ASSURED REPORT

Capital is Dear, it is Not Expensive

P/C insurers have maintained an extremely conservative financial profile for years; now is the time to flex higher through the prudent issuance of debt.

If insurance management teams are convinced that we are entering a hard market, then now is the right time to raise capital. And while the rest of corporate America has gone on a debt issuance spree to enhance liquidity in the face of an historic recession, P/C insurers can tell investors and rating agencies that they are raising capital to play offense – not simply to keep the lights on.

Share repurchase has been the capital management tool-of-choice for years, but the prudent use of financial leverage can be equally as effective – and it doesn't involve shrinking the size of the company! Moreover, we show in this report that the breakeven underwriting margins – to make the incremental debt accretive to ROE – are readily achievable.

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ASSURED RESEARCH
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Financial Analysis: Capital is Dear, it is Not Expensive

The credit markets are open; insurers should use the opportunity to raise debt capital

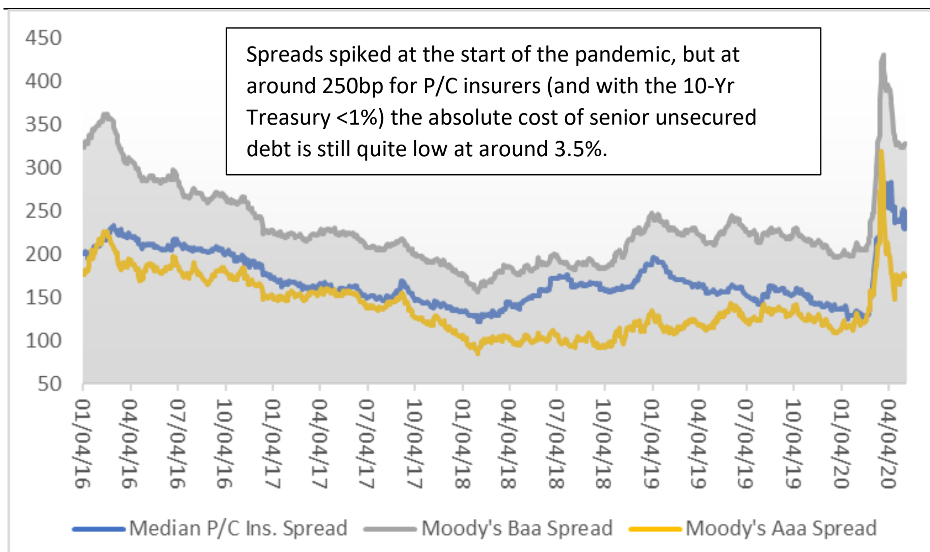
The time to raise capital is when it is available; that may or may not coincide *precisely* with when it's needed. But if insurance management teams are convinced that we are entering a hard market, then *now is the right time*. The rest of corporate American has gone on a debt issuance spree to enhance liquidity in the face of an historic recession. **We think the time is right for P/C insurers to raise their debt-to-capital (D/C) ratios at least modestly – say from the typical 20% level to 30% or thereabouts**.

> *Capital is scarce and risk is abundant.*
> *Kevin O'Donnell, CEO of Renaissance Re on 1Q CC*

Now, we realize that recommending an increase in leverage is counterintuitive as the industry faces what many executives have claimed will be the largest insured loss (COVID-19) in history. Even in the best of times insurance underwriters are not considered to be in a 'leverageable' industry considering that proceeds are down streamed to operating subsidiaries where policyholders are the senior creditors and regulators control the flow of dividends back to the holding company. But pandemic-induced actions (or rather, *promises*) by the Fed to purchase corporate bonds on the secondary market has fueled record corporate issuance – up nearly 3x y/y in April (Fig. 2).

Several insurers have already taken advantage of the liquid debt markets and favorable rates to issue senior unsecured debt. Recent issuers include Progressive, Travelers, AIG, and American Financial Group though we gather most issued debt mainly to refinance higher-cost debt.

Figure 1: Moody's Corporate Bond Yields vs. Ten Year Treasury (Spread) vs. P/C Ins. Spread



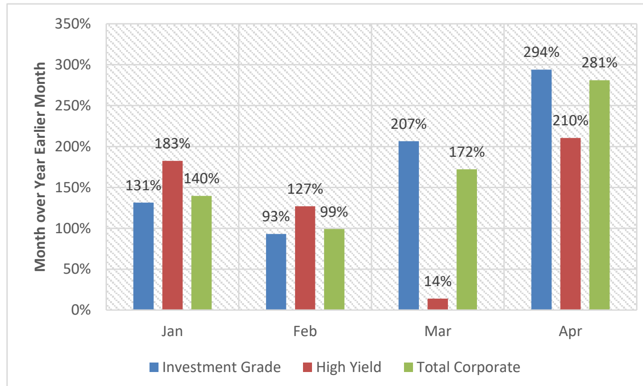
We created a cohort of 10 investment grade P/C issuers. Fig. 1 shows their spread sits in the mid-investment grade level with broadly similar market movements.

Source: St. Louis Fed (FRED), FACTSET, Assured Research. Data through May 5th.

Use Debt to Raise and Deploy Capital; Not Just to Refinance

P/C financial executives are conservative by nature – that's a good thing; this industry has a way of finding and punishing management teams who are overly aggressive either operationally or financially. We are not advocating that financial managers throw caution to the wind, but **having operated for many years at roughly a 20% D/C ratio, we think a temporary relaxation of standards to move into the 30%-range is entirely plausible and can be made without serious adverse rating agency reactions**. After all, while much of corporate America is adding leverage for *defensive* reasons – to keep the lights on in the face of an historical drop in demand and revenues - **P/C insurers can make the case that they are raising capital to play *offense***; capitalizing on evolving market opportunities while avoiding equity raises at a clearly inopportune time (with price-to-book valuations below 1.0 for many insurers).

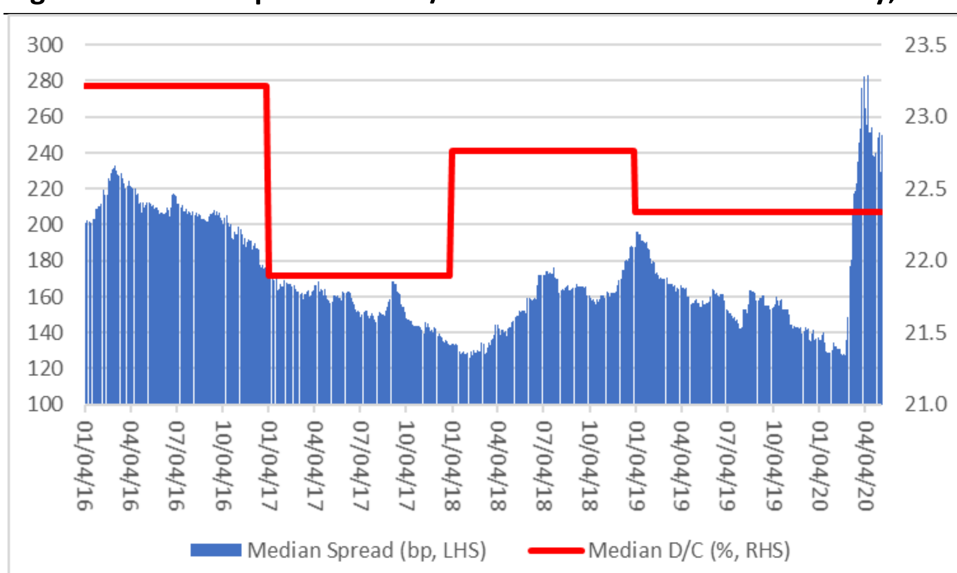
Figure 2: New Corporate Debt Issuance



Source: SIFMA, Assured Research

Rating agencies don't lose much sleep worrying about equity investors, but they do want their credits to maintain access to the equity markets and **much good will would be lost, we think, if equity was raised at depressed levels when the credit markets are flush with liquidity**.

Figure 3: Median Spread of 10 P/C Insurers over Ten Year Treasury; Debt-to-Capital Median



Since the beginning of March, a handful of purely P/C underwriters have raised over $7 bil. of senior unsecured debt at a yield to maturity of just 320 basis points

Source: FACTSET, S&P Global, Assured Research

Why raise capital at all? Our thoughts

Raising capital just because other industries are doing it isn't, admittedly, a compelling argument. **Here are the benefits as we see it**:

> *…given improved stability in and access to the capital markets since March, we are reevaluating our debt and capital plan. While reducing debt leverage to 25% or below is a medium-term goal, in the near term, our priority is maintaining strong operating capitalization, financial flexibility and liquidity.*
>
> *Mark Lyons, CFO of AIG on 1Q CC*

If the market is truly hardening, now is the time to raise capital to take advantage of business opportunities. Now, we have our doubts about the likelihood of a truly hard-primary insurance market, but as we'll demonstrate shortly, **at readily achievable underwriting margins additional debt can boost ROEs**.

The latter point is particularly important considering that premium levels are sure to be depressed by the economic recession. To some degree, we're suggesting boosting financial leverage to temper the adverse impact on ROE of declining operating leverage. See the nearby sidebar for more.

> *Using a simplified model of a typical P/C insurer, adding 10 points of financial leverage in today's environment would add about 40bp of ROE. That increase in financial leverage would roughly offset the 40bp decline in ROE were premiums to drop 10%.*
>
> *Every insurer will be slightly different, but the broader point is that prudent financial leverage can be a useful capital management tool just like share repurchases (and it doesn't involve shrinking the size of the company).*

With just a few exceptions (e.g., Allstate) insurers have paused their share buyback programs in the face of an historic, but still uncertain loss (COVID-19) and to position for a hardening market. **Based on our back-of-the-envelope math, a typical insurer that raises its D/C to 30% from 20% could reduce leverage back to the mid 20%-range in just three years** if its ROE rises to the mid-teens (as it might in an improving market) and if it retains earnings beyond paying a dividend at 1/3 of earnings – the typical payout ratio.

Investors have grown accustomed to share repurchases as a capital management tool, but the math in Figure 4 (next page) is compelling. With a bit of algebra, it can be shown to find the breakeven underwriting margin equating the value of incremental debt to its cost, one divides the spread on the debt by the premium/surplus ratio associated with the new capital. Ranges representative of today's spreads and levels of operating leverage are shown in Figure 4; **the bottom line – incremental debt is additive to ROEs at very achievable U/W margins.**

Figure 4: Breakeven Underwriting Margin Given P/S (vertical) and Debt Spread (horizontal)

P/S; Spread	2.25%	2.50%	2.75%	3.00%	3.25%	3.50%	3.75%	4.00%
0.60	3.8%	4.2%	4.6%	5.0%	5.4%	5.8%	6.3%	6.7%
0.70	3.2%	3.6%	3.9%	4.3%	4.6%	5.0%	5.4%	5.7%
0.80	2.8%	3.1%	3.4%	3.8%	4.1%	4.4%	4.7%	5.0%
0.90	2.5%	2.8%	3.1%	3.3%	3.6%	3.9%	4.2%	4.4%
1.00	2.3%	2.5%	2.8%	3.0%	3.3%	3.5%	3.8%	4.0%
1.10	2.0%	2.3%	2.5%	2.7%	3.0%	3.2%	3.4%	3.6%
1.20	1.9%	2.1%	2.3%	2.5%	2.7%	2.9%	3.1%	3.3%
1.30	1.7%	1.9%	2.1%	2.3%	2.5%	2.7%	2.9%	3.1%

The industry U/W margin in 2019 was about 5%; hitting that or higher should be possible in a hardening market.

Source: Assured Research

Of course, **risks abound** and adding financial leverage requires careful consideration and consultation with the rating agencies. The magnitude of COVID-19 losses is uncertain and **without tort reform social inflation and adverse reserve development could spike, in turn trapping debt capital** (and the dividends needed to service it) **at the subsidiary level**. As well, hurricane season is about to get underway; higher debt is never without risk.

Prudent use of financial leverage can be a valuable capital management tool just like share repurchases. And at a time of great uncertainty and a hardening market, it doesn't involve shrinking the size of the company!

Summary

In our assessment of the risks and opportunities as they appear today – the tradeoff favors P/C insurers adding incremental debt to their capital structure. As a CEO quoted in this note said many times in a recent conference call – *capital is scarce and risk is abundant*. We agree with the latter. On the former – we'd suggest a rephrasing to say that 'capital is dear', but in the debt markets it is readily available and at low rates.

P/C insurers have maintained an extremely conservative financial profile for years; now is the time to flex higher through the prudent issuance of debt.