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Insurance bond market – navigating the turbulence

July 2022

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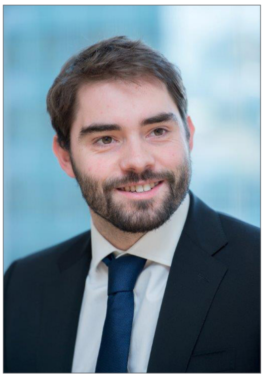
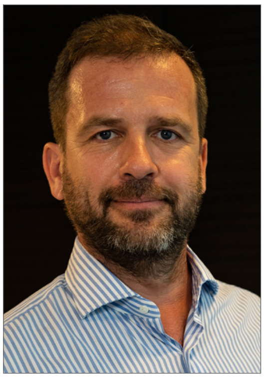
While the insurance bond market has suffered disruption and volatility from a host of macro risks – the war in Ukraine, high and rising inflation, the end of quantitative easing, and monetary policy tightening – it has remained open for select issuers and experienced investors. As tough market conditions persist, GlobalCapital discusses how issuers and investors are navigating the turbulence, together with the key trends and developments that are shaping the asset-class, from growth in RT1 and green bond issuance, to regulatory developments and proposed changes to ratings models.

Michael Benyaya
Crédit Agricole CIB

Matteo Bertolo
Pimco

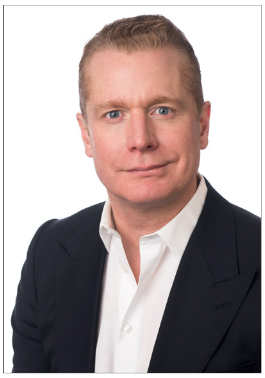


André Bonnal
Crédit Agricole CIB



Bertrand Bougon
SCOR SE

Julien de Saussure
Edmond de Rothschild Asset Management



Johan Eriksson
Allianz SE

Pierre Le Bihan
BlackRock

Participants in the roundtable were:

Michael Benyaya, managing director, co-head of debt capital market solutions and advisory, Crédit Agricole CIB

Matteo Bertolo, senior vice president, credit analyst, Pimco

André Bonnal, financial institutions group syndicate, Crédit Agricole CIB

Bertrand Bougon, head of group ratings and capital, SCOR, and finance director, SCOR SE

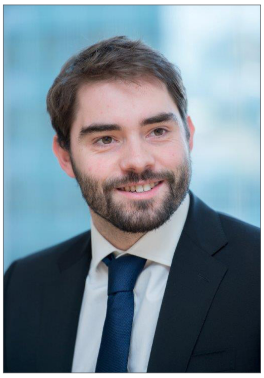
Julien de Saussure, fund manager, Edmond de Rothschild Signatures Financial Bonds Fund, Edmond de Rothschild Asset Management

Johan Eriksson, head of group treasury and corporate finance, Allianz SE

Pierre Le Bihan, director, credit analyst, European fundamental fixed income, BlackRock

Moderator
Richard Kemmish, GlobalCapital contributing editor

GlobalCapital: To set the scene, it would be useful to start with a discussion about market conditions. André, how would you characterise market conditions at the moment?


André Bonnal
Crédit Agricole CIB

Bonnal: We know all the main factors and drivers — inflation, rate hikes, war in Europe, stagflation concerns — that have made the market extremely volatile. We have insane intraday swings on rates. You had the bund doing plus 20bp, minus 20bp within three sessions last week.

The market is not completely shut. There is some activity in financials and a good amount in corporates; but on the insurance side, we are in a sector that usually comes to the market for duration in capital format and that's clearly not the combination that has performed year-to-date.

Given that combination, it is one of the asset classes that has clearly underperformed since the start of the year. We are talking a minus 10.5% return on euro sub-insurance. Restricted tier one (RT1) notes have come down 15 points on average, so it is a pretty dire situation. On the liquidity side, the secondary market has been pretty horrendous — especially in insurance — so it is not the rosiest picture.

GlobalCapital: Its difficult to get deals away, rates are rising in a long duration instrument. What can an investor do in that environment?

Bertolo: I think you need to be selective. You need to be particularly focussed on the levels at which deals are coming. You need to be careful on your entry point. The volatility in rates makes the pricing very challenging on both sides: the issuer tries to avoid printing a deal they will regret because it's too expensive. The buyer wants to avoid giving money away too cheaply. It makes our jobs as investors harder but there are opportunities out there: if you do the work and take a view it is an environment where we can find opportunities for our clients.

Le Bihan: As per André's point, tighter liquidity is a common feature of the insurance sub sector in a tough market environment. The insurance sector is less well understood compared to banks, which constitute a larger investment pool, and there is also a smaller investor base for long-dated callables. I suppose this is true in any market circumstances, but particularly in the context of rising rates. In the past we've seen more demand for bullet tier two or tier three bonds, for instance. These structures seem to be better liked by investors than long-dated callables. All of those factors are playing a greater role in the current market environment.

de Saussure: I just want to add that in 2015-16, on a spread basis, insurance actually underperformed way more than this time around. You mentioned the total return of insurance, but it is largely because of the higher duration than the market on a spread basis — less so in the sense that there is no rush to issue, as was the case in 2015 before entry into force of Solvency II and the rush to issue grandfathered tier one structures.

I would tend to make a difference between the secondary levels and the opportunities in the primary — and, yes, the conundrum that there are no short-duration products means that tinkering with a short-dated or bullet structure tier three makes sense from an issuer standpoint. When you issue a tier three at a high spread, that can have consequences for the relative value in the capital stack, so I would caution issuers not to kill their stack just to issue a cheap instrument on an absolute yield basis. I am thinking of the Mapfre tier three. You can selectively think it is attractive, but it has consequences for where the secondary market is going to trade, so I am not sure it is a viable option.

GlobalCapital: Pierre made a point about illiquidity. Is that an inevitability of this asset class or is there something that we can do? Should there be more standardisation? Can we broaden the investor base?

Bertolo: I think there's a limit to how much issuers or investors can do. There is a structural hurdle: insurance companies don't need as much debt so to an extent they also can pick the best moments to issue. Conversely, a bank has to be in the market all the time and across the capital structure for both regulatory reasons and funding needs. Insurers instead issue subordinated debt which carry some regulatory capital recognition. This limited supply results in a shallower market, fewer bonds outstanding. So, there's a structural hurdle to make it more liquid.

I think at the margin, issuers can do something. They can try and explain the insurance story in a simple, straightforward way. It's not obvious because investors tend to be less familiar with insurance business compared to banks.

Could standardisation of instruments help? Only to an extent. Insurance instruments are already fairly standard. Tier twos have been around for a long time, for example, so they are fairly standard. RT1 is a new product, obviously, as that market develops, with the large insurers starting to issue RT1, you start to learn how the RT1 market is going to behave in terms of e.g. call policy. Right now, there is still no track-record given this is still a new market. By comparison, we have a good idea of the track record on the banking side, but we don't know how the insurers are going to behave. So, all of those things at the margin will help but there still are the structural hurdles.

Benyaya: The RT1 market for insurers is about €18bn. The bank AT1 market is €180bn, so the RT1 market is 10% of the size of banks' AT1. Longer term, we could reach perhaps €35bn, maybe €40bn, but it will never become a large pool of investment.

Michael Benyaya
Crédit Agricole CIB

Eriksson: We tried at Allianz to change that but not a lot of our peers have followed suit!

de Saussure: There is a very large AT1 market, with specialised CoCo [contingent convertible] funds. Not a lot of them are really keen on entering the RT1 market. I think that's going to be a key challenge for the market ahead of the refinancing of grandfathered structures.

As far as tier two are concerned, obviously duration is a problem at the moment. I guess because of the rating agency shopping we have seen — and the Fitch structure — they are coming in a shorter-duration format. The non-call five is a solution, but only for some issuers.

For callable structures, I still have a long-term doubt about who is buying that. Asset managers may be looking because they like the duration. Then there is the question of whether insurance companies buy the tier two of other insurance companies? There is the issue of SPPI [Solely Payments of Principal and Interest] treatment of these bonds and whether there is going to be a shrinkage of the buying capacity of tier two callables — and the disadvantage for insurance versus the bank structure, which should pass the SPPI test. So, I'm still concerned there could be a technical widening of insurance tier two versus bank tier two.

Bonnal: Clearly, insurers have been involved in buying other insurers' tier two callables. That explains why the liquidity isn't so great; they tend to be locked in portfolios and held to maturity.

The SPPI test is something we hear more and more as being a worry for a lot of investors. That should have an implication on callable tier two — if you remove the pension fund or insurance bids, that's going to have quite an effect on valuations. Will we see a lot more issuers going the 10 year bullet route, even if that doesn't comply with the S&P equity content criteria?

de Saussure: I believe that SPPI failure is a result of coupon suspension, rather than the call. We have seen the developments of the Assurance Crédit Mutuel tier two; they got rid of the optional deferral mechanism — which I thought was a market standard and a requirement of S&P, but it doesn't seem to be. If you stick purely to mandatory suspension, will that be eligible for SPPI or not? I understand it won't. But I think it's the deferral that causes problems, not purely the callable aspect.

Benyaya: The SPPI test isn't straightforward. As usual with IFRS, it's substance over form and is not prescriptive in terms of the kinds of debt that will pass or not pass the SPPI test. So, I think there is still room for interpretation, which will add complexity on the investor side.

GlobalCapital: Can we bring the issuers in? Perhaps we can start with the overall market conditions and issuing in the difficult market that Andre mentioned.

Eriksson: I partly agree and partly disagree with what I have heard. Certainly, volatility is the issue; levels are not the issue. It takes us five minutes to get our head around the fact that tier two now costs 4%. It used to be 1% or 1.5%. The market is the market. The term paradigm shift is overused, but we have had a decade when central banks have helped every single asset class, directly or indirectly. That's now not going to happen for as long as they can stay out of the market. But we need to go back to before the great financial crisis when the market was the market — rather than the central bank was the market. The volatility will be much more significant. The downsides can be much greater if we do not have a buyer of last resort, and that's a bit scary. But that has been the state of markets for most of the time that markets have existed. It's the past 10 years that have been an aberration, so we need to be much smarter — and I don't want to understate the challenge. But the fact that we have to pay 4% or more for tier two capital is perfectly fine. That's normal. Volatility has to go down to some extent. We need some stability and some confidence, and I'm not really sure that we are going to get that confidence anytime soon.

GlobalCapital: **Bertrand, I hate the phrase 'paradigm shift' as well, but it is certainly a very different environment. How does that affect your crucial decision about pre-funding ahead of calls coming up?**

Bougon: Our situation is specific as we have no refinancing needs in the short term. The first call on our hybrid debts is in 2025, so we have a bit of time. We are following the market, and we always think about our debt strategy as part of our coming strategic plan. It's good not to have any refinancing needs in the current environment. Increasing interest rates could be an opportunity for a liability management, this is part of our toolbox.

GlobalCapital: **A liability management exercise sounds even more difficult in a volatile market. Is that possible?**

Bougon: If you listen to bankers, yes, it is possible. If you listen to the market, it is far more challenging. We saw a liability management exercise that failed recently.

Bertrand Bougon
SCOR SE

Bonnal: I think there was a lot more of a case before February 24 to look at liability management plus new issues. The fact is that it's also about volatility. You are in the market, depending on what type of liability management exercise you do, for at least a week. And, as we know, things can change very quickly.

Given the level of volatility we have, I don't see how opportunistic liability management exercises are viable in this market. Can that come back? Well, yes. We need a little bit more stability for that, then we still need to reassess whether it makes sense from an economic standpoint and from issuer to issuer.

Bougon: A liability management exercise can't be totally opportunistic because you have to ask for the approval of the regulator before you get started. It would take months.

GlobalCapital: **I would like everyone's opinion about what the call/no call decision looks like or the conditions for deciding to pre-fund and calling on that date.**

de Saussure: The debate has two components: there is the likelihood of a short-term call, and the pricing of a long-term call that is considered out of the money. I would differentiate between the two. In the RT1 market there is no call anytime soon – not before 2025, I think. Still, there is going to be the debate around refinancing of the grandfathered tier ones and where the market is at that stage.

We have seen Allianz not calling the fixed for life, Swiss Re drawing on three pre-funded bonds but not using the fixed spread for life perpetual bond. There is still a message from issuers that institutionally placed bonds will be subject to a different call policy, with slightly more consideration of non-economic factors. Whether that stands for RT1 or not is a bit unclear. It's not going to be tested for a while. Then, obviously, for tier twos we are still protected by the step-up, which does work in a lot of cases.

I have ongoing questions around the 30 non-call 10 structure, after the change in the S&P regulation. Whether issuers like to play the game of extending for 10 years, given the lack of recognition, does not stand anymore.

And then there are the 10 non-call fives that don't have a step-up: if they deliver the business plan, the reissuing spread should be lower than the issuing spread. But that needs to be confirmed.

So, I am still of the view that we need to assess them economically. But when we see the pricing of AT1 versus RT1 on a spread basis, I tend to believe the market has been shying away from purely repricing the call option in the RT1 market.

Eriksson: Let me answer the comment on the fixed for life.

If I buy a car and the manufacturer asks me not to drive it, or give it back without compensation, I'm going to think 'what are you talking about?' We issued a tier two bond with a fixed for life feature, meaning we paid up for optionality. You can't ask us not to make use of them. I cannot understand why people would expect us to give up something we specifically paid for.

But you also mentioned distinguishing between the institutional and retail markets. We will never do such a thing. An investor is an investor. We have a mix of investors in our transactions, and we do not make any distinction between investor bases. We do not discriminate against anyone, but we certainly try to act rationally.

Tier twos with step-ups are callable, of course. For non-step-up bonds, you have to make an assumption. In our opinion, the AT1 market is priced against economic call decisions. If you compare the reset spreads of existing AT1 bonds of any issuer with the reoffer spreads they would pay on new AT1s, you will find that AT1 bonds are priced based on the assumption that the issuer will take a broadly economic call decision.

Compared with fixed-for-life bonds, there can still be more of a discussion in AT1 and RT1 where it's the regulator that doesn't allow step-ups — rather than the issuer having made that choice — over whether you might define what is economic in a slightly different way. But when you consciously included and paid for the right not to call in certain interest rate and spread scenarios, you have to expect the issuer makes use of that right.

de Saussure: I'm not investing in fixed for life and I got the message that there was a rate option embedded. The key question is whether you overpaid for RT1 to exercise the non-call option.

Another question concerns the conditions, as far as the regulators are concerned, under which you could exercise a call option slightly out of the money. Is there leeway there? Perhaps it is too early for that sort of discussion.

Eriksson: There is a lot of leeway. Regulators will typically be very cautious about saying too much in this respect. We think that the instrument needs to be broadly economic; you can then make an interpretation of what that is. Obviously, we are all genuinely committed to our investors and greatly appreciate their support, but the instruments can't be a lie. So, there has to be at least a significant element of economics. I don't think it's the regulators that will enforce this, especially not on the insurance side. If you can compare the ECB statements on tier one – which I don't think are necessarily helpful – and the insurance side, insurance regulators don't necessarily seem to share the view of the ECB.

GlobalCapital: Matteo and Pierre, can I ask your views on Johan's point that this fundamentally is about rational economic call decisions?

Le Bihan: An issuer call policy on non-step perp instruments – and I suppose that will include RT1, but we won't find out any time soon – tends to differ from policy on institutional tier two. That is quite clear. But the question is what does 'economic call' mean? That can mean a different thing in a different market and the meaning can also differ issuer by issuer. For example, that might encompass trying to preserve market access and then some issuers might either have more or less concerns than others about this. So, I think it is important to try and understand what economic calls really mean.

Bertolo: I agree, saying that the company's call policy is based on economic considerations is too general a statement. There's a narrow meaning of economic call: in that sense, it just means that the company will assess today at what level of spread/yield it can refinance its callable bond. If it's more expensive, then the company will extend.

There's also a broader meaning, though, and that is: the decision to call or extend a specific bond, which can affect the company's cost of funding across the capital structure. If extending a bond results in higher cost of funding overall, economically it might be worth calling and refinancing the bond at a slightly higher level.

For insurance, we don't have enough data points on RT1. As Pierre just mentioned, there's a very decent track record of calling institutional placed tier two bonds. Is the future going to be the same? We don't know. Banks have more data points, and you can see that economic calls can mean different things to different issuers. Some issuers are going to look at a narrow meaning. Others are going to be more holistic in their approach.

Benyaya: From a pure regulatory standpoint, if you look at the criteria comparing banks AT1 and insurance RT1, in bank AT1 there is this condition that refinancing has to be done at terms that are sustainable for the income capacity of the institution. That criterion does not exist in insurance, so economic is not well defined and can change over time. Probably a bit early to say how a supervisor will look at this.

Eriksson: The question of sustainability for a financing instrument or capital instrument that is in any case such a small part of your balance sheet is not normally going to be a constraint for a financial institution. My view of the AT1 market is that it is priced in secondaries towards a relatively narrow definition of economic call decisions.

de Saussure: Banks have an explicit CET1 [common equity tier one] ratio, AT1 ratio and total capital ratio; on the insurance side, you have an overall solvency ratio. So, to what extent would decompression in the funding spread of AT1 versus tier two affect your optimal capital mix? Would you get rid of RT1 if it was considered non-affordable?

Eriksson: Well, if something was non-affordable of course that would limit how much could be used... but, fortunately, we are not there. We don't take too much of a view on the "right price". The market decides what the price is, and we issue when we need to — and try to ensure that we are able to issue in and take advantage of as many market windows as possible.

Johan Eriksson
Allianz SE

When it comes to capital structure, we consider how the limits applied to different types of capital affect our solvency ratio in different scenarios. That's already complicated.

That's our job to manage — but, again, we respect the market and pay what the market charges.

GlobalCapital: **The EBA has been very clear with the banking sector about climate change and other types of stress test and how they should be applied. How they will affect Pillar 2 capital. What is EIOPA [the European Insurance and Occupational Pensions Authority] doing in this regard?**

Eriksson: We have been quite clear in our comments to regulators that, as much as we want a good planet in the future, we want the risk-based regime to continue to be based on measurable risk.

We don't want different exposure types to be subsidised.

Of course, it will be an issue in global warming scenarios because the consequences could be truly severe in many parts of the world, but the insurance market has already reflected this and it will continue to do so. The longer-term changes are so slow-moving that it's not too difficult for insurance companies to respond in terms of our exposure. It's a big focus but we don't see it as a clear and present danger. We manage that, but the political aspects should not really influence the capital regime.

Bougon: The actual question concerns what the regulators will do with such stress tests. Do they have in mind to add capital buffers based on such instruments? We are managing our risks based on our internal model, which covers a very large number of scenarios. The key issue we are working on is refining the climate change effect in the model. The challenge is to embed long-term deviations in a model that has a one year prospective view, and to embed our capacity to increase our pricing.

GlobalCapital: **If you look at the banking sector and the risks that concern the EBA, they talk about the sunk costs, reputational risk, liability risk and other forms of climate-related risk – not just insurance events.**

Eriksson: Again, that's partly a political argument. I don't want to dismiss it. Of course, I understand and personally I often sympathise with it, but it can be more of a political discussion than anything else.

When it comes to climate change, European insurers and banks will move faster than others —so, if there is an issue with sunk business activities that will no longer be viable, presumably we will be less exposed to them than others. There may be bigger risks elsewhere because the differences are so vast in terms of how institutions respond to these issues between Europe, the US and Asia.

GlobalCapital: **Buy side, are you concerned about any credit risks in this area?**

Le Bihan: Regarding stress tests, I think including a component on climate risk in the stress exercises is perfectly legitimate, considering the amount of scientific evidence on climate change. It makes sense that regulators look into what specific events or scenarios would mean for the sector.

Then there is the debate about green-supporting factors, which is partly linked to societal and political forces. EIOPA is currently doing some work on this, as requested by the European Commission, and there is no conclusion yet.

We are clearly all very focused on those topics, and it is very important for our clients i.e. asset owners. Our insurance clients in particular are very engaged on sustainability. Clients are incorporating sustainability guidelines in the mandates we manage and that includes portfolio decarbonisation targets

Benyaya: Based on the EBA discussion paper published recently, I don't think there is strong support from the regulator to introduce these kinds of brown and green capital charges at this stage. They are extremely cautious. There are a number of hurdles: the obvious one is being able to identify what kind of assets you would apply these kinds of charges to. So I don't think it will be a first step for regulators to introduce ESG risk in the prudential framework. Pillar 3 and Pillar 2 look more likely to do it

GlobalCapital: **In your investment portfolio, do you buy green or ESG bonds?**

de Saussure: On my first roadshow of an insurance tier two green bond, I asked whether they invest in green bonds? They said 'no' and that they can source green assets at a more efficient level. They were sending the message that they were issuing a bond, but they don't buy green bonds.

Julien de Saussure, Edmond de Rothschild Asset Management

I would be sceptical of circularity in issuing a green bond to fulfil your green asset ratio. There is a great imbalance between big companies that can source illiquid green assets and small companies that will be forced to buy green bonds

Eriksson: Axa CoRE Europe, a real estate fund managed by Axa, issued a de facto securitized bond, a senior bond from an SPV that invested in green assets. That, to me, is a genuinely green bond.

Most other green bonds are not green bonds. If you have a few green investments that you have already made and would have made anyway and say this new bond finances these assets, it doesn't work. That link does not necessarily exist. It may be different for corporates, and maybe for banks; but for insurers, which are, by definition, well-funded, the additionality argument is much trickier.

Bonnal: It's a good development to see that, on the one hand, dedicated green or social funds skyrocketing and, at the same time, you have the shift where investors are adopting a holistic view to ESG as a whole.

GlobalCapital: **Bertrand, do you still have faith in the green bonds or do you share this holistic view?**

Bougon: I agree that a large number of green bonds are not really green.

The next step for us is to look at issuing bonds linked to green risk. It is far more challenging than investing the proceeds only in green investments. It is on the risk side that the industry is lagging.

It's quite difficult because we need to define what is an eligible green risk. We have the taxonomy from the European Union. It's a good start. Then you have to define the metric for the risk.

GlobalCapital: **How good is the taxonomy for defining these outcomes?**

Eriksson: It helps a bit, but we need to go further. It becomes a little bit of a minimum threshold.

de Saussure: You said that assets under management of green dedicated funds are skyrocketing. We are fixed income managers, and a lot of the ESG constraints come from the equity world. For example, exclusion criteria. My colleagues on the equity side manage a portfolio with 30 stocks. I manage a portfolio with many more names. So, exclusion in itself is dangerous for fixed income.

If you look at Article 9 funds, every time I receive an ESG questionnaire they ask, 'Do you exercise voting rights?' I say, 'No, I'm a fixed income investor. I don't have voting rights'.

The easy way to fulfil Article 9 criteria is to use green bonds in the portfolio.

I have a lot of sympathy for the view that the use of proceeds is a bit of a scam.

If you honestly promote SLBs, then you are confronted with questions around whether SLBs would pass the SPPI test? I have long-term concerns about SLBs.

Bertolo: I'll make a comment on how I look at an insurance company in terms of their ESG credibility.

Looking at an insurance company's balance sheet gives a clue on where the company can be more impactful. In very simple terms, running an insurance company involves primarily managing three aspects: first, underwriting insurance policies; second, issuing bonds to fulfill capital requirements; and third, managing large asset portfolios to match insurance liabilities.

Insurance underwriting and bond issuance play an important but relatively limited role: the bulk of insurance liabilities are tied to life/savings or motor/home insurance policies, i.e. not directly affecting ESG-related outcomes. Similarly, the type of bond issuance affects a small portion of an insurers' liabilities. On the other hand, an insurer can be highly impactful on the asset side, through management of its investment portfolio.

Matteo Bertolo
Pimco

Insurers have significant amounts of cash to deploy across equity, fixed income, infrastructure and other asset classes. The stock of investment is large but even the flow is massive, given the constant inflow of premiums. As large equity and bond holders, insurers can be highly influential: they can exercise votes, they can engage with a company. For me, that is where an insurance company can really be impactful.

Le Bihan: I agree that the asset side impact is very important, but I have a different view on the underwriting. An interesting development is the greater focus on sustainable underwriting. Bertrand touched on it. Insurers could arguably be efficient gatekeepers as insurance coverage is essential to get any project moving. One needs the financing of course, but insurance providers are a smaller group compared to providers of financing and capital. You will always find someone who is prepared to lend money for any type of project even with very poor ESG credentials. While the insurers and reinsurers are a much smaller group and might be able to be even more efficient gatekeepers compared to investors

Eriksson: I completely agree. That doesn't mean that you can't get insurance for a polluting business somewhere – unfortunately, you can. It is just that it's a lot more limited and more expensive.

GlobalCapital: Bertrand, gatekeepers, as per Pierre's comments, or a function of your overall asset management: where can you do the most good for the world?

Bougon: We have a lot of pressure from non-governmental organisations. For instance, we had our AGM this week, and some NGOs were actively asking to change our oil and gas underwriting commitment. Such changes are taking time on our side, and although we are member of the Net Zero Alliance our approach can be disappointing for some NGOs.

One of the challenges on the reinsurance side is that you don't know all the risks you are insuring – if you reinsure a share of an insurer book, you don't know the individuals risks and, therefore, can breach your commitment without knowing. Sustainability is closely followed by our board and management team, which are regularly increasing our commitments.

Eriksson: Then there is the question of transition activities. Gas pipelines, for example. If you have a policy to support gas pipelines to the extent that they have the requisite reinforced polymer lining to be able to transport hydrogen and there is a plan to substitute hydrogen for natural gas, then you can have a real impact there as well. I think we all will do this. I think insurers are leading on the asset origination side and on the planning side too, and that's really impactful.

GlobalCapital: How significant is IFRS 17? Do you think its fully understood? Will it change the overall level of capital?

Le Bihan: It is important. It materially impacts the accounting of certain products and the timing of earnings recognition, which is particularly true for long-term life products.

Leverage ratios will also be altered due to the change in shareholders' equity, but rating agencies are expected to adapt their approach. And investors will probably get more granular views on profit drivers.

In theory, we will get greater consistency in terms of methodology, but it is a principle-based approach and there will be different interpretations.

That said, IFRS 17 merely constitutes new lenses. The underlying business of insurance companies will not change overnight, these will still be the same companies the day after, we will just look at these with different lenses. We should not overstate the impact. Still, there could be implications in three scenarios:

First, it may change the investor appreciation of certain products or companies by highlighting strengths or weaknesses that weren't that apparent before. Those were arguably always there of course, just not so visible.

Pierre Le Bihan
BlackRock

Second, on the issuer side, it could in some cases prompt changes to corporate or product strategy for the same reason.

And it might also prompt changes to capital policies in places. To be clear, Solvency II and cash (itself driven by local accounting and capital) are becoming the main drivers of capital policy, but IFRS can sometimes remain a constraint.

Is it well understood? I'd say the current standards aren't generally that well understood in the first place. However, insurers are getting an opportunity to explain better their business and accounting and that's a useful opportunity for insurers to engage with investors. We talked about the lack of understanding of the sector and that's an occasion to engage.

GlobalCapital: **Bertand and Johan, what do you think about Pierre's point that Solvency II is the overall driver, not IFRS?**

Eriksson: I absolutely agree, Solvency II has dramatically changed European insurance for the better. Not 100%, but generally for the better. IFRS 17 is just consistent with Solvency II.

For the first time in many markets outside Europe, insurers will have a mark-to-market regime. It is going to be unpleasant for certain products that have survived outside Europe because they have not had a mark-to-market capital regime. So, there is a very real benefit for us commercially, since we haven't been able to do that business for quite a while.

I like to have consistency between the asset and liability side. Of course, market value assets and market value liability make a lot of sense. The local GAAP [generally accepted accounting principles] approach — book value assets, book value liabilities — also makes some sense. What does not make sense is IFRS 4: market value assets, book value liabilities — that's just wrong. You have to correct a wrong. IFRS 17 is a lot better. It's not perfect but it's a lot better.

Is it properly understood? No. Do I fully understand everything? No. We have already been running parallel reporting for all of our activities for quite a long time.

GlobalCapital: **Bertand, does it change corporate strategy? Is it that fundamental?**

Bougon: For the first time, with IFRS 17, we will recognise value creation. That's very good. It's far better than IFRS 4, of course.

Will it change strategy? Yes and no. In any case, it will not be a drastic change from the strategy, which was already considering value creation, and we have long-term portfolios that cannot be changed quickly.

I'm very interested in understanding the views of those looking at insurers. In practice, I suspect that nobody will understand IFRS 17 for the next few years, and that people will just focus on pure cash metric. And what are your expectations for the transition between accounting frameworks? For instance, we have an arbitration and a balance to make between CSM [contractual service margin] and shareholder equity that could lower or increase SHE versus IFRS 4. Pierre, do you believe that a change in the leverage ratio, because we are changing recognition or classification of value, is dramatic? We are waiting for rating agencies to give their views. Some of them have already announced capturing CSM in the leverage ratio, which would make sense.

Eriksson: We shouldn't overstate the differences. Essentially, it's embedded value accounting. UK issuers have done it for a long time, and we have all used MCEV [market-consistent embedded value] for a long time.

Coming back to the point of cash mattering, yes, that's one of the reasons people stopped looking at embedded value and focused on cash instead, because value does not necessarily equate to embedded value or the CSM. That's going to remain the same.

Conceptually, it's not that much different but there will be an educational process for sure.

de Saussure: Probably it's more material for equity analysts than bonds analysts, apart from the leverage calculation.

There are three side topics. One is the impact on the ADI position, in particular, for UK insurance policies reporting on local GAAP that is close to IFRS. The second is bancassurance groups. UK banks have been very vocal about the volatility impact on their profit and loss. But I am more worried about the capital impact on banking groups that are reporting under the Danish compromise. Johan, Allianz has been very vocal against the Danish compromise. We will probably see more volatility there —in particular, for big French banking groups.

The last point is, I'm still getting calls around delisting opportunities for some bonds moving from Euronext, which makes me wonder if insurance companies are so well prepared ahead of IFRS 17, particularly the smaller ones.

Benyaya: On bancassurance, IFRS 17 will affect banking group capital because IFRS equity is consolidated within bank CET1 — so, if there is lower IFRS equity at the insurance level, there will be some impact on the banking group.

On the arbitrage between CSM and shareholder equity, there are some complex choices for bancassurance groups to manage. It has been already a focus point for equity analysts.

It's a function of the profile and business mix of the insurance subsidiary and the relative size, so it's not the same for everyone, but I agree with Julien. It is clearly something to monitor.

GlobalCapital: S&P has proposed a change to their model, and withdrawn part of it. Why? Where are they going to get to? And what will the implications be?

Benyaya: I'm not an S&P analyst, so I'm not sure I can answer that question. But there has been some controversy about how S&P will factor investments where no S&P rating is available. Insurance authorities and the US Department of Justice have been quite vocal, and this resulted in the decision to withdraw that part of the request for comment.

S&P said that they would issue a new RFC later this year so it's difficult to say what the final impact will be.

Eriksson: The proposed model is beneficial for credit broadly. It's not helpful for the various equity markets, although I suspect and hope charges for alternative equity will change. But there are so many parts I would expect to change, including the rating part subject to US processes.

Bougon: There are a lot of changes in the proposed S&P model. Many of their choices are debatable and we will see if they will change with market feedback. For instance, considering whether life future profits should be recognised fully in the available capital and then charged as a risk is an example.

Keep in mind the capital model is not the rating. S&P can ask you to hold an AAA level of capital to get an AA rating, as per their criteria. With the new model, reaching a AAA level of capital will be very extremely costly – therefore, we believe, they will have to adapt their insurance criteria. The new model is a welcome change. Their current model was implemented in 2013, so it's quite old. It was before Solvency II.

What will that change? Maybe our views on some risks. Today, it's too early to say. We are waiting for a lot of clarification.

GlobalCapital: What other regulatory topics are on the horizon that might be significant for the insurance sector?

Benyaya: The review of Solvency II is a medium-term project. There is nothing concrete and nothing being implemented for a few years.

Within the review there are many moving parts. What I can say is that, for the capital instruments, there is no change in the features of tier one, tier two or tier three instruments.

The European Commission communicated the very big day one positive impact, but that is down to the fact that the more negative proposals — in particular, around extrapolation and negative interest rates — will be phased in over time. The net impact at the end of the transition period is a bit more balanced and overall neutral — in line with the original political objective to have an evolution, not a revolution, of Solvency II.

I don't think it will really change the way insurance companies manage the need for a RT1, tier two, tier three. I don't think it will affect the potential supply over the medium term.

Eriksson: Solvency II is imperfect and will continue to be imperfect. Life isn't perfect. You just get on with it. It's mainly technical changes. Some of them are good, some of them are not so good. We just have to accept that other people are going to impose expectations and criteria on us. We have to live with that, just like the S&P model.

At the end of the day, however, investors and everyone else can take comfort from the fact that the insurance sector has among the lowest default rates of all industries. This will not change, and this can help investors look through some of the complexities. GC