Subordinated Insurance Debt

Overheated AT1? Cool down with rT1!
Call discipline in rT1 remains high

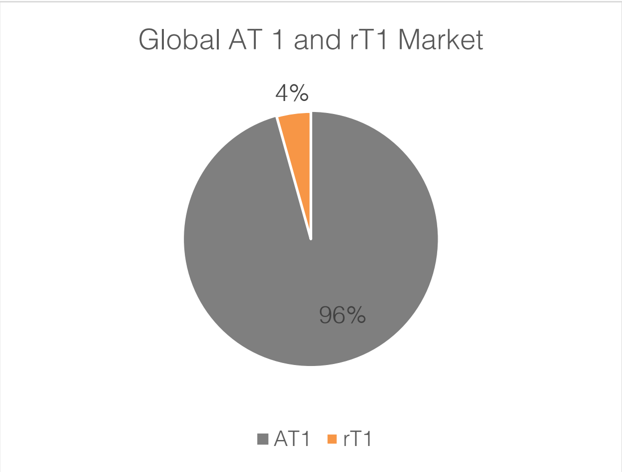
Bank AT1 paper has performed strongly year-to-date (YTD), as investors continue to chase yield in an increasingly tight market. However, the AT1 space is showing signs of overheating. Restricted Tier 1 (rT1) bonds may present a compelling alternative!

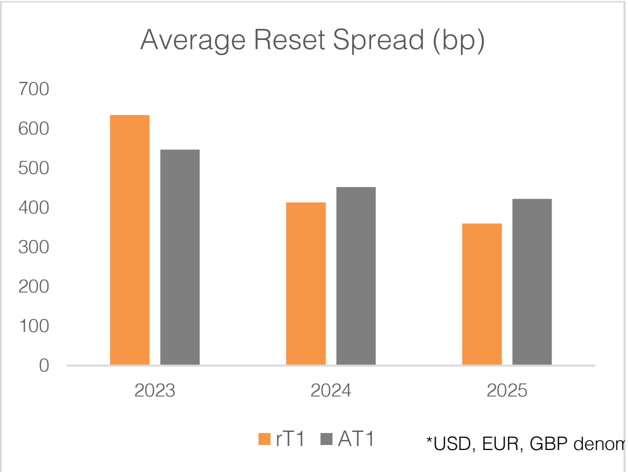
Bank AT1 paper performed strongly on a year to date basis (YTD) as investors hunt for yield in an ever-tightening market, but the AT1 market looks increasingly overheated. The significant demand on the primary market has also led to a squeeze in reset spreads and therefore – according to some investors - an increase in extension risk.

The number of AT1 extensions has already been steadily increasing in recent years. Investors are getting concerned now that with low reset rates, extensions become even more common and not calling an AT1 slowly loses its market stigma which will ultimately lead to a revaluation of AT1 paper. Several asset managers therefore made already public that they are actively reducing AT1 and see more value higher up in the capital structure (see here).

But investors do not necessarily have to give up yield when taking profit from AT1: Insurance rT1 paper is a great alternative to AT1. The rT1 market still offers substantial value relative to AT1 and insurers are highly likely to maintain their discipline and investor friendly track record while having generally higher ratings. Issuers of benchmark sized bond issues have Solvency II ratios of more than 200% on average which should give investors additional confidence but is not fully factored into rT1 valuations.

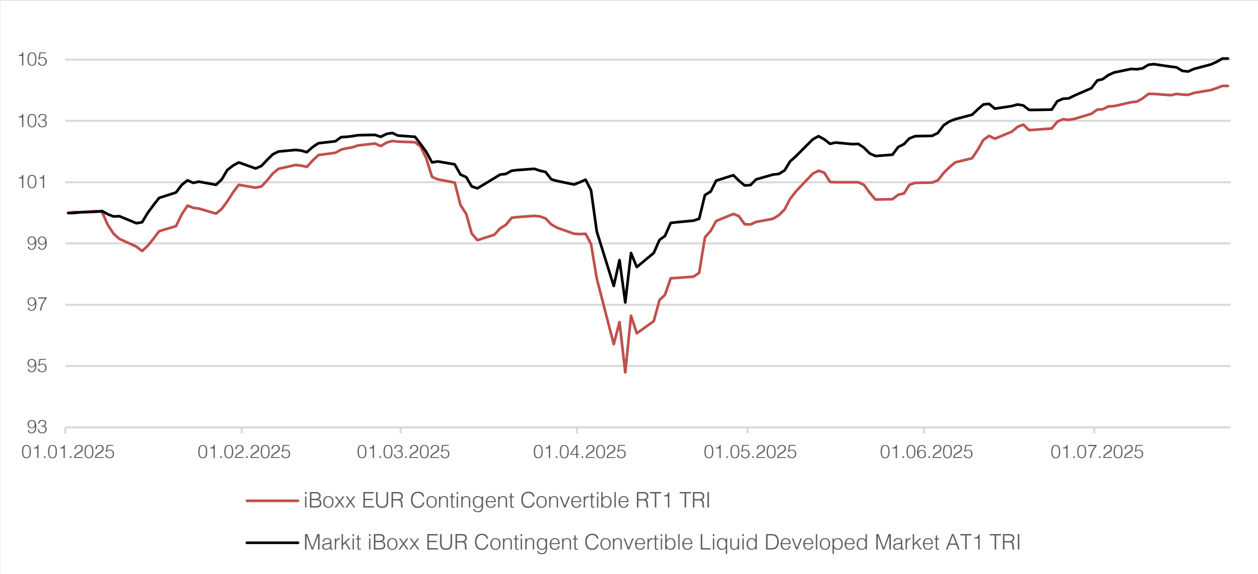
The rT1 market is still relatively small compared to AT1 but over the last five years we observed a strong increase in the number of issuers. The asset class was only introduced with the Solvency II regulation in 2016 and after that it took a few years for the first benchmark sized bonds to be issued. By now there are around 50 rT1 bonds outstanding, so there is now a good number of bonds to select for a portfolio.





RT1 new issue data also show lower reset rates but we note that the sample size is very low as only a single digit number of bonds is issued every year. Unlike in the banking sector, we have not observed an increase in extensions. Traditionally the insurance sector is very disciplined and almost all traded institutional grandfathered perpetual and T2 bonds have always been issued as “non-economic calls” and were called at the first call date. Retail-style fixed-for-life perpetuals were always considered “economic” calls.

In the rT1 segment, however, there are hardly any precedents as only a handful smaller issues reached their first call date so far as well as a USD750m issue of Phoenix Group earlier this year which have all been called. Nonetheless we are convinced that discipline is high and the vast majority of rT1 are “non-economic” calls. While only one major insurer outed itself as the exception and intends to call purely on an economic basis, almost all other major insurers have taken this as an opportunity to reiterate their intention to call at the first call date. So, we do not expect an extension by one major insurer to start a process of making extensions of institutional bonds more acceptable. It will rather led to a bifurcation of the market into two sub-segments, i.e. the disciplined issuers and a very small number of players making only “economic” calls.



We do not exclude some volatility of insurance rT1 paper in sympathy with bank AT1 in the months to come, but we view this more as an opportunity to transact and get a material return for a marginal extension risk. RT1 paper still trails the performance of AT1 YTD and with the latter getting overheated this summer and holders starting to get nervous we rather recommend switching into the safer haven of rT1. In our view, the market is pricing already for too much rT1 extension risk and a repricing of AT1 would create an even better relative value opportunity.