Statutory Accounting Principles (E) Working Group
Proposed Bond Definition
~~May 20, 2021~~March 2, 2022

Introduction: Pursuant to the direction from the Statutory Accounting Principles (E) Working Group in October 2020, a small group of regulators and industry have been meeting regularly to draft a bond definition for consideration. The intent of this project is to clarify what should be considered a bond (whether captured in *SSAP No. 26R—Bonds* or *SSAP No. 43R—Loan-Backed and Structured Securities*) and reported on Schedule D-1: Long-Term Bonds. **This exposure reflects consideration of comments received as well as clarifications of intent by the regulator and industry study group after the initial exposure in May 2021. This exposure is accompanied by a proposed issue paper that details the discussions in developing the principle-based bond definition. Proposed revisions to the SSAPs or reporting changes are not included with the current exposure.** Items shown as tracked changes are revisions from the previously exposed definition. (Revisions to reflect the "substantive credit enhancement" are not shown as tracked as those edits were previously exposed.)

Below is the proposed principles-based definition of a bond eligible for reporting on Schedule D, Part 1.

1. A bond shall be defined as any security[1] representing a creditor relationship, whereby there is a fixed schedule for one or more future payments, and which qualifies as either an issuer credit obligation or an asset backed security.

   [Need to incorporate concepts of paragraph 2 of current SSAP No. 26R but not recast here for brevity]

   Determining whether a security represents a creditor relationship should consider its substance, rather than solely the legal form of the instrument. The analysis of whether a security represents a creditor relationship should consider all other investments the reporting entity owns in the investee as well as any other contractual arrangements. A security that in substance possesses equity-like characteristics or represents an ownership interest in the issuer does not represent a creditor relationship. See Appendix I for examples of securities that, despite their legal form, do not represent a creditor relationship in substance.

2. An issuer credit obligation is a bond, the repayment of which is supported primarily by the general creditworthiness of an operating entity or entities. Support consists of direct or indirect recourse to an operating entity or entities, which includes holding companies with operating entity subsidiaries where the holding company has the ability to access the operating subsidiaries' cash flows through its ownership rights. An operating entity may be any sort of business entity, not-for-profit organization,

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[1] This statement adopts the GAAP definition of a security as it is used in FASB Accounting Standards Codification Topics 320 and 860. Evaluation of an investment under this definition should consider the substance of the instrument rather than solely its legal form.

Security: A share, participation, or other interest in property or in an entity of the issuer or an obligation of the issuer that has all of the following characteristics:

a. It is either represented by an instrument issued in bearer or registered form or, if not represented by an instrument, is registered in books maintained to record transfers by or on behalf of the issuer.
b. It is of a type commonly dealt in on securities exchanges or markets or, when represented by an instrument, is commonly recognized in any area in which it is issued or dealt in as a medium for investment.
c. It is either one of a class or series or by its terms is divisible into a class or series of shares, participations, interests or obligations.

governmental unit, or other provider of goods or services, but not a natural person or ABS Issuer (defined below). Examples of issuer credit obligations include, but are not limited to:

a. U.S. Treasury securities, including U.S. Treasury Inflation-Indexed Securities[2];(INT 01-25)
b. U.S. government agency securities;
c. Municipal securities issued by the municipality or supported by cash flows generated by a municipally-owned asset or entity that provides goods or services (e.g., airport, toll roads etc.);
d. Corporate bonds issued by operating entities, including Yankee bonds and zero-coupon bonds;
e. Corporate bonds issued by holding companies that own operating entities;
f. Project finance bonds issued by operating entities;
g. Investments in the form of securities for which repayment is fully supported by an underlying contractual obligation of a single operating entity. (e.g., Credit Tenant Loans (CTLs), Equipment Trust Certificates (ETCs), other lease backed securities, Funding Agreement Backed Notes (FABNs), etc.). For purposes of applying this principle concept, repayment is fully-supported by the underlying operating entity obligation if it provides cash flows for the repayment of all interest and at least 95% of the principal of the security.
~~g. ETCs, EETCs, and CTLs for which repayment is fully supported by a lease to an operating entity;~~
h. Bonds issued by real estate investment trusts (REITS) or similar property trusts;
i. Bonds issued by business development corporations, closed-end funds, or similar operating entities, in each case registered under the 1940 Act;
j. Convertible bonds issued by operating entities, including mandatory convertible bonds as defined in paragraph 11.b;
k. Fixed-income instruments specifically identified:
    i. Certifications of deposit that have a fixed schedule of payments and a maturity date in excess of one year from the date of acquisition;
    ii. Bank loans that are obligations of operating entities, issued directly by a reporting entity or acquired through a participation, syndication or assignment;
    ~~iii. Hybrid securities issued by operating entities, excluding surplus notes, subordinated debt issues which have no coupon deferral features, and traditional preferred stocks;~~
    iii. Debt instruments in a certified capital company (CAPCO).(INT 06-02)
    iv. Exchange Traded Funds (ETFs) that qualify for bond treatment as identified in the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* and published on the SVO's webpage. (These instruments are referred to as SVO-Identified ETFs.)

~~*[Need to incorporate concepts in paragraph 4 of SSAP No. 26R but not recast here for brevity.]*~~

[2] The inclusion of U.S. Treasury Inflation-Indexed Securities identifies these securities as an explicit exception to the principles-based bond definition that prohibits securities from being reported on Schedule D-1 that have variable principal or interest due to underlying equity appreciation or depreciation, or an equity-based derivative.

3. An asset[3] backed security is a bond issued by an entity (an "ABS Issuer") created for the primary purpose of raising debt capital backed by financial assets[4] or cash generating non-financial assets owned by the ABS Issuer, whereby repayment is primarily derived from the cash flows associated with the underlying defined collateral rather than the cash flows of an operating entity[5]. In most instances, the ABS Issuer is not expected to continue functioning beyond the final maturity of the debt initially raised by the ABS Issuer. Also, many ABS Issuers are in the form of a trust or special purpose vehicle ("SPV"), though the presence or lack of a trust or SPV is not a definitive criterion for determining that a security meets the definition of an asset backed security.

   There are two defining characteristics that must be present for a security to meet the definition of an asset backed security:

   a. The assets owned by the ABS Issuer are either financial assets or cash-generating non-financial assets. Cash-generating non-financial assets are defined as assets that are expected to generate a meaningful[6] level of cash flows toward repayment of the bond through use, licensing, leasing, servicing or management fees, or other similar cash flow generation (for the avoidance of doubt, there must be a meaningful level of cash flows to service the debt, other than through the sale or refinancing of the assets). Reliance on cash flows from the sale or refinancing of cash generating non-financial assets does not preclude a bond from being classified as an asset backed security so long as the condition in the preceding sentence is met. See Appendix II for examples (2, 3 and 4) illustrating the evaluation of the meaningful criteria.

   b. The holder of a debt instrument issued by an ABS Issuer is in a different economic position than if the holder owned the ABS Issuer's assets directly. The holder of the debt instrument is in a different economic position if such debt instrument benefits from substantive[7] credit enhancement through guarantees (or other similar forms of recourse), subordination and/or overcollateralization. In instances where the assets owned by the ABS Issuer are equity interests, 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 the equity interests. (For clarification purposes, all returns from an ABS in

[3] The underlying collateral supporting an asset backed security shall meet the definition of an asset by the ABS Issuer. Certain forms of collateral, such as rights to future cash flows, may not be recognized as assets by the selling entity but may be recognized as assets when sold to an ABS Issuer. These assets are permitted as the collateral supporting an asset backed security, although they may not represent an asset that can be liquidated to provide payment toward the issued debt obligations (i.e., if the future cash flows do not materialize). The limited ability to liquidate the underlying collateral supporting an asset backed security does not impact the structural determination of whether an issued security meets the definition of an asset backed security but may impact the recoverability of the investment, as well as the consideration of whether there is substantive credit enhancement.

[4] SSAP No. 103R defines a financial asset as cash, evidence of an ownership interest in an entity, or a contract that conveys to one entity a right (a) to receive cash or another financial instrument from a second entity or (b) to exchange other financial instruments on potentially favorable terms with the second entity. As a point of clarity, for the purposes of this standard, financial assets do not include assets for which the realization of the benefits conveyed by the above rights depends on the completion of a performance obligation (e.g., leases, mortgage servicing rights, royalty rights, etc.). These assets represent non-financial assets, or a means through which non-financial assets produce cash flows, until the performance obligation has been satisfied.

[5] Dedicated cash flows from an operating entity can form the underlying defined collateral in an asset backed security. This dynamic, perhaps noted in a whole-business securitization, still reflects an asset backed security and not an issuer credit obligation.

[6] The term "meaningful" is defined in the Glossary.

[7] The term "substantive credit enhancement" is defined in the Glossary.

excess of principal repayment are required to be considered as interest. Therefore, investments with "stated" interest and then "additional returns" to which the holder of the debt instrument is entitled are collectively considered as interest and shall be assessed together in determining whether the investment has variable principal or interest due to underlying equity interests.) See Appendix II for examples illustrating the evaluation of the sufficient criteria.

4. Whether an issuer of debt represents an operating entity or ABS Issuer is unambiguous in most instances, but certain instances may be less clear. For example, an entity may operate a single asset such as a toll road or power generation facility (e.g., project finance) which serves to collateralize a debt issuance, and the cash flows produced by the operation of the assets are pledged to service the debt. In many such instances, the entity is structured as a bankruptcy-remote entity that is separate from the municipality or project sponsor. Such entities have characteristics of operating entities as the operation of the asset constitutes a stand-alone business. They also have many common characteristics of ABS Issuers as they are formed for the purpose of raising debt capital backed by the cash flows from collateral held by a bankruptcy-remote entity. When viewed more holistically, these issuing entities are typically being used to facilitate the financing of an operating component of a project sponsor or municipality. The use of a bankruptcy-remote entity facilitates the efficient raising of debt to finance the operating project, but the primary purpose is to finance an operating project. Therefore, structures in which the issuing entity represents a stand-alone business producing its own operating revenues and expenses, where the primary purpose is to finance an operating project, shall be considered operating entities despite certain characteristics they may share with ABS Issuers.

Note: The elements captured below are not components of the core bond definition. However, comments are requested on the proposal to separately identify on Schedule D-1 or a subschedule of D-1, those ABS that qualify as bonds under the definition and have certain characteristics noted below. The purpose of separate identification would be to improve transparency and provide more specific disclosures applicable to bonds with such characteristics.

A separate reporting section on Schedule D, Bonds is being contemplated, for the purpose of capturing additional disclosures for regulators, for the following:

Any asset backed securities where:

1) the underlying collateral comprises cash generating non-financial assets and does not meet the practical expedient for evaluating the meaningful criteria defined in paragraph 3a and the glossary, or

2) the underlying collateral comprises financial assets that are not self-liquidating.

Glossary

Meaningful – What constitutes a "meaningful" level of cash flows generated to service the debt from sources other than the sale or refinancing of the underlying collateral is specific to each transaction, determined at origination, and should consider the following factors:

1. The price volatility in the principal market for the underlying collateral;
2. The liquidity in the principal market for the underlying collateral;
3. The diversification characteristics of the underlying collateral (i.e., types of collateral, geographic location(s), source(s) of cash flows within the structure, etc.);
4. The overcollateralization of the underlying collateral relative to the debt obligation; and
5. The variability of cash flows, from sources other than sale or refinancing, expected to be generated from the underlying collateral.

Factors #1 and #5 are directly related to the "meaningful" requirement. That is, as price volatility or variability of cash flows increase, the required percentage of cash flows generated to service the debt from sources other than the sale or refinancing of the underlying collateral must also increase. Factors #2, #3 and #4 are inversely related to the "meaningful" concept. That is, as liquidity, diversification or overcollateralization increase, the required percentage of cash flows generated to service the debt from sources other than the sale or refinancing of the underlying collateral may decrease.

As a practical expedient to determining whether a cash generating non-financial asset is expected to produce meaningful cash flows, a reporting entity may consider an asset for which less than 50% of the original principal relies on sale or refinancing to meet the meaningful criteria. In applying this practical expedient, only contractual cash flows of the non-financial asset may be considered. This practical expedient should not be construed to mean that assets cannot meet the meaningful criteria if they rely on sale or refinancing to service greater than 50% of the original principal or if they rely on cash flows that are not contracted at origination. Rather, such instances would require a complete analysis of the considerations described above.

Substantive Credit Enhancement – The intent of the criteria requiring the holder to be in a different economic position is to distinguish qualifying bonds from instruments with equity-like characteristics or where the substance of the transaction is more closely aligned with that of the underlying collateral. To qualify as a bond under this standard, there is a requirement that there are substantive credit enhancements within the structure that absorb losses before the debt instrument being evaluated would be expected to absorb losses. This is inherent in the context of an Issuer Credit Obligation as the owners of the equity in the operating entity are the first to absorb any variability in performance of the operating entity. The same concept applies to asset-backed securities. If substantive credit enhancement did not exist, the substance of the debt instrument being evaluated would be more closely aligned with that of the underlying collateral than that of a bond. Credit enhancement that is merely nominal or lacks economic substance does not put a holder in a different economic position.

The substantive credit enhancement required to be in a different economic position is specific to each transaction; determined at origination; and refers to the level of credit enhancement a market participant (i.e., knowledgeable investor transacting at arm's length) would conclude is substantive.

The first loss tranche (or tranches if the first tranche is not itself substantive) 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 tranche is issued as part of the securitization, and held by a reporting entity, the accounting should follow the guidance applicable to the type of instrument (i.e., debt vs. equity); however, regardless of the type of instrument, it does not qualify as a Schedule D bond and should be reported on Schedule BA.

Appendix I

Examples of securities that, despite their legal form, do not represent creditor relationships in substance:

~~Example I:~~

~~A reporting entity invests in a private equity fund, whereby each investor is required to make 75% of its investment in the form of an unsecured debt investment and 25% in the form of an equity interest. Additionally, each investor owns a pro rata share of the unsecured debt investments and equity interests outstanding, and is restricted from selling, assigning or transferring the unsecured debt investment without also selling, assigning, or transferring the equity interest to the same party.~~

~~Rationale:~~

~~Although the unsecured debt investment appears to represent a creditor relationship in legal form, consideration of the substance of its terms in conjunction with the reporting entity's other interests in the fund, reflects that of an equity investment in substance. While the unsecured debt investment would have legal priority of payment over the equity interest, both interests are contractually required to be held in the same proportion by the reporting entity and cannot be independently sold, assigned, or transferred, which only gives the reporting entity priority of payment over itself. As such, the reporting entity is in the same economic position as if it held its entire investment in the form of an equity interest in the fund. Therefore, the unsecured debt investment does not represent a creditor relationship in substance. It would also be inappropriate to conclude that a component of a similar investment, but not exact replica of this transaction, represents a creditor relationship if it in substance does not put the holder collectively in a materially different economic position than holding an equity interest (e.g., the required equity interest was not exactly pro-rata). However, requirements to hold both debt and equity interests as a result of regulatory restrictions, such as regulatory risk retention rules, should not influence the conclusion that a debt investment represents a creditor relationship in substance.~~

Example ~~2~~1:

A reporting entity invests in a debt instrument issued by a SPV that holds a large number of diversified equity interests with characteristics that support the production of predictable cash flows. The structure contains sufficient overcollateralization and liquidity provisions to ensure the production of adequate cash flows to service both principal and interest payments without significant reliance on refinancing or sale of the underlying equity investments. The debt instrument's periodic principal or interest payments, or both, contractually vary based on the appreciation or depreciation of the equity interests held in the SPV.

Rationale:

Because the instrument's principal or interest payments, or both, contractually vary with the appreciation or depreciation of the underlying equity interests, it contains an equity-like characteristic that is not representative of a creditor relationship. It would be inappropriate to conclude that a security with any variation in principal or interest payments, or both, due to underlying equity appreciation or depreciation, or an equity-based derivative, is a bond under this standard as such security would contain equity-like characteristics. A bond under this standard is required to have pre-determined principal and interest payments (whether fixed interest or variable interest) and comply with the structured note guidance within paragraph XXX.

Example ~~3~~2:

A reporting entity invests in a debt instrument issued from a SPV that owns a portfolio of ~~one or few~~ equity interests, and the debt instrument does not meet the definition of an issuer credit obligation. ~~The debt instrument benefits from sufficient credit enhancement as defined in paragraph 3b, but the timing, amount and likelihood of cash distributions from the underlying equity interests is highly uncertain. Additionally, the capital structure of the SPV does not contain adequate diversification or liquidity provisions to ensure the production of adequate cash flows to service the contractual principal and interest payments, and repayment relies primarily on the ability to refinance or sell the underlying equity interests at maturity.~~

Rationale:

~~The debt instrument does not qualify as a bond because the timing, amount, and likelihood of cash distributions from the underlying equity interests is highly uncertain, and because the capital structure of the SPV does not contain adequate diversification or liquidity provisions to ensure the production of adequate cash flows to service both principal and interest payments. Furthermore, the anticipated repayment significantly relies on the ability to refinance or sell the underlying equity interests at maturity.~~

Determining ~~of~~ whether ~~a~~ debt instruments collateralized by equity interests qualify as bonds ~~represents a creditor relationship~~ under this statement ~~in substance when the source of cash flows for repayment is derived from underlying equity interests~~ inherently requires significant judgment and analysis. Unlike ~~a~~ debt instruments collateralized by assets with contractual cash flows, or debt instruments collateralized by cash-generating non-financial assets, debt instruments collateralized by equity interests may be ~~are~~ dependent on cash flow distributions that are not contractually required to be made and/or may ~~are~~ not be controlled by the issuer of the debt. In some instances, sale or refinancing of the underlying equity interests may be the only means of generating cash flows to service the debt instruments. As a result of these factors, there is a rebuttable presumption that a debt instrument collateralized by equity interests does not qualify as a bond. ~~As a result, there is a rebuttable presumption that a debt instrument collateralized by equity interests does not represent a creditor relationship in substance.~~ Notwithstanding this rebuttable presumption, it is possible for such ~~a~~ debt instruments to qualify as bonds, ~~to represent a creditor relationship~~ if the characteristics of the underlying equity interests lend themselves to the production of predictable cash flows and the underlying equity risks have been sufficiently redistributed through the capital structure of the issuer. Factors to consider in making this determination include but are not limited to:

- Number and diversification of the underlying equity interests
- Characteristics of the underlying equity interests (vintage, asset-types, etc.)

- Liquidity facilities
- Overcollateralization
- Waiting period for distributions/paydowns to begin
- Capitalization of interest
- Covenants (e.g., loan-to-value trigger provisions)
- Reliance on ongoing sponsor commitments
- Source(s) of expected cash flows to service the debt (i.e., dividend distributions from the underlying collateral vs. sale of the underlying collateral)

~~Additionally, a debt instrument for which repayment relies significantly upon the ability to refinance or sell the underlying equity interests at maturity subjects the holder to a point-in-time equity valuation risk that is characteristic of the substance of an equity holder relationship rather than a creditor relationship. Therefore, such reliance would preclude the rebuttable presumption from being overcome.~~
While reliance of the debt instrument on sale of underlying equity interests or refinancing at maturity does not preclude the rebuttable presumption from being overcome, it does require that the other characteristics mitigate the inherent reliance on equity valuation risk to support the transformation of underlying equity risk to bond risk. As reliance on sale or refinancing increases, the more compelling the other factors needed to overcome the rebuttable presumption become.

Furthermore, this analysis ~~The analysis of whether a debt instrument that relies on cash flows from underlying equity interests for repayment represents a creditor relationship in substance~~ should be conducted and documented by a reporting entity at the time such an investment is acquired. The level of documentation and analysis required ~~to demonstrate that the rebuttable presumption has been overcome~~ will~~may~~ vary based on the characteristics of the individual debt instrument, as well as the level of third-party and/or non-insurance~~er~~ company market validation to which the issuance has been subjected. For example, a debt instrument ~~backed~~ collateralized by fewer, less diversified equity interests~~funds~~ would require more extensive and persuasive documented analysis than one ~~backed~~ collateralized by a larger ~~with a larger number of~~ diversified portfolio of equity interests~~funds~~. Likewise, a debt instrument that has been successfully marketed to unrelated and/or non-insurance~~er~~ company investors, may provide enhanced market validation of the structure compared to one held only by related party and/or insurance~~er~~ company investors where capital relief may be the primary motivation for the securitization.

Appendix II

Examples of analysis of asset backed securities under the criteria as defined in paragraphs 3a and 3b:

Example 1:

A reporting entity invests in debt instruments issued from a SPV sponsored by the Government National Mortgage Association (GNMA), the Federal National Mortgage Association (FNMA) and the Federal Home Loan Mortgage Corporation (Freddie Mac) (collectively, "Agency or Agencies"). These debt instruments pass through principal and interest payments received from underlying mortgage loans held by the SPV to the debtholders proportionally, with principal and interest guaranteed by the Agencies. While there is prepayment and extension risk associated with the repayment of the underlying mortgage loans, the credit risk associated with the mortgage loans is assumed by the Agencies.

Rationale:

Although the reporting entity participates on a proportional basis in the cash flows from the underlying mortgage loans held by the SPV, the reporting entity is in a different economic position than if it owned the underlying mortgage loans directly because the credit risk has been redistributed and assumed by the Agencies. This is a substantive credit enhancement because a market participant (i.e., a knowledgeable investor transacting at arm's length) would conclude the Agency guarantee is expected to absorb all losses before the debt instrument being evaluated. Therefore, the holder of the debt instrument is in a substantively different economic position than if the holder owned the ABS Issuer's unguaranteed assets directly, in accordance with the requirements in paragraph 3b. When guarantees do not cover 100% of principal and interest as the Agency guarantees do in this example, it is still appropriate to determine if the guarantee is substantive in accordance with the requirements in paragraph 3.b., to determine if the holder is in a substantively different economic position that if the holder held the ABS Issuer's assets directly.

Example 2:

A reporting entity invested in a debt instrument issued by a SPV that owns equipment which is leased to an equipment operator. The equipment operator makes lease payments to the SPV, which are passed through to service the SPV's debt obligation. While the debt is outstanding, the equipment and lease are held in trust and pledged as collateral for the debtholders. Should a default occur, the debtholders can foreclose on and liquidate the equipment 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 70%.

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 SPV will either need to refinance the debt or sell the underlying equipment to service the final debt balloon payment. The loan-to-value at maturity is expected to decline to 40% considering the scheduled principal amortization payments net of the expected economic depreciation in the equipment value over the term of the debt. The equipment 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 equipment could be liquidated over a reasonable period of time, if necessary.

Rationale:

The equipment is a cash generating non-financial asset which is expected to generate a meaningful level of cash flows for the repayment of the bonds via the existing lease that covers all interest payments and 50% of the principal payments. 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 collateral value to provide for the balloon payment through sale or refinancing in light of its characteristics. While the equipment 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 (40% loan-to-value) that would be able to be recovered by sale or refinancing even if it were to mature at such point in time.

The reporting entity also determined that the structure provides substantive credit enhancement in the form of overcollateralization to conclude that investors are in a different economic position than holding the equipment directly, in accordance with the requirements in paragraph 3.b. In reaching this conclusion, the reporting entity noted that the debt instrument starts with a 70% loan-to-value, which continues to improve over the life of the debt as the loan balance amortizes more quickly than the expected economic depreciation on the underlying equipment. In the context of the predictable nature of the cash flows and collateral value range over time, the reporting entity concluded that a market participant (i.e., knowledgeable investor transacting at arm's length) would consider this level of overcollateralization to put the investor in a substantively different economic position than owning the underlying equipment 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.

Example 3:

A reporting entity invested in a debt instrument with the same characteristics as described in Example 2, except that the existing equipment lease at the time of origination has a contractual term that is shorter than that of the debt instrument. It is expected with a high degree of probability that the lease will be renewed, and a substantial leasing market exists to replace the lessee should they not renew. However, in the unlikely circumstance that the equipment cannot be re-leased, there would not be enough cash flows to service the scheduled principal and interest payments, and the equipment would have to be liquidated to pay off the debt upon default.

Rationale:

All details of Example 3, including the expected collateral cash flows, are consistent with those in Example 2, except that the cash flows in Example 2 are contractually fixed for the duration of the debt while the cash flows in Example 3 are subject to re-leasing risk. Notwithstanding the involvement of re-leasing risk, the reporting entity concluded that the ability to re-lease the equipment was highly predictable and supported the conclusion that the equipment was expected to produce meaningful cash flows to service the debt.

This distinction is to highlight that the expected cash flows of a cash-generating non-financial asset may or may not be contractually fixed for the term of the bond. Certain securitized cash flow streams may not by their nature lend themselves to long-term contracts (e.g., single-family home rentals), but may nevertheless lend themselves to the production of predictable cash flows. While the non-contractual nature of the cash flows is an important consideration in determining whether a non-financial asset is expected to produce meaningful cash flows to service the debt, it does not, in and of itself, preclude a reporting entity from concluding that the assets are expected to produce meaningful cash flows.

Example 4:

A reporting entity invested in a debt instrument issued by a SPV that owns equipment which is leased to an equipment operator. The equipment operator makes lease payments to the SPV, which are passed through to service the SPV's debt obligation. While the debt is outstanding, the equipment and lease are held in trust and pledged as collateral for the debtholders. Should a default occur, the debtholders can foreclose on and liquidate the equipment 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 70%.

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 maturity, there is a balloon payment due, totaling 80% of the original outstanding principal amount. The corresponding lease has no balloon payment due at lease maturity, so the SPV will either need to refinance the debt or sell the underlying equipment to service the final debt balloon payment. The loan-to-value at maturity is expected to increase to 95% considering the scheduled principal amortization payments net of the expected economic depreciation in the equipment value over the term of the debt. The equipment 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 equipment could be liquidated over a reasonable period of time, if necessary.

Rationale:

The equipment is a cash generating non-financial asset which is not expected to generate a meaningful level of cash flows for the repayment of the bonds via the existing lease that covers all interest payments and 20% of principal payments. In reaching this determination, the reporting entity considered that, while the cash flows being produced are predictable, the ability to recover the principal of the debt investment is almost entirely reliant on the equipment retaining sufficient value to sell or refinance to satisfy the debt.

The reporting entity also determined that the structure lacks substantive credit enhancement to conclude that investors are in a different economic position than holding the equipment directly, in accordance with the requirements in paragraph 3.b. In reaching this conclusion, the reporting entity noted that the debt starts with a 70% loan-to-value, but the overcollateralization is expected to deteriorate over the term of the debt as the equipment economically depreciates more quickly than the debt amortizes. This results in a high loan-to-value (i.e., 95%) at maturity, relative to the market value volatility of the underlying collateral. Despite the predictable nature of the cash flows, the reporting entity concluded that the debt instrument lacked a substantive level of overcollateralization to conclude that the investor is in a different economic position than owning the underlying equipment directly. It was determined that the level of overcollateralization , as determined by a market participant (i.e., a knowledgeable investor transacting at arm's length), is nominal. Therefore, the reporting entity concluded that it was in a substantively similar position as if it owned the equipment 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 factor in any expected economic appreciation. Note that a debt instrument with a loan-to- value that is expected to increase over time is not necessarily deemed to have nominal overcollateralization.

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