Appendix II

Examples of analysis of asset backed securities under the meaningful and/or sufficiency 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. The reporting entity expects the Agency guarantee to be sufficient to absorb losses to the same degree as other debt instruments of similar quality under a range of stress scenarios.

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, to the same degree as other debt instruments of similar quality under a range of stress scenarios, it represents sufficient credit enhancement 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 3b, 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., a 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, is expected to absorb losses to the same degree as other debt instruments of similar quality, including during periods of stressed valuations.

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. Note that a debt instrument with a loan-to-value that is expected to decrease over time is not necessarily deemed to have sufficient overcollateralization. Rather, a wholistic sufficiency assessment must be made, evaluating the expected loan-to-value over the life of the transaction, in conjunction with the liquidity and market value volatility characteristics of the underlying collateral, particularly at points in time where the underlying equipment is expected to be off-lease or at the time of maturity, if refinancing or sale is required.
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 predictables 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 a substantive sufficient credit enhancement to conclude that investors are in a different economic position than holding the equipment directly, in accordance with the requirements in paragraph 3b. 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 deprecates 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 instruments lacked a substantive sufficient 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, expected to absorb losses to the same degree as other debt instruments of similar quality, including during periods of stressed valuations. Therefore, the reporting entity concluded that it was a substantively similar position as if it owned the equipment directly.

For the purposes of determining whether there is substantive sufficient 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. Note that a debt instrument with a loan-to-value that is expected to increase over time is not necessarily deemed to have insufficient overcollateralization. Rather, a wholistic sufficiency assessment must be made, evaluating the expected loan-to-value over the life of the transaction, in conjunction with the liquidity and market value volatility characteristics of the underlying collateral, particularly at points in time where the underlying equipment is expected to be off-lease or at the time of maturity, if refinancing or sale is required.

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