TWELVE CAPITAL INSURANCE BOND STRATEGY

Market Update

August 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 is currently one of the most attractive within Investment Grade.”

Executive Summary

- The insurance sector has performed well throughout the challenging first half of 2023, especially when compared to the broader corporate landscape. We believe it will continue to be resilient even if markets remain volatile in the second half of the year.
- The first half of 2023 was marked by troubles at US regional banks, the losses imposed to Credit Suisse AT1 holders that led many investors being more cautious of these structures, as well as Central Banks’ continued increases in interest rates in order to tame inflation.
- In a recessionary environment marked by higher interest rates we believe that insurers are better positioned than other corporate sectors, and particularly corporates with higher leverage.
- Insurance companies have reported robust solvency positions and resilient earnings year to date, solidifying the sector's position as a defensive stronghold within the current economic environment.
- Given current yields, Investment Grade bonds have become very attractive as an entry point, but also for many investors a way of repositioning their fixed income allocation given the more arduous macroeconomic trends.
- In Twelve Capital’s opinion and observing market tendencies, the insurance sector is currently one of the most attractive within Investment Grade.

Market Update

Debt issuance more active in Q2

The Insurance subordinated sector has experienced greater activity in the primary market in Q2 2023 and a handful of issuers have started to refinance bonds callable in 2023/2024. Total new issuance in Q2 2023 amounted to more than EUR 6bn compared to a bit less than EUR 1bn in Q1 2023. Still, the YTD amount is 18% down year on year despite the recent catch-up. Spreads at issuance have been attractive for investors in Q2 2023 with an average above 300bps for dated bonds compared to an average spread slightly above 250bps in 2022. We also saw greater appetite from investors’ side with order books being oversubscribed. In addition, Royal London issued the first RT1, the first by a UK mutual company.

Overall, our expectations for European insurers’ refinancing needs are in the region of EUR 14bn for upcoming quarters. These should provide plenty new investment opportunities.

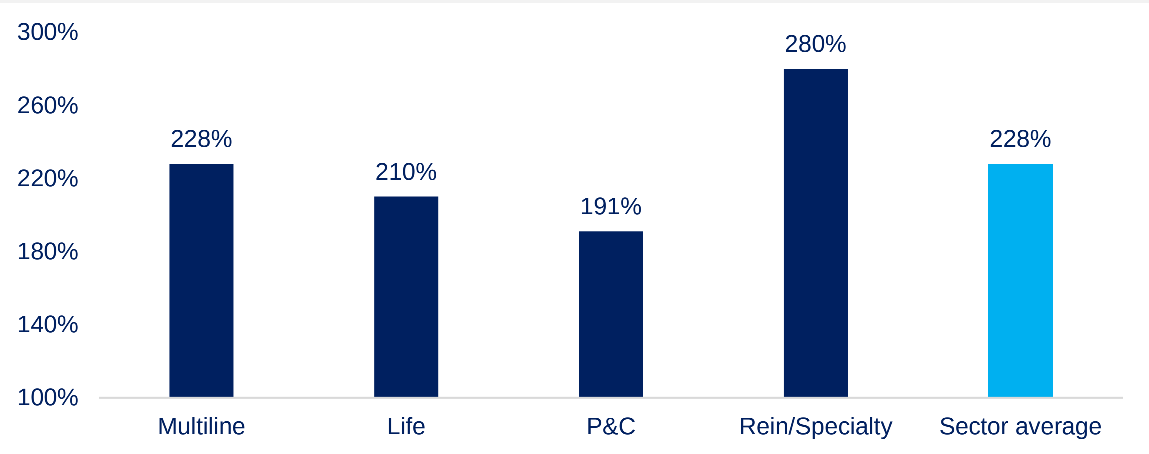
In a climate of higher interest rates we remain cautious around extension risk: namely the risk for a callable bond not to be called at its next call date. However, it is worth highlighting that Insurance Bonds placed with institutional investors have been consistently called at their first call date, testifying the insurers’ strong discipline of calling bonds as soon as they become callable. One outlier has been Liverpool Victoria who is the first and only insurer, to our knowledge, not to call a Solvency II-compliant bond at its first call date. However, it still tendered 40% of the bond at par offering investors therefore a partial exit. Liverpool Victoria is a very infrequent issuer and we see their decision of not calling the bond as an isolated case.

Half-year results are supportive for creditworthiness

Companies that have reported H1 2023 results showed strong solvency ratios, in particular for French Life players, due to more stable EUR interest rates in Q2 2023.

Companies with material property CAT exposure have reported strong earnings due to increased pricing in the business line that has materialised during the policy renewal season. On the retail side, the Spanish Motor market remains challenging due to inflation and competition as reported by Grupo Catalana Occidente and Mapfre, while the UK Motor market exhibits encouraging indications of improved prospective profitability. Finally, UK Life players have reported trading statement highlighting strong increases in premiums in the bulk pension market, which we expected to remain very active through the rest of the year.

Figure 1: Solvency ratios by sub-sector – latest reported



Source: Twelve Capital. As at 23 August 2023.

Rating agencies' actions in the first half of the year included Fitch decision to change its outlook on Utmost Group's Long-Term Issuer Default Rating to positive from stable after upgrading it in June 2022, a potential upgrade would bring the RT1 debt to Investment Grade (bond currently rated BB+). The agency indicating a full upgrade could occur over the next 12 to 24 months. Fitch has also changed the outlook from stable to positive on Axa and Ethias, while S&P improved the outlooks on Munich Re and Swiss respectively to positive and stable.

On a further positive note, we highlight that recent revised insurance regulation in Switzerland will potentially lead to more debt issuance from the region.

The amended Swiss Insurance Supervision Act will be officially implemented on 1 January 2024. As part of it, a 10-year grandfathering period on outstanding debt will be implemented, akin to the arrangement made under Solvency II. After 31 December 2033 existing Swiss Tier 2 instruments should lose all regulatory capital value while, from next year, the newly introduced Tier 1 and Tier 2 bonds will appear in the market.

M&A activity has been relatively active

Consolidation in the market continues. We observed Liberty Mutual selling its non-US operations to Generali (the mainly non-life European business) and Talanx (the LatAm units). Both acquisitions will contribute to materially strengthen the buyers' position in some of their foreign markets.

Aegon announced the disposal of its UK individual protection business to Royal London, initially via a reinsurance transaction to be followed by a legal Part VII transfer in 2024.

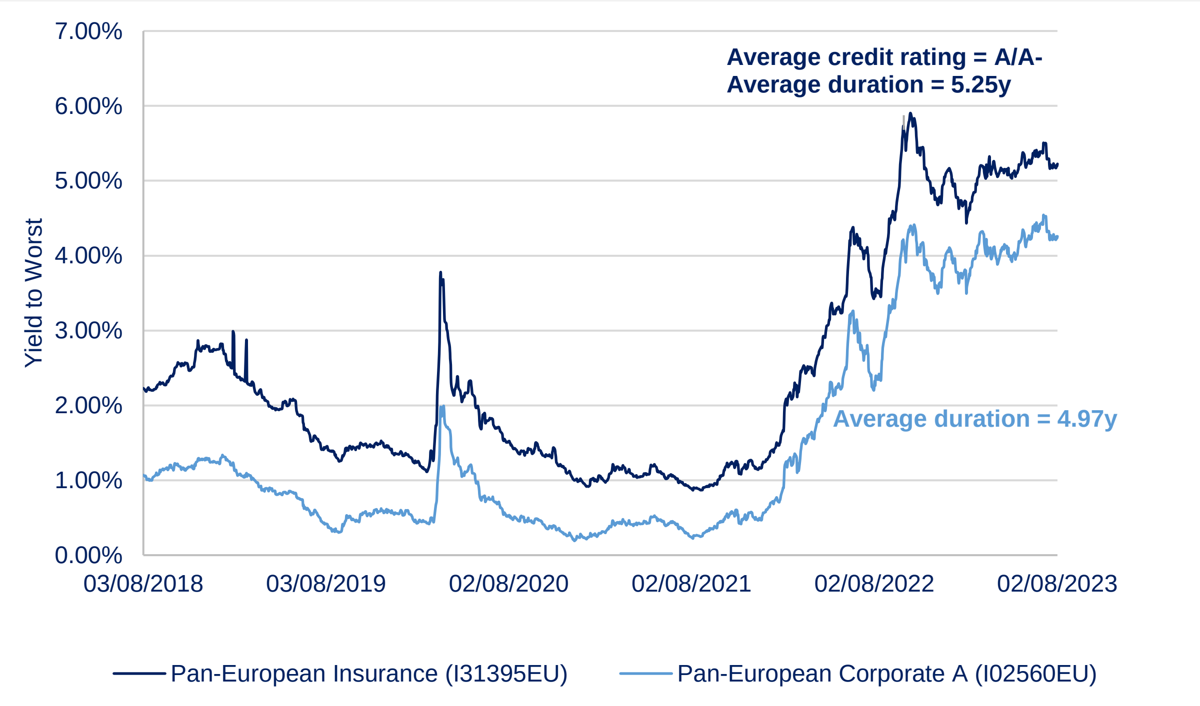
Aegon also announced that it has transferred its legal domicile to Bermuda. The company will however remain headquartered and a tax resident of the Netherlands, while no immediate material impact on the group solvency ratio is expected.

Insurance Investment Grade Bonds Relative Value looks attractive

Investment Grade bonds have been considered safer investments compared to High Yield bonds due to their better credit quality, lower historical defaults, and the financial strength of their issuers. Twelve Capital believes that investors should consider Insurance Bonds within their Investment Grade allocation.

Historically, Insurance Bonds have always traded at a premium compared to other sectors within the investment grade universe, Twelve Capital calls this the “complexity premium”.

Figure 2: Insurance Bonds vs Corporate Bond Indices

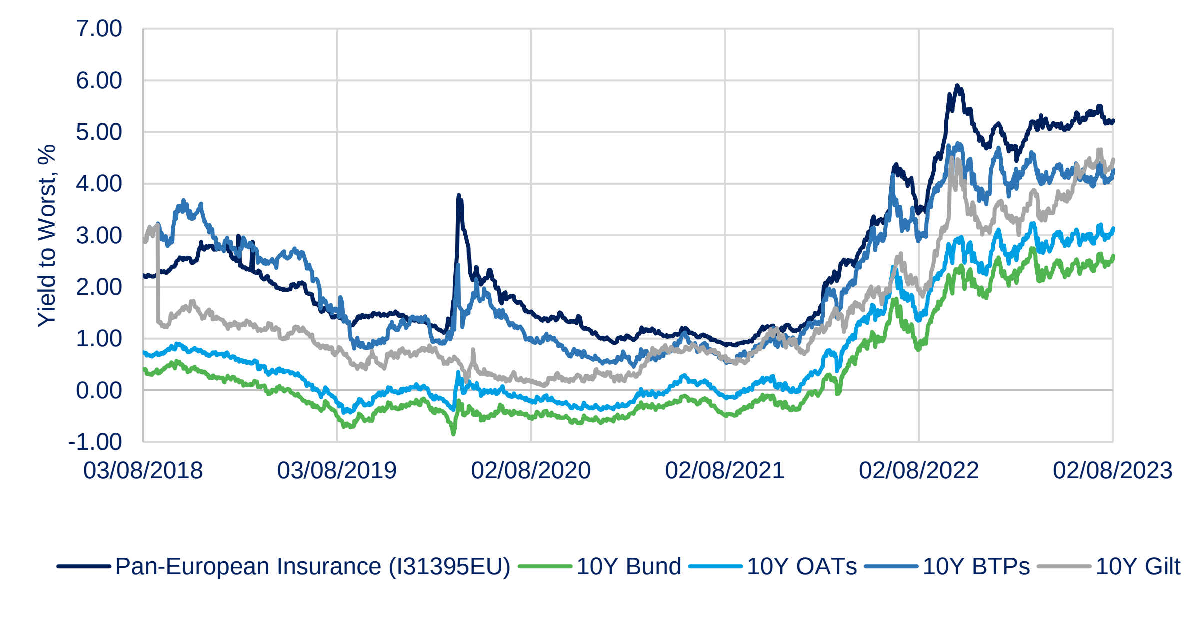


Source: Twelve Capital. As at 2 August 2023. Bloomberg Pan-Euro Corporate Insurance, EUR Unhedged (I31395EU) – The index is a subset of the Bloomberg Pan-European Corporate Index and measures the market of bonds issued by insurance companies and denominated in different European currencies. Bloomberg Pan-European Aggregate: Corporate A, EUR Unhedged (I02560EU) – The index is a subset of the Bloomberg Pan-European Corporate Index and measures the market of corporate bonds rated in the range [A+, A, A-] and denominated in different European currencies.

When looking at yields over the past five years, the Insurance “complexity premium” stood at 100bps more than corporate indices with similar rating and duration. This level remains valid today, making it a very attractive entry points for investors.

The same applies when comparing Insurance Bonds yields to benchmark risk free rates. The average Insurance Bond (EUR) currently yields between 5% and 6.5%.

Figure 3: Insurance Bonds vs Governments



Source: Twelve Capital. As at 2 August 2023.

Twelve believes that Insurance yield differential over-compensates investors given the inherent nature of the sector:

High Credit Quality and Low Risk of Default: Investment Grade Insurance Bonds are issued by companies with strong credit ratings. These issuers are deemed to have a low risk of defaulting on their debt obligations.

Diverse Issuer Base: The insurance sector can be segmented into various categories from Life, Non-Life, Reinsurers and Multi-line. Therefore, good diversification can be achieved by allocating to different lines of business and geographies from a wide range of well-established issuers.

Lower Volatility: Insurance Bonds generally exhibit lower price volatility compared to riskier assets, such as equities or high-yield (junk) bonds. This makes them suitable for investors seeking capital preservation and stability in their portfolios.

Lower Interest Rate Risk: Given the diversity of bonds that insurance companies can issue, from perpetual to bullet structures, portfolios can be constructed to optimise duration management.

Fundamentals provide insulation should the macroeconomic environment deteriorate

Furthermore, Twelve Capital maintains its confidence in the insurance sector's ability to withstand a weak macro backdrop and benefit from a “higher for longer” interest rate environment.

Several factors contribute to the resilience of insurance groups:

- Enhanced regulatory oversight, exemplified by the introduction of Solvency II in Europe since 2016, which includes regular stress testing to evaluate the sector’s resilience against various market shocks.
- The industry's response to heightened regulation, involving substantial investments in enterprise risk management capabilities, strengthening of balance sheets, and improved earnings quality.
- The insurance sector’s high levels of solvency capital, strong financial flexibility (with relatively modest debt leverage and solid fixed charge coverage), and ample liquidity.

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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About Twelve Capital

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