Regulatory capital eligibility requirements for insurers: the changing landscape

SLAUGHTER AND MAY

February 2013
1. Main changes to the eligibility requirements for UK insurers’ regulatory capital 02
   1.1. Solvency II 02
   1.2. Tiers of capital under Solvency II 03
   1.3. Eligibility requirements for Tier 1 notes 04
   1.4. Eligibility requirements for Tier 2 notes 09
2. Issuances in the insurance market 11
3. UK tax considerations 12
   3.1. Main tax issues 12
   3.2. HMRC guidance and legislative developments 13
   3.3. Position under current law 14
   3.4. Prospects for issuance 16
4. Practical considerations for issuers 17
   4.1. Dividend stoppers 17
   4.2. Early redemption for tax and regulatory reasons 18
5. Grandfathering 19
Client Briefing
Regulatory capital eligibility requirements for insurers: the changing landscape

INTRODUCTION

With the introduction of the Solvency II reforms, insurers have been bracing themselves for the regulatory changes which will take place in their industry. One of the key areas of change will be regulatory capital and while the details of the new eligibility criteria have not yet been finalised, the overall picture is becoming clearer.

This briefing will consider:

(i) the main changes to the eligibility requirements for regulatory capital applicable to UK insurers;
(ii) what challenges these proposed changes pose from the UK tax perspective;
(iii) practical considerations for an issuer if it is planning an issue now or in the near future; and
(iv) what transitional arrangements are expected to be put in place in relation to any existing regulatory capital.

IMPORTANT NOTE

This briefing is intended only as a guide. It should not be relied upon as a substitute for legal advice, which should be sought as required. The proposed regulations contain many technical provisions, not all of which are addressed by this briefing, and their application to specific situations or particular transactions will require careful consideration.

Should you require further information or advice, please contact your usual adviser at Slaughter and May or:

Miranda Leung 020 7090 3127
miranda.leung@slaughterandmay.com

Ben Kingsley 020 7090 2169
ben.kingsley@slaughterandmay.com

Jan Putnis 020 7090 3211
jan.putnis@slaughterandmay.com

William Watson 020 7090 5052
william.watson@slaughterandmay.com
1. MAIN CHANGES TO THE ELIGIBILITY REQUIREMENTS FOR UK INSURERS’ REGULATORY CAPITAL

1.1. Solvency II

Solvency II is the EU’s project to reform the prudential regulation of insurers. The Solvency II Directive is intended to introduce more sophisticated and risk sensitive standards to capital requirements for insurers in order to ensure sufficient capital is held to protect policyholders and it is based on three pillars: capital requirements, supervisory review and public reporting and disclosure.

Solvency II will follow the four level “Lamfalussy” process of legislative implementation and the Solvency II Directive, as amended, currently provides that it must be implemented by member states prior to 30 June 2013 and that the Solvency II Directive will apply from 1 January 2014.

On 29 January 2011, the European Commission proposed the adoption of a directive known as the Omnibus II Directive, in order primarily to amend the Solvency II Directive to reflect the Lisbon Treaty and the establishment of the new European system of financial supervision, but also including new powers for the European Commission to adopt transitional measures in a number of areas including regarding the classification of regulatory capital. The Omnibus II Directive proposal is currently being considered by the Council of the European Union and the European Parliament and is scheduled to be debated by the European Parliament at its plenary session in June 2013. The European Commission cannot publish the final Level 2 measures pursuant to the Solvency II Directive until the Omnibus II Directive has been finalised. Due to the delay in finalising the Omnibus II Directive, therefore, the proposed transposition into national law of the Solvency II Directive by 30 June 2013 would not appear to be achievable.

Until this legislative impasse is resolved, both the eligibility criteria under Solvency II for new regulatory capital issued by insurers and the treatment under Solvency II of regulatory capital already issued by insurers will remain somewhat uncertain. However, despite the uncertain regulatory landscape following the publication of the Solvency II Directive, insurers both in the UK and in the EU have been able to continue to issue regulatory capital. As discussed in more detail below, issuers have taken indications as to the forthcoming eligibility requirements for regulatory capital under Solvency II from two sources: (i) the Technical Specifications published by CEIOPS on 5 July 2010 after the Quantative Impact Survey (“QIS 5”) consultation exercise; and (ii) the draft Level 2 Implementing Measures for Solvency II (the draft dated 31 October 2011 is referred to below as the “Level 2 Measures”) which

---

1 Directive 2009/138/EC.  
2 The Solvency II Directive (Level 1) set out the principles of the Solvency II regime and identified a number of areas where the European Commission is required to develop implementing measures (Level 2) to provide further technical detail to elaborate on the Level 1 principles. Following changes expected to be made to the Solvency II Directive by the Omnibus II Directive to reflect the Lisbon Treaty and the establishment of the new European System of Financial Supervision, Level 2 measures are expected to take the form of delegated acts developed by the European Commission and binding technical standards developed by EIOPA and adopted by the Commission. The European Insurance and Occupational Pensions Authority (EIOPA) also plans to publish guidance (Level 3) on various aspects of Solvency II in order to enhance convergent and effective application of Solvency II and to facilitate co-operation between supervisory authorities across the EU. Member states will then be required to transpose Solvency II into their national law and the European Commission will monitor member states’ compliance with the Solvency II EU legislation (Level 4).  
4 2007/C 306  
have been made available by the European Commission to certain stakeholders but which have not been formally published.

The FSA already expects issuers to have regard to the Level 2 Measures and the Prudential Regulation Authority (the “PRA”) has publicly outlined its expectations: “The PRA will expect all capital to be capable of absorbing losses in the manner indicated by its place in the capital structure. Upon implementation, Solvency II will set out the types and quality of capital which can be recognised as permissible capital instruments for insurers. The PRA will expect all capital instruments to meet these Solvency II criteria regarding the definition of capital, and it will object to insurers issuing regulatory capital instruments that are deliberately structured to meet the letter but not the spirit of these criteria, notably where their incentive is to minimise issuance cost and promote the attractiveness to investors at the expense of genuine loss-absorbing capacity. Until Solvency II criteria are fully implemented, the PRA expects insurers to anticipate the enhanced quality of capital that will be needed, when issuing or amending capital instruments.” Accordingly, the remainder of this discussion will focus on the Level 2 Measures.

1.2. Tiers of capital under Solvency II

Solvency II recognises three tiers of regulatory capital (each referred to as “own funds”): Tier 1, Tier 2 and Tier 3. As is the case under CRD IV, Solvency II does not distinguish between Upper and Lower Tier 2 capital. Solvency II distinguishes between (i) basic own fund items, which include (amongst others) subordinated notes and preference shares, and (ii) ancillary own fund items, which include (amongst others) unpaid share capital and other legally binding commitments which are available to absorb losses. Regulatory capital under Solvency II is classified into a particular tier depending on whether it is a basic or an ancillary own fund item, and on whether it is permanently available to absorb losses or is subordinated such that it is available to absorb losses in the event of a winding-up.

For the purposes of compliance with the Solvency II Solvency Capital Requirement ("SCR"), the Level 2 Measures provide that Tier 1 capital must account for at least one half of the total amount of an insurer’s regulatory capital and that Tier 3 capital must account for less than 15 per cent. of the total amount of an insurer’s regulatory capital. As regards compliance with the Solvency II Minimum Capital Requirement ("MCR"), the Level 2 Measures require that Tier 1 capital be at least 80 per cent. of an insurer’s total regulatory capital. Within those limits, the total amount of the following types of Tier 1 capital held must be less than 20 per cent. of the total amount of the insurer’s Tier 1 capital: (i) paid-in subordinated mutual member accounts, (ii) paid-in preference shares and the related share premium account, (iii) Tier 1 subordinated notes and (iv) regulatory capital which is grandfathered into the Solvency II regime as Tier 1 capital.

---

8 Solvency II Directive, Article 93.
9 Level 2 Measures, Article 75 BSCRx et seq.
10 Level 2 Measures, Article 236 MRC1 et seq.
11 Level 2 Measures, Article 72 EOF1.
Regulatory capital eligibility requirements for insurers: the changing landscape

These limits are also reflected in the updated draft Solvency II technical specifications published by EIOPA in October 2012. Those technical specifications also provide that Tier 2 capital will be eligible for covering up to 50 per cent. of the SCR and that Tier 2 capital may be eligible for covering up to 20 per cent. of the MCR.\textsuperscript{12}

The discussion below focuses on Tier 1 and Tier 2 subordinated notes issued for regulatory capital purposes, which we refer to as “\textit{Tier 1 notes}” and “\textit{Tier 2 notes}” respectively.

1.3. Eligibility requirements for Tier 1 notes

We highlight below some of the eligibility requirements for Tier 1 notes set out in the Level 2 Measures\textsuperscript{13} and compare them to the current eligibility criteria for innovative tier 1 capital set out in GENPRU 2.2:

(i) Maturity and early redemption

“Undated or has an original maturity of at least 30 years. The first contractual opportunity to repay or redeem the basic own-fund item does not occur before 5 years from the date of issuance.

The exchange or conversion of a basic own-fund item into another Tier 1 basic own-fund item or the repayment or redemption of a Tier 1 own-fund item out of the proceeds of a new basic own-fund item of at least the same quality shall not be deemed to be a repayment or redemption. The exchange, conversion, repayment or redemption is subject to the approval of the supervisory authority.”\textsuperscript{14}

“Where... a basic own-fund item includes a contractual opportunity to repay or redeem the item between 5 and 10 years after the date of issuance, the supervisory authority shall for up to 10 years after the date of issuance make prior supervisory approval subject to the condition that the undertaking's Solvency Capital Requirement is exceeded by an appropriate margin taking into account the solvency position of the undertaking including the undertaking’s medium-term capital management plan.”\textsuperscript{15}

An Innovative Tier 1 note issued pursuant to the current GENPRU 2.2 regime must be perpetual, whereas a Tier 1 note may have a stated original maturity of 30 years under the Level 2 Measures. The ability to issue Tier 1 notes with a 30 year maturity is unlikely to be regarded as a major change by the market and the ability to include an issuer’s right of early redemption from the fifth anniversary of the issue date is consistent with current GENPRU rules. Consent from the supervisory authority is required for an early redemption unless the redemption is made out of the proceeds of the issuance of another Tier 1 instrument of at least the same quality, whilst under GENPRU 2.2, an issuer is only required to give prior notification of such redemption to the FSA. The Level 2 Measures are unclear as to what margin in excess of the SCR which an issuer must have before the relevant supervisory authority may allow early redemption before the tenth anniversary, but this requirement is likely to make the issuer’s early redemption option less easily exercisable. In addition, in contrast

\textsuperscript{12} Technical Specifications for the Solvency II valuation and Solvency Capital Requirements calculations (Part I), Section 4, OF.3 (18 October 2012).

\textsuperscript{13} This is not a complete list of such eligibility requirements. Please refer to the Level 2 Measures, Article 59 COF2 for the complete list.

\textsuperscript{14} Level 2 Measures, Article 59 COF2(1)(e).

\textsuperscript{15} Level 2 Measures, Article 59 COF2(2).
to the CRD IV requirements, it would appear that even the redemption of a Tier 1 note on its stated contractual maturity date would require supervisory consent unless the redemption is made out of the proceeds of the issuance of another Tier 1 instrument of at least the same quality.

Also in contrast to the CRD IV requirements, there is no provision in the Level 2 Measures which expressly permits redemption of Tier 1 notes prior to the fifth anniversary of their issue date due to a change in regulatory treatment resulting in the Tier 1 notes failing to qualify as Tier 1 capital, or to a change in the tax treatment of the Tier 1 notes.

(ii) No incentives to redeem

“The own-fund item… is only repayable or redeemable at the option of the insurance or reinsurance undertaking and shall not include any incentives to repay or redeem that item. Incentives to redeem are features included in basic own-fund items that increase the likelihood that an insurance or reinsurance undertaking will repay or redeem that basic own-fund item where it has the option to do so.”

This requirement is new (but in line with the CRD IV requirements). GENPRU 2.2 currently permits a moderate incentive to redeem in the form of a step-up in the interest rate payable on the notes, provided that if a moderate step-up is included, the earliest date on which the issuer can redeem the notes would be 10 years from the issue date, rather than 5 years from the issue date.

(iii) Distributions

(a) Full flexibility to cancel

“The insurance or reinsurance undertaking has full flexibility over the distributions on basic own-funds items.”

“Full flexibility over distributions… shall mean that:

(i) distributions are paid out of distributable items;

(ii) insurance and reinsurance undertakings have full discretion at all times to cancel distributions in relation to the own-fund item for an unlimited period and on a non-cumulative basis and the institution may use the cancelled payments without restriction to meet its obligations as they fall due;

(iii) there is no obligation to substitute the distribution by a payment in any other form;

(iv) there is no obligation to make distributions in the event of a distribution being made on another own fund item;
(v) *non-payment of distributions does not constitute an event of default of the insurance or reinsurance undertaking;*

(vi) *the cancellation of distributions imposes no restrictions on the insurance or reinsurance undertaking.*

Broadly speaking, these requirements are in line with CRD IV requirements but are not current requirements under GENPRU 2.2. and represent a significant commercial development for investors. In addition to the ability of an issuer to cancel distributions at its discretion, paragraph (vi) in effect prohibits the inclusion of dividend stoppers, which are currently permitted under GENPRU 2.2 (and are discussed in more detail in section 4.1 below). Market pressure may mean that issuers rarely exercise their discretion to cancel interest payments at will. However, an issuer is obliged to cancel distributions in the circumstances referred to in (b) below.

The requirements that distributions be paid out of distributable items and an issuer’s ability and obligation to cancel distributions also pose challenges for insurers who wish to obtain tax deductibility for interest paid on their notes (see section 3 (*UK tax considerations*) below).

The combination of all of the above may result in investors demanding higher pricing as they are required to take downside risk as if they were holders of ordinary shares but their potential return is, at most, the interest payments specified in the Tier 1 note.

(b) Mandatory cancellation

“The terms of the contractual arrangement governing the own-fund item provide for the cancellation of distributions in relation to that item in the event that there is non-compliance with the Solvency Capital Requirement or the distribution would lead to such non-compliance until the undertaking complies with the Solvency Capital Requirement and the distribution would not lead to non-compliance with the Solvency Capital Requirement.”

“The supervisory authority may exceptionally waive the cancellation of distributions, provided that the distribution does not further weaken the solvency position of the insurance or reinsurance undertaking and the Minimum Capital Requirement is complied with even after the distribution is made.”

The mandatory cancellation of interest payments is a new requirement for Tier 1 notes and CRD IV imposes no equivalent requirement on banks.

---

18 Level 2 Measures, Article 59 COF2(5)(b).
19 Level 2 Measures, Article 59 COF2(1)(h)(ii).
20 Level 2 Measures, Article 59 COF2(4).
(iv) Principal write-down or conversion into ordinary share capital

“The basic own-fund item... shall possess one of the following principal loss absorbency mechanisms to be triggered at the trigger event…:

(a) the nominal or principal amount of the basic own-fund item is written down in such a way that all of the following are reduced:

(i) the claim of the holder of that item in the event of winding-up proceedings;

(ii) the amount required to be paid on repayment or redemption of that item;

(iii) the distributions paid on that item.

(b) the basic own-fund item automatically converts into [ordinary share capital]; or

(c) a principal loss absorbency mechanism that achieves an equivalent outcome to the principal loss absorbency mechanisms set out in points (a) or (b).”\(^{21}\)

“The trigger event … is significant non-compliance with the Solvency Capital Requirement:

(a) the amount of own-fund items eligible to cover the Solvency Capital Requirement is equal to or less than 75% of the Solvency Capital Requirement;

(b) the amount of own-fund items eligible to cover the Minimum Capital Requirement is equal to or less than the Minimum Capital Requirement;

(c) non-compliance with the Solvency Capital Requirement, where compliance with the Solvency Capital Requirement is not re-established within a period of three months of that non-compliance occurring.”\(^{22}\)

There has been much discussion of loss absorbency features such as these since the financial crisis. They are not currently required under GENPRU 2.2. They are similar to the write-down/conversion features prescribed by CRD IV, although the trigger events are different and the Level 2 Measures do not include a further statutory write-down/conversion at the point of non-viability, as has been proposed in the draft EU Crisis Management Directive\(^{23}\). Write-down/conversion is triggered by “significant” non-compliance with the SCR but as will be seen below, any non-compliance with the SCR would also require redemption of the notes to be suspended.

\(^{21}\) Level 2 Measures, Article 59 COF2(6).

\(^{22}\) Level 2 Measures, Article 59 COF2(8).

Like the requirement for the issuer to be able to cancel distributions at will, these features will require investors to accept greater risk than they currently do when holding Innovative Tier 1 notes. If a trigger event were to occur, some investors may prefer conversion into ordinary shares rather than for the principal amount of their investment to be written down permanently. However, there may be investors who are not able to hold ordinary shares in their portfolios and a conversion feature may therefore affect the marketability of the notes to such investors. An issuer may also prefer not to adopt the conversion option as it is likely to be less attractive to its existing shareholder base.

Unlike CRD IV, the Level 2 Measures do not expressly contemplate that Tier 1 notes could be written down on a temporary basis only, although it may be that EOI PA will permit a mechanism for write-up after a temporary write-down when it develops the Level 3 guidance.

(v) Mandatory suspension of redemption

“The basic own-fund item … provides for the suspension of repayment or redemption of that item in the event that there is non-compliance with the Solvency Capital Requirement or repayment or redemption would lead to such non-compliance until the undertaking complies with the Solvency Capital Requirement and the repayment or redemption would not lead to non-compliance with the Solvency Capital Requirement.”24

“The supervisory authority may exceptionally waive the suspension of repayment or redemption of that basic own-fund item provided that the basic own-fund item is exchanged for or converted into another Tier 1 own-fund item of at least the same quality and the Minimum Capital Requirement is complied with even after the repayment or redemption.”25

This requirement, which again involves investors accepting a higher level of risk, is not found in GENPRU 2.2 and there is no equivalent requirement for banks under CRD IV. However, it is consistent with the requirements for Tier 2 notes under the Level 2 Measures, where non-compliance would also require suspension of redemption. (See paragraph (iv) of section 1.4 (Eligibility requirements for Tier 2 notes: Mandatory suspension of redemption) below.) In addition, if the supervisory authority will only be permitted to waive the suspension of redemption if the notes are exchanged for another Tier 1 own-fund item of at least the same quality, this will not provide much comfort to investors.

(vi) No hindrance of recapitalisation

“The basic own-fund item absorbs losses at least once there is non-compliance with the Solvency Capital Requirement, or with the Minimum Capital Requirement in the event that non-compliance with the Minimum Capital Requirement occurs before non-compliance with the Solvency Capital Requirement, and does not hinder the recapitalisation of the insurance or reinsurance undertaking.”26

24 Level 2 Measures, Article 59 COF2(1)(g).
25 Level 2 Measures, Article 59 COF2(3).
26 Level 2 Measures, Article 59 COF2(1)(d).
The Level 2 Measures do not specify the terms which a Tier 1 note must feature, in addition to the requirements listed above and elsewhere in the Level 2 Measures, in order to be able to conclude that the Tier 1 note “does not hinder the recapitalisation” of the issuer. Further guidance may be provided by the EIOPA.

1.4. Eligibility requirements for Tier 2 notes

We highlight below some of the eligibility requirements for Tier 2 notes set out in the Level 2 Measures\textsuperscript{27} and compare them to the current eligibility criteria for Lower Tier 2 capital set out in GENPRU 2.2:

(i) Maturity and early redemption

“The basic own-fund item is undated or has an original maturity of at least 10 years. The first contractual opportunity to repay or redeem the basic own-fund item does not occur before 5 years from the date of issuance. The exchange or conversion of a basic own-fund item into another Tier 1 or Tier 2 basic own-fund item or the repayment or redemption of a Tier 2 own-fund item out of the proceeds of a new basic own-fund item of at least the same quality shall not be deemed to be a repayment or redemption. The exchange, conversion, repayment or redemption is subject to the approval of the supervisory authority.”\textsuperscript{28}

Save for the difference in the minimum maturity, these mirror the requirements for Tier 1 notes, which means that supervisory consent would be required for an early redemption as well as a redemption on the note’s stated original maturity. The minimum maturity is 10 years for insurers rather than the 5 years for banks under CRD IV. This minimum maturity is also 5 years longer than the current GENPRU requirement for Lower Tier 2 notes. As is the case for Tier 1 notes, the Level 2 Measures do not expressly allow for early redemption if the notes cease to qualify as Tier 2 capital or there is a change in their tax treatment.

(ii) Limited incentives to redeem

“The basic own-fund item is only repayable or redeemable at the option of the insurance or insurance undertaking and may include limited incentives to repay or redeem that basic own-fund provided that these do not occur before 10 years from the date of issuance.”\textsuperscript{29}

Unlike CRD IV, where Tier 2 instruments may not include incentives to redeem, the Level 2 Measures permit incentives to redeem Tier 2 notes if they are only offered after the tenth anniversary of the date of issue. No quantitative limits are specified but it is likely that these will be developed by EIOPA in the Level 3 guidance.

\textsuperscript{27} This is not a complete list. Please refer to the Level 2 Measures, Article 61 COF4.
\textsuperscript{28} Level 2 Measures, Article 61 COF4(1)(c).
\textsuperscript{29} Level 2 Measures, Article 61 COF4(1)(d).
(iii) Mandatory “cancellation” of distributions

“The terms of the contractual arrangement governing the own-fund item provide for the cancellation of distributions in relation to that item in the event that there is non-compliance with the Solvency Capital Requirement or the distribution would lead to such non-compliance until the undertaking complies with the Solvency Capital Requirement and the distribution would not lead to non-compliance with the Solvency Capital Requirement.”

“The supervisory authority may exceptionally waive the cancellation of distributions, provided that the distribution does not further weaken the solvency position of the insurance or reinsurance undertaking and the Minimum Capital Requirement is complied with even after the distribution is made.”

It is suggested that the inclusion of this requirement in the Level 2 Measures relating to Tier 2 notes was erroneous and the applicable requirement will be one of mandatory deferral of interest payments. Certainly, the reference to a cancellation as opposed to a deferral requirement has caused concern in the market and was unexpected. It is hoped that the next draft of the Level 2 Measures will make the necessary correction. As we discuss below under “Issuances in the insurance market”, a number of issuers have issued what they expect to be Solvency II compliant Tier 2 notes on the basis that, in the event of a breach of the SCR, the requirement will be deferral of interest payments rather than cancellation.

(iv) Mandatory suspension of redemption

“The basic own-fund item…. provides for the suspension of repayment or redemption of that item in the event that there is non-compliance with the Solvency Capital Requirement or repayment or redemption would lead to such non-compliance until the undertaking complies with the Solvency Capital Requirement and the repayment or redemption would not lead to non-compliance with the Solvency Capital Requirement.”

“The supervisory authority may exceptionally waive the suspension of repayment or redemption of that basic own-fund item provided that the basic own-fund item is exchanged for or converted into another Tier 1 or Tier 2 basic own-fund item of at least the same quality and the Minimum Capital Requirement is complied with even after the repayment or redemption.”

This deferral requirement is not included in GENPRU 2.2 and is not required of Tier 2 instruments under CRD IV. However, as a number of issuers have sought to issue Solvency II compliant Tier 2 notes, the market appears to have become accustomed to provision for mandatory deferral of coupon and redemption.

10 Level 2 Measures, Article 61 COF4(1)(f)(ii).
11 Level 2 Measures, Article 61 COF4(3).
12 Level 2 Measures, Article 61 COF4(1)(e).
13 Level 2 Measures, Article 59 COF4(2).
2. ISSUANCES IN THE INSURANCE MARKET

Since the publication of the Solvency II Directive, Aviva, Friends Life, CNP Assurances, Hannover Re, Munich Re, Allianz, AXA, Old Mutual, AEGON and Standard Life have all issued Tier 2 notes which include features prescribed by the Level 2 Measures.

Investors’ reception of mandatory deferral features in Tier 2 notes has, in the UK at least, been helped by the fact that optional deferral of interest is something which the market has been used to for Upper Tier 2 notes for some time; and in some cases investors have also been offered a dividend stopper, operating until the deferred interest is paid or at least until interest payments have been resumed. Initially investors were concerned that the SCR could be set at a level which would make mandatory deferral a hair trigger. But after a number of issuances incorporating this feature the market appears to have accepted it, perhaps in part because of the strength of the issuers but also because, in some cases, investors have been given the protection of a dividend stopper.

Given that the grandfathering regime was not set out in the Solvency II Directive, it was not clear until the Level 2 Measures became available that non-Solvency II compliant issuances are likely to be grandfathered so long as they are issued before the date on which the Solvency II Directive is required to be transposed into national law (which is currently proposed to be 30 June 2013). This lack of clarity on grandfathering encouraged issuers to incorporate Solvency II features into their notes, particularly if they were acceptable to the market. Even though grandfathering may be available, both issuers and investors now tend to favour Solvency II compliant Tier 2 notes (on the basis that an early redemption by an issuer triggered by capital disqualification is still more remote than if no such features are incorporated).

In the last six months, insurers have been active in issuing Tier 2 capital: in October, Allianz SE issued €1,500,000,000 Subordinated Fixed to Floating Rate Notes due 2042; in November, Allianz SE issued U.S.$1,000,000,000 5.5% per cent. Undated Subordinated Notes, Friends Life Group plc issued U.S.$575,000,000 7.875% per cent. Reset Perpetual Subordinated Notes and Hannover Re issued €500,000,000 Subordinated Fixed to Floating Rate Callable Bonds due 2043; in December, Standard Life plc issued £500,000,000 Fixed Rate Subordinated Notes due 2042; and in January this year, AXA issued U.S.$850,000,000 5.50% per cent. Undated Subordinated Notes and AXA SA issued €1,000,000,000 5.125% per cent. Fixed to Floating Rate Subordinated Notes due 2043. All of these issuances include provisions for both optional and mandatory deferral of interest payments.

However, the same development has not been seen in the market for Solvency II compliant Tier 1 notes. Until the Level 2 Measures became available, there was a lack of clarity as to what additional features would be required. It has now become apparent that only a strong issuer could take a Solvency II compliant Tier 1 note issuance to the market given the significant number of Solvency II features which are additional to the current requirements, for example the mandatory cancellation of coupon, the prohibition of dividend stoppers and the requirement for a principal write-down or conversion to equity upon "significant" non-compliance with the SCR. In the UK, a number of these features also pose significant tax concerns for issuers.

To our knowledge, Skadeförsäkring AB remains the only insurance company incorporated in the EU to have issued notes which incorporate a principal write-down feature and a mechanism for converting such written down amounts into capital contributions in the issuer.
As the requirements have become clearer, it has also become clearer that notes issued before the required date for the transposition of the Solvency II Directive into national law are likely to be grandfathered into the Solvency II regime, apparently removing the incentive to confront the potential challenge of issuing Solvency II compliant Tier 1 notes to the market.

However, the indications are that the FSA would like any new issue of regulatory capital by a UK insurer to meet the anticipated Solvency II criteria for the relevant tier of capital on the date of issue. We understand that in particular the FSA would be reluctant to allow an insurer to issue Tier 1 notes which comply with the current GENPRU criteria for Tier 1 capital but not the anticipated Solvency II criteria, with the intention that they should nonetheless qualify as Tier 1 capital for Solvency II purposes by virtue of grandfathering. Another approach which issuers might consider would be to issue Tier 1 notes which include the Tier 2 Solvency II features so that if it is not possible to rely on grandfathering into Tier 1, the notes would still be classified as Tier 2 capital under Solvency II.

In the past year, Aviva plc (in May 2012) and Prudential plc (in January 2013) have both issued perpetual notes with a preference share exchange option.

3. UK TAX CONSIDERATIONS

The tax treatment of regulatory capital is not a simple topic. But the Solvency II rules are certainly less challenging in this respect than the CRD IV package.

We do not discuss here those tax points that should not be affected by the introduction of the new regulatory regime. The obvious examples are the “unallowable purposes” test and the anti-arbitrage regime, both of which HMRC has in the past said could apply to regulatory capital. (We would in any event be surprised if either proved problematic in practice, assuming a standard issue to the market which raises new capital or replaces existing debt.)

3.1. Main tax issues

(i) Treatment of interest

From a tax perspective, the whole purpose of regulatory capital is of course that the issuer should obtain deductions for its interest payments even though from an economic perspective the instruments share some of the characteristics of equity and can for that reason obtain the desired treatment for regulatory capital purposes.

Deductibility of the interest will depend chiefly on two points. First, the instrument must give rise to a “debt” on general principles, so that it can for tax purposes constitute a “money debt” and therefore a “loan relationship” of the issuer\textsuperscript{34}. This question arises only when the instrument is “perpetual”.

\textsuperscript{34} Corporation Tax Act 2009 (“CTA 2009”), sections 302 and 303.
Assuming there is a loan relationship, the remaining question is whether the interest is recharacterised for tax purposes as a non-deductible distribution. There are several rules which could have this effect, but the most significant in the present context is so-called "results-dependency". The statutory question is whether "the consideration given by the company for the use of the principal secured depends (to any extent) on the results of – (a) the company’s business, or (b) any part of the company’s business". The primary target of this rule is debt which carries an equity-like return, but the drafting is wide enough to catch more than that.

(ii) Interaction between tax and accounting

A second set of UK tax issues arises because, under the "loan relationships" regime, the taxation of corporate debt takes as its starting point the accounting treatment of that debt. This raises two questions in the present context. Will any contingent obligation to write down or convert the debt be treated as a derivative for accounting purposes, giving rise to possible volatility in the accounts and therefore, under the "derivative contracts" regime, in the tax treatment of the issuer? And if that feature is activated, will the result be an accounting credit and consequent tax charge for the issuer?

(iii) Stamp duty

The last tax issue that we consider is the possible liability for stamp duty, or stamp duty reserve tax ("SDRT"), on a transfer of the instruments. As a general matter, debt instruments issued by a company will constitute "loan capital" for stamp duty purposes, qualifying for an exemption from both stamp duty and SDRT. However, the loan capital exemption does not apply to securities which have certain specified characteristics. The most important exception is a stamp duty version of the "results-dependency" test.

3.2. HMRC guidance and legislative developments

HMRC has said very little that relates directly to the issue of hybrid instruments designed to comply with the requirements of Solvency II. It has however consulted extensively on the same questions in the context of regulatory capital to be issued by UK banks in accordance with principles set out in "Basel III", now embodied in CRD IV.

HMRC produced a number of papers in Spring and Summer 2011 (the "2011 Papers") which discussed the technical issues for bank capital. The main objective was to determine what changes might be needed to UK tax legislation if the Government decided that interest paid by banks in respect of such instruments should be tax deductible, as it has been in the past. Then on 26 June 2012, HMRC issued a short paper (the "2012 Paper") which set out its views on the application of current UK legislation to the features that banks’ regulatory capital will have to incorporate if it is to comply with CRD IV. (The 2012 Paper was in fact reissued on 25 September, but with very little amendment.)

---

Legislative developments targeted at banks’ regulatory capital have also begun to appear. The Finance Act 2012 gave the Treasury power to make regulations providing for “the tax consequences in relation to securities of any regulatory requirement imposed by any EU legislation (whenever adopted)”\textsuperscript{38}. And the Finance Bill 2013, which was published in draft on 11 December 2012, included provisions intended to eliminate corporation tax concerns arising from “results dependency” for any bank securities that qualify for Tier 2 capital. Once enacted, this is to take effect from 26 October 2012.

HMRC’s first attempt at amending this legislation, published as a separate item on 26 October, was unsatisfactory. The drafting set out in the Finance Bill is perhaps not perfect, but it is a considerable improvement. The central change is a proposed new section 1032A CTA 2010 which simply states that “a payment made in respect of tier two securities is not a distribution for the purposes of the Corporation Tax Acts”.

3.3. Position under current law

The new legislation described will apply only to bank issuers. So the immediate question for insurers is whether they can achieve satisfactory tax treatment under existing tax legislation for instruments that comply with Solvency II requirements.

(i) Is there a debt?

The 2012 Paper acknowledges that standard “perpetuals” do constitute debt, in view of the holder’s right to the return of principal on liquidation of the issuer. This would presumably cover any Tier 2 notes that were undated. However, HMRC believes that the new version of Tier 1 capital for banks will have to be “truly perpetual” such that the issuer has no obligation to repay the principal in any circumstances. That seems to us unlikely; we expect that they will be repayable in the liquidation of the issuer on much the same basis as Tier 1 capital issued by banks or insurers has always been (that is, as if they were preference shares).

It is not clear whether HMRC would take the same line in relation to new generation Tier 1 notes issued by insurers. We would be surprised to see the point raised at all if the issuer takes advantage of the ability (under Solvency II, but not CRD IV) to introduce a stated maturity date for its Tier 1 notes, notwithstanding the likely restrictions on the right to repay at that date. And in our view undated Tier 1 notes should also constitute debt, though the matter is not entirely beyond doubt.

(ii) Results-dependent interest

Application of the “results-dependency” rule in section 1015(4) CTA 2010 will differ as between Tier 1 and Tier 2 notes under Solvency II.

The only cloud on the horizon for Solvency II compliant Tier 2 capital is the reference in the Level 2 Measures to “cancellation” rather than “deferral” of distributions. But as we have noted above, this may simply be a mistake.

\textsuperscript{38} Section 221(1).
If it is then there is no reason why interest should not be deductible, assuming that HMRC’s long-standing approach to results-dependency does not change.

By contrast, there can be no doubt that the restrictions applying to the payment of coupon on Tier 1 notes (for example, the requirement for distributable profits) will fall foul of this rule as it currently applies, meaning that coupon payments are not tax deductible.

There is also another feature of the Solvency II Tier 1 requirements which requires attention in the context of section 1015(4) CTA 2010. The notes will have to include provision for write-down of principal and/or conversion into equity on the occurrence of a trigger event. In the context of bank regulatory capital, HMRC has suggested that such a provision will in itself make the “consideration given for the use of the principal secured” results-dependent, at least if it is not confined to conversion (rather than write-down).

If that is right, it would constitute a second reason for denying tax deductibility to interest payments on new Tier 1 capital. But the mere fact that the holder may not receive full repayment of principal should not in our view trigger application of this rule. Unlike HMRC, we believe that the obligation to repay principal should probably not be regarded as part of the “consideration given for the use of the principal secured”39; rather, there would simply be a reduction in the “principal secured”. There would also be a reduction in the coupon. But if the reduction is commensurate, it is not altogether clear that the “consideration given” has been altered; or to put it another way, a coupon of 5 per cent. provides the same proportionate return whether the principal is 100 or 10.

This second concern should disappear altogether if the issuer is able to opt for conversion rather than write-down as its bail-in mechanism. But as we observed in paragraph (v) of section 1.3 of this memorandum, commercial considerations may militate against this.

(iii) Tax and accounting

The questions that arise under this heading are in some ways the most obscure of all, as they depend in part on the accounting treatment of the instruments and that is not in itself a settled issue. However, for insurers (unlike for banks) they should be relevant only to Tier 1 notes.

If a trigger event occurs and the result is a write-down of principal, there would certainly be a tax charge for the issuer under current legislation40. We would not however expect conversion to trigger a tax charge, partly because of HMRC’s general approach to conversions and partly because a statutory exemption may apply41.

---

39 Compare “payment by time for the use of money”, the classic definition of interest. The promise to repay the principal would seem to be consideration for its advance, not for its use, a distinction which perhaps gains further support from the drafting of paragraph E in section 1000(1) CTA 2010.

40 HMRC’s record of a meeting on 28 July 2011 suggests that the point has not gone unnoticed in the context of bank capital. Paragraph 4.7 includes this statement: “It was confirmed that the regulator would take into account the effects of the tax charge, which effectively meant that higher levels of capital needed to be raised in order to meet regulatory requirements.”

41 HMRC would probably accept that the conversion involved a “release … in consideration of shares forming part of the ordinary share capital of the debtor company”, within section 322(4) of CTA 2009.
Regulatory capital eligibility requirements for insurers: the changing landscape

The accounting treatment is central to the question of volatility resulting from the conversion feature (or of any right to convert that the issuer may have). The point is discussed at some length in the 2011 Papers, without any clear conclusion emerging. We will not attempt to reach a view here either. But we doubt that any possible accounting and tax volatility would in itself be sufficient reason not to proceed with an issue of Tier 1 notes. First, there is unlikely to be a material accounting impact unless the issuer is already in serious trouble (so that conversion is more than a theoretical possibility). Second, it is not altogether clear that the conversion feature would in any event constitute a “derivative contract” for tax purposes.42

iv) Stamp duty

The stamp duty version of results-dependency is not exactly the same as the version in section 1015(4) CTA 2012, but again there can be no doubt that (without legislation amendment) it will catch Tier 1 notes issued by a UK company.

Where the loan capital exemption does not apply, a person acquiring the notes by transfer would be liable for SDRT at 0.5 per cent. of the consideration for the transfer. But there are alternative solutions to consider. The most obvious of these would be to issue the notes into Euroclear (or another clearance service) so that subsequent transfers were not chargeable. Following the ECJ’s decision in the HSBC case43, the issue into a clearance service would not itself trigger a liability to SDRT.

3.4. Prospects for issuance

The Solvency II regime does not appear to pose any particular tax problems for a UK insurer wishing to issue Tier 2 notes, so long as the reference in the Level 2 Measures to “cancellation” of distributions is indeed a mistake.

The picture is less promising for Tier 1 notes. Interest payments will certainly be “results-dependent” and so non-deductible, absent a change in the tax legislation. In theory an issuer could seek to avoid the problem by relying on grandfathering, but it is not clear to what extent this will be a workable solution in practice; for more on this topic please see section 5 (Grandfathering).

The remaining possibility is issuance through an intermediate vehicle. Some years ago this was in fact a fairly well-established solution to the problem of results-dependency, typically using a partnership as the issuing vehicle.

In the present context, that could mean a two tier structure along the following lines: a partnership controlled by the insurer issues limited partner interests to investors (directly, or via a trust) which include the new features required for Tier 1 status under Solvency II; and the partnership uses the proceeds to subscribe for a “standard” perpetual (or possibly long-dated) security issued by the insurer. The partnership would probably be established under foreign law, thereby eliminating any stamp duty concerns on transfer of the partnership interests.

42 It would have to be an option, future or contract for differences and so come within section 577(1) CTA 2009. In the 2011 Papers, HMRC records its view that the conversion feature will probably be a contract for differences. But it is not obvious that it involves “a contract the purpose … of which is to make a profit or avoid a loss”, the definition given in section 582(1) CTA 2009.

43 Case C-569/07, 1 October 2009, HSBC Holdings Ltd and Vidacos Nominees v The Commissioners for HM Revenue & Customs.
There are a number of intricate points to consider here, but a structure of this kind might allow insurers to achieve interest deductibility for new Tier 1 notes without a change in the tax legislation.

One fundamental question is whether the regulatory rules will require the terms of the interests issued to investors by the partnership (or other intermediate vehicle) to track the terms of the instrument issued by the insurer to the partnership. If they had to be essentially the same, the tax problem would reappear at that lower level. But in principle it should be sufficient if the arrangements ensure that investor entitlements can never be greater than they would have been if the insurer had issued Tier 1 securities directly. That ought not to be incompatible with the tax objective.

It should be noted that the new regulatory regime for banks does indeed appear to stipulate that the relevant terms of the debt issued to the intermediate vehicle must match those required if the securities issued to investors are to qualify for Tier 1 status. On that basis indirect issuance will not be a feasible solution to the tax problem for banks’ regulatory capital. We are not however aware of any equivalent provision in the Solvency II materials published to date.

4. PRACTICAL CONSIDERATIONS FOR ISSUERS

UK insurers who are currently considering an issue of regulatory capital may wish to be aware of the following:

4.1. Dividend stoppers

Dividend stoppers are a relatively common feature of Upper Tier 2 notes which include optional and mandatory interest deferral provisions. (As we described in section 2 of this briefing, GENPRU 2.2 provides that Upper Tier 2 notes must include the right to defer interest payments and the Level 2 Measures require mandatory deferral provisions to be included in Tier 2 notes.) Some Lower Tier 2 notes which include mandatory deferral of interest provisions also include dividend stoppers. A dividend stopper is a term which provides that if an issuer defers a coupon or redemption payment under the relevant notes, it cannot make any coupon payment or other distribution on any capital instrument which ranks equally with, or junior to, the relevant notes.

There is a specific prohibition in the Level 2 Measures on the inclusion of any dividend stopper in relation to Tier 1 Notes, but not for Tier 2 Notes. However we understand that, in addition to expecting issuers to comply with Solvency II requirements ahead of their actual implementation, the FSA has recently taken the approach that the inclusion of a dividend stopper in an issue of Tier 2 notes is not acceptable.

The FSA’s apparent interpretation of the Level 2 Measures is that the inclusion of a dividend stopper in a Tier 2 note means that an issuer would not have full flexibility over distributions in respect of its ordinary shares, resulting in its ordinary shares not complying with the Solvency II criteria for Tier 1 capital. Furthermore, the dividend stopper
could hinder the recapitalisation of the issuer because the issuer would not be able to pay dividends on any of the ordinary share capital or other Tier 1 capital it would seek to issue in order to recapitalise.

This seems to us a strange interpretation of the Tier 1 requirements under the Level 2 Measures. It leaves insurers contemplating an issuance of Upper Tier 2 notes before the implementation of Solvency II in a difficult predicament. Without a dividend stopper, investors may not feel comfortable with the issuer having the right to defer coupon payments if it wishes to do so (which is a current requirement in GENPRU for Upper Tier 2 Notes); as noted above, the market generally expects an issuer to provide such protection in return for having optional deferral rights.

4.2. Early redemption for tax and regulatory reasons

It is also common practice for issuers to include in their regulatory capital notes a right to redeem the notes early in the event that they do not qualify, or cease to qualify, for regulatory capital treatment or there is an adverse change in the tax treatment of the notes. All of the Allianz, Aviva, AXA, Friends Life, Hannover Re and Standard Life issuances referred to above include early redemption rights on account of (i) a loss of tax deductibility for interest payments, (ii) the issuer being required to gross up interest payments on account of a change in tax law, or (iii) a regulatory event which has the effect that the notes do not qualify for the intended regulatory capital treatment.

The Allianz, AXA and Hannover Re issuances also include early redemption rights on account of both (i) a change in accounting treatment which means that the issuer must no longer record the notes as a balance sheet liability (an “accounting event”), and (ii) a change in rating agency methodology which means that, in the issuer’s opinion, the capital treatment of the notes becomes materially unfavourable (a “rating event”). The Standard Life issuance includes early redemption rights on the occurrence of a rating event. Allianz and Hannover Re may only exercise these rights if Solvency II has been implemented and the inclusion of the rights would prevent the notes from counting as Tier 2 capital of the issuer, whereas the terms of the AXA and Standard Life issuances permit the exercise of such rights at any time.

For UK insurers, GENPRU 2.2.71 and GENPRU 2.2.173 expressly permit the inclusion of early redemption rights on account of a change in any law or regulation or in the interpretation of any law or regulation where it is reasonable for the issuer to conclude, judged at the issue date, that the circumstances which would entitle the issuer to redeem the notes early are unlikely to materialise. However, the Level 2 Measures do not include any such express provision for early redemption as a result of these factors. Unless this changes when the Level 2 Measures are finalised, insurers will face the risk of having to leave in place regulatory capital notes which suffer adverse tax treatment or do not benefit from the intended regulatory capital treatment.

There seems to be little reason why insurers should be at a disadvantage as compared to banks, for whom CRD IV expressly permits the inclusion of early redemption rights. The insurance industry may need to lobby the FSA and the European legislators for a similar inclusion in the final Level 2 Measures.
5. GRANDFATHERING

The Level 2 Measures suggest that if a regulatory capital instrument issued before 30 June 2013 complied, as at its issue date, with the requirements for undated or dated subordinated loan capital in accordance with the Consolidated Life Directive,\textsuperscript{46} it would be eligible for grandfathering under Solvency II as Tier 1 or Tier 2 capital respectively, until 30 June 2023.\textsuperscript{47}

Subsequently, the Economic and Monetary Affairs Committee of the European Parliament has proposed that the grandfathering provisions should be set out in the Omnibus II Directive itself. However, whilst the Committee seems to suggest that instruments should be grandfathered for up to 10 years, the date on which this 10 year period would begin is unclear, and the date before which a regulatory capital instrument must be issued in order to be eligible for grandfathering is also unclear.

It is obviously desirable for this uncertainty as to the grandfathering period, and as to the grandfathering eligibility criteria themselves, to be resolved as soon as possible. Issuers can then predict how their regulatory capital instruments will be treated in the years ahead. Unfortunately, there seems to be little sign that greater certainty will be available before the European Parliament considers the Omnibus II Directive proposal in June 2013, and as the FSA continues to encourage issuers to anticipate the Solvency II requirements, many issuers will be issuing regulatory capital notes (at least insofar as Tier 2 notes are concerned) in the expectation that they would meet the Solvency II eligibility criteria in their own right, without the need to rely on grandfathering.

The drafting of the Level 2 Measures also raises the possibility that an Upper Tier 2 note issued today could be eligible for grandfathering as Tier 1 capital under Solvency II. Article 73(2) TOF1 of the Level 2 Measures provides that an existing regulatory capital instrument will be grandfathered as Tier 1 capital under Solvency II where, in accordance with the requirements of the Consolidated Life Directive, the regulatory capital instrument:

"(a) ranks after the claims of all policy holders and beneficiaries and non-subordinated creditors;

(b) is fully paid-up;

(c) has no specified maturity date;

(d) is only repayable or redeemable at the option of the insurance or reinsurance undertaking and repayment or redemption of the [instrument] is subject to prior review by the supervisory authority;

(e) allows the undertaking to cancel or defer the payment of interest or dividends in relation to [the instrument];

\textsuperscript{46} Directive 2002/83/EC, as amended by Directive 2005/68/EC.

\textsuperscript{47} Level 2 Measures, Article 73 TOF1.
(f) provides for the loss-absorption capacity of the [instrument], while enabling the insurance or reinsurance undertaking to continue its business.\textsuperscript{48}

These requirements replicate the requirements for “undated subordinated loans” pursuant to Article 27(3)(b) of the Consolidated Life Directive. It therefore seems to be the case that, if the grandfathering criteria are adopted in the form set out in the Level 2 Measures, an Upper Tier 2 note issued today in compliance with GENPRU 2.2 would be grandfathered for 10 years into Tier 1 capital under the Solvency II regime. However, given that the grandfathering criteria are not yet settled, and given the FSA’s policy since late October 2012 of requiring insurers to comply with Solvency II requirements in any new regulatory capital notes (as noted in section 2 above), it remains to be seen whether such a “grandfathering uplift” could in fact be achieved.