Bank+InsuranceHybridCapital Briefing

Insurers pass initial test of resilience, but unknowns could impact solvency ratios

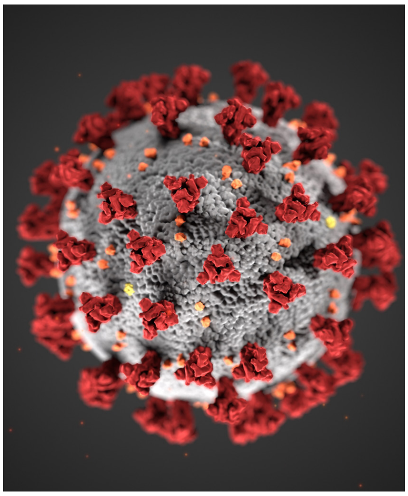
Insurers have weathered the initial impact of the Covid-19 pandemic, but second round effects could put pressure on solvency ratios. *Neil Day* surveys the industry's health, with insights from Crédit Agricole CIB's Michael Benyaya and Julien de Saussure of Edmond de Rothschild Asset Management (France), while CACIB FI syndicate appraise the market impact.

First, the good news: over a month into the most testing time for the global economy since the Great Depression, all but one of the largest insurance markets covered by S&P Global Ratings remained on stable outlook.

In a research note, *Covid-19 will test insurers' resilience*, published on 25 March, S&P highlighted that the industry's average rating of A is the highest of any corporate or financial services industry it rates, and that the capital strength typical of the insurance sector will help it stave off widespread downgrades in the face of the pandemic.

Within Europe, Solvency 2 ratios stood at around 200% or greater before the coronavirus struck, notes Michael Benyaya, DCM solutions, Crédit Agricole CIB *(see tables below and on page 5 for further details)*.

"The majority of insurance companies entered the crisis in a position of strength," he says. "And the sensitivities they have published generally show that Solvency 2 ratios are quite resilient to market shocks, so for now insurance companies seem able to weather the storm."



European insurers' regulatory solvency ratios decreased by around 20 percentage points on average from the beginning of 2020 to the end of the first quarter, according to Moody's estimates, although it noted that the ratios remained at "strong levels" of around 190% — which Benyaya says is backed up by interim announcements from the insurers themselves.

The bad news is that the strength of insurers' business models and capital buffers are set to be tested by a macroeconomic backdrop and financial market stresses that remain an unknown quantity.

S&P says the greatest "pain point" for the industry's creditworthiness is disruption to financial markets.

"The actual market shocks we are observing — particularly for equities and corporate bonds — go beyond the reported sensitivities," says CACIB's Benyaya, "and we have no idea of the behaviour of the Solvency 2 ratio in such a scenario.

"We suspect that there is a very high level of convexity," he adds, "so if we are beyond the reported sensitivities, it is very likely that the shock to the Solvency 2 ratio will be meaningful."

Moody's incorporated a 100bp increase in spreads in its estimates, double the 50bp typically used in insurers' reported sensitivities (although a 10bp swap rate fall versus a typical 50bp), but agrees solvency ratios remain very sensitive to potential further reductions in interest rates and to potential spread widening. It noted that European Central Bank and government stimulus measures — such as the ECB's Pandemic Emergency Purchase Programme (PEPP) — are providing some relief, but that corporate bond spreads remain elevated, while some government bond spreads have also increased.

The rating agencies themselves could be the harbingers of second round negative effects on Solvency 2 ratios in the

Interim Solvency 2 ratios

	Year-end 2019	Interim	as of	Other comments
Aegon	200%	190%	19-Mar	Pandemic sensitivities: Asian Flu 1957 -2% pts; Spanish Flu 1919 -18% pts
Aviva	206%	175%	13-Mar	
Generali	224%	200%	6-Mar	
Groupama	178%	150%	14-Mar	
La Mondiale	221%	221%-215%	20-Mar	negative impact of 0% pts to -6% pts
Legal & General	174%	164%	28-Feb	
M&G	176%	166%	6-Mar	
Munich Re		-	-	200 year event worldwide pandemic: max EUR1.4bn in life and health insurance claims
NN	218%	210%	13-Mar	
Talanx	211%	150%-200%	20-Mar	"comfortably within our target range of 150% to 200%" (net of transitional)

Source: Crédit Agricole CIB

form of downgrades of corporate bonds that are already underway and set to hit insurers' figures in the coming months and quarters.

"The interest rate, spreads and equity shocks affect the solvency position in real time," notes Julien de Saussure, fund manager at Edmond de Rothschild Asset Management (France) (EDRAM), "but the solvency impact stemming from the rating migration will take more time to materialise."

Should insurers' capital buffers deteriorate further, greater proximity to mandatory coupon deferral triggers could exert pressure on S&P's ratings of some hybrids, following changes to its criteria in July 2019. Under the new methodology, a Solvency 2 ratio below 165% could result in a wider notching between insurers' ratings and their hybrids' ratings to reflect a higher risk to coupon payment.

"We are closely monitoring the solvency ratios and their sensitivity to market movements for those issuers that have issued rated hybrids that include these mandatory deferral features," says S&P, noting these are most common in EMEA and Bermuda.

Claims manageable, clamour unpredictable

While S&P considers life insurers to be more at risk of negative rating actions than non-life players because of larger exposure to financial market risk, it considers mortality and medical claims to be manageable.

For example, a hypothetical US life insurance industry stress test based on a "moderate" mortality stress similar to 1957 Asian flu would result in additional mortality claims equivalent to about 2% of capital in the US life market, according to S&P analysis, while a "severe" mortality stress based on 1918 Spanish flu would result in additional claims equivalent to 12% of capital ($52bn).

Moody's says claims increases across the industry should in general remain manageable unless the lethality of the virus increases, but nevertheless has changed the outlook on the UK and Italian life insurance sectors from stable to negative. Among the largest markets S&P covers, the only one on negative outlook is Asia-Pacific primary life insurers.

Although the pressures facing insurance companies are lessened by the fact that pandemic-related claims are excluded from most business interruption policies, some observers warn that insurers could be drawn into costly ad hoc measures in response to the pandemic and its effects.

"For now, claims look to be fine," says CACIB's Benyaya, "but what happens if insurers are called upon to participate in the collective effort, so to speak? Perhaps governments will ask insurance companies to provide greater support to the population, for example, by extending initial guarantees or minimising premiums.

"If that were to happen, the impact could be quite meaningful."

French insurers have already contributed €200m to a special solidarity fund to maintain guarantees for corporates late in paying premiums and to cover some sick leave normally excluded from their policies, notes Moody's, while S&P highlights that in the US legislation to extend business interruption policies retroactively to cover virus-related losses was floated in one state.

Insurance companies have at the same time not benefited from anything like the degree of forbearance measures that authorities have granted in favour of banks, such as capital relief and the postponement of Basel IV.

"Banks benefit from regulatory forbearance because they are used by governments to channel credit to the real economy," says de Saussure at EDRAM. "This is less true for insurance companies, and regulatory measures have been limited so far."

Among the few initiatives that have been undertaken, he cites a reduction in the country-specific volatility adjuster in Italy, which mitigates for insurers the impact of severe BTP volatility. Elsewhere, the only respite offered to insurers

Supervisory actions

Authority	Measures
EIOPA	Deadline of the holistic impact assessment for the 2020 S2 review delayed to 1 June 2020
	Competent authorities should accept an 8-week delay in the submission of the YE-2019 Regular Supervisory Report both at solo and group level
	Competent authorities should accept one week delay in the submission of the Q1-2020 Quantitative Reporting Templates and the Quarterly Financial Stability reporting both at solo and group level (8 week for the Derivatives Transactions)
	EIOPA urged (re)insurers to temporarily suspend all discretionary dividend distributions and share buy-back and recommends a prudent approach to the variable remuneration
France	EUR10bn public resinurance scheme for credit insurance
	Public reinsurance for export credit capacity increased to EUR2bn
	ACPR published a statement to call insurance companies under its supervision to refrain dividend payments until 1 October 2020
Germany	Extended deadline of supervisory reporting and public disclosure
Italy	Reduced the requirements for applying the country-specific volatility adjustment (VA)
Netherlands	De Nederlandsche Bank asks insurers to temporarily suspend dividend payments and share buyback
UK	The PRA said it considered EIOPA's recommendations and will accept the delays in terms of supervisory reporting and public disclosures as indicated
	Transitional Measures on Technical Provisions (TMTP) relief for insurers
	PRA expects firms to be prudent in deciding on dividend payments or variable remuneration in view of the elevated levels of uncertainty presented by coronavirus and its impact on the global economy

Source: Crédit Agricole CIB

Market 'wide open' as insurers outperform banks in rebound

The insurance sector's apparent health entering the crisis has not offered it immunity from the volatility and widening that have struck financial markets, according to André Bonnal, FI syndicate at Crédit Agricole CIB.

"Insurers have not escaped seeing their spreads being stressed," he says, "and that's been the case across the whole capital structure, be that senior, Tier 2 or the RT1 space, which — similarly to AT1 — has been extremely bruised."

In keeping with past performance in strong credit market moves, the sector underperformed banks during financial markets' initial capitulation in the face of the coronavirus. However, Bonnal notes that more recently the insurance sector has outperformed banks, with the differential between their key iBoxx indices widening from a tight of 50bp in February to as much as 100bp, before narrowing to some 20bp *(see chart)*.

He attributes this to two factors. Firstly, the ramping up of ECB QE, with senior insurance paper eligible for the corporate sector purchase programme (CSPP) and PEPP.

"That helped erase a lot of the insurance widening," says Bonnal. "Euro insurance Tier 2 cannot but perform when you have the direct impact of the Eurosystem on the euro senior market."

The second reason behind the relative improvement in insurance spreads versus banks, he adds, is the vulnerability of bank Tier 2 ratings to downgrades that could see them become sub-investment grade or split-rated.

In spite of the sector's positives and the reopening of the euro market for a range of asset classes, insurers are yet to test investor appetite in the new environment, with no supply since as far back as January. But Bonnal says the market is wide open should any insurer step forward.

"The fact we haven't seen any supply is in itself a strong support," he says. "If you are a Eurosystem-eligible name, you are going to get direct traction from that, and even if you are not eligible you are going to indirectly benefit.

"And we've seen from the corporate side that essentially all tenors are open."

The US dollar market has already seen a resurgence of insurance supply in recent weeks. MetLife and Aflac, for example, each sold $1bn 10 year issues on 19 and 30 March at Treasuries plus 350bp and 295bp, respectively, as markets recovered from the record falls in equities, and non-US names AIA and Prudential following as the US supply tightened.

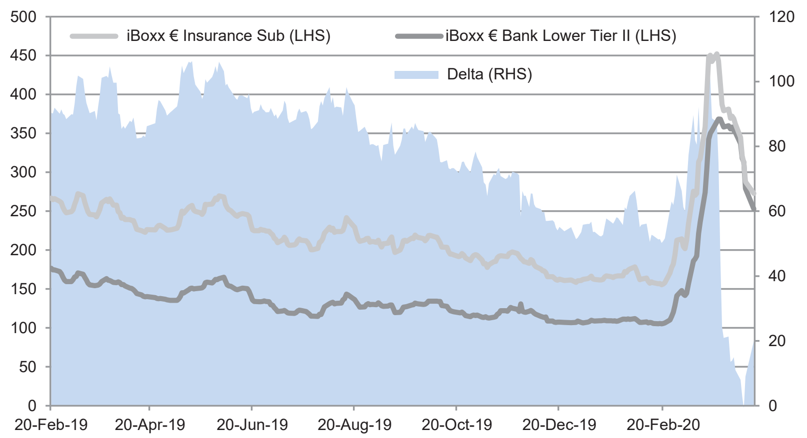
"All the deals were very well received and have performed well on the secondary, underscoring the deep bid for this rare paper," says Fadi Attia, managing director, US dollar FIG, at CACIB. "Relative value is also attractive compared to the US bank paper that has come to market in big size during the same period.

"The Investor bid has been strongest in the long end of the curve — 10 years and longer — which has dovetailed well with issuer needs in this space. The funding dynamic has been similar to other sectors, namely borrowers taking advantage of significant cash on the buyside, a robust enough market window, and the opportunity to bolster their liquidity."

Bonnal says the next step in the market reopening, for either the euro or US dollar market, is a subordinated trade.

"It was perhaps a bit premature last week, but after the recent insane rally on credit spreads, it's impossible to say that a subordinated trade would not work in the current market," he says, "especially as the underlying Covid-19 situation continues to show signs of improvement." ●

Insurance sub debt vs. bank Tier 2



Source: Markit, Crédit Agricole CIB

has mainly come in the form of week to months long delays to various reporting requirements.

Benyaya at CACIB attributes the muted response partly to the lack of a single Europe-wide supervisory mechanism for the insurance industry, contrasting this to the banking sector, where the regulatory relief was also announced in conjunction with the ECB's PEPP.

Cautious confidence on refinancing

The mitigated impact of the pandemic on insurers' businesses and their capital strength are cited by rating agencies and others as reasons to be relatively relaxed about any impact of financial market disruptions on their liquidity and capital positions.

Moody's, for example, notes that although delayed premium payments and lower levels of business activity will likely reduce insurers' liquidity, they hold substantial volumes of liquid assets — even if some have lately increased illiquid investments — and the rating agency says European insurers face little refinancing risks in the short term.

And CACIB's Benyaya says insurers' solid solvency positions mean that substantial capital-raising exercises are unlikely to materialise yet.

"But as the situation develops, I would not be surprised if here and there we see some capital-raising mostly in the form of sub debt," he adds, "if and when the market reopens, of course."

See market box for more.

S&P notes that the first insurance issuance to have occurred since the onset of the crisis — in the US market — has had to pay higher spreads, suggesting some insurers may turn to liquidity programmes such as credit facilities or commercial paper programmes to ease any pressures in the difficult environment, with short term implications for leverage.

"If bond issuances dry up for a significant period of time," the rating agency adds, "insurers with bonds due to mature during that time could face some capital pressure if they cannot refinance them. Where instruments are up for call, insurers risk alienating investors if they decide against the call due to refinancing risk."

S&P says it will closely monitor the capital positions of issuers with forthcoming calls or maturities, but notes that many insurers took advantage of low rates to prefinance.

De Saussure at EDRAM says extension risk in the insurance sector is lower than for banks, some of whom have, for example, already extended Additional Tier 1 instruments.

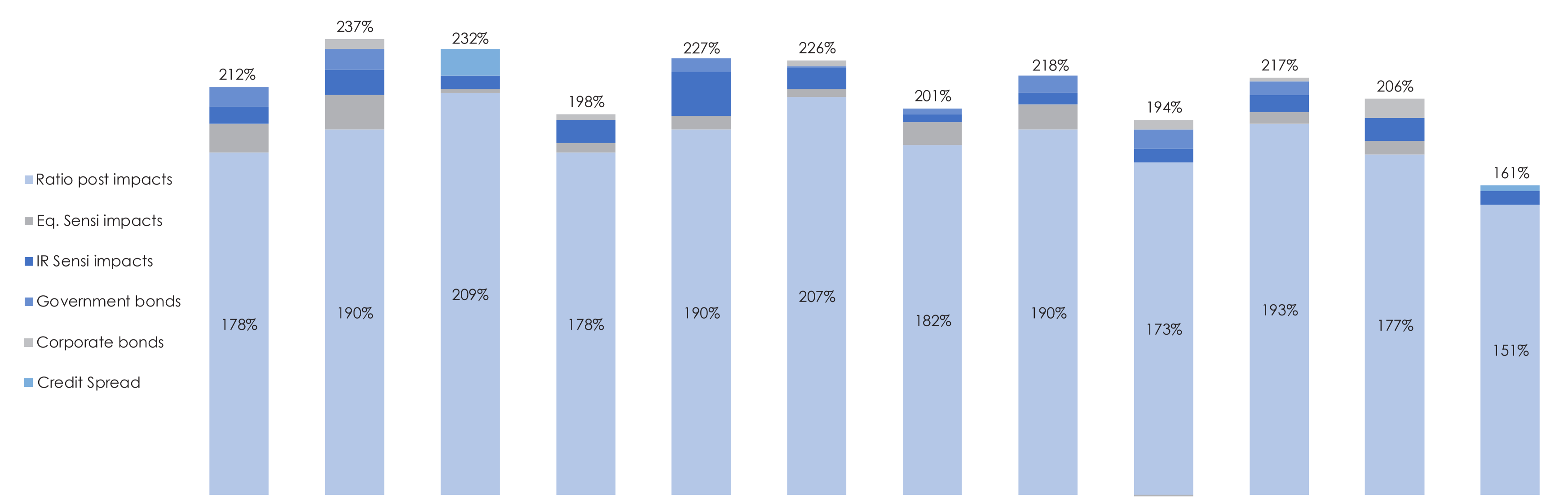
"The existence of the 100bp step-up, the amount of Solvency 2 grandfathered instruments in the insurance market, and the recent Tier 2 call by AXA show that extension risk is limited in the insurance space, despite the change in S&P criteria that reduced the minimum required residual maturity to 10 years."

Another flashpoint for bank sub debt that has not yet played out in the insurance sector is dividend cancellation to conserve capital. Observers note, again, that while the ECB was in the position to recommend this of banks, the issue is dealt with piecemeal across Europe in the insurance industry.

EDRAM's de Saussure nevertheless notes that any decisions in this regard will need to be monitored.

"The dividend debate in the insurance space also has implications for Tier 2 subordinated debt holders," he says, "as the optional deferral remains subject to a dividend pusher." ●

Solvency 2 ratio resilient to reported sensitivities, but convexity unknown (last reported ratios)



	Allianz	Munich Re	Talanx	Axa	CNP	SCOR	Aegon	NN	ASR	Ageas	Aviva	Phoenix
Sensitivity scenario as communicated												
	IR -50bp Equity -30% Spread +50bp	IR -50bp Equity -30% Spread +50bp	IR -50bp Equity -30% Spread +50bp	IR -50bp Equity -25% Spread +50bp	IR -50bp Equity -25% Spread +50bp	IR -50bp Equity -25% Spread +50bp	IR -50bp Equity -25% Spread +50bp	IR -50bp Equity -25% Spread +50bp	IR -100bp Equity -20% Govt +50bp Corps +75bp	IR -50bp Equity -25% Spread +50bp	IR -50bp Equity -25% Spread +50bp	IR -88bp Equity -20% Spread +50bp
Interest rate	-9%	-13%	-7%	-12%	-23%	-11%	-4%	-6%	-7%	-9%	-12%	-7%
Equity	-15%	-18%	-2%	-5%	-7%	-4%	-12%	-13%	1%	-6%	-7%	4%
Government	-10%	-11%	na	na	-7%	-1%	-3%	-9%	-10%	-7%	na	na
Corporate	4%	-5%	na	-3%	8%	-3%	6%	6%	-5%	-2%	-4%	na
Global	na	na	-14%	na	na	na	na	na	na	na	na	-3%
Post-impact S2 ratio vs. S2 targets (based on year-end 2019)												
S2 ratio post-negative impacts	178%	190%	209%	178%	190%	207%	182%	190%	173%	193%	177%	151%
Higher end of target range	na	220%	200%	220%	na	220%	200%	na	na	na	180%	180%
Lower end of target range target floor	180%	175%	150%	170%	na	185%	150%	na	160%	175%	160%	140%

Source: Crédit Agricole CIB