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Event update: 17 March 2020

COVID-19

Executive Summary:

Insurers have a strong track-record of navigating highly distressed past market environments.

Twelve Capital believes overall the sector remains relatively well placed to weather the current situation.

Catastrophe Bonds have not been affected by the recent financial market volatility, the asset class living up to its nature as an effective diversifier.

Given recent market moves, highly attractive investment opportunities are now clearly beginning to emerge across both equity and credit asset classes, in Twelve's view.

Insurance fundamentals point to sector resilience

It has clearly been a very volatile few weeks across investment markets, driven by the spread of the COVID-19 virus and its uncertain implications for the global economy's growth outlook. Twelve continues to monitor the situation very closely. Whilst not complacent, noting the extremely volatile and fast moving situation, this short note examines why Twelve believes that the insurance sector is overall well placed to weather the current situation.

The insurance sector has regularly demonstrated its resilience to both natural catastrophe and investment market shocks. Most recently this included the global growth scare of 2016, plus hurricanes, typhoons and wildfire events across 2017, 2018 and 2019.

However, perhaps most notable and relevant for current investment market conditions was the sector's performance throughout the global financial and peripheral European sovereign crises of 2007 to 2012. Demonstrating material fundamental resilience to market shocks in Twelve's view, 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.

Simply put, insurance groups that focused on core insurance activity were able to manage through an extremely distressed environment. Conversely, those that had allowed their business strategy to deviate from core insurance activity suffered, including Switzerland based Swiss Re and USA based AIG for example.

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Looking back to the 2007 to 2012 period, insurers benefited from numerous sources of market risk insulation, as a result of the sector's business model. These remain fully functioning today and include:

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.

Since the 2007 to 2012 period, Twelve Capital believes there has been a general upwards shift in the quality and intrusiveness of financial services regulation globally. In Twelve's view this was driven largely by issues witnessed within the banking sector during the crises.

In Twelve Capital's view, this regulatory "upgrade" has driven a substantial and positive response from insurance companies, in turn improving further the sector's defensive qualities. The response has included:

- Material investment into enterprise risk management capabilities;
- Further balance sheet strengthening, such as higher quantum and quality of capital; a stronger appreciation and management of risk in its broadest sense; and
- Improvement in earnings quality, such as a material reduction to investment guarantee exposure and reliance upon investment spread earnings; a greater focus on underwriting profitability.

Twelve Capital believes regulatory regime upgrades have, in general, also been appropriately designed to reflect the longer term nature of the insurance business model. This helps to discourage pro-cyclical behaviour, such as the forced sale of assets into falling markets. For example, in Europe Solvency 2 embeds multiple smoothing mechanisms to offset the worst impacts of shorter term market movements. In the US, mark to market accounting is not a feature of regulatory capital calculations.

Further by embedding an upwards step-change in capital charges, regulatory regimes also tend to effectively make sub-investment grade credit investing uneconomic for insurers. This reinforces insurance group's focus on investment grade credit risk, and provides an additional support to balance sheet quality.

Comfort is also taken from high starting levels of sector solvency capital (sector average Solvency 2 ratio of c.200%) and guidance provided by individual groups in terms of solvency sensitivities to market movements. Robust industry financial flexibility (seen particularly amongst the largest, most diversified names), reflected in terms of relatively modest levels of debt leverage, strong fixed charge coverage and ample liquidity provide additional support.

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From fundamentals to investment portfolios

Twelve Capital is closely monitoring direct and indirect COVID-19 risk to all portfolios it is managing using a combination of top down and bottom up analysis. Top down analysis examines exposure of individual asset classes and where appropriate establishes base and bear case macro scenarios. These are then used to assess resilience across insurance industry sub-sectors. Bottom up analysis considers the resilience of individual insurance groups and issued securities.

Twelve Capital believes that as expected Insurance-Linked Securities (including Catastrophe Bonds) is the relatively most defensive asset class for investors presently, followed by credit, with equity by far the most impacted by market volatility.

The Catastrophe Bond market has not been affected by the recent volatility in financial markets. Living up to its nature as an effective diversifying asset class, Twelve Capital's Catastrophe Bond portfolios continue to earn coupons without any major price action over the past two weeks. Twelve Capital does not hold these pandemic bonds in any of its public funds. Asset class market liquidity at this stage also appears to be unaffected, with healthy two-way flows. Twelve Capital is not aware of any major shifts in investor sentiment, the asset class continuing to be an attractive source of uncorrelated income. As a result Twelve Capital continues to expect strong interest into the asset class given the recent market turmoil.

For credit and equity investments, Twelve Capital believes that the insurance sector is relatively well placed overall to weather the current situation.

In aggregate, direct impacts from the disease outbreak in terms of insurance losses, whilst painful, are expected to be manageable (e.g. higher life mortality, disability, business interruption, travel insurance claims (the latter potentially the most complex and problematic business line to assess)). 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.

Twelve does expect more significant impacts from second order effects linked primarily to the performance of investment markets. A protracted, extreme low rate environment globally will reduce investment returns and challenge some life insurers in particular, plus smaller groups with lower business diversification and more modest financial flexibility.

Credit spread widening, rating downgrades and higher default rates are also to be expected. However, Twelve expects support from the building global monetary and fiscal response to the virus for investment grade credit, by far the focus of insurer credit investments and a key area of sensitivity for solvency ratios.

Twelve Capital continues to actively manage portfolios against the current market backdrop, reflecting:

- Extensive bottom up analysis of individual insurance groups (the firm has invested heavily in its in house analytics capabilities) in order to understand their relative strengths and weaknesses;
- A differentiated investment approach across equity and credit asset classes of insurance groups; and
- Portfolio positioning, across type of insurer supplemented in credit through consideration of differing bond risks (Tier 2 versus Restricted Tier 1 for example).

Twelve Capital believes that given recent market moves, highly attractive investment opportunities are now clearly beginning to emerge across both equity and credit asset classes.

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About Twelve Capital

Twelve Capital is an independent investment manager specialising in insurance investments for institutional clients. Its investment expertise covers the entire balance sheet, including Insurance Bonds, Insurance Private Debt, Catastrophe Bonds, Private Insurance-Linked Securities and Insurance Equity. It also composes portfolios of its Best Ideas. It was founded in October 2010 and is majority-owned by its employees. It has offices in Zurich and London.