Plenum
Insurance Linked Capital

Subordinated Insurance Debt

The End of Katzenjammer
Insurance Bonds offer significant upside potential in 2023

Attractive Sector Premium I Strong Capitalization Levels I Limited expected supply

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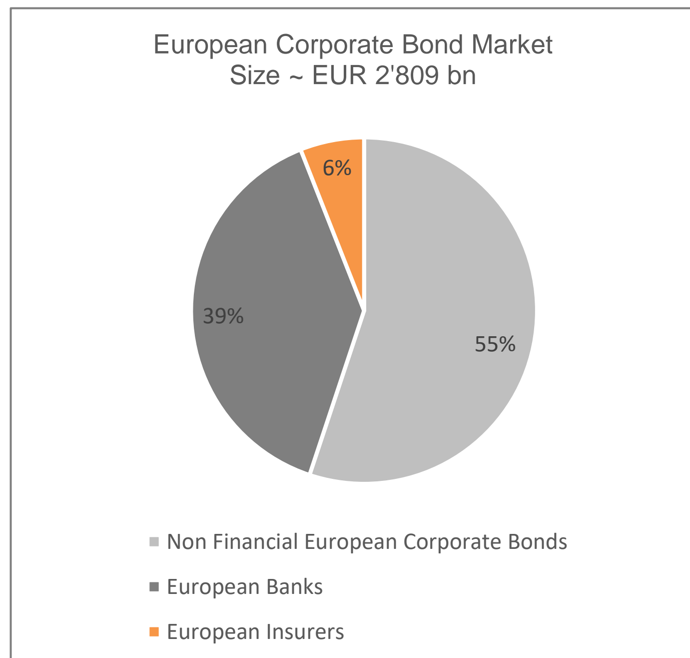
Almost a year ago we compared Insurance Bonds with Schrödinger's cat and concluded that it was very much alive. But the year 2022 brought many unforeseen developments – from the war in Ukraine to a subsequent rise in interest rates and political turmoil in the UK – leading to a massive negative revaluation not only of fixed income asset classes. Still, Insurance Bonds offer significant value for 2023 as the sector remains strongly capitalized and fundamental prospects for the sector are positive. Once macro headwinds have faded, Insurance Bonds are set for outperformance. New issue activity is likely to recede significantly which should support the secondary market, especially the restricted Tier 1 (rT1) space. The ESG credentials of Insurance Bonds are undisputed and in a year with a potentially recessionary backdrop, investors will be reminded of the conservatism that is built into the insurance sector that has led to the lowest historical default rates across all sectors.

Short-term underperformance in 2022

Subordinated Insurance Bonds generally have a high market beta and therefore underperformance during an unprecedented bear market is not particularly surprising. The roots of the high beta do not stem from fundamentals but are more due to subordinated insurance paper being a niche in the fixed income universe. Only 6% of all corporate bonds were issued by insurers and so the focus of most investors is on other sectors, i.e. very little sector expertise is maintained in the investment community. Liquidity of insurance paper is therefore lower than in other sectors and investors tend to offload names they are less familiar with first in times of uncertainty. On the flipside, this often creates bottom fishing opportunities for sector specialists and in the long run, Subordinated Insurance Bonds have demonstrated their ability to outperform other sectors.



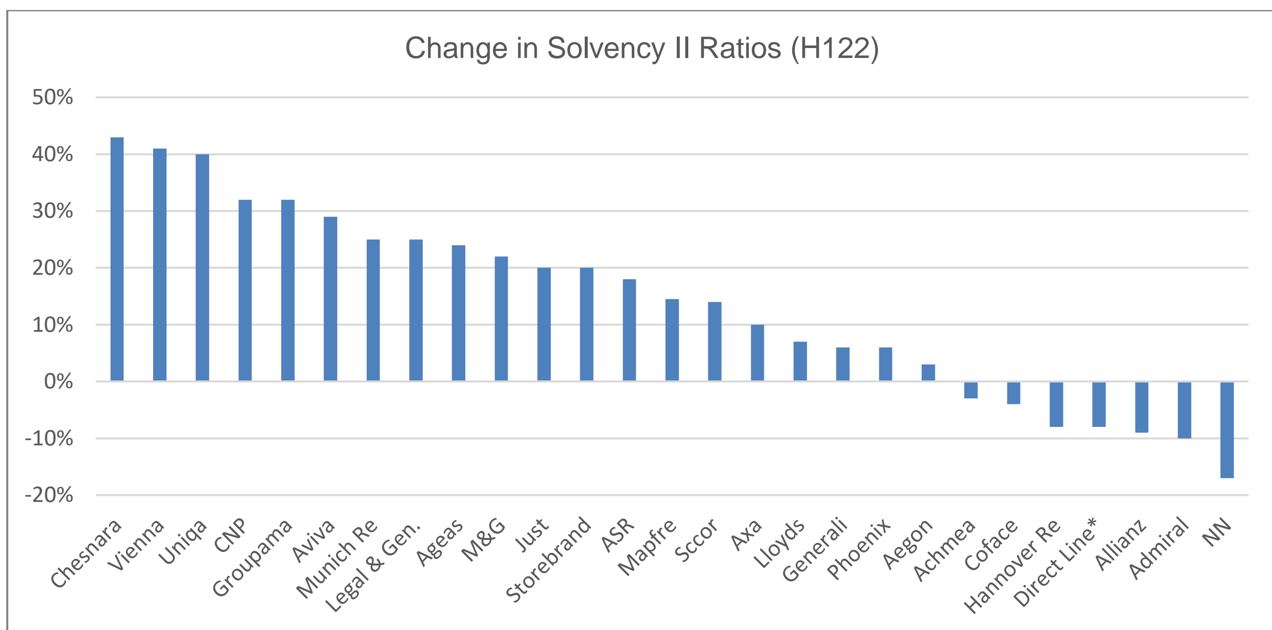
Solvency remains strong

At the beginning of the year, we projected improving Solvency II ratios of insurers. Our view was supported by interest sensitivities of Solvency II ratios published by insurers and indeed Solvency ratios followed an upward trend in H122 or were at least strongly supported by a positive interest

rate effect. Not all insurers publish quarterly updates, but the ones who did showed on average a slight reduction in Q322, mostly due to adverse market movements especially in the month of September. The rising Solvency II ratios throughout the year were also curbed by high distributions, some deleveraging and – in reinsurance – substantial capital deployments into new business. I.e. most insurers did not warehouse excess capital at these Solvency II ratios but used their additional flexibility for capital management or growth.

Still, Solvency II positions of all insurers in our universe remained within their target ranges and sometimes even significantly above. Share buybacks continued but there is a tendency of insurers to leave in such uncertain times an additional capital buffer. As a result of this, shareholder expectations of further capital distributions were not fully met.

We remain bullish regarding the earnings outlook for FY22 and FY23 and operating capital generation. Especially in reinsurance we expect continuing strong support for the Solvency II positions. Reinsurance Rates are expected to rise significantly at the January 1 Renewals with the already mentioned positive effect on Solvency. Once interest rates pivot, we will most likely see a bit of pressure on the Solvency positions, in particular, in primary insurance stemming from the life business. However, we do not expect a major impact as we do not anticipate a sudden and dramatic decline in interest rates in 2023.

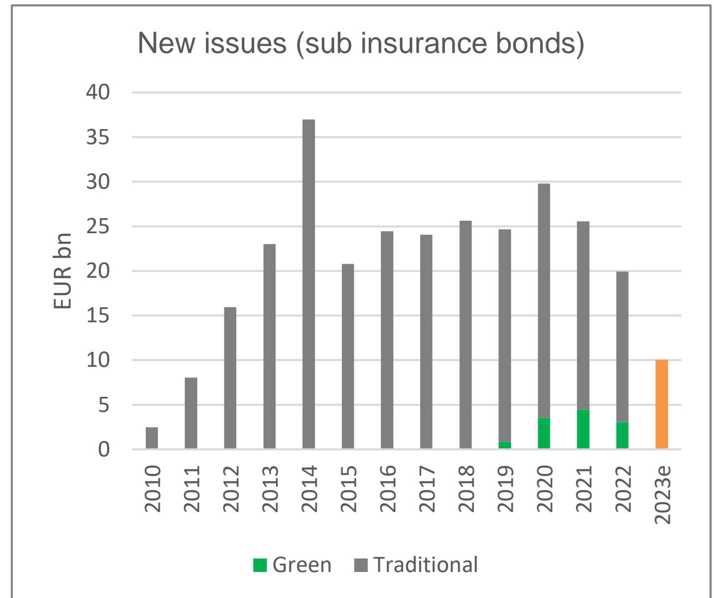


We expect below average issue activity

New issue activity is likely to be unusually low in 2023 and will probably drop to slightly above EUR 10.0bn. This compares to around EUR24bn of average annual new issues since Solvency II came into force in 2016. Refinancing needs for 2023 will only be around EUR 7.0bn of subordinated debt in Europe. The low new issue volume is likely to support bond valuations on the secondary market.

In order to fully understand this we need to get back in time. In the first half of the last decade, there was initially some uncertainty before the Solvency II classification criteria for rT1, T2 and T3 debt

and the grandfathering regime of outstanding sub debt were finalized. Hence most insurers were reluctant to come to the market. When the grandfathering regime became clearer and market conditions improved again, many issuers rushed to the market which culminated in a wave of new issues. Under the new rules, all subordinated debt issued before the cut-off date in mid-January 2015 would be grandfathered until the end of 2025. Dated subordinated debt was to be grandfathered into T2 and perpetuals into rT1. As debt issuance was much cheaper under the old regime, there was a surge in new issue activity, in particular, in the perpetual space before the cut-off date. New issue activity accelerated in 2012 and 2013 and then skyrocketed to more than EUR30bn in 2014. Some players even came to the market at the last minute in the first half of January 2015.



The typical structure for new issues at the time was a 30NC10 (i.e.: final maturity in 30 years but first call after 10 years) or perpNC10 (i.e. Perpetuals with a first call in 10 years) with a clear investor expectation of non-economic calls of institutional bonds at the first call date. So why doesn't this lead to a surge in new issue activity 10 years later in 2023? There are several reasons in our view:

- Several bonds were already tendered over the last couple of years
- New issue activity was already on a higher level in recent years due to very early refinancing of outstanding bonds, sometimes even more than a year ahead of the first call date and the refinancing of bond tenders
- Low interest rates were an additional incentive to fund growth with subordinated debt issues or to come opportunistically to the market to optimize the balance sheet
- The emergence and increased new issue activity of consolidators such as Phoenix, Rothesay or Athora

In addition to the refinancing needs for 2023, business growth will drive a few transactions as well as occasional M&A activity. At the moment, we do not expect much momentum from early refinancing of 2024 call dates. Most call dates of the bonds issued just before Solvency II came into force will be in H224 and current rates forecasts do not encourage a very early refinancing.

We anticipate new issue activity to boost again in 2024 as the bonds issued before the Solvency II cut-off date need to be refinanced.

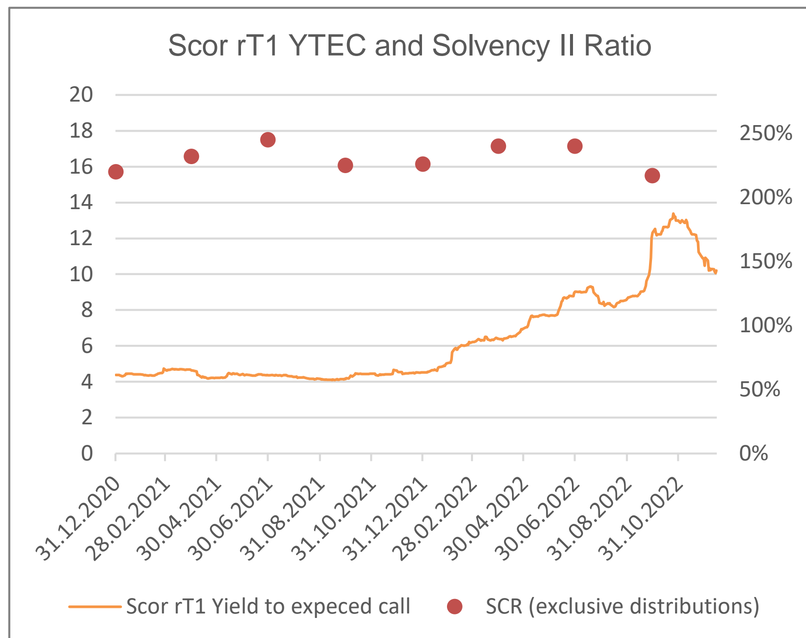
We expect green bond issuance to have reached an equilibrium slightly below 20% of total new issues. Most green bond issues are issued by the large players while smaller issuers shy away from the substantial reporting requirements for green bonds. While green bonds usually trade at tighter levels than traditional bonds this does not appear to be a strong incentive to issue in this space.

Bond valuations and fundamentals have decoupled

Although earnings remain solid and Solvency II positions strong, bond valuations went into the other direction in 2022. It appears that fundamentals and spreads have completely decoupled. In our view, this is where bond selection becomes important as many bottom fishing opportunities emerge where investors can buy high credit quality at ever more attractive levels.

Scor is an interesting example in this context. The issuer has had a bad year in terms of underwriting losses and also needed to strengthen reserves to cover for claims inflation and social inflation. Still, Scor deployed a substantial amount of excess capital into top line growth and reported a top-line growth of 24.1% in P&C and 4.7% in L&H in 9M22. The issuer also paid a generous dividend and completed a share buyback program in Q122. The Solvency II ratio, however, fell only slightly from 226% in FY21 to 217% in Q322 after peaking at 240% as massive market effects, mostly from higher rates supported the issuer's capitalisation. The Solvency II ratio therefore remains close to the upper end of the 185-220% target range, i.e. at the top-end of what investors should generally expect. For 2023 we now expect the best market conditions in P&C reinsurance in a generation which should support Scor's credit and earnings policy even further.

Bond valuations have, however, not factored this correctly in our view. E.g. the SCOR 5.25% perp rT1 was priced at a YTC of 4.5% (YTM: 5.6%) at the beginning of the year to 10.2% (YTM: 7.5%) at YE22 after peaking in October at 13.4% (YTM: 8.7%). While we acknowledge the downgrade of Scor by S&P and Fitch and the negative outlook by Moody's, we believe these rating actions are overdone and the widening has overshot. We also believe that the current spread levels do not fully take into account that the Scor rT1 is still rated BBB+ and the issuer's track record and commitment to call.



Inflation under control

Inflation has been a key area of concern over the last year. But how much does inflation impact insurers? On the life side, there should be a very limited direct impact as the underlying business is nominal.

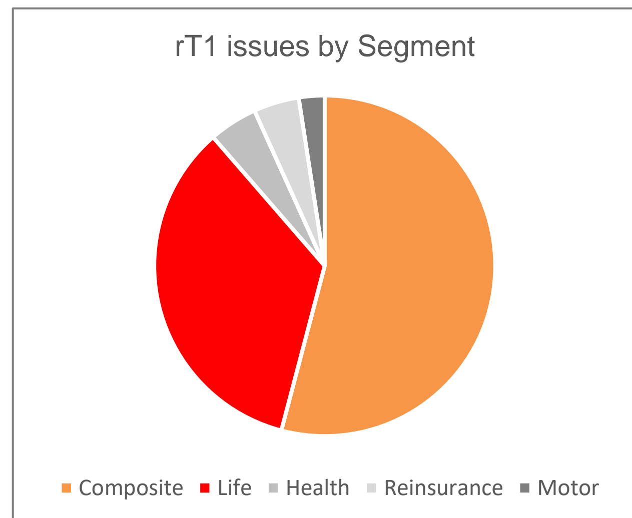
P&C is a bit more tricky. Here, inflation can have a negative effect on earnings in the short term as insurers usually receive premiums in advance to provide coverage for a period of time. The effect is curbed by annual repricing of policies. However, competitive pressures remain and so annual repricing does not fully offset inflation. Most notably, UK motor insurers such as Admiral or Direct Line have felt the impact of inflation. Admiral and Direct Line reported a significant decline in the H122 underwriting results which was to a large extent driven by claims inflation. Both insurers already undertook decisive pricing actions resulting in pressure on top line growth. Direct Line also published a profit warning for the 2022 and 2023 financial years and cut its final dividend.

Also, long tail claims which can take sometimes years to settle are at risk of requiring reserve strengthening due to inflationary pressures. We observed this, in particular, in the reinsurance sub-sector. Most insurers can, however, mitigate the inflationary impact through diversification. Inflation could therefore have a material short term earnings impact, but is by far not as significant for the credit quality of the issuers in our universe.

Restricted Tier 1 issues remain an attractive way to access balance sheet risk of insurers

rT1 paper remains highly attractive in our view. Unlike T2 paper, rT1 coupons are fully discretionary and in a solvency event, coupons are cancelled (non-cumulative) and the principal is written down or converted into equity. However, this additional risk is in our view relatively remote. We have already written that the insurers in our universe have Solvency II ratios within or above their target ranges. In addition, the vast majority of the insurer have a very disciplined and well defined capital management strategy in place with well-defined trigger levels for counteractions which they would apply to avoid a solvency event. The Solvency sensitivities published by insurers suggest that a multiple of these stress tests would be required to get even close to a Solvency event. We therefore believe that the risk of a solvency event is quite remote.

But this remote additional risk is well rewarded! The spread differential between T2 and rT1 paper ranges from 150-300bp which reflects the significant rating differential between both but overstates the marginal additional risk.



rT1 paper has so far been issued by a number of insurers. We observed a tendency that rT1 paper is primarily issued by life- rather than non-life insurers and by primary rather than reinsurers. Also in the UK, rT1 appears to be more prevalent that in Europe. Partly, the bias towards UK and Life insurance is driven by consolidators of which almost all have issued rT1.

On the reinsurance side, we have to note that the sample of players subject the Solvency II regime is much smaller and within that only Scor had issued rT1.

So how will rT1 new issuance look like going forward?

We do not expect many new issuers of rT1 paper. I.e. the insurers who showed appetite to come to the market have already done so. That will also mean very little new issuance until at least 2025 when call dates of outstanding bonds commence, mostly by consolidators funding new acquisitions. Again this scarcity of supply should support secondary market trading in a market which already will suffer from limited supply in 2023.

IFRS 17 – What is it?

After 25 years of preparations, the new accounting standard for insurers - IFRS17 - will come into force in 2023. At the same time, IFRS9 will also become fully applicable for insurers. The new standard will support comparability of financial statements and apply a more economic profit recognition. The new valuation rules for insurance liabilities will reduce accounting mismatches substantially. We expect that IFRS17 will generally produce more stable results in life insurance, but a slightly increased earnings volatility in P&C and slightly lower combined ratios. P&L and Balance Sheet presentation will change significantly, but additional disclosures in the notes will support the transition into IFRS17.

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