

## Instruments Working Paper on Marketability

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### Introduction

#### The industry welcomes the increased guidance provided in QIS4

The industry recognises the work done by supervisors and the significant undertaking that is a QIS. The industry participated in the QIS 3 and provided feedback to supervisors. One of the main concerns in QIS 3 was the lack of guidance, especially related to own funds. Eligible elements of capital was in the scope for the first time in QIS 3, which helps explain why many companies had difficulties in splitting their capital into the three tiers.

The majority of the companies would have liked more guidance with practical examples to understand how to classify the capital elements. The QIS4 draft specification can be regarded an improvement which is strongly welcomed by the industry: more guidance is provided and examples are included.

#### Marketability of instruments is key

It is essential that the European insurance industry has ready access to the capital markets and has sufficient flexibility to allow it to issue instruments that are attractive to potential investors. This is needed to ensure that companies and their policyholders are able to issue capital instruments in the most cost effective form, which will enable policyholders to benefit from reduced costs and companies to maintain / improve their international competitiveness. In some areas, we believe that the QIS4 specification does not sufficiently take this into account.

In this paper we have provided requirements we believe are critical to ensure marketability of instruments. We have identified those requirements we believe are sufficiently addressed in the proposals of QIS 4, but also those we believe have not been addressed.

To illustrate our concerns, we have provided a large number of instruments which have been issued. This illustrates more clearly key requirements for instruments to be marketable. In addition, some constraints which have been prescribed in the draft QIS4 specifications are being addressed. Specifically, the paper considers:

- The current position, whereby the type and extent of the different capital instruments currently used in the various markets to cover solvency capital requirements.

- The impact on marketability of the characteristics / constraints currently being proposed by the draft QIS4 specification.
- The paper also highlights the key requirements to ensure marketability of instruments and compares these to the proposed QIS4 requirements.

## Contents of this paper

In Section 1, we provide a brief overview of the current constraints and also describe some changes of regulation some countries have experienced such as the Netherlands and Switzerland whereby increased recognition is given to ensure marketability of instruments and specifically hybrid instruments.

In Section 2 we analyze how rating agencies treat the capital instruments. We note that the requirements differ and that the rating agencies take into account key marketability criteria.

Section 3, which is the main part of this document, provides an overview of basic own fund instruments that have been issued by companies. In addition to a description of these instruments, the tables show:

- How these instruments would be classified in the current regime.
- How these would be classified under the proposals of QIS4.
- How we believe these instruments should be classified and why.

Section 4 provides an overview of our key messages and the requirements of the proposals of QIS 4, with which we agree but also those where we believe the marketability of instruments is not adequately captured.

## Caveats

It is important to note that the comments in this document should be considered as a whole i.e. they constitute a coherent package. As such, the rejection of elements of our positions may affect the remainder of our comments. In addition, these are CEA's views at the current stage of the project. As our work develops, these views may evolve depending in particular, on other elements of the framework which are not yet fixed.

## 1. Increased recognition of hybrid capital in some jurisdictions

### Solvency I constraints

- 1.1 Under the current Solvency I regime (see Appendix D), the main constraint is that subordinated debt, either perpetual or dated, is limited to 50% of the lower between available solvency margin and minimum required margin.
- 1.2 Within the above limit, the insurer can use dated instruments up to the 25% of the lower between available solvency margin and minimum required margin and perpetual instruments up to the 50% of the lower between available solvency margin and minimum required margin.
- 1.3 The distinction between the different forms of capital is therefore based only on the maturity of the item. No other features, including subordination, loss absorbency in going concern, absence of incentives to redeem and of mandatory fixed charges, are taken into consideration. The criteria used in Solvency I is too simple and probably outdated because merely looking at the maturity of the instruments does not capture the true intrinsic quality of the capital.

### Increased recognition of hybrid instruments

- 1.4 In some member states new rules related to admissibility of capital instruments have been set up or are being set up, in advance of Solvency II. In the Netherlands, for example new rules are designed by the Dutch supervisor as of 31-12-2007. These rules will recognise Hybrid capital for solvency purposes, if the following requirements (the requirements marked with \* are regarded as the most important requirements) are met:
  - permanence (\*)
  - fully placed
  - loss-absorption (\*)
  - issuer has full say in extent and timing of payments on the financial instrument (\*)
  - subordination
  - no cumulative preferences
  - no call optionThis treatment is in line with that of the FSA in the UK.
- 1.5 In the Netherlands, as of 31-12-2007 new guidelines regarding the use of hybrid capital for solvency purposes are in place. Hybrid capital meeting certain characteristics (step-up which do not exceed the maximum between 100bp and half of the spread at issue; and step-up does not occur earlier than 10 years after the issue date) will still be allowed to cover the minimum solvency margin. Hybrid capital will however also be allowed to cover the excess capital. This is an extension compared to the old guidelines. Up to 15% (innovative financial instruments) respectively 50% (innovative plus non-innovative instruments) of excess capital may be covered by hybrid instruments. In these maximum percentages non-cumulative preference shares will be included.
- 1.6 In Switzerland the Swiss Solvency Test (SST) was introduced on 01-01-2006 as part of the new Insurance Supervision Act. The new rules also affected the eligibility of hybrid capital. Under Solvency I hybrid capital was limited to 50% of the lower between available solvency margin and minimum required capital. The new rules allow for additional capital of up to 150% of the core capital. The SST makes a distinction between upper and lower additional capital. Upper additional capital is deemed to comprise hybrid instruments which have no fixed repayment date and gets up to 100% credit of the core capital. Lower additional capital is deemed to comprise hybrid instruments with an original term of at least five years and gets up to 50% credit of the core capital. The amount credited is reduced in the last five years of the term by 20 per cent per year of the original nominal sum.

## 2. Treatment of instruments by Rating agencies

- 2.1 In the last couple of years the hybrid market has been driven by rating agency's consideration and therefore the majority of the bonds outstanding include features that are far stronger in terms of capital quality than those required by the current Solvency I requirements. This issue brings about a distortion in the insurance market, whereby poorer quality capital receives the same treatment as higher quality capital.
- 2.2 Analyzing the QIS4 draft specification an opposite situation can be foreseen. Instruments with features that will allow Tier 1 classification following QIS4 draft specification will receive less equity credit than instruments qualifying for Tier 2 treatment. Under Moody's hybrid criteria for instance there are currently outstanding instruments classified as Basket D, i.e. 75% equity credit, that would be treated as Tier 1 and instruments receiving full equity credit, i.e. Basket E, that would probably fall into the Tier 2 bucket. These conflicting criteria raised by Solvency II requirements, specified in the QIS4 draft specifications, will lead to a decrease in the appetite for hybrid instruments.
- 2.3 In appendix C, an overview is provided whereby the QIS4 proposal is compared with the rating agencies requirements for equity credit. We assumed that "Tier 2-basic own funds" is equivalent to UT2 and "Tier2-ancillary own funds" is equivalent to LT2. The key areas of discrepancies are:
  - Required loss absorption: rating agencies (with the exception of Fitch) do not give additional equity credit for a write-down or common share conversion feature and
  - Discretion over the coupon payments.
- 2.4 When assessing the requirements set by the rating agencies, one needs to take into consideration that Solvency II is calibrated at BBB rating level, whilst the rating ambition for most insurance companies/groups is at higher level, resulting in higher capital requirements than according to Solvency II.

### 3. Impact on marketability of instruments assuming QIS4' proposed characteristics / constraints

3.1 In order to assess the impact on marketability of instruments, based on the proposed characteristics of the QIS 4 draft specification, we have collected instruments that have been issued in the market. The tables below give overview of instruments that have been issued in the past by insurance companies, whereby we have:

- In the first column, provided a description of the instruments.
- In the second column, described how these instruments are treated under the current Solvency regime,
- described how these instruments would most likely be treated assuming the draft QIS 4 specification would be in force, and
- indicated how we believe these instruments should be treated.

3.2 The 1<sup>st</sup> table provides a list of instruments we believe should be qualified as Tier 1 instruments. The 2<sup>nd</sup> table provides instruments we believe are eligible for Tier 2.

**TABLE 1: OVERVIEW OF BASIC OWN FUNDS – TIER 1**

Instrument	Commentary
<p><b>Example 1: AXA €6.4bn debt instruments with common features which classify for Tier 1</b></p> <p>AXA has issued instruments with the following characteristics:</p> <ul style="list-style-type: none"> <li>■ Super-subordination (deeply subordinated debt senior only to share capital)</li> <li>■ Loss absorbency mechanism through write-down of principal in case of breach of minimum solvency margin (Solvency Event). Restoration following the end of the Solvency Event and 2 consecutive financial years with positive Consolidated Net Income</li> <li>■ Maturity = perpetual with customary 100bp step-up and call date after 10 or more years, subject to regulatory approval</li> <li>■ Customary tax, regulatory, accounting calls, all subject to regulatory approval</li> <li>■ The issuer has the option to cancel interest payments (non cumulative) if in the previous 12 months no payments (dividends) nor repurchases have been made on any class of shares of the issuer</li> <li>■ The issuer must cancel interest (non cumulative) upon breach of minimum solvency margin (Solvency Event), unless payments have been made on any class of shares since the date of the Solvency Event</li> </ul> <p>N.B. In some countries, in the last two cases (optional deferral and mandatory deferral), interest shall not be paid in cash, but issuers have the option to pay the cancelled interest via <b>ACSM (Alternative Coupon Settlement Mechanism)</b>. ACSM usually authorizes 3 mechanisms of settlement, at the issuer's option:</p> <ul style="list-style-type: none"> <li>□ Issuance or sale of common shares, the proceeds of which are used to pay the deferred interest</li> <li>□ Issuance or sale of parity securities (parity securities are securities with the same characteristics than the Tier1 instruments of which interest are deferred), the proceeds of which are used to pay the deferred interest</li> </ul>	<p>In Solvency I, the recognition of this instrument is limited to 50% of the lower between available solvency margin and minimum required margin.</p> <p>These instruments have features which are market standard and which ensure that the important characteristics are met to be eligible for Tier 1. Without ambiguity these instruments show features which allow them to be classified as Tier 1 capital.</p> <p>With the current characteristics as described in the QIS 4 draft specification most instruments would however most likely be eligible for the Tier 2 or Tier 3 bucket only, dependent on how many years from the reporting date the step-up applies.</p> <p>For this instrument the step-up will apply within 10 years and the step-up is 100 bps. As a result, according to the QIS4 draft specifications, this instrument will be Tier3.</p> <p>We believe that the economic features of this instrument are insufficiently recognised as a result of this.</p>

Instrument	Commentary
<ul style="list-style-type: none"> <li>□ Payment in kind i.e. increase of the principal amount of the notes</li> </ul>	
<p><b>Example 2: Munich Re issued in 2007 €1.5 bn debt instruments with common features which classify for Tier 1</b></p> <p>Munich Re has issued instruments with the following characteristics:</p> <ul style="list-style-type: none"> <li>■ Status: deeply subordinated debt: senior to share capital, junior to senior and dated subordinated debt</li> <li>■ No temporary write down of principal</li> <li>■ Maturity = perpetual with customary 100bp step-up and call date after 10 years, subject to regulatory approval</li> <li>■ Gross-up, tax, regulatory, accounting and rating calls, all subject to regulatory approval</li> <li>■ The issuer has the option to defer interest payments if in the previous 12 months no dividends or other payments (including share buy backs) have been made on any class of shares of the issuer and no payments have been made in respect of any parity or junior securities</li> <li>■ Mandatory deferral: the issuer must defer interest payments in case of a Solvency Event or Mandatory Deferral Event</li> <li>■ Deferred interest may be paid only by way of funds which result from ACSM (Alternative Coupon Settlement Mechanism)</li> <li>■ ACSM: Issuing or selling Payment Shares (ordinary shares oder qualifying mandatory convertible bonds) and/or issuing Placement Securities (i.e. securities with at least equivalent equity credit from the regulator and the rating agencies as this bond)</li> </ul>	<p>This instrument has features which are market standard and which would ensure that the most important characteristics are met to be eligible for Tier 1.</p> <p>To our mind this instrument includes features which should allow the qualification as Tier 1 capital.</p> <p>With the current characteristics as described in the QIS 4 draft specification most instruments would however most likely be eligible for the Tier 2 or Tier 3 bucket only, dependent on how many years from the reporting date the step-up applies.</p> <p>For this instrument the step-up will apply within 10 years and the step-up is 100 bps. As a result, according to the QIS4 draft specifications, this instrument will be Tier3.</p> <p>We believe that the economic features of this instrument are insufficiently recognised as a result of this.</p>
<p><b>Example 3: Generali issued in 2007 £ 495 mln and €1.25 bn debt instruments with common features which classify for Tier1</b></p> <p>Generali has issued instruments with the following characteristics:</p> <ul style="list-style-type: none"> <li>■ Deep subordination: Subordinated to all of unsubordinated creditors (including obligation to policyholders) and to all less deeply subordinated obligation and senior to equity and all other Junior Securities</li> <li>■ Loss absorbency mechanism: the principal is written down in case of reduction of solvency margin below the required solvency margin and it has to be reinstated in case of winding up, dissolution, liquidation or bankruptcy of the Issuer, in case of early redemption of the Notes, in case of end of Solvency Margin Event</li> <li>■ Maturity: linked to company duration (currently, set at 2131 though if this is extended, redemption of the Notes will be equivalently adjusted) with customary 100 bps step-up after at least 10 year (the call date) subject to regulatory approval. Early redemption for regulatory and tax reasons, both subject to regulatory approval</li> <li>■ Optional deferral: The Issuer can avoid interest payment if during the 12 month (or 6 or 3 months) no dividend or other distribution has been declared, made, approved for payment in respect of any Junior Securities or Parity Securities and the Issuer has not redeemed, repurchased or acquired any Parity or</li> </ul>	<p>In Solvency I, the recognition of this instrument is limited to 50% of the lower between available solvency margin and minimum required margin</p> <p>These instruments are perpetual, deeply subordinated with a temporary write down provision (loss absorbency in on going concern), providing a restoring mechanism in case of restored solvency margin. In addition, the instrument has no fixed charges due to possibility for the issuer to defer interests that are non – cash cumulative.</p> <p>The features embedded in these instruments should definitely allow the Tier 1 classification under the Solvency II framework.</p> <p>With the current characteristics as described in the QIS 4 draft specification most instruments would however most likely be eligible for the Tier 2 or Tier 3 bucket only, dependent on how many</p>

Instrument	Commentary
<p>Junior Securities in the same period</p> <ul style="list-style-type: none"> <li>■ Mandatory deferral of interest: The Issuer is required to defer interest payment if a) a Regulatory intervention regarding the Issuer has occurred (breach of solvency margin) and is continuing on the payment date; b) a Mandatory deferral event has occurred (capital + earning tests)</li> <li>■ Non cash – cumulative: deferred interest can only be paid with proceeds raised through the ACSM mechanism (on a best effort basis), i.e. with the proceeds raised through (1) issuance of new shares of the Issuer and (2) issue new Junior or pari passu security, both with a cap</li> </ul> <p>The best effort of the Issuer under the ACSM lasts 5 years following the date on which deferred interest become payable under the terms and condition of the bond. If at the end of this period the Issuer has been unable to settle all deferred interests any outstanding deferred amount shall be cancelled.</p>	<p>years from the reporting date the step-up applies.</p> <p>For this instrument the step-up will apply within 10 years and the step-up is 100 bps. As a result, according to the QIS4 draft specifications, this instrument will be Tier3.</p> <p>We believe that the economic features of this instrument are insufficiently recognised as a result of this.</p>
<p><b>Example 4: Swiss Re issued in 2007, AUD 0.75bn and GBP 0.5bn debt instruments with common features which classify for Tier1</b></p> <p>Swiss Re has issued instruments with the following characteristics:</p> <ul style="list-style-type: none"> <li>■ Subordination: deeply subordinated</li> <li>■ Junior to Senior Obligations (obligations in respect of policies of insurance or reinsurance, trade accounts payable, any liability for income, franchise, real estate or other taxes owed or owing, unsubordinated and/or dated subordinated creditors and existing undated subordinated creditors), pari passu among themselves and with Parity Obligations, and senior to Junior Obligations (all classes of shares)</li> <li>■ Maturity: Perpetual, but redeemable at the option of the issuer</li> <li>■ Issuer call: non-callable for 10 years, subject to regulatory approval</li> <li>■ Interest: 100 bps coupon step-up, on a fixed-floating basis after 10 years</li> <li>■ Early Redemption Events: The Issuer may redeem the Notes in whole but not in part upon the occurrence of a a) Par Redemption Event or upon the occurrence of a b) Make Whole Redemption Event <ul style="list-style-type: none"> <li>□ Par Redemption Event: A Par Redemption Event means a redemption by the Issuer of the Notes at their principal amount together with any accrued interest at any time following a (a) Recalculation of Interest Event or (b) Special Tax Event</li> <li>□ A Make Whole Redemption Event means a redemption by the Issuer of the Notes at the Make Whole Amount at any time following (a) an Accounting Event, (b) a Regular Tax Event, (c) a Capital Event or (d) a Regulatory Event</li> </ul> </li> <li>■ Optional deferral of interest: Issuer has the option to defer in whole or in part the payment of interest if : no dividend, other distribution or payment was declared or made during the 12 months preceding the calculation date in respect of such interest payment date, and no redemption, repurchase or acquisition of junior securities or parity securities has been made either directly or indirectly during the 12 months preceding the calculation date in respect of such interest</li> </ul>	<p>In Solvency I, the recognition of hybrid capital is limited to 50% of the lower between available solvency margin and minimum required margin. In general eligibility of hybrid capital has been less of an issue than compared to the limits for hybrid capital.</p> <p>These financial debt instruments should qualify as upper additional capital under the Swiss Solvency Test (SST) and are subject to a limit of 100% core capital (net asset value). In the UK they are considered as tier 1 capital by the FSA.</p> <p>These instruments meet all the features required to qualify for tier 1 capital to a large extent. They are:</p> <ul style="list-style-type: none"> <li>• deeply subordinated,</li> <li>• loss-absorbing in going-concern (deferral of interest payments)</li> <li>• callable after 10 years and subject to regulatory approval,</li> <li>• have 100 bps coupon step-up, on a fixed-floating basis after 10 years</li> <li>• free from mandatory fixed charges and encumbrances</li> </ul> <p>With the current characteristics as described in the QIS 4 draft specification most instruments would however most likely be eligible for the Tier 2 or Tier 3 bucket only, dependent on how many years from the reporting date the step-up applies.</p> <p>For this instrument the step-up will apply within 10 years and the step-up is 100</p>

Instrument	Commentary
<p>payment date</p> <ul style="list-style-type: none"> <li>■ Required deferral of interest: The Issuer will be required to defer payments (1) if on an Interest Payment Date or a redemption date a Solvency Event has occurred or (2) if on an Interest Payment Date a Mandatory Deferral Event has occurred</li> <li>■ No write down of principal</li> <li>■ Settlement of optional or required deferral of interest: Optionally or mandatorily deferred amounts of interest will not themselves bear interest. Deferred interest payments may only be settled by way of the ACSM (Alternative Coupon Settlement Mechanisms)</li> <li>■ Settlement of deferred interest: non-cash cumulative</li> </ul>	<p>bps. As a result, according to the QIS4 draft specifications, this instrument will be Tier3.</p> <p>We believe that the economic features of this instrument are insufficiently recognised as a result of this.</p>
<p><b>Example 5: Allianz €1-3bn debt instruments with common features which classify for Tier1</b></p> <p>Allianz has issued instruments with the following characteristics:</p> <ul style="list-style-type: none"> <li>■ deep subordination, senior only to equity</li> <li>■ optional deferral if no dividends or other payments on share capital have been declared at the AGM immediately preceding that interest payment date and no such dividend or other payment has been declared since that AGM</li> <li>■ mandatory deferral if a Solvency Event has occurred</li> <li>■ deferred interest is payable only out of any freshly raised Tier 1 capital (core or non-core (hybrid Tier 1))</li> <li>■ no write-down of the principal amount</li> <li>■ Perpetual or long-dated with ordinary issuer call after min 10 years (max step-up 100bp) or ordinary issuer call after 5 years (no step-up)</li> </ul> <p>Extraordinary call rights subject to consent from the supervisory authority in case of a Gross-Up Event, a Tax Event, an Accounting Event and a Regulatory Event</p>	<p>These instruments have strong equity characteristics which should make these instruments eligible for Tier 1.</p> <p>However, when the draft QIS 4 criteria are applied, such as:</p> <ul style="list-style-type: none"> <li>■ Required write-down-feature for Tier 1 eligibility not included</li> <li>■ 100bp interest step-up not allowed in Tier 2</li> </ul> <p>this instrument could only qualify as Tier 3.</p>
<p><b>Example 6: Eureka program for the issuance of debt instruments (€ 500 mln issued in May 2005), perpetual nc 10; Innovative instrument</b></p> <p>Eureka has issued instruments with the following characteristics:</p> <ul style="list-style-type: none"> <li>■ Subordination: The securities will rank (i) senior to Eureka's outstanding Preference Shares and ordinary shares (II) pari passu among themselves and (III) junior to all other debt of the issuer (including all senior and subordinated debt)</li> <li>■ Full loss absorbency: Upon a breach of capital requirements, the Issuer may substitute the securities with non-cumulative preference shares having materially the same terms.</li> <li>■ Maturity: Perp NC 10 (perpetual non call 10)</li> <li>■ Coupon: The securities will make annual payments at a fixed rate of 5.125% up to the first call date, and then quarterly payments at a floating rate of 3-months Euribor + 280 bps thereafter (step-up is 100 bps)</li> <li>■ step up included in coupon as described before</li> <li>■ Deferral of interest Payments: <ul style="list-style-type: none"> <li>■ Mandatory Deferral: (i) prior to the Issuer becoming subject to consolidated supervision, mandatory deferral</li> </ul> </li> </ul>	<p>In Solvency I, the recognition of this instrument is limited to 50% of the lower between available solvency margin and minimum required margin.</p> <p>The Dutch supervisor indicates that both hybrid capital issues will qualify as regulatory capital (expected "Tier1" equivalent treatment), when the Issuer becomes subject to consolidated supervision. Therefore it is reasonable to expect that they will qualify as tier 1 in Solvency II.</p> <p>With the current characteristics as described in the QIS 4 draft specification this instrument would however most likely be eligible for the Tier 2 or Tier 3 bucket only.</p>

Instrument	Commentary
<p>in case the Issuer is not solvent, (ii) following the issuer becoming subject to consolidated supervision in case the issuer is not in compliance with the applicable Capital Adequacy Regulations.</p> <ul style="list-style-type: none"> <li>■ Optional Deferral: at any time at the issuer's discretion, subject to a dividend pusher</li> <li>■ Any deferral payments (either optional or mandatory) must be satisfied by the issuer by using the Alternative Coupon Settlement Mechanism (ACSM)</li> </ul>	
<p><b>Example 7: Eureka program for the issuance of debt instruments (€ 600 mln issued in November 2006, perpetual nc 6); non-innovative instrument</b></p> <p>Eureka has issued instruments with the following characteristics:</p> <ul style="list-style-type: none"> <li>■ Subordination: The securities will rank (i) senior to Eureka's outstanding Preference Shares and ordinary shares (II) pari passu among themselves and (III) junior to all other debt of the issuer (including all senior and subordinated debt)</li> <li>■ Full loss absorbency: Upon a breach of capital requirements, the Issuer may substitute the securities with non-cumulative preference shares having materially the same terms.</li> <li>■ Maturity: a. PerpNC6 (perpetual noncall 6)</li> <li>■ Coupon: The securities will make annual payments in arrears at a fixed rate of 6.0%.</li> <li>■ No provision for a step-up in the interest margin at any time.</li> <li>■ Deferral of interest Payments: <ul style="list-style-type: none"> <li>■ Mandatory Deferral: (i) prior to the Issuer becoming subject to consolidated supervision, mandatory deferral in case the Issuer is not solvent, (ii) following the issuer becoming subject to consolidated supervision in case the issuer is not in compliance with the applicable Capital Adequacy Regulations.</li> <li>■ Optional Deferral: at any time at the issuer's discretion, subject to a dividend pusher</li> <li>■ Any deferral payments (either optional or mandatory) must be satisfied by the issuer by using the Alternative Coupon Satisfaction Mechanism</li> </ul> </li> </ul>	<p>In Solvency I, the recognition of this instrument is limited to 50% of the lower between available solvency margin and minimum required margin.</p> <p>The Dutch supervisor indicates that both hybrid capital issues will qualify as regulatory capital (expected "Tier1" equivalent treatment), when the Issuer becomes subject to consolidated supervision. Therefore it is expected that they will qualify as tier 1 in Solvency II.</p> <p>The final outcome will depend on the concrete specification of "substantially met" (will 6 years be sufficient) regarding perpetuity (sufficient duration).</p> <p>Because of this restriction, this instrument would most likely be eligible for the Tier 2 or Tier 3 bucket only, according to the QIS 4 draft specification.</p>
<p><b>Example 8: Royal &amp; Sun Alliance debt instruments with common features which classify for Tier 1</b></p> <p>R&amp;SA has issued instruments with the following characteristics:</p> <ul style="list-style-type: none"> <li>■ Issued during 2006</li> <li>■ Status: deeply subordinated capital securities: senior to share capital, junior to senior, dated subordinated and perpetual cumulative subordinated debt)</li> <li>■ No write down of principal</li> <li>■ No maturity. Perpetual instrument with step-up that was equivalent to 100bp at issue date (step-up is from a fixed rate to a floating rate) 10 years after issue. First call date 10 years after issue, subject to regulatory approval.</li> <li>■ Mandatory deferral: the issuer must defer interest payments if solvency condition is not met at or immediately after payment.</li> </ul>	<p>In Solvency I is classified as Innovative Tier 1 under the UK FSA's rules.</p> <p>This instrument conforms to normal UK standards, including the absence of provisions to write down principal. It is fully loss-absorbent, in that there can be no cash outflows from the issuer in respect of this instrument while the issuer is undergoing a 'solvency event'.</p> <p>This instrument should qualify as Tier 1 but the absence of lock-in or principal write-down would appear to disqualify it despite its other loss-absorbent features.</p>

Instrument	Commentary
<ul style="list-style-type: none"><li data-bbox="188 264 986 324">■ Deferred coupons may be satisfied only through ACSM (Alternative Coupon Settlement Mechanism)</li><li data-bbox="188 324 986 421">■ Dividend stopper: ordinary dividends shall not be paid to equity shareholders while any coupons are being deferred on this instrument.</li></ul>	

**TABLE 2: OVERVIEW OF BASIC OWN FUNDS – TIER 2**

Instrument	Commentary
<p><b>Example 1: AXA €7.0bn debt instruments with common features which classify for Tier 2</b></p> <p>AXA has issued instruments with the following characteristics:</p> <ul style="list-style-type: none"> <li>■ Ordinary subordination (junior to senior creditors, but senior to deeply subordinated debt)</li> <li>■ Maturity = perpetual or long-dated (&gt; 10 years) with customary 100bp step-up and call date after 10 or more years, subject to regulatory approval</li> <li>■ Customary tax, regulatory, accounting calls, all subject to regulatory approval</li> <li>■ The issuer has the option to defer interest payments (cumulative) (i) if the relevant regulator asked to restore any applicable minimum solvency margin at group level or in respect of any principal subsidiary, or (ii) if in the previous annual general meeting no dividend was declared on any class of shares of the issuer</li> </ul>	<p>In Solvency I, the recognition of this instrument is limited to 50% of the lower between available solvency margin and minimum required margin for non dated instruments, and limited to 25% of the lower between available solvency margin and minimum required margin for dated instruments,</p> <p>These instruments have features which are market standard and which ensure that the important characteristics are met to be eligible for Tier 1.</p> <p>We believe that these instruments should not qualify for Tier 1 because of the cumulative deferral in cash and because some of them are dated. However, these instruments are long-dated and show features which should qualify them as Tier2 instruments.</p> <p>We do however believe that this instrument is eligible for the Tier 2 bucket, but given the current characteristics of the QIS 4 draft specification, this instrument could well fall under the Tier 3 bucket.</p>
<p><b>Example 2: Munich Re issued in 2003 a) €3 bn 20 years, step-up after 10 years; b) GBP 0.3 bn 25 years, step-up after 15 years debt instruments with common features which classify for Tier2</b></p> <p>Munich Re has issued instruments with the following characteristics:</p> <ul style="list-style-type: none"> <li>■ Junior to senior creditors, but senior to undated subordinated debt</li> <li>■ Maturity = long-dated (20/25 years) with customary 100bp step-up and call date after 10/15 years, subject to regulatory approval</li> <li>■ Customary tax, gross-up call, (subject to regulatory approval) and regulatory call</li> </ul> <p>The issuer has the option to defer interest payments (cash cumulative), if no dividends or other payments have been declared at the AGM immediately preceding that interest payment date and no such dividend or other payment has been declared since that AGM.</p>	<p>We believe that these instruments should not qualify for Tier 1 because of the cumulative deferral in cash and because they are dated. However, these instruments are long-dated and show features which should qualify them as Tier2 instruments.</p> <p>We do however believe that this instrument is eligible for the Tier 2 bucket, but given the current characteristics of the QIS 4 draft specification, this instrument could well fall under the Tier 3 bucket.</p>
<p><b>Example 3: If P&amp;C Insurance €0.2bn debt instruments with common features which classify for Tier2</b></p> <p>If P&amp;C Insurance has issued instruments with the following characteristics:</p> <ul style="list-style-type: none"> <li>■ Junior to senior creditors, but senior to undated subordinated</li> </ul>	<p>In Solvency I, the recognition of this instrument is limited to 25% of the lower between available solvency margin and minimum required margin.</p> <p>We believe that these instruments should</p>

<p>debt</p> <ul style="list-style-type: none"> <li>■ Maturity; Long-dated (20 years) with customary 100 bp step-up and call date after 10 or more years, subject to regulatory approval</li> <li>■ Customary tax, law and regulatory calls, subject to regulatory approval</li> <li>■ The issuer has the option to defer interest payment (cash cumulative) if the Issuer would not or there is a risk that the issuer would not meet the minimum solvency margin. Issuer not allowed to pay dividends or other amounts on any class of share capital until all deferred interest has been repaid</li> </ul>	<p>not qualify for Tier 1 because of the cumulative deferral in cash and because they are dated. However, these instruments are long-dated and show features which should qualify them as Tier2 instruments.</p> <p>We do however believe that this instrument is eligible for the Tier 2 bucket, but given the current characteristics of the QIS 4 draft specification, this instrument could well fall under the Tier 3 bucket.</p>
<p><b>Example 4: Generali issued, respectively, in 1999 and 2000, €0.5bn and €0.75bn debt instruments with common features which classify for Tier2</b></p> <p>Generali has issued instruments with the following characteristics:</p> <ul style="list-style-type: none"> <li>■ Subordination: junior with respect to all unsubordinated unsecured creditors and at least pari passu with all other present and future unsecured dated subordinated obligations and in priority to all present and future unsecured undated obligations and further in priority to the claims of shareholders of the Issuer;</li> <li>■ Maturity: 20 years maturity with 100 bps step up and call date after at least 10 years, subject to regulatory approval. Early redemption for regulatory and tax reasons, both subject to regulatory approval.</li> <li>■ Optional deferral: the Issuer has the option to defer interest payment in case of no dividend declared at the last Shareholder’s General Meeting of Assicurazioni Generali before the coupon payment date and a “Regulatory Intervention”(request from any relevant supervisory authority to restore the applicable solvency margin, solvency requirement, adjusted solvency or capital adequacy level) has occurred and no dividend distribution has been declared since the date on which such regulatory intervention occurred.</li> <li>■ Cumulative interest deferral: deferred interests are cumulative and paid in cash.</li> </ul>	<p>In Solvency I, the recognition of this instrument is limited to 25% of the lower between available solvency margin and minimum required margin</p> <p>These instruments are senior to deeply subordinated debt but junior to all senior creditors (including policyholders), long dated (more than 10 years) with a limited step – up of 100 bps after 10 years, subject to regulatory approval, with cash cumulative interest deferral.</p> <p>We believe that these instruments do not meet all necessary requirements for Tier 1 qualification but due to the long dated nature, subordination and interest deferral, they should be treated as Tier 2 capital.</p> <p>We do however believe that this instrument is eligible for the Tier 2 bucket, but given the current characteristics of the QIS 4 draft specification, this instrument could well fall under the Tier 3 bucket.</p>
<p><b>Example 5: Allianz €4-6bn debt instruments with common features which classify for Tier2</b></p> <p>Allianz has issued instruments with the following characteristics:</p> <ul style="list-style-type: none"> <li>■ simple subordination, senior to equity and deeply subordinated debt, junior to senior debt</li> <li>■ optional deferral if no dividends or other payments on share capital have been declared at the AGM immediately preceding that interest payment date and no such dividend or other payment has been declared since that AGM</li> <li>■ deferred interest is cash cumulative</li> <li>■ no write-down of the principal amount</li> <li>■ Perpetual or long-dated with ordinary issuer call after 5 years (max step-up 100bp)</li> </ul> <p>Extraordinary call rights subject to consent from the supervisory</p>	<p>Despite its significant equity characteristics, this instrument could only qualify as Tier 3 at best, according to the QIS 4 draft specification. Given the features of this instrument, we believe this instrument should be eligible for Tier 2 rather than Tier 3.</p>

authority in case of a Gross-Up Event, a Tax Event, an Accounting Event and a Regulatory Event	
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## 4. Key marketability requirements

### Instruments need to be marketable

- 4.1 The current proposals of the QIS 4 specification raise some serious concerns both in respect of current outstanding hybrid issues (grandfathering possibilities) and in respect of refinancing possibilities for the insurance industry. In most markets, most insurance hybrids identified would qualify for Tier 3 only, with proposed QIS 4 rules. This is explained by the limited recognition of step-up coupons (measured from reporting date and stringent requirements for Tier 2, see sections below). This would imply that the industry would need to issue debt which would be less appealing for potential investors or would need to issue debt which would incur significant additional costs which would be passed on to policyholders.
- 4.2 Our empirical study confirms that the majority of the instruments currently used in the market include many common features (e.g. perpetuity, deep subordination, step-up with calls not before than 10 years after the issue date and early redemption features) and allow the use of deferral of coupons, either optionally and/or mandatory and non-cash cumulative or non-cumulative. The main differences are related to the issuance structures and specific loss absorption clauses.
- 4.3 Some of the proposed changes may not have the effects intended and may mean that many traditional fixed income investors can no longer invest in Tier 1 hybrid and even certain Tier2 hybrid instruments become unattractive. The change in definitions could potentially have a significant impact on the way insurance and reinsurance undertakings finance their business in the future as it would constrict the potential range of investors and would add further costs.
- 4.4 It is essential not to place unnecessary restrictions on the types of capital instruments firms can raise when under stress, i.e. through strict lock-ins, nor to restrict potential capacity by narrowing the range of investors who could participate.
- 4.5 The paragraphs below provide an overview of the requirements we believe are essential to ensure that instruments are marketable. Some of the requirements are indeed captured in the QIS 4 draft specification, but a number of requirements are not.

### We agree with the proposed requirements on perpetuity

- 4.6 According to the QIS 4 draft specification, the item must be perpetual or of sufficient duration (i.e. linked to the maturity of the insurance liabilities or of the company itself) and redemption is allowed, only if the item is replaced by an item with (at least) equivalent quality. This requirement needs to be met to a substantial degree and CEIOPS' interpretation of this is that for instruments in order to be tier 1/tier 2, the maturity must be at least 10 years/5 years. We believe that, in general, these requirements are reasonable.
- 4.7 Issuing perpetual instruments in the market is difficult in practice. There are fixed income investors that are allowed to invest in perpetual debt, but this investor base is relatively small especially compared to the broad investor base for hybrids with step-ups. This could lead to the situation where the price will be dictated by a small number of investors. For this reason, we support the proposals of QIS 4 on perpetuity, whereby the requirements have been set at realistic levels.

### Write-down features should not be mandatory

- 4.8 According to TS.V.C.7, hybrids or subordinated liabilities must be able to be written down or converted into equity in time of stress, notwithstanding a possible write up in case of subsequent profits. We believe that these requirements do not provide relevant security/quality but do increase costs of raising hybrid capital significantly, which we have explained in more detail in Appendix B.

### Trigger points which would lead to write down of principal need to be set at realistic levels

- 4.9 We understand that the precise level of losses which would trigger conversion or write down of hybrids or subordinated debt is still under discussion (TS.V.C.8), but to ensure that these instruments are marketable, the trigger point would need to be set at an MCR level rather than a SCR level. The latter would imply that the likelihood to convert or write down would be higher, making these instruments less appealing to traditional investors.
- 4.10 Insurance and reinsurance undertakings aim to have a high proportion of long-term fixed-income fund managers holding their hybrid instruments, rather than hedge funds and others. However, some features might make it difficult for traditional investors to participate.
- 4.11 Instruments that are convertible into equity on certain triggers (i.e. the SCR) could probably be inaccessible to mainstream fixed-income funds managers and might encourage equity arbitrage investors such as convertibles hedge funds. This would make these instruments very unattractive to issuers, and arguably less attractive from a long-term regulatory perspective.
- 4.12 For completeness, we would like to note that the trigger point in most of the bonds in the markets is linked to the Required Solvency Margin, which would be compared to the MCR under the future Solvency II regime.

### To ensure the placement of hybrids, step-up coupons after 10 years from the issue date must be allowed

- 4.13 Being able to include step-ups (e.g. up to 100bp) is important to make perpetual instruments accessible to conventional fixed income investors. Step-ups are customary in the fixed income market and they are a key feature to ensure the placement of hybrid instruments to investors. Most of the step-ups occur after the 10<sup>th</sup> anniversary after the issue date because the scope of investors reduces largely above 10 years.
- 4.14 Similarly, innovative instruments should also be allowed as tier 1 capital as long as the step-up is relatively limited (maximum between 100 bp and half of the spread at issue) and should not occur earlier than 10 years after the issue date. Those characteristics are in line with the Basel II requirements. For further information please see Appendix A.
- 4.15 In the QIS4 specification, the perpetuity/long duration is seen in relation to the reporting date rather than the issue date. Accordingly instruments with step-ups to be eligible for Tier 1/Tier 2 capital the QIS4 specification suggests that the item must have a duration of at least 10/5 years as seen from the reporting date. That would, for example, imply that a perpetual instrument issued in 2010 with a step-up in 2022 (12 years) will count as tier 1 capital from 2010, as tier 2 from 2012 and as tier 3 from 2017 (assuming the other characteristics are met).
- 4.16 This would in practice imply that most of the debt instruments would not be eligible for the Tier1 bucket. Step-ups are customary in the fixed income market and they are absolutely necessary to ensure the placement of hybrid instruments to investors. Most of the step-ups occur after the 10th anniversary after the issue date because the scope of investors reduces largely above 10 years, even if some step-ups after 12 years or even 15 years can be found in the market, especially in the Sterling market. The consequence of the current interpretation of QIS 4 on a bond issued with a step-up after 10 years is that a few days after being issued this instrument no more qualify as Tier1.
- 4.17 We believe these requirements are not necessary if the increase of the step-up is moderate (i.e. maximum of 100 bps or 50% of initial credit spread) as in times of financial distress, the issuer will not call the bond in any case: firstly, because it will not be allowed to do so by the regulator and secondly because at that time the cost of funding will likely increase by more than 100 bps.

- 4.18 These requirements would in addition, introduce an unfair competition with banks for whom the maturity is seen in relation to the issue date. This would imply that there are no incentives to issue perpetual bonds compared to dated instruments, which would in practice imply that the hybrid bond market would be reserved to banks only. Insurance companies would be excluded from this market because they would not receive an appropriate treatment in line with the cost associated to the issue of an hybrid instrument (investors claim for a higher spread to compensate the additional risk involved with the investment in a perpetual bond compared to dated).

#### **It seems illogical to put more stringent requirements on step-ups for Tier 2 instruments compared to Tier 1 instruments**

- 4.19 According to the QIS 4 specification, the step-up of an instrument in order to be eligible for Tier 1, must not exceed a prescribed level which is 100 bps or 50% of initial credit spread. In order to be eligible for Tier 2, the step-up must not exceed 50 bps or 50% of initial credit spread. This implies that the requirements in order to be eligible for Tier 2 are more stringent than for Tier 1, which seems to be illogical. We would therefore suggest to make the requirements of Tier 2 to be in line with the Tier 1 requirements, i.e. set the prescribed level at 100 bp rather than 50 bp.
- 4.20 In addition we would expect that the requirement should be such that the maximum of 100 bp or 50% of the initial credit spread is not exceeded.

#### **We strongly support the allowance of write-ups**

- 4.21 The presence of a loss absorption clause with the write-down features provides some financial flexibility to absorb losses in times of financial distress in addition to deferral of interest. However, such write-down provision is temporary and permits a write-up of principal when the issuer has restored solvency and/or has realised a balance sheet again (i.e. equity > 0). This allows investors to recover their investment when the issuer recovers from financial distress. Write down features may have unwanted tax implications for undertakings.
- 4.22 A permanent write-down of principal subordinates theoretically fixed income investors to equity investors who would subsequently be able to participate in future profits through share price appreciation following a capital reduction. This will prevent many fixed income investors from participating in this market at all or at least will reduce their appetite for this kind of instruments. Write-down features raise in general costs of capital instruments and restrict volumina of raising capital.
- 4.23 We strongly support CEIOPS interpretation that write-ups are allowed in case profits are realised (TS.V.C.7).

#### **Payments through alternative cash settlement mechanism (“ACSM”) must be allowed**

- 4.24 One of the characteristics which need to be met in order to be eligible for Tier 1 or Tier 2 is the absence of mandatory fixed charges requirement. We agree in principle, but the key characteristic should be that alternative payments can replace cash payments as this ensures that during distressed periods the funds available to protect policyholders are not reduced. These alternative payments should not be limited to stock only (TS.V.I.8) as most bond investors cannot invest in equity and therefore this could prevent many fixed income investors from participating in the market of hybrids. Alternative payments through alternative cash settlement mechanisms (ACSM), such as:

- Proceeds raised through the issuance of Parity or junior securities (issue of new Tier 1 instrument of the same kind or new shares of the Issuer/Guarantor) or
- Payment in kind (increase of the principal) which do not affect policyholder protection (because they are subordinated and do not result in cash exiting the company)

must be allowed. The empirical analysis shows that ACSM's are common practice.

### Importance of grandfathering

- 4.25 Most insurers have issued instruments in the past, with long or perpetual maturities and insurers and their policyholders cannot change these instruments to meet new Solvency II criteria. The application of new criteria for existing instruments may change the effectiveness and usefulness of such instruments for solvency purposes.
- 4.26 Changes are potentially extreme in terms of impact; according to the current definitions many/most hybrid capital would become tier 3 capital as especially the requirement "loss absorption in going concern" is not always met and the requirement that the item is free from incentives to redeem the nominal amount is not met, if allowance of step-up coupons are linked to the reporting date.
- 4.27 The analysis above demonstrates both the importance of grandfathering and the need to allow for the impact of any rule changes on the existing market for these instruments.
- 4.28 Grandfathering should be applicable to all instruments which have been placed in the market before the date when the Solvency II framework is approved in the European Parliament.
- 4.29 In our view, grandfathering should be granted to all instruments issued under the current insurance legislation and before the date of approval of the Solvency II framework by the European Parliament, in such a way that (i) instruments previously included up to the 25% of the lower between the available solvency margin and minimum required margin are treated as Tier 2 and, symmetrically, (ii) instruments previously falling within the limit of 50% of the lower between available solvency margin and minimum required margin are treated as Tier 1, both until the first call date or final maturity in case of dated instruments with bullet maturity.
- 4.30 In some countries current hybrid capital issued by insurance companies has in principle been structured according to the existing banking tier 1 guidelines. Hybrid capital meeting those banking tier 1 requirements and issued before the date of approval of the Solvency II framework by the European Parliament should via the grandfathering regime also qualify for Solvency II Tier 1.
- 4.31 Both proposals aim at maintaining the current distinction between perpetual subordinated instruments or liabilities as opposed to dated subordinated instruments or liabilities by transposing it into the proposed tiering system. In addition, this will ensure cross-border harmonization of the treatment of current and future hybrid instruments.

## Appendix A: Step-up coupons

### Issue at stake

Step-ups are upgrades (usually from 100-150bp) of the coupon of a bond or of a note paid by the issuer to investors after a call date.

These upgrades are customary in the fixed income market including debt issued by banks and insurers. These upgrades are necessary to ensure the placement of hybrid instruments to investors. Perpetual bonds without step-up do exist, but they are rare, much more difficult to sell and far more expensive for the issuer (around 50-100bp higher spread).<sup>1</sup>

If too high or too early, such step-ups might be seen as incentives for the issuer to early redeem a hybrid bond.

### Analysis of the problem

If not too high, nor too early, step-ups should not change the classification of an element of capital among Tiers for the following reasons:

- **The call is optional, not compulsory**, so the issuer still keeps the flexibility to redeem or not to redeem the bond at the call date. Under ongoing conditions, the issuer would exercise its call option only if market conditions allow him to refinance itself at a lower cost than the new stepped-up coupon. Under stressed conditions, it is very likely that refinancing conditions will be more expensive for the issuer than the legal step-up coupon, so it is very likely that the bond will not be redeemed.
- **The order of magnitude of step-ups (usually from 100-150bp) is lower than the market moves** it can be observe in the interest rate markets over several years. In other words, step-ups do not encourage the issuer to redeem more than a fixed-rate coupon without step-up would do in a declining interest rates environment, nor than a floating-rate coupon without step-up would do in a rising interest rates environment.
- **If regulatory approval is required before redemption or if the bonds embed an explicit replacement language clause<sup>2</sup>**, the regulator can get comfort about the solvency of the issuer before redemption, independently from the existence of a step-up. From a regulatory point of view, this situation is better than the use of its share buy-back program by the issuer.

### Possible solution

A possible solution is that step-ups do not change the classification that an element of capital would have gotten without step-up, as soon as two criteria are matched:

- **step-up do not exceed the maximum between 100bp and half of the spread at issue<sup>2</sup>; and**
- **step-up do not occur earlier than 10 years<sup>3</sup> after the issue date**

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<sup>1</sup> The following empirical example provides an indicative differential in pricing if step-ups are applied:

In November 2006, AXA issued two tranches in the US market:

- \$750 million Perpetual subordinated Notes callable in 2018 (12 years) without step-up, issued at T-Bond+198bp (coupon 6.463%)
- \$750m Perpetual subordinated Notes callable in 2036 (30 years) with a 100bp step-up in 2036, issued at T-bond+178bp (coupon 6.379%)

The pricing of the 30-year step-up note was 20bp tighter in Libor terms than the new issue pricing on AXA's 10-year step-up deal done in the Euro markets in June, from which it can be deduced that the implied cost of non-step-up versus step-up was approximately 40bp (=198-178+20bp).

<sup>2</sup> Such clauses state explicitly than early redemption of the issue is allowed only the issuer raised an equivalent amount of capital of same or better quality in the previous months

<sup>3</sup> Under Basel II, these two criteria must apply to qualify as Tier1 debt for a bank

## Appendix B: Write down should not be mandatory for tier 1

We believe write-down features should be optional rather than mandatory in order to qualify for tier 1. Mandatory write down features does not provide relevant additional security/quality whilst these do increase capital raising costs significantly making hybrid capital less favourable in comparison to pure equity.

Arguments against a mandatory (temporary) write-down language:

- Write-down language is **not needed to meet the requirements of Art. 92** of the draft Solvency II regulation or the proposed changes thereof according to the draft QIS4 Technical Specification (TS.V.C.5).
- Write-down language, where it currently exists, differs widely across the various jurisdictions. Nevertheless, write-down language per se **does not significantly improve the quality of hybrid capital**. It does neither generate new cash for a troubled institution, nor is it required to preserve cash for such an institution (coupon deferral and the prevention of any repayment are sufficient).
- In addition, any write-down **leaves the Tier 1 ratio unchanged** as hybrid Tier 1 is reduced to the benefit of (theoretical) profits, or rather lower losses. We view such a theoretical improvement of core Tier 1 at the hand of lower Tier 1 in the form of hybrid capital as a mere **regulatory accounting exercise that does not improve the position of policyholders**.
- Write-down language **complicates the terms and conditions of hybrid capital** if investors are not familiar with banking instruments. Clearly defined standard coupon deferral and mandatory regulatory approval prior to any redemption are standard features that are, in our view, absolute sufficient to fully address the required feature of loss-absorbency in going-concern.

Note that a potential conversion into equity is not a practical alternative since the investment guidelines of the majority of hybrid capital investors prevents investments in convertible instruments. Conversion into stocks dilutes share prices. In addition, there is the risk that investors sell shares once which would have a big impact on share prices.

### Cost Impact

#### Market

- Due to the multiple possible variations in the write-down language it is hard **to exactly define the pricing impact** on hybrid capital. In addition, the cost of write-down language clearly depends on the likelihood of a write-down actually occurring, i.e. the **cost will vary for issuers with differing credit quality**.
- As a **rough estimate** of the cost impact of write-down language (e.g. as it is currently required for German bank solo Tier 1 capital), we would estimate an increase in costs of approximately 0.20-0.40% p.a. for a strong-rated issuer. In case of the standard maturity format, i.e. perpetual non-call 10 year format, this would equate to discounted costs of approximately **1.4% - 2.8% of the nominal amount**.

#### Tax

- In Germany, and according to our understanding also in other jurisdictions, write-down language is **likely to have a negative impact on tax deductibility of coupons** on hybrid capital.
- Assuming a cost of hybrid capital of 5.00%-6.00% p.a., and an average tax rate of 30%, non-deductibility of interest on hybrid capital would lead to an increase of costs of 1.5%-1.8% p.a. In case of the standard maturity format, i.e. perpetual non-call 10 year format, this would equate to discounted costs of approximately **10.5% - 12.6% of the nominal amount**.

## Appendix C: QIS4 Proposal vs Rating Agency Requirements

### Loss Absorption and Discretion over Coupon Payments Are Key Areas of Discrepancy

#### What are the Differences between Tier 2 Basic and Ancillary Own Funds? If Adopted As Per QIS4 - Both Likely to Receive the Same Equity Credit

	Tier 1	Tier2-basic own funds (UT2 equiv)	Tier 2 –ancillary own funds (LT2 equiv)
Subordination	<ul style="list-style-type: none"> <li>■ The total amount of the item must be subordinated to all claims of policyholders and all other senior creditors (incl. T2)</li> <li>■ Same as above</li> <li>■ Same as above</li> <li>■ Same as above</li> </ul>	<ul style="list-style-type: none"> <li>■ The total amount of the item must be subordinated to all claims of policyholders and all other senior creditors (incl. Lower T2)</li> <li>■ Same as above</li> <li>■ Same as above</li> <li>■ Same as above</li> </ul>	<ul style="list-style-type: none"> <li>■ The total amount of the item must be subordinated to all claims of policyholders and all other senior creditors</li> <li>■ LT2 equiv. instruments received no equity credit</li> <li>■ LT2 equiv. instruments received no equity credit</li> <li>■ LT2 equiv. instruments received no equity credit</li> </ul>
Loss Absorption	<ul style="list-style-type: none"> <li>■ Must be able to absorb any losses permanently either because it is common equity or at a pre-determined trigger point (1) by means of a write down of the principal amount or (2) through conversion into common equity or settlement exclusively in stock</li> <li>■ Moody's does not award additional equity credit if a write-down feature is present (i.e. write-down is irrelevant)</li> <li>■ S&amp;P does not award additional equity credit if a write-down feature is present (i.e. write-down is irrelevant)</li> <li>■ Fitch DOES award some additional equity credit if write-down feature is present (limited to move from 25%-50% and from 50%-75%, not for 0-25% and 75%-100%)</li> </ul> <p><b>None of the rating agencies requires conversion into ordinary shares</b></p>	<ul style="list-style-type: none"> <li>■ For Tier 2 basic own funds items this characteristic is not mandatory</li> <li>■ Same as in "Tier 1" column</li> <li>■ Same as in "Tier 1" column</li> <li>■ Same as in "Tier 1" column</li> </ul>	<ul style="list-style-type: none"> <li>■ Must be able to absorb any losses permanently either because it is common equity or at a pre-determined trigger point (1) by means of a write down of the principal amount or (2) through conversion into common equity or settlement exclusively in stock; must not hinder the <i>recapitalisation</i> of the insurer</li> <li>■ LT2 equiv. instruments received no equity credit</li> <li>■ LT2 equiv. instruments received no equity credit</li> <li>■ LT2 equiv. instruments received no equity credit</li> </ul>
Maturity	<ul style="list-style-type: none"> <li>■ Must be undated or of sufficient duration in relation to the insurance obligations it covers (i.e. must have a duration of at least 10 years from reporting date); and must be contractually locked in at a pre-determined trigger point (i.e. redemption is postponed), where redemption is only allowed if the item is replaced by an item of capital of equivalent quality or if the supervisory authority has given prior approval</li> <li>■ 30 years maturity<sup>4</sup> is sufficient and 50 years tantamount to perpetuity; Moody's requires mandatory replacement capital (in form of a legally binding Replacement Capital Covenant) only if high equity content (e.g., 75%) is sought. Although recognises regulatory oversight it is not a key factor</li> <li>■ Minimum 20 year effective maturity is required to receive any equity credit at S&amp;P. S&amp;P does not require mandatory replacement capital feature for regulated entities. S&amp;P takes high comfort from regulatory oversight</li> <li>■ Minimum 20 year effective maturity is required to receive any equity credit at Fitch; takes very high comfort form regulatory oversight (to the extent that even a dated instrument the redemption of which is subject to regulatory approval can be viewed as undated; very negative on mandatory capital replacement provisions</li> </ul>	<ul style="list-style-type: none"> <li>■ Must be of sufficient duration in relation to the insurance obligations it covers (i.e. must have a duration of at least 5 years from reporting date); and must be contractually locked in at a pre-determined trigger point (i.e. redemption is postponed), where redemption is only allowed if the item is replaced by an item of capital of equivalent quality or if the supervisory authority has given prior approval</li> <li>■ Same as in Tier 1 column</li> <li>■ Same as in Tier 1 column; in addition if the step-up is and call feature are before year 10 legally binding RCC will be required</li> <li>■ Same as in Tier 1 column</li> </ul>	<ul style="list-style-type: none"> <li>■ Must be of sufficient duration in relation to the insurance obligations it covers (i.e. must have a duration of at least 10 years from reporting date); and must be contractually locked in at a pre-determined trigger point (i.e. redemption is postponed), where redemption is only allowed if the item is replaced by an item of capital of equivalent quality or if the supervisory authority has given prior approval</li> <li>■ LT2 equiv. instruments received no equity credit</li> <li>■ LT2 equiv. instruments received no equity credit</li> <li>■ LT2 equiv. instruments received no equity credit</li> </ul>

■ QIS 4 Report

■ Moody's

■ S&P

■ Fitch

<sup>4</sup> Combination of the call date and a step-up determine the effective maturity

## QIS4 Proposal vs Rating Agency Requirements

### Loss Absorption and Discretion over Coupon Payments Are Key Areas of Discrepancy

What are the Differences between Tier 2 Basic and Ancillary Own Funds? If Adopted As Per QIS4 - Both Likely to Receive the Same Equity Credit

	Tier 1	Tier2-basic own funds (UT2 equiv)	Tier 2 –ancillary own funds (LT2 equiv)
<b>Free from Incentives to Redeem</b>	<ul style="list-style-type: none"> <li>■ Must be free from any requirements to redeem the item; free from any incentives to redeem (i.e. step-ups must not apply before 10 years from reporting date and must not exceed a prescribed level (100 bps or 50% of initial credit spread))</li> <li>■ Moody's allows Issuer's Call from year 5 onwards; moderate step-ups allowed (100bps; 50% of initial credit spread not allowed – e.g. in wide credit spread environment)</li> <li>■ S&amp;P allows Issuer's Call from year 5 onwards; moderate step-ups allowed (100bps; 50% of initial credit spread not allowed – e.g. in wide credit spread environment)</li> <li>■ Fitch allows Issuer's Call from year 5 onwards; moderate step-ups allowed (100bps; 50% of initial credit spread not allowed – e.g. in wide credit spread environment)</li> </ul>	<ul style="list-style-type: none"> <li>■ Must be free from any requirements to redeem the item; free from any incentives to redeem (i.e. step-ups must not apply before 5 years from reporting date and must not exceed a prescribed level (50 bps))</li> <li>■ Same as in the "Tier 1" column</li> <li>■ Same as in the "Tier 1" column</li> <li>■ Same as in the "Tier 1" column</li> </ul>	<ul style="list-style-type: none"> <li>■ Must be free from any requirements to redeem the item; free from any incentives to redeem (i.e. step-ups must not apply before 10 years from reporting date and must not exceed a prescribed level (100 bps or 50% of initial credit spread))</li> <li>■ LT2 equiv. instruments received no equity credit</li> <li>■ LT2 equiv. instruments received no equity credit</li> <li>■ LT2 equiv. instruments received no equity credit</li> </ul>
<b>Absence of Mandatory Fixed Charges</b>	<ul style="list-style-type: none"> <li>■ At a pre-determined trigger point based on the firm's MCR, any coupons must be: able to be cancelled; or able to be deferred for an indefinite term, where coupons are non-cash cumulative and can only be settled in stock</li> <li>■ Full discretion required on non-cash cumulative basis; ACSM cannot be deferred indefinitely (application after 5 years or otherwise deferred coupons need to rank <i>pari passu</i> with equity in liquidation); negative on dividend pushers (max 6M look-back provisions to receive 50% equity credit)</li> <li>■ Full discretion required on non-cash cumulative basis for up to 10 years; negative on immediate application of ACSM (almost disincentive to defer in first place); less negative on dividend pushers</li> <li>■ Full discretion required on non-cash cumulative basis; ACSM allowed; negative on look back provisions</li> </ul>	<ul style="list-style-type: none"> <li>■ At a pre-determined trigger point based on the firm's MCR, any coupons must be: able to be cancelled; or able to be deferred for an indefinite term. Unclear (non-specification) whether cash or non-cash settlement required</li> <li>■ Cash cumulativeness allowed</li> <li>■ Cash cumulativeness allowed</li> <li>■ Cash cumulativeness allowed</li> </ul>	<ul style="list-style-type: none"> <li>■ At a pre-determined trigger point based on the firm's MCR, any coupons must be: able to be cancelled; or able to be deferred for an indefinite term, where coupons are non-cash cumulative and can only be settled in stock</li> <li>■ LT2 equiv. instruments received no equity credit</li> <li>■ LT2 equiv. instruments received no equity credit</li> <li>■ LT2 equiv. instruments received no equity credit</li> </ul>
<b>No Encumbrances</b>	<ul style="list-style-type: none"> <li>■ No guarantees and set-off rights</li> <li>■ Same as above</li> <li>■ Same as above</li> <li>■ Same as above</li> </ul>	<ul style="list-style-type: none"> <li>■ No guarantees and set-off rights</li> <li>■ Same as above</li> <li>■ Same as above</li> <li>■ Same as above</li> </ul>	<ul style="list-style-type: none"> <li>■ No guarantees and set-off rights</li> <li>■ Same as above</li> <li>■ Same as above</li> <li>■ Same as above</li> </ul>
	Basket C/D Possible Basket C/D Possible	Basket B	Basket A
	Up to 33% of ACE	Up to 12% of ACE	No Equity Credit
	<b>Tier 1</b>	<b>Tier2-basic own funds (UT2 equiv)</b>	<b>Tier 2 –ancillary own funds (LT2 equiv)</b>
	■ QIS 4 Report	■ Moody's ■ S&P	■ Fitch

## Appendix D: Solvency I

### Instruments eligible to cover the current solvency margin

The elements currently used to cover the solvency margin are

- a. Share capital including member's accounts
- b. In case of a mutual member's accounts can be included. Those accounts should be statutory and of subordinated nature
- c. After approval by the supervisor part of the "obligo" (unpaid share premium) can be included as available capital after approval by the supervisor. The maximum percentage will be 50% of minimum (available solvency margin, required solvency margin) if at least 25% of share capital has been paid
- d. Reserves: share premium, revaluation reserve, legal and statutory reserves and other reserves
- e. Retained earnings
- f. Supplementary capital that mutual companies working in Non-Life business can ask from their members on a statutory basis. Maximum is 50% of the (maximum contribution minus amounts required) and 50% of minimum (available solvency margin, required solvency margin)
- g. Additional values linked to a low valuation of assets or based on profit expectations from life insurance companies. Approval by the supervisor is required. At maximum 50% of additional value based on profit expectations of life insurance companies can be included up to 25% of minimum (available solvency margin, required solvency margin).
- h. Cumulative preferential share capital.
- i. Dated subordinated share capital. If the remaining period is less than 5 years, this kind of share capital will only be counted for a factor (remaining period/5 years)
- j. Perpetual subordinated share capital  
Cumulative preferential share capital and subordinated loans can be included up to 50% of minimum (available solvency margin, required solvency margin). Cumulative preferential share capital and dated subordinated share capital may consist up to 25% of this solvency margin (minimum (available solvency margin, required solvency margin)), if the following requirements are met:
  - subordination
  - only paid amounts
  - original minimum duration 5 years, at least one year before redemption a plan is presented to the supervisor how solvency levels will be retained after redemption of the subordinated loan.
  - no terms making redemption of the loan necessary before the end date of the subordinated loan
  - changes in the loan agreement can only be done with approval from the supervisor
- k. Perpetual securities with defined characteristics. These can be included up to 50% of minimum (available solvency margin, required solvency margin), under the condition that
  - redemption only after approval from the supervisor
  - in the issuing agreement it is said that the insurer can defer interest payments
  - subordination compared to other liabilities
  - in the issuing agreement it is said that losses only can be compensated with the amount of the loan and interest still to be paid
  - only paid amounts can be included

## Available capital under Solvency I

The available capital under the Solvency I regime is the result of

### *Add*

- Share capital (deducted by own shares)
- 50% of the unpaid share capital (if paid part is at least 25% of equity)
- Reserves
  - o Revaluation reserve/ Legal Reserve /Other reserves /Share Premium
- P&L Results
  - o Retain Earnings / Result of the year
- Preferred Shares & Subordinated loans until 50% solvency Margin
- Undated debt until 50% solvency Margin

### *Deduct*

- Elements not free of obligation
- Intangible assets
- Unrealised gains/losses in bonds portfolios
- Responsibilities with Pension Funds not funded

### *Add for Solvency Margin*

- Future profits of Life Business