Capital Resources

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Capital Resources Discussion Topics

- Additional Capital Sources under ICS
- Senior Debt
- Surplus Notes

ICS Additional Capital Sources

Arbitrarily limiting capital sources in stress situations..

Tier One (Unlimited)

- Common stock
- Non-cumulative convertible perpetual preferred

Tier One (Limited)

- Perpetual non-cumulative preferred callable by issuer after 5 years
- Principal loss absorbency mechanism

Tier Two < 50% of total capital

Tier Two – Paid Up (Limited)

- Subordinated debt

Tier Two – Non-paid Up (<15%)

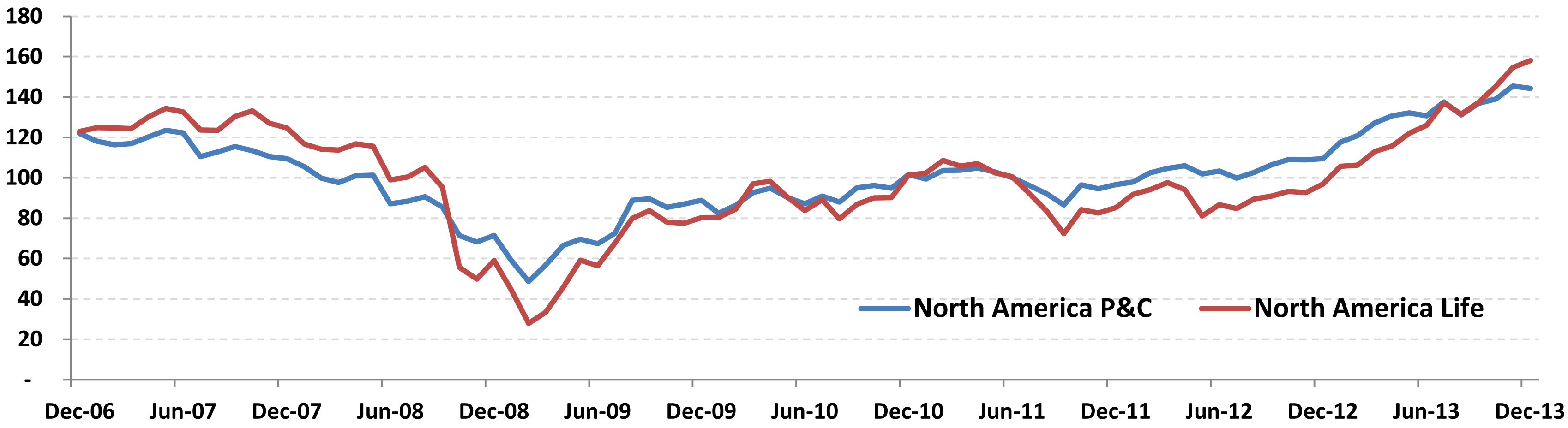
- Bank credit facility
- Letter of credit
- Promissory note

…could make ICS results a self fulfilling prophecy.

U.S. Insurance Industry Capital Sources

Under stress, common stock issuance…

North American Insurance Company Equity Analysis

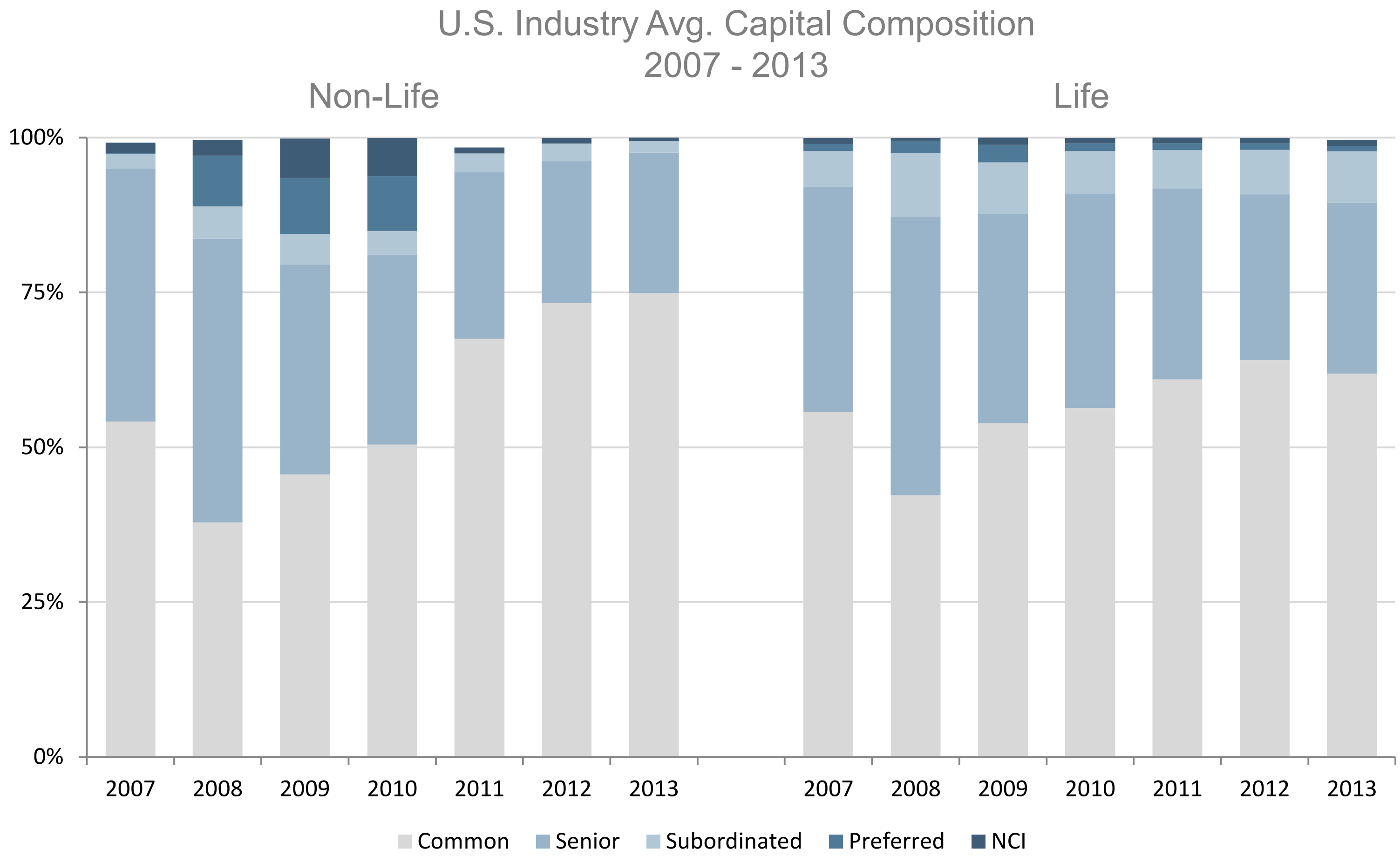


Source: Bloomberg North America P&C (BINPPCPB) and Life (BILIFENP) Price Indexes

…has minimal benefit and increases risk of pro-cyclically.

U.S. Insurance Industry Capital Sources

Under stress, significant reliance on interest bearing instruments…



Source: SNL. Population reflects all potential U.S. IAIGS with the exception of U.S. statutory only filers

…precluded or significantly limited in the ICS.

Senior Debt

Perceived Issues:

- How does structural subordination compare to contractual subordination?
  - In the U.S. both require supervisory notification or approval prior to moving capital to pay principal or interest
  - In both structures in the event of an insolvency, the debtholders are effectively subordinated to policyholders' claims
- Does the default acceleration clause found in U.S. senior debt issuance cause a run on the bank?
  - Neither insurance subsidiaries board of directors nor regulators can be compelled to pay dividends to pay bondholders
  - Most defaults are remedied through negotiated refinancing efforts
  - Federal bankruptcy proceeding ensures an orderly process
  - Example outlines winding-up of insolvent group when refinancing cannot be achieved

Senior Debt Default Example

Scenario Assumptions

Insurance holding company issues $1,000 of senior debt in Year 1.

Insurance holding company makes $1,000 capital contribution in insurance subsidiary in Year 1.

In Year 5, the insurance holding company defaults on its debt.

Bondholders push holding company into bankruptcy proceedings.

Bankruptcy court appoints trustee to oversee process.

Commissioner typically places insurance affiliates into receivership to ensure policyholder assets are preserved.

Senior Debt Default Example

Holding Company Balance Sheet

Hold Co.
Balance Sheet
December 31, 20XX

	Assets	Liabilities	
Cash	$1	Outstanding Debt	$1,000
Investment in Insurance Affiliate	3,999		
		Total Liabilities	1,000
		Equity	
		Common Stock	2,500
		Retained Earnings	500
		Total Equity	3,000
Total Assets	$4,000	**Total Liabilities & Equity**	$4,000

Senior Debt Default Example

Final Resolution

Holding Company liquidated by bankruptcy trustee.

Sale of insurance affiliate to third party, approved by domestic insurance regulator.

Bankruptcy trustee pay bondholders for principal and unpaid interest.

Surplus Notes are Deeply Subordinated and Closely Regulated

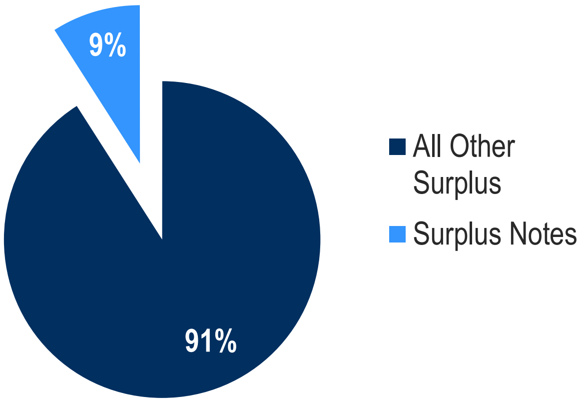
- **Deeply subordinated** to all present and future policyholder and creditor claims
- Require regulatory **approval of issuance** both on form and substance
- Require regulatory **approval of all principal and interest payments**
- **Regulators will prohibit payment** if they believe it could potentially put policyholders and the company at risk, **without triggering a default**, allowing capital to be available during times of financial distress
- **No investor recourse** to accelerate the payment if regulator takes action
- **Uniform requirements** for subordination and regulatory approval across all U.S. states under Statement of Statutory Accounting Principles No. 41
- **Long-term capital** with an average maturity of 20-25 years, with many issued for 30-50 years
- **Provide regulators flexibility** to attract capital to entities under financial distress
- Provide a **source of capital to mutual companies** who do not have direct access to traditional equity markets for capital needs

Surplus Notes are High Quality Capital Instruments

- Strict regulatory controls and deep subordination features make surplus notes one of the highest quality forms of capital for insurers
  - ☑ Deeply subordinated to all other claims
  - ☑ Available to fund policyholder claims
  - ☑ Loss absorbing in going-concern and winding-up
  - ☑ Permanent given the long duration and regulatory deferral of both principal and interest
  - ☑ Absent of mandatory servicing costs

- Given the high quality form, limiting capital availability of surplus notes is unnecessary

U.S. Mutual Company Surplus Notes
(as of year-end 2013)



Source: Outstanding surplus notes from the Liabilities, Surplus and Other Funds page of the 2013 NAIC Annual Statement