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John Hale
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Dear John

We understand that some of your members have raised questions about the regulatory treatment that would apply for insurance companies that may hold the new Enhanced Capital Notes (ECNs) that have recently been issued by Lloyds Banking Group. We are therefore writing to you to offer some clarifications on how we believe that the rules and guidance in our Handbook would apply when insurers hold ECNs.

We believe that the ECNs should be characterised as debt instruments with an option to convert to equity stock that would be exercised in the event that the bank's capital ratio fell below the specified trigger ratio. The regulatory treatment to be applied by insurance firms to the new ECNs would then be no different in principle from that applied to other debt instruments. In particular:

- 1) The assets would continue to be valued by insurers in line with GENPRU 1.3 by reference wherever possible to readily available quoted market close out prices from independent sources.
- 2) Life insurers would continue to assess the relevant risk-adjusted yield on these assets in accordance with INSPRU 3.1.30R - 3.1.44R. In particular, they would be expected to apply INSPRU 3.1.30(4)R in conjunction with INSPRU 3.1.41R to exclude that part of the assumed yield that represents compensation for the 'credit' risk that a loss would be incurred for investors in the event of conversion to equity being triggered.
- 3) Realistic basis life firms would be expected to apply the credit risk and interest rate scenarios in INSPRU 1.3 to any ECNs that have not been converted to equity stocks, when assessing the firms' RCM capital requirement.
- 4) For the purpose of the Pillar 2 calculations (eg the ICA) made by all insurers, an appropriate stress should be applied to allow for the risk that the value of the ECN may reduce in adverse conditions. This stress should continue to be calibrated to 99.5% VaR over 12 months, and should take account of potential adverse movements in interest

rates, credit spreads and equity prices, as well as the risk that the ECN may be converted to equity stock that is worth less than either the current value of the ECN or the amount otherwise payable on redemption of the ECN.

Insurers may also wish to consider the capital requirements that may apply under the new Solvency II regime. For the calculation of the SCR, it seems likely that these ECNs would still be characterised as bonds, as long as they have not been converted, so that the relevant capital charge is likely then to depend on the latest credit rating along with the relevant factors for bonds that will be set out in the credit spread risk module.

We are of course willing to offer individual guidance to firms as well, on any specific issues relating to the operation of our rules.

Yours sincerely

Paul Sharma
Director, Prudential Policy Division

I am also copying this letter to your colleague, Peter Vipond.