

Insurance Bonds: 24 March 2020

Compelling Value Opportunity Emerges

Executive Summary:

Twelve believes that the insurance sector is relatively well placed overall to weather the current situation, seeing average European insurer solvency ratios at 191% today (208% pre-sell-off).

Whilst spread widening has been painful, robust marked to market solvency ratios indicate actual material impairment to investor cashflows remains unlikely at this stage.

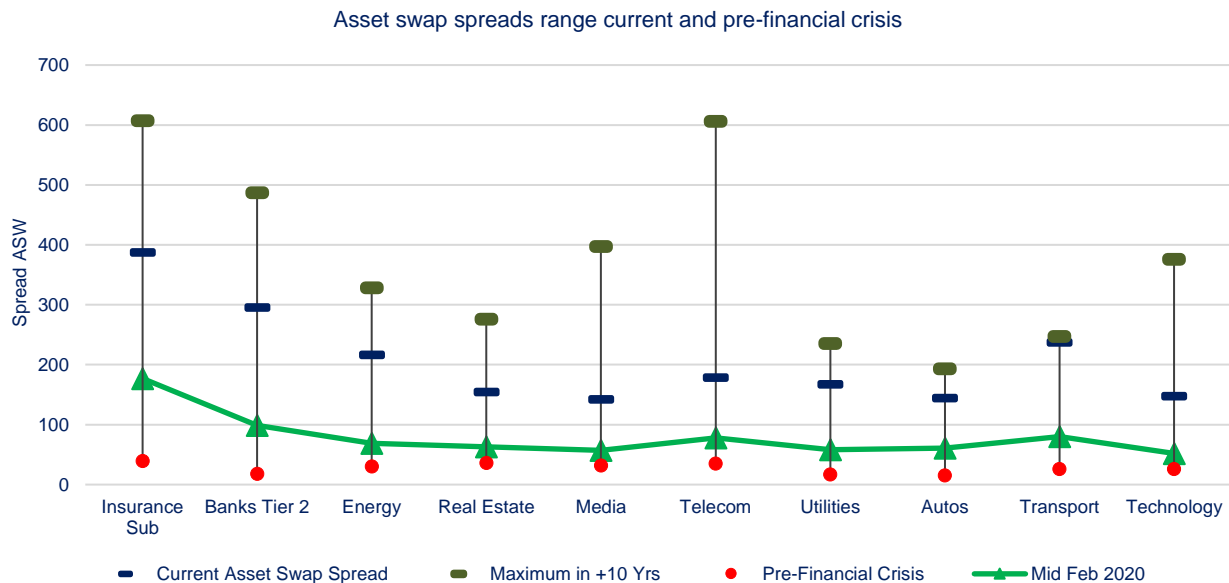
As a result this both fundamental and technical led market sell off is increasingly looking overdone, compelling value opportunities emerging amongst insurer bonds, in Twelve's view.

Average yields to call within European Insurance Tier 2 debt are now c. 5.0% in Euro terms (c. 6.25% in US dollars), those for Restricted Tier 1 at c. 11.0% in Euro terms (c. 12.25% in US dollars).

Market sell off driven by both fundamental and technical factors looking overdone

Recent bond price movements have been truly extraordinary, driven by the developing COVID-19 pandemic and its implications for the growth outlook of the global economy. Specifically in relation to insurance bonds, at the time of writing, Twelve Capital notes that as a result of the market sell off, Tier 2 bonds issued by European insurers are down by up to 30 points, with Restricted Tier 1 instruments down even more by up to 50 points.

Placing these moves into a wider context, as the following chart shows, since the market tights in early February asset swap spreads for subordinated insurance risk have widened substantially by 210bp to 390bp. Whilst insurance levels remain inside their financial crisis wides, they are still by far the widest amongst the industrial sectors shown. Further the absolute 210bp move wider in insurance is greater than that seen elsewhere within the investment grade space (the absolute move wider in high yield significantly greater at 330bp to 690bp).



Source: Twelve Capital, Bloomberg. As at 23 March 2020.

Whilst not agreeing with the degree of spread widening seen from a fundamental perspective, Twelve believes a combination of generalist investor misunderstanding of sector fundamental strength and market technical factors explain the spread movements in insurance.

Clearly, some negative market movement in credit markets ought to be expected given uncertainty around insurance fundamentals due to the nature of the COVID-19 pandemic. However, in Twelve’s view the sector’s relatively niche profile lends itself to the inherent strength of insurance groups still not being fully appreciated by generalist credit investors.

For evidence of insurance resilience during periods of extreme market stress, Twelve would point to the sector’s performance throughout the global financial and peripheral European sovereign crises of 2007 to 2012. During that entire period only one coupon was lost to credit investors in European insurers and only one insurer had to restructure debt, to the best of Twelve’s knowledge. Further, European insurers continued to meet investor expectations around redeeming bonds at their first call date throughout that period.

Away from fundamentals, technical factors have also impacted bond prices and should not be overlooked. Twelve believes price declines have been accelerated and exacerbated by insufficient market liquidity during this period of stress. Twelve has observed even small volumes of bond trading generating an exaggerated impact on bid-offer spreads.

Further, it should be noted that insurance subordinated debt pricing is currently not supported by the ECB’s outright purchase of corporate bonds. Subordinated instruments to date remain ineligible for purchase.

Correctly timing when markets will stabilise and subsequently rebound is obviously very difficult to do. Nonetheless, overall Twelve believes the market reaction to the pandemic is increasingly looking overdone. This suggests that a compelling value opportunity is now becoming apparent within insurance subordinated debt against the backdrop of a very low interest rate environment. To illustrate, average yields to call within European Insurance Tier 2 debt are now c. 5.0% in Euro terms (c. 6.25% in US dollars), those for Restricted Tier 1 at c. 11.0% in Euro terms (c. 12.25% in US dollars).

Insurance fundamentals point to continued sector resilience

Twelve continues to believe that the insurance sector is relatively well placed overall to weather the current situation. This means that the spread widening witnessed to date is not expected to translate into the significant and widespread loss of coupons or principal suggested by current market pricing.

Sector strong fundamentals were discussed in detail within a recent note (see [here](#)). Key factors pointing to resilience amongst insurance groups included:

- Numerous sources of insulation to market risk inherent to the insurance business model (see table below);
- The benefit to sector financial strength of enhanced regulatory oversight (e.g. Solvency 2 in Europe from 2016, this regime also featuring regular stress testing to assess sector resilience against various market shocks);
- The industry's reaction to heightened regulation (e.g. material investment into enterprise risk management capabilities, further balance sheet strengthening and improvement to earnings quality); and
- Ahead of the pandemic, high levels of sector solvency capital, robust financial flexibility (i.e. relatively modest levels of debt leverage, strong fixed charge coverage) and ample liquidity.

No funding gap	Duration matching	Underwriting less correlated	Ability for loss sharing
No reliance on wholesale markets for liquidity funding. Insurer working capital is provided predominantly by policyholder premiums, leading to relatively muted senior debt issuance and materially reduced refinancing "roll-risk".	Sticky liabilities lower liquidity pressures further, removing the need to sell assets at depressed levels to meet claims during periods of mark-to-market stress. Insurers tend to closely match the duration of liabilities with invested assets and are able and willing to buy and hold to maturity.	Substantial profit sources that are not investment spread-based. Insurer profits from underwriting risk often have a low, and, occasionally, negative correlation to investment markets.	A proven ability to share asset-related losses with policyholders and through taxes. Some life insurers can lower the impact of losses by reducing pay-outs to policyholders in excess of policy guarantees, retained losses further benefiting from tax offsets.

Twelve continues to expect that in aggregate, direct impacts from the disease outbreak in terms of insurance losses, whilst painful, will be manageable (i.e. higher life mortality, disability, business interruption, travel insurance etc. claims). To illustrate, as stated within a Q&A from the UK Association of British Insurers (see [here](#)), standard insurance purchased to cover against business interruption are unlikely to cover the effects of global pandemics. It is also possible that the profitability of some insurance classes may even improve, such as motor insurance, as lower driving activity translates into reduced claims frequency.

More significant impacts are expected from second order effects linked primarily to the performance of investment markets. These have of course been extremely volatile, providing at different times over recent weeks headwinds and even at times tailwinds to sector solvency.

One potential source of risk faced by insurers relates to their credit investing activity. Investment grade is by far the focus of insurer credit investments, regulatory regimes effectively making sub-investment grade credit investing uneconomic. Therefore, any action that supports investment grade credit is positive for insurance groups and by extension investors in insurance bonds.

With that in mind, Twelve notes the extraordinary building global monetary and fiscal response to the virus designed to underpin the strength of the global economy and investment grade credit, including:

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- The European Central Bank's commitment to purchase an additional EUR 1trn of eligible instruments during 2020, and activation of the Pandemic Emergency Purchase Programme (PEPP) that will purchase up to a further EUR 750bn of bonds and commercial paper; and
- The US Federal Reserve announcing unlimited buying capacity for US treasuries and mortgage back securities.

In conclusion taking the potential direct and indirect impacts together, Twelve expects overall, sector financial strength to prove resilient.

Robust solvency ratios protect against losses for credit investors

European domiciled (though many with global footprints) insurers represented the vast majority of Twelve's credit investment portfolios heading into this market sell off. This reflected the more attractive risk adjusted spreads on offer from European insurers and the material drag of hedging costs for non-US dollar investors.

These insurers, subject either to Solvency 2 or the Swiss Solvency Test (SST), have provided market movement sensitivities. These allow Twelve to forecast where solvency ratios currently lie and take stock of "real time" sector financial strength.

At the time of writing and compared to the average 208% level reported ahead of the market sell off by 48 insurance groups, Twelve believes the average solvency ratio for European insurers has indeed fallen but is believed to still stand at a healthy 191%. Twelve sees the largest drivers of the move down as being interest rates (c. 8 points), equity markets (c. 8 points) and credit spreads (c. 4 points), partially offset by operating capital generation since year end (c. 3 points). Putting this marked to market level of solvency into context, the Solvency 2 regime is calibrated so that a ratio of 100% is sufficient to withstand an aggregate 1 in 200 year stress event over a one year period, across both sides of the balance sheet.

In relation to bond triggers, it is also only at a level of 100% or below that the Solvency 2 regime demands that coupons are either cumulatively deferred (Tier 2) or non-cumulatively cancelled (Restricted Tier 1; noting issuers retain full discretion over coupon payments at all times for these instruments). Further, it is only at solvency ratios of below 75% (absent an extended period below 100%), that principal loss absorption is activated for Restricted Tier 1 instruments.

Whilst spread widening has clearly been painful, robust marked to market solvency ratios indicate to Twelve that actual impairment to investor cashflows remains unlikely at this stage.

In contrast, using current Tier 2 debt market pricing as a guide, average yields to call of c. 11% in Euro terms for Restricted Tier 1 bonds are suggesting on average either an immediate c. 15% haircut to principal of these bonds, or the cancellation and loss of approximately the next two and a half years of coupons.

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