Lessons & outlook from the inaugural Solvency II reporting

Twelve Capital hosted a roundtable meeting at its London offices on 14 April, and over breakfast debated the lessons learnt and outlook for the insurance sector flowing from the first round of financial results under the new Solvency II regime. Benefitting from a few week's hindsight, this latest Twelve Capital Research Spotlight shares the key conclusions from the discussion.

Why are Solvency II ratios important to credit and equity investors?

From the perspective of credit investors, participants agreed that Solvency II margins above 100%, alongside an understanding of the expected volatility of these ratios, is key. If the margin falls below 100%, coupons for Tier 2 debt are mandatorily deferrable (on a cumulative basis) and redemptions can be blocked even at maturity for dated instruments. As a result, credit investors prefer to see issuers reporting stable Solvency II ratios significantly above 100%.

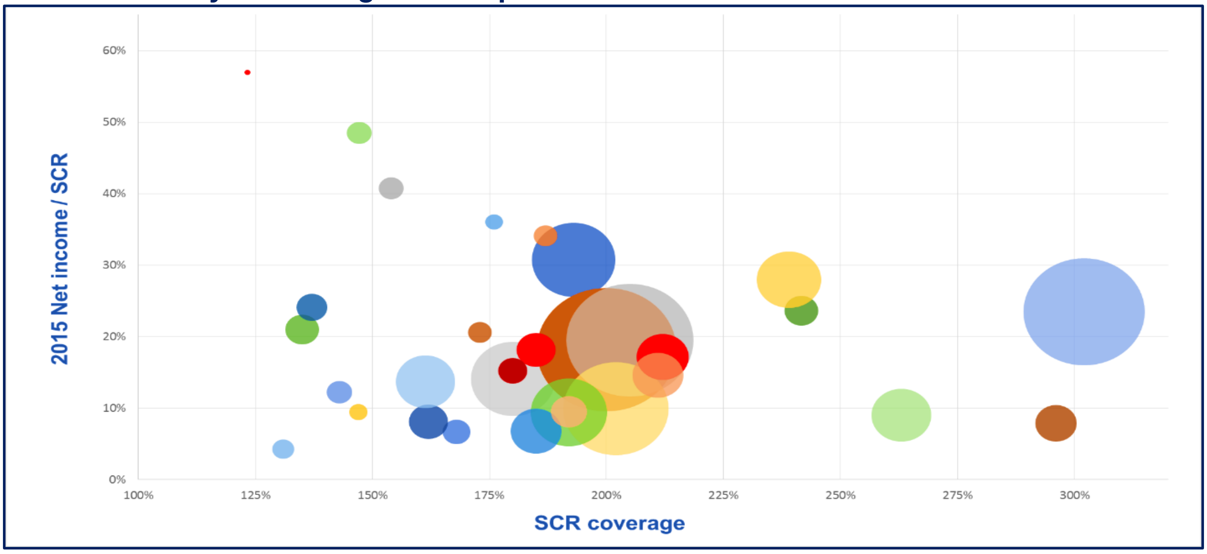
From the perspective of equity investors, the group discussed the differing implications of high and low ratios on individual stock investment cases. The conversation focused on assessments of dividend yields, a key debate given that growth within the sector remains muted and margins for many business lines remains under pressure. Two Dutch insurers were taken as an example: Delta Lloyd and NN Group. Despite a Solvency II ratio of 131% for fiscal year 2015 ("FY15"), Delta Lloyd has felt it necessary to undertake a EUR 650m rights issue in order to improve its balance sheet to support future, reliable dividend payments. Conversely, NN Group's share price already embeds expectations of special capital returns to investors given the stated Solvency II position lies comfortably in excess of 200%.

What are reported FY15 headline Solvency II ratios indicating?

Turning to the headline Solvency II ratios published alongside FY15 reporting, the participants agreed that the industry looks very well capitalised under the new regime. Examining a sample of names that have reported figures, the average Solvency II ratio ("SCR" or "Solvency Capital Ratio") stood at 188% (with a range from 123% to 302%).

"It's a balance: credit and equity investors are after different things."

Chart: Solvency II Coverage and Capital Generation



Source: Twelve Capital, various company reports & accounts.

The sample may not be fully representative of the investment opportunities across the wider European industry, given that these names are predominantly the larger, listed insurance groups. Nonetheless, Twelve Capital believes the reported ratios reflect the culmination of a multi-year effort to prepare for Solvency II's introduction. In the wake of the financial crisis balance sheets have been strengthened through a combination of factors including: capital raising, conservative dividend policies, non-core asset disposals and investment de-risking.

Are all Solvency II ratios created equal?

However, as the discussion developed, it became clear that great care needs to be taken when comparing reported Solvency II ratios. Ultimately it was felt that not all Solvency II ratios are created equal. Sources of potential variability are widespread and include:

- Differences arising from adopting the Standard Formula, a full internal model or a partial internal model;
- Potential inconsistent calibration of internal and even Standard Formula models; and
- Differing use of transition arrangements across geographies.

The example of France-based insurer Groupama was highlighted. Its headline Solvency II ratio of 263% would at first suggest it is one of the strongest capitalised insurers in Europe. However, it was noted that 130% of this 263% ratio relates to varying types of transitional relief, a degree of support not all insurers benefit from, Twelve Capital believes.

Have key original Solvency II goals been achieved?

As a result, whilst it was felt that Solvency II has undoubtedly improved the overall quality of insurance regulation across Europe, it was also agreed that another key goal of the framework, namely the easy comparability of financial strength between insurers has been missed, so far.

Moreover, the costs of preparing for Solvency II have been onerous, with many insurer's costs for developing models and rebuilding their reporting systems running into the hundreds of millions of pounds. As Anthony Hilton (financial editor) highlighted on 29 May 2013, "next time you pass the Olympic Park in Stratford, consider this: we could have a second park – with the stadium, the swimming pool, the velodrome, the athletes' village and even the shopping centre – for the amount the insurance industry based in London has spent on getting ready for Solvency II."

Solvency II winners

So who are the Solvency II winners? The roundtable agreed that the characteristics of 'winners' include an ability to demonstrate relatively stable ratios, with an appropriately comfortable margin above 100%, supported by credible and clean modelling. One participant highlighted how bank investors focus on 'fully loaded' capital ratios (i.e. ratios that strip away elements such as transitional relief) whereas this approach has not yet found itself into the insurance sector. It was felt that the three pillars of ratio stability, appropriateness and credibility will be a key driver for both equity and fixed income future outperformance. Examples of winning insurers flagged include Netherlands based NN Group and UK based Direct Line.

> *"… not all Solvency II ratios are created equal."*

Solvency II Investment strategies

The discussion turned to ways in which investors can benefit from the insurance sector's transition to Solvency II. Twelve Capital highlighted three related investment strategies, across liquid bonds, private debt and listed equity.

1. Firstly, bonds. In early 2010, Twelve Capital developed an investment strategy that targets the EUR 63bn legacy bonds of 133 insurance subordinated debt issues which Twelve believed were likely to lose their regulatory capital status with the arrival of Solvency II and the first call record to date supports this view. These issues offer an

attractive yield to first call and in Twelve Capital's view, the change in regulatory framework has reinforced the likelihood that these bonds will be redeemed at their first call date rather than continue to maturity.

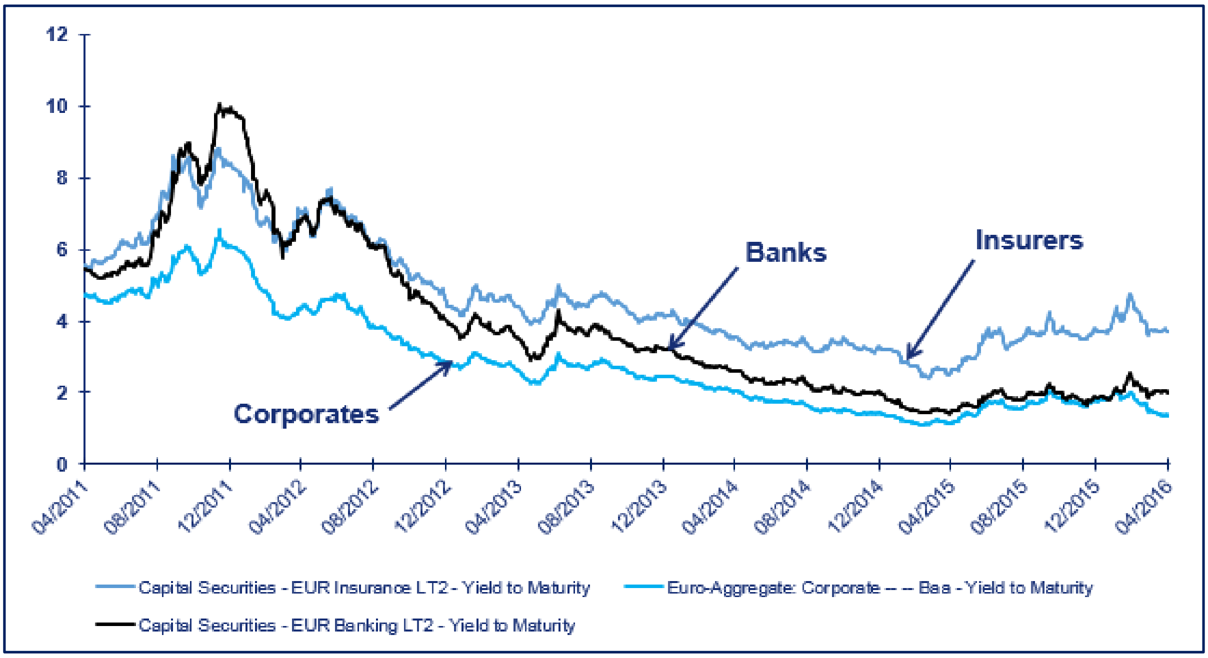
2. Second, private debt. Small to medium-sized European insurers seeking to raise relatively modest amounts of capital in absolute terms in order to improve their Solvency II positions remains a key source of private debt transactions for Twelve Capital's private debt strategies. It is believed that this is going to grow over the next couple of years, given the initial focus from regulators on the more systemically significant insurance companies. Moreover, these transactions can be balanced within a portfolio alongside the steady opportunities to provide growth capital to small-medium sized US insurance firms.

3. Third, listed equity. Solvency II is one of a number of key drivers currently supporting insurance M&A. Twelve Capital has a number of products aimed at capturing (from fundamentally attractively priced stocks) the additional equity upside generated from heightened insurance M&A activity.

Outlook: Are we at the end of the Solvency II journey?

The consensus was that this is an opportunity lost for an industry often criticised for its perceived complexity, especially by the generalist investor. It was hoped that the comparability issue will be addressed with the eventual release of Pillar 3 reporting disclosure by the industry. In the meantime, Twelve Capital believe insurance equity and fixed income investments will continue to include a 'complexity premium', benefiting investors willing to put money to work across the sector today.(See chart below that compares the yields on insurers to corporates and banks.)

Chart: European Insurance Bonds offer favourable yields to bank and corporate bonds



Source: Barclays Live. As at 2Q 2016

The view of the group was that management action to optimise balance sheets for Solvency II is not yet complete. For Twelve Capital the new regulatory regime is one key driver behind the heightened M&A activity currently being witnessed across the sector.

Some insurers have sought to acquire in order to improve operating diversification or scale in business lines (notably workplace pensions and asset management) that are attractive under Solvency II; others are looking to sell non-core operations that are capital inefficient from a Solvency II perspective, in order to refocus elsewhere. Aegon's recent announcement in relation to the part disposal of its UK annuity legacy liabilities was just one example highlighted.

Future changes to the Solvency II framework (EIOPA has committed to review elements of the Standard Formula by December 2018) could prove a spur for further management action in the years to come.

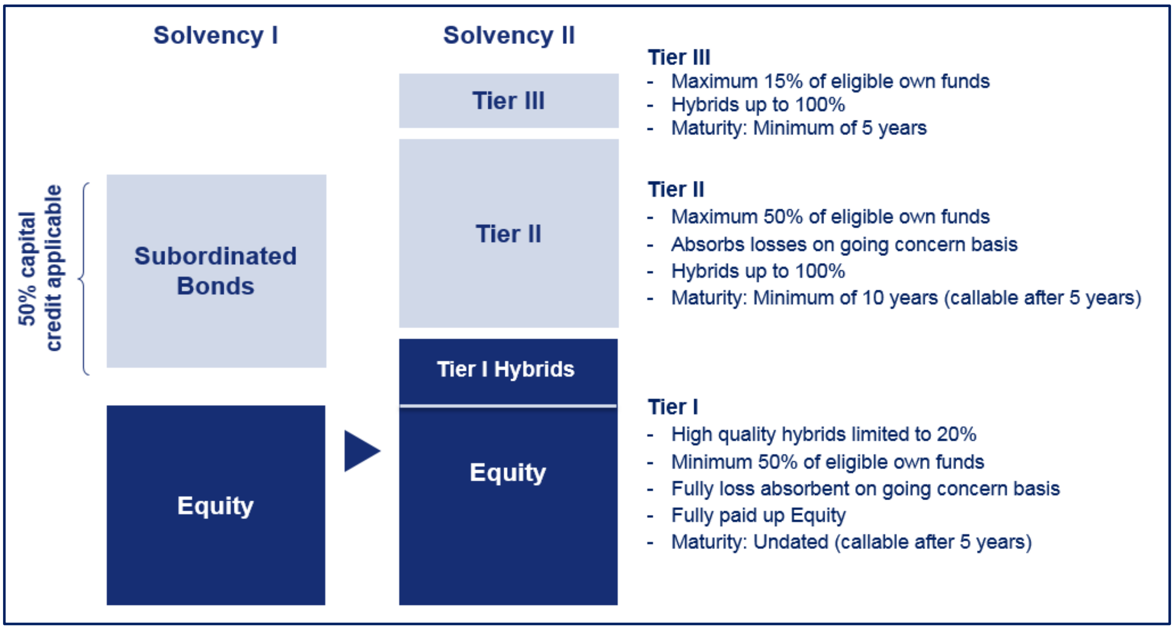
And finally …Brexit?

To conclude, the conversation briefly turned to a separate topic, namely the upcoming UK referendum on EU membership. People felt that this is set to be a major driver of performance over the coming months, both before and after the vote on 23 June 2016. Expectation is that market volatility will be high as the date approaches, particularly given that the outcome remains in the balance.

Glossary

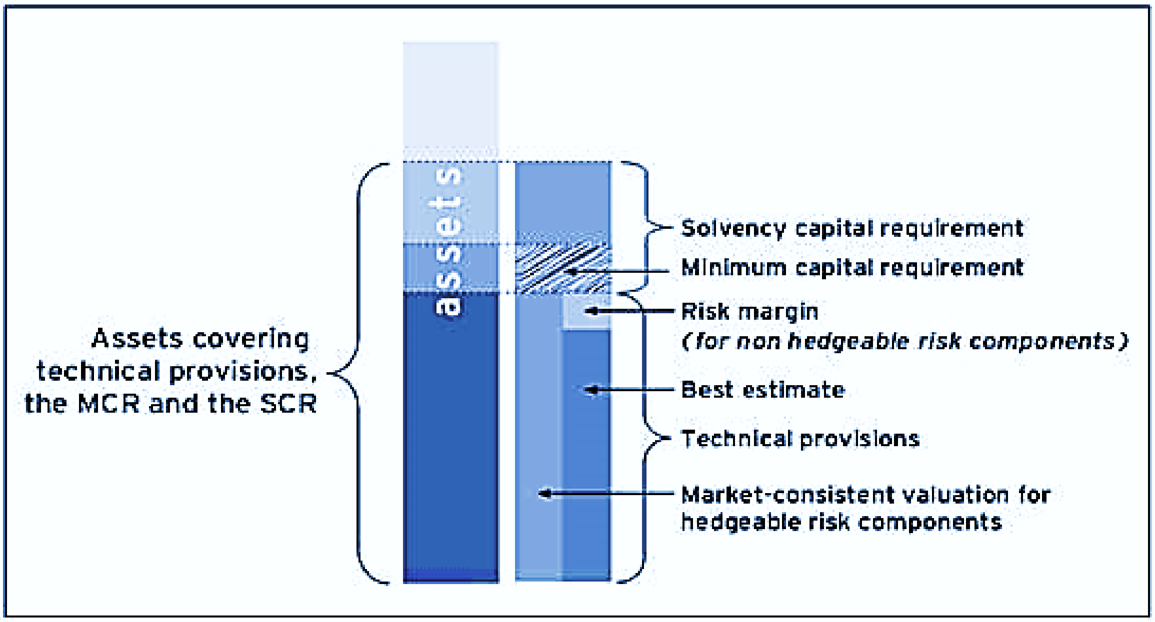
- **EIOPA –** The European Insurance and Occupational Pensions Authority (EIOPA) is a EU financial regulatory institution formed in 2011, and composed of high level representatives from the insurance and occupational pensions supervisory authorities of the European Union's Member States.
- **First Call date –** the first date on which the issuer may redeem a bond either partially or completely.
- **Solvency II –** an EU Directive that codifies and harmonises EU insurance regulation, primarily in terms of the amount of capital that EU insurance companies must hold to reduce the risk of insolvency. It came into effect on 1 January 2016. Solvency II is somewhat similar to the banking regulations of Basel II – both are based around risk-based capital, and both have three main pillars:
  - **Pillar 1** consists of the quantitative requirements (for example, the amount of capital an insurer should hold).
  - **Pillar 2** sets out requirements for the governance and risk management of insurers, as well as for the effective supervision of insurers.
  - **Pillar 3** focuses on disclosure and transparency requirements.

Chart: Solvency II will increase insurers' capital requirements



Source: Twelve Capital

- **Solvency Capital Ratio (SCR) –** the amount of economic capital that insurers and reinsurers need to hold in order to ensure that ruin occurs no more often than once every 200 years. All else being equal, a 99.5 per cent confidence level over a 1 year period is said to equate to a BBB rating.
- **Standard Formula model/Internal model –** Insurers and Reinsurers can calculate the SCR using either a standard formula; a bespoke internal model that has been approved by the insurer's supervisor; or a mixture of both. The standard formula covers underwriting risk, market risk, credit risk and operational risk in a formulaic way (e.g. assumed stress level for equities).



Source: CEIOPS "Adjustments concerning the ability to absorb losses via policy bonuses" March 2007

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About Twelve Capital

Twelve Capital is an independent investment manager specialising in insurance investments for institutional clients. It is also a leading provider of capital to the insurance and reinsurance industry.
Twelve's investment expertise covers the entire insurance 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. Its capital solutions are drawing the world of insurance and reinsurance into a closer, more productive relationship with capital markets.
The firm was founded in October 2010 and is majority-owned by its employees. It has offices in Zurich and London.