06-D-417

September 1, 2006

# Evaluation on Hybrid Capital of Life Insurance Companies

Japan Credit Rating Agency (JCR) has summarized below the basic perspectives and standards for the evaluation of hybrid capital obtained by life insurance companies (refer to press release 06-D-415 announced together with this issue for the general framework of the evaluation on equity content of hybrid securities).

**Concept behind evaluation on hybrid capital of life insurance companies**

The term hybrid capital, including hybrid securities (subordinated bonds, etc.) of life insurance companies, is generally used for a type of financing that possess the characteristics of both common stocks and bonds. This type of financing option comes in various forms, ranging from one that has a prominent debt-like feature to one that appears more like common stock. Several life insurance companies have issued subordinated debt, including subordinated bonds; subordinated loans; and funds and perpetual subordinated debt with call and interest-rate step-up provisions. These companies are working to optimize their capital structure by taking into account their hybrid capital. In analyzing various types of hybrid capital, the capital nature is determined by initially examining the attributes of the hybrid capital concerned, and then individual conditions including investor objectives and the environment surrounding the life insurance company, such as the company's challenges, the purposes of the hybrid capital as well as medium- and long-term capital policies.

**Analysis: Attributes of hybrid capital of life insurance companies**

When evaluating the equity capital of life insurance companies, acknowledging the capital nature of instruments such as subordinated bonds and loans requires that the financing satisfies certain requirements. JCR focuses on the following requirements to ascertain that hybrid capital is indeed equity capital in a broad sense: (a) it is permanent or super long-term financing in the form of a stable "risk buffer" that results in financial stability and flexibility for the company; (b) the presence of dividend and interest payment deferral clauses that provide the company with financial flexibility and stability by curbing incidents of cashing out under stressful conditions; and (c) the ability to allow a higher rate of recoverability for creditors when an issuer declares bankruptcy -- compared with that for pure debt -- by acting as a buffer to absorb losses under stressful conditions. From this perspective, we emphasize the three conditions in the following table when evaluating a particular type of hybrid capital: (a) no obligation for the issuer to redeem the principal and no expiration, (b) no obligation to pay interest and dividends, and (c) the order of claim in the case of bankruptcy is the most subordinate. The evaluation on the equity content of hybrid capital is thus based on a comprehensive judgment on how each of these requirements is satisfied of.

Table 1: Criteria for evaluation on hybrid capital

| | Items examined | Expected Benefits | Related Contract Provisions |
|---|---|---|---|
| 1 | No obligation to redeem the principal and no maturity | • No repayment pressure or refinancing risk, adding to financial stability and flexibility | • Redemption period<br>• Call provision<br>• Interest-rate step-up provision, etc. |
| 2 | No obligation to pay interest and dividends and no accumulation of deferred interest and dividends | • Can curb cashing out under stressful conditions, adding to financial stability and flexibility<br>• Deferral does not lead to default or cross default | • Deferral provision for interest and dividends (mandatory/optional)<br>• Cumulative/non-cumulative<br>• Mandatory payment provision<br>• Conditions for default, etc. |
| 3 | Order of claim in case of bankruptcy is the most subordinate | • Increased rate of recoverability in case of bankruptcy | • Special conditions for subordination |

**1. No obligation to redeem the principal; no expiration**

As noted earlier, one of the requirements we use to acknowledge the capital nature of hybrid capital is that the term to maturity is either permanent or super-long. Based on this criterion, we focus on the following in evaluation on hybrid capital issued by life insurance companies: (a) the term to maturity and (b) features, including call and step-up interest rate and dividend clauses.

(a) Term

Needless to say, the most desirable term to maturity would be permanent in view of capital nature, but some types of hybrid capital actually do mature. Specifying a maturity date is a negative factor in evaluation on equity content of an instrument. If, however, the term is super-long, it is more likely that the instrument can be seen to possess features of a capital nature than ordinary debt. In terms of the characteristics of life insurers' liabilities, a term to maturity of 20 years or more at the beginning of financing can be deemed to possess a certain type of capital nature, even if the term is fixed. An instrument with a term to maturity of 10 years or more but less than 20 years may be recognized as equity capital, but in this case, we assess the situation based on factors such as capital structure and rating levels of each insurance company. For mutual insurance companies in Japan, because the term to maturity of funds that mutual they can raise is normally limited to five years or shorter, there is a limit to recognize this type of debt as part of equity capital.

(b) Call provision and step-up of interest rates and dividend payments

Even when the term to maturity is permanent or super-long, many hybrid securities issued by life insurers include a call (optional redemption of the issuer before maturity) provision. If the issuer is likely to actually exercise the call, the maturity of the hybrid capital is deemed substantially the same as the expiration of the call. We see a possibility of an issuer exercising the call to control its cost of financing when there is a step-up clause that automatically increases the interest rate after the expiration of the call and if the increase is large (generally about 100 bps), or if the initial cost of financing is extremely high. Given the maturity in this instance, the capital nature of the instrument would be considered weak in our comprehensive evaluation. If no step-up clause is attached and the initial cost of financing is low, the possibility of exercising the call varies depending on the financial condition and investment policy of the issuer and the level of investors' expectations for the call. In this case, from the perspective of the instrument's term to maturity, its capital nature would be considered weaker than an instrument without a call provision. However, the evaluation would not be uniform and we would need to focus more on the individual situation of the issuer.

## 2. No obligation to pay interest and dividends

We focus on the following features when evaluating hybrid capital in the context of it preventing a financial default by allowing voluntary control of minimizing any cashing out under stressful conditions and the ability to defer interest and dividends: (a) whether a deferral clause is attached; whether the deferral is mandatory or optional; (b) terms of deferral; and (c) whether or not the deferred payments are to be cumulative, and a possible deferral period.

### (a) Mandatory or optional deferral

Hybrid capital often features an interest and dividend deferral clause, in which deferrals of interest and dividends (including non-payment) would not correspond to a default so long as conditions in the deferral clause (conditions for deferment) are met. Various clauses of securities commonly incorporate a function that prevents a legal default. However, especially when only an optional deferral clause is added under which a deferral is at the discretion of the issuer, the life insurance company may continue to pay interest and dividends even when under considerable financial stress. Thus, the capital nature of a security with an optional deferral clause would be recognized in the sense that the issuer defers interest and dividends under stressful conditions at the issuer's own discretion, but the degree to which the instrument has a capital nature is not considered to be high. With a mandatory deferral clause, meanwhile, concerns such as those that exist for securities with an optional deferral clause are not present. In a comprehensive evaluation on these securities, the degree of their capital nature is considered high.

### (b) Conditions for deferral

Positive evaluation of a deferral clause requires that the conditions for deferral be established at an appropriate level in advance and the trigger be set to control a cashing out at a stage significantly earlier than a debt default by a life insurance company. Such a trigger may be when the terms as specified in Article 55 of the Insurance Business Act are exhausted or a solvency margin that indicates the company maintaining a certain level of financial health.

In evaluating hybrid capital, for instance, it is important that mandatory provisions concerning interest rate deferral that are more conservative than the clear standards set out by regulatory authorities are included in agreements. It is also critical that the trigger is designed to control a cashing out that is earlier than a debt default by the issuer. Thus, when considering the capital nature of securities, the trigger must be set at a level that is considerably higher than the minimum solvency margin specified by regulatory authorities.

### (c) Cumulative or non-cumulative deferral period

In evaluation on equity content of hybrid securities issued by life insurance companies, we do not see a positive factor if the nature of the deferral clause is optional and cumulative as this would provide fewer incentives for a life insurance company to defer payments in the future. If deferral is cumulative, the contribution of the deferral clause to an increase in the capital nature of securities is considered low unless the issuer holds the right to defer accumulated interest and dividends payments for at least about five years.

3. **Order of claim in case of bankruptcy is the most subordinate**

Another requirement for recognizing hybrid capital as equity capital in broad terms is subordination. If the securities concerned are regarded as subordinate, in the event of a bankruptcy (default), repayment takes place only after distribution is made to preferential creditors, or in other words, subordinated creditors have the function of absorbing the loss before the preferential creditors. If a more subordinated debt exists or could exist, its subordinated characteristic is deemed slightly weak when comprehensively evaluating the equity content based on the three requirements stated earlier.

However, evaluating the subordinated nature of hybrid capital is secondary to other characteristics like not having an obligation to redeem the principal, not having a maturity date, and not having mandatory interest and dividend payments. Evaluation on equity content of hybrid capital aims to contribute to the analysis of a life insurer's certainty in honoring its obligations. This certainty depends largely on whether a life insurance company is able to continue its business without going bankrupt and continuously receive necessary cash flow. Placing emphasis on analyzing factors related to recoverability is not appropriate in the evaluation on equity content of hybrid capital unless the creditworthiness of the life insurance company is substantially weak.

The requirements for recognizing the capital nature of hybrid capital from the perspective of subordination cannot be determined easily. The treatment of subordination of hybrid capital issued by life insurance companies is likely to have been affected by the lowering of the assumed interest rate as a result of the introduction of the contract revisions system. In terms of credit rating, JCR considers changes in contractual terms, such as a reduction of the assumed interest rate, a default, but since this does not legally constitute bankruptcy, it does not fall under the conditions for subordination in the conventional contract for hybrid capital. This could result in a change in the priority of payments, whereby those to be made to policyholders who should have first priority are reduced and made subordinate to payments to hybrid capital holders. This may jeopardize the consistency of the priority-subordination relationship between insurance policy obligations and hybrid capital. JCR considers an issuer can prevent this type of inconsistency and ensure that priorities are maintained by incorporating terms, such as a reduction of assumed interest rates, as a condition for subordination.

**Addition of individual conditions**

As previously noted, evaluation on hybrid capital consists of a comprehensive evaluation of the attributes of the hybrid capital because (a) the issue is not obligated to redeem the principal and there is no expiration; (b) the issuer is not obligated to pay interest and dividends; and (c) the order of claim in the case of bankruptcy is the most subordinate. In addition to these attributes, we assess the individual conditions of each life insurance company.

Broadly speaking, hybrid capital must satisfy the above requirements to be considered a part of equity capital. In addition to how each requirement is satisfied, however, individual circumstances of each insurance company could cause a different final evaluation on whether hybrid capital can be considered equity capital. Of these individual conditions, the financial management of an issuer is important. If an issuer's management deems that exercising a call related to hybrid capital will have an adverse effect on financing and its ratings, the probability of the call being exercised is expected to be relatively low. In reality, however, it is difficult to expect a low probability of an issuer exercising a call option solely based on the financial management policy of an issuer. Our policy is to make a careful assessment of the situation by examining the financial data of each issuer to see whether its financial management policy is based on rational grounds.

In assessing a life insurance company with excessive hybrid capital, we must also consider setting a ceiling for the amount of hybrid capital allowed to be counted as equity capital, even if the aforementioned requirements are satisfied. Over-reliance on hybrid capital results in higher financial leverage as it would increase related obligations, such as interest rate payments, maturity, and call provisions. Compared with costs related to common stocks, costs related to hybrid capital are more difficult to change flexibly in line with intermittent changes in an issuer's profit and loss levels.

Table 2: Hybrid securities: Criteria for evaluation on their equity content (example)

| Equity Content | Criteria for Analysis | Applicable Example |
|---|---|---|
| Equivalent to debt | 0 | • Fixed-term subordinated bonds that prohibit deferral of interest and dividend payments |
| Low | 25 | • Subordinated bonds, senior securities, and preferred stocks; permanent or super-long term; call option possible; interest rate step-up; interest and dividend deferral possible (optional deferral clause only) |
| Medium | 50 | • Subordinated bonds, senior securities, and preferred stocks; permanent or super-long term; call option possible; interest rate step-up; replacement language available; interest and dividend deferral possible |
| High | 75 | • Senior securities and preferred stocks; permanent or super-long term, prohibits a call option; allows dividend deferral (mandatory deferral and non-cumulative)<br>• Preferred stocks (non-cumulative) with a mandatory conversion clause within three years |
| Common stocks | 100 | |

Rating hybrid capital involves the assessment of capital adequacy, including the decisions concerning these securities. We note that rating involves a multifaceted analytical process. Analyzing capital adequacy, which is just one of a number of wide-ranging perspectives used in rating, involves many elements: risk profile; historical data on capital; estimated future capital adequacy in multiple scenarios; unrealized profits and losses on asset holdings; dividend policy; expected future income and retained earnings; economic conditions of insurance liabilities; acquisition and merger and disposal; investment policy and management strategy.

Likewise, we intend to perform our analysis by taking into account the final standards for insurance policies currently developed by the International Accounting Standards Board (IASB) and trends seen in the common standards for solvency assessment of International Association of Insurance Supervisors (IAIS). While keeping in mind the direction of these global changes in solvency regulations, JCR intends to assess insurance policy reserves, the status of equity capital, financial data as well as the status of the internal model of each insurance company and their risk assessment.

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