A Special Preface

After dedicating 14 years to the Credit Research Initiative (CRI), Professor Jin-Chuan Duan, the founder, is due to retire from the National University of Singapore on June 30, 2023. The launch of the CRI in July 2009 marked a pioneering step in offering, as a public good, daily-updated corporate credit risk assessments on a global scale. The CRI platform has also set the new scientific and operational standards for credit risk analysis. The CRI team thanks Professor Duan for his inspirational leadership and many contributions in this remarkable journey.

Interest rate hikes exacerbate the credit profile of the Eurozone insurance sector

by Claudio Bonvino

- **NUS-CRI Agg PD for the Eurozone insurers gradually increases along with the interest rate hikes of the ECB mainly due to their investment portfolio being exposed to heightened market risk**
- **NUS-CRI Forward PD for the Eurozone insurers suggests a deterioration of the credit profile in light of the ongoing inflation and flames of an economic downturn**

The Eurozone insurers might follow the steps of the banks, with significant exposure to the value-declining fixed-income investments due to the continuous interest rate hikes. Specifically, the recently forced administration of Eurovita[1] has sent tremors through a sector where bankruptcies are relatively rare and raised risks for the most vulnerable life insurance companies, as well as "mass lapse" risk. Despite the idiosyncrasy of the case, it may signal the vulnerability of Eurozone regional insurers to monetary tightening.

The NUS-CRI Aggregate (median) 1-year Probability of Default (Agg PD) of Eurozone insurance companies[2] increased since Aug-2022. The impact of interest rate hikes on the whole sector's credit health has increased its Agg PD when proxied by PDiR2.0[3] (see Figure 1a). Looking ahead, the NUS-CRI Aggregate (median) Forward 1-year Probability of Default (Forward PD)[4] for the Eurozone insurance companies suggests the worsening of their credit risk profile over the coming 24 months, closing to the BBB- upper bound (see Figure 1b). Further, the interquartile range of Forward PDs of insurers suggests variations within the insurance companies' sub-sectors, requiring the need to assess them individually.

[1] Eurovita is an Italian life insurance company acquired from the UK private equity Cinven in 2017. The rising interest rates impacted its holdings and materialized the lapse risk, forcing the company to a temporary administration. The Italian authorities are orchestrating a rescue plan that would divide Eurovita among Italian insurers.
[2] The sample includes life insurance, P&C insurance, reinsurance, and insurance brokers and services companies in the Eurozone.
[3] The Probability of Default implied Rating version 2.0 (PDiR2.0) provides a more familiar interpretation by mapping the NUS-CRI 1-year PDs to the S&P letter grades. The method targets S&P's historical credit rating migration experience exhibited by its global corporate rating pool instead of relying solely on the reported default rates.
[4] The Forward PD estimates the credit risk of a company in a future period, which can be interpreted similarly to a forward interest rate. For example, the 6-month Forward 1-year PD is the probability that the firm defaults during the period from 6 months onwards to 18 months – this is conditional on the firm's survival in the next 6 months.

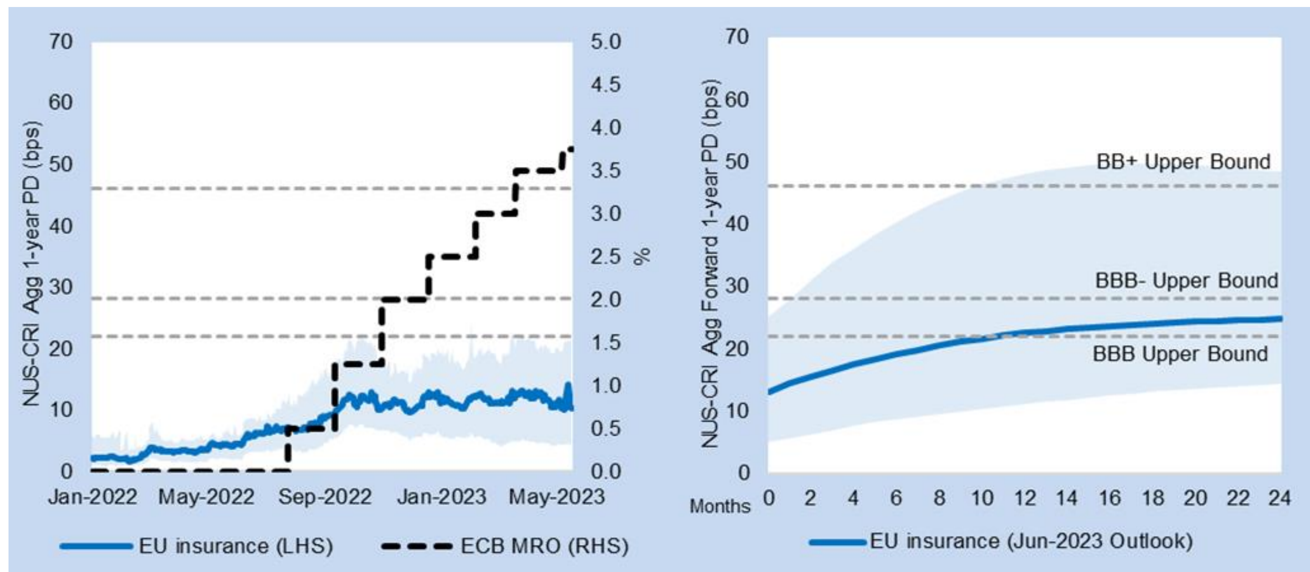

Figure 1a (LHS): NUS-CRI Agg (median) 1-year PD for Eurozone insurance companies with their interquartile range from Jan-2022 to Jun-2023, with reference to PDiR2.0 bounds; The ECB interest rate on the main refinancing operations (MRO) from Jan-2022 to Jun-2023. Figure 1b (RHS): NUS-CRI Agg (median) Forward 1-year PD for Eurozone insurance companies with their interquartile range as of Jun-2023, with reference to PDiR2.0 bounds. *Source: NUS-CRI, ECB*

The profitability of Eurozone insurers deteriorated in 2022 primarily due to the losses on interest rate-sensitive investments, the increase in claims payable, and the drop in gross written premiums for life insurance companies. Both the median return on asset and the median return on the excess of assets over liabilities marginally reduced to 0.40% and 6% in Q4 2022, compared to 0.56% and 8% in Q4 2021 respectively. Although there are different trends across countries, liquidity for distressed insurers with low liquid assets (those in the 10th percentile) also worsened, with their liquid assets ratio[5] dropping 4 percentage points to 13% in Q4 2022. Though the drop in the liquid assets ratio may not be large for the sector as a whole, the decreasing trend may suggest why the credit profile for the sector is likely to be pressured in the near term (see Figure 1b).

Persistent inflation pressures may limit households' ability to maintain payment of premiums as the cost of living increases, while a simultaneous recession may see the value of insurers' investment holdings continue to decrease. Threats of failure, like the one seen in Italy's Eurovita, might also increase the surrender rate faced by insurance companies as funds transfer to higher-yielding assets, increasing the lapse rates[6]. The solvency capital requirement (SCR) ratio, though differing across countries, remains robust and is above 207% in all insurance sub-sectors, suggesting a strong fundamental capital position. As such, though the current macroeconomic environment provides some headwinds to insurers' fundamentals, the sector may be able to withstand the decrease in asset values and the potential increase in investment losses, with the Forward PD not exceeding the 28bps investment-grade threshold over the next 24 months.

The past few years have seen Eurozone insurers gradually pivot their investment strategies to riskier investments in an effort to earn higher yields in a low interest-rate environment. Specifically, Eurozone insurers' investment portfolio continued the shift towards alternative investments like unlisted equities and properties (5.6% of total investments in 2022 compared to 4.4% in 2021) to boost profitability. Since 2019, the proportion of governments, corporate bonds, and collective investments has reduced in favor of unlisted equity, mortgages and loans, and property investments (see Figure 2a)[7].

Despite the limited exposure to the US regional banking crisis of Mar-2023, the resultant fallout signaled the risk of transmission as the insurance sector has a sizable exposure to the domestic EU banking sector, which was affected by the shotgun merger of Credit Suisse and UBS. Additionally, as the Eurozone real estate sector started its price decline, the insurance companies face a significant risk from their exposure to the sector; however, these investments are usually held for a long period, which enables insurers to withstand short-term price swings. However, real estate investments may be subject to downward revaluations in periods of property price declines, like those seen in major European cities recently, which may negatively impact their asset quality.

[5] The liquid assets ratio shows the proportion of liquid assets to total assets and is calculated by applying different weights ranging from 100% for cash to 0% for intangible assets to different assets according to their liquidity profile.
[6] The lapse rate measures the percentage of insurance policies that have not been renewed by customers. The "mass lapse" is the equivalent of a bank run in the banking sector.
[7] Eurozone insurers are also exposed to concentration risk and sovereign risk as a large proportion of their investments are in their home countries. At the same time, about 24% of government and corporate bonds in EU insurance portfolios are rated BBB, which in the current macroeconomic environment, may be at risk of being downgraded to non-investment grade.

Although currently robust solvency ratios provide some reprieve to insurance firms, a continued decline in real estate prices may increase the possibility of a deterioration in credit health.

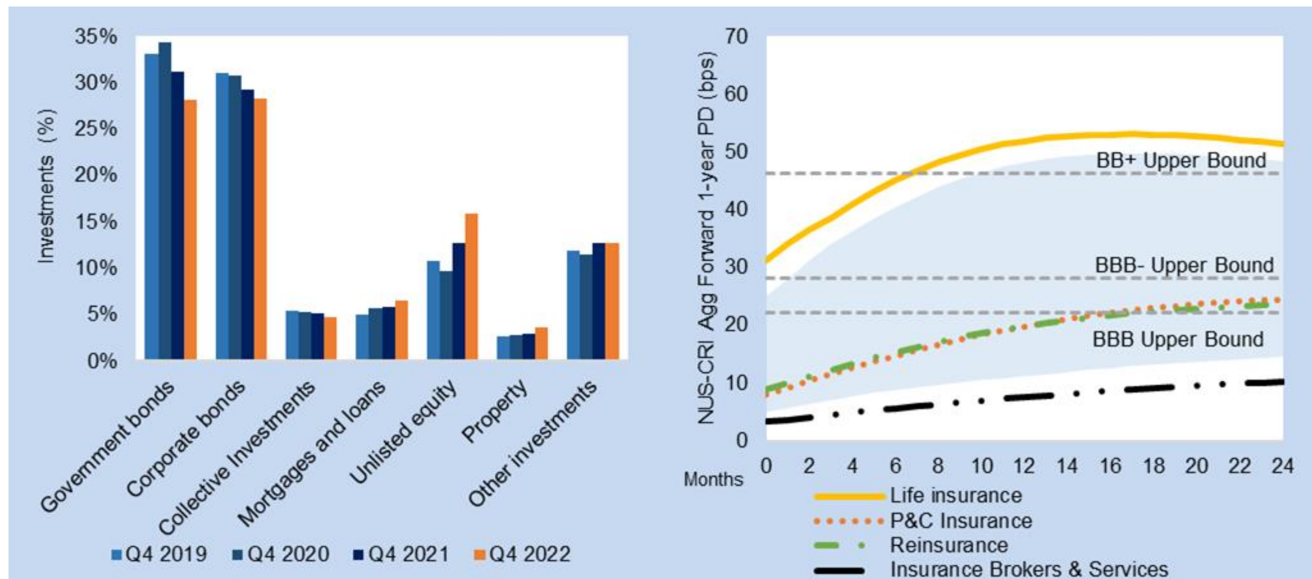

Figure 2a (LHS): Split of investments by Eurozone insurance companies, as a percentage of total investments. Figure 2b (RHS): NUS-CRI Agg (median) Forward 1-year PD for Eurozone insurance sub-sectors with their interquartile range, as of Jun-2023 outlook, with reference to PDiR2.0 bounds. *Source: EIOPA, NUS-CRI*

The deterioration of the credit quality of the Eurozone insurers differs between sub-sectors. As seen in Figure 2b, Eurozone-domiciled Life insurers are susceptible to higher deterioration in their credit risk profile, compared to their Reinsurance and P&C Insurance counterparts. This may possibly suggest that life insurers are more susceptible to surrender risk as a mass lapse of insurance contracts due to inflationary pressures mentioned above can hinder potential revenue for the sub-sector. Comparatively, reinsurers are set to be relatively better off, despite also facing potential deterioration in their credit profile. Reinsurers, that have benefitted from the rising interest rate environment, may see a drop in demand that could contribute to their profitability and asset quality worsening. The resulting impact on the sector, the credit profile of which is likely to worsen as shown in the Forward PD in Figure 1b, could also be because of the lack of diversification benefits that are provided by reinsurance contracts should reinsurance products' demand drop. The Forward PD in Figure 2b also suggests that Insurance brokers are likely to be least affected by the headwinds faced by the sector, possibly being less sensitive to interest rates. As such, though the sector currently has robust fundamentals and strong solvency positions, the macroeconomic environment in which insurers operate could provide hurdles that worsen their credit profile.

Credit News

UK mortgage borrowers face greater pain as BoE raises rates

Jun 23. Mortgage borrowers are being warned about potential increases in the cost of both fixed and variable-rate mortgage deals. The Bank of England's decision to raise its base rate to 5% came as a blow to borrowers already facing rising bills. While some experts believe that fixed rates have already adjusted significantly, others anticipate more dramatic and protracted changes in the mortgage market. The impact on house purchase activity remains uncertain, but higher rates could force some homeowners to reassess their situations. Lenders are uncertain about how to price loans due to the market's volatility, leading to potential increases in fixed rates in the short term. Heavily mortgaged buy-to-let landlords, particularly those with interest-only loans, may struggle to make a profit and could consider selling their properties. Although fixed-rate mortgages provide some protection, base rate rises can affect borrowers looking to refinance, as lenders assess affordability based on stressed conditions at higher rates. (FT)

Bets on bond renaissance frustrated by stubbornly high inflation

Jun 25. Investors who flocked to fixed income in anticipation of a strong rebound have been disappointed as global bond markets have lost 1% this quarter due to high inflation leading central banks to raise interest rates. The setback comes after a 3% gain in the first quarter and follows last year's 16% loss for the Bloomberg Global Aggregate index. Many investors who bet on declining inflation and recession have suffered losses. While significant inflows into taxable bond funds were seen at the beginning of the year, outflows have been observed from short-dated government bond funds, as investors opt for Treasury bills offering higher returns. Despite the underwhelming performance, fund managers remain optimistic, citing higher yields as a cushion for potential price declines. (FT)

Junk-rated companies accept tougher terms to borrow

Jun 26. Low-rated companies are adjusting to higher interest rates by issuing secured speculative-grade bonds with shorter maturities, aiming to minimize borrowing costs. This year, they have issued USD 91bn in such bonds, up 35% from the previous year when rising rates hindered issuance. The majority of these bonds, 62%, are secured with collateral, providing investors with more protection in case of default. The average maturity of junk debt has decreased to 6.1 years, giving companies greater flexibility. This trend reflects investors' caution in an uncertain environment, seeking defensive options. Despite concerns about a credit crunch, the healthy bond market in the US helps offset any reduction in bank lending. (WSJ)

Wall Street buys more T-bills, parks less at Fed

Jun 20. Money markets are parking fewer funds with the Fed, demonstrating signs that the recent debt ceiling debacle has not upended borrowing confidence by the markets. The reverse repo market, which borrows from money market funds and other firms in exchange for securities that it returns the next day, saw the biggest drain in the last six months last thursday, dropping the market cap below USD 2tn for the first time since Jun-2022. This may suggest that inflow of capital into money markets is diminishing post the banking crisis in Mar-2023, buoying the sentiment against capital outflow in the domestic stock markets. Investors are therefore looking at the reverse repo market as a safe haven that, since the aversion of US' default, has provided sufficient return in the market as demand for new issuances remains robust. (WSJ)

Europe's bank resolution authority seeks 'firepower' to deal with collapsed lenders

Jun 25. Following the financial collapse of regional banks in Mar-2023 that led to the US government guaranteeing deposits, as well as the forced merger of Credit Suisse and UBS by the Swiss central bank, Global central banks have iterated that banking regulations on global rules on capital and liquidity are insufficient. The situation is especially dire for banks in the Eurozone, which may pressure the central bank to offer liquidity lines and guarantees for systemically important large banks as a short-term reprieve to prevent bank runs, according to Single Resolution Board (SRB) chair Dominique Laboureix. Put simply, the SRB chair has asked for a new framework within the Euro area that allows individual supervisory institutions to offer liquidity facilities as quickly as possible to maintain contagion fears arising from potential bank runs. (FT)

Big US banks to fare well in annual health checks despite spring turmoil (Reuters)

India to tighten scrutiny of offshore funds after Adani probe (Nikkei Asia)

Japan's MUFG to float USD 2bn in AT1 bonds (Nikkei Asia)

Regulatory Updates

Investor scepticism remains after Turkey's 'baby step' towards ending crisis

Jun 22. The Turkish central bank increased its benchmark interest rate from 8.5% to 15% in an effort to lower the country's over 40% inflation rate. This is the first indication that President Recep Tayyip Erdoan's economic team, which is comprised of the central bank governor Hafize Gaye Erkan and finance minister Mehmet Imşek, will use conventional economic tools to put Turkey's economy back on a more sustainable path and attract investors who have fled the market. The price of insurance against a default on Turkish debt increased, while the lira also dropped 5% to a record low versus the US dollar. For the first time, the value of the currency fell below 25, contributing to a loss of about 26% this year. (FT)

Bank of England seeks to get on front foot in fight against inflation

Jun 23. The recent half-percentage hike in interest rates indicated that the Bank of England finally was taking a strong stance towards fighting inflation. The larger than expected hike surprised markets and raised the interest rate to 5%. At the same time, BoE governor Andrew Bailey delivered a tough message to households highlighting that the upcoming pain in mortgages was necessary to avoid a worse situation in the future. Experts in the Treasury anticipate inflation to trend downwards from 8.7% seen in May to BoE's target range of 2% over a period of 18 months. (FT)

Swiss central bank calls for overhaul of banking regulations after Credit Suisse rescue (FT)

BOJ member called for early tweak to YCC, yen worries resurface (Reuters)

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