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Twelve Capital Research Spotlight

Analyst Views

Twelve Capital's 'Research Spotlight' report aims to highlight some of the most compelling investment opportunities currently available across the universe of insurance related investments, as evaluated by the firm's analytics team. Post the UK's referendum on its membership of the European Union, this note takes an initial look at the wider implications that such a decision may have for the insurance sector.

UK/EU Referendum – What now?

The outcome of the United Kingdom's referendum on European Union membership has been a vote in favour of leaving the EU.

Robust insurer fundamentals

In preparation for and ahead of the UK referendum, Twelve Capital's analytics team reviewed individual insurers in order to consider risks to operations from a potential 'out' vote. Exposed insurers were placed into one of five categories, as set out below.

Pure Play UK: Direct Line, Esure, Legal & General, Liverpool Victoria, Pensions Insurance Corporation, Royal London, Rothsay

Mainly UK based, trading in EU without passporting: Admiral, Aviva, RSA

Mainly UK based, trading in EU with passporting: Society of Lloyd's, Beazley, Catlin, Hiscox, Novae, Standard Life

Mainly EU based, trading in UK without passporting: Aegon, Ageas, Allianz, Axa

UK based, mainly trading ex-Europe: Old Mutual, Prudential PLC

The key conclusion of this work, in our view, is that the potential operational impacts of the UK leaving the EU are expected to be manageable for exposed insurers going forward. Looking at 'Pure Play' UK insurance companies, for instance, revenues are not viewed as being impacted significantly, given that market access is not expected to be disrupted in a meaningful way. Furthermore, we would not expect claims experience for these insurers to deteriorate simply because the UK withdraws from the EU.

Twelve Capital also notes that only a relatively small number of UK insurers have material trading exposure to the EU. For most of these names, ongoing trading is expected to be largely unaffected given that, in the main, they do not rely on freedoms provided by EU directives to passport services from the UK into the single market. Instead, these insurers generally operate separate legal entities established within the EU that are subject to local supervision. The ability of these entities to undertake business is not expected to be compromised.

In our view, the more significant impact of a so-called 'Brexit' on insurance market fundamentals has always been related to increased market risk generated by rates, FX, credit spreads, equity moves and general market volatility. As a result, we are not surprised by today's post referendum widening of insurer credit spreads and reduced equity values. Given their role as major investors in capital markets, we believe it is natural for investors to raise questions over the financial health of insurer balance sheets.

Having said this, we continue to believe insurance sector fundamentals are robust. In particular, sector balance sheets are strong in our view, having benefited from substantial post financial crisis and pre-Solvency II strengthening. Action already taken by the industry has included: conservative policyholder and shareholder distributions, financial debt deleveraging, disposal of non-core operations and an ongoing cautious approach to investment.

Additional points to consider:

1. The insurance sector has a demonstrable track record of navigating more extreme periods of market volatility than that currently being experienced (including the financial, peripheral European sovereign crises). Furthermore, at the time of writing, the tools available to central banks today that were not in place during previous crises appear to have somewhat helped calm markets.

2. Insurance company assets remain mainly invested in diverse fixed income portfolios (which

make up approximately 80% of invested assets, compared to equities at only c. 5%).

3. Fixed income portfolios remain focused on investment grade securities (only c. 3% of assets are explicitly invested in sub investment grade securities, with c. 4% in unrated assets). Furthermore, regulatory regimes such as Solvency II reinforce this.

4. The sector actively seeks to mitigate market risk, for example through substantial hedging activities.

5. Some insurers are expecting a tailwind to reported earnings given the observed FX moves, especially the weakening of sterling against the US dollar.

Credit

For Twelve Capital, the UK's referendum was always going to be a major driver of 1H16 performance, given its potential to generate substantial market volatility. With this in mind, heading into the event from a credit perspective we aimed to position portfolios as neutrally as possible. This included further focusing portfolios on core holdings and high quality names whilst, at the same time, actively reducing exposure to those expected to come under the most pressure. These included selective UK domiciled and peripheral European insurers, the inclusion of the latter reflecting the potential risk of market contagion post an 'out' vote (which we have indeed seen). This approach has provided investment flexibility as insurer credit spreads have widened. As a result, we see attractive opportunities from mispriced securities in our core markets.

Equity

Understandably, insurance equity prices have also reacted negatively today. However, reflecting our cautious view on markets ahead of the vote we believe funds are well positioned given: 1). sizeable cash balances available for investment at lower prices; 2). a greater exposure to defensive names, i.e. greater exposure to non-life vs. life insurers, defensive asset exposures, etc. and 3). a large proportion of our UK/European exposed names have either material foreign exchange benefits (given sizeable assets/earnings held/generated in non-European countries), or are in fact pure play UK domestic businesses that are not impacted by potentially changing legal arrangements with the EU.

Insurance-Linked Securities

Events over the last 24 hours have been a further illustration, in our view, of the long term benefits of ILS as an attractive investable asset class. Furthermore, today's events have had no fundamental impact on Twelve Capital's ILS investments, neither Cat Bonds nor Private ILS transactions. The volatility being witnessed in other markets during this time further reinforces the fundamental lack of correlation to financial markets and geopolitical events in our view.

Although Twelve Capital does transact with UK domiciled counterparties, such as Lloyd's syndicates, they purchase USD denominated ILS instruments as a natural match to their peak liabilities from the US insurance market.

In general, given the relative lack of reliance of the Lloyd's market on EU business, it is not anticipated that the event will have a significant trading effect for our counterparties in the longer term. The currency of our instruments is fully matched to peak liabilities. Our peak exposures remain natural perils affecting property insurance and exposure to man-made perils is carefully managed. The UK is not the peak exposure in any investment in which the firm invests and a weakening of the GBP against USD or EUR loss triggers in instruments actually reduces our liabilities in the territory.

Although it is possible as FX rates settle that those counterparties consolidating their balance sheet in GBP may eventually need to purchase some greater level of reinsurance protection, particularly for frequency losses from non-domestic exposures, we expect this to be a considered action over the coming months rather than a knee-jerk issue.

With regard to non-property catastrophe classes, we will monitor the political and civil stability of the UK, adjusting terrorism/political risk investments accordingly over time.

In summary, the outcome of yesterday's UK referendum is seen as a significant political event but one which is insignificant from the point of view of the ILS market, very clearly illustrating once again the value the asset class can bring to investors.

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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.