Contingent Capital

The Insurance and Bank Executive's Key to Solvency II Compliance, Catastrophe Risk Management, Credit Enhancement and Basel III Requirements

A White Paper by the Municipal Guarantee Fund

Since the worldwide financial crisis occurred in 2008, capital markets have suffered unprecedented volatility. A handful of highly-rated financial institutions in the United States and Europe, deemed "too big to fail," either completely failed or were rescued by their governments. The consensus among regulators was that banks were too highly leveraged and that, in the future, they should be required to hold more capital.

The financial crisis also prompted regulators to reexamine how much capital is enough for the insurance industry. The culmination of that regulatory effort can be found in the European Union's Solvency II Directive, scheduled to take effect in early 2013.

Unlike reinsurance, contingent capital does not involve a transfer of an insurer's risk of loss to the investor. Thus, the insurer can secure additional capital at more favorable rates and terms.

Insurance executives need to determine how they will obtain adequate capital to comply with Solvency II capital requirements, while continuing to manage catastrophic risk and maintaining their capacity to absorb losses. Simple reliance on traditional reinsurance or insurance-linked securities may no longer be enough.

Insurers may find the solution to these challenges in the form of <u>contingent capital</u>.

Contingent capital arrangements may be suitable for insurers that want to hedge against the occurrence of severe loss events. Unlike reinsurance, contingent capital does not involve a transfer of an insurer's risk of loss to the investor. Instead, in the event of a catastrophic loss, the insurer receives a capital infusion in the form of debt or equity to cover losses. Thus, the insurer can secure additional capital at more favorable rates and terms.

What is driving insurers' demand for more capital?

More Stringent Capital Requirements

The European Union's Solvency II regulatory framework is expected to significantly impact the insurance[1] industry on a global scale. The main policy goal of Solvency II is to protect policyholders by, among other things, ensuring that the industry has adequate capital available to cover losses.

Frequency and Severity of Natural and Man-Made Catastrophes

Ordinarily, natural and man-made catastrophes have a low probability of occurrence. However, in today's difficult market, such disasters occur more frequently and with greater severity. According to a recent report issued by Guy Carpenter & Company, the reinsurance industry experienced its highest prior-year catastrophe bill in two years. Insured losses from global catastrophes outside the United States reached USD$36 billion in 2010, up from USD$27 billion in 2009. Natural hazards were the largest source of losses in 2010 at USD$31

[1] Unless stated otherwise, all references to "insurance," "insurer" or "insurers" made in this paper include reference to "primary insurer(s)," "reinsurance," or "reinsurer(s)," as the case may be.

billion, while man-made disasters cost reinsurers USD$5 billion. Above-average hurricane activity is now being forecast for 2011.[2]

Challenges of Maintaining Adequate Capital

Challenges Faced by Insurers

Insurers that are under constant pressure to maintain adequate capital face a whole host of challenges. These challenges include compliance with Solvency II capital requirements, managing catastrophe risk, the cyclical nature of the reinsurance market and assorted credit issues.

Compliance with Solvency II Capital Requirements

A major regulatory challenge faced by insurers is how they will obtain and maintain an adequate amount of available capital to satisfy Solvency II's complex capital requirements.

If an insurer falls below its Solvency II MCR, the result could be revocation of its authorization to pursue business and provide services.

Solvency II will require insurers to meet a risk-sensitive Solvency Capital Requirement ("SCR"). The SCR is defined as that level of eligible capital (known as "own funds") needed for an insurer to absorb unforeseen losses and provide assurance to policyholders and beneficiaries that payments will be made to them as they fall due. Insurers will also have to meet a Minimum Capital Requirement ("MCR"). The MCR is a stricter level of eligible own funds below which the amount of an insurer's financial resources should not fall.

If an insurer falls below its SCR but stays at or above its MCR, it would have to cover the deficit in eligible own funds over a certain period of time in accordance with a workable plan approved by its supervising authority. But if an insurer falls below its MCR, the result could be revocation of its authorization to pursue business and provide services.

Managing Catastrophe Risk

The staggering losses sustained as a consequence of the recent global occurrence of natural and man-made disasters present sizeable risk management problems for reinsurers. Without reinsurance, many insurers would be unable to provide continuing coverage to businesses, homes and families.

However, reinsurers frequently bear an outsized proportion of catastrophic losses when they occur. In the face of extremely large or multiple catastrophic events, insurers might not have purchased sufficient reinsurance, or reinsurance providers might not have sufficient capital to meet their existing or future loss obligations.

The Cyclical Nature of the Reinsurance Market

Reinsurance, especially catastrophic reinsurance, is clearly influenced by price cycles.

[2] "Points of Inflection: Positioning for Change in a Challenging Market," Guy Carpenter & Company, Global Reinsurance Outlook, January 2011, pp. 25-27.

For example, when a catastrophic loss occurs, reinsurers may limit the availability of future catastrophic reinsurance, while the demand of potential victims for reinsurance increases. This results in higher reinsurance prices, which causes new reinsurance firms to enter the reinsurance market or investors to purchase new equity issued by existing reinsurers. Once the supply of catastrophe coverage goes up, prices start to stabilize.

In the event no major catastrophe happens in the meantime, reinsurers may offer premiums at below expected loss and cost, while primary insurers hold an excess supply of capital and thus capable of supporting new risk exposures. To win or retain market share under such conditions, reinsurers would have to lower their underwriting criteria and accept marginal risks or liberalize policy conditions, resulting in lower premiums.

Credit and Ratings Issues

Credit ratings agencies such as Standard & Poor's, Moody's, Fitch and A.M. Best may penalize an insurer if a catastrophic event adversely impacts the insurer's financial position and thwarts its ability to cover losses or book future underwriting business. If an insurer must draw down existing capital facilities (assuming such facilities are available after the event occurs) or approach the capital markets (which may be inhospitable at that time), that will mean tapping into critical financial resources needed for future growth.

What insurers need is access to capital instruments and facilities specifically designed to inject liquidity in such adverse situations, without the stigma attached to using such facilities (as may be the case with bank loans or banking credit facilities).

Challenges faced by Banks

New banking regulations triggered by the financial crisis, require banks to hold more capital.

Meeting New Basel III Requirements

In the mid 90's the liquidation of a German bank resulted in the formation of the Basel Committee on Bank Supervision (BCBS). They release the banking regulations known as the Basel Accords. These accords are released to help financial institutions manage their capital and handle their losses better.

The first accord released by the BCBS was Basel I, but in 2004 these banking rules were made stricter with the release of the Basel II. But in the 2007 and 2008 financial crisis, banks found it really hard to raise equity from the private sector. They ended up raising equity from the wealth funds and the government.

To prevent banks from absorbing capital from the real economy the new stricter Basel III accords have been set forth. The Basel III accords require Banks to hold quality capital of a higher percentage. In case a financial crisis occurs the banks can draw upon this high quality capital instead of drawing funds from the government. This way the real economy can be protected.

Maintaining this really high percentage of capital will be difficult for banks.[10] If the bank's capital ratio goes below the required amounts, they will face restrictions on payouts of dividends, share buybacks and bonuses.[11] Banks require an alternative source of capital when their capital ratio goes down. This will help them withstand periods of economical stress.

THE BURDEN ON REINSURANCE: SOME QUICK FACTS

►A report released at the World Economic Forum in February 2011 by Swiss Reinsurance Co. Ltd. revealed that the financial consequences of the 2010 earthquake in Haiti produced losses that were **114%** of the island nation's gross domestic product.

►A.M. Best Company's BestWire News reported recently that from 2007 through 2010 four secondary peril flood events in Australia caused insured losses exceeding **A$1 billion each**.

►According to Guy Carpenter & Company, LLC, U.S. domestic insured losses from Hurricanes Katrina, Rita and Wilma in 2005 amounted to USD$64 billion. Of these losses, an estimated USD$30 billion were borne by reinsurers even though the reinsurance sector is roughly **1/10** the size of the insurance sector in terms of premium and dedicated capital.

Insurers Struggle for More Capital: A Brief History

In the late 1990s, insurers turned heavily to the capital markets for their risk transfer solutions as a way to supplement, or as an alternative to, traditional reinsurance. With this convergence in the reinsurance and capital markets, the insurance-linked securities ("ILS") market began in earnest. By issuing ILS products such as "catastrophe bonds," "longevity bonds" and assorted derivative instruments, insurers could transfer their risk and raise additional capital, while investors diversified their portfolios with high-yield bonds or asset-backed notes uncorrelated with the economic risks of the financial markets.

From 2001 to 2009, the ILS market skyrocketed, with over USD$15 billion trading between capital market investors.[3] This growth was severely disrupted in 2008 with the collapse of the sub-prime market in the United States and Europe. That event had a disastrous effect on all structured financial markets, including life insurance risk.

In the last two years, some of the world's largest banks started issuing capital instruments of a more hybrid nature.[4] These newer vehicles are designed to provide financial institutions with ready access to capital upon the occurrence of certain triggering events. Unlike ILS products, the terms of these instruments are negotiated up front and structured strictly as capital funding facilities at lower cost to issuers, with no element of insurance contracting.

This movement toward such instruments, commonly known as "contingent capital," signifies a noticeable shift in market preference to a form of capital readily available before a crisis or disaster strikes.

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[3] Boucher, Mathieu. "Development in the insurance-linked securities (ILS) life market, post financial crisis." 2009 East Asian Actuarial Conference. (2009): 14.

[4] "CoCo nuts: Lloyds is first out of the gate with a new kind of capital," The Economist, November 5, 2009, http://www.economist.com/node/14816673?story_id=14816673; "Rabobank successfully issues Senior Contingent Notes," Rabobank Press Release, March 12, 2010, http://www.rabobank.com/content/news/news_archive/005-RabobanksuccesfullyissuesSeniorContingentNotes.jsp; "Credit Suisse Agrees to Sell $6.2 Billion of CoCos," Bloomberg Businessweek, February 14, 2011, http://www.businessweek.com/news/2011-02-14/credit-suisse-agrees-to-sell-6-2-billion-of-cocos.html.

BANKS AND INSURERS ARE CATCHING ON TO CONTINGENT CAPITAL

♦ In November 2009, Lloyds Banking introduced debt that will automatically convert to equity capital worth £7.5 billion if the bank's cushion of equity capital falls below 5%.

♦ In March 2010, Rabobank issued €1.25billion in 10-year fixed rate notes, written down by 75% of their face value, with the remaining 25% paid to investors, if the bank's equity capital ratio falls below 7%.

♦ In December 2010, SCOR launched a three-year €150m equity line facility, which is triggered when SCOR has experienced total aggregated losses from natural catastrophes above certain thresholds occurring over a three-year period.

♦ To satisfy an estimated 50% of Swiss high-trigger capital requirements, Credit Suisse issued approximately CHF 6 billion in capital notes in February 2011 to Middle Eastern shareholders to be paid up no earlier than October 2013 for cash or in exchange for capital notes issued in 2008.

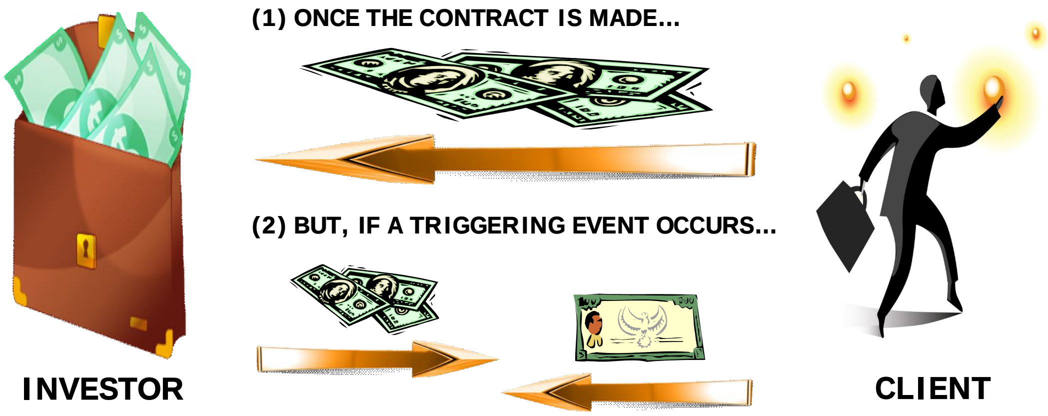
What is "contingent capital?"

In a nutshell, contingent capital is the guarantee of funds under certain circumstances.

In a typical contingent capital transaction, the client and the investor enter into a contract, whereby the client pays a capital commitment fee (i.e. a premium) to the investor, who, upon the occurrence of a certain triggering event, agrees to purchase debt or equity at a pre-set price for a fixed period of time, thus providing the client with a capital infusion.

If the risk of the triggering event occurring is higher, the investor will demand a higher premium. But if the triggering event does not occur, the client will have no need for additional capital and the facility remains unused.

BASIC STRUCTURE OF A CONTINGENT CAPITAL TRANSACTION



What are the various forms of contingent capital?

Contingent capital instruments are generally issued as debt that is convertible into common or preferred equity. Other forms of contingent capital instruments can include contingent debt facilities, contingent surplus notes, catastrophe equity put options or standby loans. Contingent capital loans are typically backed by assets and may be issued as fixed or floating rate loans.

Structural provisions of contingent capital arrangements may include payment deferral mechanisms, conversion options, maturity extension features and other elements designed to enhance a client's financial flexibility. Like the triggers for a catastrophe bond, contingent capital triggers can also be designed on an indemnity basis to match a client's exposure to a specific loss-making event, or they can be based on transparent market indexes.

What are the various uses of contingent capital?

Uses for contingent capital differ depending on the industry and the triggering event. Banks employ contingent capital to stabilize themselves in the event of a decline in their regulatory capital ratios, with a view to "bailing themselves out" so that taxpayers are not exposed. Construction firms use contingent capital to enhance their balance sheets so they can qualify to bid for contracts previously unavailable to them. Oil and gas traders often use contingent capital to prove to investors their ability to pay losses should they occur.

Below are some of the more common uses for contingent capital in the insurance industry:

Insurance Underwriting

With contingent capital, insurers more easily obtain approvals, and achieve lower rates and more advantageous terms, with reduced decision times.

When catastrophe or natural disasters strike, insurers will use contingent capital financing to pay underwriting losses. The capital commitment premium paid by an insurer is commensurate with the risks undertaken and the predictability of losses.

Statutory Surplus

Insurance companies need to keep a certain level of funds over and above anticipated losses as a cushion to satisfy regulators. Contingent capital is ideally suited for this, as it avoids tying up cash.

Credit Enhancement

Credit ratings dramatically affect an insurer's cost of doing business and access to new clients. Credit agencies will look more favorably on insurers that increase their available capital sources, which may result in preferential rates and terms for insurers looking to borrow. In a tight lending environment, insurers may qualify for financing that they were unable to receive previously. By demonstrating superior balance sheet strength, an insurer may retain a credit rating that it was in danger of losing or increase their credit grade.

Supplemental Source of Capital

Contingent capital is not a substitute for commercial banking credit or reinsurance facilities. It is a supplemental capital source that should be used in co-ordination with other financing and insurance products. Contingent capital facilities can supplement an insurer's existing capital resources and complement bank facilities by virtue of its structural flexibility.

Benefits of Contingent Capital Arrangements

Easier Access to Capital on More Favorable Terms

Insurers may find that raising contingent capital is easier than other alternative capital sources because it ranks as lower-risk capital available only upon the occurrence of a triggering event and not available to an insurer for daily operating funds.

Contingent capital arrangements are especially suitable for insurers that want to hedge against extremely rare, but severe loss events, such as natural catastrophes. Unlike reinsurance, contingent capital instruments do not involve a transfer of an insurer's risk of loss to the investor. Instead, after a loss occurs, the insurer receives a capital injection in the form of debt or equity to help cover the loss.

In a tight lending environment, financing is offered to insurers at high interest rates and unattractive terms, if at all. Insurance underwriting periods are lengthy with numerous conditions imposed on borrowers. By approaching investors for a 100% asset backed loan, insurers more easily obtain approvals, and achieve lower rates and more advantageous terms, with reduced decision times.

Ability to Meet Solvency II Capital Requirements

Under Solvency II, insurers must meet two sets of capital requirements: the solvency capital requirement ("SCR") and the minimum capital requirement ("MCR"). To meet both requirements, an insurer must have adequate capital

("own funds") available to absorb unforeseen losses on a going concern basis and in the event of wind-up.

An insurer's own funds are composed of high quality "Tier 1" capital (i.e. basic own funds), medium quality "Tier 2" capital and lower quality "Tier 3" capital. Tier 2 and 3 capital (split into "basic own funds" and. "ancillary own funds") can also be used by insurers to absorb losses once Tier 1 capital is exhausted, albeit at much lower proportions.[5]

An insurer can cover its MCR with only Tier 1 and Tier 2 basic own funds. However, an insurer can cover up to two-thirds of its SCR with Tier 2 and Tier 3 capital (with Tier 3 comprising no more than one-third of its SCR).[6]

For purposes of Solvency II, contingent capital, as an off-balance sheet item in the form of unpaid and callable hybrid capital instruments and unbudgeted supplementary member calls, is classified as Tier 2

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[5] "Solvency II – Eligibility of Contingent Capital," Scandinavian Capital Solutions, October 2009, p.1, http://www.globalreinsurance.com/Journals/Newsquest/Global_Reinsurance/Scandinavian_Capital_Solutions_White_Papers/attachments/Solvency%20II%20-%20Contingent%20Capital%20-%20Scandinavian%20Capital%20Solutions_22102009.pdf

[6] *Id.*, p. 2.

ancillary own funds.[7] Contingent capital, in the form of unpaid and callable hybrid capital instruments and non-Tier 2 eligible supplementary member calls, is classified as Tier 3 ancillary own funds.[8]

Because contingent capital is classified largely as Tier 2 or Tier 3 ancillary own funds, it is not eligible to cover an insurer's MCR. However, ancillary own funds, along with contingent capital, can be a useful tool to cover the deficit between its MCR and SCR.[9]

How can Banks use Contingent Capital?

Capital to Meet Basel III Requirements During a Period of Financial Stress

Under the new Basel III requirements banks will be required to hold more capital than they had to under Basel II. This capital will help banks absorb losses during periods of financial and economic stress instead of relying on the government and public funds.

In the Basel II regulations the minimum Tier 1 capital ratio was 4% and the Core Tier 1 capital ratio was 2%. Under the new Basel III regulations banks are supposed to hold a minimum Tier 1 capital ratio of 6% and a Core Tier 1 capital ratio of 4.5 %.[11] The minimum for Tier 2 remains at 8% and tier 3 has been eliminated.[12]

Under Basel III regulations banks will also be required to hold a capital conservation buffer of 2.5% to help them withstand any crisis that occur in the future. This brings the common equity requirements to 7%. During periods of financial and economic stress this buffer can be used to absorb losses. Drawing upon the buffer will lead the regulatory capital ratios to approach the minimum requirements. This will result in constrains on earning distributions.[11]

Banks will also be required to have a Countercyclical Capital Buffer within a range of 0 to 2.5% of common equity. The loss absorbing capacity of systematically important banks should be higher than the standards set.

If the banks fail to have the required minimum capital ratio it will lead to them facing restrictions on payouts of dividends, share buybacks and bonuses.[11] During a period of financial distress the capital ratio of the banks will go below the minimum capital ratio as capital will be required to absorb losses. This will lead to many of the above problems. Banks will require some extra capital in order to protect themselves.[13]

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[7] *Id.*
[8] *Id.*
[9] Id.
[10] New bank rules could force BofA to sell its BlackRock stak http://mycrains.crainsnewyork.com/in_the_markets/2010/09/will-basel-3-free-blackrock-from-bofa.php
[11] The Basel iii Accord From the Basel iii Compliance Professionals Association (BiiiCPA) http://www.basel-iii-accord.com/
[12] Basel III http://www.asymptotix.eu/content/basel-iii
[13] Contingent Capital: An In-Depth Discussion http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1653877
[14] Newfangled Bank Capital http://www.nytimes.com/2009/11/13/business/13views.html?_r=1&adxnnl=1&adxnnlx=1300713147-ICHdYm6kxY6rhwkXUys5sA

The best solution for banks is to have some contingent capital securities. During periods of financial and economic stress should a bank's capital ratio fall below the required minimum, the contingent capital arranged by the bank can turn into an equity injection.[14] This equity injection can keep the bank out of distress.

BOTTOM LINE: Contingent capital can be a powerful tool that insurers can use to comply with Solvency II capital requirements.

Improved Financial Position and Reduced Overall Risk Profile

Since contingent capital is accessible only if a certain triggering event occurs, it is by its very nature an "off balance-sheet reserve" arrangement. In issuing contingent capital to investors, an insurer does not transfer its risk (as it does with insurance, which affects the income statement). Nor does an insurer have to show a liability on its books (as it does for a loan, which affects the balance sheet). Instead, the insurer receives a critical capital injection exactly when needed without having to negotiate from a position of weakness.

By not having to carry contingent capital on its balance sheet, an insurer can enhance its solvency and capital adequacy ratios, with no adverse effect on its income statement and without increasing its overall risk profile.[15] Contingent capital structures may also be cheaper than general insurance and allow insurers to free up capital, thus increasing their return on assets.[16]

Credit Enhancement

Contingent capital facilities are specifically designed to inject liquidity when adverse situations occur. Hence, there is little stigma associated with the use of such facilities, as may be the case with bank credit facilities, particularly backup lines of credit. Credit rating agencies recognize this, and factor this into their valuations of an insurer's quality. Therefore, an insurer's use of contingent capital may actually enhance its credit rating, which will improve its financial position and standing with potential investors.

Acquiring New Business and Increased Capacity

Though dominated by a few large-sized firms, the insurance industry remains highly competitive. Insurers are constantly seeking new underwriting business. They must carry sufficiently high levels of capital to bid for new business and increase their underwriting or reinsurance capacities. Leasing assets to add to their balance sheets gives insurers the ability to attain higher capacities and qualify for underwriting work previously unavailable to them.

[15] Tobias Povel, "Some Aspects of Contingent Capital," pp. 5-9 Swiss Re, ICA Presentation, March 2002, http://www.actuaries.org/EVENTS/congresses/Cancun/ica2002_subject/general_reinsurance/gralreinsurance_43_povel_a.pdf.
[16] *Id.*, pp. 6, 19.

What to look for in a Contingent Capital Provider

When seeking a contingent capital provider, be sure to consider the following requirements:

Excellent Track Record in Contingent Capital Deals

A provider should be able to show prospective clients that it has established itself in the market for contingent capital. It goes without saying that a provider should have a successful track record in facilitating contingent capital transactions.

Specialization in Contingent Capital

Pay particular attention to whether a provider has developed a wealth of knowledge and experience in providing contingent capital by looking at the breadth and complexity of the provider's transaction history.

Expert Knowledge of the Insurance Industry

As an insurance executive, you want to know that a provider is well-acquainted with the financial, risk management and regulatory challenges that insurers deal with on a daily basis. A provider that is an insurance industry expert is well-positioned to recommend a contingent capital arrangement that best fits your company's particular circumstances.

Success-Based Compensation - No Upfront Fees

A reputable provider should not be in the contingent capital business solely to collect service fees without regard for the success of your transaction. Find a provider that will not charge upfront fees for their services, but will have every incentive to see your particular contingent capital arrangement through to its successful conclusion.

The Municipal Guarantee Fund Advantage

The Municipal Guarantee Fund ("MGF") offers insurers a wealth of knowledge and experience in facilitating multi-billion dollar contingent capital transactions. With over sixty years of expertise in the insurance and reinsurance industries, MGF is well-equipped to provide insurers with suitable contingent capital products for a wide variety of purposes.

MGF's services to its insurance clients include actuarial modeling and preparing business plans, term sheets and capital raising proposals for presentation to investors. MGF representatives perform these services free of charge or at cost if any outsourcing is required on any particular proposal, and their compensation is based solely on the successful closings of their clients' contingent capital transactions. MGF has access to a large pool of private equity and institutional investors for the purpose of providing suitable forms of contingent capital, such as zero-rated instruments that can serve as statutory surplus in compliance with NAIC accounting standards in the United States, Bermuda Monetary Authority standards in Bermuda and the Financial Services Authority in the United Kingdom.

About The Municipal Guarantee Fund

The Municipal Guarantee Fund is a non-profit, non-governmental organization, established to assist local governments in the United States with creating additional income streams for public expenditure purposes. MGF is a leading provider of contingent capital solutions to banking institutions and insurance companies.

To find out more about MGF, visit www.MunicipalGuaranteeFund.org.

"Since the subprime disaster, capital market conditions are some of the most volatile that I have seen since I have been in the insurance industry. With billions in catastrophic losses absorbed by reinsurers in recent years, I was concerned about getting access to capital on terms we could live with. With the help of MGF and Mark Cooke from Comp Capital, we were happy to discover that contingent capital financing meant more cost-effective financing, not to mention peace of mind knowing that additional capital will be there when we need it."

Ron Kehrli
CEO, MBSI Insurance Company