April 3, 2023

Skadden

The Standard Formula

Robert A. Chaplin
Partner / London
44.20.7519.7030
robert.chaplin@skadden.com

Azad Ali
Of Counsel / London
44.20.7519.7034
azad.ali@skadden.com

George D. Belcher
European Counsel / London
44.20.7519.7280
george.belcher@skadden.com

One Manhattan West
New York, NY 10001
212.735.3000

22 Bishopsgate
London EC2N 4BQ
44.20.7519.7000

Lessons for the Insurance Sector From the Credit Suisse Sale

UBS' acquisition of Credit Suisse sent waves across the global markets and raises questions about possible impacts on the availability of regulatory capital in the insurance sector.

Whilst there is likely limited direct read-across from the 19 March 2023 Credit Suisse acquisition to the insurance sector, the following holds true:

- The UK's Prudential Regulation Authority (PRA) has significant concerns about trading conditions in the insurance sector and has reinforced key messages about liquidity to the market.
- The wipe-out of certain Credit Suisse bondholders will rattle institutional investors in regulated balance sheets, including insurers. But the high coupons available on regulatory capital are likely to tempt investors back in quickly.
- The Credit Suisse acquisition flags the difficult choices regulators face in deciding to implement a resolution for insurers (or a "write-down" under the new planned PRA regime).

Treatment of Additional Tier 1 Instruments

Key to the acquisition of Credit Suisse was the treatment of the Additional Tier 1 (AT1) instruments that the bank had issued. The notional value of Credit Suisse's AT1 instruments (16 billion Swiss francs, or 17 billion U.S. dollars) was reduced to zero, whilst some value (3 billion Swiss francs, or $3.2 billion) for common shareholders was preserved.

AT1 instruments are a creature of regulation forming part of the Tier 1 capital of banks under regulations derived from the Basel bank capital accords. Tier 1 capital is made up of AT1 and Common Equity Tier 1 (CET1).

The AT1 layer is limited in amount to 25% of overall Tier 1 capital (ignoring additional buffers of capital that banks have to hold), with CET1 capital (which is largely comprised of ordinary share capital and retained earnings/profits) representing the balance.

Key features of AT1 instruments under the Basel standards include that they are:

- Senior in the insolvency hierarchy to CET1 capital and subordinated to all other liabilities, meaning that (in theory) AT1 instruments form the penultimate layer of defence, with equity as the ultimate layer (and the last to be paid out on failure).

- Subject to "bail-in," *i.e.*, a write-down or conversion if certain conditions are met. The numerical trigger in AT1 instruments for write-down/conversion into equity is generally unlikely to be met in most well-capitalised banks, as losses would have to be substantial for the threshold to be breached. However, AT1 instruments issued by Credit Suisse had a higher trigger level then the minimum of 5.125% required under the Basel standards.
- Perpetual (*i.e.*, have no maturity date), and coupons are noncumulative.

At present, it is unclear whether the terms of the AT1 instruments permitted a write-down without shareholders being wiped out first. Most of the AT1 instruments are governed by Swiss law, with a small portion issued under New York law.

AT1 holders are likely to argue that the authorities should have placed Credit Suisse into resolution instead, so that the creditor hierarchy would have been respected. They may also look to see if the emergency laws used by the Swiss authorities to facilitate the acquisition were somehow unconstitutional.

Impacts for the Insurance Sector

These developments raise questions for the insurance sector, though it should be noted that there are important differences between banks and insurers. For example, insurers do not engage in maturity transformation (borrowing short and lending long) the way banks do, at least not to the same extent. Nor does the leverage of insurers work in the same way as for banks.

Insurance Capital

UK and EU authorities have been quick to confirm that AT1 instruments would rank senior to shareholders under the UK and EU insolvency and bank resolution regimes. Questions have inevitably arisen, however, as to whether AT1 issuances elsewhere will perform as expected in a distressed situation or be subject to a potential inversion.

Similar questions arise in the insurance sector. Although there is no direct equivalent to AT1 in the Solvency II capital hierarchy for insurers, any Tier 1 instrument included in an insurer's balance sheet (that is not common equity or accumulated profit) must be capable of a write-down on prescribed solvency triggers.

This is an important point both for investors and for the regulatory balance sheets of the insurers concerned. Indeed, the inversion of the normal creditor hierarchy in the case of Credit Suisse ran counter to Swiss laws on insolvency and the Swiss bank resolution regime (that was put in place after the global financial crisis), with emergency legislation required at the 11th hour to facilitate this. Whether the same thing could happen elsewhere, and in other sectors, remains to be seen.

The PRA's Response

In a speech on 27 March 2023, PRA Insurance Supervision Director Shoib Khan laid out the equivalent risk areas for insurance (with clear references to Credit Suisse) and the questions that an insurer's management should be asking themselves:

- Are they ready for unprecedented operating conditions?
- Do they know their key vulnerabilities, from various sources of stress and in various combinations, and are they ready for volatility in variables that they have been treating as near constants?

The PRA also highlighted the following:

Use of models. Whilst the PRA encourages firms to develop their own internal models, model-users should consider whether:

- The factors (inside and outside) of the business have moved on since the model was first designed.
- Events in the future may not be reflected in historical experience (referring in particular to how the UK's financial sector was shaken by the rapid re-pricing of long-term gilts in the UK in late 2022).
- Models might be misleading in the midst of a crisis (and, following the same example, a 1-in-100-year rise in gilt yields does not necessarily mean that it will not occur again the following week).
- Different combinations of stressed inputs can lead to modelled outputs that are just as severe as individual "biting" scenarios.

Stress testing. The PRA's recent Insurance Stress Test 2022 exercise for a number of the UK's largest insurers concluded that the industry is broadly resilient. However, it also highlighted common gaps — in particular, how concurrent management actions across the sector would limit their feasibility if all insurers took the same action at once.

Using an extended air traffic control analogy, the PRA considered an event where a number of aircraft are impacted by a single incident, and all inadvertently choose to fly into the same calmer airspace to recover. Suddenly, a plan that was viable for one insurer is no longer achievable when all others are thinking exactly the same way (*e.g.*, relying on their ability to trade out of subinvestment-grade instruments).

As a result, the Bank of England plans to run an exploratory systemwide resilience exercise to investigate the behaviours of a range of sectors — including banks, central counterparties, insurers and a range of funds — in response to a severe but plausible stress to the financial markets.

Ease of exit. The PRA went on to revisit its various interlocking (and well-reported) initiatives relating to insurer failure, including around the write-down of an insurer's liabilities. We covered these in the January 2023 and February 2023 editions of *The Standard Formula*. Although the PRA did not announce any new initiatives, it did encourage management of a struggling firm to consider:

- When ceasing a new business may be the most sensible course of action (particularly where capital or liquidity conditions are difficult).
- The point at which continuing to push for recovery could make it more difficult for the insurer to exit the market in an orderly way and, in the process, harm policyholders.

Takeaways

Direct comparisons between the banking and insurance sectors may be hard to draw, and indeed there are fundamental differences in the nature and duration of the underlying liabilities and exposures. To date, there has never been a "run" on an insurer. However, the tone, volume and speed of the PRA's response clearly indicates that it has substantial concerns.

The case of Credit Suisse also illustrates the issues that the PRA would have to contend with when deciding the relative advantages and disadvantages in bailing in a capital instrument (or indeed any other liability of a (re)insurer under the PRA's imminent write-down regime).

No doubt the Swiss Financial Market Supervisory Authority (FINMA) and the Swiss authorities were aware that the preference given to common shareholders over the holders of AT1 instruments would be controversial, but they considered that better than the uncertainty and instability that a bank resolution process would bring.