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Layout & Distribution: Valéria Kozakova

New Capital Raising By Insurers: The Standard & Poor's Perspective

David Anthony




Hybrid Capital Quality Continuum...

S&P Agrees That Quality of Debt Capital Can Be Defined Across A Range:

- Mandatory convertible preference shares (with deferrable coupons) that convert within 3 years
- Mandatory convertible non-deferrable debt that converts within 3 years
- Irredeemable perpetual preference shares
- Callable perpetual preference shares with no step-up
- Perpetual preference shares with step-up
- Perpetual subordinated debt
- Dated subordinated debt with deferrable coupons
- Dated subordinated debt with non-deferrable coupons


Strongest; most common equity-like



Weakest; least common equity-like

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...But There Is Also A Common Equity Continuum !


Some Elements Are (Relatively) Easy:

- Common Equity + Retained Earnings + General Reserves (50% of ‘Undoubted’) +

But What About:

- (Un)Realised Capital Gains ?
- Goodwill / ‘Good’ Goodwill ?
- FFA / RfB, etc. ?
- Value of In-Force (VIF) ?
- Def. Acquisition Costs (DAC) ?
- Double Leverage ?
- Supplementary Premium Calls ?
- Reserve Redundancy
- Discounted Reserves ?
- Mandatory Convertibles ?
- Hybrid Equity ?
- Cash re Securitisations ?
- Investment in Affiliates ?
- Unpaid Capital, Etc. Etc..?

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S&P Guidelines for Inclusion of Hybrids in Equity

	Description	Treatment	Example
EQUITY	Common Equity or its equivalent	Included in TAC (total adjusted capital) & ACE (adjusted common equity) without fixed limit	Common equity
I	Very Strong Equity-like features	Eligible for inclusion up to 25% of insurance TAC Eligible for inclusion up to 35% of banking ATE	3-Year Mandatory Convertibles
II	Strong Equity-like Features	Eligible for inclusion up to 15% of insurance total capital Eligible for inclusion up to 25% of ATE	Perpetual or long-dated insurance non-call 10 Yr. issues; preference stock; most ‘Tier 1’ securities
III (a)	Good Equity-like Features	Eligible for inclusion up to 10% of banking ATE or up to 15% of insurance total capital	Most bank ‘Upper Tier 2’ issues; trust preferred securities; insurance 20 non-call 10’s (Lower Tier 2)
III (b)	Marginal Equity-like features	Eligible up to a sub-limit of 5% of the standard 15% of insurance total capital or 5% of banking ATE	Eligible Funded Contingent Capital Facilities
DEBT	Weak Equity-like Features	Ineligible for hybrid credit from S&P and excluded from both TAC and ACE/ATE	Senior debt; sub. debt without coupon deferral; shorter-dated hybrids; auction preferreds


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The Facts re Insurance Debt & Debt Leverage From The Standard & Poor's Perspective

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Debt, Equity or Hybrid?


Equity Characteristics

- **Requires No On-going Payment That Could Lead to Default**
- **Expected to Remain a Long-term Feature of the Capital Structure**
- **Deeply Subordinated on Wind-up (Liquidation)**
- **Recognised As Eligible Solvency Capital by Regulators**

In Other Words, Any Assessment Must Be Based on the Characteristics and Certainly Not on the 'Name' of the Instrument !

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Standard Hybrid Leverage Tolerances


$$\text{Hybrid Equity Leverage Ratio} = \frac{\text{Total Hybrid Equity}}{\text{Common Equity} + \text{Eligible Hybrids}}$$

Maximum as % of Group TAC

AAA	15% (also <u>max.</u> for holding co. analyses)
AA	20% (regulated op. co's only)
A	25% (regulated op. co's only)
BBB and below	30% (regulated op co's only)

Although not technically hybrid equity, credit of up to 25% of TAC can also be given for eligible 3-Year Mandatory Convertibles or their equivalent

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Financial Leverage

Guideline Benchmarks

AAA	<15%
AA	15%-25%
A	25%-35%
BBB	35%-45%
BB	45%-65%

$$\text{Financial Leverage Ratio} = \frac{\text{Debt} + \text{'Excess' Hybrids}}{\text{TAC} + \text{Total Debt \& Hybrids}}$$

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Fixed Charge Coverage Tolerances

EBITDA

Totality of Actual & Notional Annual Interest & Pref. / Hybrid Equity Dividends

	<u>Low interest rate environment</u>	<u>High interest rate environment</u>
AAA	10x+ (approx.)	8x+ (approx.)
AA	8x — 10x (approx.)	6x — 8x (approx.)
A	5x — 8x (approx.)	4x — 6x (approx.)
BBB	3x — 5x (approx.)	3x — 4x (approx.)
BB	2x — 3x (approx.)	2x — 3x (approx.)

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Double Leverage

Double Leverage Ratio =

$$\frac{\text{Holding Company Investment In Subsidiaries}}{\text{Holding Company Common Equity + Eligible Hybrids}}$$

- Measures the extent of debt downstreamed as equity
- Helps determine quality of capital at an operating company
- Excessive double leverage is deducted from a sub's capital

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Double Leverage

Tolerance Limits

AAA	115%
AA	125%
A	135%
BBB & below	145%

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Is The Emperor Naked?

- Dated v. Undated / Cumulative v. Non-cumulative / Alternative Coupon Settlement Mechanism, etc.
- What Do Deferral Clauses Really Achieve ?
- What Security Do The Varying Degrees of Subordination Actually Give To Noteholders ?
- Are The Coverage Ratios Really Decisive Re Debt Servicing?
- What If the Notes Are Placed With an 'Inappropriate' Investor Base ?
- What If 'Management Intent' Is Suspect Re Buy-backs, etc.) ?
- Is Japanese Practice The Way To Go ?


Do All The 'Bells & Whistles' Really Matter ?

(Besides, Is the EU Going to Do Away With Tax Deductibility re Hybrids ?)

-- Net, Net, Does Hybrid Equity Really Exist Or Are All Hybrids Just 10-year Senior Notes In Disguise ?

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Some Conclusions re Debt Capital

- **‘Management Intent’, ‘Quality of Capital’ and ‘Why Are They Doing This?’ & ‘What On Earth Are They Going To Do With The Money?’ Are All Key!**
- **Even Legal Deferral of Interest on a Hybrid Equals ‘Default’ for S&p and the Deferred Debt Instrument Rating Will Go to ‘D’ (Which Is Not an Investment Grade Characteristic...!!)**
- **Mandatory Deferral Triggers Are Not Equity-like! If We Find Them, We May Widen Notching Relative to Issuer’s Counterparty Credit Rating to 3 From 2 Notches (Allianz; Nationwide US, etc.)**
- **Common Equity Is Still the Best Form of Capital! Retained Earnings Are Still the Best Form of Capital Increase! However, There Is a Role for the *Prudent* Use of Hybrids & Debt in Insurance Capital Management!**
- **Despite This Presentation, Structured Solutions Rather Than Hybrids Are Probably The Next *Really* ‘Big Thing’ in Insurance Capitalisation ...**

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