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Insurance Bonds: 20 April 2020

Compelling Value Opportunity Remains

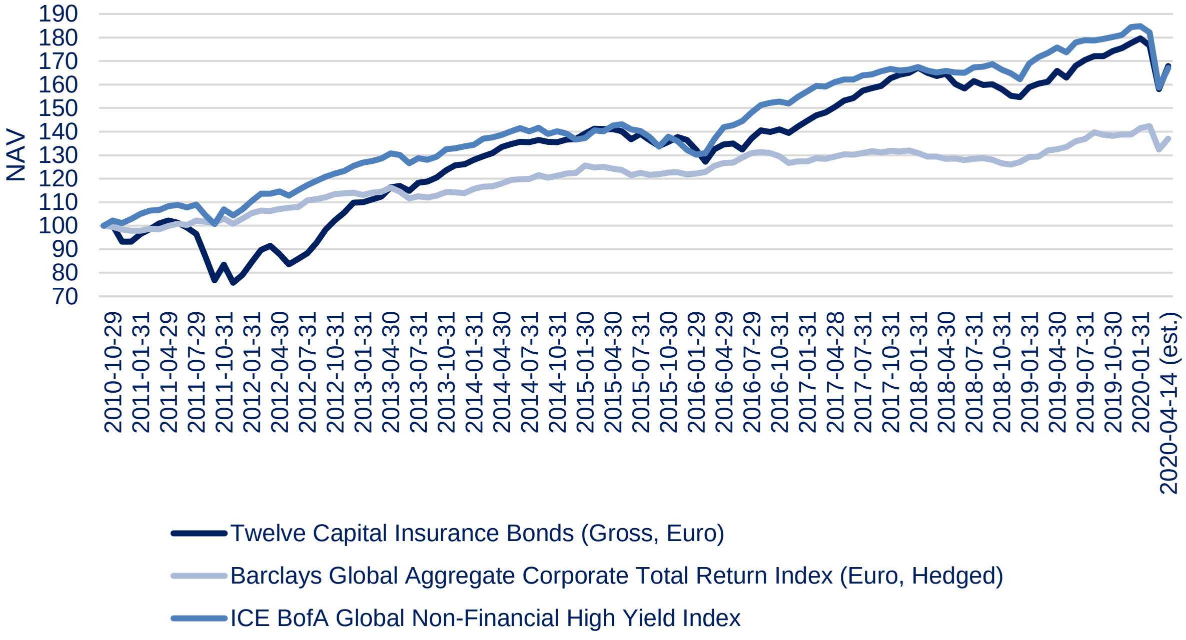
Executive Summary:

- Long term, buy-and-hold insurance investors have been rewarded by positive outperformance versus the broad corporate credit market and, since 2012, versus global non-financial high yield.
- Despite some tightening since March 2020 wides, spreads on Insurance Bonds remain at attractive levels, Twelve believes.
- Insurance continues to offer a complexity premium to other credit sectors that is not justified by strong industry fundamentals in Twelve's view.
- Robust Solvency II capital ratios support this fundamentals view, as do predominantly investment grade ratings and low long term industry default rates.
- Coupons are generally sustainable and are expected to continue to be paid during this period of COVID-19 led stress.
- However, credit risks are not uniform across the sector, reinforcing the importance of extensive fundamental analytics.

Insurance Bonds - an asset class that has rewarded long term, buy-and-hold investors

A criticism sometimes levelled against Insurance Bonds as an asset class is that it can prove to be one of the more volatile sub-sectors within credit, with a tendency to overact in times of exogenous market stress. Whilst this is indeed true, as the chart below shows, investors that are willing to buy and hold have been well rewarded over the past decade, in Twelve's view.

Figure 1: Insurance credit has delivered positive outperformance over the long term



Source: Twelve Capital, Bloomberg. As at 14 April 2020.

Over this period, the aggregate performance of the active strategy managed by Twelve has delivered positive outperformance versus the broad corporate credit market. Further, during the eight years post the 2007-2012 global financial and peripheral European sovereign crises, a period marked by steadily recovering credit markets, insurance has also outperformed global non-financials high yield.

If rating agency default data from 2007-2012 is indicative of what could be expected in terms of defaults due to the pandemic led global slow down, Twelve believes investor returns could benefit from a focus on investment grade investing and insurance bonds.

Figure 2: S&P global annual corporate default rates by rating category, 2007-2012 average

Rating	AAA	AA	A	BBB	BB	B	CCC/C
2007-2012 Average	0.00%	0.06%	0.10%	0.19%	0.44%	3.23%	26.4%

Source: S&P Global Ratings.

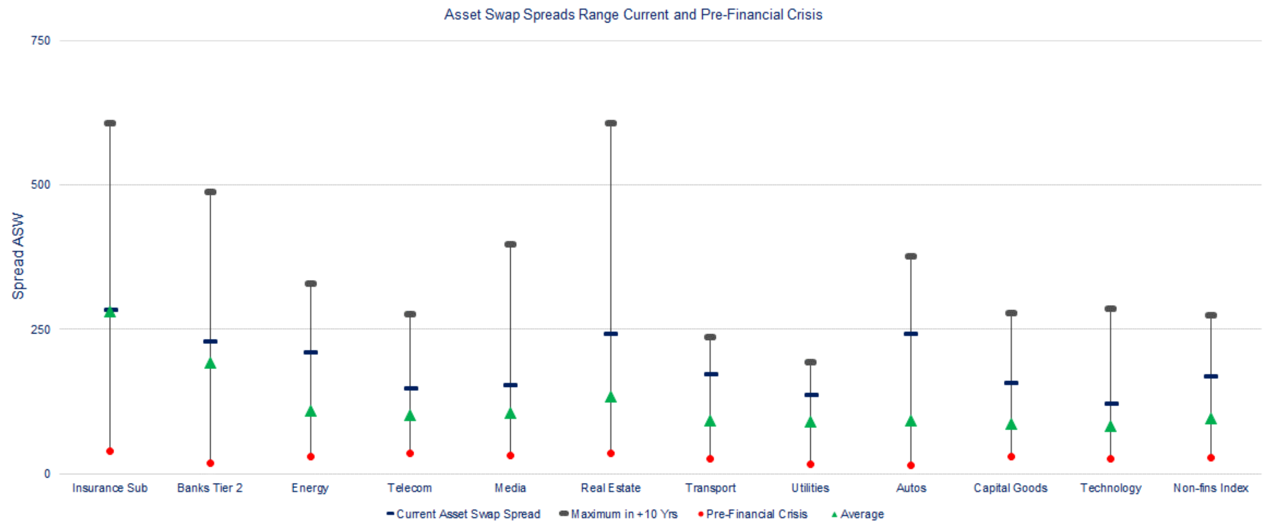
Insurance remains a compelling investment opportunity within liquid credit

Volatility within global credit markets has been extreme over past weeks, driven by the developing COVID-19 pandemic. Specifically in relation to Insurance Bonds, at the time of writing, Twelve Capital notes that since pre-pandemic Tier 2 bonds issued by European insurers are down on average by 7 points, with Restricted Tier 1 instruments down even more by on average 15 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.

Current asset swap spreads of 284bp mean that insurance remains the widest amongst the European industrial sectors shown, above the 10 year average of 281bp, offering investors an attractive entry level.

Figure 3: Credit spread comparison across sectors



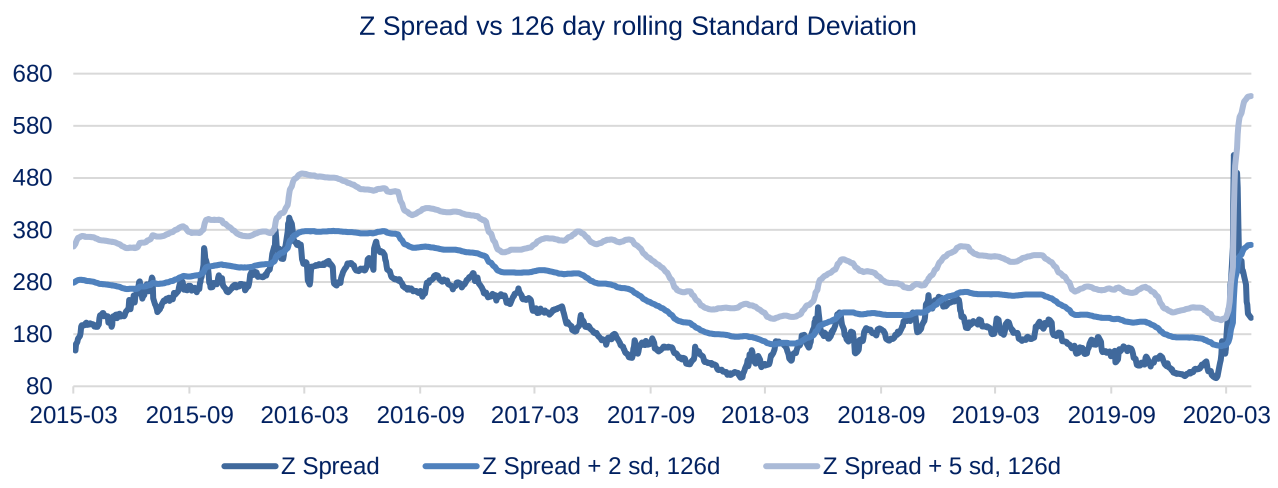
Source: Twelve Capital, Bloomberg. As at 14 April 2020.

Credit markets have at times been dislocated in recent weeks

During mid-March 2020, unprecedented market volatility and at times indiscriminate selling across global credit resulted in a dislocated market, Twelve believes. By way of example, some bonds from even the strongest, European insurers exhibited +5 sigma spread moves in the month, as the following examples show;

Figure 4: Even bonds from 'national champion' insurers suffered during recent weeks

Example 1 - Allianz €3.375 Perp (ISIN: DE000A13R7Z7)



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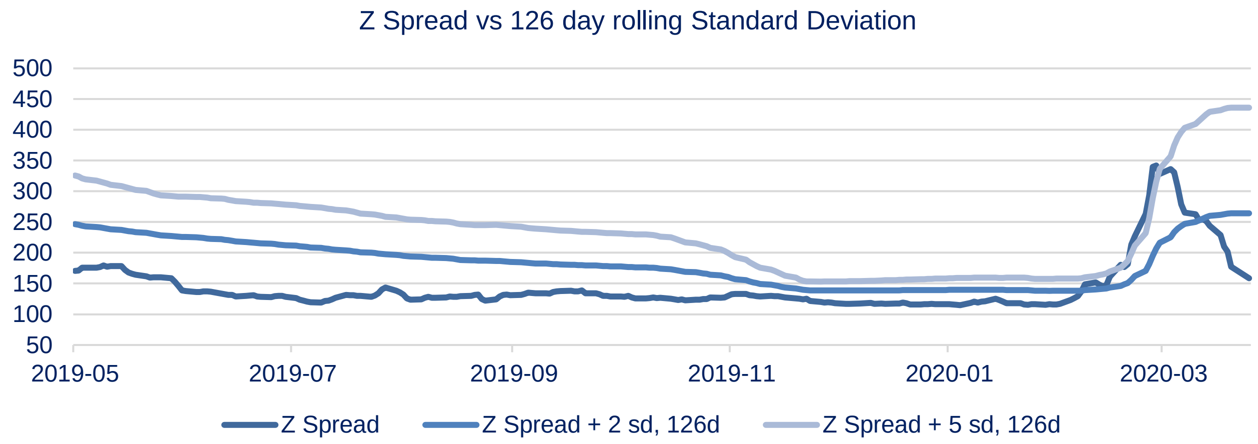
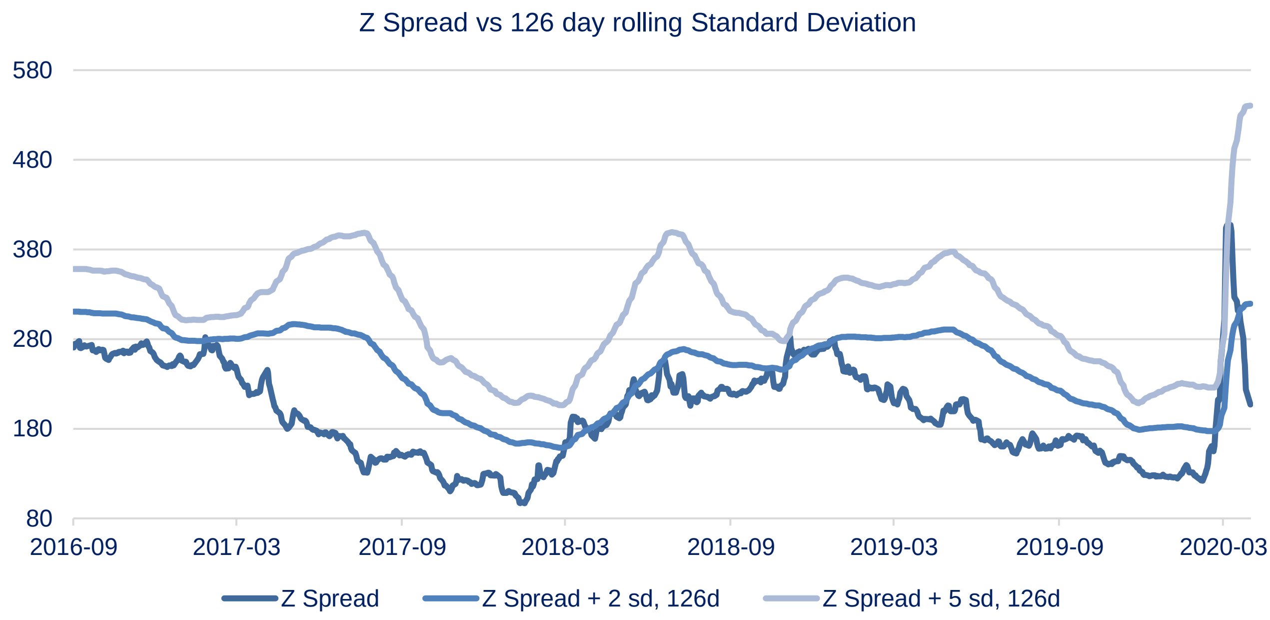
Example 2 - Munich Re €3.25 49NC29s (ISIN: XS1843448314)



Example 3 - AXA €3.378 47NC27s (ISIN: XS1346228577)



Source: Twelve Capital, Bloomberg. As at 14 April 2020.

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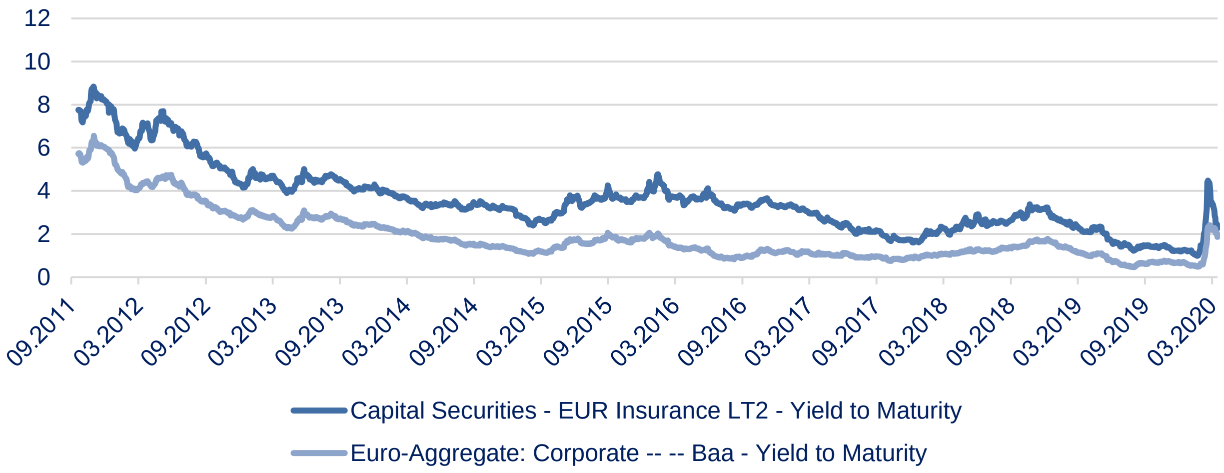
Favourable yields in comparison to investment grade corporate bonds

Moving from asset swap spread data to yields, as can be seen from figure 5 below, levels of 2.3% from European insurance Tier 2 debt are attractive when set against the lower yields on offer from Baa rated corporates of 1.9%. 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 5: Insurance yields remain wide of corporates in general



Source: Twelve Capital, Barclays Live. As at 14 April 2020.

European solvency ratios resilient at a sector level despite COVID-19 driven volatility

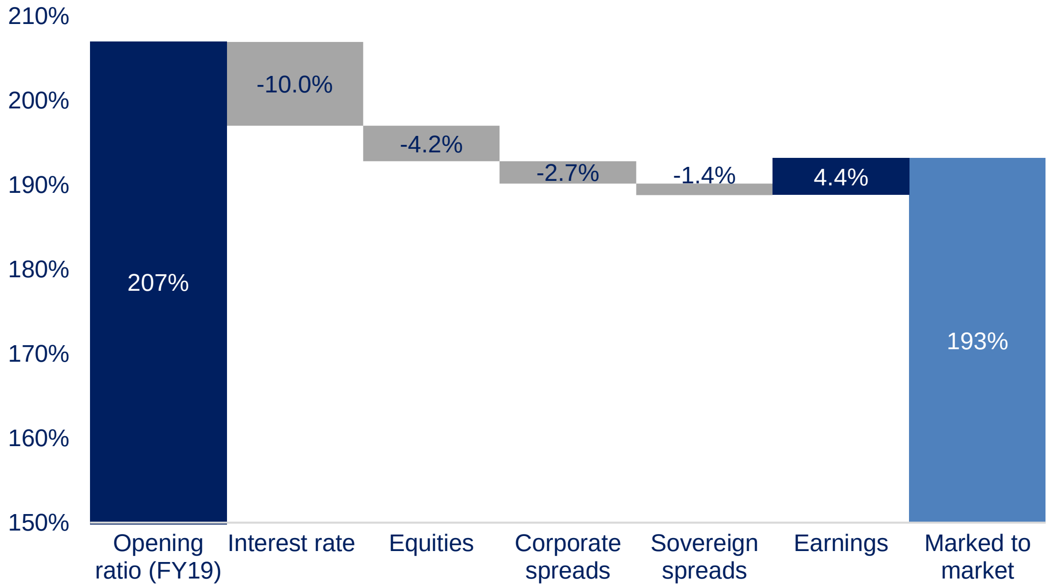
Twelve continues to expect that in aggregate, direct impacts from the COVID-19 disease outbreak in terms of insurance losses, whilst painful, will be manageable (i.e. higher life mortality, disability, business interruption, travel insurance etc. claims). Some of the loss potential does remain highly 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 lines of insurance 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.

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 to 16 April 2020, remain at a strong average level of 193% 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. To clarify, it is not until ratios fall to 100% or below (unlikely in Twelve's view) that bond coupon deferral becomes mandatory (Tier 2) or must be cancelled (Tier 1).

Twelve recently wrote on the topic of insurance company dividend expectations for 2020, concluding that dividend deferrals driven by regulatory intervention (not willingness, nor ability to pay) are likely to benefit credit investors. From a Solvency II capital ratio perspective, Twelve notes that a final 2019 dividend typically 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 6: Solvency II mark to market points to continued resilience



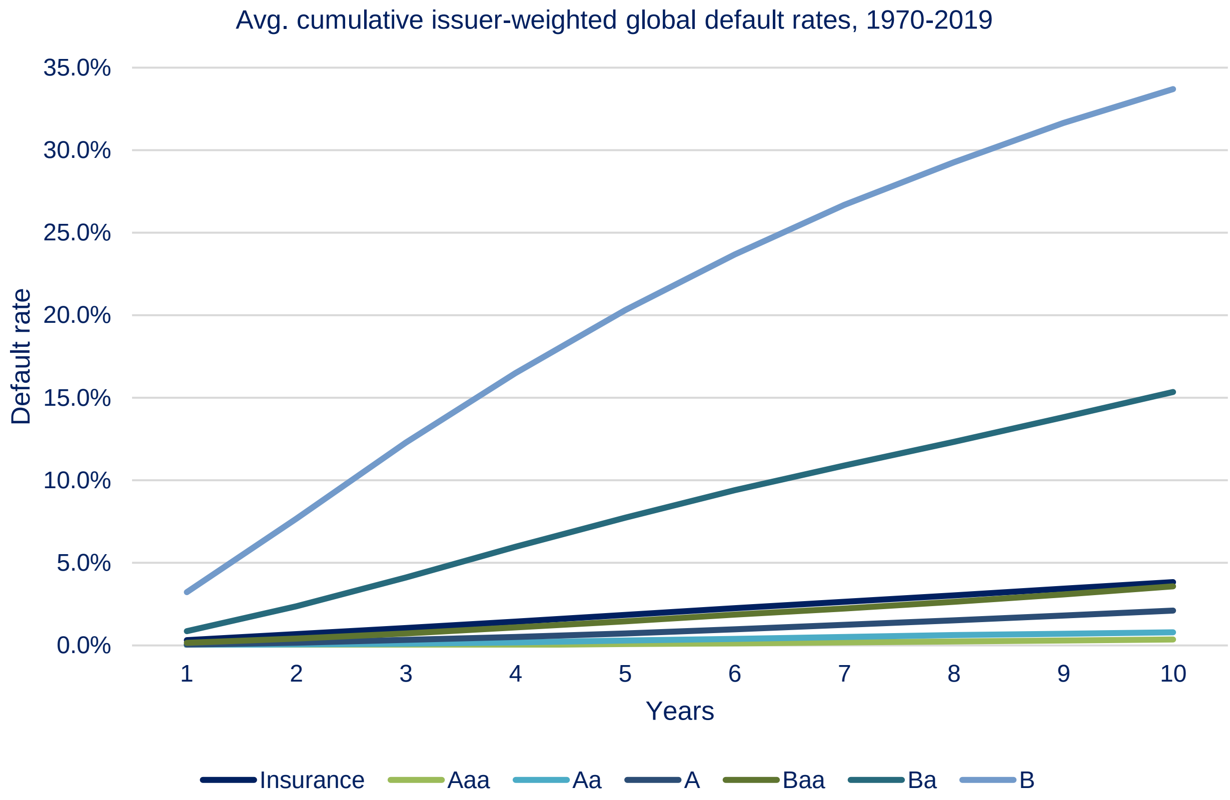
Source: Twelve Capital, Company Reports. As at 16 April 2020.

Long term insurer actual defaults empirically support investment grade ratings

The view of insurance being intrinsically an investment grade asset class (at least in relation to the insurers within the investment universe for Twelve's liquid credit strategy) is also supported by long term performance data compiled by rating agency Moody's Investors Service. As can be seen from the chart below, the average cumulative issuer-weighted global default rate for insurance seen between 1970 and 2019 (i.e. nearly a 50 year period) is comparable to Baa rated corporates.

In Twelve's view the Moody's data potentially overstates the default experience of insurers typically found within its liquid credit strategy. This is because the defaults embedded within the statistics since the financial crisis of 2007/2008 largely comprise financial guarantor and mortgage insurers – institutions that are not a focus for investment.

Figure 7: Moody's default data confirms insurance as an investment grade asset class



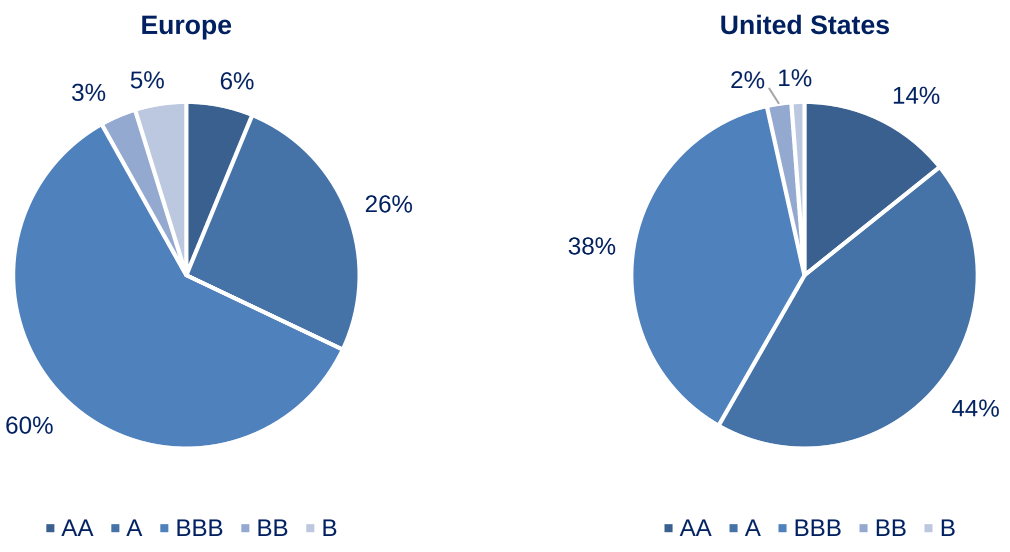
Source: Moody's Investors Service.

Higher yielding, but not high yield

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, in the main. The insurance groups within the investment universe for Twelve's liquid credit strategy are typically highly rated by rating agencies.

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. As a result, 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 8: Insurance Bonds predominantly an investment grade asset class



Source: Twelve Capital, Bloomberg. As at 17 April 2020.

Insurance focus is on relatively more defensive debt instruments than CoCos

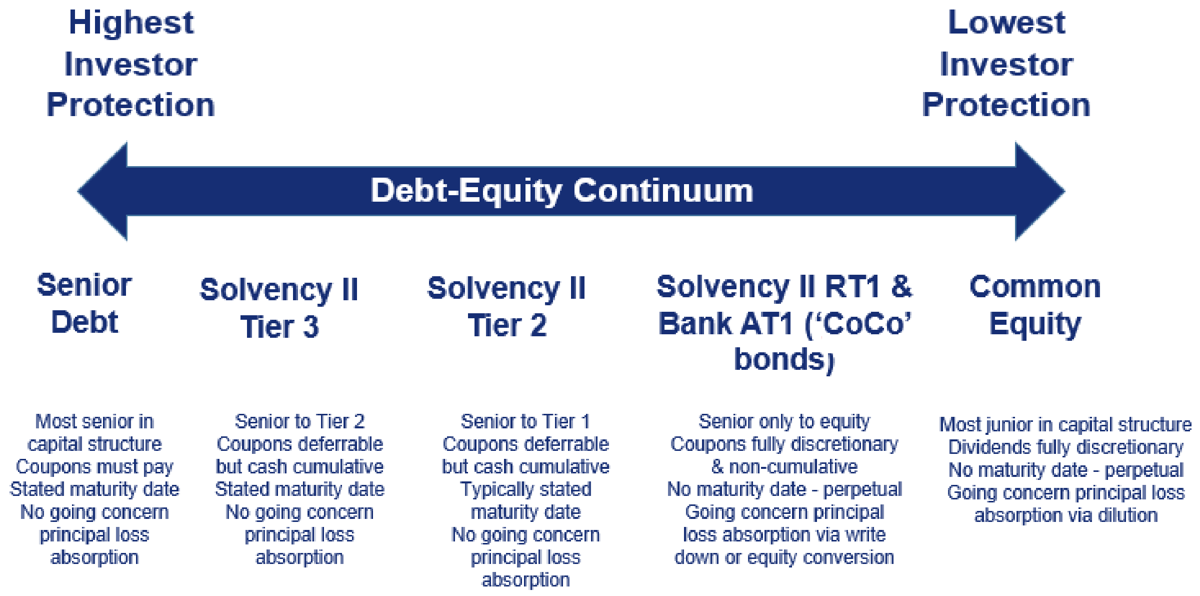
In aggregate, insurance credit portfolios managed by Twelve Capital currently focus on Solvency II qualifying Tier 2 debt issued by European insurance companies. This reflects first the ongoing relative attractiveness of Euro denominated debt for predominately Euro investors, despite the recent reduction 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 (67% of 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 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 9: Placing Insurance Bonds on the debt-equity continuum



Source: Twelve Capital.

Debt servicing capacity expected to remain generally sustainable sector wide

In Twelve's view, insurance hybrid debt coupons are generally sustainable and will in the main 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.

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About Twelve Capital

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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