Article Title: ARCHIVE | Criteria | Insurance | Life: Hybrid Capital Opens New Financing Doors To Japanese Life Insurers Data: (EDITOR'S NOTE: —This article is no longer current. It has been superseded by "Hybrid Capital Handbook," published Sept. 15, 2008.) When seeking to ramp up their capitalization, Japanese life insurers have traditionally relied on closely allied banks for subordinated loans and "kikin," another type of subordinated debt available only to mutual companies. In return, insurers have provided banks with capital in the form of preferred stock or subordinated debt. This symbiotic relationship created a long-standing "double-gearing" problem of capital interdependence. Recently, however, Japanese life insurers are making increased use of direct financing, reducing their dependence on banks and broadening their funding base to include foreign and local investors. Issuances of hybrid debts have the potential to increase the overall financial flexibility of domestic life insurers, benefiting their credit quality. A good example of this trend is the recent issuance of the 'BBB' euro-denominated junior subordinated bonds by Fukoku Mutual Life Insurance Co. (A-/Stable/--). For the first time in the industry, bond issuance stipulations include as a subordination event the alteration of insurance policy terms and conditions before insolvency. This feature became available to insurers via controversial revisions to the Insurance Business Law in 2003, and it has shaken up the previously senior and junior status between policyholders and hybrid debt creditors. Because these new terms clear up the blurry status of creditor seniority, they have the potential to make debt issuances by Japanese insurers a stronger form of capital than other types of subordinated debt. And while these changes open up new funding options for insurers, the companies will also be under increasing pressure to provide investors with a clearer picture on subordination events and interest-deferral triggers on these debts. Key Requirements For Hybrids To Be Counted As Equity In determining whether a hybrid debt issue should be treated as equity-like capital during the rating process, Standard & Poor's assesses the strength of the deferral clause alongside other elements, such as the bond's tenor and its degree of subordination upon liquidation. In times of financial distress, interest and dividend payments on the hybrid debt can be deferred without legally constituting default. This protects the insurer from being forced to service the debt in situations where it is close to financial failure. Also, in the event of default, repayment on the hybrid debt is made only after senior creditors are paid. A final condition is that the hybrid capital must be perpetual or have very long maturity, so as to remain as a permanent or a very long-term feature of the insurer's capital structure. In practice, all hybrid capital with maturities of more than 20 years is adequately long-lived. Issues with maturities between 10 and 20 years may be considered capital depending on their structure and the ratings of the issuing company. With maturities under 10 years, hybrid securities cannot be treated as capital. For instance, Japanese insurers' kikin is not treated as capital by Standard & Poor's, since its maturity is typically short at five years or less. As the remaining maturity of hybrid capital falls to under 10 years, its value as capital decreases in phases by 20% annually. When the residual period is less than five years, the security is no longer recognized as capital. It is not rare to see perpetual or very long-term subordinated debt carry step-up and call option clauses that can be exercised after a certain period, typically 10 years. The issuer is most likely to exercise the call option when the step-up interest raises considerably, typically over 100 basis points. In such cases, the period from issuance until the call option is exercised is considered to be the security's de facto maturity. Evaluation Of Japanese Insurers' Hybrid Capital The degree to which hybrid debt can qualify as capital depends also on how much it meets the aforementioned capital requirements. It can also be affected by unique market conditions, such as local insurance regulations. In Japan, the Insurance Business Law was revised in 2003 allowing insurance companies in dire financial straits to alter insurance policy contract terms, including the lowering of guaranteed yields to policyholders, before bankruptcy. Standard & Poor's views cuts to guaranteed yields as a default on the insurer's contractual obligations to its policyholders, even if it is not regarded as default under the law. As cuts to guaranteed yields or other revisions to insurance policy agreements are not treated as default under the law, they do not count as subordination events under traditional hybrid capital contracts. This can create a distorted situation, where payments to policyholders, which should be given the highest priority, are reduced and subordinated to payments to hybrid capital creditors. Clearing up subordination status The Financial Services Agency (FSA) has defined a number of preconditions that insurers must meet before they may alter insurance policy terms. The companies must clearly show that they are not passing off too much burden on policyholders, and are required to disclose their treatment of existing kikin and subordinated loans to policyholder representatives and shareholders. Compared to the clearness of regular bankruptcy procedures, where hybrid debt creditors are always forced to share losses before policyholders, this scheme muddles the status of senior and subordinated debt holders, since hybrid debt creditors can only be asked to share losses on a voluntary basis. Even so, Japanese banks have often granted some degree of debt forgiveness on subordinated loans, particularly during corporate restructurings. But with directly financed hybrid capital, there is much less likelihood that investors in the general public would accept this kind of debt forgiveness. On Sept. 28, 2005, Fukoku Mutual Life Insurance Co. issued its junior subordinated bonds, the first time that a bond issued in Japan carried a clause that made revisions to insurance policies a contractual subordination event. According to the clause, in the event that insurance contracts are revised, no payment will be made on the junior subordinated bonds before all payments are made in full to policyholders. Consequently, the junior subordinated bonds issued by Fukoku Life have higher capital quality compared to traditional subordinated loans of Japanese life insurers because their terms spell out explicitly their preference and subordination structure. Adequate interest-deferral triggers When insurance companies raise hybrid capital in the U.S. and European markets, the regulatory solvency margin ratios (SMRs) typically function as a trigger to defer interest payments. Standard & Poor's considers that SMR triggers should be set much higher than, or a given multiple of, regulatory minimums, since deferral of interest reduces the debt burden on an insurer nearing default. Fukoku Life's junior bonds have an interest deferral trigger set for when the insurer's SMR falls to below 400%, as determined by the FSA's calculation methods. This level is twice the regulatory minimum of 200%. Based on our analysis of Japan's SMRs and de facto triggers for policy revisions, Standard & Poor's currently considers 400% to be a satisfactory trigger level for interest deferral. However, this is not the only satisfactory standard by which insurers may decide interest deferral triggers. For example, as stipulated in Article 55 of the Insurance Business Law, exhaustion of surpluses may also function as a trigger. More Disclosure Needed To Expand Investor Market The financial profiles of Japanese life insurers have been improving in recent years, supported by the recent stock market recovery and their renewed focus on accumulating internal reserves while keeping policyholder dividends low. As a result, life insurers have been financing capital less often as a means to enhance capitalization. On the other hand, life insurers will continue to have refinancing needs as their subordinated loans and kikin mature. Even in such cases, refinancing schemes are likely to diversify, including securitization and issuances in domestic and overseas capital markets. As financing schemes diversify, investors in insurers' hybrid capital will come to include a greater range of institutional and individual investors in Japan and abroad. This will be a positive ratings factor, as it will broaden financial flexibility. In return, Japanese life insurers will be required to satisfy investor information requirements by ensuring explicit standards for subordination and interest deferral, while also deepening overall financial disclosure. Reference Articles "Reduction In Guaranteed Yields By Japan's Life Insurers Would Be Viewed As Default," published on Nov. 25, 2002. "Limited Effectiveness Of Cuts To Guaranteed Yields By Japanese Life Insurers," published on Sept. 18, 2003.