



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

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RE: Update the Definition of Principal Protected Securities in the Purposes and Procedures Manual of the NAIC Investment Analysis Office

DATE: November 11, 2021

Summary – In May 2020 the Task Force adopted an amendment to the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (the “P&P Manual”) to include Principal Protected Securities (“PPS”) as a new security type ineligible for the filing exempt process. At the time, the types of PPS which the SVO had seen were mixes of a traditional bond or bonds with additional assets that could possess any characteristic. These additional assets, which we called “performance assets,” were intended to generate excess return. They included, among other things, derivatives, common stock, commodities and equity indices. The performance assets generally included undisclosed assets and were typically not securities that would otherwise be permitted on Schedule D, Part 1 as a bond. In each case, the external credit rating provider (CRP) rating was based solely on the component dedicated to the repayment of principal and ignored the risks and statutory prohibitions of reporting the performance asset on Schedule D, Part 1

Recently, the SVO received a proposal for a security which posed many of the same risks as a PPS but was structured in a way that it did not cleanly fit the definition in the P&P Manual. In this example, the security was not issued by an SPV holding both the principal protection bond and the performance asset. Rather, the security was the direct obligation of a large financial institution whose obligation it was to pay principal at maturity and a premium based on the performance of a referenced equity index and an index comprised of equities, fixed-income instruments, futures and other financial assets. Though the obligation was solely that of the issuing financial institution, meaning there were no *underlying* bonds or performance assets, the structure posed the same risk of exposure to a performance asset because the amount of the issuer’s payment obligation was directly dependent on the performance of the referenced indices. Additionally, unlike a PPS transaction with an underlying bond and performance asset, the likelihood of payment of that performance asset premium, whatever the amount might be, was linked directly to the creditworthiness of the issuer.

As such, the SVO proposes amending the P&P Manual definition of Principal Protected Securities to account for alternate structures which pose similar risks.

Proposed Amendment - The proposed text changes to the definition of Principal Protected Securities is shown below with additions in red underline and deletions in ~~red strikethrough~~, as it would appear in the 2021 P&P Manual format.

PART THREE

**SVO PROCEDURES AND METHODOLOGY FOR PRODUCTION OF NAIC
DESIGNATIONS**

PRINCIPAL PROTECTED SECURITIES

Definition

312. Principal Protected Securities (PPSs) are a type of security that packages or repackages one or more investment exposures or referenced or underlying investments and for which contractually promised payments according to a fixed schedule are satisfied by proceeds from an issuer obligation or 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 investment exposures or referenced or 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 PPS 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 PPS through Filing Exemption than it would were it to separately file the issuer obligation, investment exposures or referenced or underlying investments in accordance with the policies in this Manual.