SECP

SECURITIES AND EXCHANGE
COMMISSION OF PAKISTAN

CONCEPT PAPER

ISSUANCE OF SUBORDINATED DEBT SECURITIES BY INSURANCE COMPANIES AND TREATMENT FOR SOLVENCY PURPOSES

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Message of the Commissioner

I am delighted to present this concept paper, which delves into the issuance of subordinated debt securities by insurance companies and their treatment with regard to solvency considerations. The main aim of this concept paper is to examine how the issuance of subordinated debt can fortify financial stability and enhance the risk management capabilities of insurance firms, offering them an alternative capital source. Furthermore, this concept paper puts forward a regulatory framework that would enable insurance companies to efficiently utilize subordinated debt to fulfill their solvency requirements.

At present, insurance companies in Pakistan are not involved in the issuance of debt securities, especially subordinated debt securities, one potential reason is lack of benefits in the existing solvency regime. The proposed subordinated debt framework has been thoughtfully designed to offer insurance companies several advantages, including the ability to maintain solvency margins, engage in cost-effective capital raising, enhance creditworthiness, and provide capacity to absorb risks during financial stress. Moreover, the issuance of subordinated debt by insurance companies has the potential to play a pivotal role in the growth of the corporate debt market in Pakistan, with insurance companies emerging as new players in the domain of debt instrument issuance.

The concept paper is part of the Insurance Division ongoing efforts under the five years insurance sector development plan for sustainable growth and insurance for all in Pakistan. I look forward to a robust engagement with and constructive feedback from the insurance sector and other stakeholders on the concept paper and matter related thereto.

In conclusion, I would like to express my appreciation for the unwavering support of all members of the Insurance Division and the Chairman of SECP in their commitment to advancing the insurance sector. Special gratitude goes to authors of this concept paper: Shazia Rehman, Joint Director; Jibran Paracha, Additional Joint Director; and Sache Dino, Management Executive, for their vibrant efforts in developing this concept paper.

Aamir Khan
Commissioner-Insurance

1. Introduction

1.1. This concept paper revolves around the issuance of subordinated debt by insurance companies and explores the manner in which issued subordinated debt can be leveraged by insurance companies to meet their solvency requirements.

1.2. The issuance of subordinated debt securities represents a strategic financial move that empowers insurance companies to enhance their financial standing and actively pursue growth opportunities while adeptly managing risks as well as the applicable solvency requirements. Issuance of subordinated debt can play a pivotal role in elevating the overall stability and competitiveness of insurance entities in the market. This concept paper, accordingly delves into subordinated debt issuance, its characteristics, regulatory requirements, advantages as well as utilization in maintaining solvency.

1.3. Additionally, the paper examines various factors that influence the formulation of a policy by the regulator aimed at integrating subordinated debt into the solvency framework of insurers. It also draws insights from international jurisdictions to comprehend the characteristics of subordinated debt considered as Tier-II capital and/or other forms of capital, along with the associated conditions and limits set by different regulators.

1.4. The paper also evaluates the existing regulatory landscape of insurers in Pakistan and assesses the current status of subordinated debt issued in the Pakistani market by commercial banks, which is considered as a form of regulatory capital. Building upon an examination of international regimes, this paper deliberates the characteristics and conditions for permitting subordinated debt to contribute to the solvency of insurers and for that purpose this paper proposes necessary regulatory amendments to the Insurance Rules, 2017.

2. Objective of the Concept Paper

2.1. Under the current solvency requirements applicable to insurers in Pakistan, no allowance and/or benefit is available against any subordinated debt issued by an insurer. This may be one reason why insurance companies have not ventured into the issuance of subordinated debt, since it would be considered as a normal debt liability and no benefit is allowed, in respect of its subordination and loss absorbing capacity, in maintaining required solvency margins.

2.2. The objective of this concept paper is to explore how the issuance of subordinated debt by insurance companies can bring about financial stability, enhance their risk management capabilities and provide insurance companies with an alternative source of capital, whilst focusing on meeting solvency requirements effectively. Further, this concept paper aims to propose a regulatory way forward to allow insurance companies to leverage the subordinated debt to meet their solvency requirements effectively.

3. What is Subordinated Debt?

3.1. Subordinated debt is an unsecured loan or bond that ranks below other, more senior loans or securities with respect to claims on assets or earnings. In the case of borrower default, creditors who own subordinated debt will not be paid out until after senior loans and securities and creditors are paid in full. In the case of insurance companies, the claims of subordinated debt instrument holders are subordinated to the claims to policyholders in addition to the claims of other creditors of the insurer.

3.2. Subordinated bonds are debt securities as compared to hybrids, such as preference shares, and generally, interest payments must be met and the principal repaid at maturity whilst the issuing financial institution is solvent and a going concern. However, it is important to note that in times of financial stress or insolvency, subordinated bonds/loans stop making interest payments and their right becomes subservient to the claims of depositors for banks, policyholders for insurers and other creditors, which is the underlying purpose of Tier-II Capital i.e. to absorb loss to prevent the failure of the financial institution.

4. Capital Adequacy and Subordinated Debt – Guidance from ICP's of IAIS

4.1. Insurance Core Principles (the "ICP's") by the International Association of Insurance Supervisors (the "IAIS") describe capital adequacy, *inter alia*, as an area that has to be addressed in the legislation or the regulations laid down by the insurance regulator or other competent bodies in each jurisdiction. The purpose of supervising insurers is to maintain efficient, fair, safe and stable insurance markets for the benefit and protection of policyholders. Capital adequacy and solvency regimes are one of the most important elements in the supervision of insurance companies.

4.2. An insurance company is solvent, if it is able to fulfil its obligations under all contracts under all reasonably foreseeable circumstances. Insurance regulatory authorities require insurers to maintain an excess of admissible assets over the liabilities, defined as a surplus capital or a solvency margin. The determination of regulatory capital requirements may also have aspects of both a going concern and a run-off or winding-up perspective. Regulators should establish regulatory capital requirements at the level necessary to support this objective.

4.3. ICP 14 establishes requirements for the valuation of assets and liabilities for solvency purposes and other reporting purposes. With respect to subordinated debt, it provides that if the terms of the debt make it subordinate to the insurer's obligations in respect of insurance contracts, the value of the debt may reflect the lower probability of repayment under subordinated debt and the lower capital needed to cover the risk of non-payment.

4.4. ICP 17 focuses on capital adequacy requirements for solvency purposes. It requires a total balance sheet approach to assess solvency, recognizing the interdependence between assets, liabilities, regulatory capital requirements, and capital resources. Capital resources under ICP 17 are broadly defined as the amount of assets in excess of liabilities, including technical provisions and other liabilities. However, certain liabilities, such as subordinated debt, may be treated as capital resources under certain circumstances.

4.5. ICP 17 further requires that the supervisor defines the approach to determining eligible capital resources and their value, considering the total balance sheet approach and the quality and suitability of capital elements. Perpetual subordinated debt, although classified as a liability, may be considered a capital resource for solvency purposes due to its availability to absorb losses through subordination. Further, it provides that capital elements must be legally subordinated to the rights of policyholders and senior creditors in insolvency or winding-up, and there should be no encumbrances that undermine subordination.

4.6 Figure 1 below explains the main functions of capital from the perspective of an insurance company:

Absorb Losses

Allows insurers to continue operating as going concerns during periods when operating losses or other adverse financial results are experienced, it decreases the probability of solvency by absorbing losses.

Promotes Public Confidence

Capital provides a measure of assurance to the public that an institution will continue to provide services even when losses have been incurred, thereby helping to maintain confidence and minimize liquidity concerns.

Protects Policy holders

Reduces the loss to policy holders in event of insolvency and winding up scenario.

Restricts excessive assets growth

Capital, along with minimum capital ratio standards, can act as a constraint on expansion by requiring that asset growth be funded by a commensurate amount of capital.

Figure 1 – Main function of capital for an insurance company

5. Subordinated Debt - A Preferred Source of Capital for Financial Institutions

5.1. The universe of international subordinated financial debt is growing and now has a market cap in excess of USD 1 trillion split between banks (USD 700 billion), insurances (USD 250 billion) and corporates (120 billion)[1]. As of March 31, 2022, insurance companies operating in India had raised a total of INR 9,345 crores (life insurers: INR 4,194 crores; Non-Life & Health: INR 5,151 crores) as other forms of capital i.e. including subordinated debt and preference shares.[2]

5.2. Historically, the raft of subordinated debt has been issued by financial institutions under the obligation to meet the requirements of the regulatory regime. Both banks and insurers are obliged to maintain or exceed a minimum amount of capital. Capital requirements must mostly be met with equity capital, with an allowance for subordinated debt and other permissible forms of capital/Tier II capital.

5.3. Internationally, subordinated debt can be a cheaper solution than equity capitalization for issuers. An article published in February 2020 states: *"To illustrate the attractiveness of issuing subordinated debt for issuers, the cost of equity for European financials is estimated to be above 10%, compared to subordinated debt paying coupons of 4% or above in euros. This is indeed a cheaper solution for issuers as well as being a very attractive income opportunity for investors."*[3]

Alternative sources of captial for meeting solvency margins and for other strategic objectives	Cheaper than equity	More Flexible than equity
Indicator of financial stablity and can improve credit rating	Interest payments are tax deductible	Access to market and diverisifed investors

Figure 2 - Advantages of subordinated debt over equity financing

[1] Subordinated Debt – an Attractive Asset Class. Article by Tarek, published on February 4, 2020. [https://atlanti.ch/subordinated-debt-an-attractive-asset-class/]
[2] IRDAI Annual Report 2021-22
[3] Subordinated Debt – an Attractive Asset Class. Article by Tarek, published on February 4, 2020.

6. Subordinated Debt by Insurer from Investors Point of View

6.1. Insurance subordinated debt placed into the international market accounts for a much smaller proportion of global subordinated debt than bank capital and corporate hybrids. It is however, a growing market, with net international subordinated debt supply denominated in USD, EUR, GBP and SGD totaling USD20 billion equivalent in 2019. More than half of the abovementioned internationally-placed subordinated debt is denominated in US dollars, with Europe accounting for more than 60 per cent of total issuance from the start of 2015 to May 2020.[4]

6.2. Insurance companies are generally rated by credit rating agencies, and the majority of companies seek to preserve investment grade ratings. Unlike non-financial corporates, the insurance industry is highly regulated in a similar way to banks with capital adequacy rules in place to protect policyholders. The existence of prudential regulation, including a capital adequacy framework, may also be seen positively by debt investors, on the basis that the regulatory framework should reduce the risk of insolvency.[5]

6.3. Investing in insurance subordinated debt is an interesting opportunity and will continue to be so, because it allows the possibility to invest in a sector that has some external supervision, which is not the case for most non-financial corporates.[6]

6.4. According to a recent report by McKinsey, the past decade has seen a continuous rise of private capital–backed platforms—typically fully or partially owned by alternative asset managers, which find the life insurance industry attractive for several reasons. Primarily, they're enticed by the opportunity to drive improvement in performance and by the potential to access "permanent" capital in form of a stable pool of liabilities, which can be deployed into various asset strategies, from traditional fixed income to more structured products. In turn, they can generate more predictable fee-based earnings streams while reducing the overall fundraising burden.[7]

6.5. It is important to note that the specific investors in subordinated debt can vary depending on the issuer, the terms of the security, the prevailing interest rates, and market conditions. Additionally, regulatory requirements and investor preferences can influence the composition of investors in subordinated debt of banks and insurers. Here are some of the main categories of investors in subordinated debt:

[4] Demystifying Insurance Hybrid Capital. HSBC Global Banking and Markets, July 2020. [https://www.gbm.hsbc.com/insights/growth/insurancehybrid]
[5] Demystifying Insurance Hybrid Capital. HSBC Global Banking and Markets, July 2020.
[6] Demystifying Insurance Hybrid Capital. HSBC Global Banking and Markets, July 2020.
[7] Global Insurance Report 2023: Reimagining Life Insurance – McKinsey & Company [https://www.mckinsey.com/~/media/mckinsey/industries/financial%20services/our%20insights/global%20insurance%20report%202023%20reimagining%20life%20insurance/global-insurance-report-2023--reimagining-life-insurance.pdf]

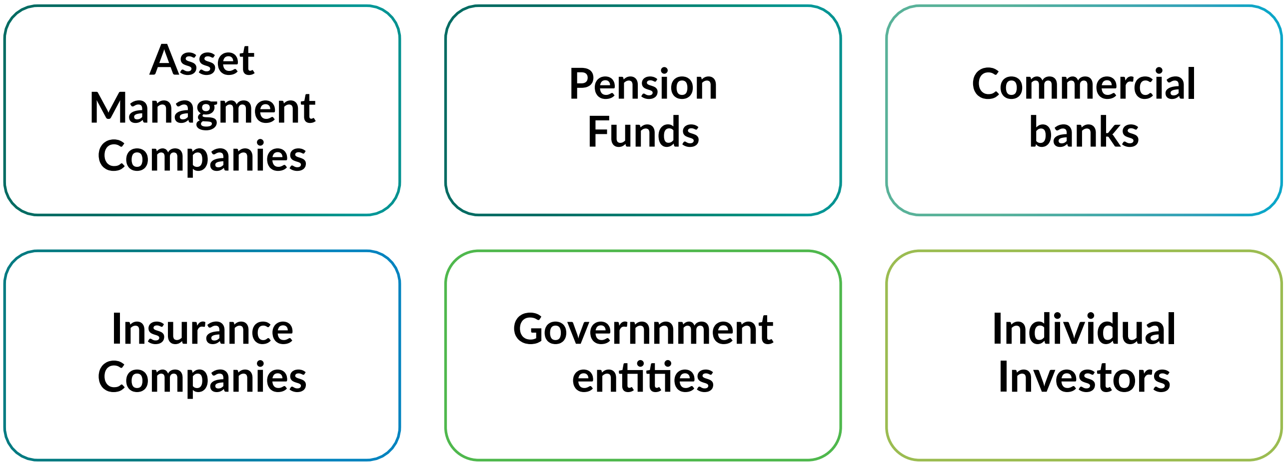

Figure 3 - Main investors in Subordinated Debt of Insurers

7. Impact of Subordinated Debt on overall Debt Market

7.1. The issuance of subordinated debt by insurance companies can significantly support the development of corporate debt market of Pakistan. This can be achieved through several key mechanisms. Firstly, by introducing subordinated debt as a new instrument, the market diversifies, attracting a broader range of investors and enhancing overall market depth and liquidity.

7.2. Additionally, subordinated debt's distinct risk profile offers investors more options, contributing to a more mature market. This also encourages conservative investors to participate, providing a crucial risk buffer. Moreover, the pricing of subordinated debt sets a benchmark for riskier assets, establishing clearer pricing standards for various debt instruments.

7.3. Furthermore, the longer tenures associated with subordinated debt promote a long-term investment outlook, fostering market stability. The presence of subordinated debt signals a more sophisticated market, instilling confidence in both domestic and international investors. This, in turn, encourages companies to maintain high levels of corporate governance and transparency.

7.4. A well-developed corporate debt market, inclusive of subordinated debt, contributes to financial system stability and supports economic growth by providing stable and reliable funding for businesses. Ultimately, the issuance of subordinated debt is pivotal in advancing the maturity and strength of Pakistan's corporate debt market, playing a vital role in the country's broader economic development.

7.5. More importantly for insurance companies in Pakistan the debt capital on a long-term basis provides sufficient opportunities for insurance and pension funds to develop adequate asset-liability matching strategies, hedging their interest rates risk and develop longer-term assets in Pakistan given the long-term nature of operations. This can also enhance capital diversification and encourage investments in insurance companies' growth.

8. Analysis of Capital Requirements Solvency Framework for Insurance Companies in Pakistan

8.1. In Pakistan, the current regulatory framework i.e. the Insurance Ordinance, 2000 (the "Ordinance") and the Insurance Rules, 2017 (the "Rules"), prescribe paid-up capital requirements as well as rule-based solvency requirements for life and non-life insurers. Briefly stating the capital as well as solvency requirements currently applicable to insurers are as follows:

(A) **Non-Life Insurers:** Under the current requirements, non-life insurers are required to have minimum paid-up capital of Rs.500 million in order to underwrite non-life insurance business. The solvency requirements for non-life insurers are provided in section 36 read with section 32 of the Ordinance and rule 12 and 15 of the Rules.

Briefly stated, the solvency regime for non-life insurers is to maintain an excess of admissible assets over liabilities equal to or greater than the minimum solvency requirement, which is the greater of: (a) Rs. 150 million; (b) 20% of earned premium revenue net of reinsurance expense; and (c) 20% of sum of liability for unexpired risk and outstanding claims liability net of reinsurance in each case.

(B) **Life Insurers:** Life insurance business is allowed to be undertaken by insurers with paid-up capital of Rs. 700 million. The solvency requirements for life insurers is provided for in section 35 read with section 32 of the Ordinance and rule 12 and 14 of the Rules.

Briefly stating, the solvency regime for life insurers is applicable on all the funds of the life insurers i.e. the shareholders fund and each of its statutory funds. Solvency of the shareholders' fund is to have admissible assets less liabilities equal to or greater than Rs. 165 million. For each of the statutory funds, the regime requires having admissible assets less liabilities equal to or greater than the policyholder liabilities and a prescribed solvency margin for each fund.

8.2. According to our current solvency regime, any subordinated debt issued by an insurer would be considered as a normal debt liability and no benefit would be allowed in respect of its subordination and loss absorbing capacity.

9. Landscape of Subordinated Debt issued by Banks in Pakistan classified as Tier II capital

9.1. In the Basel II regime as implemented by SBP, subordinated debt is classified as Tier II capital. Subordinated debt is subject to prescribed eligibility requirements and limits and is available to banks as an alternate source of capital which is used for absorbing losses and meeting regulatory capital requirements. Listed below are the main subordinated debts issued by the banks that are classified as Tier II capital. Notably, the most popular form of the subordinated debt securities issued by banks is Term Finance Certificates with a tenure of 10 years.

No	Name of the Bank	Instrument	Listed/ unlisted	Date of issue	Amount PKR Bn	Tenure	Rating
1	Bank AL Habib	Tier-II TFC	Unlisted	December 2018	4	10 years	AAA
2	Bank AL Habib	Tier-II TFC	Listed	December 2022	7	10 years	AAA
3	Bank AL Habib	Tier II TFC	Unlisted	September 2021	5	10 years	AAA
4	The Bank of Punjab	Tier II TFC	Unlisted	April 2018	4.3	10 years	AA
5	Askari Bank	Tier-II TFC	Listed	March 2020	6	10 years	AA
6	Soneri Bank	Tier II TFC	Listed	December 2022	4	10 years	A+
7	JS Bank	Tier II TFC	Unlisted	Dec 2017	2	10 years	A+
8	NRSP Microfinance Bank	Tier II TFC	Unlisted	July 2017	0.77	10 years	A-
		Total			**33.07**		

Table 1 – Subordinated Debt Issuance by Banks in Pakistan

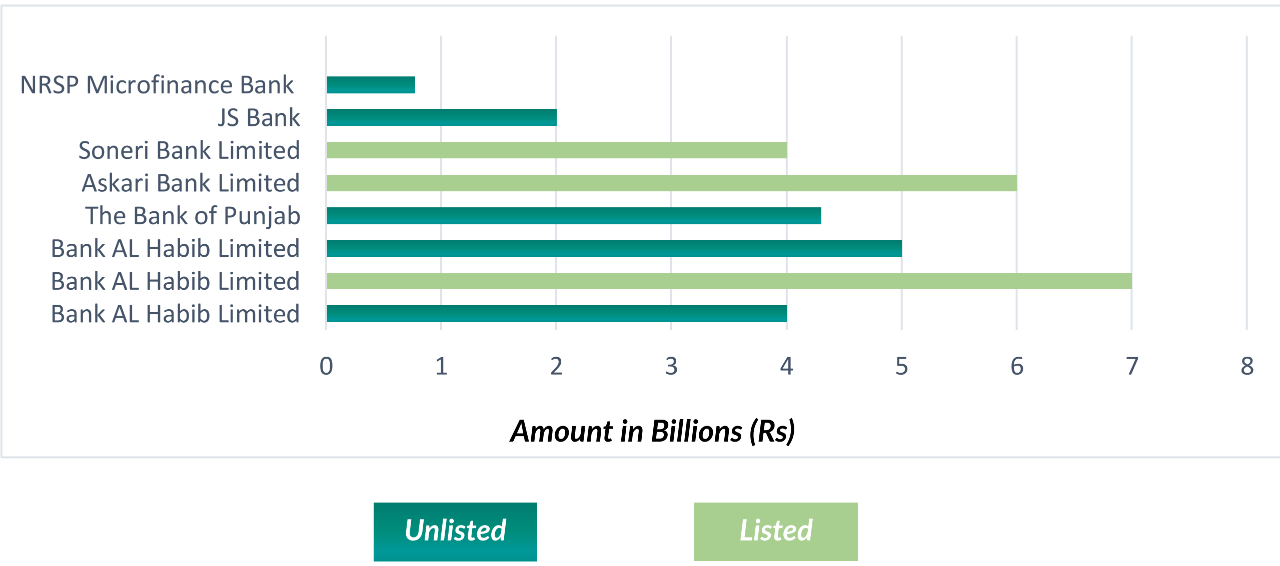

Figure 4 - Subordinated debt securities issued by Commercial banks of Pakistan

10. Factors in Designing an Explicit Subordinated Debt Policy for Insurers by the Regulator

10.1. The important question that arises next is, what should be the features of subordinated debt? Indeed, there is no uniform consensus over this issue. Some of the important factors that are considered in this regard are as follows:

- Subordinated debts should be issued to independent third parties who are neither affiliated nor involved with the issuing financial institution's business activities for the real risk diversification.
- The issuing financial institution or any individual or organization related with the issuing financial institution should not be allowed to buy or hold the subordinated debt instruments to avoid any correlation of risks. The same restriction will also apply to the employees' retirement benefit funds of the issuing financial institution to avoid insider trading or any other manipulation.
- As subordinated debt securities approach maturity, they pose a higher risk to the insures capital adequacy. When subordinated debt is nearing maturity, the insurer is at risk of losing a significant portion of its capital if it is unable to replace the maturing debt with new capital instruments. They should be subjected to progressive discounts for capital treatment as they approach maturity.
- The instruments may be 'plain vanilla' with no special features like the option of converting into equity and may not be callable. However, option of convertibility may also be assessed by the companies where the concern of the controllability of an entity is not under consideration.
- Requirement as to proper disclosure including the amount/details of subordinated debt raised as supplementary capital by way of explanatory notes in the annual financial statements, regulatory return and solvency statements.
- Listing of the subordinated debt may be considered as a preferred mode which not only enhances the marketability of such instruments but also supports the corporate debt market. Listed instruments also have visibility with regards to the valuation of the instrument contrary to non-listed instruments, where it would also be difficult for pension funds, Government entities and individuals to invest in these instruments.

11. Review of International Jurisdictions and SBP's regime on Characteristics and Treatment of Subordinated Debt Securities in the Capital Adequacy Requirements

11.1. An extensive review was conducted of three international jurisdictions for insurers and one local framework under Basel II as implemented by the SBP. In the Basel II regime as implemented by SBP, Tier II and Tier III capital are categorized as supplementary capital.

11.2. This examination specifically focused on the treatment of subordinated debt within Tier II capital, as well as its incorporation in the calculation of solvency and capital requirements. This detailed analysis aimed to provide a comprehensive understanding of how subordinated debt is factored into the regulatory framework in different jurisdictions, offering valuable insights for effective capital management within the insurance industry.

SBP	MALAYSIA	SRILANKA	INDIA
REGULATORY FRAMEWORK			
Minimum Capital Requirements for Banks & DFIs	RBC Framework	Solvency Margin (Risk Based Capital) Rules, 2015	IRDAI (Other Forms of Capital) Regulations, 2022
INCLUSION OF SUBORDINATED DEBT IN TIER II CAPITAL / OTHER FORMS OF CAPITAL			
Yes	Yes	Yes	Yes
ELIGIBILITY / QUALIFICATION REQUIREMENTS: SUBORDINATED DEBT TO BE FULLY PAID UP IN CASH			
Yes	Yes	Not specified	Yes
LOCK - IN CLAUSES			
Yes. Neither interest nor principal may be paid, even at maturity, if such payment would result in the bank falling below or remaining below its minimum capital requirements.	Not specified	Yes. Payment of either interest or principal (even at maturity), cannot be made if the payment would cause the insurer's Capital Adequacy Ratio (CAR) to fall, or remain, below CAR required.	Yes. Prior approval of IRDAI required for payment of interest if: (i) The solvency is below the minimum Control Level of Solvency; or (ii) The impact of such accrual or payment would result in the Control Level of Solvency falling below or remaining below the regulatory requirement specified by the IRDAI; or (iii) The impact of accrual or payment of interest results in net loss or increases the net loss.

LIMITS ON INCLUSION AS TIER LI CAPITAL/OTHER FORMS OF CAPITAL			
Yes. Max. of 50% of the amount of Tier I capital.	Yes. The amount eligible for inclusion shall not exceed 50% of Tier I capital. In exceptional cases, this limit may be exceeded with the prior written consent of the Bank Negara Malaysia (BNM).	Yes. In determining Total Available Capital, Tier II capital shall not exceed 50% of Tier I capital.	Yes. Amount of other forms of capital to be taken as lower of: (i) 50% of total paid up capital and securities premium of an insurer; or (ii) 50% of net worth of the insurer.
EARLY REPAYMENT OR REDEMPTION			
Allowed, however, subject to prior written approval of the SBP.	Allowed, however, subject to prior written approval of BNM.	Not Specified	Allowed. No incentives can be paid to holders of subordinated debt for early redemption.
SUPERIORITY OF CLAIMS			
Superior to equity only. Subordinated as to the payment of principal and profit to all other indebtedness of the bank, including deposits.	Superior to equity only.	Superior to equity only	Superior to equity and preference shares only. Subordinated to the claims of policyholders and creditors.
SECURED / UNSECURED			
Unsecured	Unsecured	Unsecured	Unsecured
MINIMUM TERM TO MATURITY			
Original term to maturity of five years or more.	Minimum original term to maturity of five years.	Minimum five-year term.	Issue shall either be: (i) perpetual; or (ii) maturity/ redemption period shall not be less than: (a) Ten years for life, general and reinsurance companies; and (b) Seven years for health insurance companies.
CONVERTIBLE/NON-CONVERTIBLE			
The instruments should be 'vanilla'. The issuer shall decide rate of profit.	Not specified	Not specified	All instruments shall be non-convertible, fully paid up and unsecured.
PRIOR APPROVAL FOR CLASSIFICATION AS TIER LI CAPITAL/OTHER FORM OF CAPITAL			
Yes. Prior approval of SBP required to qualify for inclusion in Tier II capital.	Yes. An insurer which plans to issue any new capital instruments is required to seek the BNM's approval on the classification of the instrument.	Not specified	Not specified
LISTING OF THE SECURITIES			
Not specified	Not specified	Not specified	Not specified

RATING OF THE SECURITIES			
Minimum Rating (A+, A-, A)	Not specified.	Not specified	Not specified.
CLASSIFICATION AS LONG -TERM LIABILITIES			
Not specified	Not specified	Not specified	Yes. Under the head “borrowing” in the relevant schedule.
ALLOWANCE TO GRANT ADVANCES AGAINST SUBORDINATED DEBT			
No. Bank should not grant advance against the security of its own subordinated debt issue.	Not specified.	Not specified	No. Insurers not allowed to grant loan against security of subordinated debt instruments.
AMORTIZATION SCHEDULE FOR CONSIDERING IN TIER LI CAPITAL/ SOLVENCY			
During last five years, discount factor of 20% be applied. In effect straight line amortization over last five years of life of security.	Straight line amortization over the last 5 years of life of the security	Not Specified	Straight line amortization over the last 5 years of life of the security.

Table 2 – Comparison of International Jurisdictions on Subordinated Debt Requirements

12. Regulatory Landscape for Issuance of Debt Securities in Pakistan

12.1. As per the current regulatory landscape of Pakistan, a company may by public offer or, in an agreement in writing, issue any instrument in the nature of redeemable capital. The debt securities are defined as any instrument creating or acknowledging indebtedness which is issued or proposed to be issued by a company including in particular, debentures, stock, loan stock, bonds, notes, commercial paper, term finance certificates, sukuk or any other conventional or Islamic debt security of a company, whether constituting a charge on the assets of the issuing company or not. Accordingly, insurers can issue both listed and unlisted debt securities.

The listing of debt securities is of two types and are described below:

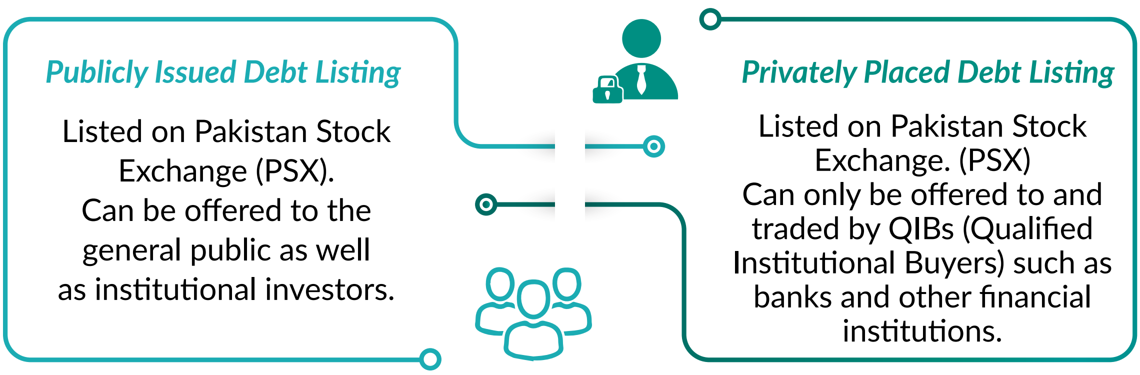

Figure 5 - Listing of debt securities on Pakistan Stock Exchange

12.2. Various business requirements for the issuance of publicly listed debt securities, privately placed listed debt securities, and unlisted debt securities, along with the main governing laws and regulations are summarized in **Annexure-I.**

13. Proposed Framework for Subordinated Debt, Characteristics, Treatment in Solvency and Other Conditions/ Restrictions

13.1. From the discussions made in the preceding sections of this concept paper, it is evident that subordinated debt securities issued by insurers / banks are considered to be a capital resource for the purposes of solvency / capital adequacy by considering them to be Tier – II capital / other sources of capital. Hence, in light of the deliberations and findings above, this section of the concept paper provides the proposed characteristics of subordinated debt, other conditions/ restrictions and its utilization in the computation of solvency requirements for insurers.

(A) Proposed Characteristics of Subordinated Debt Securities:

13.2. It is proposed that subordinated debt securities which may be allowed for the purposes of solvency requirements of an insurer shall carry the following characteristics:

(a) **Underlying Instrument:** The instrument to be considered as a subordinated debt shall fulfill the definition of "securities" as provided in section 2(lii)(b) of the Securities Act, 2015.

(b) **Subordination:** The debt security shall be unsecured and the claims of the holders of the subordinated debt securities shall be subordinated to the claims of the policyholders, beneficiaries and all the non-subordinated creditors, however, senior to the claims of the equity shareholders.

(c) **Fully Paid Up:** The debt security must have been issued and fully paid up in cash.

(d) **Unsecured Debt Security:** The debt securities issued shall neither be secured nor should be covered by a guarantee of the insurer or other arrangements that may legally enhance the seniority of the claims as against the claims of the insurer's policyholders and senior creditors.

(e) **Maturity Period:** The issue of the subordinated debt shall either be perpetual, or have a minimum fixed term to maturity as given below:
   (i) for life insurers of 10 years; and
   (ii) for non-life insurers of 7 years.

(f) **Encumbrance:** The debt security shall be free from any and all encumbrances by the issuers that may undermine the subordination or render it ineffective. However, an investor may secure financing against the debt security by encumbering it.

(g) **Rate of Profit/Interest:** The rate of profit/interest can either be floating or fixed. The issuer shall decide rate of profit.

(B) Proposed Treatment of Subordinated Debt Securities for Solvency Purpose and other Conditions/Restrictions:

13.3. Following is the proposed treatment of subordinated debt for solvency purpose and other conditions/restrictions:

(a) **Limits:** The amount of the subordinated debt eligible for solvency purpose shall not exceed 50% of the capital, accumulated profits/(losses) and reserves of the insurer, excluding revaluation reserves (available for sale instruments and fixed assets) or foreign exchange translation reserves.

(b) **Treatment for solvency purpose:** For the purpose computation of solvency of an insurer, the outstanding amount of subordinated debt towards the liability of the insurer, during the last five years to maturity, shall be arrived by application of a discount factor of 20% per year, as per the following table:

Remaining Years to Maturity	Rate of Discount
Less than or equal to one year	100%
More than one year but less than or equal to two years	80%
More than two years but less than or equal to three years	60%
More than three years but less than or equal to four years	40%
More than four year but less than or equal to five years	20%
More than 5 years	0%

For clarity, instead of taking the total amount of liability against subordinated debt for solvency, a discounted amount of liability shall be taken, as detailed above.

(c) **Treatment of Investments in subordinated debt securities:** The investment by an insurer in the subordinated debt issued by another insurer shall be subject to the admissibility requirements provided in section 32(2) of the Insurance Ordinance, 2000. Additionally, where the issuer of the subordinated debt is a related party, as defined in section 32(7) of the Ordinance, the investment shall be inadmissible by virtue of section 32(2)(g) of the Ordinance.

(d) **Recording of subordinated debt in the Statement of Financial Position and Balance Sheet:** Subordinated debt issued by an insurer shall for the purpose of the Statement of Financial Position (published financial statements) and balance sheet (regulatory returns) be recorded as per the requirements of the applicable international financial reporting standard.

(e) **Prior approval of Commission for inclusion in solvency computation and on early redemption:** Prior approval of the Commission shall be necessitated for inclusion of subordinated debt securities for solvency purposes and for redemption before maturity.

(C) Proposed Changes in Regulatory Framework:

13.4. The Insurance Accounting Regulations, 2017 (the "Accounting Regulations") specifies the accounting treatment to be followed in with respect to insurance-related assets, liabilities, revenues and expenses. For non-insurance related assets, liabilities, revenues and expenses and for matters not expressly provided for in the said regulations, the requirements of the international financial reporting standards are to be followed.

13.5. Accordingly, the Accounting Regulations do not provide any treatment to be followed with regard to the recognition and measurement of liabilities arising out of the issuance of debt securities by an insurer and hence, the IFRS framework is followed as required by the Accounting Regulations.

13.6. Currently, for the purposes of computation of solvency, liabilities are taken on the same basis, as is taken in the published financial statements. However, it would be important here to refer to the guidance available in ICP 17 of the IAIS, which is reproduced as under:

17.10.8 *Liabilities include technical provisions and other liabilities. <u>Certain items such as other liabilities in the balance sheet may be treated as capital resources for solvency purposes.</u>*

17.10.9 *For example, perpetual subordinated debt, although usually classified as a liability under the relevant accounting standards, could be classified as a capital resource for solvency purposes. This is because of its availability to act as a buffer to reduce the loss to policyholders and senior creditors through subordination in the event of insolvency. More generally, subordinated debt instruments (whether perpetual or not) may be treated as capital resources for solvency purposes if they satisfy the criteria established by the supervisor. Other liabilities that are not subordinated would not be considered as part of the capital resources; examples include liabilities such as deferred tax liabilities and pension liabilities.*

[Underlined to add emphasis]

13.7. Hence, while subordinated debt would be classified as a liability under the relevant accounting standard, it can be classified as a capital resource for solvency purposes for reasons more specifically provided in the ICP itself, however, it needs to satisfy the criteria established by the regulator (refer characteristics deliberated in section 5.1 above).

13.8. Building up on the premise, PART V of the Insurance Ordinance, 2000 relates to "Solvency Requirements"; section 34(1) of the Ordinance under the said part, states:

34. **Valuation of assets and liabilities:-** (1) For the purposes of this Part, assets and liabilities shall, subject to sub-section (2), be valued in accordance with such accounting rules as may be prescribed by the Commission.

13.9. Section 34 of the Ordinance, as reproduced above empowers the Commission to prescribe rules for valuation of assets and liabilities of an insurer for the purposes of solvency requirements. Accordingly, the proposed regulatory change contemplates amendments to the Insurance Rules, 2017; notification of which is enclosed as **Annexure - A** with this paper. Comments, if any, received by the SECP within 30 days of the date of notification shall be taken into consideration.

14. Conclusion and Way forward

14.1. The SECP is of the view that in line with the prevalent practices in international jurisdictions as well as the guidance available in the ICPs of IAIS, the insurance industry in Pakistan should also reap the benefits of having subordinated debt in the computation of solvency. Accordingly, for the purposes of achieving the same, the following way forward is suggested:

Action Item	Responsibility	Timeline
Notification of Amendments to the Insurance Rules, 2017	SECP	October 31, 2023
Comments from Stakeholders including insurance companies and IAP	Insurance Companies and IAP	November 30, 2023
Compilation of Comments and Internal Approvals including Approval from the SEC Policy Board	SECP	February 28, 2024

ANNEXURE-I

Listing of Debt Securities at PSX – Listing Requirements		
Major Requirements	**Publicly Listed Debt Securities**	**Privately Listed Debt Securities***
Operational Status of the Company	Must be in operations.	No such condition.
Profitability requirements	Profitable track record for last two preceding years. Additional conditions, in case company is not profitable.	No such condition.
Paid Up Capital of the Company	PKR 200 million or above.	PKR 25 million or above.
Issue Size of the Instrument	PKR 200 million or above.	PKR 25 million or above.
Credit rating requirement	Instrument rating: i. A2 (short term) in case of short-term debt securities ii. BBB+ (long term)/ A2 (short term) in case of long-term debt securities. In case of short-term instrument, instrument rating can be waived if the issuer has obtained entity rating and such rating is not less than "A-" (long term)/ "A2" (short term).	Instrument rating: i. BBB+ (triple B plus) in case of long-term instrument. ii. Short term debt securities are not required to be rated provided the issuer is rated and such rating is not less than BBB (triple B).
No Overdue amount	No overdue loan in CIB report of the Issuer, the sponsors/promoters, substantial shareholders and directors.	No overdue loan in CIB report of the Issuer, the sponsors/promoters, substantial shareholders and directors.
Structure of debt security	Trust structure or issuance agreement as per the structuring of Debt Securities Regulations, 2020.	Trust structure or issuance agreement as per the structuring of Debt Securities Regulations, 2020.
Appointment of Intermediates	i.Consultant to the Issue. ii. Underwriter. iii. Debt securities trustee or Investment agent depending on structure. iv. Shariah advisor in case of shariah compliant security.	i. Debt securities trustee or Investment agent depending on structure. ii. Shariah advisor in case of shariah compliant security.
Offering document	Issuance and publication of Prospectus	Issuance of Information Memorandum
Placement of instrument to Investors.	General Public	Eligible investors notified by the Commission under section 66 of the Companies Act, 2017.
Regulatory approvals	i.Approval of Prospectus by the PSX and SECP. ii.Approval of Listing application by PSX. iii.Approval of shariah structure by SECP in case of shariah compliant security.	i.Approval of listing application by PSX. ii.Approval of shariah structure by SECP in case of shariah compliant security.
Main applicable laws and regulations	(1) Securities Act, 2015 (2) Public Offering Regulations, 2017. (3) Chapter 5B of the PSX Rule Book titled Listing of Debt Securities Regulations. (4) Structuring of Debt Securities Regulations, 2020. (5) The Companies (Asset Backed Securitization) Rules, 1999 (6) Asset Backed Securitization Regulations, 2022. (7)Shariah Governance Regulations, 2023.	(1) Section 66 of the Companies Act 2017. (2) Notification issued by the Commission under section 66 of the Companies Act, 2017. (3) Private Placement of Securities Rules, 2017. (4) Chapter 5C of the PSX Rule Book titled Privately Placed Debt Securities Listing Regulations. (5) Structuring of Debt Securities Regulations, 2020. (6) Sukuk (Privately Placed) Regulations, 2017. (7) Shariah Governance Regulations, 2023. (8)The Companies (Asset Backed Securitization) Rules, 1999. (9) Asset Backed Securitization Regulations, 2022. (10) Issue of Commercial Papers Regulations, 2013.

Annexure 1- Listing of Debt securities on PSX – Business requirements

* In respect of issuance of unlisted privately placed debt securities, any company except a single member company can issue privately placed debt securities to eligible investors in compliance with Private Placement Rules, 2017. Eligible investors are specified by the Commission vide S.R.O. 1011(I)/2021 dated August 6, 2021 issued under section 66 of the Companies Act, 2017.

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