

# Solvency II: Growing concerns on loss absorption

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A stand-off is developing between insurers and regulators over the grandfathering rules for some hybrid Tier 1 capital securities issued by insurers. Under the Solvency II rules, all Tier 1 capital must be able to absorb losses on a going concern basis. That is to say that the investors must be in a position where they take losses without being able to wind-up or liquidate the company. In many ways this is the fundamental difference between equity and debt that was perhaps missed in the go-go markets where innovative Tier 1 capital instruments first appeared for financial institutions.

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## Boom and bust

Hybrid capital for banks and insurers boomed in the mid-noughties as investment banks sought new products with increased fee income and business management sought to leverage their businesses ever higher to report increasing RoEs. Hybrid capital, or in its most aggressive form, innovative Tier 1 capital, was a magic mix of a debt instrument that attracted a certain amount of equity treatment from both regulators and ratings agencies. This made it a must have in the capital structure as a cheap form of equity that was accretive not dilutive to stock holders.

Issued by the largest institutions, these structures were also attractive to bond investors who saw them as higher yields for fundamentally the same risk as senior debt. Pre the financial crisis and the 2008 collapse of Lehmans, AIG and others, the common wisdom was that bond holders of financial institutions would always be made whole, rather than being given the keys to the firm.

The innovative Tier 1 capital market suited all players. The regulators allowed the party to continue...

Like many practices of the credit boom, the innovative Tier 1 capital market suited everyone:

- The issuer got cheap, non-dilutive equity
- The investors got higher yields for what was perceived as the same risk
- The investment banks got higher fees.

### Nothing can go wrong; go wrong; go wrong ...

Everyone was happy with hybrid capital, until the issuers hit rough times. Whatever the contracts might say, all issuers know that not paying contracted coupons and preferred dividends is Market suicide for issuing further securities. BRAVE Partners has heard gossip that back in the 1993 Credit Lyonnais was still paying the dividends on its preferred debt even as the French Government bailed it out.

As the credit crunch hit and financial institutions racked up losses, innovative Tier 1 capital was put to the test. Regulators expected Tier 1 capital to absorb losses, the investors expected not to take any losses, especially not if the institution survived and remained as a going concern.

### Changing the rules

As is usual in these circumstances, the Regulators won. Regulators expressed concern that Tier 1 hybrid capital instruments had not absorbed sufficient losses and set about making changes to the regulations. These changes spurred the contingent capital, or CoCo, market.

### CoCo with a bitter after-taste

CoCo securities are debt instruments that have a mandatory conversion to equity in certain stress circumstances. Whilst this clearly satisfies the regulators to some degree and a number of deals were done, the market has not proven buoyant. Most importantly the banking Financial Stability Board, that is drafting the Basel III regulations, has rejected CoCos for core Tier 1 capital. Credit Suisse has recently placed a deal and is bullish on the market, but to date there is little actual issuance. To BRAVE Partners the investor base is an important issue.

Whether a capital security is equity or debt ultimately does matter to the insurers, a core investor base. Equity attracts substantially more capital requirements than debt securities.

Innovative Tier 1 capital was bought on the basis that it is and always would be debt. CoCos do not have that luxury and therefore the investor base must at least be different.

### Equity or debt - it matters to investors

The investors in the Credit Suisse CoCo were existing equity investors, mainly sovereign wealth funds. However, many investors in bank bonds are pension funds and life insurance companies. Here it really matters if the instrument is equity or debt, especially for the life insurers. The life insurers are subject to capital rules and a rated bond issued by a European institution will attract a lot less capital than an equity.

### Double whammy

Moreover, under the mandatory conversion criteria in times of stress, the CoCo will convert to the higher capital charge equity at a time of stress, which is just at the point that the insurer's own capital ratios will be under pressure. A CoCo makes no sense for many of the traditional investors in hybrid capital. These securities only made sense if they were to stay as debt in times of distress.

## Grandfathering

Throughout the Quantitative Impact Study (QIS) process, the regulators and the industry have battled over whether or not existing Tier 1 capital instruments, that do not absorb losses on a going concern basis, can continue to be counted as Tier 1 capital post Solvency II. Currently it looks as if the decision will go against the industry and a number of players will need to re-adjust their capital.

## Capital optimisation

Optimal solutions to this issue might not lie in simply exchanging securities, or re-issuing capital. Careful placement of liabilities within other Solvency II compliant jurisdictions and other capital management techniques might well come to the fore.

## BRAVE Partners' services

BRAVE Partners is a boutique investment bank that focuses on the insurance and reinsurance sector. The firm believes that Solvency II will have broad consequences for the insurance industry both within Europe and beyond. The treatment of existing capital bases both during a transition period and within full Solvency II implementation will be a major issue for the insurance industry. The optimal solutions might lie across a range of banking services from advisory to equity to debt.

BRAVE Partners has considerable insurance industry expertise and can advise on transitioning of capital securities through the implementation of Solvency II, as well as capital optimization in a post Solvency II environment.

## Interaction

If you enjoyed this commentary and would like to receive a weekly update by E-Mail, then please contact BRAVE Partners on [commentary@bravepartners.com](mailto:commentary@bravepartners.com)

If you would like to comment on the content of this piece, then please send an E-Mail to [discussions@bravepartners.com](mailto:discussions@bravepartners.com)

- Solvency II has created a range of issues for many insurance businesses.
- As insurers scramble to implement the base requirements, most do not have time to work on optimizing their business through the transition and into the new regulatory environment.
- BRAVE Partners believes that many insurers need to review their capital structure in view of both the grandfathering (transition) rules and for the new regulatory environment.
- The BRAVE partners have a track record in advising on the capital structure of insurers through changes in the regulatory environment.
- BRAVE Partners can work with insurers to structure their existing capital base to optimise it for the transition to Solvency II and then within a Solvency II environment.

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