TWELVE CAPITAL INSURANCE BOND STRATEGY

Q1 2023 Review

April 2023

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Dinesh Pawar, Head of Insurance Bonds at Twelve Capital, provides an update on the Insurance Bond market.

"The Insurance sector has continued to show resilience from a fundamental perspective."

Executive Summary

- Q1 2023 has been a challenging start for markets: persistent inflation, uncertainties around Central Bank rate policies and fears around bank contagion risk.
- The bank failure of Silicon Valley Bank (SVB) and the forced merger of Credit Suisse (CS) with UBS led to a major rout in financial markets across global financial markets. The complete write down of Credit Suisse AT1 caused much angst not only amongst holders of the CS instruments but many investors to reassess their holding in AT1 bank debt across all financials.
- There are fundamental differences between banks and insurers and we believe insurers to be better positioned.
- The insurance sector has continued to show resilience from a fundamental perspective and for Insurance Bonds any spread widening has been in line with a poorer market backdrop.

Market Summary

The recent events that have unfolded in the past weeks have been very challenging for the Global Banking system. It is still unclear what the longer-term impacts will be for smaller and less regulated banks in the US or for European Banks in an environment where risks are growing of recession and increased NPLs (non-performing loans). What is clear is that the bank system was once again susceptible to a bank run (rapid deposit withdrawals) as in the case of SVB, or in the case of Credit Suisse a complete lack of confidence going forward.

The insurance sector suffered more secondary order effects in terms of spread widening. The greatest volatility for Banks was experienced in the most subordinated AT1 space where bonds in some cases fell by almost 20 points before partly recovering. Fortunately, Insurance Bonds in the RT1 universe sold off only 5-8 points and recovered quickly as the markets where acutely aware that the crisis was very much a banking problem and not an insurance sector problem.

The current landscape for investing across Insurance Bond capital structures (see Table 1) presents yields still at the most attractive level they have been in the past 12 years. But more importantly we believe that the recent crisis in the banking sector should force investors to reconsider their allocation to the banking sector especially to AT1 structures and potentially switch to a more defensive and compelling sector, Insurance Bonds.

Global Financial Credit funds were impacted significantly from the recent banking crisis, due in most part to their exposure to AT1 type structures. Volatility in the RT1 subsect of the Insurance Bond universe experienced a higher degree of correlation to Bank AT1 structures. Overtime we would like to see this subsector develop although we expect recent events to represent a drag for supply, at least in the short term. Moreover, to put things into context the Insurance RT1 universe, being circa EUR 19bn in issuances, is still small, and just slightly larger than the total amount of AT1 of Credit Suisse that were wiped out.

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Table 1: Current yields across structures

Capital classification/Currency	Characteristic	GBP	EUR	USD
Solvency II - T1 (RT1)	Principal loss absorbing with equity conversion features/cancellable coupon	YTBB = 9.63% Duration = 5.51	YTBB = 7.45% Duration = 5.67	YTBB = 8.13% Duration = 4.01
Solvency II - T2	Benchmark deals, with broad investor base Also includes higher yielding Tier 2 structures, some of them launched as 10Y bullet structures	YTBB = 7.02% Duration = 5.56	YTBB = 5.87% Duration = 4.61	YTBB = 6.61% Duration = 8.32
Solvency II - T3	Often bullet structures with maturity of between 5 to 10yrs	YTBB = 6.63% Duration = 2.89	YTBB = 4.92% Duration = 4.20	N.A.
Senior	Unsecured debt less subordinated than Tier 3 and not recognised as regulatory capital	YTBB = 5.13% Duration = 7.89	YTBB = 3.63% Duration = 4.50	YTBB = 3.58% Duration = 6.17

Source: Twelve Capital. As at 31 March 2023. Table showing where various structures within the Insurance Bond universe are currently trading. YTBB: Yield to buy back.

Differences between banks and insurers

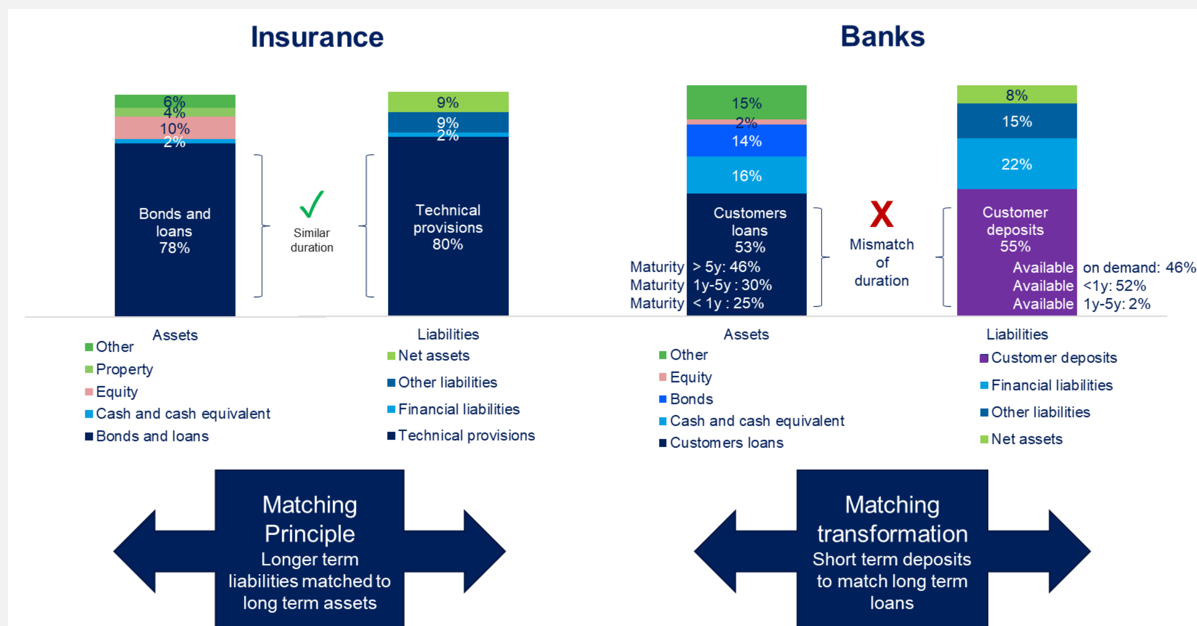
We believe it is key for investors in the current market environment to understand the differences between banks and insurers. In fact, there are important differences in their balance sheet structures, as well as risks and investment strategies that are driven by the nature of their underlying business models: while banks' main objective is maturity transformation, insurers' focus is on maturities matching.

Banks' liabilities are mainly comprised of short-term deposits that are invested in longer term typically illiquid loans. This creates a mechanical duration mismatch and exposes banks to liquidity risk. This makes banks more subject to lack-of-confidence induced withdrawals, as seen in the sector in 2023 and during the Financial Crisis of 2008/2009.

Insurers tend to have predictable liabilities, driven by law of large numbers or having contractually set pay-outs and duration that can be matched with assets that have similar duration and are, in most cases, highly-rated and very liquid.

Moreover, insurance products tend to be illiquid (e.g. P&C products, term life products, pension annuities) for policyholders and even insurance savings business is often less exposed to surrender risk than bank deposits thus diminishing further reducing liquidity risk for insurers.

Chart 1: Defining insurance balance sheets vs banks



Source: Twelve Capital. As at March 2023.

It is important to flag that post-crisis regulation has been a key topic since the Financial Crisis to ensure that banks have recovery and resolution plans in place and that regulators have all the necessary tools at their disposal in order to quickly deal with the failure of a bank, thereby aiming at limiting contagion of the wider financial system and losses for taxpayers.

In the case of insurers, unlike banks, size is not necessarily a good indicator of their systemic risk potential. In fact, the more diversified an insurer is and the larger the number of independent risks it insures, the lower the probability a single event would require a pay out all at once. Insurers are less exposed to very sudden market crashes and challenging situations can be better addressed by regulators.

Albeit, there is no defined resolution yet in place for insurance companies in most markets, the European Union is in the process of standardising resolution regimes across its different countries.

Lastly, we highlight that deeply subordinated debt issued by insurance companies typically has loss absorbency features that include either a conversion into equity or principal write-up mechanisms, which are less penal to investors than permanent write-down.

Fundamentals remain solid

Insurers have weathered well the current environment. In particular, diversified multiline players have benefited from their strong risk diversification by geography, line of business and distribution channels. We observed that more life-orientated players benefitted from the effect of higher interest rates on their guaranteed business (that saw lower capital requirements), however, some challenges arise from rapidly rising interest rates as the risk of lapse increases (i.e., the risk policyholders surrender their existing policy to buy a new one offering better terms).

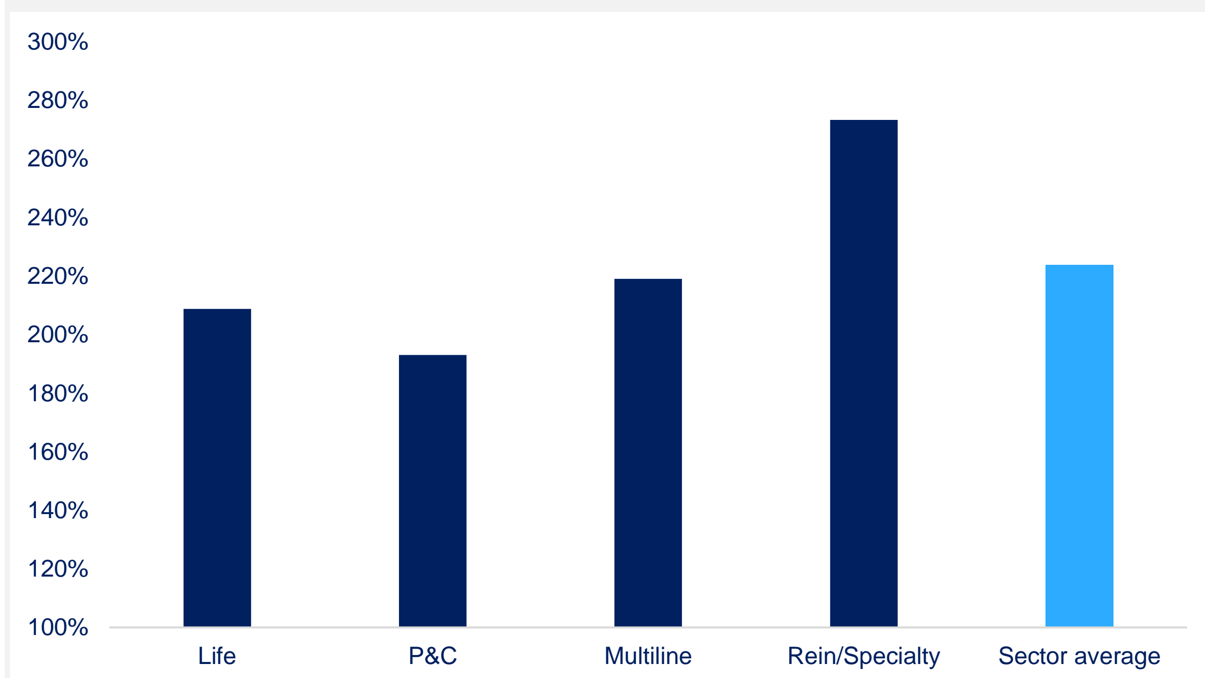
P&C players skewed towards Commercial lines saw increases in insurance rates more than offset higher inflation, and they typically fared better than insurers focusing on Personal lines, particularly in competitive markets such as Spain and the UK.

2022 has been one of the most intense years for reinsurers and specialty players, as Nat Cat losses came in well above the 10-year industry averages. Reinsurance capacity for 2023 is

limited with a lot of significant players exiting or reducing their exposure to Cat risk (e.g. AXA-XL, SCOR). Reinsurance rates are therefore increasing thus benefitting reinsurers as they can bolster reserve buffers, increase margins and be more selective in underwriting Cat risks.

Finally, we reiterate that solvency ratios remain at historically high level, and on average well above 2.0x the minimum required by the respective regulators (see Chart 2).

Chart 2: Solvency ratios by subsector as at 31 December 2022



Source: Twelve Capital. As at 31 December 2022.

Key risk associated with investments in Insurance Bonds include

Concentration in one industry risk: When a portfolio is reliant on one industry or market segment (i.e., insurance industry), this creates concentration risk. Thus, it increases the likelihood that a single impact can have a big effect.

Counterparty risk: The counterparty in a credit, or trading transaction may not fulfil its part of the deal and may default on the contractual obligations.

Interest rate risk: In particular fixed rate securities may be affected by changing interest rates which may reduce or increase the market value of a bond.

Market risk: The price of investments may fluctuate and can decline in value due to factors affecting financial markets generally or particular industries, sectors, companies, countries or geographies represented in the portfolio.

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