



# SOLVENCY II AND CORPORATE BONDS **TURNING CONSTRAINTS INTO OPPORTUNITIES**

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For professional investors only, not for retail investors

- **Stable business**
  - Royal London Group established over 150 years ago
  - UK's largest mutual life, pensions and investment company with a strong credit rating\*
  - Total assets: £87.9bn; Fixed Income and Cash £51.4bn
- **Experienced team**
  - Long established, stable and collegiate Fixed Income Investment Team
  - Insurance Asset Manager
- **Approach**
  - Distinctive and consistent philosophy and process

Source: RLAM as at 31 March 2016. \*A stable rating, S&P July 2015.

**An award winning Investment Team**

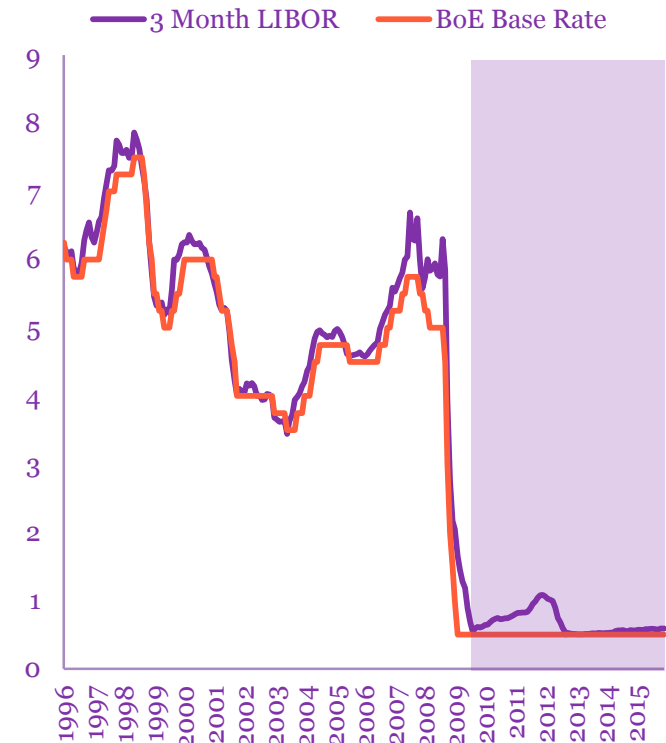


- Continued low interest rate and low yield environment
- Reduced underwriting margins
- Regulatory environment – Solvency II

- **Continued low interest rate and low yield environment**
- Reduced underwriting margins
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Source: RLAM as at 31 December 2015.

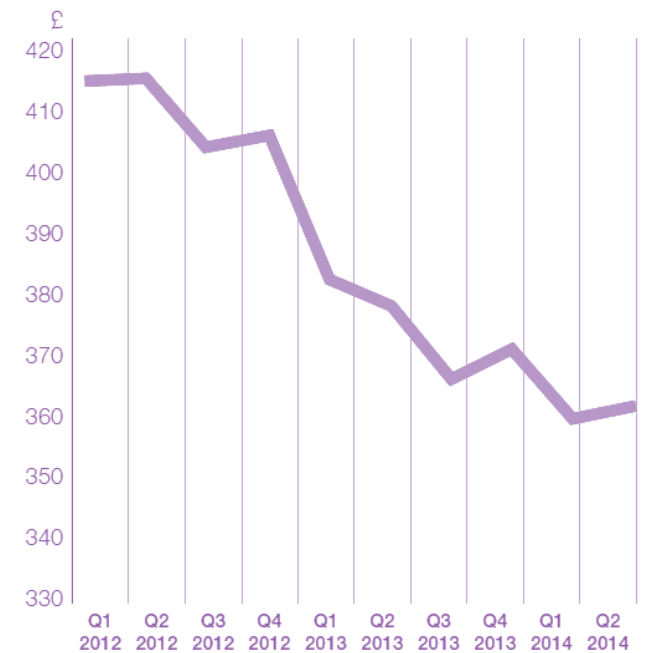


- Continued low interest rate and low yield environment
- **Reduced underwriting margins**
- Regulatory environment – Solvency II



Source: Association of British Insurers (ABI) annual reports 2015.

Average premium paid for private motor insurance\*, £

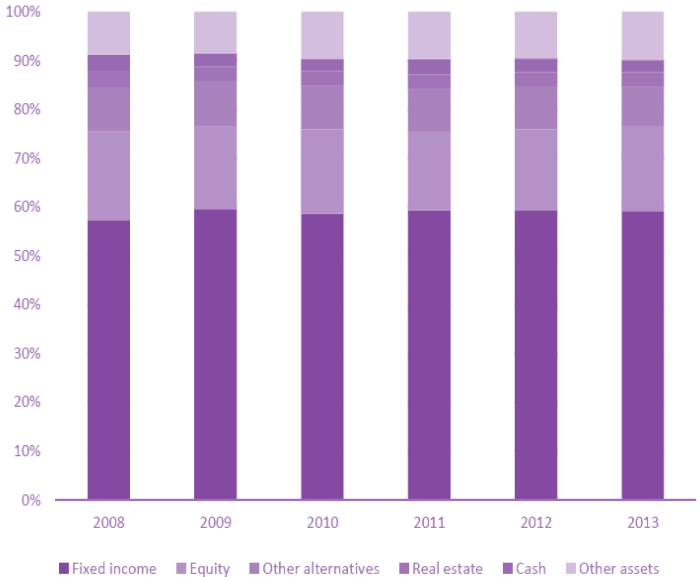


- Continued low interest rate and low yield environment
- Reduced underwriting margins
- **Regulatory environment – Solvency II**



Source: Spence Johnson Insurance report 2016.

Historic European asset allocation (2008-2013)



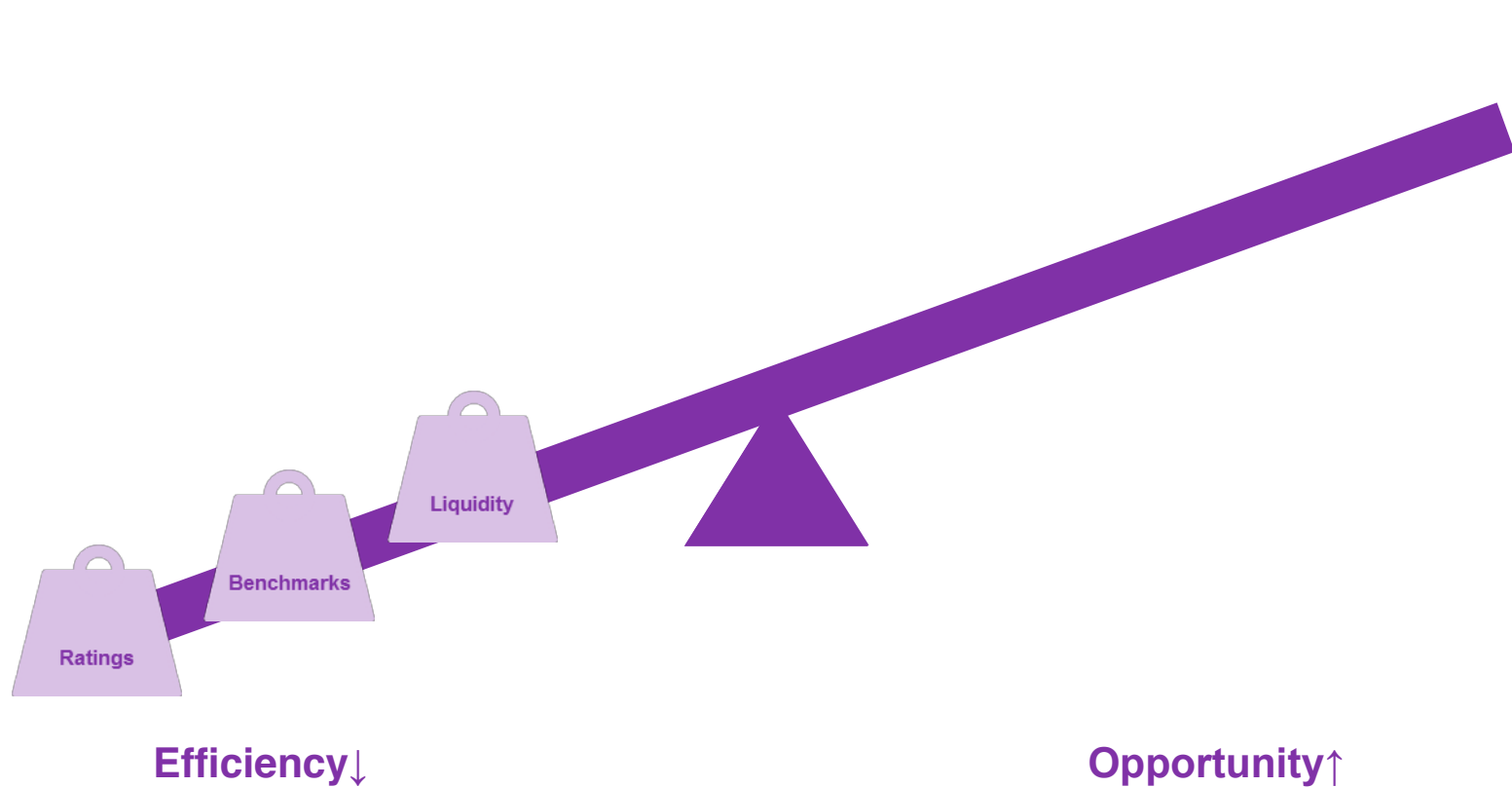
# CREDIT AN INEFFICIENT MARKET

ASSET MANAGEMENT



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What is the impact on Solvency II?



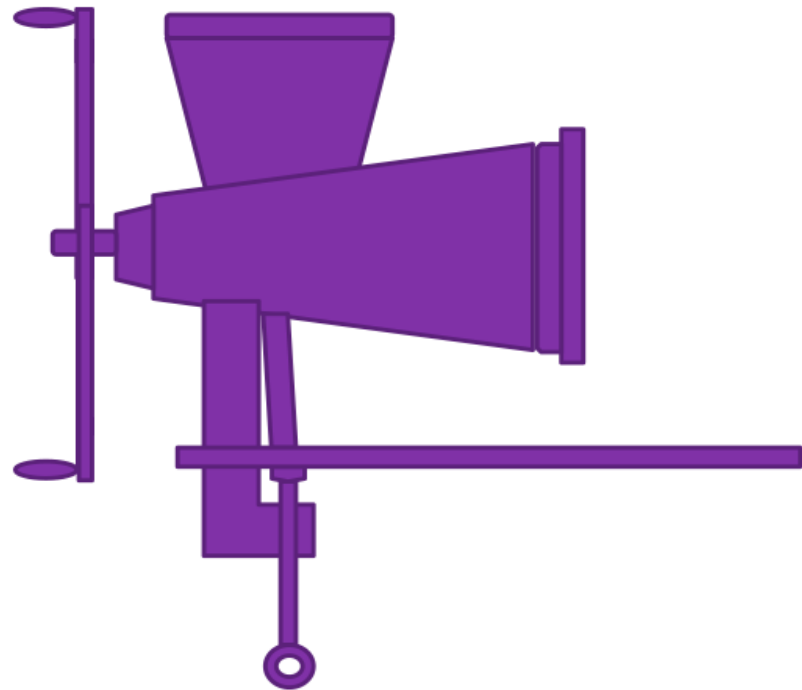
# KEY DRIVERS OF SII CAPITAL REQUIREMENT

## THE CORE FRAMEWORK FOR STANDARD FORMULA

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### Constraints

1. Credit ratings
  - Solvency Capital Requirement
2. Asset type
  - Secured vs unsecured



**Does the sausage machine approach create opportunities for active investors?**

- Rating x Duration

Duration (yrs)		Rating				
		AAA	AA	A	BBB	BB
0	a	0.0%	0.0%	0.0%	0.0%	0.0%
	b	0.9%	1.1%	1.4%	2.5%	4.5%
5	a	4.5%	5.5%	7.0%	12.5%	22.5%
	b	0.5%	0.6%	0.7%	1.5%	2.5%
10	a	7.0%	8.4%	10.5%	20.0%	35.0%
	b	0.5%	0.5%	0.5%	1.0%	1.8%
15	a	9.5%	10.9%	13.0%	25.0%	44.0%
	b	0.5%	0.5%	0.5%	1.0%	0.5%
20	a	12.0%	13.5%	15.5%	30.0%	46.6%
	b	0.5%	0.5%	0.5%	0.5%	0.5%

<5yr	b*dur
5-10yr	a+b*(dur-5)
10-15yr	a+b*(dur-10)
15-20yr	a+b*(dur-15)
>20yr	a+b*(dur-20)

Source: EIOPA as at 21 June 2016.

**A ratings based framework**

# CREDIT RATINGS THEIR ROLE IN THE GLOBAL FINANCIAL CRISIS

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Financial Crisis Inquiry Commission – Official US  
Government Edition, Feb 2011

“Credit Rating Agencies (CRAs) – essential cogs in  
the wheel of **financial destruction**”

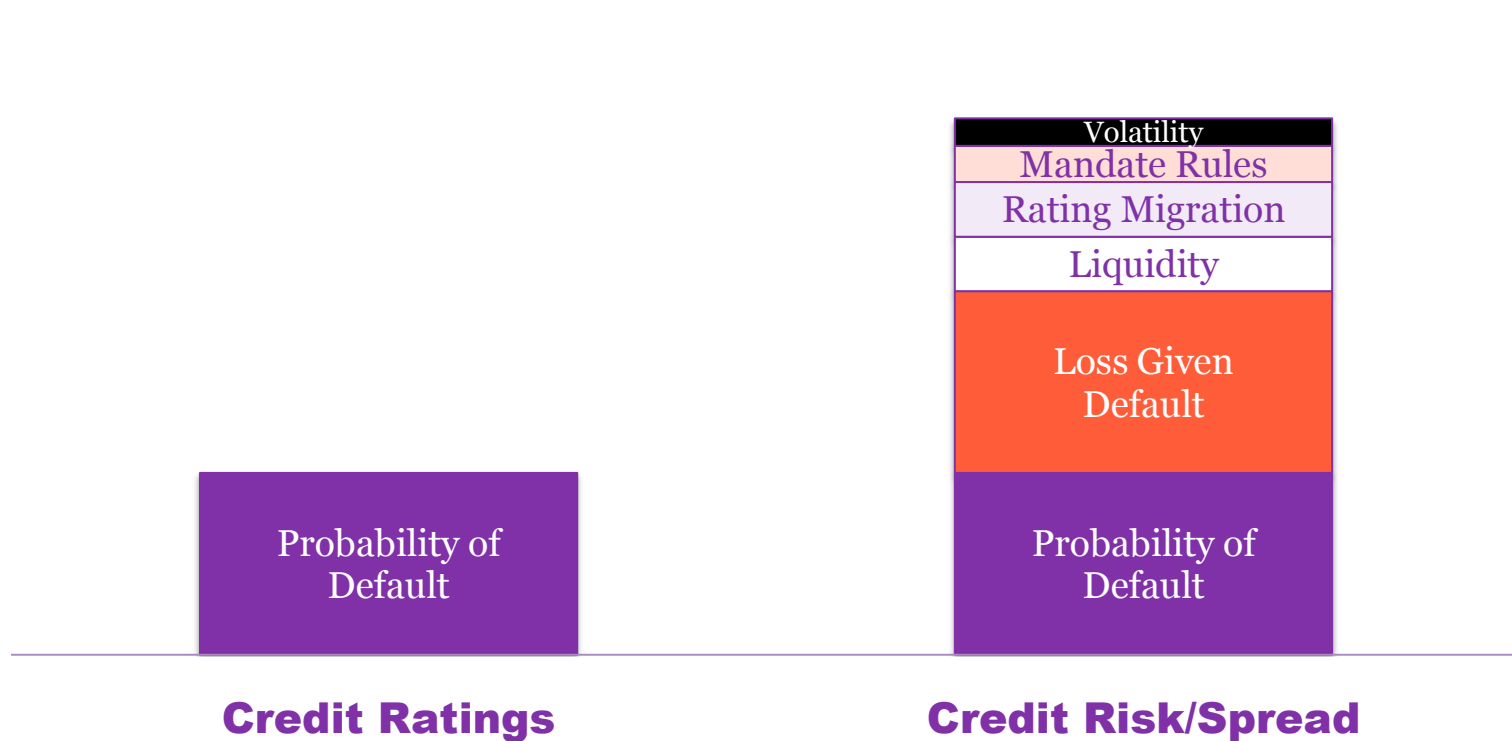
“...key enablers of the **financial meltdown**

“...The Commission concludes that the CRAs **abysmally failed**”

Credit Rating Agencies (CRAs) – essential cogs in  
the wheel of **Solvency II capital**

**Oh the irony!**



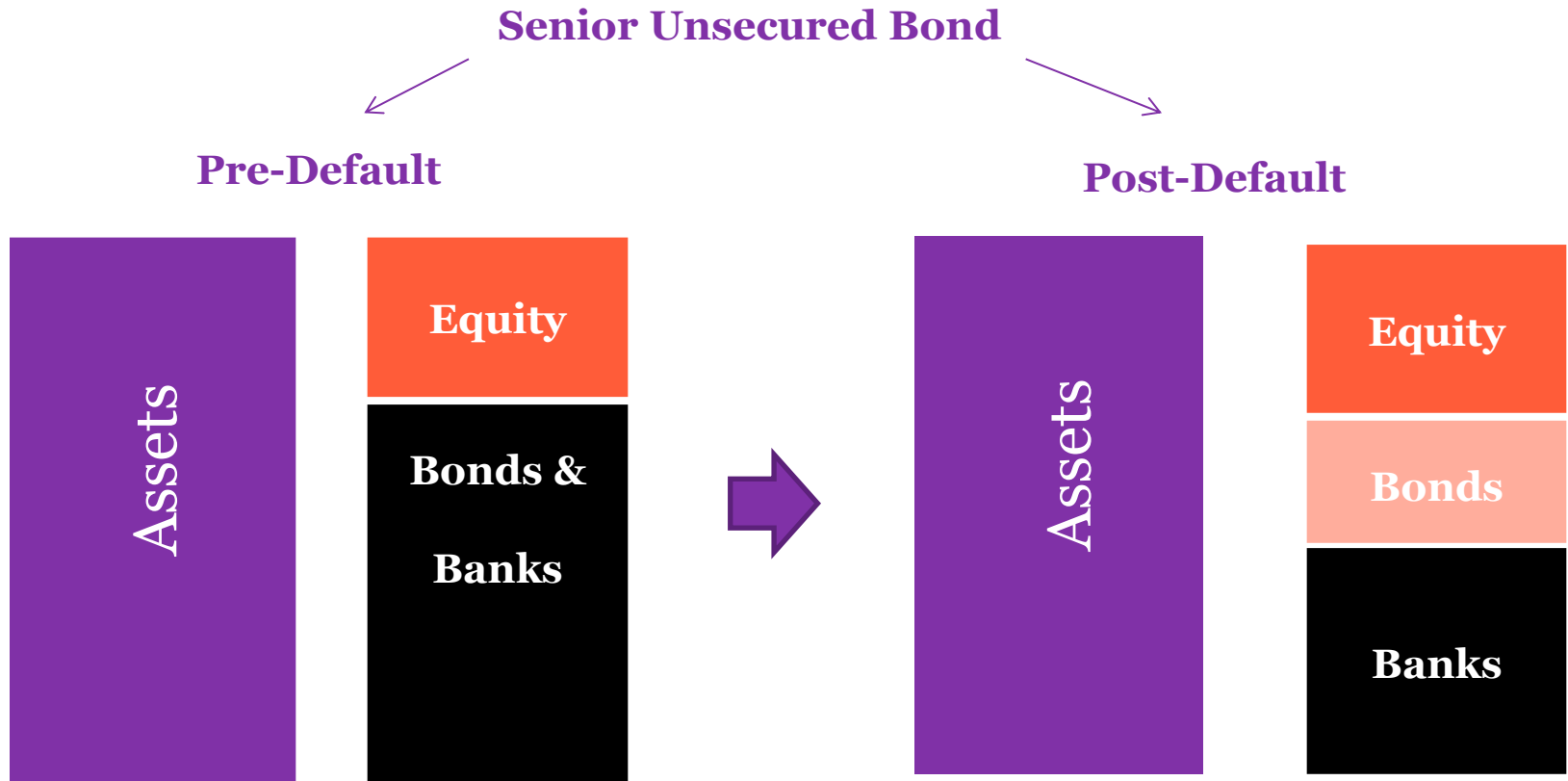


- An incomplete component of credit risk assessment
- An incomplete component of value

**Application rather than concept flawed**

# CREDIT RATINGS THE MISSING PIECE

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Senior unsecured becomes “junior” unsecured

# CREDIT RATINGS AN IMPERFECT PROXY FOR CREDIT RISK

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- Co-operative Bank 4.75% 2021
- £600m bonds outstanding
- Secured on £1.25bn of prime mortgages
- Secured on ~£2.8bn of residential property
  
- Additional claim on Co-op Bank
- Ring-fenced from potential bail-in
- Rating
  - Baa1/BBB+
- +1.7% spread premium

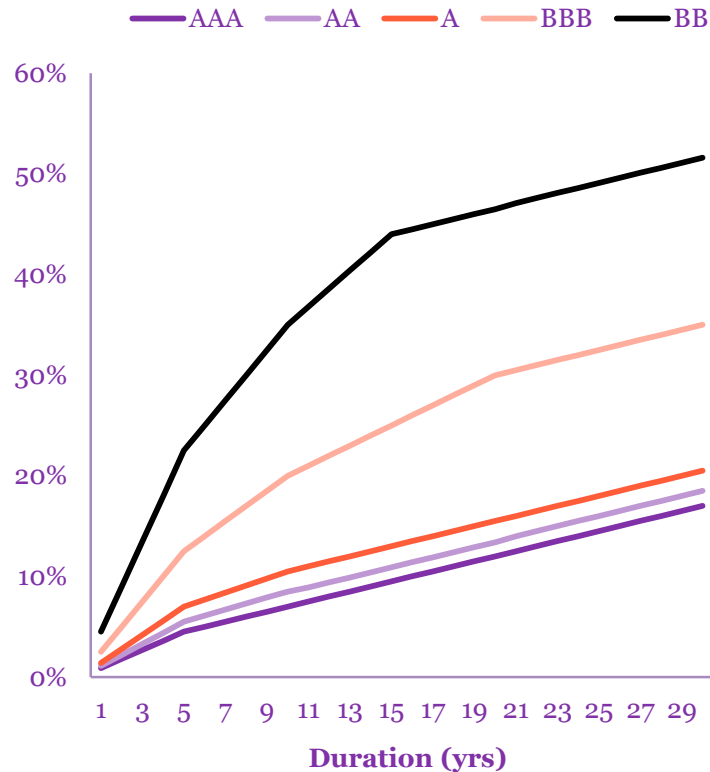
**AAA risk, BBB return**



# ASSET TYPES

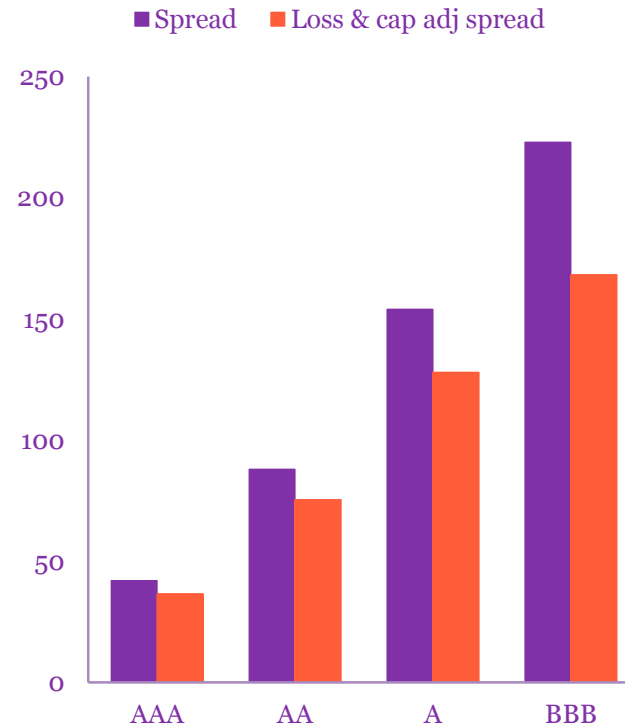
## CORPORATE BOND CAPITAL REQUIREMENTS

Corporate Bond SII cap charges



Source: EIOPA as at 21 June 2016.

Loss and capital adjusted credit spread

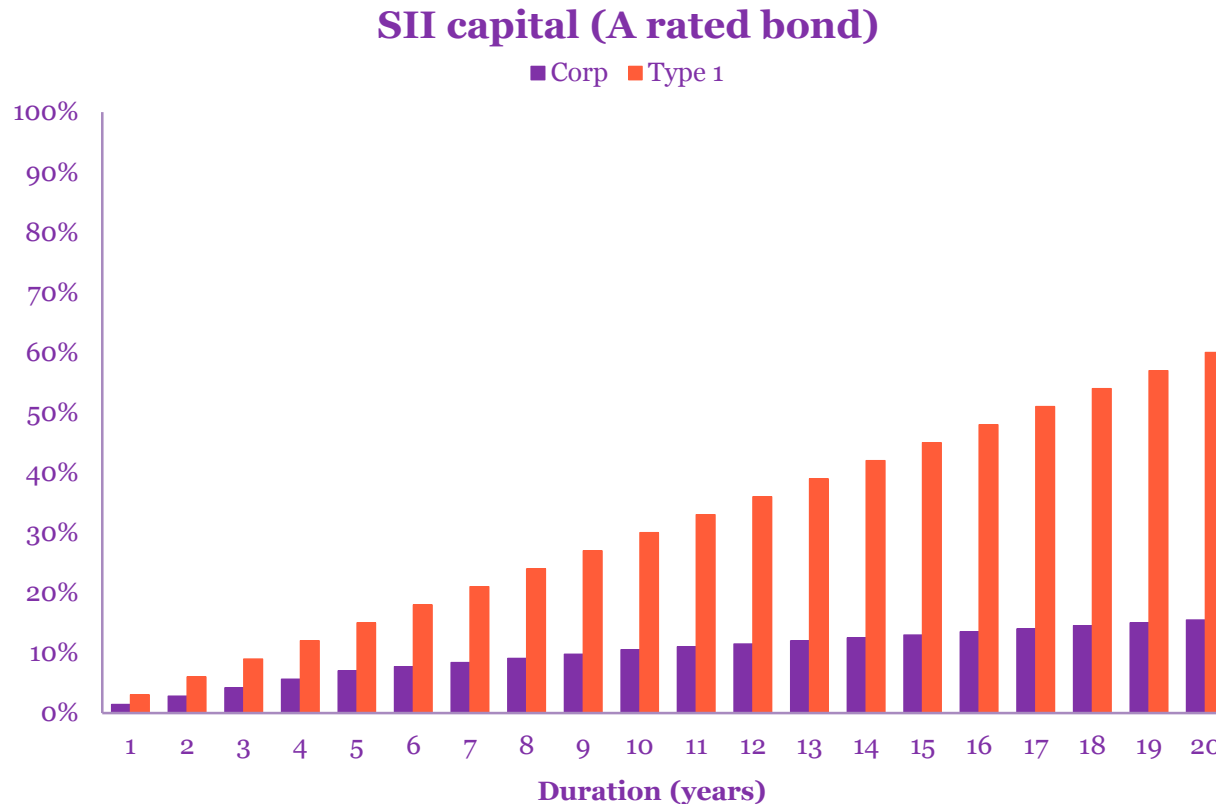


Source: BoAML, Moody's, RLAM as at 21 June 2016.

**Taking credit risk still valid in SII world**



- Capital requirements for 'highest quality' securitisation – **'Type 1'**



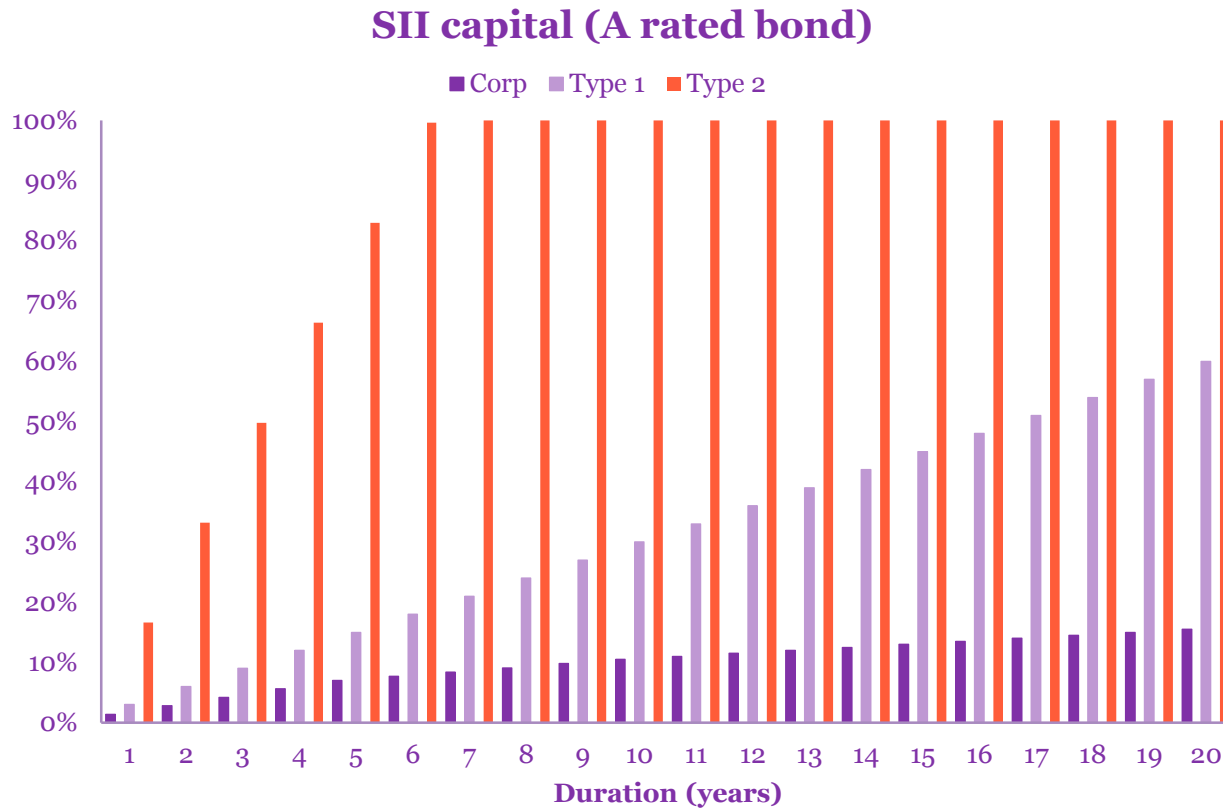
Source: EIOPA.

**Punitive but appropriate?**



# THE SECURED CURSE - EVEN WORSE FOR TYPE 2

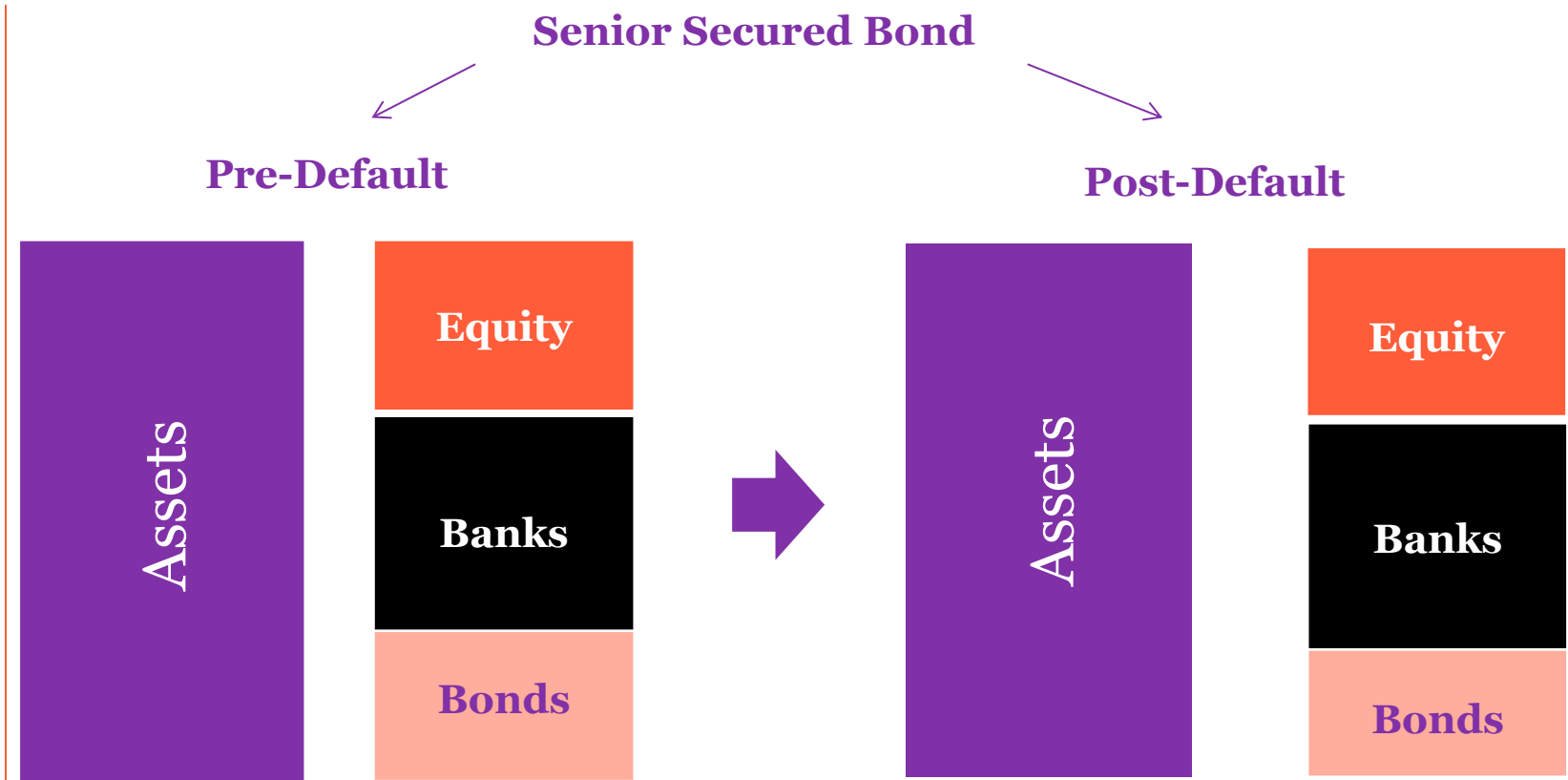
- Capital requirements for other securitisation – ‘Type 2’



Source: EIOPA.

**Punitive but appropriate?**

# THE SECURED CURSE – CONTRADICTED BY COMMON SENSE

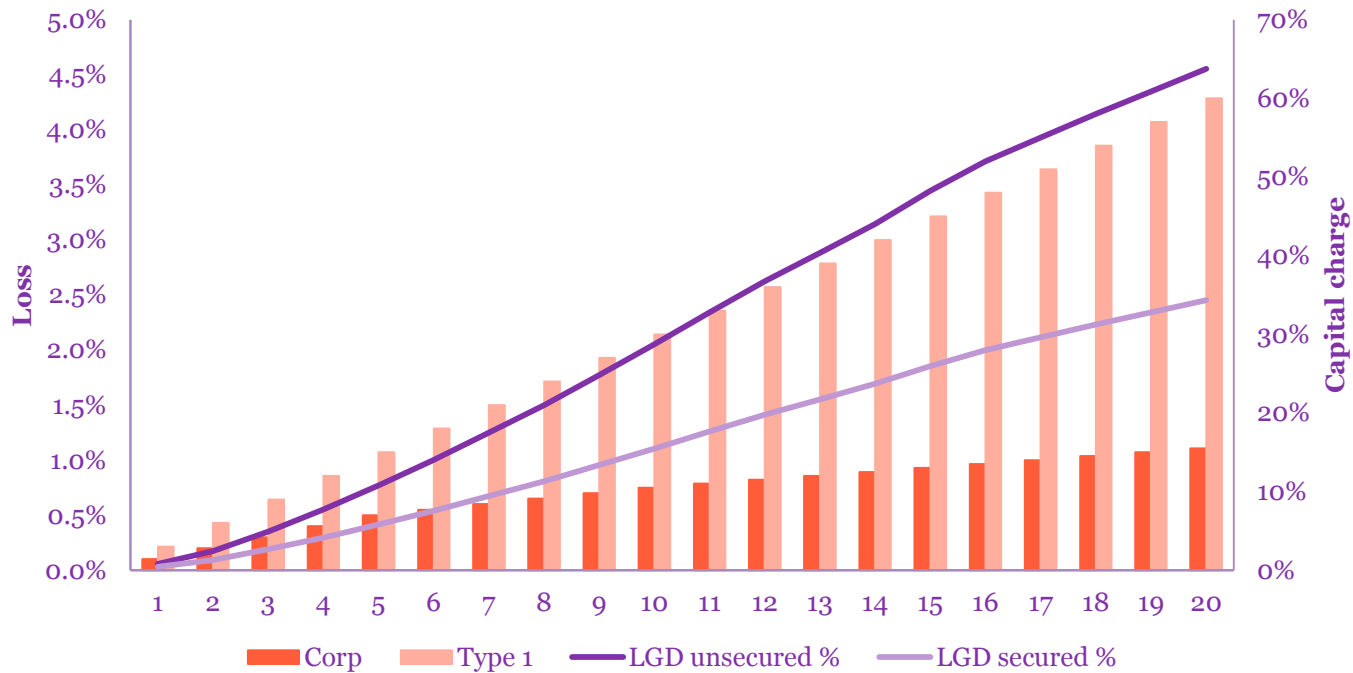


**All capital allocation counter-intuitive**

# ASSET TYPE

## THE SECURED CURSE – CONTRADICTED BY FUNDAMENTALS

### SII capital vs historic loss experience (A rated bond)



Source: Moody's, RLAM as at 21 June 2016.

**Clear disconnect between SII capital and risk**



# CAPITAL COST V FUNDAMENTAL RISK DISCONNECT DEMANDS FURTHER INVESTIGATION

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**Stage 1:** not all secured bonds are securitised

**Stage 2:** not all securitisations are SII securitisation

*“an exposure that creates a direct payment obligation for a transaction or scheme used to finance or operate physical assets should not be considered an exposure to a securitisation, even if the transaction or scheme has payment obligations of different seniority” Solvency II Delegated Acts Oct. 2014*

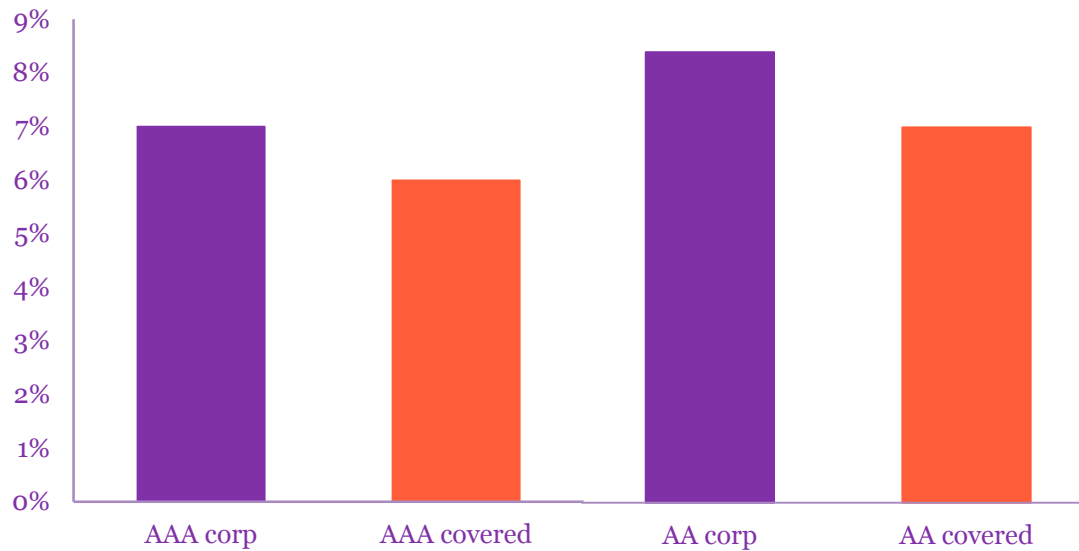


RLAM identify two distinct securitisation types:

- SII Securitisation – **Type 1 or Type 2**
- Corporate Funding Securitisation – **Corporate Bond**

**Not all secured bonds are equal under SII**

**Corporate bond vs covered bond SII capital charge**



Source: EIOPA as at 21 June 2016.

**Regulators can be pragmatic**

# SOLVENCY II A POP QUIZ!!

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Allied Irish Bank (GB)

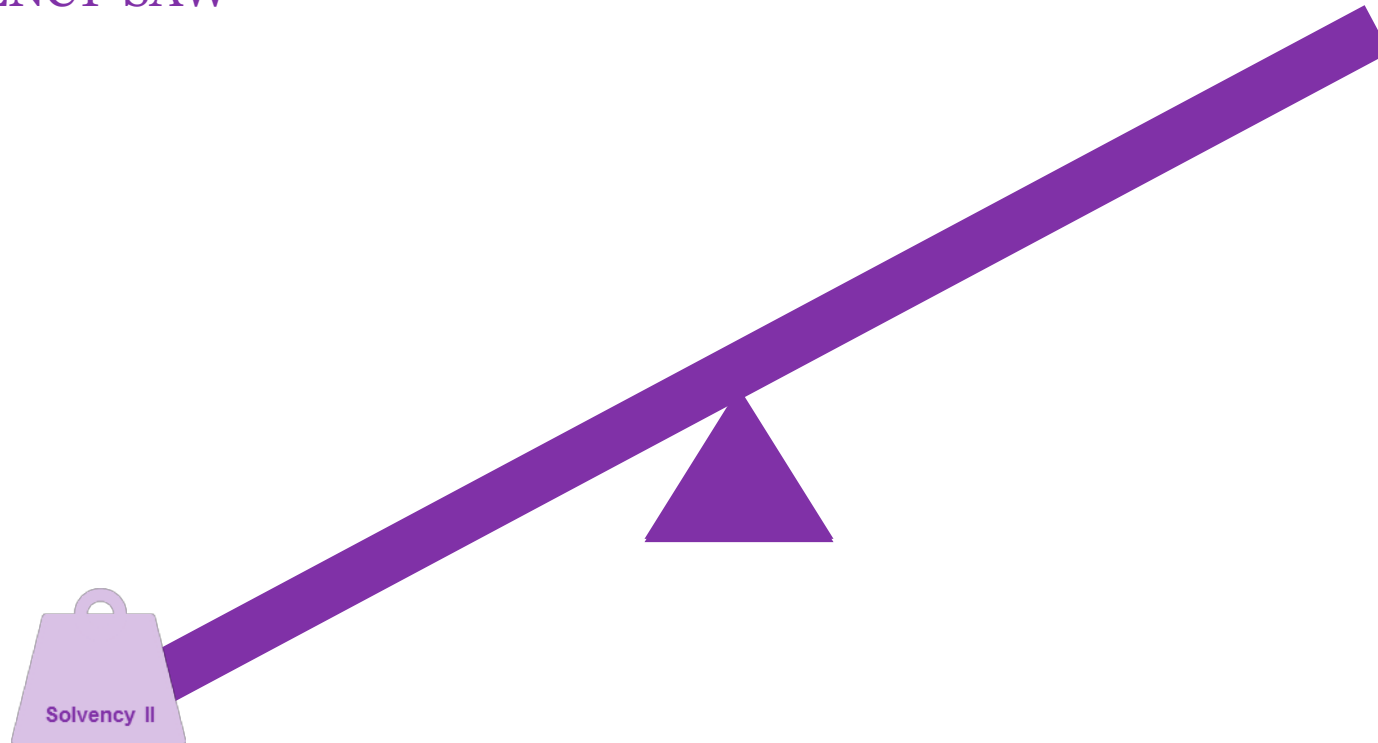
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Sector	RMBS	RMBS
Collateral	Prime UK residential mortgages	Prime UK residential mortgages
Rating	AAA	AAA
Indexed LTV	47%	44%
Credit Enhancement	17%	63%
Yield	1.2%	1.8%
SII Classification	Type 1	Type 2

Source: RLAM as at 14 June 2016

**Solvency II dampening return, not credit risk**





**Efficiency**↓

**Opportunity**↑

- Dislocation in SII world between fundamental risk and capital requirement
- Further embeds established inefficiencies
- Clear opportunities for active credit investment

**SII Delegated Acts should not herald delegated responsibility!**

# TURNING CONSTRAINTS INTO OPPORTUNITIES

## **SOLVENCY II – CAPITAL EFFICIENCY**

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### Example Portfolio Solution

**No** sub-investment grade securities ✓

**No** unrated securities ✓

**No** type 2 securitised assets ✓

Covered bonds have a lower Solvency Capital Requirement (SCR) ✓

Short dated credit is more capital efficient ✓

Solvency II reporting ✓

Complementary credit rating ✓

**Understanding and evaluating assets is central to RLAM's credit process**





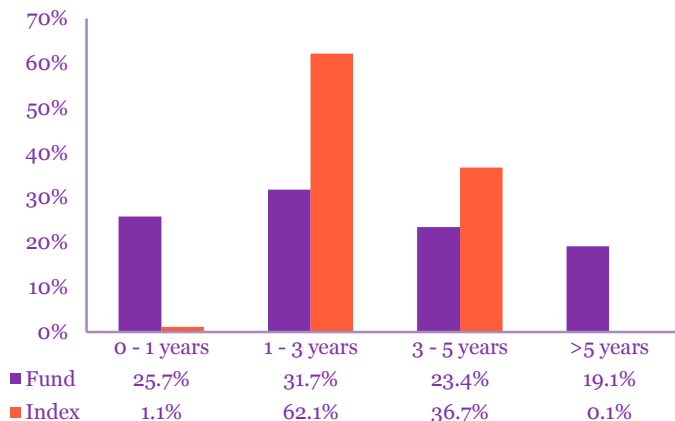
# RL INVESTMENT GRADE SHORT DATED CREDIT FUND

## PORTFOLIO CHARACTERISTICS

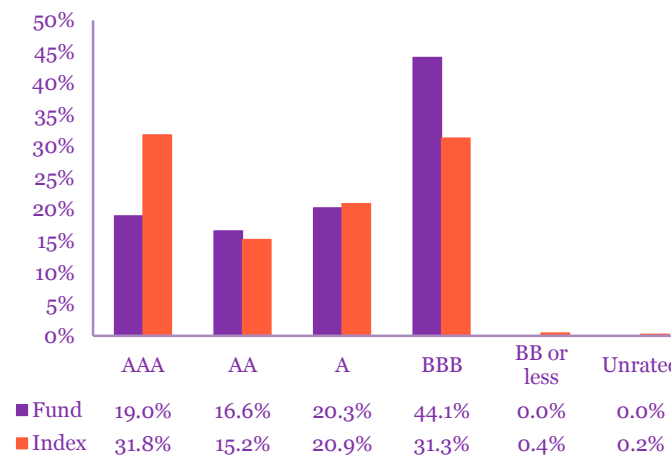
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Fund facts	Fund	Index <sup>1</sup>	
Fund size	£71.3m	-	
No. of holdings	184	345	<b>Diversified</b>
Duration (yrs)	2.3	2.5	
Gross redemption yield (%)	2.3	1.7	<b>Portfolio yield reflects value</b>

### Yield curve positioning



### Credit Rating



Source RLAM, as at 31 March 2016, subject to rounding.

<sup>1</sup>The index for the Fund is Bank of America Merrill Lynch 1-5 year Sterling Non-Gilt all Stocks Index. The above is a model portfolio and is for illustrative purposes only.



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