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Insurance Bonds: 27 May 2020

Higher yielding (not high yield) income opportunity

Executive Summary:

- Against the backdrop of equity dividend cuts and a low yield environment Twelve sees Insurance Bonds as a compelling source of reliable income for investors.
- Despite some tightening since March 2020 wides, spreads on Insurance Bonds remain at attractive levels, in Twelve's view.
- Coupons are generally sustainable and are expected to continue to be paid during this period of COVID-19 led stress.
- Higher yielding but not high yield: the potential risk of insurance 'fallen angels' in 2020 looks very limited to Twelve.
- New supply of bonds expected to be manageable, in support of secondary market spreads, the sector's strong first call track record to be maintained, Twelve believes.
- However, credit risks are not uniform across the sector, reinforcing the importance of extensive fundamental analytics.

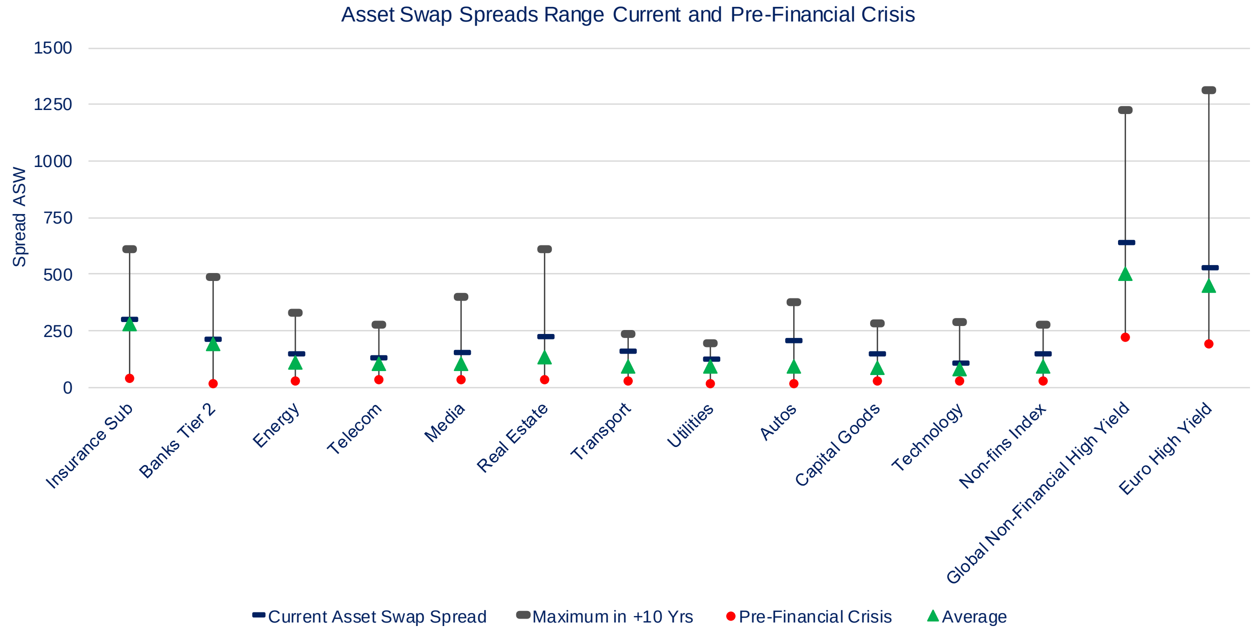
Insurance Bonds – a compelling and reliable investment income opportunity

Equity income investors have been materially hit by decisions from companies to cut or suspend dividends since the outbreak of the COVID-19 pandemic. To illustrate, a recent analysis from UK-based investment platform AJ Bell highlighted that dividend cuts or deferrals from UK companies alone has now exceeded GBP 30bn ('Dividend Cuts By UK Companies This Year Exceed GBP 30 Billion' – 19 May 2020), with the result that on average investors have reported a 27% cut in investment income. Against this dividend backdrop and the very low yield environment in general, Twelve Capital believes Insurance Bonds represent a compelling source of reliable income for investors.

In Twelve's view, pandemic led volatility within global credit markets has created an attractive entry point for the Insurance Bond asset class. At the time of writing, Twelve notes that since pre-pandemic, Tier 2 bonds issued by European insurers are down on average by around 7 points, with Restricted Tier 1 (RT1) instruments down even more by on average 16 points. This performance is despite some recovery since the lows seen in mid-March 2020.

Placing these moves into a wider context, as the following chart shows, insurance asset swap spreads are sitting well inside their financial crisis wide point and have tightened from the recent mid-March 2020 wides of 400bp. Yet current asset swap spreads of around 300bp mean that insurance remains one of the widest amongst the European industrial sectors shown, above its more than 10 year average of 281bp.

Figure 1: Credit spread comparison across sectors

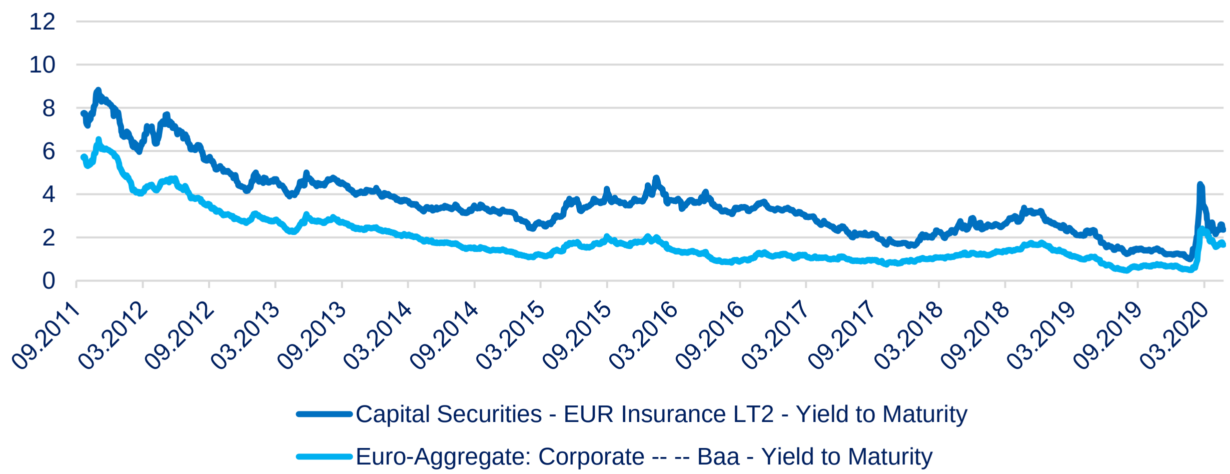


Source: Twelve Capital, Bloomberg. As at 22 May 2020.

Favourable yields in comparison to investment grade corporate bonds

Moving from asset swap spread data to yields, as can be seen from figure 2 below, levels of 2.4% from European insurance Tier 2 debt are attractive when set against the lower yields on offer from Baa rated corporates of 1.7%. In Twelve's view this premium to other credit sectors is unwarranted given strong industry fundamentals, being driven more by the sector's perceived complexity versus other sectors.

Figure 2: Insurance yields remain wide of corporates in general



Source: Twelve Capital, Barclays Live. As at 22 May 2020.

Insurance Bond income expected to remain resilient sector wide

For evidence of past insurance income 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 period only one coupon was lost to credit investors in European insurers and only one insurer had to suspend coupon payments (which were accrued and paid at a later stage), to the best of Twelve's knowledge.

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In Twelve's view, insurance hybrid debt coupons are sustainable and are likely to continue to be paid during this period of COVID-19 led stress. Nevertheless, reflecting the importance of deep fundamental analytics, risks to RT1 coupons (the most junior and therefore most vulnerable of debt payments) are not uniform across the sector, in Twelve's view.

Twelve previously discussed the strengths inherent in the insurance business model, that support business resilience during bouts of market volatility (see here). Being more specific, Twelve believes companies with some or all of the following features are likely to be among the most resilient over the coming weeks, months, and quarters of uncertainty:

- Demonstrably strong enterprise risk management capabilities, including the ability to reliably communicate on mark to market solvency positions;
- Access to well diversified, strong performing sources of earnings and cash generation;
- An emphasis on fee or underwriting driven earnings, with less focus on investment spread businesses;
- Liquidity positions, especially in relation to holding companies, built to withstand extended periods of financial market stress;
- Robust and effective market risk hedging programs, where applicable;
- Generally lower investment leverage; and
- Lower debt leverage, with well laddered debt maturities.

The ability to look through industry aggregates and assess these company specific factors, including through solvency and balance sheet stress testing at the industry and individual company level, will be key in navigating what is sure to be a period of marked uncertainty and market stress.

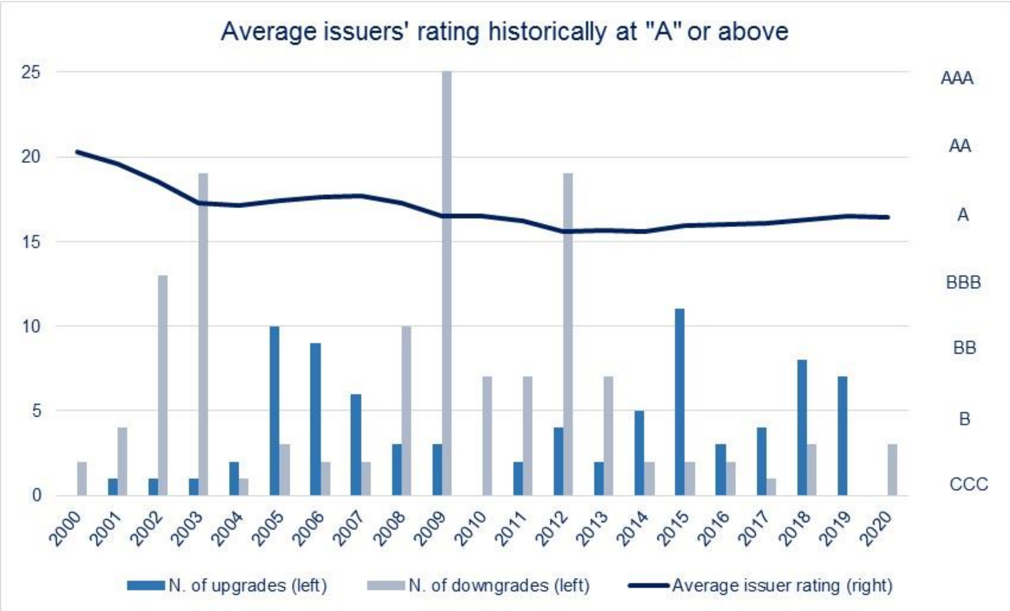
Higher yielding, but not high yield

Twelve regularly monitors the ratings assigned by Fitch Ratings, Moody's Investors Service and S&P Global Ratings across 33 insurance groups in order to assess on an ongoing basis rating agency sentiment towards the sector. The focus on European names reflects the bias of funds' investing activity to Euro and Sterling bonds, these currently offering attractive credit spreads and hedge cost adjusted investor returns, in Twelve's view. The groups monitored are responsible for issuing around 90% of total Euro and Sterling denominated bonds outstanding.

As Twelve has written on before, strong industry fundamentals means that the ongoing yield pick-up on offer in insurance credit versus the wider corporate credit market does not come at the cost of sub-investment grade ratings for bonds, in the main. The insurance groups within the investment universe for Twelve's liquid credit strategy are typically highly rated by rating agencies.

Since 2013 the average issuer rating of the insurance groups monitored has remained solid at around single 'A'.

Figure 3: Insurance groups rated at around single 'A' on average

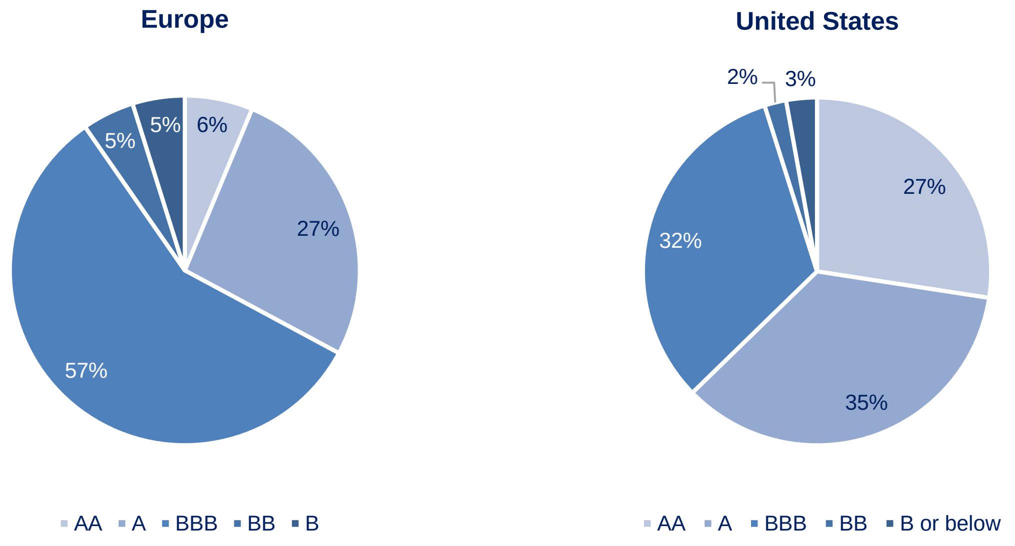


Source: Twelve Capital, Fitch Ratings, Moody's Investors Service, S&P Global Ratings. As at 25 May 2020.

This ratings skew reflects the robust regulatory standards insurers have had to meet with the substantial global regulatory upgrade seen since the financial crisis of 2007/2008 (e.g. Solvency II in Europe since 2016). Twelve would also point to the positive response from the sector to that regulatory upgrade including; material investment into enterprise risk management capabilities; general balance sheet strengthening and improvement to earnings quality. This strong starting point suggests to Twelve that the sector is well positioned to weather potential ratings headwinds related to the economic and financial consequences of the COVID-19 pandemic.

As a result of the high ratings assigned to the insurance groups, when examining the ratings split of bonds with an assigned composite Bloomberg rating (average of rating from rating agencies DBRS, Fitch, Moody's and Standard & Poor's), 90%+ of bonds are investment grade rated in both Europe and the US (the main sources of insurance investment opportunity).

Figure 4: Insurance Bonds predominantly an investment grade asset class



Source: Twelve Capital, Bloomberg. As at 25 May 2020.

Potential risk of insurance 'fallen angels' looks very limited

Within credit markets the term '*fallen angel*' is used to describe a bond that was initially given an investment-grade rating but has subsequently been lowered to sub-investment grade. By extension a '*potential fallen angel*' is a 'BBB-' rated bond (i.e. just above sub-investment grade) carrying either a negative outlook or negative credit watch.

Investors are interested in this category because in the event of a downgrade to sub-investment grade, credit spreads on such bonds typically spike higher with negative implications for bond cash prices.

In a 14 May 2020 report ('*Credit Trends: Potential Fallen Angles Hit A Record-High 111*'), S&P Global Ratings assessed the current risk to credit investors from potential fallen angels using data as at 30 April 2020. Reflecting data covering issuers and bonds only rated by S&P Global Ratings the report highlighted:

- For 2020 so far, fallen angels total 24, impacting over USD 300bn in rated debt, the highest volume for fallen angels the agency has seen since 2015;
- The number of potential fallen angels has risen to 111 issuers globally, a record for the agency;
- Of this number, 26 have ratings on CreditWatch negative, which carries a shorter timeline for potential downgrade (within 90 days) compared with a negative outlook (two years); and
- The negative bias for all investment-grade issuers (the proportion with negative outlooks or ratings on CreditWatch negative) has risen to a post-financial crisis high of 25%.
- The difference in option-adjusted spreads for US corporate entities rated 'BBB-' and 'BB+' (in basis points) was 234 bps as of 30 April 2020.

Within the list of potential fallen angels, 16 were identified as either a financial institution or insurance group. Of this total only 2 were insurance groups, both in the US (i.e. American Equity Investment Life Holding Co (debt outstanding of USD 900m) and Argo Group US Inc. (USD 125m)).

In contrast, as of 25 May 2020, only 10% of the European insurance ratings Twelve monitors across all three major rating agencies carry a 'negative' outlook, 85% with 'stable" ratings and 4% with 'positive' outlooks. Whilst Twelve notes there has been some negative bias in ratings since year-end 2019, the picture has not deteriorated materially. At year-end 2019 the split of ratings outlook was 5% 'negative', 85% 'stable' and 10% 'positive'.

Importantly, amongst these 33 monitored insurers, only one 'BBB-' rated bond presently carries a 'negative' outlook[1]. Further, analysis of the remainder of the 'BBB-' rated bonds outstanding leads Twelve to conclude that the near term risk of negative action on outlooks or ratings themselves is low. This reflects factors such as: robust current solvency ratios at the insurers concerned, substantial flexibility to support solvency if required and in some cases action recently undertaken to bolster capital, including fresh equity raising at two names. Therefore Twelve believes the current risk of fallen angels within the European insurance sector is low.

Figure 5: Insurance issuers with 'BBB-' rated bonds[1]

Insurance group	Country of domicile	Rating outlook	Twelve comment
Achmea BV	Netherlands	Stable	Dutch national champion. Last published Solvency II ratio at 214%. The 'Stable' Outlooks were confirmed in April 2020 by Fitch and in September 2019 by S&P.
Ageas SA/NV	Belgium	Stable	Belgian national champion substantially diversified internationally. Last published Solvency II ratio at 192%. Only most junior of total debt outstanding rated 'BBB-' (i.e. RT1 notes and legacy convertibles).
ASR Nederland NV	Netherlands	Stable	Last published Solvency II ratio at 235%. Operating earnings for 2020 guided to be likely lower than 2019 but in line with 2018.
Assicurazioni Generali SpA	Italy	Stable	Italian national champion. Group ratings exposed to sovereign actions by rating agencies (note recent negative action by Fitch). Fundamental metrics strong, last published Solvency II ratio at 196%.
CNP Assurances	France	Stable	French national champion, 62% owned directly/indirectly by the French state. Last published Solvency II ratio at 218%. Only most junior of total debt outstanding rated 'BBB-' (i.e. RT1 notes).
Just Group PLC	United Kingdom	Negative	Last published Solvency II ratio at 138%. Only most junior of total debt outstanding rated BBB- (i.e. RT1 notes). Vulnerable to Fitch downgrade from factors including COVID-19 related macro risks.
La Mondiale	France	Positive	Last published Solvency II ratio at above 215%. Positive S&P outlook protects from short-term downside risk. Only most junior of total debt outstanding rated 'BBB-' (i.e. RT1 notes).
Mapfre SA	Spain	Stable	Spanish national champion. Last published Solvency II ratio at 187%. Spain sovereign ratings currently comfortably investment grade rated.
NN Group	Netherlands	Stable	Dutch national champion with last published Solvency II ratio at 225%. Recently longevity risk transfer transactions expected to bolster solvency further.
QBE Insurance Group	Australia	Stable	Recently raised USD 750m of fresh equity as part of a package of capital strengthening activity to underpin credit position and to take advantage of market growth opportunities.

[1] For bonds rated by 2 credit agencies or more, the Bloomberg aggregate rating was considered; for single-rated bonds, the only available rating was considered. Ratings apply to a class of securities rather than a specific instrument. Nothing herein should be construed as a recommendation to buy, sell or otherwise deal in any security.

Rothesay Life	United Kingdom	Stable	Last published Solvency II ratio at 203%. Deep-pocketed shareholders are a material source of financial flexibility. Only most junior of total debt outstanding rated ‘BBB-’ (i.e. RT1 notes).

Source: Twelve Capital, Bloomberg, Fitch Ratings, Moody’s Investors Service, S&P Global Ratings. As at 25 May 2020.

In some of the cases mentioned above only the most junior debt instruments outstanding (RT1 notes) from issuers are currently rated ‘BBB-’. Tier 2 bonds from the same issuer will be rated higher than ‘BBB-’. This reflects higher investor risks embedded in RT1 notes, including capacity for loss absorbency via coupon cancellation or going concern principal loss absorption. This is reflected by rating agencies via the implementation of wider, thus more negative, notching. The differences between RT1 and Tier 2 notes are discussed in more detail below.

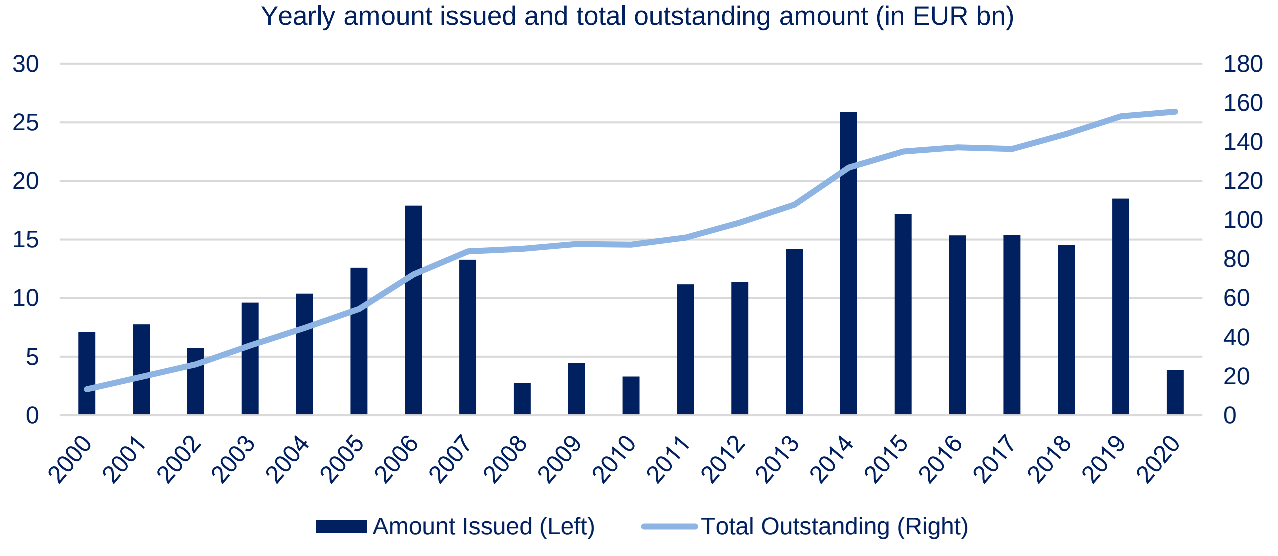
New supply of bonds expected to be manageable

Subordinated insurance debt has become an integral part of European insurers’ own funds, as the Solvency II regulatory regime allows Tier 2 and 3 to cover up to 50% of capital requirements, and Restricted Tier 1 to account for up to 20% of total Tier 1 funds. Appetite from institutional investors has supported the growth in supply, leading to a 14% CAGR of the outstanding amount of insurance subordinated debt over the past two decades to above EUR 150bn.

Twelve expects a manageable level of debt issuance from the European insurance sector in 2020, to the benefit of secondary market credit spreads. A substantial amount of issuance linked to debt refinancing activity is not anticipated given 2010 was not a significant year for new deals from the sector (Insurance Bonds are typically issued with an expected maturity date of 10 years). This leaves ample market capacity for fresh supply to be absorbed, in Twelve’s view.

Twelve has observed seven new issuances in 2020 to date. Nearly half of these were from UK-based life players wanting to exploit growth opportunities and to strengthen further comfortable solvency positions.

Figure 6: European insurance sector issuance steadily growing



Source: Twelve Capital, Bloomberg. As at 25 May 2020.

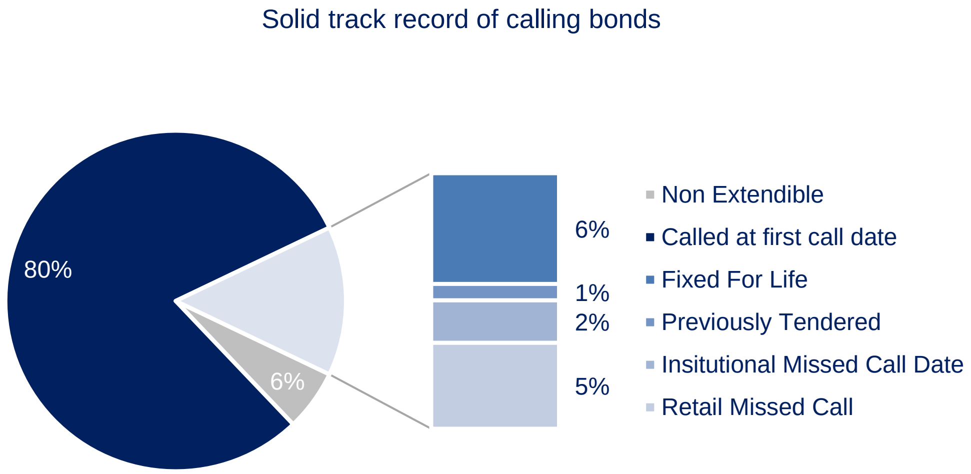
First call redemption expectations to be met in 2020

Twelve expects the insurance sector to maintain its strong track record of calling institutionally placed bonds at their first call date during 2020. This first call track record is important and mutually beneficial in Twelve's view, helping investors assess and price new transactions whilst also easing market access for insurers as well as their cost of issuing capital into debt markets.

Twelve notes that since 2000, 86% of the bonds (by amount issued) with a call date or maturity before May 2020 were called/redeemed at the first available date i.e. over 130 bonds. Bonds placed with an institutional investor base that missed their first call date represent a very small 2% of the total.

Even against the current backdrop of financial uncertainty and reflecting its ongoing commitment to meeting investor expectations, France based insurer AXA redeemed EUR 1.3bn of callable bond in April 2020.

Figure 7: European insurers strong track record of redeeming bonds at their first call date



Source: Twelve Capital, Bloomberg. As at 25 May 2020.

Insurance focus is on relatively more defensive debt instruments than CoCos

In aggregate, insurance credit portfolios managed by Twelve Capital currently focus on Solvency II qualifying Tier 2 debt issued by European insurance companies. This reflects first the ongoing relative attractiveness of Euro denominated debt for predominately Euro investors, despite the recent reduction in Euro-US dollar hedging costs. Furthermore, this also reflects that Tier 2 subordinated debt is by far the most common form of instrument issued by European insurers (above two-thirds of the debt outstanding across Twelve's investment universe).

The focus on Tier 2 debt is driven by a number of factors. These include; no need for senior debt funding given highly liquid business model; and efficient pricing of Tier 2 debt for issuers to meet regulatory and rating agency requirements compared to Restricted Tier 1 ('RT1'; 7% of debt outstanding across Twelve's investment universe; referred to as 'Restricted' due to 20% regulatory allowance of total Tier 1 outstanding).

There are key important differences between European insurance Tier 2 and Restricted Tier 1 debt structures (and the bank sector counterpart Additional Tier 1 (or 'AT1')), that add to the attraction of the core insurance debt investment opportunity, in Twelve's view. The diagram below maps out the Debt-Equity Continuum for insurance capital, also including bank AT1's for reference.

Both RT1's and AT1's are senior only to equity in an institution's capital structure, are perpetual in nature, have fully discretionary coupons that if not paid are non-cumulative and finally include going concern principal loss absorption that triggers under certain circumstances (hence the term 'Contingent Convertible' or 'CoCo'). In

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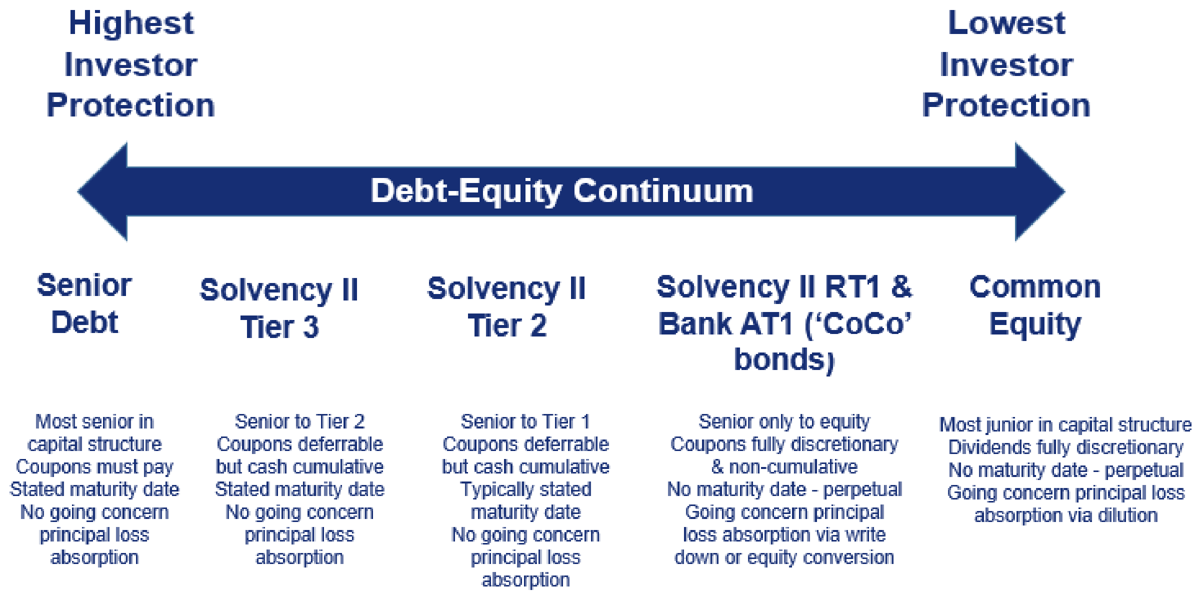
contrast, insurance Tier 2 sits closer to senior debt on the continuum. These instruments rank above all forms of Tier 1 capital, have stated maturity dates, provide for coupon deferability (if deferred coupons are cash cumulative) and crucially do not contain any going concern principal loss absorption features.

Figure 8: Placing Insurance Bonds on the debt-equity continuum



Source: Twelve Capital.

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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.

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