Statutory Accounting Principles (E) Working Group
Sufficient Credit Enhancement - December 11, 2021

Introduction: Since the initial exposure of the principles-based bond definition, a key discussion point has been on the determination of "sufficiency" in determining the level of credit enhancement required for asset-backed securities (ABS).

The prior concept of "sufficiency" pertains to the requirement that a holder of an ABS be in a different economic position than if they held the underlying collateral directly. This is a requirement for all ABS securities, regardless of if the ABS is backed by financial or cash-generating non-financial collateral assets. The original exposure identified that the determination of whether the holder of ABS was in a different economic position would be based on whether there was "sufficient credit enhancement." This was then defined in the glossary. However, comments have been raised as to the application of that guidance and whether any ABS that had obtained a credit rating from a CRP could conclude that the ABS had obtained "sufficient credit enhancement." This original intent was not to make the "sufficiency" determination equivalent to a credit assessment, as credit ratings should not be a driver for accounting classification. As a result of these discussions, the small group has evaluated the original exposed draft and has developed alternative language (and terminology) for exposure.

(Note – This discussion is specific to "different economic position" criteria so other aspects of the definition are not included.)

Definition of Asset-Backed Security:

3. An asset-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 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. 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[1] 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.

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

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~~sufficient~~[2] credit enhancement through guarantees (or other similar forms of recourse), subordination and/or overcollateralization[3]. 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. See Appendix II for examples illustrating the evaluation of the sufficient criteria.

Glossary Definition:

~~Sufficient~~ 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 ~~"sufficient" threshold is~~ specific to each transaction; determined at origination; and refers to the level of credit enhancement a market participant (i.e., knowledgeable ~~reasonable~~ investor transacting at arm's length) would conclude is substantive.~~expected to absorb losses (or decreases in cash flows) to the same degree as other debt instruments of similar quality, under a range of stress scenarios (i.e., scenarios are similar to stress scenarios performed for other debt instruments of the same quality). Losses are those a market participant would estimate and considers historical losses (including loss recoveries) on similar collateral, current market conditions, reasonable and supportable forecasts, and prepayment assumptions associated with the collateral. Excluded from the estimate of expected losses are historical gains on similar collateral and expected market appreciation on the collateral.~~

The first loss tranche (or tranches if the first tranche is not itself ~~sufficient~~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.

https://naiconline.sharepoint.com/teams/frsstatutoryaccounting/national meetings/a. national meeting materials/2021/13. fall national meeting/exposures/n - sufficiency discussion - concept.docx

~~[2] The term "sufficientsubstantive" is defined in the Glossary.~~

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

