01 NEGATIVE YIELDING DEBT IN EUROPE SEPTEMBER 2020

REVISITING INVESTMENT OPTIONS FOR INSURERS HOLDING NEGATIVE YIELDING DEBT

In 2019 we identified strategies that insurers should consider given the prevailing negative rates environment in Europe. Following the COVID-19 crisis in early 2020, there has been unprecedented monetary and fiscal support to prop up European economies. The macroeconomic environment has changed significantly since the end of 2019. We are likely to see negative rates for longer than previously expected, as the ECB attempts to encourage economic activity, control inflation and allow both companies and individuals to weather the COVID-19 induced crisis.

2020 INVESTMENT OPTIONS

Given the macroeconomic environment and the clear signal from Central Banks, who will be leaving short-term interest rates lower for longer, we have identified a range of investment options for insurers holding Euro bonds. The options we have identified have been put together to take advantage of the expected monetary policy tilt by the ECB and designed with longevity in mind. These strategies should remain relevant over both the medium to long-term:

01 MOVING DOWN THE CAPITAL STRUCTURE

The ECB's bond purchasing programme in response to COVID-19 has pushed down yields on investment grade (IG) bonds. IG issuers have used this opportunity to raise funds by issuing bonds further down the capital structure, such as subordinated and hybrid debt.

Moving down the capital structure, from senior to hybrid bonds, within investment grade issuers is an effective way of increasing yield while maintaining exposure to high quality issuers. These hybrid bonds can yield up to 2% more than senior debt.

This move down the seniority rank is usually accompanied by a two-notch reduction in credit rating to reflect the subordinate nature of the bond. However, under Solvency II, if that two-notch reduction remains within the same credit quality step (e.g. BBB+ to BBB-), then the hybrid bond would incur the exact same capital charge. This allows insurers to benefit from the additional yield offered without necessarily attracting any additional capital charge. Below is an example of this strategy applied to bonds issued by Volkswagen:

	Senior Debt	Junior Debt (Hybrid)	Difference
Credit Rating	BBB+	BBB-	Two-notches
Yield	0.43%	2.90%	2.47%
SCR*	7.50%	7.50%	0.00%
Net Yield*	-0.02%	2.45%	2.47%

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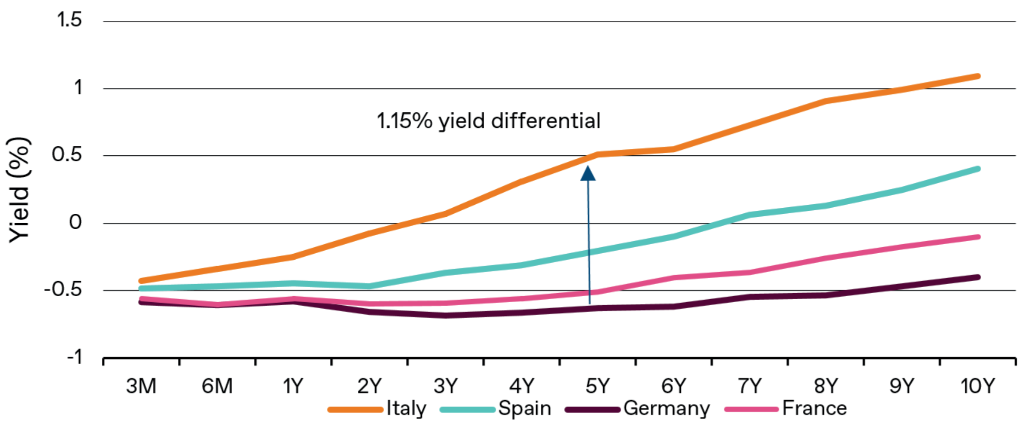
02 SWITCH FROM CORE TO PERIPHERY SOVEREIGNS

Core European sovereign bonds are one of the lowest yielding bonds available globally. These bonds are the main target of the ECB's bond purchasing programme which has pushed their yields deeply negative. Insurers tend to be holders of these bonds due to their low default/downgrade risk, their capital efficiency and the liquidity they can provide.

A viable strategy for many insurers may be to switch from these types of exposures to periphery sovereigns such as Italy and Spain. This would provide a significant yield pickup in most cases, without compromising on some of the attractive characteristics that core Euro sovereign bonds offer (security, liquidity and low capital charges).

EURO SOVEREIGN YIELD CURVES (AS AT AUGUST 2020)



03 NON-EURO BONDS, CURRENCY HEDGED

With interest rates collapsing across developed economies in response to the health crisis, the cost of hedging FX exposure has reduced. Specifically, the cost of hedging USD exposure for Euro-based investors has fallen significantly. This has presented opportunities to add exposure in non-Euro investment grade bonds in order to capture a yield pickup (net of currency hedging costs).

Below is an example of a switch out of a Euro-denominated bond into a USD bond of the same issuer (Credit Agricole) and with similar characteristics:

	EUR 2021	USD 2024	Difference
Credit Rating	BBB-	BBB-	No difference
Local Yield	2.09%	4.17%	2.08%
Hedging Cost	-	0.83%	0.83%
Hedged Yield	2.09%	3.34%	1.25%

From a Solvency II perspective, there would also be a counterparty charge to be considered. That would depend on the credit rating of the FX hedging counterparty which would likely be between 2% - 8% of the notional derivative exposure.

04 HIGH YIELD BOND ALLOCATION

This strategy involves holding bonds that are rated BB+ and lower. The risk and overall success of this strategy is heavily reliant on the names chosen and the duration of the bonds. Ideally, insurers should avoid holding long-duration high yield bonds in order to reduce spread risk:

SOLVENCY II SCR: SPREAD RISK CHARGE

Credit Rating / Duration (years)	AAA	AA	A	BBB	BB	B	CCC	Unrated
0	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
1	0.9%	1.1%	1.4%	2.5%	4.5%	7.5%	7.5%	3.0%
2	1.8%	2.2%	2.8%	5.0%	9.0%	15.0%	15.0%	6.0%
3	2.7%	3.3%	4.2%	7.5%	13.5%	22.5%	22.5%	9.0%
4	3.6%	4.4%	5.6%	10.0%	18.0%	30.0%	30.0%	12.0%
5	4.5%	5.5%	7.0%	12.5%	22.5%	37.5%	37.5%	15.0%

The maximum estimated spread risk market SCR impact of this change would be c.0.9% of invested assets. This is on a standard formula basis, if exposure is limited to minimum BB rated bonds and duration is limited to max 5 years.

In the current environment, insurers also need to be selective and avoid holding names that are adversely exposed to an economic downturn and/or a prolonged COVID-19 recovery situation. That said, the potential yield pickup (even allowing for additional Solvency II capital charges) can be significant:

	High Yield (HY) Bond Index	IG Bond Index	Difference
Credit Rating	BB-	AA-	Eight-notches
Yield	4.02%	-0.05%	4.07%
SCR*	18.0%	4.4%	13.6%
Net Yield*	2.94%	-0.31%	3.25%

*Spread risk SCR based on the Solvency II Standard Formula method. Net yield is net of the cost of holding regulatory capital. We assume the cost of capital is 6% in line with the Solvency II standard formula assumption.

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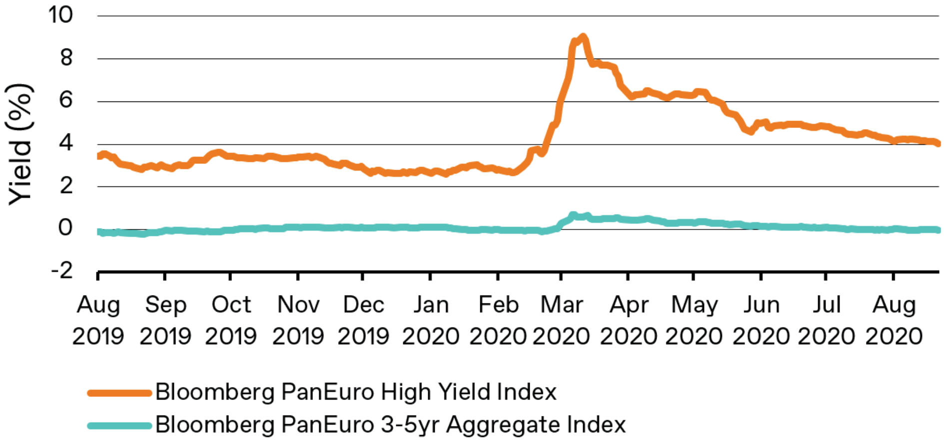
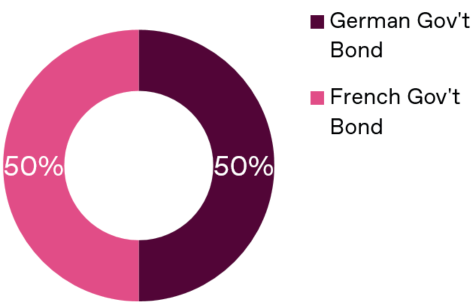
HIGH YIELD BOND VERSUS INVESTMENT GRADE BOND YIELDS



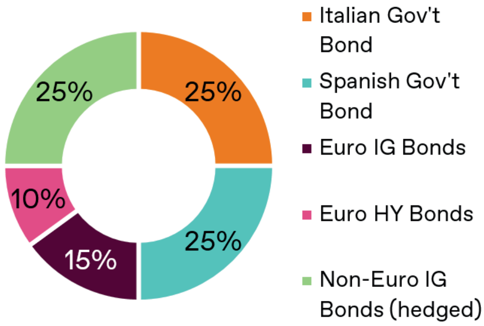
EURO PORTFOLIO EXAMPLE

To illustrate the effectiveness of the proposals set out in this paper, we have shown the impact of an insurer holding a 100% allocation in core European sovereign bonds, switching to a balanced allocation of the strategies described above:

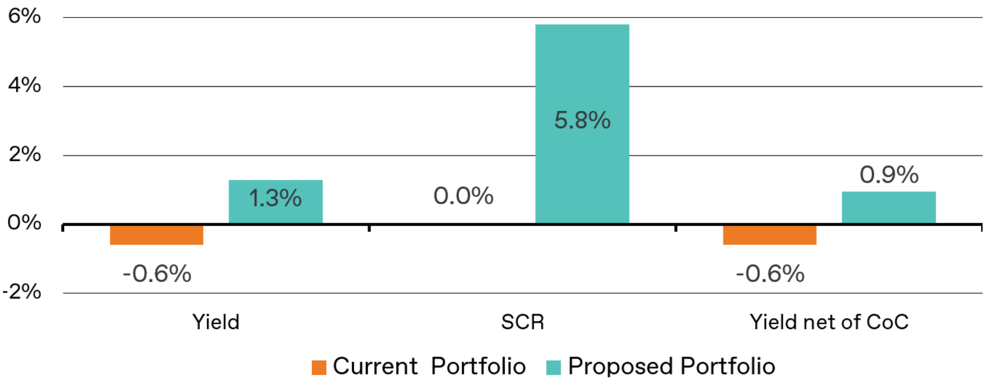
CURRENT PORTFOLIO



PROPOSED PORTFOLIO



PORTFOLIO COMPARISON



The benefit of this strategy is clear from a yield and yield net of the cost of regulatory capital perspective. However, there is a large increase in SCR from fully deploying this strategy. This can be controlled by reducing allocations to the respective options or choosing allocations to options that are in line with capital budgets and constraints.

SUMMARY

Navigating the next 12-36 months will be challenging for insurers holding significant allocations to investment grade Euro bonds as negative yielding investment grade debt is likely to remain a feature of the investment landscape.

The investment options discussed in this paper will allow insurers to improve the yield on their investment grade portfolios without taking on undue economic and/or regulatory risk.

We recognise that each insurer is different and will require individual solutions tailored to the idiosyncrasies of their insurance business and risk appetite. London & Capital has 15 years of experience helping insurers think through the implications of deploying these types of strategies and are happy to discuss this in more detail on an individual basis.

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