The Importance of Sustainable Finance Debt for Insurers Is Growing

Green Bonds Dominate, but Flexible Sustainability-Linked Bond Issuance May Increase

> "Insurance companies are increasingly using SF-focused debt instruments in subordinated debt of either tier 2 or tier 3 format to achieve sustainability-related corporate targets. SLBs may be another feasible option to do so, given their greater flexibility."
>
> Robert Mazzuoli, CFA, Fitch Ratings

Stakeholder pressure on insurance companies to align their business with environmental, social, and governance (ESG) principles has led to the increasing issuance of bonds that incorporate sustainable finance (SF) standards, such as green bonds, since 2019.

Insurers have also started to consider sustainability-linked bonds (SLBs) due to their fairly high flexibility as the proceeds' usage is not limited to funding ESG-focused investments.

Under Fitch Ratings' insurance rating criteria, Fitch's assessment of SLBs that qualify as regulatory own funds is unlikely to have their ratings and equity credit affected by the additional structural features that would be linked to sustainability targets.

SF Debt Instruments Growing Fast

Debt instruments that focus on SF features have had strong growth in recent years as SF investment strategies have become ever more popular. Issuers' key motivations are meeting tightening ESG-related regulation, such as the EU's Green Deal, and stakeholder expectations, as well as lowering refinancing costs.

Insurers Prefer Green Bonds So Far

Insurance companies have preferred green bonds over other types of SF debt instruments, which is in line with the dominance of green bonds in the broader market and societies' focus on fighting climate change. Most of the green bonds have been issued in Tier 2 format.

Fitch believes insurers will follow the example of other sectors in issuing SLBs over the next 12 to 18 months as market acceptance grows and issuers embrace their greater flexibility. Insurance companies will be most interested in issuing regulatory-qualifying SLBs to bolster solvency capital and simultaneously achieving sustainability-related corporate targets.

SLBs Offer Greater Flexibility

SLBs have a distinctly different and more flexible structure to green bonds. Instead of relying on "use of proceeds" they typically have coupon step-ups that are triggered if sustainability targets defined by key performance indicators (KPIs) are not achieved. Therefore, they may be the better option for some issuers to show their commitment to sustainability.

Based on the features of recent SLB issues of corporates and banks, we believe there would be no impact on the ratings of, or equity credit assigned to, insurers' SLBs in relation to comparable debt issues, but without the sustainability-linked features.

Fitch expects that insurers' SLBs will be most likely be structured to qualify as capital for regulatory purposes. In such cases, Fitch typically mirrors the regulatory treatment of such debt in its own treatment in capital adequacy ratios (CARs).

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SF Debt Instrument Definitions

As defined by the International Capital Market Association (ICMA), green bonds enable capital-raising and investment for new and existing projects with environmental benefits, while social bonds raise funds for new and existing projects with positive social outcomes. Sustainability bonds combine green and social objectives.

ICMA has also provided a definition of SLBs and published voluntary process guidelines that recommend structuring features, disclosure and reporting.

An SLB is defined as any bond instrument whose structural or financial characteristics depend on the achievement of pre-defined sustainability targets within a predefined timeline.

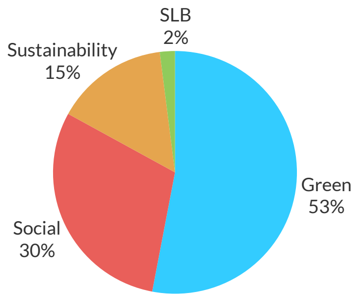
In contrast to sustainability bonds, including green or social bonds, the proceeds of an SLB are not ring-fenced for sustainability goals, but can be used for general purposes.

Strong Growth of SF Debt Instruments

The issuance of global corporate SF debt instruments increased to USD350 billion in 1H21 from USD100 billion in 2018 (2019: USD200 billion; 2020: USD300 billion), according to Bloomberg. The majority of this group of debt instruments were green bonds, followed by social bonds and sustainability (green and social combined) bonds. Fitch expects that this growth will continue in 2021 and 2022, with an increasing share of sustainability bonds and SLBs.

Corporate SF Debt Instrument Issuance

USD300bn (2020)



Source: Fitch Ratings, Bloomberg

The insurance industry was a relatively small contributor to the SF debt instrument market, issuing just USD6 billion of new debt in 2020, all of which were green bonds. The US insurer Prudential Financial Inc. (Insurer Financial Strength Rating (IFS): AA-/Stable) has become one of the first insurers globally to link the borrowing cost of its five-year USD4 billion credit facility to sustainability targets in July 2021, while Assicurazioni Generali S.p.A. (IFS: A-/Stable) placed its first sustainability bond in June 2021.

The funding needs of insurance companies are more limited than for other sectors and new issuances are typically used to refinance maturing or callable existing debt instruments. Fitch expects that SF debt instruments will grow in importance for the insurance sector.

One limiting factor for the growth of insurers' green, social and sustainable bonds is finding sufficient amounts of eligible investments for the underlying asset pools due to a lack of SF-related disclosure. This is likely to improve as disclosure standards are defined and enforced.

Insurers' Major Green Bond Issuance in 2020–2021

Issuer	Type	Volume	Maturity	Issue rating
Assicurazioni Generali S.p.A.	Tier 2	EUR600m	2031	BBB-
AXA SA	Tier 2	EUR1bn	2041	BBB
Groupama Assurance Mutuelle	Tier 3	EUR500m	2028	BBB
Just Group plc	Tier 2	GBP250m	2031	BBB
Munich Reinsurance Group	Tier 2	EUR1bn	2042	A
Unipol Gruppo S.p.A.	Senior unsecured	EUR1bn	2030	BBB-

Source: Fitch Ratings, company information

Increasing Pressure from External Stakeholders

SFs have become an increasingly popular group of investment strategies over the last decade. As an example, dedicated green bond funds' assets under management have almost quadrupled their market share in Europe since the beginning of 2018 to 0.20% in 1Q21, according to Lipper.

To remain attractive for as broad an investor base as possible and to keep refinancing costs low, issuers – including insurance groups – have added new types of debt instruments, such as green bonds. These efforts flow into Fitch's assessment of an issuer's debt service capabilities and financial flexibility, one of the key credit factors under its insurance rating criteria.

The EU has developed a sustainable finance framework to promote investments into a sustainable economy and standardise disclosure requirements. The EU Taxonomy provides a common classification of economic activities that significantly contribute to environmental objectives, using evidence-based criteria. This framework increases the pressure on EU insurance companies to align an increasing proportion of their balance sheet – including investments, technical reserves and financing instruments – with the EU's environmental targets in the European Green Deal.

The issuance of SF-compliant bonds is one answer companies give to growing political and societal pressure to support the fight against climate change. The insurance sector, in particular, is well placed to use the proceeds of issued SF debt to increasingly invest in assets that are environmentally sustainable. Its long-term investment focus, especially in life insurance, means insurers can channel investment into infrastructure projects, notably in renewable energy.

SF debt also helps insurance companies to adapt their investment portfolios to the challenges of climate change by complementing sustainable investment strategies that aim to reduce the risk of stranded assets. The International Energy Agency defines stranded assets as investments that, at some time before the end of their economic life (as assumed at the investment decision point), are no longer able to generate an economic return, as a result of changes in the market and regulatory environment.

SF Growth Positive for Insurers' Climate Change Risk

Fitch considers climate change and its impact on natural catastrophe losses to be one of the most important ESG risks for non-life and composite insurers, and reinsurers. Strong growth of the SF market will mitigate climate change risk and therefore is credit-positive for the insurance sector over the long term.

SLBs Latest Addition to SF Debt Instruments

SLBs are the most recent addition to debt instruments that integrate SF aspects. While the proceeds of green, social and sustainable bonds are dedicated towards financing a specific pre-defined asset pool that has either an environmental or social impact, or both, SLBs are linked to sustainability targets through their structural features. Therefore, the issuance of SLBs gives the issuer more flexibility as the proceeds' usage is not limited to funding ESG-focused investments and therefore is easier and cheaper to implement.

However, the flexibility of SLBs can raise potential issues. There is a moral hazard for investors, as they will benefit from a company's failure to deliver on its sustainability ambitions and goals. The flexible structure with customised KPIs probably makes it easier for issuers to manage the objectives to suit their needs, so potentially leads to 'greenwashing'. As a common framework for performance and reporting standards have not yet been agreed on for SLBs, this makes it difficult for external stakeholders to compare and assess different SLBs.

SLBs' Sustainability Targets Are a Key Differentiating Factor

SLBs typically have structural features that are linked to the achievement of sustainability targets, defined by KPIs. Recent issuances mostly have a coupon step-up to be paid if these KPIs are missed. The current market standard for the step-up is 25bp. The penalty can also be structured in the form of a redemption premium or the payment of an absolute amount of money to a project that fosters ESG objectives. As well as avoiding a penalty, meeting the KPIs may also lead to a reward such as a lower coupon to be paid.

Solvency II Treatment of SLB Features

A core principle of loss-absorbing capital is that instruments are available to absorb losses incurred on all types of assets in the balance sheet of the institution. In that regard, SLBs recognised as own funds meet this principle.

An important criterion of regulatory own funds' eligibility under the EU Solvency II regime is whether there are incentives for the issuer to repay or redeem own-fund instruments. Step-up coupons are allowed for tier 2 and tier 3 instruments under Solvency II, while they are not permitted in callable tier 1 or tier 2 instruments before year 10. The latter also applies to redemption premiums. Therefore, we expect SLB issuance to occur in tier 2 and tier 3 formats only.

The step-up amount is capped at either 100bp or 50% of the initial margin for tier 2 and tier 3 instruments – whichever is higher. It must take the form of a single increase in the coupon. The typical 25bp step-up for SLBs therefore falls within the Solvency II own-fund eligibility criteria.

The insurance regulator, EIOPA, has not provided additional public guidance regarding the implications for own-fund eligibility when incorporating SLB or ESG features into capital instruments. However, a surge in SLB issuance in tier 2 or 3 formats could lead EIOPA to comment on this nascent asset class.

The European Banking Authority opined in June 2021 that step-up or fees based on missing certain ESG targets or other performance indicators should not be allowed or encouraged for bank own-fund instruments. The EBA was concerned that such features could be regarded as incentives to redeem, thereby contradicting the bank's own-funds eligibility criteria. However, we believe that the bank rules would not directly translate to the insurance sector as the risks and the regulatory regimes of banks and insurers are quite different.

Fitch's Evaluation of Prospective Insurers' Hybrid SLBs

In contrast to most existing green, social and sustainable bonds, SLBs have additional structural features that need to be assessed under Fitch's rating methodology.

Based on recent issuances of SLBs by corporates and banks, Fitch assumes there to be no difference on the notching of insurers' regulatory-qualifying SLBs compared to the notching of traditional regulatory-qualifying instruments.

Fitch expects that the additional financial cost, should the sustainability targets be missed, would not materially increase the debt servicing burden of the issuer. Therefore, the structural features of SLBs neither meaningfully increase the non-performance risk nor decrease the expected recovery in the case of default

The debt or equity-like aspects of hybrids for the purposes of CARs and the financial leverage ratio are evaluated based on Fitch's view of how the features of the hybrid support viability and loss absorption under stress.

The key features of hybrids that are assessed include convertibility into equity, maturity or coupon deferrals. The structural features of SLBs may render the evaluation of a hybrid's performance more difficult. However, it should still be possible as long as the penalty is measured in size, is not overly complex and is not directly linked to the creditworthiness of the issuer.

Fitch believes that in most cases insurers will structure their SLB issues in such a way that they qualify as capital for regulatory purposes. If these conditions are met, then Fitch typically mirrors the regulatory treatment of such debt in its own treatment CARs.