Article Title: ARCHIVE | Criteria | Insurance | Life: Assessing Canadian Life Insurers' Innovative Tier I Capital Data: (EDITOR'S NOTE: —This article is no longer current.) Canadian life insurance regulators have revised the rules on what qualifies as capital. In August 2001, the Office of the Superintendent of Financial Institutions (OSFI) released its final document on the Principles Governing Inclusion of Innovative Instruments in Tier 1 Capital for Canadian life insurance companies. This document sets out the parameters under which Canadian life insurance companies will be allowed to issue innovative Tier 1 instruments or Canadian hybrids, and follows in the footsteps on what has been allowed within the Canadian banking sector. In early 2000, domestic banks began issuing hybrids starting with the C$900 million capital trust securities (TD CaTS) offered by The Toronto-Dominion Bank and the C$500 million capital trust securities (Scotia BaTS) launched by Bank of Nova Scotia. The hybrids will allow Canadian life insurance companies to raise cost-effective and tax-deductible Tier 1 capital. Sun Life Assurance Co. of Canada is expected to be the first life insurance company to issue these types of hybrids within the Canadian market. Capital Treatment These new insurance hybrids will be treated as preferred stock within Standard & Poor's insurance criteria based on Standard & Poor's view that the bank and insurance hybrids have been structured with OSFI's oversight to mimic a synthetic noncumulative preferred share that pays interest rather than dividends. Overlaying this, OSFI has complete and ongoing regulatory jurisdiction over Canadian banks and life insurance companies and any hybrid that they issue. The key features of these life insurance company hybrids are that: They have ongoing and permanent loss absorption features (distributions can be suspended and are noncumulative, and loss of principle could occur to provide a cushion for more senior creditors in the case of bankruptcy). They are deeply subordinated (structurally, life insurance company hybrids rank pari passu with the company's preferred stock). They are perpetual (they can be viewed as a permanent feature of the company's capital structure). Issuance of these instruments will be followed closely by Standard & Poor's as any reduced reliance on pure equity, which is common shareholders' equity and retained earnings, within a life insurance company's Tier 1 capital could result in the erosion of a financial institution's creditworthiness. The use of any combination of innovative instruments and noncumulative preferred shares above 15% of an insurance company's net Tier 1 capital will be put under closer scrutiny by Standard & Poor's. (See "Life Insurance Ratings Criteria," RatingsDirect, 1998, for a full discussion of preferred stock ratings methodology.) Within its notching criteria, Standard & Poor's does not differentiate between cumulative and noncumulative; however, OSFI does not allow cumulative instruments to be included within Tier 1 capital. Canadian Hybrid Market As these innovative instruments are expected to be a less expensive form of Tier 1 capital, (narrower spread on a tax equivalent basis as compared with preferred stock, and no capital tax will be levied on these instruments) in contrast to preferred or common stock, but a higher yielding instrument than subordinated debt; and because similar instruments have been issued by the Canadian banks, Standard & Poor's anticipates that there will be a significant market appetite for these types of securities in Canada. As of Aug. 31, 2001, the Canadian banks have issued C$3.75 billion of these instruments. In addition, the hybrids provide life insurance companies with another capital instrument for increasing their financial leverage in their quest for higher return on equity following demutualization. Characteristics of Sun Life's SLEECS Sun Life with its capital trust securities (SLEECS) is expected to be the first insurance company to come to market with a Canadian hybrid instrument. The need for this issue reflects the company's need for financing following its plans to purchase Keyport Life Insurance Co. and Independent Financial Marketing Group Inc., which is expected to be completed in the second half of 2001. (See "Sun Life Assurance Co. of Canada and U.S. Subsidiaries 'AA+' Ratings Affirmed; Outlook Neg," RatingsDirect, June 4, 2001.) Within the Canadian market place, it remains OSFI's stated objective to have the capital rules and the structure of hybrids as similar as possible for both banks and life insurance companies given these financial institutions compete in the same market with similar products and services. Despite these objectives, there are a number of subtle differences between the bank and life insurance company hybrids, with the most significant one being that life insurance company hybrids will be structured with a loan-based structure versus the asset-based structure seen with the banks. The loan-based structure will allow for better cash flow matching as the term of the loan can be structured to match the tenor of the hybrid. Canada Mortgage and Housing Corp. or government-guaranteed conventional mortgages found within the bank hybrid structure have a maximum term of five years versus the longer tenor of the hybrid, and the pools of conventional mortgages are more cumbersome to manage than a loan or small pool of loans. An added advantage of the loan-based structure is that by not using a life insurance company's assets to fund the trust; no mismatch is created between balance sheet assets and policy liabilities. Key OSFI Guidelines As with the Canadian banks, life insurance companies will be allowed to include hybrids in their Tier 1 capital to a maximum of 15% of net Tier 1 capital. This 15% limit on hybrids has been placed within the 25% limit formerly reserved for noncumulative preferred shares. No changes have been made to the basic requirement that common shareholders' equity and retained earnings must constitute a minimum of 75% of net Tier 1 capital. Hybrids should have an ongoing loss absorption feature through a suspension of distributions feature, and a permanent loss absorption feature through the mandatory conversion into noncumulative perpetual preferred shares of the life insurance company. Hybrids should allow the life insurance company to absorb losses within the company on a liquidation basis, that is, these instruments could lose principal in liquidation. Hybrids must not contain any features that could impair the permanence of the instrument. Hybrids must be free from mandatory fixed charges. Rationale for Canadian Preferred Stock Rating Standard & Poor's has assigned a preferred stock rating to Sun Life's SLEECS as these hybrids have more preferred stock characteristics than debt characteristics. Debt features. Income from SLEECS will be taxable in the hands of Canadian investors as if it were interest paid on a corporate bond. If distributions in full are not received on the SLEECS, dividend payments to all preferred and common shareholders are suspended. Cash distributions will be paid semiannually. Par redemption for cash in year 10 would be expected, but only at the option of the issuer and with OSFI approval. Preferred share features. For regulatory purposes, SLEECS will be included in Tier 1 capital. Tier 1 capital is considered by both Standard & Poor's and OSFI to be the permanent equity capital of Sun Life, underpinning even the most junior of subordinated debt. Under scenarios of financial stress, SLEECS are automatically exchanged for noncumulative perpetual preferred shares of Sun Life. The holders of these hybrids have no rights to any of the assets held within the trust. The only purpose of the trust assets is to generate the cash flow required to service the obligations of the outstanding hybrid instruments if and when they are paid. In liquidation, ranking is subordinate to all policyholders, senior unsecured creditors, and subordinated debt holders of Sun Life and pari passu with preferred stock issued directly by Sun Life. After 10 years, the securities may be exchanged for noncumulative perpetual preferred shares of Sun Life, which have a conversion feature into common shares. Only Sun Life carries the option to redeem SLEECS for cash at the end of year 10 with OSFI's permission; the investor does not have this option. At any time a life insurance company fails to pay dividends on its directly issued preferred or common shares, no distributions are paid on the SLEECS. Instead, any distributions are redirected to Sun Life for general operating purposes. Distributions are noncumulative. Maturity is perpetual, callable after five years with OSFI's permission. There are no creditor rights. Canadian Banks and Life Insurance Companies Ratings Summary COUNTERPARTY CREDIT RATING TRUST ESTABLISHED TO ISSUE INNOVATIVE TIER 1 CAPITAL INSTRUMENTS INNOVATIVE TIER 1 CAPITAL INSTRUMENTS GLOBAL/CANADIAN PREFERRED STOCK RATING BANKS Bank of Montreal AA-/Negative/A-1+ BMO BoaTS A/P-1(Low) Bank of Nova Scotia A+/Stable/A-1 Scotia BaTS A-/P-1(Low) Canadian Imperial Bank of Commerce AA-/Negative/A-1+ -- -- -- HSBC Bank Canada A+/Stable/A-1 HSBC HaTS A-/P-1(Low) Laurentian Bank of Canada A-/Stable/A-2 -- -- -- National Bank of Canada A/Stable/A-1 -- -- -- Royal Bank of Canada AA-/Stable/A-1+ RBC TruCS A/P-1(Low) Toronto-Dominion Bank (The) AA-/Stable/A-1+ TD CaTS A/P-1(Low) LIFE INSURANCE COMPANIES Canada Life Assurance Co. (The) AA/Stable/-- -- -- -- Clarica Life Insurance Co AA/Stable/A-1+ -- -- -- Great-West Life Assurance Co. AA+/Stable/A-1+ -- -- -- Industrial Alliance Life Insurance Co. A+/Stable/-- -- -- -- London Life Insurance Co. AA+/Stable/A-1+ -- -- -- Manufacturers Life Insurance Co. (The) AA+/Stable/A-1+ -- -- -- Maritime Life Assurance Co. AA/Negative/-- -- -- -- Sun Life Assurance Co. of Canada AA+/Negative/-- SLEECS A+/P-1 Transamerica Life Canada AA+/Stable/-- -- -- --