The National Association of Insurance Commissioners ("NAIC") held its most recent national meeting from August 3-6, 2019 in New York City. At that meeting, the NAIC Valuation of Securities (E) Task Force ("VOS Task Force") and the NAIC Statutory Accounting Principles (E) Working Group ("SAP WG") addressed certain initiatives that could have significant impact on insurance company investments.

I. VOS Task Force

A. STRUCTURED NOTES

On August 4, 2019, the VOS Task Force adopted amendments to the Purposes and Procedures Manual (the "P&P Manual") of the NAIC Investment Analysis Office with respect to "structured notes," in response to a referral from the SAP WG.

On April 6, 2019, the SAP WG amended Statement of Statutory Accounting Principles ("SSAP") No. 26R – Bonds to define a "structured note" as "an investment that is structured to resemble a debt instrument, where the contractual amount of the instrument to be paid at maturity is at risk for other than the failure of the borrower to pay the contractual amount due." The April 6, 2019 SAP WG amendments provide that, effective on December 31, 2019, “structured notes” will be excluded from the scope of SSAP No. 26R – Bonds and (unless they are “mortgage referenced securities”) will be excluded from the scope of SSAP No. 86 – Loan-Backed and Structured Securities and captured within the scope of SSAP No. 43R – Derivatives. SSAP No. 43R defines “mortgage referenced securities” as “credit risk transfer” securities issued by a government sponsored enterprise, where payments on the securities are linked to the credit and principal payment risk of a referenced pool of mortgages.

On August 4, 2019, the VOS Task Force amended the P&P Manual to eliminate the separate definition of "structured notes" and “mortgage referenced securities" in favor of simply cross-referencing the definition in SSAP No. 26R quoted above. The VOS Task Force also amended the P& P Manual to provide that “structured notes” are not exempt from filing with the NAIC Securities Valuation Office ("SVO"). That means that “mortgage referenced securities” will no longer automatically receive the SVO designation equivalent to the rating they receive from a credit rating provider, but rather will need to be pre-filed with the SVO so that the NAIC Structured Securities Group ("SSG") can utilize its own methodologies to assess the overall risk presented before an SVO designation is assigned. “Structured notes” that are not “mortgage referenced securities” will be treated as derivatives, as noted above, and will not qualify as admitted assets unless
applicable state investment laws provide prescribed practices that permit admittance.

Importantly, principal protected notes ("PPNs") are not included in the definition of "structured notes," because in a PPN the contractual amount of the instrument to be paid at maturity is not at risk for other than the failure of the borrower to pay the contractual amount due. However, the VOS Task Force has also proposed changes to the treatment of PPNs, which we will now discuss.

B. PRINCIPAL PROTECTED NOTES
On August 4, 2019, the VOS Task Force received a presentation on a July 2, 2019 memorandum from Charles Therriault, Director of the SVO, proposing that the P&P Manual be further amended to provide that PPNs would no longer be exempt from filing with the SVO. Mr. Therriault discussed the memorandum with the VOS Task Force, focusing on the following points:

- PPNs (which the memorandum states are 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 (e.g., derivatives, equities, commodities, non-rated debt, loans, funds, private equity, real estate, affiliated, undisclosed, etc.) that would not be eligible for reporting as bonds on Schedule D of an insurer’s statutory financial statements if they were owned directly, but are indirectly included on Schedule D by being embedded within the note and benefit from the overall credit rating received by these notes.

- The aim of the proposed amendment to the P&P Manual is to remove these potentially ineligible assets from the filing-exempt category, so that the SSG can examine the overall risk of these structures and, if any non-admissible assets are identified, the SVO could then alert regulators.

- The SVO also recommended referring the memorandum to the SAP WG to consider treatment of the asset transformations described in the memorandum.

Although no discussion of the memorandum by members of the VOS Task Force or interested parties took place at the August 4, 2019 public meeting, during the week following the meeting the VOS Task Force exposed the memorandum (including the recommendation to eliminate the SVO filing exemption for PPNs) for public comment, which is the next step toward potential adoption of the recommendation. Comments are due by September 20, 2019. Following the close of the comment period, it is likely that the VOS Task Force will hold an interim meeting via conference call to discuss next steps.

C. REGULATORY TRANSACTIONS
In the P&P Manual, the term “regulatory transaction” is defined as a transaction engineered to address a regulatory concern that one or more insurers have or may have that should be submitted to a state insurance department for approval and that has a component a security or other instrument which on a stand-alone version may be a type of investment security that is eligible for assignment of an NAIC designation. The P&P Manual provides that regulatory transactions (1) are not eligible for credit assessment; (2) are not eligible for exemption from filing with the SVO; (3) cannot be self-assigned the administrative symbol Z under the 120 rule; (4) cannot be self-assigned as 5GI securities; and (5) cannot be entered into NAIC systems maintained for the VOS Task Force.
The P&P Manual allows a state insurance regulator to request the assistance of the SVO or the SSG in the assessment of a regulatory transaction, with the understanding that the state can adopt the SVO or SSG work product as its own, although the determination itself remains a determination by the state insurance regulator (rather than the NAIC). However, previously, there were no specified methods for the reporting of such transactions and reporting entities did not have available reporting options when investment schedules require an NAIC designation.

At its meeting on April 6, 2019, the SAP WG adopted reporting codes for the investment components of regulatory transactions. Under this procedure, a reporting entity would use the code “RTS” when the domiciliary state received assistance from the SVO or SSG in reviewing a regulatory transaction. In such cases, the code would be reported with an “analytical value” assigned by the SVO and given to the state. An “analytical value” is an expression of the credit quality of the security component of a regulatory transaction which is expressed with the numerical symbols 1 through 6. All other regulatory transactions in which a state insurance regulator did not ask the SVO for assistance or where the SVO was unable to determine an analytical value for the regulatory transaction, would use the code “RT” and would be reported with an analytical value of 6.

At the August 4, 2019 meeting of the VOS Task Force, an amendment proposing corresponding changes to the P&P Manual to incorporate changes resulting from the adoption of new reporting codes by the SAP WG was considered. However, in the course of the discussion, it became clear that additional editorial changes would be required to properly revise the P&P Manual. At the suggestion of an industry representative speaking for American Council of Life Insurers and North American Securities Valuation Association, the suggestion was made that the amendment be briefly re-exposed for friendly amendments to adjust the wording of the proposed language to be included in the P&P Manual. A motion was adopted to re-expose the amendment for a 14-day comment period to be followed by an interim meeting in September to approve the revised amendment.

D. NON-SUBSTANTIVE AMENDMENTS TO THE P&P MANUAL

Two non-substantive amendments to the P&P Manual were also introduced at the VOS Task Force meeting. First, the SVO proposed a non-substantive amendment to the P&P Manual to provide instructions to insurers to assign an NAIC designation to a newly issued or newly acquired mortgage referenced security prior to the publication of the annual surveillance data gathered by the SSG to financially model such securities. This proposed amendment was exposed for a comment period ending September 5, 2019.

Second, the SVO proposed conforming amendments to certain sections of the P&P Manual to remove a stray reference to “Modified Filing Exemption,” in line with the previously adopted decision to delete all references to Modified Filing Exemption procedure from the P&P Manual. This amendment was adopted by the VOS Task Force.

E. STAFF REPORTS

In addition to reviewing proposed amendments to the P&P Manual, the VOS Task Force also heard five brief staff reports, which are summarized below.

First, the staff confirmed that it was continuing to review existing guidance for credit tenant loans and examining possible new guidance for other lease-based transactions. A credit tenant loan is a real estate loan that is secured by the obligation of a single (usually
investment grade) company to pay debt service by means of rental payments under a lease, where real estate is pledged as collateral. Accordingly, a credit tenant loan is a mortgage loan made primarily on reliance of the credit standing of a tenant (through the assignment of lease rental payments to the note or certificate holders) rather than based on the characteristics of the mortgaged property (such as its property value).

Depending on precisely how it is structured, a credit tenant loan can be reported by an insurer as a long-term bond or a mortgage loan. The staff confirmed that, while it is continuing to review documents it has received in connection with revising current guidance for credit tenant loans, that the current method of reporting such loans would remain in place until any new guidance is developed.

Second, the staff reported on projects before the SAP WG. We separately discuss highlights from that meeting below.

Third, the staff reported on its view of the potential impact on RMBS/CMBS price breakpoints of the upcoming change in NAIC designation categories to make those categories more granular (replacing the current six categories with twenty subcategories). A main concern that the staff voiced was that, until the actual impact of the change in designation categories was apparent, that the development of a new approach with respect to price breakpoints could be premature. The staff stated that a memo on this topic was in process and confirmed that it would welcome industry feedback and input in the finalization of the memo and in determining whether a new approach with respect to price breakpoints would be required.

Fourth, the staff reviewed with the VOS Task Force a slide presentation on “bespoke securities.” As described by the staff, these securities appear to be tailored specifically for a given investor, do not appropriately represent their risk and appear to often be found in the portfolios of troubled companies. In the view of the staff, these instruments are not subject to or constrained by market forces and competition and, as a result, may severely underrepresent risk. By their very nature, bespoke securities are flexible in form and difficult to define. However, the staff offered the following criteria for defining a “bespoke security”: (a) it is not broadly syndicated; (b) it is created by or for one or a few related insurance companies as an investment; and (c) it has been assigned a credit rating by only one NAIC credit risk provider (often via a private rating).

The staff went on to set out three main challenges in developing and implementing an approach with respect to bespoke securities:

- Given the mutability of bespoke securities, it is very difficult to describe, a priori, all possible versions of what constitutes such securities;
- As these securities are one-off and private, there are no third-party resources which exist to help locate such securities in an insurance company’s portfolio; and
- Currently, the NAIC lacks the ability to realistically resolve issues pertaining to bespoke securities.

Accordingly, the current plan of the staff is to continue researching these products and draft an issue paper outlining its findings, though no timeline was provided for the issuance of such a paper.

Finally, the staff informed the VOS Task Force that it would be issuing a request for information with respect to its ongoing study of investments by insurance companies in infrastructure and potential impediments to such investments. Persons on the VOS Task Force’s “interested parties” list received an invitation to participate in the study on August
9, 2019, with a request to submit comment letters by September 30, 2019.

The materials for the VOS Task Force meeting are available here.

II. SAP WG

The SAP WG considered a large number of topics during its meeting on August 3, 2019. Set out below are summaries of the actions which the SAP WG took with respect to several key proposals during this meeting:

- **SSAP 43R – Loan Backed and Structured Securities**: The SAP WG exposed for comment proposed revisions that, if adopted, would exclude collateralized fund obligations ("CFOs") from the scope of SSAP No. 43R. The proposed new language states that SSAP No. 43R is intended to capture investments with bond-like cash flows and “does not include equity instruments, investments with underlying assets that include equity instruments or any structures representing an equity interest (e.g., joint ventures, limited liability companies, partnerships) in which the cash flow payments (return of principle [sic] or interest) are partially or fully contingent on the equity performance of an underlying asset.” The proposed amendment would also provide that the “scope of SSAP No. 43R shall not include any securitization of assets that were previously reported as standalone assets by the insurance reporting entity. In other words, an insurance reporting entity is not permitted to repackgate existing assets as “securitizations” to move the reporting of the existing assets within scope of SSAP No. 43R.” Comments on this proposal are due October 11, 2019.

- **SSAP No. 21R – Other Admitted Assets**: The SAP WG adopted certain non-substantive amendments to SSAP No. 21R to clarify that an investment captured in the scope of another SSAP does not automatically become a collateral loan because it is also secured with collateral.

- **SSAP No. 25 – Affiliates and Other Related Parties, SSAP No. 26R – Bonds, SSAP No. 32 – Preferred Stock, SSAP No. 43R – Loan-Backed and Structured Securities, and SSAP No. 48 – Joint Ventures, Partnerships and Limited Liability Companies**: The SAP WG adopted the proposed revisions to the specific wording of the above-captioned SSAPs to clarify the application of SSAP No. 25, as well as an “affiliated” classification, when the transaction is in substance a related party transaction.

- **SSAP 86 – Derivatives**: The SAP WG re-exposed certain revisions to the language of SSAP No. 86 to clarify that “other” derivatives not used in hedging, income generation or replication shall be reported at fair value and do not qualify as admitted assets. Such “other” derivatives would include securities that fall within the definition of “structured notes” discussed earlier in this report in connection with the VOS Task Force.

The materials for the August 3, 2019 SAP WG meeting are available here and here.

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