MEMORANDUM

TO: Group Capital Calculation (E) Working Group

FROM: Lou Felice, Solvency and Capital Policy Advisor

DATE: October 30, 2017

RE: Treatment of Senior Debt and Surplus Notes in the Group Capital Calculation

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As part of the discussions related to the available capital (numerator of a capital ratio) in an RBC aggregation approach to a group capital calculation (GCC), the issue of how to treat senior debt and surplus notes will be considered.

Background

Statement of Statutory Accounting Principles (SSAP) 41 establishes a strong State-based entity specific regulatory structure for surplus notes issued by insurers which is further supported by state receivership laws. SSAP 15 requires all types of debt, including senior debt to be recorded as a liability. However, both are based upon insurance legal entity principles that are not designed to consider the financial flexibility that senior debt issued by a non-insurer holding company can provide the insurance holding company. In addition, they do not consider any prohibitions / limitations on the investments of holding company debt instruments. Part of the reason for less regulatory guidance on holding company issuers of senior debt is related to the States' focus on insurance legal entities (a bottom up approach) vs. a GAAP consolidated approach to available capital that views the group as a single structure and eliminates any intra-group double-counting (top down) and even further where an economic valuation approach may consider how such debt is created when the insurance holding company receives assets that can be allocated to provide capital to the legal entity insurer(s). Surplus notes are generally issued by insurers or mutual holding companies in a holding company structure. They may be issued to insurers within the group or to outside investors. Senior debt is generally issued by non-operating holding companies and is issued to investors that are outside the group (or outside the definition of control within the group). Other issues related to these instruments include the manner in which "subordination" of debt (other than surplus notes) is established, the quality of capital generated, and what becomes of the capital generated via issuance of such debt.

Entity vs. Consolidated view:

In a consolidated calculation the value of intra-group surplus notes or loans are offset and eliminated (i.e. the asset held by the purchaser and the debt reported by the issuer are offset). When surplus notes (or any type of debt) are issued to entities outside the group, consolidated GAAP will treat them as a liability along with any associated accrued interest on the issuer's balance sheet (***See APB 15***)**.** Where the proceeds of other debt issued is held within the holding company structure, consolidated GAAP would offset that portion of debt issued that is held as capital by affiliated entities or retained by the issuer. Any excess debt issues would be treated as a liability of the issuer.

By contrast, in the statutory entity-based calculation where surplus notes are issued intra-group to an affiliated insurer it creates capital value at both the issuer and at the purchaser since such obligations are subordinated to policyholder claims. In addition, U.S. Risk-based Capital (RBC) assigns an asset risk charge (typically based on holding the note as a Schedule BA asset) to the purchaser. The double counting of capital and the associated RBC charge to the affiliated insurer purchasers needs to be addressed in an aggregation approach. Under current SAP, senior or other debt issued by a non-insurance holding company to the insurance company is generally considered an asset if the purchase of the debt is approved by the domestic

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regulator and to the extent criteria demonstrating the financial strength of non-insurance holding company is met, similar to GAAP, but it would be eliminated under GAAP consolidated statement since the non-insurance holding company would treat it as a liability.

Nature of subordination
For surplus notes, the State-based regulatory framework applies “contractual subordination” in that the subordination provisions to restrict movement of funds from the licensed insurer to repay the note are contained within the language of the note itself. For other senior debt issued by a holding company the State-based regulatory system relies on what is referred to as “structural subordination”. In general, subordination ranks other creditors behind policyholders in priority of repayment. Structural subordination is achieved via regulation of movement of funds between insurers and other entities within the holding company structure. An example of how regulatory practices work under structural subordination is demonstrated in the regulatory review and oversight of stockholder dividends paid to the holding company. Dividends paid to the holding company are generally the primary source of income for holding companies which are then used to service their outside debt.

Treatment of Surplus Notes
Treatment of issuers of surplus notes and holders of surplus notes or capital notes is specified in SSAP #41 as follows:

*3. Surplus notes **issued** by a reporting entity that are subject to strict control by the commissioner of the reporting entity’s state of domicile and have been approved as to form and content shall be reported as surplus and not as debt only if the surplus note contains the following provisions:*

a. Subordination to policyholders;
b. Subordination to claimant and beneficiary claims;
c. Subordination to all other classes of creditors other than surplus note holders; and
d. Interest payments and principal repayments require prior approval of the commissioner of the state of domicile.

*9. **Investments in** capital or surplus notes meet the definition of assets as defined in SSAP No. 4— Assets and Nonadmitted Assets and are admitted assets to the extent they conform to the requirements of this statement. Additionally, the amount admitted is specifically limited to the following two provisions:*

a. The admitted asset value of a capital or surplus note shall not exceed the amount that would be admitted if the instrument was considered an equity instrument and added to any other equity instruments in the issuer held directly or indirectly by the holder of the capital or surplus note.
b. The surplus note shall be nonadmitted if issued by an entity that is subject to any order of liquidation, conservation, rehabilitation or any company action level event based on its risk-based capital. Subsequent to this nonadmittance, if any of the conditions described ceased to exist, the holder may admit the surplus note at the value determined under paragraph 11. If a surplus note was nonadmitted pursuant to this paragraph, and the surplus note was ultimately determined to be other-than-temporarily impaired, the reporting entity shall recognize a realized loss for the portion of the surplus note determined to be other-than-temporarily impaired, with elimination of a corresponding amount of the previously nonadmitted assets.

Treatment of Senior Debt
While there is no specific SAP regulatory treatment (independent of GAAP treatment as a liability) for debt issued by a non-operating holding company, it is recognized that in an insurance-led holding company structure that most of the funds needed to repay the holders of the debt will be generated and provided by the insurers in the group. Therefore, it is reasonable to recognize the structural subordination described above in considering how to treat the debt for purposes of available capital. However, because the issuance of debt within a holding company structure makes assets available within the holding company system that could be used to help absorb losses originating from the insurer or another entity within the holding company structure for which the group capital calculation attempts to require capital for, another consideration is criteria similar that that used by the rating agencies, which recognizes the value, but places limits on the amount of capital resources (e.g., 20% in the case of U.S. firms by S&P) that can be funded by debt or perhaps further modified to grade down the credit as the debt rating moves further away from the highest quality.

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<u>Quality of Capital</u>
Under SAP (or GAAP) there is no distinction in quality of capital (i.e. tiering) for assets that meet the definition of admitted assets such as surplus notes. Based on this, it seems logical that any other asset values allowed in an aggregation approach should be treated similarly. However, there is such a distinction under U.S. banking rules and there may be under other sectoral rules. So it seems logical to respect the available calculations of the regulators in those sectors.

Recommendations for an aggregation approach to a GCC:

1. Surplus Notes –In all cases treat the assets transferred to the issuer of the surplus note as available capital. Eliminate the investment value from the affiliated purchaser of the surplus note and eliminate the purchaser's RBC charge on the Surplus note investment.
2. Subordinated Senior Debt issued –Recognize structurally subordinated debt as available capital to some degree. For purposes of recognition it is assumed that the purchaser has fully funded the debt instrument and that all of the following criteria are met:

    a. The instrument has a fixed term (e.g. a minimum of 5 years including any call options)
    b. There is not an expectation, either implied or through the terms of the instrument, that supervisory approval will not be withheld upon request for the repurchase or redemption of the instrument.
    c. The instrument does not have distributions that are tied or linked to the credit standing or financial condition of the issuer or another related entity.
    d. The instrument does not give purchasers rights to accelerate the repayment of future scheduled principal or coupon payments, except in winding-up.

    Related question: What limitations should be placed on the amount of available that may be comprised of subordinated senior debt (e.g. no more than 20%)?

3. Recognize the proceeds of surplus notes and structurally subordinated senior debt as capital in line with the criteria described above, but respect quality of capital classifications defined by other U.S. sectoral regulators on their regulated entities' available capital.

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