Academy Invested Asset Work Group Status Report: Required Capital for Hybrid Securities

Presentation to the NAIC Hybrid Working Group
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Presentation Outline

- Charge to Academy's Invested Asset Work Group (AIAWG)
- AIAWG Review of Hybrids: Methodology
- Tentative AIAWG Observations and Recommendations
- Discussion of Hybrid Features and Risks
- Items in Need of Additional Review

Charge to Academy's Invested Asset Work Group (AIAWG)

The charge of the AIAWG is to recommend the appropriate risk-based capital treatment for hybrid securities, including preferred stocks and surplus notes, for life insurers, health insurers, and property & casualty insurers. The expectation from the NAIC Hybrid Working Group is that the three risk-based capital formulas would treat hybrid securities identically. As such, the AIAWG has worked on behalf of the Academy's Life, Health, and Casualty Practice Councils. The AIAWG received written support from the Health and Casualty Practice Councils and have included representatives from those Practice Councils to assist with this charge.

Based on discussions with the NAIC Hybrid Working Group, the charge does not include the risk-based capital treatment for convertible securities or the treatment of surplus notes in an insurer's total adjusted capital.

AIAWG Review of Hybrids: Methodology

- Review focused on risks to the investor, not to the issuer.
- Review started with a blank slate approach to reviewing hybrids – understanding features and risks in hybrids. While the SVO classification has played a significant role in the RBC treatment of hybrids, the Academy focused on the underlying risks rather than classification.
- Review focused on evaluating the risks of hybrids captured in the current RBC formula, in light of the stated purpose of regulatory capital. Review did not encompass a quantitative evaluation or modeling of the risks given the limited statistical experience on hybrid securities.

AIAWG Review of Hybrids: Methodology (cont.)

- Review focused on a comparative evaluation of hybrid risks, relative to the risks of other types of securities
- Review considered input from rating agencies, investment banks, interested parties, and the SVO

Tentative AIAWG Observations and Recommendations

- Hybrids are an evolving asset class.
  - The first generation (pre-1992) included traditional preferreds or preference shares
  - The second generation (1993 – 2003) included structured securities such as trust preferreds and mandatorily convertible securities
  - The third generation (2003 and beyond) includes second generation structured securities with additional features such as coupon deferral, long maturity periods, and alternate forms of payment to the investor.
- Hybrids are rated by NRSROs; each of the major rating agencies evaluates each issue and reflects varying levels of "debt-like" risks and "equity-like" risks.
- AIAWG believes that NRSRO ratings capture the credit risk or risk of principal default. NRSRO ratings do not capture other investment risks, such as extension, market, or event risks. AIAWG recognizes that the NRSRO rating methodologies have continued to evolve along with developments in the hybrid market.

Tentative AIAWG Observations and Recommendations (cont.)

- Hybrids, as a general class of securities, are similar to preferred equity, versus debt or common equity. Primary distinction is that debt and preferred equity contain a maturity schedule, while common equity does not contain a schedule of principal repayment.
- AIAWG recognizes that the NRSRO ratings do not capture all investment risks; however, we believe that most investment risks are captured in the current RBC formula. The C1 component captures the risk of asset default and the C3 component captures the extension risk via the C3P1 Cash Flow Testing component and the additional C3P1 charge for callable securities.

Tentative AIAWG Observations and Recommendations (cont.)

- AIAWG recommends that the RBC for hybrids should be based on factors for preferred stock.
- AIAWG recommends that the short-term RBC solution involving notching be reversed since illogical results can be produced (e.g., hybrid securities that are higher in the capital structure can carry a higher RBC charge due to the effect of notching).

Tentative AIAWG Observations and Recommendations (cont.)

AIAWG recommendation is based, in part, on a comparative analysis of hybrid risks versus other types of securities and how investment risks are captured in the NAIC RBC formulas.

- Purpose of RBC is to identify weakly capitalized companies. The RBC formula is primarily factor-based and is a fairly blunt instrument for capturing risk. The current factor-based RBC formula does not capture all investment risks explicitly; perhaps implicitly, on average.
- Market and event risks, generally accepted as not reflected in the NRSRO rating for hybrids, are not reflected in the NRSRO rating for *any* security. Therefore, within the current RBC framework, we do not think that hybrids pose any unique risk due to market changes or event risk.

Tentative AIAWG Observations and Recommendations (cont.)

- The AIAWG does not believe the emphasis on hybrids is warranted. We understand that the hybrid market continues to evolve with ever more complicated structures being issued. However, many of the risks contained in hybrid securities are also present in other securities (e.g., coupon deferrals in private placement bonds, extension risk in CDOs, CMOs, etc.) and may not explicitly be captured in the current RBC formula.

Discussion of Hybrid Features and Risks

- Which features contribute to investment risk?
- Which features distinguish hybrids from traditional debt?
- Which features contribute to extension risk?
- Which features are common in the newer forms of hybrids?
- Which features should be more closely monitored?

Hybrid Features: Investment Risk

- Subordination
- Callability
- Long Maturity
- Liquidity
- Replacement Capital Covenant
- Coupon payment discretion (step-ups, reset at first call to floating rate, optional/mandatory deferral, cumulative/non-cumulative deferral, alternative coupon settlement mechanism)
- Extendability
- Dividend Stopper

Features of Hybrids vs. Traditional Debt

- Deep subordination: *captured in NRSRO ratings*
- Coupon deferability: *captured in NRSRO ratings*
  - Note that probability of coupon deferability varies with the credit quality of the issuer, not with the specific feature (such as step-ups, etc.)
  - Hybrids issued by regulated companies, such as banks or insurers, exhibit lower risk of deferring coupons, as the regulators may have stepped in as company health was deteriorating.
  - Hybrids issued by Industrials show greatest probability of coupon deferral.
- Extendability: *NOT captured in NRSRO ratings*

Drivers of Extension Risk

- Replacement capital covenants: increase extension risk
- Coupon step-ups at first or final call date: decrease extension risk
- Switch to a floating rate at call date: decrease extension risk
- Improved credit quality of issuer at call date: decrease extension risk
- Likelihood of extension is ultimately influenced by the issuer's cost of capital at call date.

Features in Newer Hybrids

- Replacement capital covenants (intentional or binding)
  - Generally, not reflected in NRSRO ratings from S&P, but reflected in Moody's ratings.
  - Note that intentional covenants have been standard in hybrids for some time; the covenants that allow an issuer to issue alternative forms of capital to make hybrid payments are part of newer hybrid structures.
- Non-cash cumulative feature (lies between cumulative and non-cumulative)
  - Non-cash cumulatives are more marketable than non-cumulative.
  - Reflected in NRSRO notchings
- ACSM (alternative coupon settlement mechanisms)
  - Missed payments are settled through the issuance of other securities.
  - Reflected in NRSRO notchings.

Features in Newer Hybrids (cont.)

- Greater complexity:
  - Newer hybrids are more complicated and contain more credit risk than earlier issues.
  - Credit risks are captured in the NRSRO ratings.
- Greater protection for investors:
  - Demand for change of control covenants
  - Mitigants to the extension risk (interest rate step-ups, scheduled maturity).
- Foreign Issuers:
  - Hybrids are structured with tax considerations and the issuer's capital structure in mind; some of the foreign issues can contain greater extension risk as coupon step-ups are not common in foreign issues.
  - Extension risks generally not captured in the NRSROs.

Features to be Monitored

- Long maturity periods
- Deferability of payments, particularly non-cumulative deferral
- Limitations on investor rights

- The NAIC will need to determine how best to monitor historical experience on risks and developments in the Hybrid market.

Items in Need of Additional Review

- Historical experience on hybrids, such as Fitch's recent report ("Hybrid Securities: an Empirical View" May 11, 2007)
- SVO Reports on Hybrid Classification, issued May, 2007
- Additional consideration of extension risk: materiality, sufficient provision for risk in C3 capital, sufficient C3 instructions
- RBC treatment for insurers' investment in surplus notes
- Recommendations for future experience studies of hybrid market to quantify the materiality of the risks of certain hybrid features
- Recommendations to monitor the statistical characteristics and developments in the hybrid market (types of issues, features, investors, etc.)

Questions?