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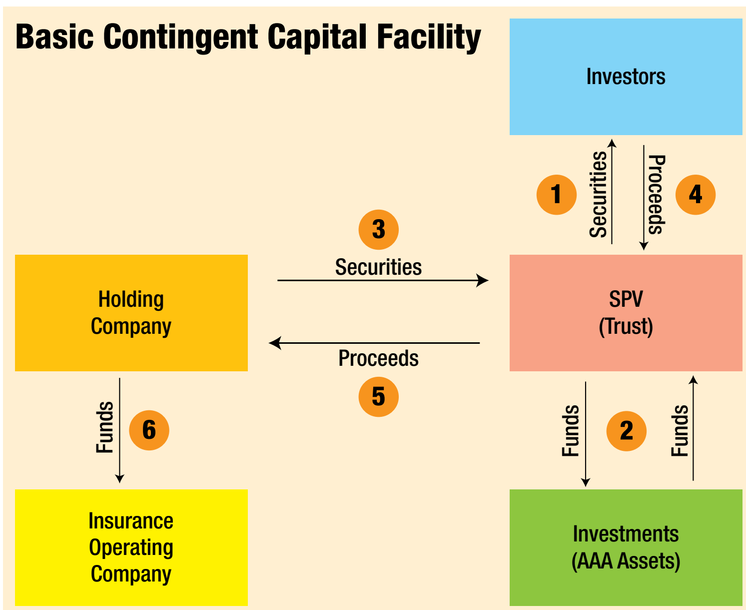
Analyzing Contingent Capital Facilities

A primary concern for an insurance organization is its need to maintain an amount of capital that is commensurate with the entity's risk profile. For companies with strong balance sheets, robust earnings and limited opportunities for growth, effective capital management may involve returning a portion of that capital via stock buy-backs or the retirement of debt. While A.M. Best does not advocate aggressively removing capital from the balance sheet, too much capital can be problematic in that it exerts pressure to grow and expand operations at a pace that may not be prudent under certain market conditions.

During periods when the market is flush with capital, stock buy-backs become a popular mechanism for companies to achieve an appropriate balance between capital and risk. However, with a diminished capital cushion, management teams become concerned with their ability to take advantage of future market opportunities. A favorable business opportunity such as an acquisition or new line of business may not wait for the company to raise capital. Moreover, under a shock-loss scenario such as a catastrophe, companies may find it difficult to recapitalize afterward at a reasonable cost. This refers to the concept of financial flexibility, which goes hand in hand with capital management and is a key component of A.M. Best's rating analysis.

Credit for Contingent Capital Facilities

Some management teams have taken proactive steps toward enhancing their financial flexibility. One popular approach is through contingent capital facilities, which allow companies to preset the terms and conditions of future capital-raising initiatives. Based on the provisions of the facility, A.M. Best will consider giving qualitative and, in some cases, quantitative credit for contingent capital. It should not be inferred, however, that A.M. Best expects all highly rated companies to maintain contingent capital facilities. This is simply one of many ways insurance organizations can demonstrate their financial flexibility.



1. SPV is formed and issues contingent notes to investors.
2. SPV invests funds in highly rated, liquid assets.
3. Holding company excercises put option, issues securities to SPV.
4. Contingent notes replaced with newly issued securities.
5. SPV liquidates asset and proceeds transferred to holding company.
6. Funds downstreamed to operating company.

Considering the recent interest in contingent capital, A.M. Best has determined which provisions likely would

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warrant credit in Best's Capital Adequacy Ratio (BCAR), which measures risk-adjusted capital available to meet policyholder obligations. Generally, more credit is given to fully funded facilities, where the special-purpose vehicle (SPV) holds highly rated, liquid securities that the sponsor can access on short notice. A.M. Best also looks favorably on facilities that require put options to be exercised when certain events occur, such as a catastrophe loss (i.e. natural, man-made or pandemic). If the put option rests with the holding company, credit is given if the holding company is obligated contractually to downstream the funds to its insurance operating subsidiary. In cases where the put option involves a hybrid issuance at the operating company level, the maximum available credit would be 90%. This could reach 100% if the facility involves the issuance of equity securities. However, since limitations are placed on all forms of soft capital, in cases where credit is given in the published BCAR model, the maximum credit allowance is 10% of equity capital. Also, where credit is given on a pro forma basis – that is, prior to exercising the put option – the securities to be issued pursuant to the contingent capital facility will count toward the financial leverage calculation.

Facilities that do not conform to these specifications (i.e. the SPV is not fully funded; triggering the facility is subject to management discretion) still can receive credit on a qualitative basis, and on a quantitative basis toward the stress-tested capital requirement. Here, the securities to be put to the SPV would not count toward the financial leverage calculation until actually issued. The cap on credit given in the stress-tested BCAR would be increased to 35% of equity capital.

Case Study – Treatment of Contingent Capital Facility

Holding Company Capital Structure

Debt	$600
Hybrid	$200
Equity	$1,800
Total Capital	**$2,600**
Contingent Capital	$400*

*operating company has put option to issue a hybrid security

Operating Company BCAR Treatment

Assuming facility meets guidelines for receiving credit in BCAR (see Table).

	Baseline	Add Contingent Capital Credit
Adjusted Capital	$2,800[1]	$3,060[3]
Required Capital	$2,000[2]	$2,050[4]
BCAR Score	140	149

1 Adjusted Capital – Baseline: Starting Equity Capital is $2600 (assumes all holding company capital downstreamed as equity to operating subsidiary) plus Adjustments totaling $200 (loss-reserve equity, fixed-income equity, deduction for after-tax net PML) = Adjusted Capital of $2800.
2 Required Capital based on the risk profile of the company.
3 Figure reflects addition of $260 (90% of $400 from contingent capital hybrid issuance is $360; subject to cap of 10% of equity capital = $260).
4 Required Capital with Contingent Capital Credit includes additional investment risk of new assets.

Financial Leverage Treatment

Assume security issued via contingent capital facility qualifies as a hybrid and gets 90% credit – subject to 20% total capital cap ($600).

Unadjusted for Equity Credit	
Debt + Hybrid + Contingent/Total Capital	600+200+400/3,000 = 40%

Adjusted for Equity Credit	
Debt + Hybrid charge + Contingent charge/Total Capital	600+20+40/3,000 = 22%

20% cap on equity credit not applicable because $540 < $600.

Conclusion

Contingent capital facilities provide companies with financial flexibility and protect the balance sheet against the unexpected. Alternatively, they can enable a company to seize a market opportunity in a timely fashion, without first having to test the appetite of the capital markets. Plus, they allow a company to establish the terms and conditions of future capital-raising activities up front, which reduces the chances of having to pay a risk premium under adverse conditions.

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