How sub debt can fulfil your regulatory requirements under Solvency II

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Insurance Regulatory Capital

IRC sub debt

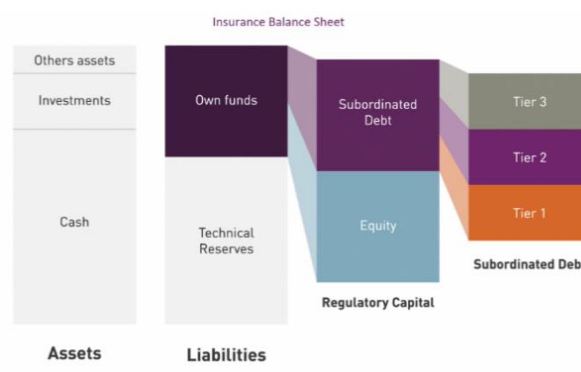
Subordinated debt has been pre-approved by European Insurance Regulators to function as regulatory capital under Solvency II. Priced lower than equity but with many similar qualities, cash is transferred directly to the issuing insurer's balance sheet. Issuing subordinated debt is a quick and easy process with a simple loan note.
Repayable after ten years and with no restrictions on its use, it can be used as regulatory capital to fund growth or to replace equity to increase ROE. With the Solvency II deadline looming, demand for subordinated debt is increasing significantly.

Solvency II requirements for Tier 2 capital

- Must be subordinate to all policyholders and beneficiaries and all non-subordinated creditors
- Must have a minimum maturity date of at least 10 years with an earliest call option at 5 years
- The regulator may intervene and suspend interest payments or repayment if the SCR is breached
- Incentives to redeem or repay are only permitted after 10 years and are limited. Prior to 10 years, redemption or repayment of funds is only permitted at the option of the insurer

IRC's sub debt product is tailored to match the requirements set out in the regulations for Tier 2 capital under Solvency II

Small and mid-sized insurers can also issue subordinated debt in a private placement. IRC targets investments in such private placements. Insurers in all lines of business and with a variety of ownership structures are eligible to issue subordinated debt. A formal rating is not required.



IRC's philosophy is to develop long term relationships with insurers to provide them with on balance sheet capital and risk optimisation solutions. Please call us if you would like to learn more about our investment process.

Particular cases arising out of Solvency II

In preparation for Solvency II, insurers may conclude that they are under-capitalised or in a grey area under the new regime. Sub debt provides an easy way to meet new capital requirements.
Some insurers will hold legacy instruments that are not compliant as regulatory capital under Solvency II. Insurers may refinance these instruments using Solvency II compliant subordinated debt, often under more advantageous terms.

The Advantages of Sub Debt

Quick and Easy Process

- Compared to other forms of regulatory capital, issuing sub debt is quick and easy
- The product is transparent and the loan notes have a simple structure with limited restrictions or covenants
- Unlike in an equity raise, there is no dilution of control for shareholders and no voting rights are conferred to the note holder

Strengthens the Balance Sheet and Other Benefits

- The capital is transferred directly to the insurer's balance sheet
- Subordinated debt improves an insurer's regulatory capital position enabling it to grow by writing additional business
- Bringing leverage to an insurer's balance sheet enhances the return on equity
- Alternatively, adding subordinated debt to a balance sheet can allow the company's shareholders more flexibility to release equity or stabilise dividends
- As Tier 2 subordinated debt is issued for a minimum of 10 years with a fixed coupon, it provides long term cost of capital certainty, thereby facilitating financial planning
- The proceeds of the loan are invested earning a return while interest payments are tax deductible
- Subordinated debt does not amortise over its term, the full amount as eligible as regulatory capital until maturity

Reinsurance and Subordinated Debt

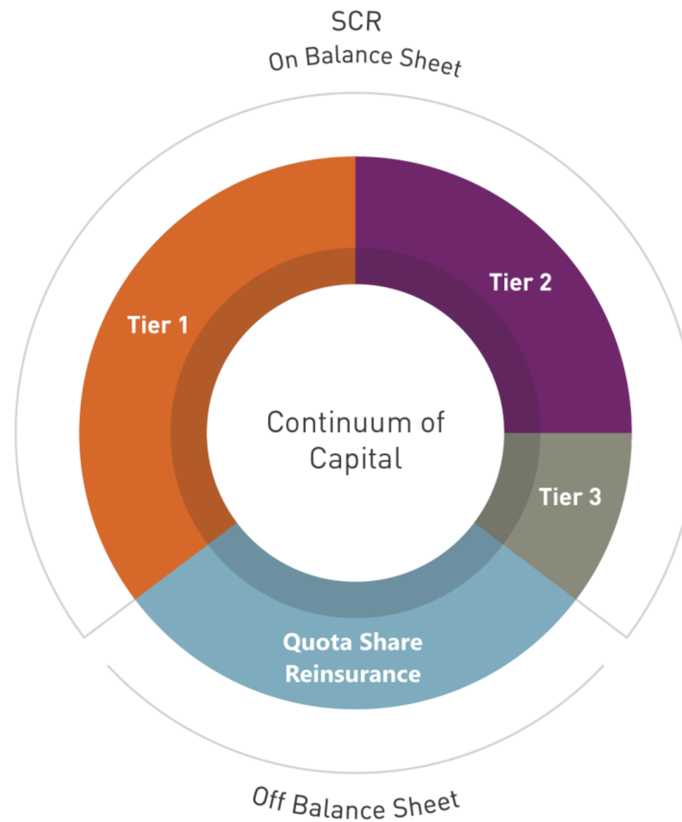
- Reinsurance (especially QSR) and sub debt work in a complimentary fashion
- Sub debt sits on the insurer's balance sheet and is senior to ordinary equity. In comparison, QSR is available pari-passu to the insurer's equity when certain events trigger. In both cases policyholders are senior and their claims are paid first
- QSR costs can vary over time whereas subordinated debt has a fixed cost
- IRC can work with individual insurers to evaluate the most appropriate and advantageous capital and risk mix

Flexible in Stress Situations

- Subordinated debt alleviates a company's financial stress when it is vulnerable.
- There is no default trigger. The coupon payment or principal repayment is deferred if the SCR falls below 100%

Sub debt actually alleviates a company's financial stress when it is most vulnerable

The Continuum of Capital



Tier 1

- Tier 1 must make up a min of 50% of the SCR
- Equity or 30NC10 subordinated debt are eligible as Tier 1
- Sub debt can make up a maximum of 20% of the Tier 1 capital

Tier 2

- Tier 2 can make up the remaining 50% of the SCR
- Tier 2 subordinated debt can be a 10 year bullet or a 10NC5
- The proportion of Tier 2 must be greater than that of Tier 3

Tier 3

- Tier 3 must not be greater than 15% of the SCR
- Tier 3 subordinated debt is issued for a minimum of 3 years

QSR

- Proportional sharing of premium, losses and expenses

Contact Us

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