Update – At the Spring National Meeting held on Apr. 5, the SVO was directed work with industry on technical modifications to the original proposed language and expose a revised amendment. The SVO met with representatives of the American Council of Life Insurers (ACLI), Private Placements Investors Association (PPIA) and North American Securities Valuation Association (NASVA) on Apr. 29, May 6 and 24, and Jun. 17. The attached revised amendment reflects those discussions.

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. Text changes in green underline reflect existing guidance that has been moved to improve clarity.
PART ONE

POLICIES APPLICABLE TO SPECIFIC ASSET CLASSES

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PRINCIPAL PROTECTED SECURITIES

**Defined**

116. Principal Protected Securities (PPS) 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 PPSs, along with examples, in Part Three of this Manual.

**Intent**

117. Transactions meeting the criteria of a PPS as defined in Part Three of this Manual may possess Other Non-Payment Risks and must be submitted to the SVO for review under its Subscript S authority.
PRINCIPAL PROTECTED SECURITIES

(NOTE: This change is effective as of Jan. 1, 2021. PPS acquired prior to Jan. 1, 2021 must be filed with the SVO by Jul. 1, 2021.)

Definition

313. Principal Protected Securities (PPSs) typically have both a principal protected component and a performance component whose payments originate from, or are determined by, non-fixed income like sources and, therefore, pose the risk of non-fixed income like cashflows. PPS do not include the exclusions listed below in this section.

314. The following transaction examples are included for demonstrative purposes only, to highlight the intent behind the principle-based PPS definition and the core regulatory concern (that there are Other Non-payments Risks associated with PPSs beyond the contractually promised payments that may not be reflected in a CRP rating) but are not intended to encompass all possible PPS variants. Each of these examples meets the definition of a PPS. Any design that circumvents the definition, and related examples, through technical means but which in substance achieves the same ends or poses the same risk, shall be deemed a PPS.

Example Transactions

315. **Example 1** – PPSs are a type of includes any 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 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 underlying investments in accordance with the policies in this Manual.

316. **Example 2** – 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.

317. **Example 3** – In the second this 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 PPS a BBB or NAIC 2.B. Again, the PPS 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.
Example 4 – This 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.

Example 5 – In this example, a financial institution issues notes pursuant to which it is obligated to make (i) fixed quarterly coupon payments which are less than the comparable risk-free rate, (ii) performance payments linked to the performance of referenced equity and futures indices and the net asset value of a basket of undisclosed securities, and (iii) a principal payment at maturity. This example differs from the others in that the issuer is an operating entity and not an SPV with underlying assets. Even though the payment of all amounts is the obligation of the issuing financial institution, the size of the performance payments, if any, is wholly dependent on the performance of non-fixed income like reference assets.
Exclusions

320. For the avoidance of doubt, PPSs 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

321. Investments in PPSs 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.

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

- Disclosure of any Subsidiary, Controlled or Affiliated relationship between the PPS 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 PPS 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).