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Twelve Market Perspectives 2015

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Investment Outlook

We continue to believe that insurance investments will provide excellent opportunities in 2015 despite the challenging environment of low interest rates, uncertainties associated with declining oil prices and volatility in Emerging Markets. The extent to which Cat Bonds and Private ILS investments are uncorrelated to other markets and the attractive pick-up relative to cash is likely to draw more investors into the asset class. Within the liquid insurance bond markets, the mixture of high running yields and attractive spread pick up relative to corporate bonds with the same credit rating should provide continued support to subordinated insurance bonds.

Kind regards,
Mark Wauton, Director
Sandro Kriesch, Partner
Dr. Roman Muraviev, Director

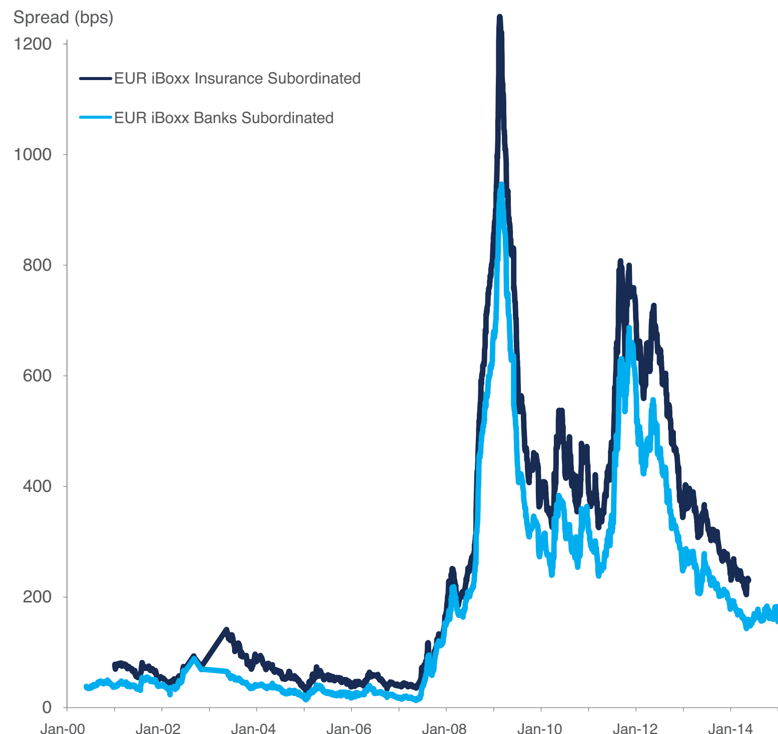
Investors in insurance-related assets were well rewarded in 2014 as markets were supported by the strength of the underlying government bond markets and the garnering of coupon for traded insurance debt. Within the Insurance-linked Securities market (Cat Bonds, Private ILS), and despite a reduction in premium rates, the historically low level of natural disasters, particularly hurricanes in the US, resulted in few impairments and therefore attractive returns for the asset class.

Insurance Debt

Global insurance debt in 2015 will continue to offer opportunities for investors. Despite the economic backdrop in Europe remaining weak, it is unlikely to undermine the basic creditworthiness of insurers – any rating downgrades are more likely to be due to the weak economic environment rather than deterioration in the respective insurer's credit profile. Low interest rates, particularly in Europe, present a challenge, but insurers have shown and should continue to demonstrate their ability to adapt and cope well in this environment.

With 10 year German Bunds trading below 50bps and higher yielding sovereigns such as Spain and Italy offering only a modest pick-up in spread, the search for yield by investors is likely to remain the dominant theme for 2015. It is on this basis that we consider subordinated insurance paper, both Sterling and Euro denominated, as offering strong value on a relative basis to other credit asset classes such as High Yield and, in particular, investment grade corporate.

By way of example, Tier 1 GBP insurance bonds are currently yielding 5.1 %, and similar Euro denominated bonds are yielding 3.6 %. Further, given the high spread levels seen in insurance relative to other business sectors, prospects are good for continued outperformance, and this is even more the case for insurance private debt transactions.



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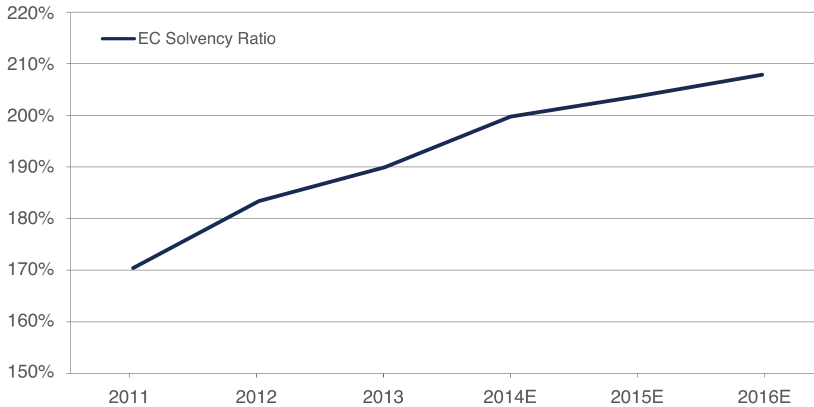

The balance sheet strength of insurers is a key attraction and supports investment in subordinated as opposed to senior paper. Insurers have benefited from both a solid stock of capital and strong free cash flow generation. This has provided investors with support throughout the financial crisis. Having undergone many years of de-risking and improved financial management, insurers' balance sheets are now well capitalized. The sector's economic capital ratio finished 2014 at close to 200 %, which we think is a reasonable proxy for Solvency II capital requirements. The 150 % level we believe is a reasonable practical minimum and, in our view, a level of 180 % would provide a healthy buffer against adverse market moves. Therefore we can argue that many insurance companies have as much as 20 % of market cap in excess capital, with some in the 5–10 % range. This would suggest there is sound investor protection available to investors within subordinated debt.

In the U.S., the prospect of gradually rising interest rates, if economic data remains robust, should boost the fortunes of life insurers, and could have interesting implications for floating rate securities. As EU-based insurers settle into Solvency II, we expect to see an on-going wave of liability management and exchange offers carrying on into 2015. That said, the opportunity set for large total return plays has narrowed somewhat after five years of general credit and spread recovery.

Given the structural mismatch of assets relative to liabilities on a duration basis, coupled with demanding guaranteed rates on liabilities in some countries, interest rate risk for European life insurers remains a key risk given the low yield environment. We do not expect rate increases in Europe in the foreseeable future so this is a negative that will continue to overhang life insurers throughout 2015.

Within the re-insurance sector, pricing premium is under downward pressure, primarily as a result of increased reinsurance overcapacity, limited catastrophe events and increasing insurer capital adequacy. The increased use of capital market alternatives (Private ILS and Cat Bonds) as a substitute for traditional reinsurance is beginning to impact the European insurance market and will be a trend that continues over the next year. Nevertheless, reinsurers are well capitalised and continue to offer value within the financial sector and also when compared to traditional corporate debt.

Solvency II hangs over the Euro- and Sterling- denominated, EU-based insurance market. Capital standards, for all intents and purposes, have been finalized and Solvency II is slated to go on line in January 2016. We believe the new capital standards and grandfathering guidelines will likely result in an on-going wave of liability management/exchange offers, and new security issuance in 2015. EU-regulated insurers have a window of opportunity to exchange legacy Tier 1 and Tier 2 structures with step-ups prior to the year-end 2025 grandfathering expiration period and replace them with new securities with extended call periods beyond 2025. We have already seen Groupama, La Mondiale, Axa and Generali engage in liability management exercises, and we expect to see more of this activity in 2015. This should provide a base of support to the Euro/Sterling hybrids market, and we expect to see issuers offering one to two point-plus premiums to encourage investor participation.

Cat Bonds

For the Catastrophe Bond market, it is likely that spreads will widen during the first half of 2015 and then tighten

thereafter (provided no substantial catastrophe events occur). This is a reflection of the cyclical imbalance between institutional capital demands for Cat Bonds versus their supply (a dynamic which must be balanced and reconciled with the hurricane season itself). Rates for risk-remote and diversifying notes (Japan Earthquakes, etc.) reached their lows in 2014 and have only a small degree of potential to increase in 2015, if at all. Rates for peak-perils such as hurricanes in the US, as well as for riskier transactions, still have the potential for decreases (although 5% – 10% at most in our view). Furthermore, large numbers of Cat Bonds mature in 2015 and more than 80 % of these will be re-issued. In total, we believe that a volume of at least USD 6.5bn of publicly offered Cat Bonds will be issued in 2015.

Private Cat Bonds as an asset class will continue to expand throughout 2015, both in terms of volume and number of issuances. We are looking to engage in the facilitation of at least four new private Cat Bonds in 2015. New, mid-sized cedants are likely to prefer buying protection via Private Cat Bonds rather than issuing 144A notes, due to the costs associated with the latter of these methods.

Innovation remains a key thematic within the industry and new triggers, structures, transactional mechanics, types of risks, territories and perils will continue to appear in the Cat Bond market. We will see about ten new Cat Bond sponsors in 2015, similar in number to recent years. External Cat Bond ratings are of little significance for sponsors and investors, and many cedants have abandoned these.

Cat Bonds will continue to be very attractive compared to other classes of fixed income securities, due to their idiosyncratic nature, reputation as a stress-proven asset class, accurate quantitative risk modelling, risk-adjusted returns, diversification potential, low volatility, short duration and high quality transactional structure (segregating them from operational, credit and other types of risks).

Private ILS

Investments in reinsurance contracts still represent an interesting sub-asset class and this “direct reinsurance” group continues to offer a premium over more liquid Cat Bond names. Direct reinsurance pricing, as determined by Guy Carpenter, has taken, on average, another 11 % price reduction YoY compared to Cat Bonds (with an expected loss of 2 %) which themselves experienced a 19 % reduction. Specifically, US property rates lost between 7 % and 14 % over the same period. Twelve Capital’s renewal figures (direct reinsurance down 8 % on average), suggest the case of holding on to an existing book of lasting reinsurance relationships.

2015 will likely continue to see price challenges, a natural occurrence in the reinsurance market and one which will impact premiums when a larger event occurs. We continue to monitor both price and conditions, with the focus being on the latter of these two. Sourcing, the analysis and control of risk metrics and legal due diligence, i.e. our underwriting discipline, remain top priorities for the year.

With continued interest in the direct reinsurance asset class, we anticipate an increase in the volume of collateralized reinsurance from today’s levels of USD 50bn to around USD 55bn. At the same time, given fee pressures, a consolidation of players in the lower tiers would also be a likely occurrence. Those that are transparent, have strong performance and are excellent service providers will persist in this evermore competitive market.

Conclusion

Subordinated Insurance bonds offer excellent carry opportunities and the prospect of capital gains as spreads continue to tighten.

The diversification provided by Cat Bonds and Private ILS, and pick-up compared to cash, remains compelling as the yield provided in sovereign bonds is largely eroded and emerging markets become more volatile.

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