Special Report:

Tax Deductible “Equity”: Insurance Hybrid “Obligations”

The insurance sector has a vintage of hybrids that were issued mostly in the 2005-2007 timeframe – a period of financial glee when Wall Street and rating agencies collaborated to create a set of rules that would offer insurance companies material equity credit for debt issuance. This debt (or “equity”; you decide after you read on) was commonly referred to as an “equity enhanced capital security” (i.e., “Ecaps”) where the insurance issuer could receive between 75% to 100% equity credit from the rating agencies for financial leverage calculations. The criteria for the equity credit were engineered differently at each rating agency and the deals were structured to meet the uniquely different goal posts of each agency – typically, those of Moody’s and S&P (though Fitch played the game too). A consistent theme, however, was the step-up coupon which was borrowed from the Yankee bank tier1 market to create an effective 10year maturity – ironically, it was the insurance company investment departments that demanded this feature because 10yr durations were in the sweet spot of their fixed income mandates for the general accounts. S&P described the step-up language this way:

“Step-ups are specifically designed to motivate the calling of the issue. They clearly signal to investor’s the issuer’s initial intention to refinance the issue in time to avoid the step-up. Yet, as long as the step-up is moderate…the issuer could still choose to keep the issue in place and not refinance it…We would be concerned in such a scenario about the possibility of the issuer facing a backlash among investors who had not appropriately taken account of the so-called extension risk.

The predominant structure of the insurance Ecaps was to put a 10year step-up in place on a 60yr final repayment date which would provide a 10year equity credit (when combined with other features such as optional coupon deferral, replacement capital restrictions and mandatory deferral triggers). For Moody’s, the credit was typically 75% (i.e., “Basket D”) for the first 10 years; then it would roll down to 50% (i.e., “Basket C”) for the next 20yrs; and then it would roll into “Basket B” for the next 20yrs after that – once the issue aged to be a 10yr maturity, it would lose all equity credit and be classified as debt (which, we submit, it was from the start). S&P provided similar equity treatments in 3 categories: “high” (as much as 100%), “intermediate” (ranging from 25%-75%) and “minimal” (basically 0%). The functional key with S&P was that any “intermediate” class hybrid that had a remaining life of less than 20yrs would be pushed into the “minimal” equity content category -- importantly for S&P, only “intermediate” equity class hybrids could count as 100% equity for financial leverage calculations (this still holds true).

There are 8 factors in IRS Notice 94-47 (see page 15) that guide a debt or equity classification on a hybrid, and no single factor weighs more heavily than another in making this determination. In order to provide some issuer’s tax counsel with more comfort that a hybrid with a long final maturity (e.g., greater than 49yrs) would not trouble the IRS (and unduly risk the tax deductible interest payments), a 30yr “scheduled maturity” scheme was created for some issues. A
“scheduled maturity” is really nothing more than a future best efforts obligation by the company to refinance the issue with another similar issue. It is not an enforceable obligation for holders, but it is a strong indication of intent by management to redeem the issue. A key tax question could be “can the issuer sell enough pari passu securities to refund the Ecap 30 years from now?” If the answer is “yes”, then the tax legal community could be comforted by this “effective maturity” of 30yrs (regardless of the additional 30yr term remaining before repayment is enforceable) as being in the reasonably foreseeable future. From a tax interpretation standpoint, the “scheduled maturity” being viewed as an effective maturity could be constructive reasoning for the issue to have additional debt characteristics, thereby preserving the tax deductibility of the payments for the issuer. Along similar reasoning, issuers also show clear initial intent to redeem with a step-up feature in place – effective maturities and intentions to call securities have been weighed in favor of interest deductions. We believe that if an insurance issuer were to extend its hybrid (i.e., pay the coupon step-up rather than call the security), this would not only be a moral misstep but an action that strikes any notion that the step-up was intended to be an effective maturity at issue. The Internal Revenue Service could look back and determine that an effective maturity balance has been tipped from the initially intended 10yrs to 60yrs (or longer in some cases) – this could be judged as being beyond the reasonably foreseeable future when weighed against the other equity features of the instrument and the uncertain nature of insurance solvency in the aftermath of the AIG bailout.

Many people will argue that Enron won its IRS challenge from its field audit in the late 1990s so there is consequently little if any tax risk in hybrids – we disagree. We caution that the IRS merely provided “technical advice” during a period of immensely forceful lobbying efforts from Wall Street and the Bond Market Association (among others) – there was no tax court precedent in the case of Enron’s 2 hybrid deals. In Enron’s first deal (i.e., the 8% coupon), it used a 50yr loan with a rollover option in the partnership for another 50yr loan making the total term available at 100 years. In its second deal (i.e., the 9% coupon), Enron used a 30yr loan with a rollover term of 19yrs making the total term available at 49 years. Interestingly, it does appear that in order to mitigate some tax risk, Enron used the 49yr maturity in its second deal to cleverly align itself within the Monon Railroad case (see page 22). Certainly, things can change quickly (even for a utility) – the technical advice determined that a 30yr, 49yr and 50yr maturity appeared to be within reason because Enron had been in existence for over 60 years (see page 23) at that point – yet 2½ years later Enron was bankrupt. Indeed, as it is impossible to see the future, the IRS states that there is no bright line test for maturity; although the technical advice did say that the 100yr extended term may appear to be unreasonable (see page 23). We note that the context of the technical advice does appear raise a specter of uncertainty regarding maturities beyond 50yrs, which is in keeping with the “no bright line test” policy of the technical advice. Consequently, we believe that the tax risk to an insurance issuer will increase if an issuer extends as it would breach any 10yr effective maturity from the step-up/call structure as having accurately projected repayment for the initial holders within a 49yr term (e.g., RGA 6.75% due 2065 could be the first test of a breach).

More conservative issuers have taken a less ambiguous route by structuring a 30yr “scheduled maturity” within a 60yr final maturity (e.g., Chubb 6.375% due 2067) to reduce the tax risk. This 30yr “scheduled maturity” would also align S&P’s reduction of intermediate equity credit with the 10yr step-up date (once time rolls to be 20yrs away from this 30yr effective maturity) and Moody’s reduction in “D-Basket” equity with the 10yr step-up date (once time rolls to be 50yrs away from this 60yr final maturity) – this alignment further enhances the existing moral spirit of the step-up date as an effective maturity because equity credit could not be extended. As a
result, this tighter structure that gave insurance managements the most tax comfort and
combined 10yr equity content from Moody's and S&P – we refer to this structure as the “30/60”
hybrid as it contains the 30yr “scheduled maturity” with a 60yr final maturity structure. Only
managements apparently willing to “roll the dice” issued 60yr final maturities with no “scheduled
maturities” in order to leave available the prospect of a 100% equity credit from S&P for another
30 years by extending the issues.

Since then, Moody’s and S&P have changed the rules causing some insurance hybrid equity
credits to be lowered in an arbitrary and unbalanced fashion. Some managements, being
unsatisfied with this change, redeemed their hybrids through the open market or via tender
offers. Street research that discusses extension risk in insurance hybrids has raised the
discussion about the moral obligation to call a security on the step-up date rather than extend it
with a floating rate coupon. Indeed, more investors (e.g., hedge funds) seem worried about
managements’ prospective “immorality” than their “good conscience”. Consequently, many
insurance hybrids that are not “30/60s” have traded down to discounts, which shows little (if
any) faith that industry management will be righteous in appropriately calling their hybrids.
Recent ambiguous statements from managements suggest that they want to be dice rollers as
the process of extension has begun for some by doing the rates swap move (see page 11). We
believe that these seeming “extension minded” managements are so selfishly myopic about
prolonging the current economics of their equity credit from S&P (which can easily be extended
with better structure), that they not only risk the wrath of conscientious investors, but could risk
losing millions in back taxes to the IRS by not restructuring the equity credit more conservatively
via redemption and replacement.

We believe that extending insurance hybrids could be a risky game of blind ambition by
managements. Let’s remember that the Federal Reserve, which has stated that the long lives of
trust preferreds were an “economic perpetuity” (hardly a supportive representation of
repayment) and that a coupon deferral was an “economic indefinite deferral” (see page 2), is no
longer in the halls of Ways & Means arguing in favor of tax deductible Tier1 equity. Today, the
Fed’s powerful regulatory voice (that may have emboldened a more risky structuring approach 8
years ago) no longer argues in favor of tax-deductible equity, which could have very well played
some role in the settlement memorandum’s concession on Enron in 1998. The tone in
Washington today regarding the financial industry is austere. There is also heightened scrutiny
of the rating agencies, whereas 8 years ago they operated in nirvana with some members of
Congress “rolling the dice”.

We believe that any management of an extended hybrid would certainly need to keep hoping
that the IRS continues to look the other way. Our main concern is that S&P’s 100% equity credit
is subject to the risk of being “bootstrapped” by the IRS (see factor (h) on page 15), which
means that if a rating agency or regulator views the paper as equity (which S&P unambiguously
does), then the IRS could (or can) take the same view and consequently eliminate the tax
deduction on the interest expense and perhaps even seek a claw back. In the technical advice
on Enron, the word “some” (see page 21) was used in describing the equity credit from S&P, but
in the case of the RGA 6.75% hybrid for example, the equity credit is 100% from S&P until 2045
– 100% is not “some”. Furthermore, the Enron technical advice focused on “labeling” when
discussing the intent of the issue being treated as equity for non-tax purposes – “labeling” debt
is not exclusive evidence of an intention to be treated as the equity it is by a rating agency. An
insurance hybrid could be labeled as a “fish” and still get full equity treatment from S&P. In the
case of Enron, this labeling rationale as it pertains to “intent” as debt misses the whole point of
why these hybrids were issued in the first place and why they could extend – which is to obtain
and prolong S&P’s full equity credit. Indeed, S&P has a strong hand in the insurance industry because it’s the leading provider of financial strength ratings for insurance claims paying ability (more so than Moody’s and Fitch, for example). So, the S&P equity credit weighs heavily on the economic motivations of an insurance issuer as it relates to redemption actions (or extension actions) on a hybrid security.

Determination of whether a hybrid security should be classified as indebtedness or equity for U.S. federal income tax purposes requires a sound and reasoned judgment based on all relevant facts and circumstances. Tax counsels will provide opinions, though they will state that they are not free from doubt. Circumstances can change. If insurance hybrids extend based predominantly on the availability of extending S&P’s equity credit, then investor trust in management’s initial intentions will be breached. So too will any view toward a step-up structure being an effective maturity by insurance industry issuers – this could weigh unfavorably on any interest deductions taken up to that point as no intent to redeem would be deemed to exist based on a maturity of 60yrs or more. Some companies such as Lincoln National Corp and StanCorp Financial have clearly broadcast an intention to extend (in advance) and prolong S&P’s equity credit by entering into private long term swap rate agreements (to evidence permanence to S&P) which abrogates the initial intent to redeem (ex-post).

In conclusion, we believe that extension of insurance hybrids would manifest managements’ intent to preserve full equity credit and that such action could disqualify its labeling as debt for tax purposes – this is in conflict with the supportive technical advice of the Enron settlement which looked favorably upon Enron as having “consistently labeled and treated these obligations as debt”. We fear that a management’s choice to extend engenders heightened risk of IRS bootstrapping, which makes the intent to be treated as equity in Notice 94-47 a “smoking gun” and potentially sufficient to cause recharacterization as equity despite some characteristics of debt. Common equity shareholders should take note of any extension actions as heightened tax event risks that could lead to claw back of prior tax benefits which would negatively impact retained earnings. As for the assortment of “non-30/60” insurance hybrids that are trading at discounts, any hedge fund shorts may ultimately be quite difficult shorts to cover if relevant managements ultimately rethink their positions to act prudently by calling their hybrids -- if for no other reason than to reduce tax risk and preserve shareholder value. RGA will be the first management to be tested. In our opinion, the extension dice do not appear to be worth rolling. We would be comforted to see at least one of the industry’s management groups behave more conservatively in respect of the broader implications of this risk to shareholders, rather than behave like a lemming. The conservative trade is to redeem the old “non-30/60s” and replace them a new less risky tax structure for the same equity credit at minimal marginal cost – otherwise, blind ambition may very well backfire into a cost of poor judgement. Any member of Congress with clear ambition could potentially raise significant political capital just by challenging the financial industry on the tax deductibility of hybrids (again).

Phil Jacoby
CIO, Spectrum Asset Management
April 27, 2015