Tight Credit Provides Opportunity to Utilize P-CAPs Facilities

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In May 2022, we wrote about a contingent capital financing technique that entails the issuance of pre-capitalized trust securities ("P-Caps"). P-Caps facilities had been attractive standby sources of contingent capital for companies (primarily, companies in the insurance sector) while debt markets were "frothy." In short, this is because P-Caps facilities provide ready access to cost-effective capital, generally free of counterparty risk with off-balance sheet treatment until drawn. With the current Federal Funds rate hovering around 5%, coupled with a tight debt market, companies with existing P-Caps facilities generally now have the option to avail themselves of a highly liquid and relatively inexpensive source of financing by "drawing down" under those facilities. As of the date of this note, we are aware of certain companies that have in fact drawn under their P-Caps facilities.

DRAW—BENEFITS

Cost-Effective and Certain Capital

In the current credit market, drawing under a P-Caps facility provides the drawing company with ready access to highly liquid assets (*i.e.*, the principal and interest strips of the U.S. Treasury securities ("Eligible Assets") held by the P-Caps trust (the "Trust")) that should be easily converted into cash by the company (absent a material dislocation in the market for U.S. government securities). The carrying cost to the drawing company (in the form of interest payments on senior notes issued by the company to the Trust) will equal the interest payable on the principal amount of the outstanding P-Caps (assuming a full draw). Interest payments on the senior notes should be more cost-effective than the interest costs that would accompany a current day financing because the effective carrying costs to the drawing company under the facility were likely established at a time when financing costs were lower (in fact, many existing P-Caps facilities were established at a time when interest rates were considerably lower). Further, interest payments by the drawing company are typically fixed, thereby providing certainty against further movement in prevailing interest rates. Finally, even if the interest payments on the senior notes are not effectively lower (*e.g.*, because the facility was more recently established), the drawing company benefits from ready access to liquidity (upon sale of the Eligible Assets) at a time when access to the capital markets for fresh financing may be "tight" or unavailable.

P-Caps Liquidity May Be Refreshable

Many existing P-Caps facilities include provisions that provide refreshable access to facility liquidity. These features allow the company to draw on the facility and then subsequently repay and re-draw as frequently as it would like during the tenure of the facility. The repayment is effectuated through a repurchase by the company of some or all of its senior notes then held by the Trust in exchange for Eligible Assets that the company holds or purchases in the market. Thus, drawing on a P-Caps facility should not impair a drawing company's ability to manage its capital structure to appropriately leverage prevailing market conditions as they shift during the life of a facility.

Further Upside to P-Caps Liquidity

P-Caps facilities do not typically contain restrictions on the use of Eligible Assets by the drawing company, and the company may choose to hold the assets as U.S. Treasury strips pending future use or immediately sell them into the market for cash proceeds. Similarly, these facilities do not typically contain any restrictions on the use of the proceeds to the drawing company upon conversion of Eligible Assets, and the proceeds may be applied to a range of potential financing or strategic needs including to fund an immediate capital need (*e.g.*, a regulatory capital shortfall) or a business development initiative (*e.g.*, a pending asset acquisition). Further, depending upon when the facility was established, the drawing company may benefit from a built-in gain on the Eligible Assets upon their conversion to cash.

DRAW—CONSIDERATIONS

There are certain considerations to bear in mind when drawing on a P-Caps facility:

- **Increased Leverage**. Drawing under a P-Caps facility entails the issuance of senior notes to the Trust. What this effectively means is that drawing under the facility moves the financing onto the drawing company's balance sheet from an off-balance sheet status, and the senior notes will be reflected on the company's balance sheet and in the company's financial leverage as newly incurred debt. This is an important consideration for companies that may be subject to leverage-related financial covenants or regulatory capital tests.

- **Costs**. There may be transaction costs incurred in connection with the monetization of the Eligible Assets received upon drawing under the P-Caps facility and sourcing Eligible Assets to refresh the facility if it is drawn and repaid.

- **Fixed Maturity**. Once the facility is drawn and senior notes are issued to the Trust, the drawing company's senior notes will need to be repaid or refinanced at their fixed maturity. As such, the drawing company would be subject to future refinancing risk based on then-prevailing market conditions, which may be in the relative near term if the facility was established many years ago.

- **Public Filings**. When a company draws under a P-Caps facility, the company incurs new debt. To the extent that the drawing company is a public reporting company registered with the Securities and Exchange Commission, the incurrence of new debt could trigger an obligation to file a Current Report on Form 8-K. As part of the 8-K filing (or a subsequent Form 10-K or 10-Q filing), the Company may also be required to file as exhibits certain agreements that govern the P-Caps transaction, such as the supplemental indenture governing the senior notes issued to the Trust.

- **Investor Relations**. Drawing on a P-Caps facility could send a negative signal to the market since P-Caps facilities are sometimes understood by investors to be contingent sources of last-resort capital. Companies would be well advised to consider the investor relations messaging related to a draw and to provide relevant regulators or rating agencies with advanced notice.

FINAL THOUGHTS

As traditional financing options have become more expensive or unavailable, companies with existing P-Caps facilities may wish to consider the efficacy of a draw under their facilities to the extent that they have an immediate or near-term need for additional capital or financing. We are available to discuss any of the matters touched upon in this note. For more information on P-Caps, please see our article, "The Financing Flexibility of P-Caps" (here).

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Please do not hesitate to contact us with any questions.

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