



FERMAT CAPITAL
MANAGEMENT, LLC

September 19, 2022

Mr. Dale Bruggeman, Chairman
Statutory Accounting Principles Working Group
National Association of Insurance Commissioners
1100 Walnut Street, Suite 1500
Kansas City, MO 64106-2197

Dear Mr. Bruggeman

I am writing to thank the NAIC Statutory Accounting Principles (E) Working Group (the “Working Group”) for the continuing effort to address the various statutory accounting issues related to bond definition and statutory reporting. We appreciate the opportunity to comment on appropriate classification of Working Capital Finance Investments (“WCFI” SSAP 105R) and offer the following comments:

1. WCFI meets the proposed definition of issuer credit obligations under SSAP 26R
2. WCFI reporting should be encompassed on Schedule D Part 1
3. SSAP 105R currently includes restrictions to issuer credit obligation eligibility determined by the Securities Valuation Office as corresponding to those issuers with CRP equivalent ratings of NAIC 2 or better, and such restrictions should be eliminated as it is incongruous with the existing RBC framework as well as creates undue burden on the prospective filing of investments given the potential for downgrade and asset in-admissibility.

As the Commission is aware, FASB recently adopted revisions to its codification that requires all filers of financial statements to footnote the classification of such WCFI arrangements – irrespective of whether the filer has a CRP rating or has an investment or non-investment grade rating by a CRP. The NAIC should use the bond project to clarify its WCFI requirements and make the noted changes.

Please let me know if you have any questions or if I can assist in any way by calling (203) 454 6815.

Sincerely,

THE LEASE-BACKED SECURITIES WORKING GROUP

October 19, 2022

Mr. Dale Bruggeman, Chairman
Statutory Accounting Principles Working Group
National Association of Insurance Commissioners
1100 Walnut Street, Suite 1500
Kansas City, MO 64106-2197

RE: Lease-Backed Securities Working Group Comments on the Four Items Exposed Related to the Definition of a Bond – Bond Definition, Issue Pape, SSAP No. 26R and SSAP No. 43R

Dear Mr. Bruggeman:

The Lease-Backed Securities Working Group appreciates the opportunity to comment on the Four Items Exposed Related to the Definition of a Bond. Of the four exposure items, our comments are limited to SSAP 43R -- and specifically to one small proposed addition to the Appendix of SSAP 43R. We believe the inclusion of one additional example in the Appendix is necessary in order to clarify the accounting treatment of some investment structures which are not covered in the other four examples. We have attached the proposed text of a new “Example 5” to this letter, which would provide the guidance necessary to regulators covering this class of investments.

Specifically, the inclusion of this example is necessary to clarify that there is a class of asset backed securities where the ABS Issuer does not own in the underlying collateral, but rather has a security interest through the loan documents which provides recourse to the collateral in the event of a default.

Example 1 in the Appendix deals with pass-through securities issued by Federal Agencies. The other current examples, 2 through 4, all start with an equipment leasing transaction where the reporting entity invests in a “debt instrument issued by an SPV that owns equipment”. This would exclude the many asset-backed securities where the SPV’s recourse to the underlying collateral is provided by a security interest rather than an ownership interest. This is an important distinction that the inclusion of the additional example attached is necessary to clarify.

In addition, Examples 2-4 are intended to provide guidelines to regulators for transactions that either meet -- or could fail to meet -- the two ABS requirements for “meaningful” cash flows and “substantive” credit enhancement. In this analysis, these examples look at initial leverage, but also consider various combinations of amortization and asset depreciation over the life of the loan. This excludes ABS transactions backed by real estate, which -- unlike all other asset classes -- is widely acknowledged to be a non-depreciating asset. This is a significant difference, and the inclusion of an Example 5 would provide some useful benchmarks to regulators in determining which of these transactions meet the requirements for both meaningful cashflows and substantive credit support.

In summary, we believe that the addition of the attached proposed Example 5 to the Appendix to SSAP 43R is necessary to clarify the accounting treatment of an important class of securities which

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are not covered in the other examples, and that without this example, it leaves unspoken how these securities would be classified.

We look forward to working together with the regulators to clarify our comments and to consider any modifications or edits to the text of the example which we have attached for their consideration.

Sincerely,

John Garrison

John Garrison
On behalf of The Lease-Backed Securities Working Group

Cc: Carrie Mears
Julie Gann
Robin Marcotte
Jake Stultz
Jason Farr

[See proposed text of a new “Example 5”, attached.]

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PROPOSED NEW EXAMPLE 5:

Example 5:

A reporting entity invested in a debt instrument issued by a SPV. Payments under the instrument are secured by a note, a legal assignment from the borrower of a lease for real property and an assignment of the lease payments from an operating entity tenant. Additional security is provided by a mortgage on the leased property (the “underlying collateral”). The leased property is owned by the borrower under the note -- the SPV does not have any ownership interest in the underlying collateral, though it has legal recourse to it through the mortgage. The tenant makes contractually-fixed payments over the life of the lease to the borrower, who has assigned both the lease and the lease payments to the SPV as security for the debt. While the debt is outstanding, the lease, the lease payments, the mortgage, and any other forms of credit enhancement all serve as security for the debtholders. Should a default occur, the debtholders can foreclose on and liquidate the real property as well as submit an unsecured lease claim in the lessee’s bankruptcy for any defaulted lease payments. The loan-to-value at origination is 100%.

The existing lease payments are sufficient to cover all interest payments and all scheduled debt amortization payments over the life of the debt instrument. However, at debt maturity, there is a balloon payment due, totaling 50% of the original outstanding debt principal amount. The corresponding lease has no balloon payment due at lease maturity, so the borrower will either need to refinance the debt or sell the underlying real property to service the final debt balloon payment. The property has a high probability of appreciating in value over the term, however ignoring any potential for appreciation, the 50% loan-to-value at maturity is the expected figure at the end of the debt term based solely on scheduled amortization payments. The real property is expected to be subject to some market value volatility and periods of lower liquidity at certain points in time but has a predictable value range and ready market over a longer period of time, such that the property could be liquidated over a reasonable period of time, if necessary.

Rationale:

The lease is a cash generating non-financial asset which is expected to generate a meaningful level of cash flows for the repayment of the bonds that covers all interest payments and 50% of the principal payments. The level of reliance on the collateral value for sale or refinancing is just over the cutoff for using the practical expedient (<50%), so a full analysis is required. In reaching this determination, the reporting entity considered the predictable nature of the cash flows, which are contractually fixed for the life of the debt instrument, as well as the ability of the underlying collateral value to provide for the balloon payment through sale or refinancing in light of its characteristics. While the real property may have some market value volatility and periods of lower liquidity at points in time, the cash flows produced by the lease were concluded to reduce the loan balance to a level (50% loan-to-value) that would be able to be recovered by sale or refinancing of the property at the maturity of the loan.

The reporting entity also determined that the structure provides substantive credit enhancement in the form of overcollateralization for the final balloon payment to conclude that investors are in a different economic position than holding the real property directly, in accordance with the requirements in paragraph 3.b. In reaching this conclusion, the reporting entity noted that although the debt instrument starts with a 100% loan-to-value, contractual fixed payments from the operating entity are sufficient to cover the payment of all interest and 50% of the outstanding principal over the term of the lease. Based on the priority claim on the real property, the predictable nature of the cash flows and the collateral range over time, the reporting entity concluded that a market participant (i.e., knowledgeable investor

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transacting at arm's length) would consider that this level of overcollateralization to put the investor in a substantively different economic position than owning the underlying property directly.

For the purposes of determining whether there is substantive overcollateralization, it is appropriate to consider any expected economic depreciation, if it is reasonably expected, but it is not appropriate to consider any expected economic appreciation. Note that a debt instrument with a loan-to-value that is expected to decrease over time is not necessarily deemed to have substantive overcollateralization.

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October 20, 2022

Mr. Dale Bruggeman, Chairman
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RE: Interested Parties Comments on the Four Items Exposed Related to the Definition of a Bond – Bond Definition, Issue Paper, SSAP No. 26R and SSAP No. 43R

Dear Mr. Bruggeman:

Interested parties appreciate the opportunity to comment on the Four Items Exposed Related to the Definition of a Bond. Specifically, our comments pertain to four interrelated items – Bond Definition, Issue Paper, SSAP No. 26R and SSAP No. 43R. Interested parties understand the magnitude of this project, and all the necessary changes that need to occur to embed within the appropriate accounting literature. Interested parties are especially appreciative of both the disciplined efforts of Staff in preparing the materials and their willingness to seek timely input from interested parties throughout the process and comment period.

As all four documents are interrelated, interested parties have organized their comments in three sections, Bond Definition, Issue Paper and SSAP No.'s 26R and 43R, each with their own subsections. All interested party comments have been discussed with Staff and we believe we are in general alignment. For comments related to paragraph 3b, while we believe we are in general thematic alignment, further collaboration will need to occur to ensure intent is fully understood, agreed upon and the words adequately reflect that intent, given the complicated nature of this topic.

Such collaboration throughout this project has proved invaluable in re-defining the definition of a bond, re-writing the relevant SSAPs, and making sure that it is conceptually sound and has the necessary clarity.

Bond Definition

Substantive Credit Enhancement

The proposed changes to the last paragraph of the substantive credit enhancement language, within the glossary, are conceptually consistent with what interested parties had previously proposed in their last comment letter. However, interested parties proposed the following technical edits for clarification purposes:

The first loss position may be issued as part of the securitization in the form of a debt or equity interest, or it may be retained by the sponsor and not issued as part of the securitization. If the first loss position (or a more senior position(s), if the first loss positions(s) lacks contractual payments along with a substantive credit enhancement) is issued as part of the securitization, and does not have contractual principal and interest payments along with substantive credit enhancement and is held by a reporting entity, the ~~structure~~ investment(s) does not qualify as a Schedule D bond and should be reported on Schedule BA.

Examples 1&2 of Appendix I

In our previous comment letter, interested parties suggested that Examples 1 & 2 of Appendix I should be incorporated within the body of the definition itself, as they are more closely aligned with guidance rather than interpretative examples.

In dialogue with Staff, we have reached agreement on how best to incorporate these examples within the body of the bond definition. Please see our comments under Paragraph 3b – Embedded Derivatives below and under SSAP No.'s 26R and 43R.

Such changes may not need to occur within the Bond Definition itself, as the actual guidance itself has not changed, and may only be needed within SSAP No. 26R.

Paragraph 3b – Embedded Derivatives

The Bond Definition includes new proposed changes to paragraph 3b which interested parties believe needs additional clarification, specifically, in terms of consistency and readability, substance, and unintended consequences. We interpret this language to relate to potential embedded derivatives which is very nuanced and complicated as evidenced by the FASB and IASB efforts which took significant time to develop and includes many of pages of interpretative guidance. Please see our comments under Paragraph 3b – Embedded Derivatives under SSAP

No.'s 26R and 43R.

Issue Paper

Feeder Funds

Interested parties worked with Staff on language related to Feeder Funds, included within the issue paper, and ultimately agreed upon language that addresses both concerns of interested parties and Staff. The agreed upon language, while important, is not included in our letter for the sake of brevity.

SSAP No.'s 26R and 43R

Glossary and Definitions

The glossary in SSAP No. 26R includes definitions including Terms Related to the Bond Definition, Structured Notes, Principal Protected Notes, Bank Loans and Other Legacy Terms. Interested parties do not believe a glossary is necessary for the following reasons.

Terms Related to the Bond Definition

The glossary includes terms related to the Bond Definition (e.g., Asset-Backed Security, Issuer Credit Obligation) which are already included within the body of the standard. Including such terms within the glossary is at best redundant and at worst includes a definition that is not precisely the same as the definition included within the standard itself. Interested parties believe it is best to only include the definition of such terms once (i.e., within the standard) to ensure there are no inconsistencies and the standard is otherwise more efficient and cohesive.

Further, the bond definition is split between, or includes parts, within each of SSAP No. 26R and 43R. After discussions with Staff, it was suggested that it might be appropriate to only include the bond definition once, within SSAP No. 26R. As the bond definition clearly separates bonds into one of two classifications – Issuer Credit Obligations and Asset-Backed Securities, it is likely more efficient and cohesive if SSAP No. 26R addresses the definition of a bond for both SSAP No.'s 26R and 43R.

Further, it makes sense for SSAP No. 26R to address classification for both SSAP No.'s 26R (Issuer Credit Obligation) and 43R (Asset-Backed Securities) while SSAP No. 26R and 43R each separately address the separate and nuanced accounting for each.

Interested parties support this approach as it would make for greater clarity and readability.

Structured Notes

The structured note concept is a carryover from existing SSAP No. 26R, but has been changed in subtle but meaningful ways, and is also a subset of the paragraph 3b language. Such language is

better positioned within the body of the standard, in closer coordination with paragraph 3b (see our comments below under Paragraph 3b – Embedded Derivatives) and be more closely aligned with what is currently included within existing SSAP No. 26R.

Principal Protected Notes

The Principal Protected Note / Security (PPS) definition within the glossary is different from the PPS definition, which was recently adopted by the VOSTF, with interested party support, for use within the P&P Manual. Interested parties believe these definitions should be consistent and any use of PPSs within SSAP No. 26R should reference the P&P Manual Definition. Conflicting definitions would only serve to sow additional confusion related to what is already a highly complex and nuanced definition.

Bank Loans

The definition of bank loans is a legacy term from existing SSAP No. 26R which was the culmination of an extensive effort several years ago to properly define. While there are other legacy terms (see below) included within the glossary, interested parties do not believe they are necessary. However, as bank loans are explicitly defined for purposes of SSAP No. 26R, interested parties believe bank loans should be retained, as a defined term within SSAP No. 26R, but embedded within the standard itself as otherwise the glossary might only have one definition.

Other Legacy Terms

All other legacy terms, which are included within SSAP No. 26R, have a readily and common understanding (e.g., convertible bond) that are used within SSAP No. 26R (i.e., paragraph 7). However, there are other similar terms within paragraph 7 (e.g., Municipal Bonds, REITs, etc.) or elsewhere which are not included within the glossary. It would seem to make sense that either all such terms should be included within the glossary, or no such terms should be included. Interested parties do not believe the glossary is needed. However, should regulators wish to include such terms, and their related definitions within the glossary, interested parties would have no objections.

Income Recognition

Paragraphs 21 – 31 of SSAP No. 43R include very nuanced language, and complicated concepts, related to income recognition for Asset-Backed Securities, much of which is derived from US GAAP. Further, such language was re-aggregated within the proposed language by Staff. Interested parties agree with the reasons behind the re-aggregation by Staff, as it more coherently presents that which is currently articulated within existing SSAP No. 43R. However, interested parties worked with Staff to further refine this language to achieve two objectives; namely, ensure it appropriately fully captures the intent and common understanding of both interested parties and Staff and ensure that intent is clearly articulated. Interested parties believe both objectives have been achieved after working with Staff on the language within paragraphs 21 – 31. The agreed

upon language, while important, is not included in our letter for the sake of brevity.

Paragraph 3b – Embedded Derivatives

The newly added language in paragraph 3b of the Bond Definition, and paragraph 9b of SSAP No. 26R, is the most challenging concept the interested parties will be commenting on. It is very important that this concept and language be carefully assessed in terms of consistency and readability, substance, and unintended consequences. We interpret this language to relate to potential embedded derivatives which is very nuanced and complicated as evidenced by the FASB and IASB efforts which took significant time to develop and includes many pages of interpretative guidance. We have made significant progress working with Staff but ultimately believe more time and dialogue is needed to ensure intent is fully understood and captured. Interested parties also believe it may be beneficial for regulators to be part of all, or some of such dialogue, if they so desire. Interested parties include the most salient points below.

Consistency and Readability

Interested parties note that the latter part of paragraph 3b (bond definition) and 9b (SSAP No. 26R) includes language related to certain types of embedded derivatives. If a security runs afoul of such language, it would not be reported as a bond on schedule D. This can have potentially severe consequences. Interested parties make the following comments related to consistency and readability:

- 1) The paragraph 3b language is embedded within the part of the bond definition that relates only to Asset-Backed Securities (ABS). Yet the Issuer Credit Obligation (ICO) language refers to this language for Treasury Inflation Protected Securities (TIPS). Therefore, as written, it is unclear if this language is applicable to both ABS and ICOs or just ABS. Discussions with Staff have indicated that the intent is it should apply to both. As such, it was agreed that such language should be moved toward the front of the standard as an “exclusion” from the definition of a bond.
- 2) The structured note guidance, referred to above, is an integral part of the standard and should not be relegated to the glossary. Discussions with Staff have indicated that such language is a subset of the paragraph 3b language, and therefore should be included directly after such language. A key distinction, however, is if a security runs afoul of paragraph 3b, the security would be reported on Schedule BA, whereas a security that runs afoul of the structured note language would be reported as a derivative on Schedule DB. Several other points related to the language also need to be addressed:
 - a. The base of the structured note language should be more closely aligned with the existing language within existing SSAP No. 26R.
 - b. The guidance related to Cash Components of Replication Synthetic Asset Transactions (RSAT) will likely need to be changed in the P&P Manual to refer to securities that are both bonds to be reported on Schedule D and “bonds” that hereafter may be reported on Schedule BA, to ensure their eligibility will not be in question. Clarifying guidance will also be necessary in relation to the newly added

“3b” language in the AP&P Manual to ensure that the adopted updates to the Bond Definition do not unintentionally compromise the eligibility of “Safe Harbor” RSATs, or those RSATs approved by the SVO, as “Effective” RSATs, both as defined in the P&P Manual, or the eligibility of the fixed income Cash Component and Derivative Component of such “Effective” RSATs for statutory accounting measurement and valuation that is consistent with that which would apply to the otherwise permissible bond investments that the Components of “Effective” RSATs combine to replicate synthetically.

- c. There will need to be clarifying guidance for when a security runs afoul with both the structured note guidance and the paragraph 3b guidance so as it is clear which takes precedence for reporting (e.g., Schedule DB or Schedule BA, respectively).
- 3) Example 1 of Appendix 1 essentially deals with a security where the interest or principal moves up or down in accordance with underlying equity appreciation or depreciation. As this is no longer needed (i.e., it is covered in the paragraph 3b language), interested parties recommend the deletion of this example. While example 2 of Appendix 2 is not directly related to this concept, interested parties suggest it be included right prior to the paragraph 3b language. We have shared this in a proposal with Staff, inclusive of some of other proposed changes, and believe we have general agreement on placement as well as the general acknowledgement that more collaboration needs to occur on paragraph 3b itself.

Substance

The language included within paragraph 3b is similar to concepts included within US GAAP and IFRS. However, discussions with Staff have indicated that the intent is not to mirror either of them but to prevent abuses that could occur (e.g., having interest that moves up or down with the performance of an underlying equity asset or derivative that makes the security more equity like than bond like). Trying to thread the needle on preventing abuses, not making needlessly complex and/or having unintended consequences, is nonetheless challenging. A few areas of substance that will need to be addressed include the following:

- 1) Interested parties have identified three types of securities with embedded derivatives that should be addressed to ensure they will not run afoul of the paragraph 3b language:
 - a. Securities where the where variable interest is interest related (e.g., linked to SOFR or other similar benchmark interest rate),
 - b. Securities where the variable interest is linked to credit risk characteristics of the issuer, and
 - c. Securities where the interest or principal is denominated in a foreign currency.
- 2) Interested parties have been working with Staff, and have made progress, but additional language changes may need to be made. Both Staff and interested parties are continually thinking through the intent and specific language required with the goal of appropriately threading the needle. Nonetheless, more work needs to be done and interested parties look

forward to and anticipate further collaboration with Staff and/or regulators on this topic to clarify both intent and language.

- 3) Securities that run afoul of paragraph 3b will need to be reported on Schedule BA. This is in addition to any securities that will need to be reported on Schedule BA that otherwise more generally no longer meet the definition of a bond and therefore can also no longer be reported on Schedule D. This is an important point as many states have limits on the aggregate amount of investments that can be reported on Schedule BA. Many of these investments, are not inappropriate investments, but just will not meet the definition of a bond for Schedule D reporting. Interested parties are therefore concerned about the unintended consequences of this language if it is too broad – both from the limits on such investments imposed by statute and inappropriate risk-based capital charges. It is therefore important that the requisite time and commitment be dedicated to both getting this definition appropriately defined and ensuring a concurrent referral for timely risk-based capital factor development for their Schedule BA reporting. This work should be finalized simultaneously when the bond definition gets adopted.

Unintended Consequences

As noted previously, interested parties are continually thinking about this new concept, and working to identify securities that would run afoul of this new language where the intent of the language was not to capture. A few examples are included below:

- 1) Many insurers hold Environmental, Social and Governance (ESG) bonds where the coupon may change if certain sustainability targets are or are not met (e.g., increase or reduction of interest on CO2 emissions or workplace injuries). Typically, such adjustments are minimal or around 5 basis points.
- 2) Similarly, there are certain highly rated CLO transactions where the senior tranche may get additional interest if the equity or residual tranche returns meet a certain threshold.
- 3) Certain public ABS transactions backed by prime student loans have interest payments that vary based on the composition of the underlying pool of loans (e.g., if high interest loans prepay early, the interest due to the senior tranche may decline).
- 4) Certain ABS include an anticipated repayment date (ARD) function that require a step-up in interest rates payable to the holder if the securitization is not paid in full on or before the ARD.
- 5) Lastly, at the crux of paragraph 3b is the following sentence:

“The debt instrument must have pre-determined principal and interest payments (whether fixed interest or variable interest) with contractual amounts that do not vary based on the appreciation or depreciation of any underlying collateral value or other variable.”

While interested parties agree with what we understand to be the intent behind this language (i.e., having interest that moves up or down with the performance of an underlying asset or derivative that makes the security more equity like than bond like), there are nuances that interested parties believe still need to be addressed. For example, the “pre-determined

principal or interest” language can be interpreted several ways. It could be interpreted to mean that both the magnitude and timing of principal and interest payments must be known in advance, while it could also be interpreted to mean the amounts need to be contractual in nature but can still vary as long as the variability is not dependent on the appreciation/depreciation of an asset or variable. Further, the reference to “other variable” could be interpreted to mean interest is not allowed to vary based on any variable or just the appreciation/depreciation of the variable. See also our comments above as they are often related to this specific language.

Paragraph 44 Transition Language

The transition language in paragraph 44 of SSAP No. 26R should also be closely aligned with what proposed changes occur within SSAP No. 21 which we understand will address securities not meeting the definition of a bond for reporting on Schedule D. Currently, paragraph 44 has potentially conflicting guidance, but nonetheless will need to be read in conjunction with changes to SSAP No. 21. How to affect the transition will also need to be more fully developed – e.g., will there be gains or losses recognized on securities that may have to change reporting schedules upon transition to the new SSAP No.’s 26R and 43R, and if so, how will they be reported (e.g., as part of income, surplus, etc.).

Re-Exposure

Given the substantial scope and complexity of both this project and the changes that still need to occur, interested parties believe these documents should be re-exposed. The proposed changes not only include substantial changes related to ordering and repackaging, there is substantial flow through or references throughout the Issue Paper and SSAPs that will also need to be updated. While we have passed on many editorial and/or wordsmithing comments to Staff, at least another thorough review is warranted related to this as well. We are also the understanding that changes related to SSAP No. 2, as an example, are needed to clarify that commercial paper ABS can only be reported on Schedule D. Ideally, such SSAPs should also be re-exposed simultaneously.

Interested parties continue to support the development of high-quality bond standards and believe they are headed in the right direction. Staff has tackled this project with appropriate rigor and their collaboration with us has been greatly appreciated. We stand ready to assist as this project gets nearer the finish line.

Sincerely,

D. Keith Bell

Rose Albrizio

C: Interested parties
NAIC staff