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Asset Management

European Insurance Regulatory Capital Evolution a Positive

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The European insurance sector has evolved under Solvency 2 (S2) regulation implemented in 2016. We expect well capitalized insurers to continue to replace legacy instruments with S2 eligible securities ahead of the end of the 10-year grandfathering period at year-end 2025.

Solvency 2 regulation requires at least 50% of insurer solvency capital requirements (SCR) in the form of Tier 1 capital, of which at least 80% must be unrestricted (*e.g.,* common equity). Up to 20% of Tier 1 capital may also be in the form of restricted Tier 1 (RT1) bonds. Tier 2 (T2) subordinated instruments – and to a lesser extent Tier 3 – are eligible to make up a portion of capital as well.

RT1s are deeply subordinated and the insurance sibling of bank additional tier 1 (AT1) contingent convertible (CoCo) instruments. RT1s contain coupon deferral and write-down features, *e.g.,* upon breach of SCR and other regulatory thresholds. Given the potential risks, investors expect to be compensated with a notable spread premium over more senior instruments.

Under Solvency 2, leading insurers maintain robust capitalization, averaging over 2X stringent regulatory requirements and with relatively low sensitivities to market and insurance related stresses. Funding is stable, investment portfolio quality is sound and the industry has a good track record through volatility. **In our opinion, RT1 coupon deferrals and write-downs are remote risks for high quality issuers**.

Insurers tend to sustain significant excess unrestricted tier 1 capital and thus do not always issue RT1. They may also have ample balance sheet capacity to issue less costly T2 debt. Yet, as we approach the end of grandfathering at the start of 2026, we have seen an uptick in RT1s coming to market. *Moody's "rated European insurers had close to €22B of outstanding grandfathered debt at YE2022, and around 50% of these issuers had already exhausted their Tier 2 and Tier 3 capacity or do not have enough capacity to fully replace grandfathered debt with Tier 2." Moody's estimates new issuance could require "at least €8B of new RT1 securities" to replace grandfathered instruments.*

Over time, we anticipate issuance across Europe will exceed these figures. As the end of the S2 grandfathering period nears and new separate Swiss insurance regulation transitions (10 years from 2024 start date), we expect insurers to optimize capital structures/costs**. Spectrum believes this as an opportunity to invest in new capital securities issued by high-quality insurance companies.**

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