submitted to the SVO for review because they may possess Other Non-Payment Risks that the SVO must assess under its Subscript S authority. If the SVO determines in its judgement that there are not any Other Non-Payment Risks, the SVO will permit the security to benefit from Filing Exemption, if it is otherwise eligible.

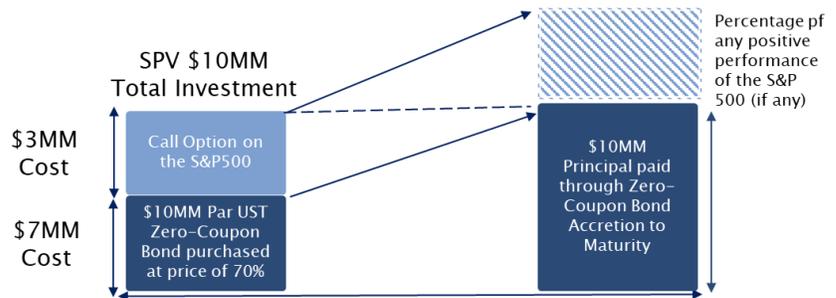
327. In addition to *Filing Process and Required Documents* outlined in Part Two of this manual, the following additional information is required for PPNs:

- Disclosure of any Subsidiary, Controlled or Affiliated relationship between the PPN or any of the underlying investments and the insurer; including, how the underlying investments were acquired.
- Prior four quarterly financial statements, if produced, trustee or collateral agent reports from the entity issuing the PPN sufficient to identify: security specific details of each underlying investment (security identifier, descriptive information, all Eligible NAIC CRP Credit Ratings (if any), par value, market value, and explanation as to how the market value was determined).

Example Transactions

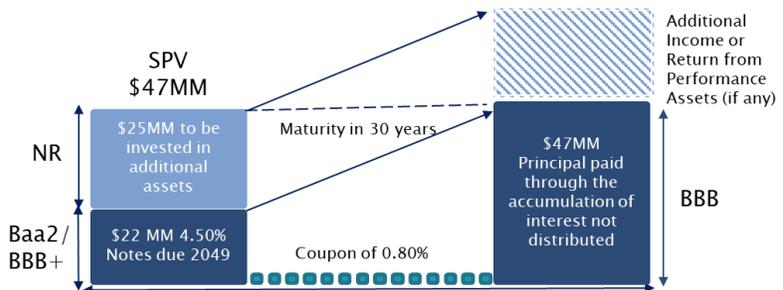
328. The following transaction examples are included for demonstrative purposes only, to highlight the core regulatory concern (that there are Other Non-payments Risks associated with PPNs beyond the contractually promised payments that may not be reflected in a CRP rating) but are not intended to encompass all possible PPN variants. Each of these examples meets the definition of a PPN.

329. In this initial example there are only two components: 1) a \$10 million par United States Treasury (UST) zero-coupon bond sold at discount (ex. \$70) from par (\$100)



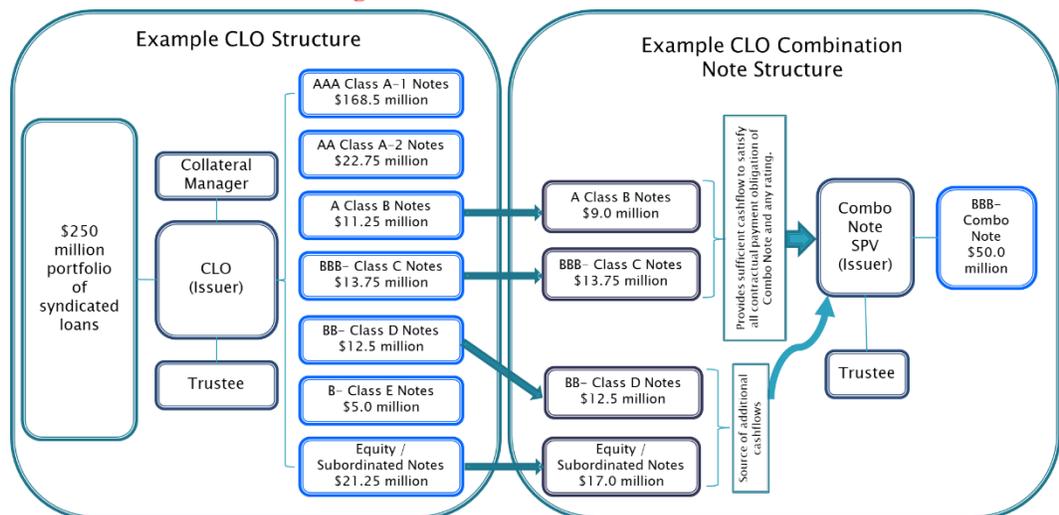
that will pay par (\$100) at maturity and 2) a return linked to any positive performance of call options on the S&P 500 Index (if the S&P 500 Index has a negative performance, investors will only receive an amount equal to their initial investment). The CRP rating would be AAA/AA+ or an NAIC 1.A, based solely on the risk of the UST security; whereas, the Weighted Average Ratings Factors (WARF) applied by the SVO would result in an NAIC 4.B when it includes the exposure to the call options on the S&P 500 Index.

330. In the second example there are multiple components: 1) a \$22 million corporate bond paying a fixed coupon (ex. 4.50%) with a stated maturity date (ex. 9/30/2049), 2) the corporate bond has two CRP ratings (Moody's Baa2, S&P



BBB+), 3) the Special Purpose Vehicle (SPV) also invests \$25 million in additional undisclosed and unrated assets, 4) the SPV pays a below market 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 CRP rated the PPN a BBB or NAIC 2.B. , Again, the PPN rating is based solely on the corporate bonds that represent less than 50% of the total investment in this example, whereas, the WARF methodology would result in an NAIC 4.C when the exposure to all of the underlying investments are included.

331. The third example is a repackaging of collateralized loan obligation (CLO) notes into a CLO Combination Note (Combo Note). The initial CLO holds \$250 million of syndicated loans and issues \$255 million of notes (the CRP rating for each tranche is listed before the Class, ranging from AAA to B-) and Equity / Subordinated Notes. The Combo Note is formed in this example by re-packaging the Class B, C, D, and Equity / Subordinated Note tranches together. The total notional amount of all the tranches in the



Combo Note is \$52.25 million. The Combo Note raises proceeds by issuing a single \$50 million notional tranche of debt through an SPV. The cashflows from the Class B and C notes are sufficient to repay the \$50 million Combo Note principal and interest, if any; which, may constitute a reclassification of the Class B and C tranche interest to repay principal on the Combo Note. Payments from the underlying investments in the Class D and Equity / Subordinated Note tranches provide returns to the repackaged security in addition to the contractually promised cash flows according to a fixed schedule that are based upon the payments from the Class B and Class C Notes. The Combo Note receives a BBB- rating or NAIC 2.C on the notional of \$50 million based upon payments from the Class B and C tranches even though \$29.5 million or 57% of the underlying investments are rated BB- or unrated, whereas, the WARF would result in an NAIC 4.B when the exposure to all of the underlying investments are included.