IR+M INCOME RESEARCH + MANAGEMENT

Insurance Industry Trends: How the NAIC Principles-Based Bond Definition Impacts Asset-Backed Securities

With the National Association of Insurance Commissioners (NAIC) preparing to implement new reporting guidelines for fixed income securities, we engaged with various industry participants to better understand the impact on our insurance clients' portfolios. By connecting directly with the NAIC, vendors, and regulatory partners, we determined the likely impacts on our clients' investments, which are summarized below.

NAIC Principles-Based Bond Definition: FAQ

Why is the NAIC implementing new accounting rules for Asset-Backed Securities (ABS)?

Due to increasing innovation in investment portfolios, NAIC regulators created a new Principles-Based Bond definition to emphasize the substance of investment risk over its legal form. The new approach avoids references to legal structure and distinguishes between two types of fixed income securities: 1) Issuer Credit Obligations and 2) Asset-Backed Securities.

When will the rule become effective?

The rule becomes effective January 1, 2025. All fixed income investments will be impacted, regardless of the purchase date (no "grandfathering").

Who is responsible for compliance, and how will enforcement work?

The reporting entity is responsible for compliance. We anticipate that enforcement/audits will occur through the regular five-year state examination process.

Creditor Relationship in Substance

Issuer Credit Obligations	Asset-Backed Securities
Definition: Security investment for which repayment is fully supported* by an underlying contractual obligation of a single operating entity. *Fully supported if the operating entity is contractually obligated to cover at least 95% of the principal of the bond. Examples: • *Corporate Bonds* • *Equipment Trust Certificates* • *Credit Tenant Leases* *Reporting Schedule:* ***D-1-1***	Definition: Bond created for the primary purpose of raising debt capital backed by financial assets or cash-generating non-financial assets owned by the ABS issuer. Repayment is primarily derived from the cash flows associated with the underlying collateral. Examples: • *Auto Loan ABS* • *Equipment Loan ABS* • *Franchise Royalty ABS* *Reporting Schedule:* ***D-1-2 (for vast majority)***

Which ABS sectors are expected to remain on Schedule D, and which ones are expected to move to Schedule BA?

We believe that most ABS sectors – including those we actively invest in – will remain on Schedule D. Financial ABS, backed by financial assets such as credit card or auto loans, are expected to be reported on Schedule D-1-2. Non-Financial ABS, which are backed by cash-generating non-financial assets such as royalties, licensing, or leasing fees, will need to generate a "meaningful level of cash flows" to be reported on Schedule D-1-2. For a security to meet this criteria, the repayment of principal cannot be overly-reliant on the sale or liquidation values of the underlying collateral. The NAIC provides a "practical expedient" to its Meaningful Cash Flows Test for securities that can amortize over 50% of their debt obligation from in-place cash flows. Securities that cannot satisfy this requirement must be assessed through the "Full Analysis" version of the Meaningful Cash Flows Test. Structures that effectively repackage equity risk through a "bond" structure may be required to move to Schedule BA.

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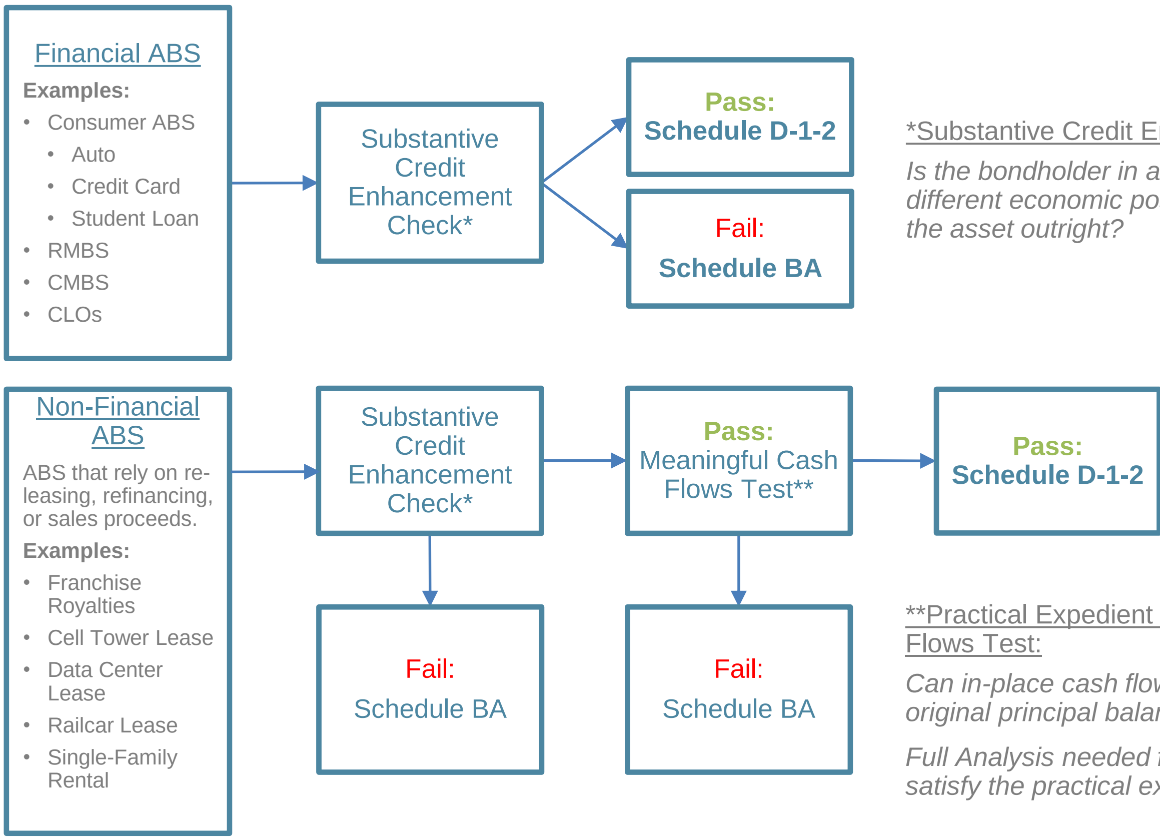
Reporting Categories Flowchart: ABS



*Substantive Credit Enhancement Check

Is the bondholder in a fundamentally different economic position than holding the asset outright?

**Practical Expedient to Meaningful Cash Flows Test:

Can in-place cash flow amortize > 50% of the original principal balance?

Full Analysis needed for sectors that do not satisfy the practical expedient.

NAIC ABS Reporting Requirements: FAQ

Which sectors will require a “Full Analysis” of the Meaningful Cash Flows Test to remain on Schedule D?

We believe that ABS backed by Franchise Royalty Securitizations, Cell Tower Leases, Data Center Leases, Railcar Leases, and Triple-Net Leases will require the “Full Analysis” of the Meaningful Cash Flows Test, as these sectors generally cannot amortize the majority of the principal balance from in-place cash flow (excluding re-leasing cash flow). While this list is not exhaustive, most issuers in these sectors cannot satisfy the “practical expedient” of the Meaningful Cash Flows Test.

There may be exceptions for certain issuers within these sectors if debt service coverage is sufficiently high.

How should Insurers document compliance with the Meaningful Cash Flows Test for Non-Financial ABS holdings that require a “Full Analysis”?

Currently, the required documentation is undefined. Consistent with other large insurers, IR+M supports an approach that documents the necessary information in memorandums for each Non-Financial ABS sector that cannot pass the practical expedient of the Meaningful Cash Flows Test. IR+M will prepare and distribute the memorandums for client ABS holdings that require the full analysis. These sector-level memorandums should describe the payment waterfall mechanics and relevant deal triggers, and include a table of the key features of the holdings within those sectors (overcollateralization, liquidity, diversification etc.).

Where can I find more information?

Effective 7/5/24, participants can enroll in an online training module through the NAIC’s Continuing Education program.

Illustrative Example: Meaningful Cash Flows Test

Issuer #	Non-Financial ABS Sector	Debt Service Coverage Ratio¹	Wtd. Avg. Cost of Debt	Remaining Contract Term²	% Bond Balance Amortized	Meaningful Cash Flow Test	Supporting Characteristics – Meaningful Cash Flows
1	Cell Tower	7.26x	4.98%	6 years	100%	PASS (Practical Expedient)	N/A
2	NNN Lease	2.09x	4.62%	11 years	96%	PASS (Practical Expedient)	N/A
3	NNN Lease	2.22x	1.99%	17 years	50%	FULL ANALYSIS NEEDED	▪ Significant overcollateralization ▪ Geographic & tenant diversification ▪ High lease renewal rates
4	Cell Tower	4.49x	2.88%	4 years	42%	FULL ANALYSIS NEEDED	▪ Significant overcollateralization ▪ Highly rated tenants ▪ High lease renewal rates
5	Data Center	2.89x	2.72%	7 years	40%	FULL ANALYSIS NEEDED	▪ Significant overcollateralization ▪ Highly rated tenants ▪ High lease renewal rates
6	Rental Car	N/A	5.27%	2 years	38%	FULL ANALYSIS NEEDED	▪ Significant overcollateralization ▪ Highly granular and diversified fleet ▪ Liquid and deep secondary market
7	Railcar	1.64x	2.53%	2 years²	19%	FULL ANALYSIS NEEDED	▪ Significant overcollateralization ▪ Highly granular and diversified fleet ▪ Liquid and deep secondary market
8	Franchise Royalty	4.04x	3.69%	N/A³	0%³	FULL ANALYSIS NEEDED	▪ Highly predictable cash flow ▪ Highly diversified franchisee base ▪ Long-dated franchise agreements

1) For certain sectors like Triple-Net Lease and WBS, the DSCR is inclusive of scheduled principal (0.5% to 1.5% per annum)
2) Remaining Contract Term excluding renewal options. For Rental Car ABS, assumed 2-year holding period for cars, with monthly depreciation of 2%
3) While Franchise Royalty Securitizations technically lack 'contractual' cash flow, they nonetheless are backed by long-dated franchise agreements with high predictability in cash flow.

Full Analysis Example – Rental Car ABS

Issuers that do not pass the practical expedient, but still produce a high level of recurring cash flow available to service the debt balance, are expected to pass the Meaningful Cash Flows Test. The Full Analysis incorporates a number of key components, which we can apply, as an example, to Issuer 6 in the table above (Rental Car ABS):

Analysis Component	Issuer Characteristics
Price volatility of underlying collateral	Used car market exhibits low month-over-month price volatility based on the Manheim US Used Vehicle Value Index
Liquidity of underlying collateral	Used car market is deep and liquid, with tens of millions of used cars sold every year in the United States
Diversification characteristics of underlying collateral	Rental car fleets consist of hundreds of thousands of vehicles that are diversified across OEMs and models
Overcollateralization of underlying collateral relative to debt	35 – 40% (varies based on fleet mix); subject to step-ups
Variability of cash flows from sources other than sale or refinancing	Repayment relies on rental car lease payments (typically for 1-2 years) followed by sale of rental cars in secondary market

Based on these characteristics, we would determine that Issuer 6 passes the Full Analysis of the Meaningful Cash Flows Test. We expect our other Rental Car ABS holdings, along with current holdings of Franchise Royalty Securitizations, Cell Tower Leasing ABS, Data Center Leasing ABS, Railcar Leasing ABS, and Triple-Net Lease ABS, to pass the Full Analysis.

At IR+M, we continue to closely monitor the development and ultimate implementation of the NAIC's new guidelines. With the regulation taking effect in a few months, we will be a resource for our insurance partners, providing further clarity on their portfolio holdings and answering any outstanding questions.