



BANK OF ENGLAND  
PRUDENTIAL REGULATION  
AUTHORITY

Consultation Paper | CP9/14

# Subordinated guarantees and the quality of capital for insurers

May 2014

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**Please address any comments or enquiries by email to:**

CP9\_14@bankofengland.co.uk by Friday 11 July 2014.



## 1 Introduction

1.1 This consultation seeks views on a draft supervisory statement which sets out the PRA's expectations of PRA-authorized insurers (firms) in relation to:

- the use of subordinated guarantees in connection with capital instruments issued by a company, whereby the payment of coupons and repayment of principal are guaranteed by a firm (the guarantor);
- how subordinated guarantees should not undermine the quality of capital held by firms to meet capital requirements (this expectation applies regardless of both the motivation for using a subordinated guarantee and the structure in which a guarantee is used); and
- how the guarantor's regulatory capital position should be reported if the liability created by the guarantee serves to undermine the guarantor's quality of capital.

1.2 The draft supervisory statement is intended to apply to all firms and may also be relevant to insurance holding companies and other entities in the same group, together with their advisors. The statement also looks ahead to Solvency II (SII), and is aimed at firms and groups within the scope of the Directive. It is intended to be equally relevant for life insurers, general insurers and mutuals.

### Purpose of the statement

1.3 The statement is designed to help the PRA meet its statutory objectives of promoting the safety and soundness of the firms it regulates and contribute to securing an appropriate degree of protection for policyholders. As set out in the insurance approach document,<sup>(1)</sup> capital is a key risk mitigant in the PRA's supervisory framework as high-quality capital absorbs unexpected losses and reduces the risk of insolvency. Guarantees should not override the loss-absorbing features of a capital instrument and investors should not avoid bearing losses when it is appropriate for the holders of a capital instrument to do so.

1.4 The statement will assist firms in assessing their compliance with the General Prudential sourcebook (GENPRU) rules on connected transactions (GENPRU 2.2.65R and 2.2.169R). It sets out the actions that the PRA expects to be taken by firms and the time frames for such actions.

### Statutory obligations

1.5 The PRA has considered matters to which it is required to have regard, and it considers that this statement is compatible with the Regulatory Principles<sup>(2)</sup> and relevant provisions of the Legislative and Regulatory Reform Act 2006. The PRA has considered equality and diversity issues and has not identified any impacts arising from the statement.

1.6 The PRA has also assessed whether the content of this consultation facilitates effective competition in markets for services provided by PRA-authorized persons in carrying on regulated activities, in light of the introduction of its secondary competition objective. The statement is designed to promote compliance with the rules set out in GENPRU. It is also designed to assist firms to prepare for the implementation of harmonised prudential capital standards anticipated under SII. The PRA therefore considers the content of this consultation as compatible with the facilitation of effective competition.

1.7 This statement aims to ensure firms' compliance with the existing rules on connected transactions — the Financial Services Authority (FSA) carried out a cost-benefit analysis of the connected transaction rules in CP06/3: Capital Standards, 2 February 2006.<sup>(3)</sup>

1.8 The PRA welcomes views on the statement. As a preparatory exercise for this consultation, the PRA carried out a survey of firms in November 2013 to determine the prevalence and treatment of these arrangements. Respondents to the November 2013 survey are invited to provide responses to this consultation notwithstanding any previous responses.

(1) *The Prudential Regulation Authority's approach to insurance supervision*, April 2013, available at [www.bankofengland.co.uk/publications/Documents/praaapproach/insuranceappr1304.pdf](http://www.bankofengland.co.uk/publications/Documents/praaapproach/insuranceappr1304.pdf).

(2) In particular, Section 3B(1)(b) of the Financial Services Act 2012 which provides that the principle that a burden or restriction which is imposed on a person, or on the carrying on of an activity, should be proportionate to the benefits, considered in general terms, which are expected to result from the imposition of that burden or restriction.

(3) [www.fsa.gov.uk/pages/library/policy/cp/2006/06\\_03.shtml](http://www.fsa.gov.uk/pages/library/policy/cp/2006/06_03.shtml).

## Draft supervisory statement on subordinated guarantees and the quality of capital for insurers

### 1 Introduction

#### Purpose of the statement

1.1 The supervisory statement applies to all PRA-authorised insurers (firms) and may also be relevant to insurance holding companies and other entities in the same group, together with their advisors. The statement also looks ahead to Solvency II (SII), and is aimed at firms and groups within the scope of the Directive. It is equally relevant for life insurers, general insurers and mutuals.

1.2 The PRA intends to ensure a consistent and clear communication of its expectations to enable firms and the PRA to make judgements which advance the PRA's objectives.

1.3 This statement sets out the PRA's expectations of firms in relation to:

- the use of subordinated guarantees in connection with capital instruments issued by a company, whereby the payment of coupons and repayment of principal are guaranteed by a firm (the guarantor);
- how subordinated guarantees should not undermine the quality of capital held by firms to meet capital requirements (this expectation applies regardless of both the motivation for using a subordinated guarantee and the structure in which a guarantee is used); and
- how the guarantor's regulatory capital position should be reported if the liability created by the guarantee serves to undermine the guarantor's quality of capital.

1.4 This statement is an application of the connected transaction rule set out in 2.2.65R and 2.2.169R of the General Prudential sourcebook (GENPRU). The PRA anticipates that similar rules will apply under SII (Article 93 of Directive 2009/138/EC), where own funds items will be required to be free from encumbrances and not connected with any other transaction which could result in an item not displaying the required features to count as own funds.

#### Actions expected of firms

1.5 Affected firms should read this statement and take the relevant actions set out in Section 3. These actions are summarised below:

- within one calendar month following the publication of this statement,<sup>(1)</sup> firms should inform their usual supervisory contact at the PRA if their capital structures involve the use

of subordinated guarantees and whether they have made any adjustment to the tiering of their capital resources to reflect the existence of such guarantees;

- if their capital structures involve the use of subordinated guarantees, firms should provide additional information relating to their use of subordinated guarantees to their usual supervisory contact by 31 December 2014.<sup>(2)</sup> Depending on firm-specific circumstances, this information may take the form of:
  - information as to how adjustments have been made, or will be made, to a firm's reporting of capital resources to reflect the existence of subordinated guarantees; or
  - an independent legal opinion setting out the basis as to why no adjustment to firm's reporting of capital resources is necessary where subordinated guarantees have been used; or
  - a detailed plan of a proposed restructuring or proposed changes to contractual terms that would address the issues raised by the statement, including the expected implementation date of that plan.

1.6 Firms are expected to liaise with their usual supervisory contact at the PRA who will inform the firm whether any action is necessary for the purposes of year-end 2014 or 2015 reporting.<sup>(3)</sup> Generally, the PRA expects any firms with relatively simple structures (see the Type 1 example in Section 5 below) to have these accurately reflected in their year-end 2014 reporting. The PRA expects any further issues relating to the use of subordinated guarantees to be resolved by 31 December 2015.

#### Other considerations of scope

1.7 This statement relates only to structures where guarantees are being used to facilitate obtaining finance. The statement is written without prejudice to any other rules, including the Prudential sourcebook for Insurers (INSPRU) 1.5.13 R (1) which provides that 'a firm other than a pure reinsurer must not carry on any commercial business other than insurance business and activities directly arising from that business'.

1.8 For guarantees outside of the scope of this statement that firms may be party to, firms should still consider whether those guarantees serve to undermine the quality of their capital and discuss these with their usual supervisory contact as appropriate.

(1) The PRA expects to publish the final supervisory statement within one month following the closure of the consultation period on 11 July 2014.

(2) Dates may be subject to change depending on the results of the consultation.

(3) In preparation for this statement, the PRA carried out a survey of firms to determine the prevalence and treatment of these arrangements — participation in that survey does not replace the need to perform the actions detailed in this statement.

## 2 Acceptable outcomes when using subordinated guarantees in connection with capital instruments

2.1 The PRA is aware that firms utilise subordinated guarantees for a variety of reasons within a variety of corporate structures (two illustrative examples are provided in Section 5 of this statement). Regardless of the reason or structure, subordinated guarantees should not serve to undermine the quality of capital held by firms to meet capital requirements. Generally, the quality of capital is undermined when firms take on additional potential liabilities that are not taken into account in, and would have to be met from, the guarantor firm's capital resources.

2.2 Any subordinated guarantee arrangement will be assessed by the PRA to ascertain whether it is consistent with one of the following two situations deemed acceptable by the PRA, and whether it displays the characteristics set out in paragraph 2.3 below.

### Situation 1

- From the perspective of the guarantor firm, if a subordinated guarantee is called upon, the guarantee should effectively extinguish or replace an existing subordinated liability. Otherwise the guarantee represents an additional potential liability that has not been reflected in, and would have to be met from, the guarantor's capital resources. The subordinated guarantee should possess the same, or better, features regarding quality of capital (eg loss absorbency and subordination) as the subordinated liability it is replacing.

### Situation 2

- Where a subordinated guarantee does not extinguish or replace an existing subordinated liability, the firm should acknowledge the existence of the guarantee by disqualifying the guaranteed amount from the guarantor's Tier 1 capital. The amount may still count towards a lower tier of capital if the terms of the subordinated guarantee meet all of the relevant criteria — in effect a relegation. Whether the relegated amount can count towards total capital will also depend on the capital gearing rules, which constrain the amount of lower quality capital that can count as capital resources.

2.3 In either case, any capital instrument that is guaranteed should still fulfil its regulatory purpose. The subordinated guarantee should not override the loss-absorbing features of a capital instrument and investors in a capital instrument should not avoid bearing losses when it is appropriate for them to do so.

## 3 The PRA's expectations of firms to provide evidence that they have properly assessed the quality of their capital

3.1 The PRA expects to rely on the quality of a firm's capital resources. With corporate structures, capital instruments and the regulatory regime itself evolving over time, the potential for guarantee structures to undermine the quality of capital is significant. Firms are expected to provide evidence so that the PRA can make informed judgements.

3.2 Within one calendar month following the publication of this statement, firms should inform their usual supervisory contact at the PRA if their capital structures involve the use of subordinated guarantees and whether they have made any adjustment to the tiering of their capital resources to reflect the existence of such guarantees.

3.3 If firms do not have these capital structures in place, and are not considering using them, the PRA will expect confirmation of this within one calendar month following the publication of this statement. Category 4 and Category 5 firms are not expected to provide such confirmation unless specifically requested to by the PRA.

3.4 In cases where an adjustment to capital resources has been made, or will be made, in the firm's regulatory returns for year-end 2014, the PRA expects firms to provide the following to their usual supervisory contact by 31 December 2014:

- the contractual terms governing the subordinated guarantee. Where the terms are incorporated in the terms of a capital instrument issued by a group entity or another firm, the contractual terms of that instrument and any related instruments should be provided; and
- information as to where in the firm's regulatory returns the adjustment has been, or will be, made.

3.5 In cases where a firm has made no adjustment to its capital resources and has no intention of making an adjustment, and is not proposing a restructuring or changes to contractual terms to change the impact of its subordinated guarantees, the PRA expects firms to provide the following to their usual supervisory contact by 31 December 2014:

- the contractual terms governing the subordinated guarantee. Where the terms are incorporated in the terms of a capital instrument issued by a group entity or another firm, the contractual terms of that instrument and any related instruments should be provided; and
- an independent legal opinion from a law firm to support their position. The legal opinion should address the

economic substance of the structure as well as the legal form, and assess whether the capital instrument that is guaranteed is fulfilling its regulatory purpose (see paragraph 2.3).

3.6 In cases where a firm has made no adjustment to its capital resources but is proposing a restructuring or changes to contractual terms to address the issue, the PRA expects firms to provide the following to their usual supervisory contact by 31 December 2014:

- the contractual terms governing the subordinated guarantee. Where the terms are incorporated in the terms of a capital instrument issued by a group entity or another firm, the contractual terms of that instrument and any related instruments should be provided; and
- a detailed plan of the proposed restructuring or changes to contractual terms including the expected implementation date of that plan, which should be no later than 31 December 2015. Firms should include a justification for their proposed date of implementation.

## 4 The PRA's assessment of information received

4.1 The PRA is aware that the issues raised by this statement may take time to analyse and that firms may need to discuss issues with their usual supervisory contact.

4.2 The PRA will assess the information received in accordance with the PRA's existing GENPRU rules, this statement and the likely impact of SII.

4.3 Where the PRA disagrees with a firm's analysis, whether supported by an independent legal opinion or not, the PRA will communicate its expectation to firms that an adjustment to the reporting of capital resources should be made.

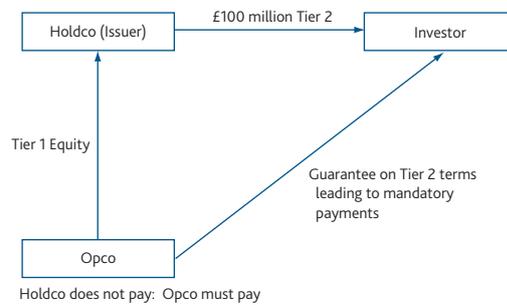
4.4 Where firms have proposed a restructuring or changes to contractual terms and these have not been implemented to a standard that meets the PRA's expectations by 31 December 2015, the PRA will expect firms to make adjustments to their reporting of capital resources for year-end 2015. This would usually involve an amount of capital not qualifying as Tier 1. It is anticipated that SII will require a similar approach.

## 5 Situations where the quality of capital is undermined by a guarantee

5.1 Two situations where the quality of capital is undermined by a subordinated guarantee are set out below. They are designed to be illustrative of the issue which this statement addresses, but they are not the only possible examples.

5.2 Type 1 describes a situation where a holding company (Holdco) issues a Tier 2 capital instrument to investors. Holdco owns an operating company (Opco) by virtue of holding 100% of its equity share capital (**Figure A**).

**Figure A** Simple structure where the quality of capital is undermined



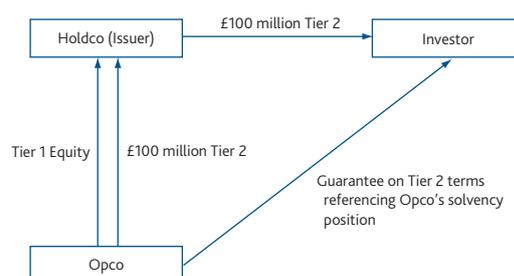
5.3 The issuer is purely a holding company and relies on the dividends of Opco to pay the coupons due to the holders of the Tier 2 subordinated debt instrument. Furthermore, the contract governing the debt instrument provides that Opco will guarantee the coupon payments and principal.

5.4 The economic effect of the arrangement is that Opco is liable for the Tier 2 debt instrument. The quality of Opco's capital is undermined as it has a potential liability to the investors in the capital instrument issued by Holdco.

5.5 As such, in reporting its regulatory capital on a solo basis, Opco should disqualify £100 million of its Tier 1 capital. The amount may still count towards a lower tier of capital if the terms of the subordinated guarantee meet all of the relevant criteria.

5.6 A more complicated example is referred to as Type 2 (**Figure B**). The structure is broadly similar to Type 1, but there is an additional internal Tier 2 instrument issued by Opco to Holdco. The coupon payments on the internal instrument could be seen to support the coupon payments on the instrument issued by Holdco to the market.

**Figure B** Complex with internal instrument



5.7 For Type 2, it will depend on the precise contractual arrangements of the internal instrument and the subordinated guarantee as to whether two sets of liabilities can be assumed by Opco.

5.8 Disqualification of Opco's Tier 1 capital is not required if, when the subordinated guarantee is called upon, the guarantee effectively extinguishes or replaces the existing subordinated liability arising from the internal Tier 2

instrument. The subordinated guarantee should possess the same, or better, features regarding quality of capital (eg loss absorbency and subordination) as the subordinated liability it is replacing.

5.9 The above examples are not the only ones where the situation arises. This statement applies to any arrangement where a firm has guaranteed, on a subordinated basis, a regulatory capital instrument issued by another entity.

**Table A** Summary table of important actions and dates

Date	Action
30 May 2014	Publication of consultation paper. Consultation closes six weeks after publication.
11 July 2014	Consultation closes.
2014 Q3 <sup>(a)</sup>	Publication of the final supervisory statement, approximately one month after the consultation closes.
2014 Q3 — one calendar month following publication of the final supervisory statement	All firms which have these capital structures in place, or are considering using them, should inform their usual supervisory contact at the PRA, as set out in paragraph 3.2.  Category 1 to 3 firms (or any firm specifically requested by the PRA) which do not have these capital structures in place, and are not considering using them, should confirm this to the PRA, as set out in paragraph 3.3.
31 December 2014	All firms with these capital structures in place should provide additional information relating to their use of subordinated guarantees to their usual supervisory contact, as set out in paragraphs 3.4 and 3.5.
31 December 2015	The PRA expects firms to have resolved all issues relating to the use of subordinate guarantees (see paragraph 4.4).

(a) Anticipated for purposes of consultation.