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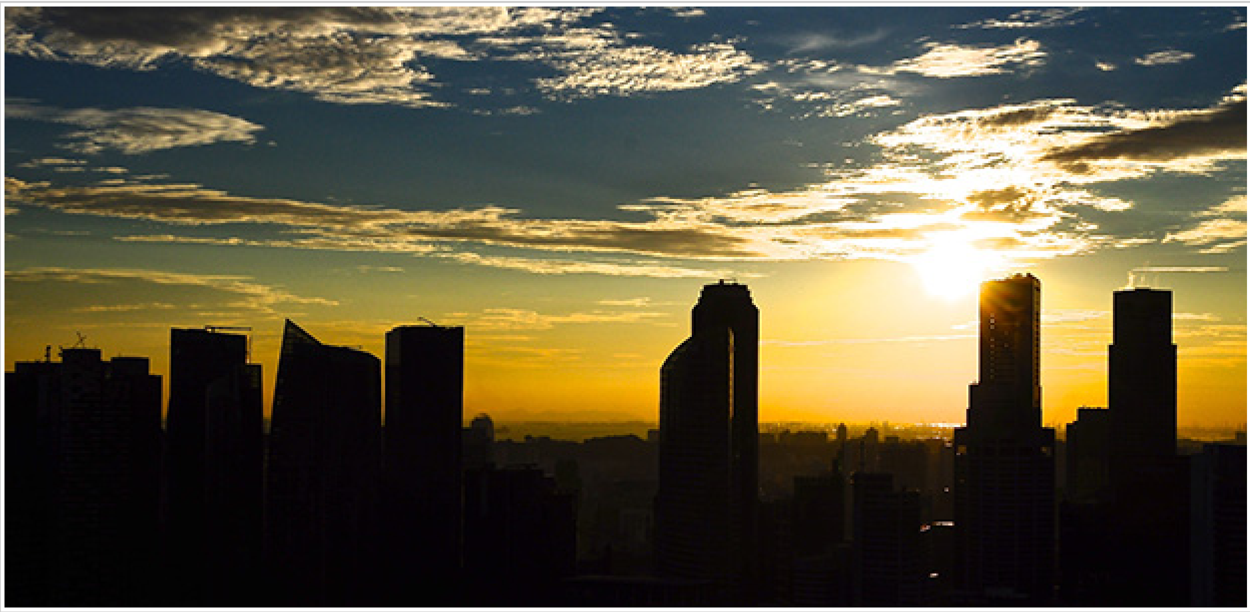
A false dawn for restricted tier 1 debt?

09 September 2016

Published in: Capital, Capital management, Capital markets, Regulation, Solvency II, Rest of Europe

Companies: Insurance Regulatory Capital, Gjensidige Forsikring, Twelve Capital, S&P Global Ratings

The market for restricted tier 1 debt took off last month with an issue by Gjensidige, but may remain subdued for as long as the Solvency II grandfathering provisions last. Hugo Coelho reports



Few investors would have guessed a year ago that Gjensidige Forsikring was going to spearhead the market for Solvency II-compliant contingent debt. The Norwegian insurer sold NOK1bn ($120m) in restricted tier 1 (RT1) notes on 29 August, beating the likes of Aegon, Axa and Generali. Its move defied expectations, but failed to dissipate dim prospects about the evolution of this niche market.

"This was likely a false start for the RT1 market. Until a large European insurer completes a large transaction the market is not really open," says Daragh Clune, chief investment officer at Insurance Regulatory Capital (IRC), a specialist insurance subordinate debt lender owned by Bermudian reinsurer Maiden. "This was a very well structured and very well priced transaction, but it was small in size and it was targeted at the Nordic market, therefore it is difficult to see how this will inform pricing on pan-European issuance," he adds.

> "Insurers will exhaust their tier 2 buckets before issuing RT1 debt" - Darragh Clune, IRC

As more bonds are issued across Europe, confidence will grow, but observers expect the RT1 market to remain modest in size. "There might be some issues going forward, but we do not expect a material volume to come to the market in the coming years," says Vittorio Sangiorgio, analyst at specialist insurance investment manager Twelve Capital.

This contrasts with the evolution of banking sector's equivalent instrument: additional tier 1 (AT1) debt. This has grown rapidly over the years, touching $231.7bn at the end of March according to Fitch, as banks sought to shore up their balance sheets to meet the post-crisis requirements.

Regulators responsible for Solvency II included incentives for insurers to hold highly subordinated debt that could absorb losses when things turn ugly. Firms are required to cover at least half of the solvency capital requirement (SCR) with tier 1 capital. Most of this must be equity, but one fifth can be in RT1 debt instruments. These are defined in the directive as perpetual bonds that can be converted into equity or written down once a regulatory capital threshold is breached.

Legacy issues

Owing to its nature, RT1 is a cheaper form of capital than equity. So why have insurers not rushed into it? And why is no one expecting them to?

The first part of the answer is that insurers need to some time to structure these instruments, given their complexity. In the early days of Solvency II, firms had other priorities, such as getting their internal models up and running.

Anna Hall, Twelve Capital

What is more, first movers would typically pay a premium for having the honour. Capital market volatility in the first half of the year, in particular the doubts about Deutsche Bank's AT1 instrument, would have only increased the price.

From this point, the reasons that prevent the market from growing are varied. The abundance of legacy RT1 capital instruments in many insurers' balance sheets stands out as one major drag. Solvency II allowed firms to grandfather Solvency I-compliant debt instruments issued before January 2015, for a maximum period of ten years.

The industry made the most of this window of opportunity, Sangiorgio says. In the year before the deadline, insurers issued a record of €25bn in debt, one third of which was in tier 1 instruments.

As the grandfathering provisions come to an end and as instruments are called, both the availability of space in the RT1 bucket and the need for fresh tier 1 capital is likely to increase. This effect may materialise faster in some jurisdictions, as some supervisors have put pressure on the industry to stop issuing debt instruments under the old regime well before the cut-off date of January 2015, explains Anna Hall, legal specialist at Twelve Capital.

A second reason for the low growth prospects of the RT1 market is that most insurers remain below the 50% issuance limit for tier 2 debt. Because the risk of deferral and thus pricing levels are lower for tier 2, it should take priority over tier 1 debt issuance. "Insurers will exhaust their tier 2 buckets before issuing RT1 debt. I would advise them to do that to optimise their capital structure, as RT1 will be more expensive and will not provide any additional capital benefit within permitted limits," says IRC's Clune.

No bond for simple insurers

> "The starting point for restricted tier 1 debt is three notches below the rating of the issuer" Dennis Sugrue, S&P Global Ratings

There are also structural factors that will weigh on RT1 supply in a more permanent way. The heightened transparency that investors in contingent debt expect from their issuers is likely to limit the opportunity to the largest and most sophisticated insurers.

The typical RT1 bond will automatically convert into equity or be written down upon three events: a breach of the SCR for more than three months, a drop in the level of the solvency ratio below 75% of the SCR, or a breach of the minimum capital requirement. To assess the risk that the triggers will be reached, investors need visibility on the insurers' solvency position, the volatility of the SCR and their ability to generate capital. They also need this information to be provided frequently, and rapidly.

Banks have proven capable of delivering, but only a minority of insurers can do it. What is more, there are a number of adjustments and transitional measures that cloud the picture, making it hard to compare ratios across jurisdictions.

Rating constraints

Credit ratings is another factor to take into account. Because of the risks involved, investors are expected to prefer investment grade deals, Clune argues. But this is out of reach for the many firms, because of the reduction in the credit rating that comes with RT1 subordination. Gjensidige's RT1 bond was rated at 'BBB-' by Standard & Poor's, compared to the insurers' counterparty rating of 'A'. Insurers issuing bonds in the future should brace for a similar reduction.

Dennis Sugrue, S&P Global Ratings

"The starting point for restricted tier 1 debt is three notches below the rating of the issuer," says Dennis Sugrue, senior director, insurance, at S&P Global Ratings, noting that these instruments are subordinated, allow for interest payment cancelation and have a conversion or writedown feature.

"From this point, we assess the bonds on a case-by-case basis to determine the additional non-payment risk, taking into account, for example, how close to the trigger for conversion a firm's solvency ratio is. If a company has a massive coverage ratio and the figures are not very volatile, we might not deduct additional notches if we felt that the risk of non-payment was fully captured in applying a three notch gap.

"However, if the coverage ratio is closer to the trigger or is potentially much more volatile the bond rating could be much lower than the issuer's credit rating. We do not impose any arbitrary limit on the size of the gap."

With many hurdles on the way, it is difficult to be sanguine about the RT1 market. Issuance is likely be restricted to a small group of firms, and will be made in small quantities. A boom in the medium and long term is not out of the question, but it will depend on how the capital structures of insurers and the regulations evolve.

RT1 vs AT1

While insurer RT1 debt shares the principles of bank AT1 debt – both are instruments that convert into equity or are written down upon breach of a predetermined capital threshold – there are important differences in the way they are treated in the regulations, as well as in the metrics on which the trigger points are set.

On the insurance side, the relevant metric is the coverage ratio of the Solvency II solvency capital requirement (SCR), while on the banking side the trigger is set on the level of common equity tier 1 capital ratio (CET1), which is essentially a ratio of top notch capital. What is more, RT1 debt adds to insurers' available capital from the outset, but the opposite happens with banks and AT1.

"Banks' AT1 instruments are not included in the CET1 ratio until they convert into equity or are written down. At that point, they receive a pound for pound improvement. For insurers, RT1s are included in the Solvency II ratio from issuance, so when an RT1 converts or is written down, the insurer's Solvency II ratio does not directly improve," says Dennis Sugrue, primary credit analyst at S&P Global Ratings.

Investors need to understand these discrepancies and their implications to thoroughly assess the risks in the bonds and price them. As things stand, RT1 seems poised to price below AT1. The yield on Gjensidige's bond was 3.6% over the 3-month Norwegian interbank rate (Nibor), which has been hovering just above 1%. Days after, UK bank Barclays offered $1.5bn in AT1 securities, paying 7.8%.