Public

INTERNATIONAL ASSOCIATION OF INSURANCE SUPERVISORS

Capital Resources

IAIS Stakeholder Meeting
La Jolla, 17 January 2017

Open issues to be considered by FSTC after Stakeholder meeting

1. Structural vs contractual subordination (treatment of senior debt)
2. Treatment of mutual IAIGs
3. Treatment of non-paid-up capital items
4. Discretionary repurchases of Tier 1 unlimited financial instruments
5. Treatment of certain items deducted from Tier 1
6. Financial instruments issued by consolidated subsidiaries to third parties
7. Encumbered assets

Issue 1: Structural vs. contractual subordination

Issue: Should the Tier 2 qualifying criteria be modified in order to recognise senior debt and the characteristics of regulatory regimes that enforce structural subordination?

Option 1: Maintain the approach from 2016 Field Testing. Do not amend the Tier 2 qualifying criteria in respect of subordination, acceleration of repayments and supervisory approval for redemption or repurchase. Maintaining the qualifying criteria means that senior debt issued by a holding company of an IAIG would not be recognised as qualifying ICS capital resources.

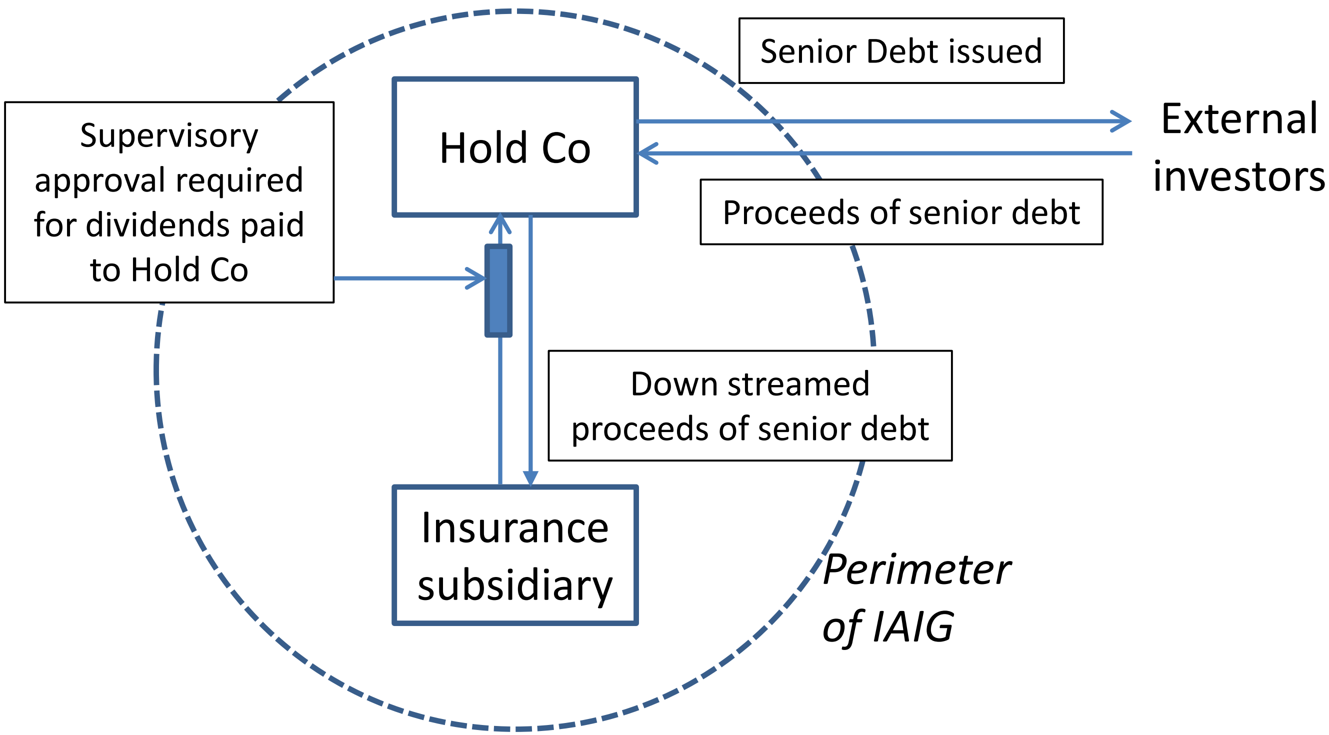
Option 2: **Structural subordination that is enforced by insurance supervisors should be recognised in the Tier 2 criteria.** Recognise within Tier 2 capital resources the amount of structurally subordinated (senior) debt that the IAIG can demonstrate to the supervisor’s satisfaction as having been downstreamed and ring-fenced into licensed/regulated insurance subsidiaries. This would require amending criteria b), e), f) and j) related to subordination, acceleration of repayments and supervisory approval for redemption or repurchase.

Issue 1: Structural vs contractual subordination

The following diagram outlines the connected transactions that give rise to ‘structural subordination’:

a) External debt issuance at Hold Co

b) Down-streaming the proceeds of a) as equity investment



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Issue 1: Structural vs. Contractual Subordination

Views of those that support Option 1 (1/3)

- **Recognition of structural subordination is fundamentally at odds with a consolidated standard**
  - To deliver a group perspective, all intra-group transactions (IGTs) should be eliminated, including down-streaming of debt proceeds from a Holding Company to an insurance subsidiary. Making concessions for some IGTs undermines the consolidated approach.
  - For the consolidated group, senior debt is a liability with no loss absorbing capacity in a winding up.
  - Any experience with established regulatory controls around structurally subordinated debt has been on a legal entity basis; it does not extend to a consolidated group standard such as the ICS.
  - Legal entity level supervisory approval for dividend payments takes into account only the protection of the subsidiary's policyholders. It offers no protection to policyholders of other insurance subsidiaries within the group.
  - Not clear if/how it applies where a Holding Company invests debt proceeds in a subsidiary in a different jurisdiction.
  - It may be difficult / impossible to clearly identify the proceeds of debt issuance at the Holding Company that are down-streamed into insurance subsidiaries, and hence structurally subordinated to policyholders.

Issue 1: Structural vs. Contractual Subordination

Views of those that support Option 1 (2/3)

- **Contractual subordination is stronger & more reliable than structural subordination**
  - Main objectives of the ICS are protection of policyholders and to contribute to financial stability; senior debt does not fulfil those objectives.
  - Contractual subordination is more transparent and consistent than the case-by-case assessment of structural subordination, which depends on local regulations that may have varying degrees and scope of authority.
  - In some jurisdictions where regulatory controls over dividend payments are enforced, it is not clear that those controls apply in all circumstances (e.g. does not apply to dividends below a certain threshold).
  - Provides a level playing field with banks (Basel III does not recognise senior debt within capital resources).
  - Structural subordination may not be effective in situations where a Holding Company has other assets or income streams in addition to the insurance subsidiaries. In such cases, holders of senior debt could be paid in full while policyholders do not have their claims fulfilled.

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Issue 1: Structural vs. Contractual Subordination

Views of those that support Option 1 (3/3)

- **A Holding Company should be a source of strength for an insurance subsidiary, not a drain on resources**
  - Recognition of structural subordination would encourage “double leverage”, which can undermine the quality of capital in insurance subsidiaries through dividend pressure.
  - Acceleration clauses common in senior debt issuances also create dividend pressure and could accelerate insolvency at the Holding Company level.
  - Senior debt can be redeemed or repurchased at all times; recognising it as Tier 2 capital resources would undermine the expectation of a degree of permanence for capital resources.
  - These features of structurally subordinated (senior) debt can pose risks to the safety & soundness of an IAIG.
- **The issue is not limited to subordination**
  - Senior debt fails other criteria re: permanence, acceleration of repayments and supervisory approval not addressed by structural subordination. Changing all of them would significantly lower the quality of capital in ICS Tier 2 capital resources.

Issue 1: Structural vs. contractual subordination

Views of those that support Option 2 (1/3)

- The issue is ***not*** whether senior debt should qualify as capital or not; the issue is whether the Tier 2 criteria for ***subordination*** is appropriate. ***Any*** instrument would be tested to qualify, or not, against that criteria.
- The current ICS specifications are explicit in allowing only one ***legal form*** of subordination, i.e., through the contractual terms and conditions of the instrument.
- The specifications explicitly exclude another ***legal form*** of subordination, through the features of the regulatory and legal regime of the jurisdiction. In other words, ***structural subordination is prohibited.***
- Structural subordination, which for insurers in the United States is ***enforced*** by the regulatory and supervisory regime, achieves ***comparable outcomes*** to contractual subordination.
- By permitting only one form of subordination to the exclusion of another and without regard to the comparability of outcomes, the criteria focus on ***form versus substance***.
- The impact is seen in disparity by region, which vary as to nature of regimes/markets:
  - Europe, South Africa, Canada and Asia: reliance largely on contractual subordination
  - The U.S.: reliance largely on structural subordination
- As an international standard, ***the ICS must be implementable*** in major markets. Also, many stakeholders support that such a standard ***respect and accommodate local regimes***. Allowing structural subordination – in jurisdictions where it is enforced by the legal regime and by proactive supervisory processes – ***will help to accomplish those goals***.

Issue 1: Structural vs. contractual subordination

Views of those that support Option 2 (2/3)

- Holding Company issues senior debt; most/all is "pushed down" and ring-fenced as capital of an operating subsidiary.
- The concept of "structural subordination," per se, is achieved by the push down alone; creditors of the holding company do not have access to funds of subsidiaries.
  - Option 2 provides that ***only the amount that is pushed down would qualify as Tier 2***, a substantive difference from treatment of contractually subordinated debt in the ICS*.*
- However, in the United States, such structural subordination with respect to insurers is also subject to ***proactive enforcement*** by the laws and processes of the state-based insurance regulatory regime.
- Unlike some other jurisdictions, state insurance regulators in the U.S. have ***review and prior approval requirements over dividends*** from operating subsidiaries.
  - The ability of the holding company to ***fund redemptions and repurchases*** is thus effectively ***restricted***
  - Option 2 will provide ***criteria to define "enforcement***" to determine in which jurisdictions structural subordination could qualify
- Should acceleration be triggered, federal laws provide the means to achieve an orderly restructuring of debt, as a going concern, so as to protect financial stability **–** ***another key aspect of the integrated state/federal U.S. regime.*** Some of the largest firms in the U.S. have undergone this process successfully, e.g., airlines, auto companies, health care systems, etc.
- While the ***form*** of structural subordination differs from contractual subordination, both are embodied within laws and legal precedence and well recognized by the markets in respective jurisdictions.
- The ***substance*** is that the ***outcomes as to subordination are comparabl***e.

Issue 1: Structural vs. contractual subordination

Views of those that support Option 2: Q&A

- ***Is fungibility an issue?*** Yes, just as for proceeds of contractually subordinated debt that is housed within legal entites of a group. The ICS needs a holistic view on fungibility that applies to all forms of capital wherever located within the group.
- ***Is contractual subordination inherently better than structural subordination?*** Not necessarily. Parties to contracts have disputes. Structural subordination benefits from a contemporaneous approval process that also involves a supervisory authority rather than reliance on contract terms that might not anticipate developments that could occur years into the future.
- ***Will structural subordination work if the debt proceeds are pushed down to a subsidiary in another jurisdiction?*** It depends on whether the host jurisdiction enforces structural subordination; if not, the amount pushed down to that subsidiary should not qualify as capital.
- ***Does structural subordination involve a case-by-case assessment of regimes?*** Yes, but only a few regimes would likely even be considered to qualify and changes would not occur frequently. Contractual subordination, on the other hand, requires a case-by-case assessment of every individual instrument of each firm.
- ***Can the amount of proceeds down-streamed be objectively determined (e.g., when numerous refinancings have occurred)?*** To date, there has been no need for U.S. firms to track such cash flows for capital purposes. That can change immediately. Firms can also do a "fresh start." More guidance in this area and field testing would be beneficial.
- ***Does structural subordination inhibit transparency to supervisors and markets?*** No. In the U.S., for example, prospectuses contain comprehensive risk and other disclosures; are filed with the Securities and Exchange Commission and readily available on its public web site; and are widely understood by supervisors and market participants. Disclosures such as these are typical:
  - ***As a holding company, [Holdco] will depend on its subsidiaries for funds to meet its payment obligations under the Notes or the Guarantees.***
  - ***Because of [Holdco's] holding company structure, the Notes and the Guarantees will be subordinated to the claims of creditors and policyholders of the subsidiaries of [Operating company].***

Issue 2: Treatment of mutual IAIGs

Issue: Should there be a carve-out in Tier 1 for financial instruments issued by mutual IAIGs (e.g. surplus notes and Kikin), which currently qualify as Tier 2 capital resources?

Option 1: Maintain the approach from 2016 Field Testing. Concessions involving preferential treatment for instruments issued by mutual IAIGs as qualifying capital resources should not be made for ICS Version 1.0. Eligibility of financial instruments should be determined based on a substance-over-form evaluation against the qualifying criteria that are formulated to ensure an appropriate quality of capital.

Option 2: Create a carve-out for mutual insurers within Tier 1 Unlimited. Modify certain criteria for Tier 1 Unlimited capital resources in order to classify surplus notes and Kikin issued by mutual IAIGs as Tier 1 Unlimited.

Issue 2: Treatment of mutual IAIGs

Views of those that support Option 1:

- All financial instruments should be evaluated in a substance-over-form assessment against the same qualifying criteria, regardless of the type of instrument or issuer.
- Maintains a level playing field among insurers as approaches that favour legal form may be subject to regulatory arbitrage.
- There are no impediments to mutual insurers issuing other financial instruments that would meet the Tier 1 qualifying criteria.
- Would incentivise mutual IAIGs to restructure future financial instruments to meet ICS qualifying criteria.
- Despite regulatory controls (e.g. supervisory approval of distributions and redemption) that can defer distributions, including redemption of these instruments, possibly indefinitely, these instruments are not “effectively” perpetual nor non-cumulative and do not provide going concern loss absorbency. Once the supervisor approves a payment, investor and market expectations are that any previously deferred distributions will also be paid.

Issue 2: Treatment of mutual IAIGs

Views of those that support Option 2:

- Mutual insurers have an inherent disadvantage in terms of limitations on means to raise capital, as compared to stock companies.
- A carve-out for mutual insurers in Tier 1 Unlimited would recognise that both mutual insurers and their supervisors may need additional assurance in times of stress that capital resources paid in to alleviate the stress do, in fact, qualify as capital resources and without limitation.
- Supervisory discretion or supervisory restrictions that apply to surplus notes and Kikin instruments can result in the deferral of payment indefinitely, even into winding up, effectively making the instrument permanent and non-cumulative.
- Recognises that there can be various ways in which IAIGs can achieve the objectives of the stated criteria. Avoids restructuring current and future financial instruments and potentially disrupting local markets and regimes solely to meet chosen ICS criteria which are based on laws, legal precedence and market conditions from certain other regimes which may not be implementable in all jurisdictions. Does not diminish in any way the quality of capital or policyholder protection.

Issue 3: Non-paid-up capital

Issue: Should a limited amount of non-paid-up capital items qualify as capital resources (Tier 2 Non-Paid-Up)?

Option 1: Maintain the approach from 2016 Field Testing. Permit non-paid-up capital within qualifying Tier 2 capital resources, subject to appropriate safeguards and a suitable limit (e.g. 10% of the ICS capital requirement).

Option 2: Only paid-up capital is included in an IAIG's capital resources. As such, sections 11.2 and 11.5.1 of the 2016 Technical Specifications are removed from ICS 1.0. The criterion of Tier 1 unlimited, Tier 1 limited, and Tier 2 capital resources calling for qualifying instruments to be fully paid up should be retained.

Issue 3: Non-paid-up capital

Views of those that support Option 1:

- Non-paid up capital items may be an important source of funding for certain types of insurers and business models (e.g. mutual IAIGs) in some jurisdictions. Not recognising this source of financing would create significant pressure for these groups and place them under a significant competitive disadvantage.
- This approach is subject to safeguards including requirements for supervisory approval and that payments are legally enforceable and callable on demand, which ensures that the promised amounts can be paid in full and are available to absorb losses.

Issue 3: Non-paid-up capital

Views of those that support Option 2:

- Capital resources reported will be available with 100% certainty (the same cannot be said with non-paid-up capital; i.e. the “safeguards” referred to above for Option 1 cannot effectively “ensure”, or guarantee, the willingness or ability of counterparties to pay in the future).
- The need for non-up-paid-up capital has not been demonstrated

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Issue 4: Discretionary repurchases of Tier 1 Unlimited financial instruments

Issue: Should the requirement for prior supervisory approval of discretionary repurchases of Tier 1 Unlimited financial instruments (e.g. common/ordinary shares) be maintained?

This criterion would have the impact of not allowing common/ordinary shares from jurisdictions that do not have this requirement to qualify as ICS capital resources.

Option 1: Maintain the approach from 2016 Field Testing. Require prior supervisory approval for the discretionary repurchase of Tier 1 Unlimited financial instruments. As such, criterion 333 e) of the 2016 Technical Specifications should be left unchanged for ICS Version 1.0.

Option 2: Modify the criterion to remove the requirement for prior supervisory approval: "*The principal amount of the instrument is not repaid outside winding-up, other than by means of discretionary repurchase which is permitted or not prohibited under ~~national~~ applicable jurisdictional law or regulation~~, which is subject to prior supervisory approval~~.*

Issue 4: Discretionary repurchases of Tier 1 Unlimited financial instruments

Views of those that support Option 1:

- It protects the permanence of Tier 1 capital, which ensures that it is available when it is most needed (i.e. in times of stress).
- It enhances the quality of capital within the ICS framework and holds Tier 1 Unlimited capital resources to at least the same standard as Tier 1 Limited and Tier 2 capital resources as regards the discretionary repurchase of financial instruments. It would not be consistent to include supervisory approval prior to repurchase as a requirement for Tier 1 Limited and Tier 2 capital resources but not for Tier 1 Unlimited capital resources.
- This requirement protects policyholders by ensuring that such an operation will not cause the insolvency of the IAIG nor accelerate the process of the IAIG becoming insolvent.

Issue 4: Discretionary repurchases of Tier 1 Unlimited financial instruments

Views of those that support Option 2:

- Consistent with the Basel III regulatory framework which does not require prior supervisory approval for discretionary repurchases of common /ordinary shares for banks.
- Avoids regulatory complexity regarding ordinary share repurchases.
- Corporate law provides safeguards (e.g. limits on the amount of financial resources that can be used to repurchase financial instruments, board oversight of governance, securities regulators oversight of stock price manipulation, etc.).
- Implementable in all Member jurisdictions.
- Allows common shares from all jurisdictions to qualify as Tier 1 Unlimited capital resources.

Issue 5: Treatment of certain deductions from Tier 1

Issue: Should certain items that are deducted from Tier 1 (deferred tax assets that rely on future profitability, computer software intangibles and defined benefit pension fund surplus) receive some limited recognition in Tier 2 capital resources?

Option 1: Develop a Tier 2 basket for these items. The basket would be constructed by allowing a proportion of the amount deducted from Tier 1 to be added to the basket. The sum of the items in the basket would then be capped at a predefined level, such as 5% or 10% of the ICS capital requirement.

Option 2: No scope for add-backs into Tier 2 capital resources of items deducted from Tier 1.

Issue 5: Treatment of certain deductions from Tier 1

Views of those that support Option 1:

- Provides a flexible approach to recognise some value of the Tier 1 deductions in a winding up scenario.

Views of those that support Option 2:

- This approach recognises that the specific deductions from Tier 1 capital resources are unlikely to absorb losses in a winding up scenario.

Issue 6: Financial instruments issued by consolidated subsidiaries of the IAIG and held by third parties

CSFWG will make the following recommendation to FSTC:

CSFWG recommends that for ICS Version 1.0, an appropriate placeholder limit on the recognition of third party capital should be determined. If Volunteer IAIGs do not provide the data necessary to calculate the limit, then their third party capital will be fully excluded from qualifying capital resources, thereby providing an incentive to firms to provide the required information. CSFWG will also collect additional data in 2017 Field Testing in order to refine the limit for ICS Version 2.0.

Issue 7: Encumbered assets

CSFWG will make the following recommendation to FSTC:

For ICS Version 1.0, CSFWG recommends to simplify the encumbered assets deduction by determining an appropriate proxy for the incremental capital requirement. In addition, CSFWG proposes that the amount deducted from Tier 1 be added back into Tier 2, subject to the limit on Tier 2 capital resources. The amount included in Tier 2 would be subject to a credit risk charge. CSFWG will also collect additional data in 2017 Field Testing in order to refine the treatment for ICS Version 2.0.