Plenum
Insurance Linked Capital

Restricted Tier 1 Capital – A new chapter in the Insurer financing is being opened

Purpose, Growth Potential and Yields

- Axa, Gjensidige and NN have already issued RT1 bonds this year
- The end of the grandfathering period leads to further RT1 issues
- Additional risk compared to Tier 2 capital is compensated with more than 200bps
- RT1 capital of insurers is more interesting than banks AT1

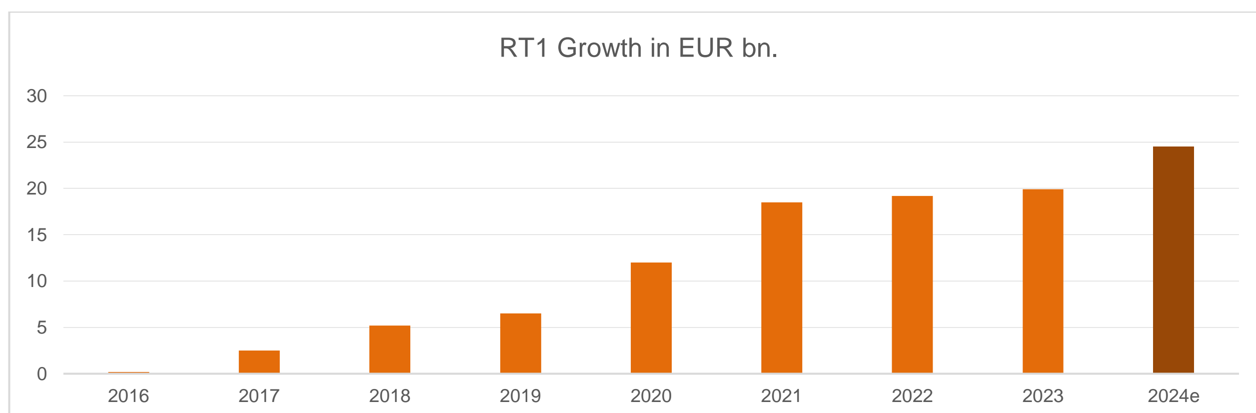
Due to the expiry of the grandfathering period of old Tier 1 bonds in December 2025, we expect a higher number of new RT1 issues in the current and next year. In the second week of the year, Axa already issued an EUR1.5bn RT1 bond with a coupon of 6.375%. NN and Gjensidige followed with further rT1 issues, so that the total volume issued as of mid-March 2024 is already over EUR 2.25bn. For 2024 as a whole, we expect a new issue volume of up to EUR 5.0bn. What are the reasons for issuing and investing in RT1 bonds from insurers?

What is RT1 capital?

RT1s are the most subordinated form of hybrid bonds issued by European insurers, similar to AT1 bonds issued by banks. The EU Solvency II Directive defines the classification criteria for these bonds. Accordingly, they have no maturity date, have discretionary coupons and the capital can be written down or converted into equity capital if the issuer's regulatory capital requirements are not met. In this case, the coupon is also mandatorily cancelled (non-cumulative). The threshold for conversion into shares or write-down is a Solvency II ratio of less than 100% for 3 months or 75% once. The conversion or write-down of the nominal value is solely dependent on the Solvency II ratio and regulators have no discretion as to the extent of the amortization. This means that there is no "non-viability" clause for European RT1 - Switzerland will introduce such a regulation after the planned reform of supervisory law, although it is unclear whether Swiss insurers will make use of RT1 under these conditions.

Growth of the RT1 segment (EUR bn.)

After Solvency II came into force, it took a while for the first RT1 bonds to be issued. With the abolition of the grandfathering period, growth will pick up strongly - from the current perspective, a total volume of EUR 35bn seems possible.



Source: Plenum Investments Ltd.

Example: Allianz 2.6% RT1 Notes with quantitative trigger

According to the prospectus, a "trigger event" occurs if one of the following two conditions is met:

- 75% or less of the Solvency Capital Requirement
- Solvency Capital Ratio is below 100% but more than 75% and has not improved to at least 100% within three months

RT1 compared with Tier 2 Capital

RT1 and Tier 2 capital are the most important forms of hybrid bonds for insurers. The differences are explained in the table below.

	Restricted Tier1	Tier 2
Eligibility	Tier I Capital min. 50% of eligible own funds. Restricted Tier I max. 20% of total Tier I capital	Tier II + Tier III not more than 50% of eligible own funds
Maturity	Maturity: undated (first call after 5 years). Redemption only with supervisory approval	Maturity: min. 10 years at issue date (first call after 5 years) Redemption only with supervi-sory approval
Loss Absorbency	Coupon cancellation on SCR* breach/Coupon fully discretion-ary	Coupon and Principal deferral in case of SCR* breach
Loss of principal	Write-down or equity conversion on SCR* breach	Write-down only in insolvency

Source: Plenum Investments Ltd. / SCR = Solvency Capital Ratio

Both classes of capital have the same trigger for their respective capital measures - namely a solvency breach, i.e. the Solvency II ratio falling below the required 100%. Since the probability of occurrence of the capital measure is the same and both forms of capital differ only in their conse-quences when the shortfall occurs, the question arises as to what extent the spread differential (structural premium) of over 200 basis points between the two forms of capital is justified. Since, in our view, the probability of a solvency shortfall among existing issuers of traded institutional bonds is extremely low, we consider the spread differential or structural premium to be generous. How-ever, the spread may deviate significantly in individual cases.

Table: Structure premium measured by the asset swap

	Tier 2	RT1	Structure premium (bps)
Achmea	253	449	196
Aegon	196	406	210
Ageas	207	468	261
Allianz	143	354	211
ASR	294	487	193
Athora	423	480	57
Aviva	260	437	177
Axa	148	358	210
Direct Line	311	699	388
Just	407	584	177
Legal & General	167	405	238
Macif	270	621	350
Phoenix	230	555	325
Pension Insurance	230	469	239
Royal London	306	556	250
Rothesay	350	543	193
Unipol	145	425	280
Utmost	386	700	314

Source: Bloomberg, January 2024

Why are RT1s from insurers more attractive than AT1s from banks?

Banks and insurers pursue completely different business models. The biggest difference lies in the *run risk*. In the case of banks, deposits can be withdrawn very quickly in the event of a loss of confidence and without any significant costs to the depositor.

With insurers, on the other hand, the withdrawal of capital is only possible in life insurance and is associated with high costs - for example, the surrender value of a policy is significantly lower than the maturity benefit. As a result, a small crisis at banks can quickly develop into an uncontrollable and existence-threatening event. For insurers, negative surprises are part of the business model and are calculated in advance using actuarial methods and covered by reinsurance contracts. Even a loss of confidence in an insurer is hardly a threat to its existence, as the Solvency II model also provides capital for policy buy-backs.

As a result, an average of 85% of all RT1 bonds (28 out of 33 bonds) have an investment grade rating (Bloomberg Composite), while the figure for banks is significantly lower. The table below shows the ratings of the largest issuers at issue level.

Bond ratings of the largest issuers at banks and insurance companies

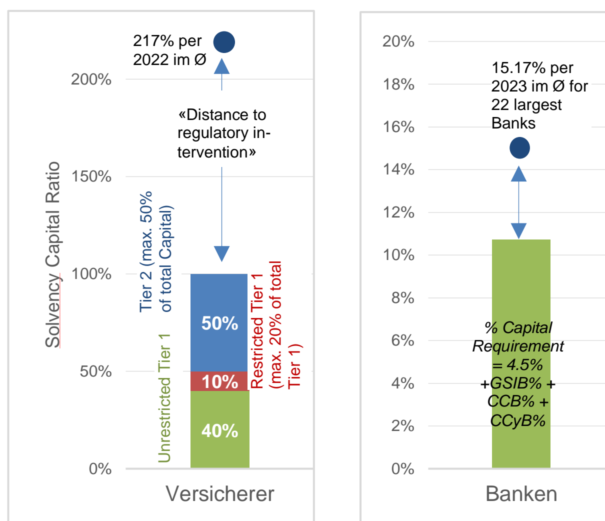
5 largest bank issuers	AT issue rating*	5 largest insurance issuers	RT1 issue rating*
Barclays	BB	Allianz	A-
HSBC	BBB-	Axa	BBB+
BNP	BBB-	Phoenix	BBB+
UBS	BB+	Rothesay	BBB
Banco Santander	BB+	CNP	BBB

** Bloomberg Composite*

Source: Bloomberg

As mentioned, the Solvency II ratio is of paramount importance when assessing the risk of an RT1 bond. The Solvency II ratio for all issuers is well above the minimum requirement of 100% - on average, the Solvency II ratio at the end of 2022 was 217%, which results in a very large *"distance to regulatory intervention"*. If the capital position deteriorates, the insurer has time to pull the usual standard instruments from the CFO toolbox to increase capital again, e.g. dividend cuts, reinsurance, discontinuation of unprofitable business, capital increase. In addition, insurers regularly measure the sensitivity of the Solvency II ratio to fluctuations in interest rates, spreads, share prices, real estate valuations or rating downgrades.
The so-called *distance to regulatory intervention* is significantly lower for banks and can quickly fall further due to various additional buffers that regulators can require on an ad hoc basis. In addition, as in the case of Credit Suisse, the instrument can also be written off if the regulator considers the statutory point of non-viability to have been exceeded.

«Distance to regulatory intervention»



Source: Plenum Investments Ltd.

At the same time, the leverage ratio in the insurance sector remains low - most large insurers operate with a maximum leverage ratio of 20-30%. Many RT1 issuances come from composite insurers with a well-diversified business model where cash flows are well spread across lines of business and geographies.

Call discipline in case of RT1 issues

The first benchmark size Solvency II-compliant RT1 bond (PHNXLN 5.625% perp-25) will have its first call date in January 2025. Unlike Tier 2 securities, where non-economic calls are standard market practice, there is still no such market practice for new RT1 securities due to a lack of precedents. It may well be that the practice varies between issuers depending on the insurer's business model and the insurer's reputation in the capital market. For example, it is difficult to imagine an insurer such as Phoenix, whose growth depends heavily on access to the capital market, not redeeming a bond from the market on the first call date.

Outlook and growth potential

The total volume of subordinated bonds issued by European insurers amounts to around EUR 180bn. This contrasts with around EUR 500bn in hybrid debt instruments from European banks, of which EUR190bn is AT1. As a result, the RT1 space will naturally remain smaller but will grow over the next two years.

Around 85% of RT1 issues have at least an investment grade rating, and yields in this area are comparable to those of AT1 bonds and higher than those of high yield bonds. Given the higher ratings and excellent capitalization of this sector, we believe this asset class offers a better risk/return ratio than high yield bonds and AT1 bonds, making it highly attractive to investors.

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