Capital Resources

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Capital Resources Discussion Topics

- Additional Capital Sources under ICS
- Senior Debt
- Surplus Notes
ICS Additional Capital Sources

Arbitrarily limiting capital sources in stress situations...

<table>
<thead>
<tr>
<th>Tier One (Unlimited)</th>
<th>Tier One (Limited)</th>
</tr>
</thead>
<tbody>
<tr>
<td>- Common stock</td>
<td>- Perpetual non-cumulative preferred</td>
</tr>
<tr>
<td>- Non-cumulative convertible perpetual preferred</td>
<td>callable by issuer after 5 years</td>
</tr>
<tr>
<td></td>
<td>- Principal loss absorbency mechanism</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Tier Two – Paid Up (Limited)</th>
<th>Tier Two – Non-paid Up (&lt;15%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>- Subordinated debt</td>
<td>- Bank credit facility</td>
</tr>
<tr>
<td></td>
<td>- Letter of credit</td>
</tr>
<tr>
<td></td>
<td>- Promissory note</td>
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</tbody>
</table>

...could make ICS results a self fulfilling prophecy.
U.S. Insurance Industry Capital Sources

Under stress, common stock issuance...

North American Insurance Company Equity Analysis

![Graph showing equity analysis for North American P&C and Life insurance companies from Dec-06 to Dec-13.]

Source: Bloomberg North America P&C (BINPPCPB) and Life (BILIFENP) Price Indexes

...has minimal benefit and increases risk of pro-cyclically.
U.S. Insurance Industry Capital Sources

Under stress, significant reliance on interest bearing instruments…


Non-Life

Life

Common
Senior
Subordinated
Preferred
NCI

Source: SNL. Population reflects all potential U.S. IAIGS with the exception of U.S. statutory only filers

…precluded or significantly limited in the ICS.
Senior Debt

Perceived Issues:

- How does structural subordination compare to contractual subordination?
  - In the U.S. both require supervisory notification or approval prior to moving capital to pay principal or interest
  - In both structures in the event of an insolvency, the debtholders are effectively subordinated to policyholders’ claims

- Does the default acceleration clause found in U.S. senior debt issuance cause a run on the bank?
  - Neither insurance subsidiaries board of directors nor regulators can be compelled to pay dividends to pay bondholders
  - Most defaults are remedied through negotiated refinancing efforts
  - Federal bankruptcy proceeding ensures an orderly process
  - Example outlines winding-up of insolvent group when refinancing cannot be achieved
Senior Debt Default Example

Scenario Assumptions

- Insurance holding company issues $1,000 of senior debt in Year 1.
- In Year 5, the insurance holding company defaults on its debt.
- Bankruptcy court appoints trustee to oversee process.
- Insurance holding company makes $1,000 capital contribution in insurance subsidiary in Year 1.
- Bondholders push holding company into bankruptcy proceedings.
- Commissioner typically places insurance affiliates into receivership to ensure policyholder assets are preserved.
# Senior Debt Default Example

## Holding Company Balance Sheet

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>Outstanding Debt</td>
</tr>
<tr>
<td>$1</td>
<td>$1,000</td>
</tr>
<tr>
<td>Investment in Insurance Affiliate</td>
<td>3,999</td>
</tr>
<tr>
<td>Total Liabilities</td>
<td>1,000</td>
</tr>
<tr>
<td>Common Stock</td>
<td>2,500</td>
</tr>
<tr>
<td>Retained Earnings</td>
<td>500</td>
</tr>
<tr>
<td>Total Equity</td>
<td>3,000</td>
</tr>
<tr>
<td>Total Assets</td>
<td>$4,000</td>
</tr>
<tr>
<td>Total Liabilities &amp; Equity</td>
<td>$4,000</td>
</tr>
</tbody>
</table>
Senior Debt Default Example

Final Resolution

- Holding Company liquidated by bankruptcy trustee.
- Sale of insurance affiliate to third party, approved by domestic insurance regulator.
- Bankruptcy trustee pay bondholders for principal and unpaid interest.
Surplus Notes are Deeply Subordinated and Closely Regulated

- Deeply subordinated to all present and future policyholder and creditor claims
- Require regulatory approval of issuance both on form and substance
- Require regulatory approval of all principal and interest payments
- Regulators will prohibit payment if they believe it could potentially put policyholders and the company at risk, without triggering a default, allowing capital to be available during times of financial distress
- No investor recourse to accelerate the payment if regulator takes action
- Uniform requirements for subordination and regulatory approval across all U.S. states under Statement of Statutory Accounting Principles No. 41
- Long-term capital with an average maturity of 20-25 years, with many issued for 30-50 years
- Provide regulators flexibility to attract capital to entities under financial distress
- Provide a source of capital to mutual companies who do not have direct access to traditional equity markets for capital needs
Surplus Notes are High Quality Capital Instruments

- Strict regulatory controls and deep subordination features make surplus notes one of the highest quality forms of capital for insurers
  - Deeply subordinated to all other claims
  - Available to fund policyholder claims
  - Loss absorbing in going-concern and winding-up
  - Permanent given the long duration and regulatory deferral of both principal and interest
  - Absent of mandatory servicing costs

- Given the high quality form, limiting capital availability of surplus notes is unnecessary

U.S. Mutual Company Surplus Notes (as of year-end 2013)

- 91% Surplus
- 9% Surplus Notes

Source: Outstanding surplus notes from the Liabilities, Surplus and Other Funds page of the 2013 NAIC Annual Statement