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PRUDENTIAL TREATMENT
OF "DEEPLY SUBORDINATED DEBT"

AGENDA ITEM REQUESTED
BY THE FRENCH DELEGATION

DIRECTION GÉNÉRALE
DU TRÉSOR ET DE LA POLITIQUE ÉCONOMIQUE

SERVICE DU FINANCEMENT DE L'ECONOMIE

SOUS-DIRECTION ASSURANCES

BUREAU ASSUR 2 - ENTREPRISES ET INTERMEDIAIRES D'ASSURANCE

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Note from the French Delegation

PRUDENTIAL TREATMENT OF "DEEPLY SUBORDINATED DEBT"
PROPOSAL TO USE THE COMITOLOGY PROCEDURE

The Insurance Directives distinguish between various types of liabilities that, depending on their characteristics, can be admitted with or without limitation as elements of the solvency margin. This classification aims at ensuring the quality of own funds by offering more favourable treatment to instruments that offer greater guarantees (e.g. in terms of permanency and subordination) for the financial strength of insurance undertakings.

However, we consider that the current classification (say roughly, between capital on the one hand, and subordinated debt on the other hand) has been blurred by the increasing use of hybrid capital. In France, an example is the issuance by insurance companies of "deeply subordinated debt" (which was authorized by a law passed in August 2003).

This note aims at demonstrating that, from an economic point of view, hybrid capital can, under certain conditions, offer guarantees very close to those of own funds and, in any case, much higher guarantees than those provided by subordinated debt. Thus, the insurance directives could be adapted, through the comitology procedure, to better take into account hybrid capital for the constitution of the solvency margin and thus reconcile both regulatory and economic demands.

Case study

"Deeply subordinated debt" ("*Titres super-subordonnés*" in French) was created by Article 61 of the French *law on financial safety* passed in August 2003. These financial instruments present the four following features, which are also presented by ordinary share capital and provide the undertaking with financial flexibility :

- **Permanency:** the instrument must be perpetual, and early redemption features must be under the sole control of the issuer;
- **Ranking:** in case of liquidation, the securities must rank senior only to share capital;

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- **Conditional payment of interest:** under certain conditions, such as non-payment of dividends to shareholders, payment of coupon/dividend to investors must be left at the issuers' entire discretion; such non-payment must not be considered as a default event, but as a cancellation of the remuneration, with no deferred remuneration (non-cumulative coupon). Moreover, should the payment endanger the solvency soundness of the undertaking, the non-payment must be compulsory. Step-up remuneration clauses are forbidden.
- **Loss absorption mechanism:** the securities must give the issuer the ability, in addition to the non-payment of interest, to absorb potential losses by a reduction of the nominal value of the securities, in order to pursue its activity;

The future Solvency II Directive should clearly define rules for the use of hybrid capital instruments (deeply perpetual debt being only one example) based on their financial characteristics. It could, for example, list the criteria that hybrid instruments should fulfil in order to receive better treatment than subordinated debt for the purpose of constituting the solvency margin. A precise list of criteria would encourage harmonized implementation of the directive by supervisory authorities.

Possible Use of the Comitology Procedure

However, without waiting for Solvency II finalisation, the Committee procedure mentioned in the Life Insurance Directive (Article 27 of Directive 2002/83/EC) and in the Non-Life Directive (Article 16.5 of Directive 73/239/CEE introduced by Article 1 of Directive 2002/13) could be used to speed up such evolution of the insurance directives and, thus, rapidly take into account financial innovations introduced by hybrid capital.

Indeed, the directives state explicitly that the Commission, assisted by the Insurance Committee (Now the EIOPC Level II Committee) instituted by Directive 91/675/EEC, is allowed to modify these articles, in order to " *take into account developments that justify a technical adjustment of the elements eligible for the available solvency margin*".

This adaptation is also necessary to allow the insurance companies to take full advantage of the evolution of financial instruments, without waiting for Solvency II implementation. Deeply subordinated debt instruments present a **higher issue flexibility** than ordinary shares. They can also be issued by companies which have no or limited access to equity markets (e.g. mutual insurance companies) or by companies which have foreign subsidiaries in order to improve the match between their assets and their capital[1].

1 debt titles can be issued in different currencies vs. capital can only be issued in the currency of the home country.

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ANNEX :

Proposal for a modification of Directives 73/239/CE and 2002/83/CE

<u>**ARTICLE 16 OF DIRECTIVE 73/239/CE :**</u>

1. Each Member State shall require of every assurance undertaking whose head office is situated in its territory an adequate available solvency margin in respect of its entire business at all times which is at least equal to the requirements in this Directive.

2. The available solvency margin shall consist of the assets of the insurance undertaking free of any foreseeable liabilities, less any intangible items, including:

(a) the paid-up share capital or, in the case of a mutual insurance undertaking, the effective initial fund plus any members' accounts which meet all the following criteria: (…)
(b) reserves (statutory and free) not corresponding to underwriting liabilities;
(c) the profit or loss brought forward after deduction of dividends to be paid ;

<u>**2bis. The available solvency margin may also consist of fully paid up securities issued by the undertaking on a regulated market, up to [15 %] of the required solvency margin, and provided they have the following features :**</u>

- <u>**in the event of bankrupcy or liquidation of the insurance undertaking, binding agreements must exist under which the securities capital ranks after the claims of all creditors and is not to be repaid until all other debt outstanding at the time, including other subordinated loans or securities, have been settled ;**</u>

- <u>**the securities must be perpetual ; they may not be repaid on the initiative of the bearer or without the prior consent of the competent authorities ; they may not be repaid until a five year period after the issuance has elapsed. ;**</u>

- <u>**the issuance or loan contract does not allow the step- up of interest;**</u>

- <u>**the undertaking is not bound to pay the interest ; it must not pay interest where such a payment may endanger its obligations pursuant to this Directive ; in case of non-payment of the interest, it may not be deferred to a subsequent year ;**</u>

- <u>**the securities may absorb potential losses.**</u>