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Revival uncertain as century-old Phoenix flames ebb

by KHAW Ker Wei

Anticipation has been steadily building up in the markets that the year 2015 could finally be the year the US hikes its benchmark interest rate for the first time in nine years. Just a week ago, the Federal Reserve Chair Janet Yellen re-affirmed the view of raising the interest rate towards the end of the year. The interest rate hike, if and when it happens, would stir up the winds of change in the economy and for some industries such as the life insurance and annuity industry, it would be a major event for mid-sized firms like The Phoenix Companies (Phoenix).

Phoenix hails from a background rich in history. It is the result of a merger between two predecessor insurance companies that were founded back in the mid-nineteenth century. Both companies held fast to pull through the Depression of 1873-39, when more than 100 life insurance companies folded up, and were rather successful in the early twentieth century. In 1992, the companies merged into a single mutual insurance company and later, converted into a stock company at the turn of the 21st century. At present, the company owns two principal subsidiaries, which provide life insurance and annuity products to the mass affluent market segment. Phoenix also holds an ownership stake in Saybrus Partners, a subsidiary that was set up to provide insurance product distribution and consulting services, to both the parent company as well as other insurance companies.

While the company has a commendable track record of survival, the events of the beginning of this century, in particular the Great Financial Crisis, may be its greatest test of endurance yet. The crash of the financial sector in 2008 triggered the Fed to slash its benchmark interest rate from 3.50% to almost zero by the end of the year. When that failed to calm the markets, the Fed embarked on its ambitious quantitative easing programs, and interest rates have continued to stay low since.

The low interest rate environment has presented multiple challenges to Phoenix's business. The company has increasingly looked towards investment income as a source of revenue in recent years. While it also derives its revenues from net premiums, as well as policy charges and fees, the annual income from net premiums has shrunk considerably – halving from USD 684.2mn in 2009 to only USD 332.1mn in 2014. The reliance is evident, as the investment income segment contributed almost 50% of Phoenix's revenue mix in the year 2014. In contrast, net premiums were only 20% of the company's total revenue during the year. With persistent low interest rates, Phoenix is cornered into reinvesting its proceeds at lower yields, compared to the yield of its existing investment portfolio. Given that approximately 35% of the company's total policy liabilities of USD16.4bn contain guaranteed minimum credit rates, interest rate spread management would be the key driver to Phoenix's near-term profitability. Already, as of 31 December 2014, the 4.0% guaranteed minimum policyholder crediting rate of its universal life account, which totaled USD 2.0bn in size, had almost caught up to the investment yield of 4.8% generated by the portfolio that backed it.

With annual revenues only generating a small surplus over its operating expenses, Phoenix's has been reporting net losses annually since 2009, with the exception of the year 2013. Despite the long streak of poor performance, Phoenix's share price held up well and only took a plunge after the announcement of its quarterly results in March 2015, when it was also discovered that there were material weaknesses in the internal controls over financial reporting. That quarter, Phoenix reported a net loss of USD 140.3mn. Subsequently, Phoenix also booked a net loss of USD 74.0mn for the first quarter of 2015, primarily driven by legal settlements and financial reporting expenses. As of mid-July 2015, the share price of the company had lost almost 80% of its start-of-year value.

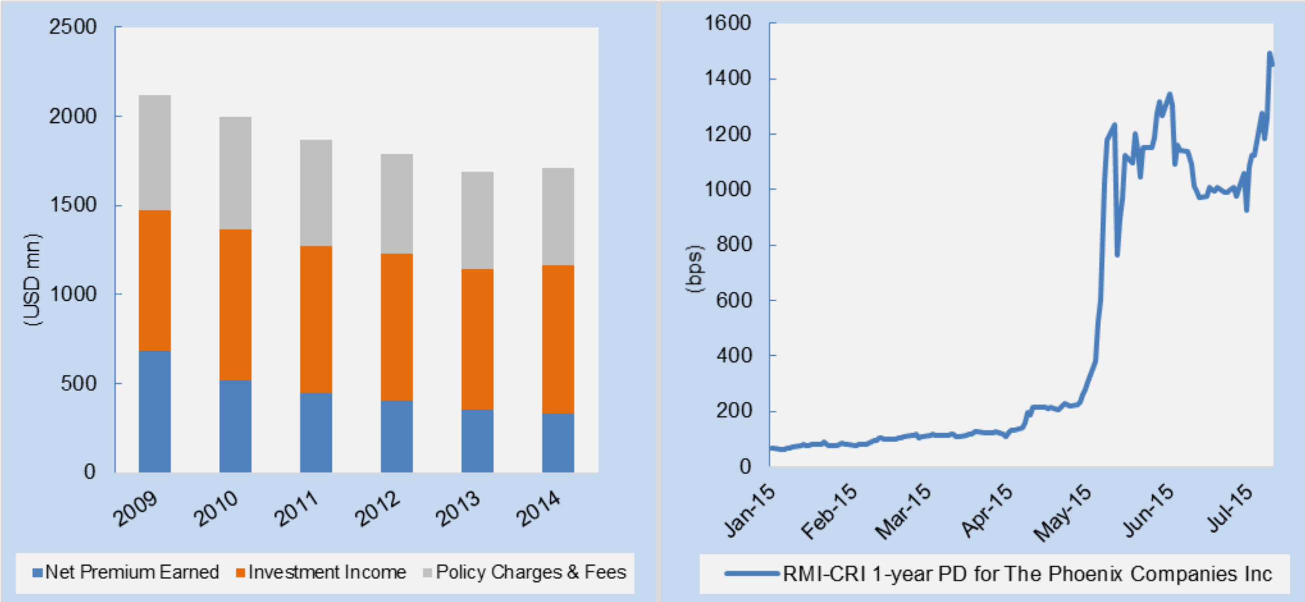

Figure 1: The change in revenue composition in The Phoenix Companies in the years leading to 2014 and the surge in the RMI-CRI 1-year PD in 2015. *Source: RMI-CRI, Bloomberg*

The heavy loss in market capitalization, as well as its consecutive net losses, has increased Phoenix's RMI-CRI 1-year probability of default (PD) significantly. By 10 July 2015, its RMI-CRI 1-year PD had surged to more than 1400bps from just under 100bps at the beginning of the year (see Figure 1).

If the anticipated hike does indeed materialize, insurance companies may finally find further room to maneuver their businesses, as the higher rates would support sales growth and margins. Furthermore, the present value of policy liabilities that insurers carry on their balance sheet would also decline, which should translate into improvements in the RMI-CRI 1-year PD generally. In the more immediate term though, the interest rate hike would also pose substantial market risk to the investment portfolio of Phoenix. The portfolio held more than USD 12bn in debt securities, which were categorized as available-for-sale as of 31 December 2014. A hypothetical interest rate hike of 100bps, although very unlikely, would result in an unrealized loss of about 5.4% of its value. A further loss of ground in equity value, coupled with the changes in macroeconomic variables, could then potentially offset any gains and limit the improvements to the RMI-CRI 1-year PD for Phoenix.

2015 has already proven to be a difficult year for Phoenix thus far. The company previously launched a sale process back in July 2014 but the outcome of that exercise remains inconclusive to date. With the share price languishing just slightly above the record low, Phoenix is already a more attractive acquisition target but the material weakness found in its historical financial reporting could prove to be a major deterrent. Even if the deal were to move ahead, it will most probably happen at less favorable terms to shareholders.

Sources:

2014 Annual Report, The Phoenix Companies Inc
Form 10-Q Q12015, The Phoenix Companies Inc
RMI-CRI
Bloomberg

Credit News

Eurozone leaders reach rescue deal for Greece, with tough conditions

Jul 13. Greece's chances of securing a fresh bailout to save it from financial collapse is now conditional on its capability to withstand through adverse austerity measures and challenging economic overhauls, as well as dealing with its volatile politics in the coming days. Unfortunately, even if Greece completes the bailout program in the following weeks, many European officials will express strong doubt on Athens's ability to stick with the tough economic measures, given that the Greece government which tried to implement similar unpopular measures was brought down in the past few years. Additionally, economists pointed out that the speed and intensity of the new economic measures may be beyond Greece's ability to endure and may lead to further political instability. (WSJ)

Debt load digs into mining industry

Jul 12. As China's demand for resources ebbs, the mining industry's profits suffer amid falling commodity prices. Metals such as iron ore, copper and aluminium fell to near six-year lows when Chinese share prices plummeted last week. Because of their misjudged investment choices and because of the changing financial situation, heavily indebted mining companies, cut big project spending recently. Many also face the decision to reduce dividends to shareholders, or borrow more to keep funding high pay-outs, risking downgrades to their credit ratings that would drive up interest costs. (WSJ)

IMF sees global growth as weakest since crisis

Jul 9. The IMF downgrades growth outlook to 3.3% as China and other emerging markets decelerate. The growth rate is set to its weakest pace since the financial crisis. While mounting threats from China's recent stock-market turbulence to Greece's long-festering debt woes add to a long list of forces restraining the world economy, these bouts of turmoil underscore the fragility in the world's economy. As governments have pushed debt to dangerously high levels and central banks are constrained by the lower limits of rate reductions, the IMF forecasts that weak growth, mountains of debt, high unemployment and limited policy options are setting the stage for more market volatility ahead. Yet, the IMF still expects the global economy picking up in 2016, expanding to its fastest pace in five years, at 3.8%. (WSJ)

Loan exposure to Indian steel players a cause for concern

Jul 9. The fall in metal prices, along with the debt burden of the steel industry has raised concerns over the banking sector's exposure to the steel industry. Credit Suisse has a negative outlook on banks with significant portion of exposure to steel industry, given the signs that the debt burden of many steel companies have reached unsustainable levels, and a recovery of these accounts seemed implausible without haircuts. Additionally, several companies in the steel industry have defaulted on their payment, which may impinge on banks with significant exposure to the steel industry. (Economic Times)

Microsoft takes USD 7.6bn Nokia writedown and cuts 7,800 jobs

Jul 8. Despite its ambition to become a leading player in the smartphone world, Microsoft's Lumia phones are languishing with a miniscule 3% market share, powerless to rival flagship phones from Samsung and Apple. After taking into account restructuring charges, Microsoft is scaling down its mobile phone activities as it takes a writedown of USD 7.6bn, which is almost the entire value of its Nokia handset acquisition. The tech titan will also cut 7,800 jobs, primarily in the phone division, which had been hit hard in a company-wide cull of 18,000 positions last year. 2,300 layoffs of the 3,200 remaining workers will be made in Finland, where Nokia is headquartered. (FT)

Asia's rising economic stars lose luster on China's slowdown (Bloomberg)

Saudi Arabia borrows USD 4bn as oil price reality hits home (FT)

US banks may increase provisions in coming quarters (SCMP)

Regulatory Updates

APRA says bank capital will not be tied to international benchmarks

Jul 13. While raising the total capital of Australia's big banks will in no doubt strengthen its financial system, the Australian Prudential Regulation Authority (APRA) has no intention to tie Australian capital adequacy to a continually moving international benchmark. APRA claims that its research at comparing the common equity tier 1 (CET1) capital ratio of Australia's major banks with its international peers aims to understand the strength of Australian's financial system, rather than to determine Australian's bank capital adequacy requirements. APRA also claims that the CET1 ratios for major banks would be about 300 basis points higher, if they used a similar computation methodology by the international regulators, as APRA responded to criticism by banks in Australia that its conservative approach in computing capital has reduced Australian's banks reported capital relative to their international peers. (Sydney Morning Herald)

BOE designs leverage ratio rules to curb window-dressing

Jul 10. To prevent banks from temporarily adjusting their balance sheets around the reporting date as banks attempt to create a false impression of their risk exposure through a methodology known as "window-dressing", the UK prudential regulation authority has proposed banks to report their daily leverage ratio. This proposal will ensure that firms are satisfying the leverage ratio requirements over time, as well as avoid instability in financial markets due to transactions associated with "window dressing. The regulators proposed that the leverage ratio should be applied to banks and building societies with a minimum of GBP 50bn of retail deposits. (Bloomberg)

Regulators on hook for China stock slide

Jul 9. Following the stock slide in China, the China Securities Regulatory Commission (CSRC) has tried almost all means to stabilize the market, but has instead left the impression that they overreacted. On Thursday morning, China's banking regulator and its public security ministry has joined the CSRC and the central bank in attempting to stabilize the rout on Shanghai and Shenzhen stock exchanges. The combined efforts had shown some results when the Shanghai and Shenzhen composite indices went up by 5% and 3.7% respectively, after the lunchtime break on Thursday. (FT)

MAS refines proposals to strengthen REIT market (Channel NewsAsia)

Insurers imagine the worst for stress test (FT)

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Contributing Editor: Victor Liu