CHINA'S C-ROSS COMPLIANT REGULATORY CAPITAL BONDS

BACKGROUND

China Life's perpetual note marked a new precedent for financial institution regulatory capital bonds

China Life's June 2015 USD1.28bn issuance of perpetual bonds marked the first Chinese insurance regulatory capital issued under new C-ROSS[12] standards. US, European and Australian insurance groups have long utilised hybrid capital and/or subordinated debt instruments as part of their regulatory capital management strategies. However, Asian insurers have been relatively better capitalised making bond issuance less urgent. As these insurers internationalise and compete with the global peer groups, regulatory capital instrument issuance may feature more.

"Investors have ingested billions of dollars in Asian bank capital since 2013. Asian insurance credit is more scarce and C-ROSS bonds could provide a chance to diversify portfolios" says Kang Jae Kim, Global Head, Financial Institutions DCM.

Figure 11 – Financial Institution Subordinated and Hybrid capital instrument issuance[13] (in USD bn)

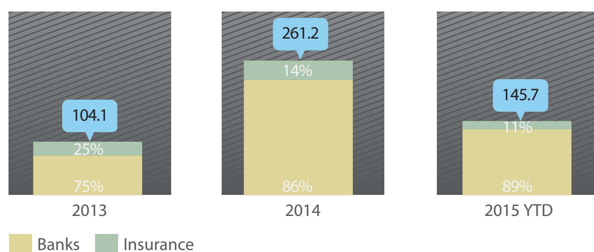
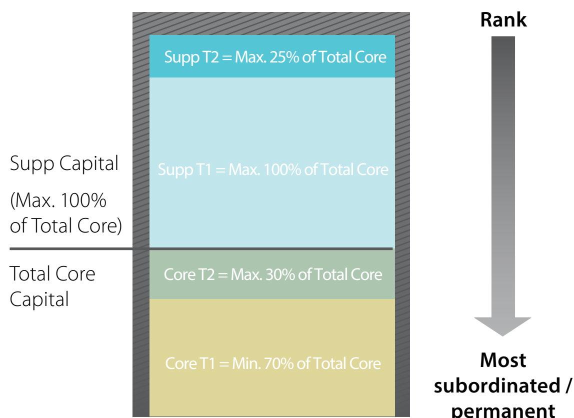


Figure 12 – C-ROSS regulatory capital hierarchy



Expected / minimum requirements

	PERMANENCE	COUPONS/DISTRIBUTIONS
ST2	< 5 yrs	Mandatory
ST1	≥ 5 yrs	Optional deferrable (cumulative)
CT2	≥ 10 yrs with loss absorption language; Perpetual without loss absorption language	Optional deferrable, if dated, subject to solvency tests (cumulative)
CT1	Perpetual	Fully discretionary

Note: Only precedent instrument as at September 2015 is China Life's CT2 perpetual notes.

C-ROSS outlines structural terms for new capital instruments for Chinese insurers

C-ROSS introduces an expanded range of eligible capital instruments, comprising core & supplementary capital, each featuring unique structural requirements. Core capital and supplementary capital are each broken down into two categories, Tier 1 and Tier 2. Both tiers of core capital are subordinated to the two tiers of supplementary capital in a hierarchy demonstrated in Figure 12.

Core capital represents the primary source of loss absorption for the insurer and a minimum of 70% of core capital must be in the form of Tier 1 ("CT1"), comprising ordinary equity. Up to 30% of core capital can be Tier 2 ("CT2") instruments. These CT2 instruments must have a minimum tenor of 10 years, with call options no earlier than five years. If structured as a dated instrument, CT2 bonds must feature loss absorption language, however the CIRC is yet to define a trigger event and no precedents exist to date for this structure. CT2 bonds are not required to contain loss absorbing language if structured as perpetual bonds, like the China Life CT2s.

12 The China Insurance Regulatory Commission (CIRC) finalised its China Risk Oriented Solvency System (C-ROSS) in February 2015

13 Sample comprise subordinated debt and deeply subordinated debt issues (i) by Banks and Insurance companies; (ii) in both onshore and offshore markets; (iii) for issuers with home country Australia, China, Hong Kong, Japan, Philippines, Singapore, Thailand, Taiwan and Europe. 2015 YTD reflects Bloomberg data as at August 31, 2015

Supplementary capital does not require loss absorption language and is capped at 100% of total core capital. Of this, at least 75% must be in the form of Tier 1 ("ST1") instruments which closely resemble traditional dated subordinated debt instruments although coupon deferral is optional. The remaining supplementary capital up to 25% can be in the form of Tier 2 ("ST2"), which can be shorter dated and have mandatory coupons. To date, there has been no precedent for supplementary capital issuance offshore.

Similar but different to Basel III bonds

China Life's CT2 bond shared similarities with Basel III bank Additional Tier 1 securities, however there are several key differences between the requirements under C-ROSS vs. Basel III illustrated in Figure 13.

Figure 13 – Key Feature Comparison C-ROSS vs. Basel III regulatory capital instruments

	C-ROSS	BASEL III
Tiers of Capital	4 Tiers of Capital: Core Tier 1, Core Tier 2, Supplementary Tier 1, Supplementary Tier 2.	3 Tiers of Capital: Common Equity Tier 1, Additional Tier 1 ("AT1"), Tier 2 ("T2").
Regulatory Capital Bonds	Can qualify as CT2, ST1 or ST2.	Can qualify as AT1 or T2.
Loss Absorption	Loss absorption language required for dated CT2 bonds.	Loss absorption language required on all AT1 and T2 securities.
Triggers	CIRC has not defined what the trigger event would be. No precedents exist as trigger is only required for dated CT2 bonds.	Both AT1 and T2 instruments require loss absorption triggers at the point of non-viability. Liability-accounted AT1 instruments (in some jurisdictions, all AT1 instruments) also require a CET1 loss absorption trigger.
Ratings Agency 'Equity Credit'	There is no global regulatory framework prescribing a common structure for insurers. Therefore C-ROSS compliant regulatory capital instruments also need to meet the minimum rating agency requirements for corporate hybrids to gain equity credit.	AT1 instruments that qualify under Basel III rules will typically receive equity credit without additional structural adjustments. T2 instruments do not typically qualify for equity credit.
Coupon Deferral	Optional (cumulative, deferrable) for CT2 and ST1. ST2 allows for mandatory coupons. Dated CT2 instruments also subject to solvency test for distributions.	Fully discretionary, non-cumulative for AT1 and subject to dividend tests. T2 allows for mandatory coupons.
Permanence	CT2 instruments must be at least 10yrs minimum tenor with a minimum non-call period of 5yrs. ST1 instruments must be at least 5yrs minimum tenor and ST2 instruments can be less than 5yrs tenor.	AT1 notes must be perpetual in nature with minimum non-call period of 5yrs. T2 notes can be 5yrs minimum tenor, but regulatory capital benefit will reduce by 20% per annum in the last 5yrs to final maturity.
Incentives to redeem	No incentives to redeem are permitted on core capital, however it is not explicitly stated for supplementary capital.	No incentives to redeem permitted, such as step-ups coinciding with call dates. No call dates coinciding with mandatory conversion (minimum 2yr gap). Indirect incentive to redeem T2 instruments prior to their regulatory capital amortisation in last 5 years (therefore call date is typically 5 years prior to final maturity).

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While bank capital instrument criteria has become more harmonised globally through the Basel III framework, the insurance capital instrument criteria remains highly customised to the domicile of the insurer. This limits the ability of ratings agencies and investors to easily categorise and compare different country insurance capital instruments by tier of capital. Indeed, for many insurers, it is the minimum criteria for 'equity credit' from ratings agencies that drives a more loss-absorbing structure than the country's prudential supervisor.

ANZ Financial Institutions DCM team has worked with a number of Asia Pacific insurers on capital instrument issuance that both complies with local regulatory requirements and achieves the targeted equity credit from rating agencies.

In Australia, this has even included a structure for a bank and insurance conglomerate that is fully harmonised with Basel III, LAGIC and rating agency criteria. Greater investor education requirements are assured as many more jurisdictions follow Australia's LAGIC and China's C-ROSS lead, including Solvency II in Europe and RBC 2 in Singapore. ANZ looks forward to working more closely with both issuers and investors as this nascent suite of bond structures develops.

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