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Insurance outlook 2022: industry 'well placed' to face regulatory, rating challenges

IFRS 17 and a revised S&P model are among challenges the insurance sector will have to tackle this year, even if they have weathered the Covid-19 pandemic well. ESG is meanwhile rising up the agenda, and the interest rate environment could see insurers bringing forward issuance plans. *Neil Day* reports, with insights from Crédit Agricole CIB DCM solutions and advisory, and syndicate.

Insurance companies are entering 2022 on a stable footing, according to the rating agencies. The health of the industry is reflected in both their individual ratings of insurers, and their outlooks for the main sectors.

For life, P&C and reinsurance, all Moody's and S&P's outlooks are stable, with the exception of Moody's having a negative outlook for P&C and S&P negative for reinsurance, while Fitch's outlook for the latter is "improving". At least 80% of each rater's outlooks for insurers are stable, with the remaining positive and negative outlooks evenly balanced.

"Insurance companies have proven pretty resilient," says Michael Benyaya, co-head of DCM solutions and advisory at Crédit Agricole CIB (CACIB), "and were on track to end 2021 in good shape in terms of capital position. This is reflected in the level of comfort the rating agencies have with the sector."

Moody's, for example, noted in its global outlook for life insurance that European insurers' solvency ratios are stabilising at a higher level entering 2022 as a result of higher interest rates, after having fallen amid the pandemic. As well as higher rates, the economic recovery is helping the sector, while many companies have been able to raise prices. The reinsurance sector is meanwhile benefiting from diminished Covid-19 claims uncertainty.

The inflation seen in conjunction with higher rates is, however, seen putting some pressure on parts of the industry. Moody's noted in its P&C outlook, for example, that elevated inflation will push up the average cost of claims, while pandemic-related improvements in insurers' financial results in 2020-2021 will magnify social and political resistance to price increases this year, with intense competition also deterring issuers from raising prices.

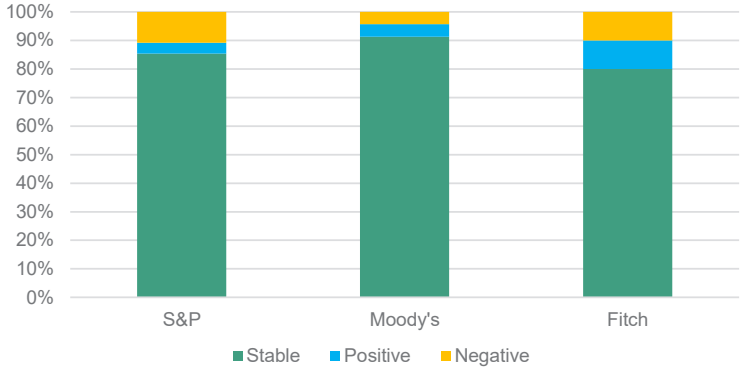

Photo: Isolino Ferreira/Flickr

But overall, the view from the rating agencies is encouraging.

"S&P Global Ratings considers EMEA insurers to be well prepared for the challenges of 2022," it said in its outlook for the year. "Their capital surplus has largely recovered, and now stands at 92% of its pre-pandemic level. For the EMEA insurance sector in aggregate, capitalization is 9% above the AA category, which supports our current ratings.

"EMEA insurers are well prepared for the current and upcoming challenges."

Breakdown of rating outlooks as of end-November 2021
(>80% stable outlook)



Source: Rating agencies, CACIB

IFRS 17: Choose wisely

Among the challenges facing the sector is IFRS 17, which will finally enter into force on 1 January 2023 together with an opening balance sheet (2022 comparative year).

"That will for sure be a major challenge for insurance companies," says Benyaya at CACIB, "notably in terms of financial communications, because a number of KPIs will be affected by the introduction of IFRS 17. And there is some leeway in the transition to the new standard, so insurance companies will have important policy and management decisions to take.

"These management choices will impact their financial reporting, which will result in challenges for investors in terms of comparability of KPIs."

For example, return on equity could be calculated either including or excluding the new Contractual Service Margin (CSM) element. Other important policy choices to be made include transition methodology and what to take through P&L or other comprehensive income.

"This will impact the future shape of financials," says Benyaya.

The introduction of the Risk Adjustment element as well as the CSM will meanwhile lead to potentially higher volatility and, particularly in the life sector, lower equity in the IFRS 17 balance sheet.

However, the new standard is not in itself expected to impact the ratings of insurance companies, even if changes to some metrics may be required.

"Rating agencies will have to adapt their criteria and have already communicated on some potential adjustments, with a key focus being the CSM," adds Benyaya. "But rating criteria are supposed to be applicable across accounting frameworks, and there are parts of the world like the US, for example, that are not under IFRS 17 and have the same rating criteria.

"Furthermore, Solvency 2 is now pretty well established in Europe and is a key part of insurance reporting, including for the rating agencies."

Potential lower equity under IFRS17

Source: CACIB

S&P update 'a major event'

The industry can expect rating actions on up to 10% of S&P Global's ratings in the insurance sector, after the rating agency flagged the possible consequence of proposed changes to its risk-based capital model for insurers and reinsurers on 6 December. A consultation on the proposals is open until 18 March.

Insurers will be busy understanding and assessing the magnitude of the changes proposed by S&P, according to Benyaya.

"It's a major event for the sector," he says. "Firstly, because S&P's capital model is a key part of the capital management for insurance companies. And secondly, because the last version of the model was published almost 10 years ago and the scope of the changes is very large.

"S&P is proposing many adjustments, both in terms of eligible capital and in terms of required capital."

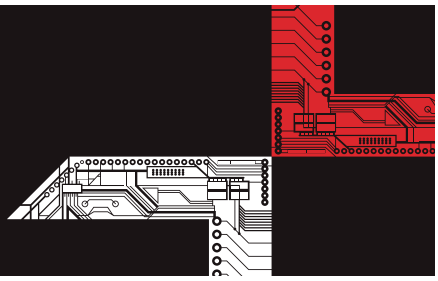
The rating agency anticipates a material impact on its capital and earnings assessment, with changes in this key rating factor foreseen for up to 35% of insurers, in turn affecting up to 20% of standalone credit profiles. According to S&P, the majority of rating changes would be by one notch, with more upgrades than downgrades.

"We anticipate potential improvements in capital adequacy for some insurers, primarily due to our proposal to capture diversification benefits more explicitly and due to increases in total adjusted capital (TAC), owing to the removal of various haircuts to liability adjustments and not deducting non-life deferred acquisition costs," said S&P. "On the other hand, some insurers could face declines in capital adequacy because of factors including changes to our methodology for including hybrid capital and debt-funded capital in TAC, as well as the recalibration of our capital charges to higher confidence levels."

Key proposed changes include:

Hybrid capital and debt-funded capital

- No changes to the hybrid criteria but some adjustments and new limits are introduced in the proposal.
- Debt-funded capital eligible in TAC is defined as proceeds of a non-operating holding company (NOHC) debt issuance that are downstreamed as common equity or S&P -eligible hybrid capital, and where the structural subordination is considered to be high. The subordination is "high"



where the NOHC is outside of the regulatory perimeter (which is *not* the case in Europe and Bermuda for example).

- Hybrid eligibility in total adjusted capital is now based on adjusted common equity (ACE). For example, the updated tolerance limit for intermediate equity content hybrids, at 33% of ACE, is broadly equivalent to 25% of TAC (the previous limit).
- S&P also aligns the tolerance limits on a global basis.

Diversification benefits

- More explicitly capturing diversification benefits by revising the confidence levels to calibrate risk charges and updated correlation assumptions.

Up to 100% Value of In-Force in TAC

- S&P is proposing to include up to 100% of VIF in TAC (vs. 50% under the current approach). VIF can reflect values that are shown in other reports (e.g. EV report) or on balance sheet.
- Under IFRS 17, the contractual service margin and the life risk adjustment are viewed as eligible under VIF.

Narrower definition of policyholders' capital eligible in TAC

- Eligible policyholders' capital is available to absorb losses across the entity; not restricted to absorbing losses in a segregated, or ring-fenced, fund and it does not relate to the expected value of future discretionary benefits included in technical provisions.
- Participation aux excédents (PPE) in France or freie Rückstellung für Beitragsrückerstattung (free RfB) and terminal bonus in Germany are eligible according to S&P.

New pandemic risks capital charge

- New charge to capture excess mortality losses due to pandemic risks.

Solvency 2 review, IRRB pending

Longer term, the Solvency 2 review is an ongoing preoccupation of the industry. Following EIOPA's opinion in December 2020, the European Commission in September 2021 adopted its comprehensive review package, but the legislative process and finalisation of the initiative is not anticipated until at least 2024.

Although the Commission proposals largely mirror EIOPA's, differences between the two mean that the September package is more balanced, according to Benyaya. A figure of €90bn of capital relief has been touted in the market, but he notes that this is a gross number also reflecting the short term impact, and says the net impact, including the phase-in of changes in respect of interest rates, will be €8bn.

Michael Benyaya, CACIB: 'The phase-in periods will help to smooth the impact'

"Factoring negative interest rate in the IR risk sub-module and the change in the extrapolation approach will have sharp negative implications," he says. "The phase-in periods will help to smooth the impact.

"But for 2022, I don't expect that it will impact the way insurance companies manage their balance sheet," he adds.

The proposed Insurance Recovery & Resolution Directive (IRRD) is meanwhile expected to have only limited credit and rating implications for insurers and the instruments they issue, given that — unlike the Bank Recovery & Resolution Directive (BRRD) — there is no requirement for a minimum amount of bail-in-able liabilities. ●

Key S2 items	Proposed change	Impact on capital resources* (€bn)	Countries to watch
Extrapolation	Change of extrapolation method and better reflection of market rates (long phase-in until 2032)	-73 *(Impact for «Changes on interest rates in the EC Impact assessment»)*	🇩🇪 🇳🇱
Interest rate risk sub-module calibration	Reflecting the existence of negative interest rates in the standard formula (floor at -1.25%) Phase-in over 5 years		🇩🇪 🇫🇷
Volatility Adjustment	VA to be split into a permanent VA and a macro-economic VA (overall positive)	+45	🇫🇷 🇮🇹
Dynamic VA	Introduction of a DVA prudency principle which frames the DVA benefit	-	🇳🇱 🇫🇷
Risk Margin	Lower and less volatile risk margin (reduction of the cost of capital to 5%)	+16	🇳🇱 🇧🇪
Equity (standard formula)	Lower capital charge for long term equity holdings	+10	🇪🇺

**Impact shown for the European Commission's Option 3, i.e. including the phase-in of the interest rates calibration and extrapolation measures.*

Climate stress tests point the way, 'bolder' issuance anticipated

ESG factors are expected to be an increasing focus for insurers in 2022, with climate-related stress tests and potential capital charges on the horizon, and both the volume and nature of sustainability-related bond issuance set for exciting developments.

"ESG is now established as a key strategic angle for issuers and a priority for supervisors," says Alpesh Varsani, executive director, DCM solutions and advisory at CACIB. "It's fair to say that at this stage there is a strong focus on climate risk, mainly in the form of stress tests and ORSA.

Alpesh Varsani, CACIB: 'Insurance companies are behind somewhat compared to the banks'

"But longer term, there is the possibility of the supervisors looking at different capital regimes and requirements based on exposure to such risks."

EIOPA intends to launch a climate risk stress test in 2023 or 2024, and Varsani also cites moves such as ACPR's pilot exercise in France and IAIS's climate change impact study on investments, while in October the UK Prudential Regulation Authority (PRA) said it will this year explore how it might enhance regulatory capital frameworks to reflect climate-related financial risks.

"As we enter 2022, the PRA will switch its supervisory approach on its climate-related supervisory expectations from one of assessing implementation to actively supervising against them," it said.

The European Commission has meanwhile taken steps on two fronts in the Solvency 2 review package in line with its European Green Deal.

It has proposed the introduction of a new Article 45a on climate scenario analysis, whereby insurers will have to identify any material exposure to climate change risks and, where relevant, assess the impact of long term climate change scenarios on their business. (Insurers classified as low-risk profile undertakings are exempted from scenario analyses.)

The Commission has also issued two ESG-related mandates to EIOPA. Firstly, to review new evidence on environmentally or socially harmful investments with a view to potential changes in the Solvency 2 standard formula, and to draw up a report at the latest by 2023.

And secondly, to regularly review the evidence on trends in the frequency and severity of natural disasters and EU (re)insurers' exposure to such disasters, with a view to potential changes in the Solvency 2 standard formula catastrophe risk modules.

SLBs subject to hurdles

The end of 2021 saw a flurry of green bond issuance from insurers — with Talanx issuing a €500m 22 year non-call 11 Tier 2 green debut and Uniqa returning for €375m of green Tier 2 in late November and early December, respectively — helping lift the share of green, social and sustainability bond supply within the sector for the year to 25%.

While growth is expected to continue, the nature as much as the volume of supply could be notable in 2022, according to André Bonnal, FIG syndicate at CACIB.

"What we hear is that a lot of issuers don't necessarily want to go down the traditional route that some of the other insurers have taken, but want to be a little bolder," he says, "and it's going to be quite interesting to see if we start to see some novelties in regards to the way that insurance companies approach the market."

Specifically, sustainability-linked bonds (SLBs) could offer insurers a way to tap into the developing tastes of investors.

"Rather than focusing on green bonds and the use of proceeds in their investment decisions," says Varsani, "they are taking a broader view and looking more at the overall ESG strategy of issuers."

Issuance from banks has so far been constrained by SLB's structure — notably their step-up coupons — running counter to regulations governing capital instruments in the eyes of the European Banking Authority. According to Michael Benyaya, co-head of DCM solutions and advisory at CACIB, the EU insurance framework contains no such obstacle.

"Under Solvency 2, it's probably possible to structure an SLB that will be compliant with the rules," he says.

However, potential issuers could still face a major hurdle in the form of S&P's criteria, adds Benyaya, which would mean that an SLB would not receive any equity credit from the rating agency.

"They consider that a step-up or any form of financial compensation is a drag on the insurance company's cashflow, and therefore does not fit S&P's criteria in respect of the ability to retain cash in a stress scenario."

The PRA is understood to have similar misgivings.

Varsani meanwhile notes that investor focus on the ESG qualities of issuers rather than just their bonds could see ESG ratings in focus for the sector this year.

"Insurance companies are behind somewhat compared to the banks," he says. ●

Interest rate outlook could spur supply

Crédit Agricole CIB insurance specialists expect supply of €20bn-€25bn across all currencies from European insurers in 2022, following issuance of €24bn last year. Another year of such magnitude would again reflect the steady state of the sector, after issuance in 2020 had spiked at €26bn, as issuers' initial reaction to the pandemic was to play it safe and raise additional buffers of subordinated debt in the market.

"The past year felt more 'business as usual' in terms of supply, after a pragmatic 2020," says André Bonnal, FIG syndicate at CACIB, "and this year is probably going to be quite similar, with again some upside stemming from issuers' opportunism."

Issuance is expected to be supported by redemptions, which total €28bn in 2022, with the shortfall partly explained by several companies being in deleveraging mode.

Bonnal says whether volumes ultimately turn out at the upper or lower end of the €20bn-€25bn range will likely depend on developments in interest rates and how issuers react to these.

"Are rates pushing issuers to come earlier rather than later?" says Bonnal. "Or will they just come as and when their needs arise?"

"In that regard, we had a lot of trades post summer 2021 that materialised then and not in 2022 because of the inflation and rate outlook."

This could be particularly relevant for Restricted Tier 1 (RT1) issuance, according to Bonnal, and have the potential to raise the profile of the asset class. Dual-tranche issues of €2.3bn-equivalent from Allianz in both 2020 and 2021 have boosted RT1 volumes in the past two years, but beyond that, the instrument's share of the insurance market remains subdued relative to the dominant Tier 2.

"Even if rates have crept higher, we're still looking currently at overall low levels of rates," he says, "and the question is, to what extent will issuers accelerate looking into the calls of all the grandfathered Tier 1 bonds that were issued in 2014 and 2015, the perp non-call 2024 and 2025 bonds that nearly every European insurer has outstanding?

André Bonnal, CACIB: 'Are rates pushing issuers to come earlier rather than later?'

"That's some time away, but there will be a case for issuers looking to refinance early, and potentially liability management exercises embedded with new RT1 transactions. Hence how RT1 supply is the question mark of the year."

> Investors' bid for duration is clearly subdued

Bonnal nevertheless suggests the rate environment could prompt issuers to consider a structure such as perpetual non-call seven rather than the typical non-call 10.

While the rate outlook could spur issuers' interest in the market, it could prove a limiting factor for investor interest.

"Investors' bid for duration is clearly subdued given the current rate environment and trajectory, while the insurance bid that would normally take over at 10 year and longer tenors is far from being dominant in RT1," says Bonnal, "which potentially poses a bit of a problem for long duration RT1.

"But I don't expect that in reality it will derail the overall demand for the asset class, because it's what will give you the highest yields and spreads while retaining a very good investment grade rating, whether you compare it with banks, corporates or other asset classes.

Indeed, when Axa opened European insurance issuance for the year on 5 January, it went out with initial guidance reflecting a yield above 2% for the €1.25bn 1.875% 20 non-call 10 deal, rated A3/BBB+/BBB, ultimately pricing the new issue at 160bp over mid-swaps, reflecting a new issue premium of 7bp-8bp, on the back of some €2.6bn of demand.

"That kind of yield and rating combination is clearly something that investor have not seen for most of last year," says Bonnal.

"And — just as investors tend to see banks as a good hedge against interest rate rises because higher rates means more profitability for banks — insurance is a sector that would gain from higher interest rates as well," he adds.

Subordinated insurance paper also enters the year on the back of positive performance in 2021, with euro RT1s returning around 2% and euro Tier 2s also slightly positive.

"That compares relatively well with the banking sector," says Bonnal. "And it is a good sign for investors that this is still an interesting sector.

"RT1 is still a good bet for scope for performance," he adds. "It offers quite a decent spread pick-up for the additional risk over Tier 2 that in the insurance space is fairly limited, and in most cases you still retain an IG rating."

Balanced against the attractions of the sector is that it remains quite illiquid, particularly when compared with, for example, bank Tier 2.

"What we hear from investors is that recycling, say, a €40m position can take up to several weeks," says Bonnal. "This is always a bit of a hurdle for investors, who tend to ask for a bit of a premium to reflect it.

"And even if we continue to see more investors looking into insurance Tier 2 and RT1, the sector is not as well covered as banks, and this will remain an issue." ●

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