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Insurance Credit & Equities: Credit investors to benefit from regulatory intervention on dividends

7 April 2020

Executive Summary:

Current elevated dividend yields reflect understandable uncertainty around sector fundamentals, plus regulatory intervention (especially in Europe) that unhelpfully has been inconsistently applied.

Twelve believes robust insurance industry fundamentals and risk management mean that many insurers are currently able and willing to pay dividends, absent regulatory intervention, currently estimating an average Solvency II capital ratio for the sector in excess of 190%.

Where regulatory intervention has taken place, Twelve believes this most likely represents a postponement rather than cancellation of shareholder payments.

Twelve sees credit investors as the obvious beneficiaries of regulatory intervention on dividends.

Hybrid debt coupons are sustainable and generally believed will continue to be paid though Twelve notes risks to Restricted Tier 1 (RT1) coupons are not uniform across the sector.

Dividend yields - a key insurance sector attraction

A high relative dividend yield has traditionally been a key attraction for equity investors in the insurance sector. This has particularly been the case in Europe given the backdrop of a low (and declining) yield environment over the past ten years. Twelve believes that in direct response to this environment, many of Europe's largest insurers have actively sought to reposition and restructure their business activity in order to be able to deliver reliable and growing income for equity investors i.e. have transitioned into quasi bond proxies. This process of transition has reflected itself in a steady rise in dividend payout ratios amongst European insurers over the past decade.

By contrast, the income dynamic has been less prevalent in the US, in Twelve's view, potentially because the US yield environment has not been as low when compared to Europe. As a result, dividend payout ratios from US based insurers have remained materially below those seen in Europe; additional shareholder returns being delivered instead via share buyback activity.

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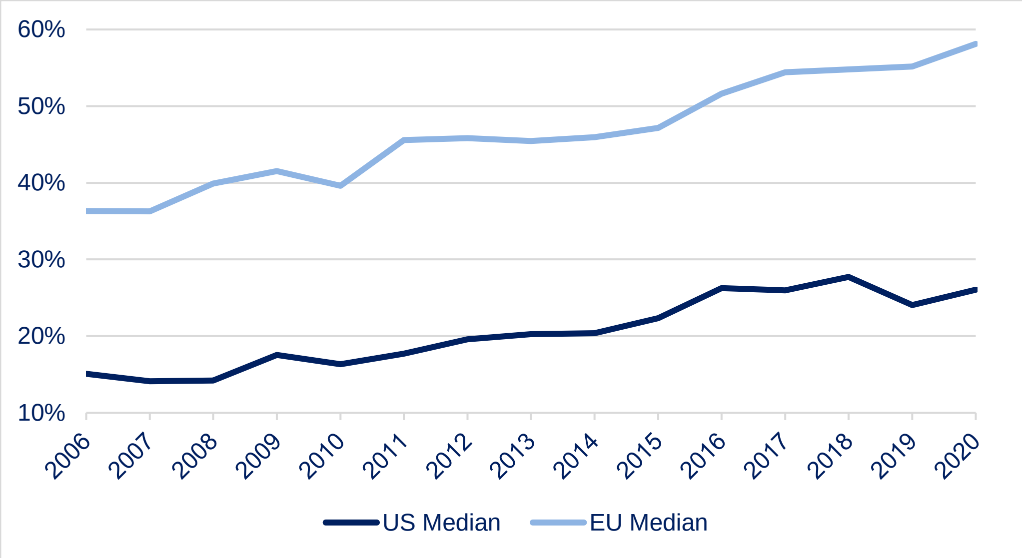
Figure 1: Payout ratios – consensus expectations at the beginning of each year

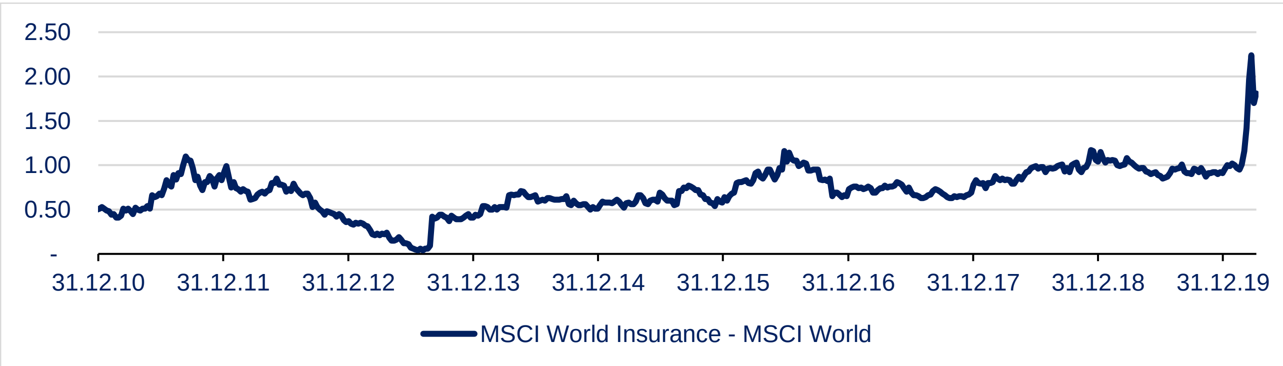


Source: Twelve Capital, Bloomberg. As at 6 April 2020.

The past month and a half has seen some of the sharpest financial market moves in history. Currently, equity markets are down 24% (MCSI World index) since the start of the year, investment grade corporate bond spreads have increased 169bps (Barclays Global Investment Grade index), reaching these levels at speeds faster than in the financial. In addition, interest rates have moved meaningfully lower, in some cases to record low levels.

In part due to such moves, the dividend yield of the insurance sector has only increased given 8% relative underperformance of the insurance sector versus broader equity markets year to date. The current dividend yield on the MSCI World Insurance Index of 4.9% is now well in excess of the broader MSCI World Index dividend yield of 3.1%. Such a level of relative yield differential has not been seen for at least 10 years the graph below shows. Twelve notes an even larger gap in many mature markets, such as the UK and Europe, where sources of secure dividend yield have become scarce.

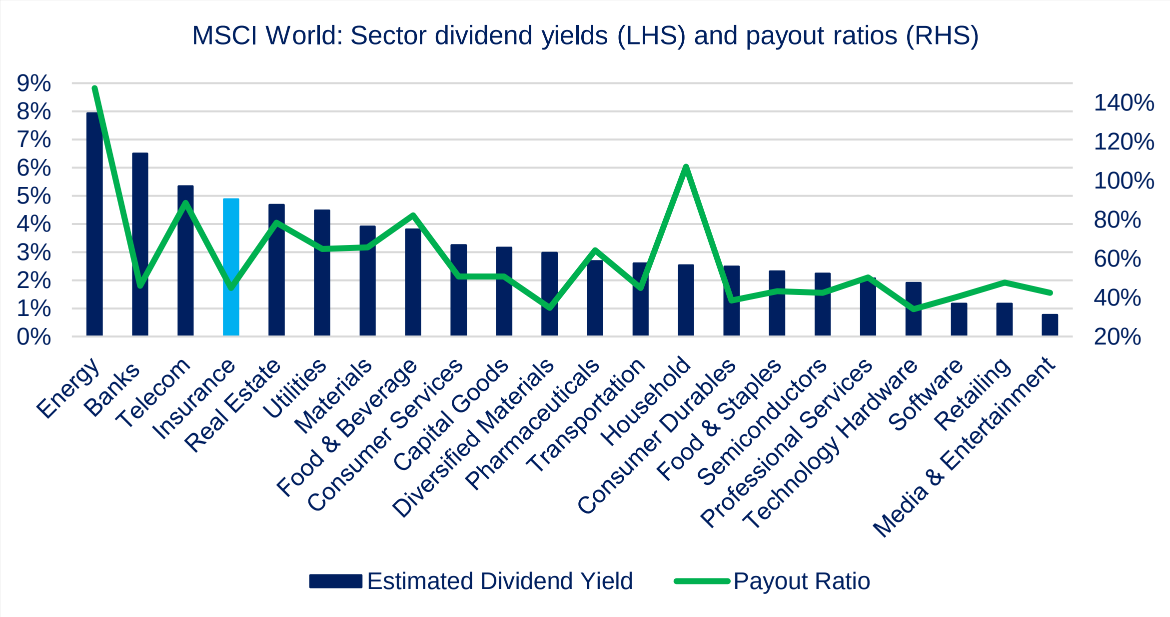
Figure 2: Relative dividend yield



Source: Twelve Capital, Bloomberg. As at 6 April 2020.

Further, as the following chart shows, the 1 year forward dividend yield of Insurance globally ranks comfortably amongst the highest across the global equity market.

Figure 3: MSCI World: Sector dividend yields and payout ratios



Source: Twelve Capital, Bloomberg. As at 6 April 2020.

Elevated dividend yields are understandable given uncertain fundamentals…

Higher dividend yields can reflect increased equity investor nervousness around the sustainability of dividend payments i.e. do insurance groups have the financial strength to support expected dividend payments? In Twelve's view, some increase ought to be expected for insurance and other industry segments, given uncertainty around fundamentals due to the nature of the COVID-19 pandemic. As Twelve has written on before, the current financial market environment is having an impact on the global insurance industry, from both an asset and liability perspective and uncertainties remain around the global economic outlook.

Further, Twelve notes that there is historical precedent of insurance companies reducing dividends in periods of stress. In a sample of 32 listed mid and large cap European insurance companies, 18 reduced dividends through the 2008/2009 financial crisis, while out of 30 listed insurance groups in the US reviewed by Twelve, 11 reduced dividends. In general, Twelve notes a higher concentration of dividend reductions during that period amongst the global composites, businesses with large life insurance segments (especially variable annuity writers), those that had higher levels of structured credit exposure or had strategically allowed themselves to drift away from core insurance activity, for example into providing credit wrappers or guarantees.

…although inconsistent regulatory intervention on dividends not helpful

Twelve observes a growing list of interventions from regulators around the world urging financial companies to carefully consider cash payouts to shareholders this year. The motivation for intervention is fully understandable. Supervisors want firms to remain financially secure so that they can play their full part in supporting the broader economy during this period of stress. However, the pattern of intervention has not been consistent.

Twelve believes that the most significant interventions have so far been in Europe. By comparison, to date in the US, actions around shareholder returns has largely been limited to voluntary action on share buybacks by some banks.

The ECB has urged listed European banks not to accrue dividends or undertake share buybacks in 2020. The PRA in the UK recently asked the boards of all banks under its supervision to consider suspending dividends and share buybacks until the end of 2020, threatening that it stands ready to use supervisory powers to force compliance if banks do not voluntarily agree to such action.

A less strict approach has been applied by the Swiss regulator FINMA. It has welcomed the cancellation of share buyback activity by financials in the Swiss market and has only recommended that boards carefully consider the level of upcoming dividends.

Until very recently it appeared that regulators were typically drawing a clear demarcation between banks and insurance companies when it came to dividend payments. In Twelve's view, this made sense given intervention is not obviously required for the sector as a whole given the general robust capital positions of insurance groups, combined with the fact that the sector is not benefiting to the same degree as banks from government and central bank support during this period of stress.

However, last week, EIOPA (the European insurance supervisory authority) changed its advice to regulators, "*urging (re)insurers to temporarily suspend all discretionary dividend distributions and share buy backs*." Previously EIOPA had only advised that insurance companies should take measures to preserve their capital position including via prudent dividend and other distribution policies.

Complicating matters for investors, EIOPA's advice has not been immediately followed in a consistent manner by national regulators across Europe. Some, such as the Dutch and French regulators have mirrored the EIOPA stance. Others are preferring to take a more nuanced approach, with the German regulator, for example, writing in response to the EIOPA statement that it "*does not currently consider a blanket ban on distribution of insurance companies and pension funds as necessary*."

In the UK, the PRA has to date also taken a more measured approach in relation to insurers, only asking company boards to "*pay close attention to the need to protect policyholders and maintain safety and soundness*" when considering dividend payments.

Robust fundamentals would support ongoing dividend payouts from most insurers

Clearly, the pandemic is a rapidly evolving situation. Nonetheless, Twelve continues to believe that robust insurance sector fundamentals mean the industry remains relatively well placed overall to weather the current pandemic situation.

Strong sector fundamentals were discussed in detail within previous notes (see here). Key factors pointing to resilience amongst insurance groups included:

- Numerous sources of insulation to market risk inherent to the insurance business model (such as no reliance on wholesale markets for liquidity funding, asset-liability matching, ability to share losses with policyholders);
- The benefit to sector financial strength of enhanced regulatory oversight (e.g. Solvency II in Europe from 2016, this regime also featuring regular stress testing to assess sector resilience against various market shocks);
- The industry's reaction to heighted 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.

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). Some of the loss potential does remain highly uncertain, for example with disputes over the degree that commercial property policies will pay out on business interruption claims related to government enforced closures of restaurants, bars, and other public venues. Based upon current expectations, Twelve believes each of these, in aggregate, to be on the scale of moderate natural catastrophe loss events and, while difficult to precisely estimate, be manageable by the industry. 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.

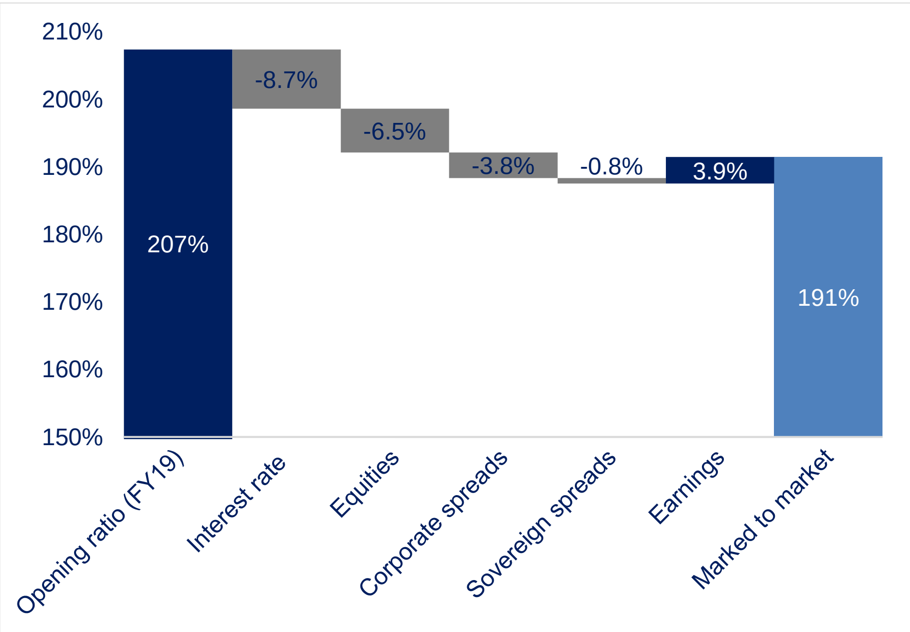
With that in mind, Twelve notes the extraordinary building global monetary and fiscal response to the virus designed to underpin the strength of the global economy and investment grade credit, including:

- 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, and new programs to purchase certain investment grade bonds in the primary and secondary markets.

Taking the potential direct and indirect impacts together, Twelve believes that, overall, sector financial strength is proving resilient. As evidence of this, Twelve estimates that Solvency II capital ratios in Europe, marked to market at the end of the first quarter, remain at a strong average level of ~191% across 48 monitored insurance groups (including accrued final 2019 dividends). Though down from ~207% reported at the end of last year, in Twelve's view most companies maintain a cushion over internal targets, which themselves are typically well above regulatory mandated levels, sufficient to comfortably fund dividend payments.

From a Solvency II capital ratio perspective, Twelve notes that a final 2019 dividend represents between 5 and 10 points of solvency. Therefore, where insurers are forced to cancel (rather than defer dividend payments), solvency ratios will move higher.

Figure 4: Solvency II mark to market



Source: Twelve Capital, Company Reports. As at 6 April 2020.

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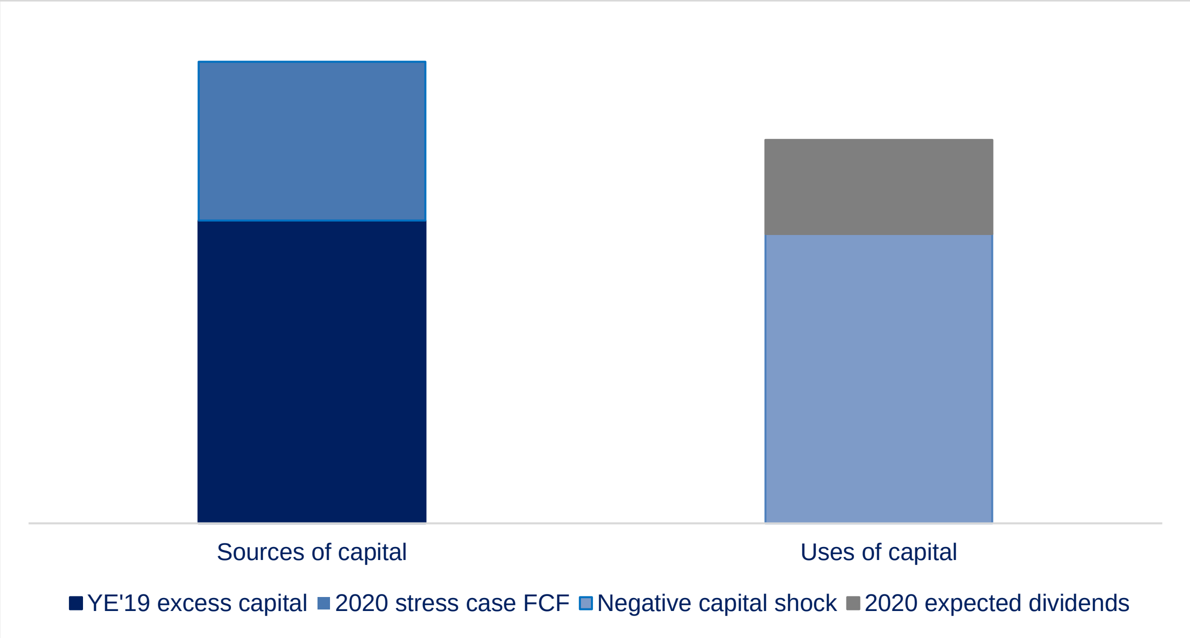
In the US, Twelve's modelling suggests that the majority of life insurers, historically the most exposed to macroeconomic shocks, maintain sufficient on balance sheet excess capital plus resilient free cash flow to both absorb expected capital impacts (e.g. credit losses, liability mark-to-market) and to continue to fund common dividends at existing levels.

Figure 5: US Life Insurance – industry aggregates



Source: Twelve Capital, Company Reports. As at 6 April 2020.

Dividend affordability varies across insurance groups

Twelve believes many insurers are currently able and willing to pay dividends, absent regulatory intervention. Where regulatory intervention has taken place, in Twelve's view this is most likely a postponement rather than cancellation of shareholder payments.

Putting aside the issue of regulatory intervention, looking through sector-level considerations and beyond 2020, Twelve does expect a range of outcomes among companies in relation to dividend security. This underscores the importance of deep fundamental work in assessing which individual insurers are best positioned to maintain shareholder distributions, and to emerge with strengthened competitive positions from this period of market stress.

In Twelve's view companies with some or all of the follow 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 stresses.

Credit investors to benefit from regulatory intervention on dividends

The rapidly developing dynamic around European bank dividends has also generated debate over the security of coupons on bank hybrid debt instruments. This debate has been most prominent in relation to coupons on Additional Tier 1 (or 'AT1') instruments. These are the most junior (and therefore risky) of debt instruments issued by European banks key features providing for the cancellation of coupon payments.

At the time of writing, it would appear that these coupons are safe for now. Twelve notes explicit comments made by banks alongside their announcements around dividend cancellations, explicitly stating that the dividend actions do not have implications for AT1 coupons. Twelve also would point to comments made by Andrea Enria, the ECB's Supervisory Board Chairman during a recent interview on Bloomberg TV. He was asked directly whether the recommendations around equity dividends extend to AT1 and other hybrid debt coupons, replying "*We have no plan to suspend AT1 or Tier 2 payments*." He went on to make it clear that there are clear rules that determine when payments on AT1 bonds should be suspended, noting that banks currently are "*very far from reaching that point*."

Given the dividend debate in the insurance sector, Twelve has been closely monitoring Restricted Tier 1 (or 'RT1') instruments. These are the insurance sector's closest equivalent instruments to bank AT1s, also including full discretion around coupon payments. For various reasons, RT1s remain a relatively small class of insurance hybrid debt capital (the first RT1 was issued in 2017). Twelve estimates the amount outstanding of RT1s is in total ~EUR 7bn, split across 14 issues, representing ~7% of total European insurance hybrid debt notional.

In Twelve's view, insurance hybrid debt coupons, including RT1, are generally sustainable and will continue to be paid. As previously stated, where insurers are forced to cancel (rather than defer dividend payments), solvency ratios will move higher, adding to credit investor protection. Nonetheless, the potential risks to RT1 coupons are not uniform across the sector, in Twelve's view, also lending support to the importance of deep fundamental analytics for which Twelve Capital is well-positioned.

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