'BBB-' European Insurance Debt Demonstrates Investment-Grade Performance

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Key Takeaways

- 2020 has demonstrated that despite efforts to reduce risk across the sector, some insurers still have high exposure to asset risk. During the year to date, regulatory solvency positions at European insurers that have debt rated 'BBB-' and below has fallen by an average of about 20 percentage points.
- Some of our recent rating actions have highlighted the potential increased risk that hybrid coupon deferral features could be triggered; this is linked to lower and more-volatile regulatory capital positions.
- That said, management actions, combined with the sound capital levels at the start of 2020, have made insurance debt unlikely to suffer widespread downgrades, in our view.

The unprecedented turmoil in asset prices during 2020 had a knock-on effect on the solvency positions of European insurers. S&P Global Ratings calculates that for European insurers that have outstanding debt rated at 'BBB-' or lower, solvency ratios have fallen by an average 20 percentage points (pps) since year-end 2019. That said, the stabilizing effect of Solvency II countercyclical measures has played a part in mitigating some of the market impact on capital positions.

Hybrid notes often have coupon deferral features linked to regulatory capital positions, but we do not currently anticipate that the erosion of regulatory solvency levels is likely to lead to widespread increases in payment risk for bondholders. Thus far, downgrades have been limited by still-sound capital levels at insurers, risk mitigation features such as equity and interest rate hedges, and issuers' supportive creditworthiness.

We expect these factors will continue to apply, and forecast that the economy will recover from 2021 onward. Therefore, we see little likelihood of a sharp rise in downgrades of investment-grade hybrid debt issues ('BBB-' or higher) to speculative-grade levels ('BB+' or lower). The rise in issuance of 'BBB-' or lower rated insurance debt in recent years mainly relates to hybrid instruments that satisfy the EU's Solvency II regulatory requirements. We rate Tier 2 instruments of this type at least two notches below the issuer credit rating, or at least three notches if they are Restricted Tier 1 (RT1) instruments. European insurers usually issue debt out of the holding company. We typically rate a European insurance holding company two notches below the credit rating on the operating company. Nevertheless, only a few European insurers have outstanding instruments rated 'BBB-' or lower. About 8% of our European insurance hybrid universe is rated in this range, amounting to around €14 billion of issued debt. As of Aug. 5, 2020, only two rated European debt issuances rated 'BBB-' or lower had a negative outlook on the issuer (see table 1).

Table 1

European Issue Ratings At Or Below 'BBB-'

Issuer	Issuer rating	Tier 2 / Preference shares	Restricted Tier 1
Achmea	BBB+/Stable	BBB-	BB+
Aegon N.V.	A-/Stable	BBB	BBB-
Aspen Insurance Holdings	BBB/Stable	BB+	
ASR Nederland N.V.	BBB+/Stable	BBB-	BB+
Hiscox	BBB+/Stable	BBB-	
LVFS Ltd	BBB+/Stable	BBB-	
NN Group N.V.	BBB+/Stable	BBB-	
RSA Insurance Group Plc	BBB+/Stable		BB+
La Mondiale	A-/Positive	BBB	BBB-
Societa Cattolica di Assicurazioni	BBB/Negative	BB	
Sogecap	BBB+/Negative	BBB-	

*As of Aug. 5, 2020.

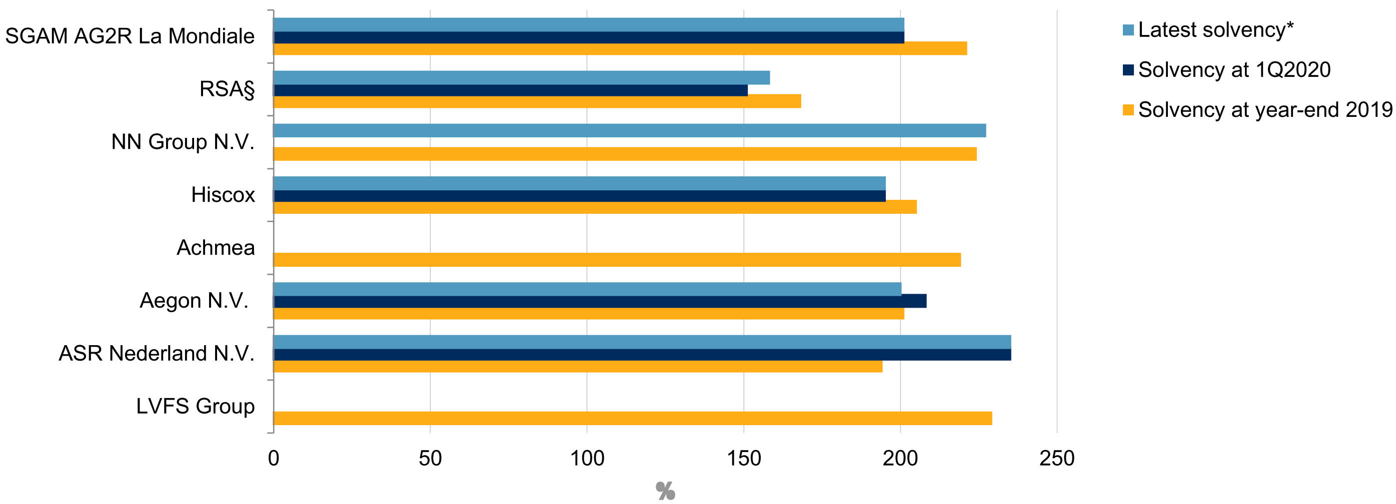
Market Volatility Could Outpace Capital Buffers

During the first quarter of 2020, the solvency ratios of those issuers that have outstanding debt rated 'BBB-' or lower deteriorated by up to 30 pps. Although the recent rebound in global markets helped to mitigate the first quarter and 2020 market shock, the positive effect on regulatory Solvency 2 ratios is likely to be largely offset by the sharp drop in the volatility adjustment, down to 19 pps on June 30, 2020 from 46 pps on March 31, 2020. In addition, at the individual issuer level, the change in the Solvency II ratio has varied widely (see chart 1). Life-oriented insurers that have large balance sheets and mostly traditional guaranteed technical reserves are generally more exposed to market shocks than property/casualty-oriented insurers or life insurers that have mostly nonguaranteed technical reserves.

The scale and magnitude of these solvency movements emphasize how the heightened volatility in market and credit conditions is associated with increased risk for insurers because of their significant asset risk exposures. Data published by the European Insurance and Occupational Pensions Authority (EIOPA) indicates that market risk (which includes spread risk) accounts on average for about 60% of European insurers' solvency capital requirement, and that spread risk is the largest component of market risk. Despite the material swings, the latest solvency positions for these issuers average around 180%, suggesting that they retain some resilience to future volatility. Some issuers suspended dividend payments and share buybacks, which supported their solvency ratios by five to 10 percentage points. Chart 1 shows the changes in the solvency positions of some European insurers that have debt rated 'BBB-' or lower.

Chart 1

Solvency Positions Have Fallen By About 20 Percentage Points
Solvency ratios of some European issuers that have debt rated 'BBB-' or lower



*NN, and Achmea year-end 2019 solvency ratios are including the impact of dividend suspension; Aegon Group Solvency II ratio at the end of April: Estimated at 190%-200% as per company. §RSA at HY2020, Aegon at end of April company estimate 190% to 200%, NN group at end of May. Source: Company reports, S&P Global Ratings. Data may not be directly comparable. Refer to company reports for details.

We also note that Solvency II measures such as the volatility adjustment (VA) and equity dampener have eased the pressure on solvency ratios for some issuers. The sharp increase in the VA in the first quarter of 2020 drove the increase in the Solvency II ratios of ASR and Aegon. Likewise, the above-mentioned decline in the VA after March has dampened the Solvency II ratios of those insurers that had benefitted the most. For example, Aegon indicated that, despite the market rebound, group solvency stood at 190%-200% at end-April 2020. Insurers' own risk management actions, such as interest rate and equity hedges, also somewhat offset their exposures to market shocks.

Until May 2020, the combined drop in the VA and increase in credit spreads on Italian government bonds penalized the Solvency II ratio of Cattolica, because of its heavy concentration to the domestic sovereign. Its Solvency II ratio reached a nadir of 122% on May 12, 2020. As subordinated debt instruments under Solvency II have mandatory coupon deferral triggers linked to a breach in regulatory solvency capital requirements, we consider a lower solvency ratio heightens payment risks for bondholders. We reflected this in our rating action on Societa Cattolica di Assicurazione's Tier 2 notes (see "Societa Cattolica di Assicurazione's Tier 2 Debt Downgraded To 'BB' On Weakening Solvency II Ratio; Ratings Affirmed," published on June 10, 2020).

We are closely monitoring potential capital and earnings risks from falling interest rates, credit spreads, credit migrations, and corporate defaults, especially where matching adjustments have been applied. The risks will be exacerbated if, as we forecast, the nonfinancial corporate speculative-grade default rate increases to 12.5% in the U.S. and 8.5% in Europe by March 2021. This will increase the economic costs of the pandemic.

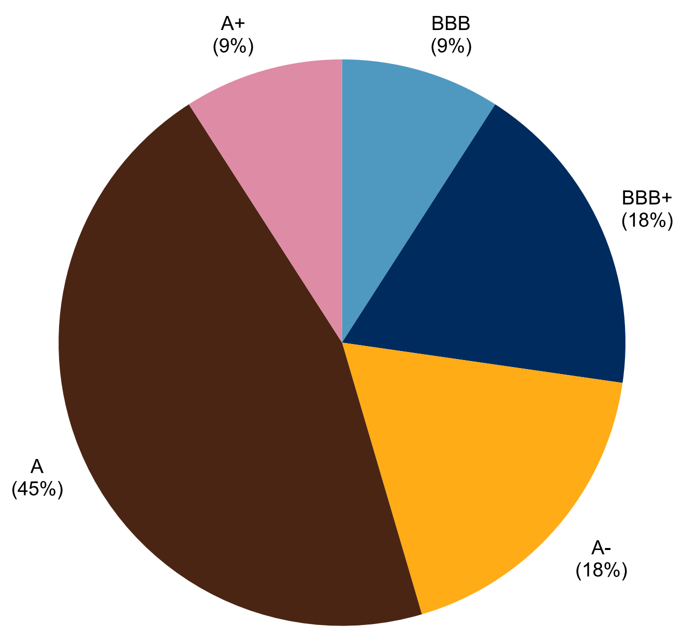
Capital Is Not The Be-All And End-All Of Creditworthiness

If we lower our rating on an issuer, we are likely to lower the debt rating by at least the same number of notches. Although our outlook on the European insurance sector is stable, some insurers are exposed to idiosyncratic risks stemming from their own deteriorating operating performance and balance sheet exposures. Lower-for-longer rates have generally been a key concern for European insurers because they could reduce the amount of capital generated to cover strategic and financial needs and distributions.

Currently, most European insurance issuers that have outstanding debt instruments rated 'BBB-' or lower have a stable outlook. There are three exceptions: Cattolica and Sogecap have a negative outlook; and SGAM AG2R La Mondiale has a positive outlook. We also lowered our rating on Aspen's preference shares to 'BB+' from 'BBB-' in March 2020, in line with our one-notch downgrade of the issuer.

Chart 2

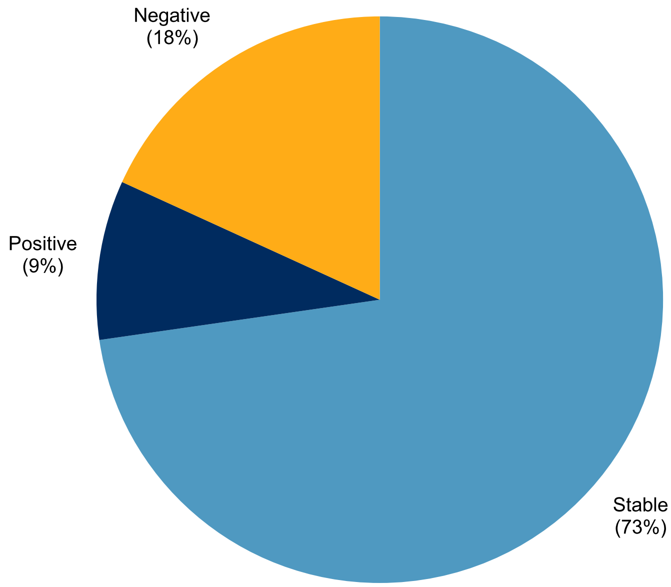
Rating Distribution
Ratings on European issuers that have debt rated 'BBB-' or lower



As at Aug. 5, 2020; Source: S&P Global Ratings.

Chart 3

Outlook Distribution
Outlooks on European issuers that have debt rated 'BBB-' or lower



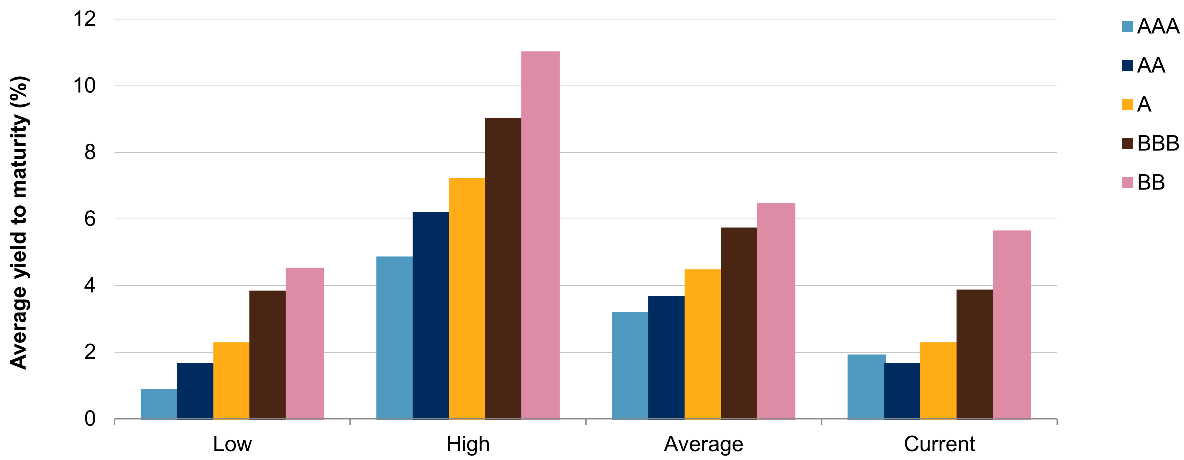
As at Aug. 5, 2020; Source: S&P Global Ratings.

'BB' Category Issue Ratings May Face Rising Yields

Financial flexibility and market access can determine the effectiveness of insurers' capital management strategies. The cost of funding insurers' large balance sheets affects their financial stability and business prospects. The ability to tap into markets at low rates drives insurers' strategies for engaging in mergers and acquisitions, writing capital-intensive insurance business; and building capital surplus, particularly in times of stress. Yields on an insurer's debt issuances reflect the appetite among investors for its bonds as well as the subordination, maturity, and loss-absorbing features of the instruments issued. Currently, market yields for insurers' debt securities are lower than they have been for two decades. However, average yields for the 'BB' category, at 5.6%, are materially higher than the 3.8% available to the more creditworthy securities in the 'BBB' category. It is notable that half of the instruments rated in the 'BB' category are RT1 instruments issued by Achmea, ASR, or RSA (see table 1). RT1 hybrids have much wider loss-absorbing features in case of stress than Tier 2 instruments. As a result, where insurers have issued both types of instrument, the difference in yield can be 100-200 basis points.

Chart 4

Insurance New Issuance Yields Across The Ratings Spectrum
Yields over the past two decades



Data as of July 17, 2020. Source: S&P Global Ratings; Thomson Financial.

Historically, insurance debt has been priced at a premium to other sectors. Investors generally consider that insurance debt carries higher valuation and capital risks, and could be less liquid. Subordinated securities in the insurance sector can also have more complex structures than corporates, with different loss-absorption features and clauses for discretionary coupon deferability. That said, banks' AT1 hybrid instruments are similarly complex hybrid instruments that have loss-absorbing characteristics and were issued in regulated sectors. The yield paid by insurance companies on RT1 hybrid instruments is not materially different from the yield paid by a similarly-rated bank on its AT1 hybrid instruments.

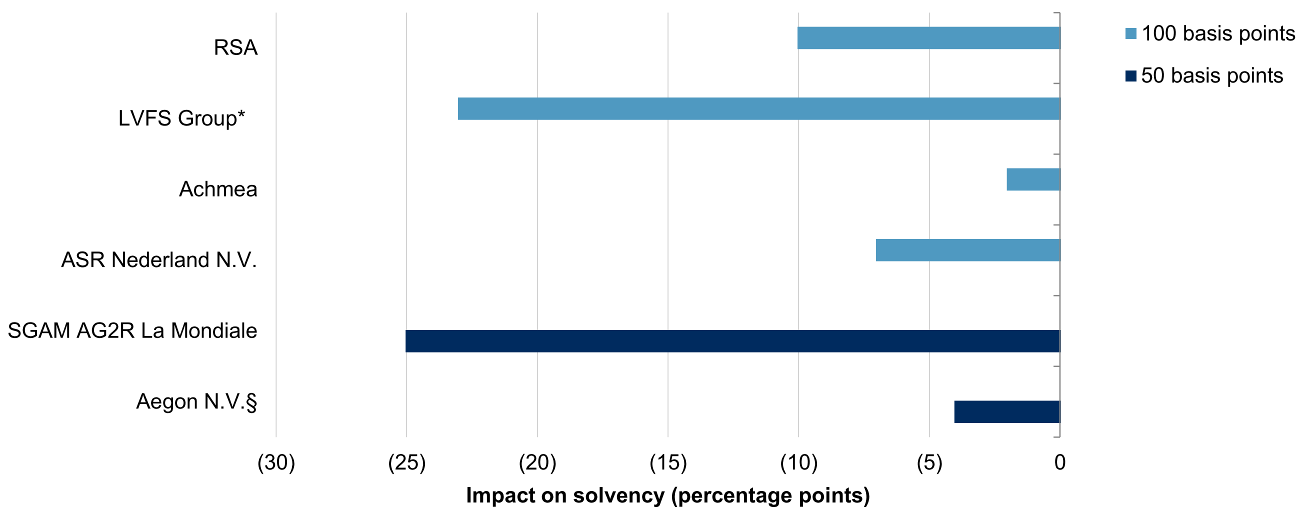
Because investors considered that insurers were exposed to increased risk, insurance yields can balloon during a crisis such as the 2008 financial crisis. Since then, insurance bond yields have gradually declined, especially because of the low interest rates. Insurers could also be benefitting from incremental improvements in reporting transparency, offset by the relative lack of liquidity in the insurance bond markets compared with other sectors, for which investors demand extra compensation. Globally, insurers account for about 4% of total financial and nonfinancial corporate debt, banks account for about one-third of this debt, and nonfinancial corporates for the remainder (as of April 1, 2020). Of the speculative-grade debt outstanding, 87% was issued by nonfinancial corporates.

During the COVID-19 pandemic, those insurers that have debt instruments rated 'BBB-' or below have seen their capital positions deteriorate. Nevertheless, most have been able to comfortably accommodate the change by taking management actions and because they started the year with sound capital positions. Thus, although we see some risks to the downside, there is limited potential for widespread downgrades of insurance debt in Europe.

Appendix

Chart 5

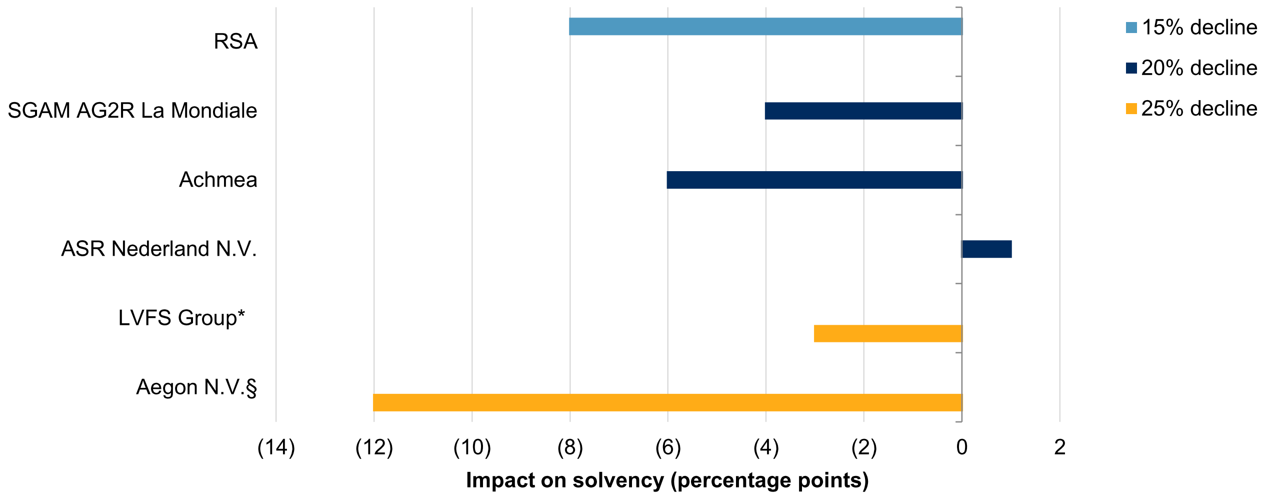
Reported Sensitivity To Fall In Interest Rates
Sensitivities as per year-end 2019



*LVFS sensitivity on investor basis; §Government spread excluding volatility adjustment; RSA sensitivities include pensions. Source: Company reports, S&P Global Ratings. Data may not be directly comparable. Refer to company reports for details.

Chart 6

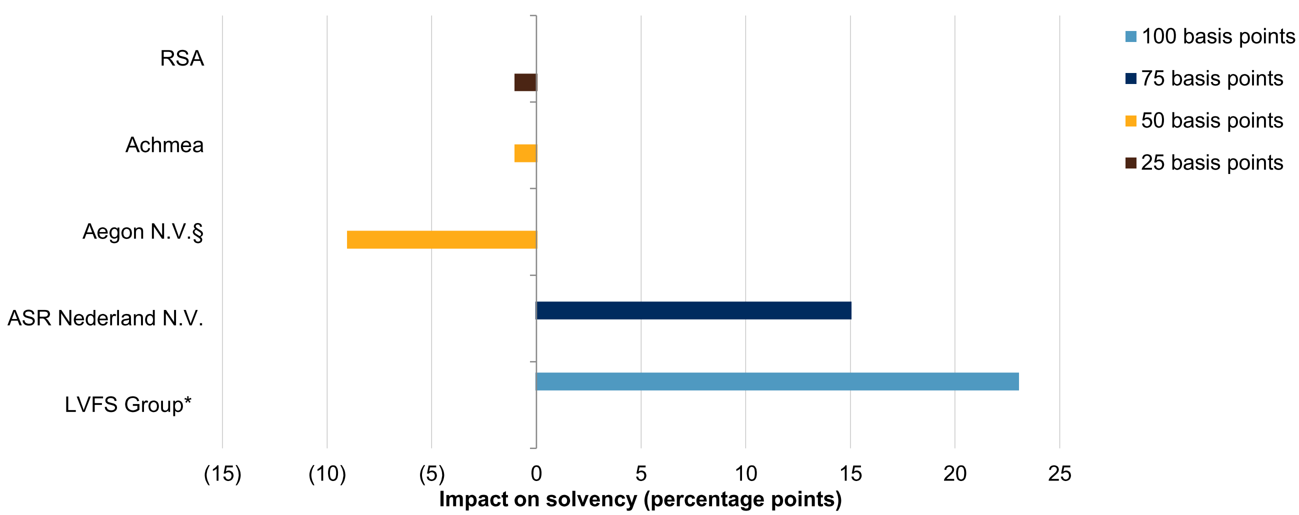
Sensitivity To Equity Shocks
Sensitivities as per year-end 2019



*LVFS sensitivity on investor basis; §Government spread excluding volatility adjustment; RSA sensitivities include pensions. Source: Company reports, S&P Global Ratings.Data may not be directly comparable. Refer to company reports for details.

Chart 7

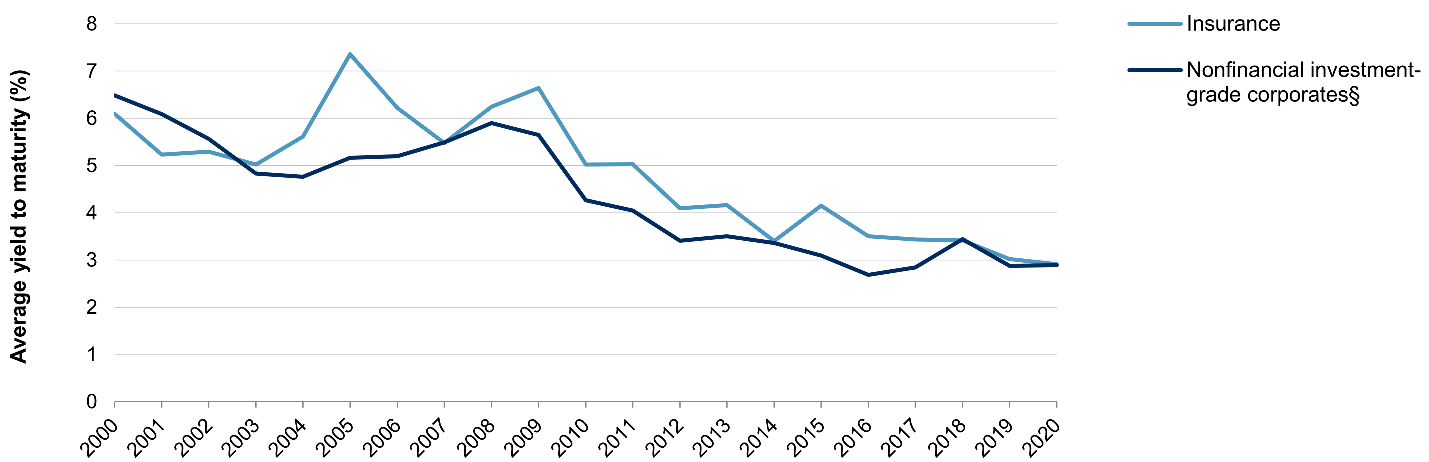
Reported Sensitivity To Widening Credit Spreads
Sensitivities as per year-end 2019



*LVFS sensitivity on investor basis; §Government spread excluding volatility adjustment; RSA sensitivities include pensions. Source: Company reports, S&P Global Ratings. Data may not be directly comparable. Refer to company reports for details.

Chart 8

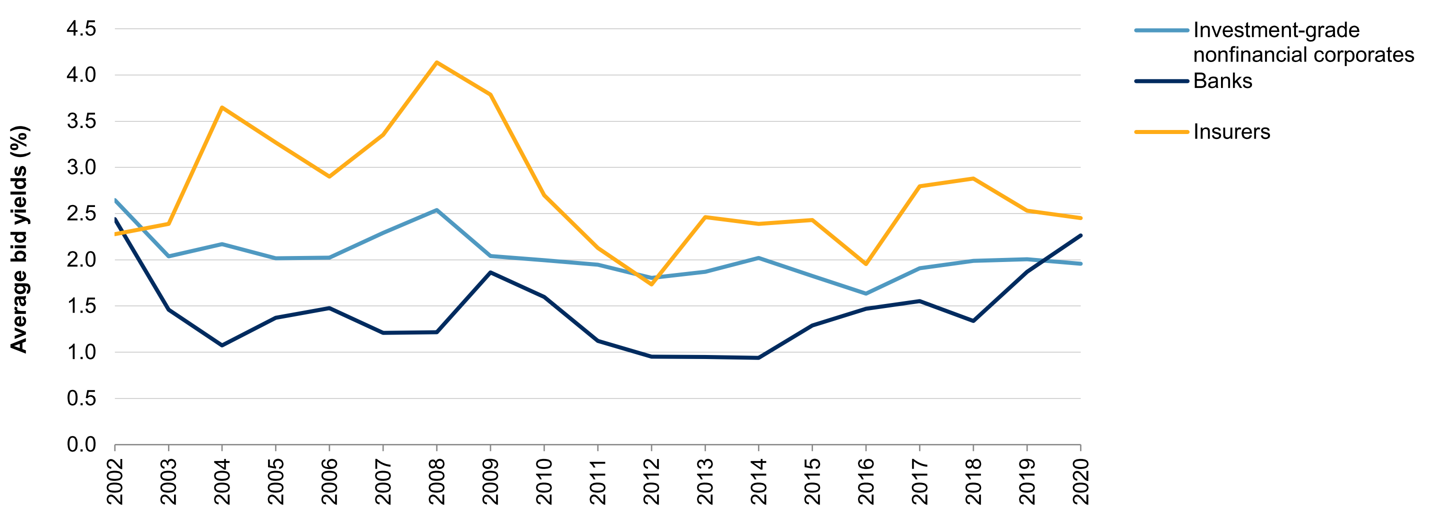
Insurance Bond Yields Are At Their Lowest Levels Over The Past Two Decades*



*Data as of June 1, 2020. §Investment-grade corporate ratings data, based on issuer credit rating. Source: S&P Global Ratings; Thomson Financial.

Chart 9

Bonds Yields For Insurers, Banks, And Corporates*



*Data as of July 1, 2020. §Investment-grade corporate ratings data, based on issuer credit rating. Source: S&P Global Ratings; Bloomberg.

This report does not constitute a rating action.