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From AT1 to RT1

Market Focus
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While both Basel III and AT1 bonds have been largely explained in various specialized publications and in several newspapers, many investors are not yet confident with their comparisons for the (re)insurance sector. As a result, we explain briefly below the framework and the characteristics of Solvency II and Restrictive Tier 1 (RT1) bonds.

Unlike the AT1 coco bonds market which is already largely developed, the RT1 bonds market is still at the beginning. Currently, there is only one RT1 benchmark bond which was issued last month: XS1700709683 – 4.625% ASR Nederland Perpetual. However, we expect that this will certainly be a growing market in the coming years.

Solvency II allowed firms to grandfather Solvency I-compliant debt instruments issued before January 2015, for a maximum period of ten years but when the grandfathering provision will come to an end and as legacy instruments will be called, the issuance of Tier 1 instruments may intensify. This effect may materialise faster in some jurisdictions as some supervisors have put pressure on the industry to stop issuing debt instruments under the old regime well before the cut-off date of January 2015.

RT1 – Restrictive Tier 1 bonds

The Solvency II Directive harmonises the EU insurance regulation and determines the amount of capital that EU (re)insurance companies must hold to reduce the risk of insolvency. As we are fixed income specialists and not regulators, we will only focus this publication on RT1 bonds and there characteristics.

Similar to the banking AT1 coco transactions, **RT1 bonds are loss absorbing capital instruments.** Consequently, they should be perpetual bonds with no step-up in coupon and a first call date 10 years after issuance. Then the key characteristic of these bonds is the mandatory interest cancellation if necessary and/or in some cases the capital write down. To determine if such a mechanism should be triggered, Solvency II regulation relies on three key thresholds (SCR, MCR and the solvency ratio) which we briefly explain below.

The key point to remember is that RT1 bonds carry great risks for the investor and a high degree of due diligence is required and selectivity will be essential.

RT1 – Three key thresholds

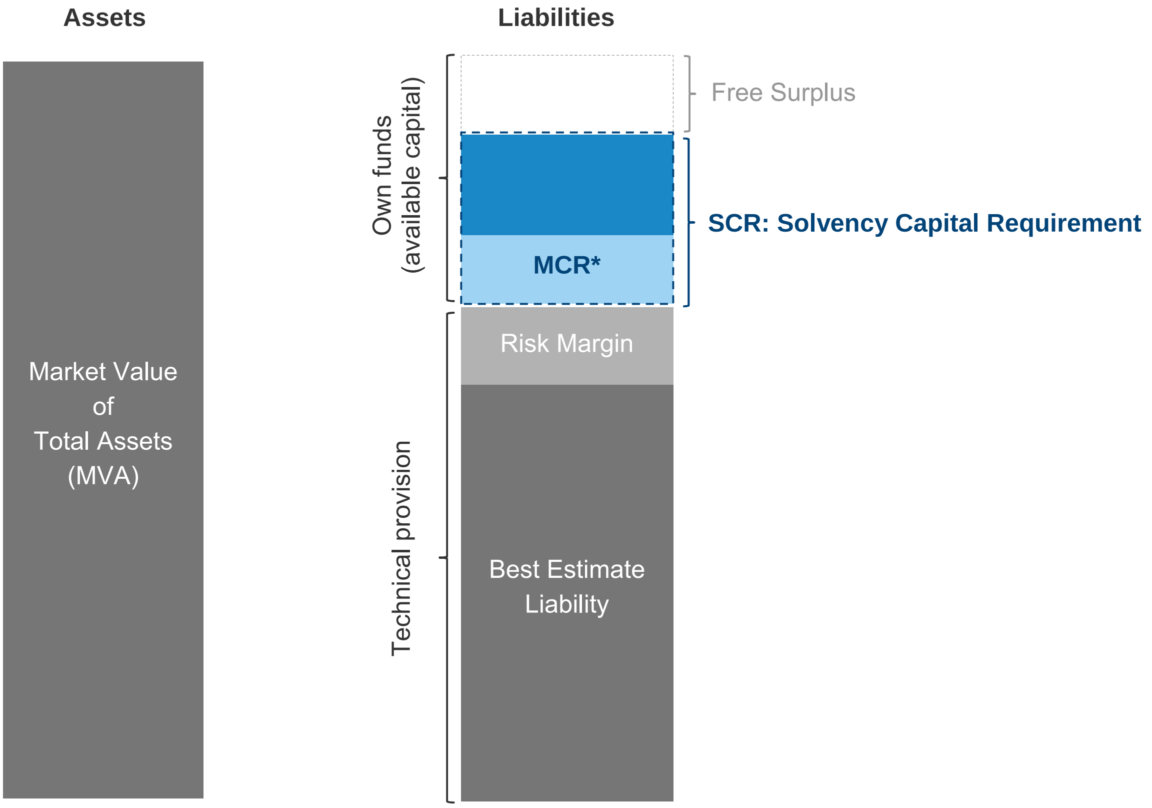
- The **Solvency Capital Requirement (SCR)** is the capital required to ensure that the (re)insurance company will be able to meet its obligations over the next 12 months with a probability of at least 99.5%. Any less, and regulators will become more closely involved.
- The **Solvency Ratio** is calculated dividing the amount of own funds by the SCR. Own funds refers to surplus capital that remains when the liabilities are deducted from the total assets. Each insurance company is required to maintain its Solvency Ratio at 100% over time. Should the insurance company fall below this level, it needs to inform the regulator and present a realistic recovery plan that shows how it aims to bring its Solvency Ratio to 100% over the following six months.
- The **Minimum Capital Requirement (MCR)** represents the threshold below which the national regulator would intervene. The MCR should not be less than 25% of the SCR. If an insurer gets close to the MCR, it is likely that regulators will step in to run the business and cancel the coupon. Any less, and the company would be insolvent for regulatory purposes.

RT1 – Loss absorbing capital instruments

While each bond may have specific rules described in its prospectus, according to the Solvency II's framework, the typical RT1 will automatically convert into equity or be written down upon three events:

- A breach of the SCR for more than three months
- A drop of the solvency ratio below 75% of the SCR
- A breach of the MCR.

Solvency II – Balance Sheet



Solvency ratio: Own funds / SCR

Own funds need to be sufficient in amount, quality and liquidity to be available when the liabilities they are to cover arise. Own funds will be constituted by both '*permanence*' and '*loss absorbency*' instruments.

Items with a fixed duration, or a right to redeem early may not be available when needed. Similarly, obligations to pay distributions or interest will reduce the amount available to the insurer. The rules on 'tiering' are designed to reflect the existence of such features and Solvency II impose limits on the amount of each tier (tier 1, tier 2 and tier 3) that can be held to cover capital requirements.

- Tier 2 can be up to 50% and Tier 3 can be no more than 15% of eligible own funds.
- At least 50% of the SCR should be Tier 1 capital and Tier 1 is divided into '*restricted*' and '*unrestricted*' tier 1. Most of this must be equity. It is also expected that at least 80% of Tier 1 items should be unrestricted Tier 1 with no more than 20% being Restricted Tier 1 (RT1).
- It is expected that 80% of the own funds used to cover the MCR need to be Tier 1.