research

CREDIT OUTLOOK: THE FINANCIAL SECTOR

Miles Capital

RESULTS THAT MATTER

From tax cuts to charge-offs precipitated by corporate tax reform to a growing trend toward deregulation, a host of dynamics are affecting companies in the financial sector as we move through 2018. The implications of these emerging factors can be both positive and negative, depending on the sector and investor type.

The macroeconomic environment remains conducive to growth. Nevertheless, banks and insurance firms continue to grapple with low interest rates, which are a considerable drag on both business sectors, while P&C insurance companies are less affected by this trend.

The cut in the corporate tax rate has already meant a better bottom line for many of these companies, but it has not come without consequences, namely the deferred tax assets that were forced to be charged off as an expense in late 2017.

A general movement toward federal deregulation may increase profitability and financial flexibility as banks are able to return capital to the market that they had used to shore up their balance sheets following the financial crisis. This increased flexibility is actually a negative for bond holders, who will lose the cushion they have come to enjoy, even though a dramatic decline in capital is unlikely through 2018.

What follows is an overview of these trends and how they are affecting the creditworthiness of banks and insurance firms moving forward.

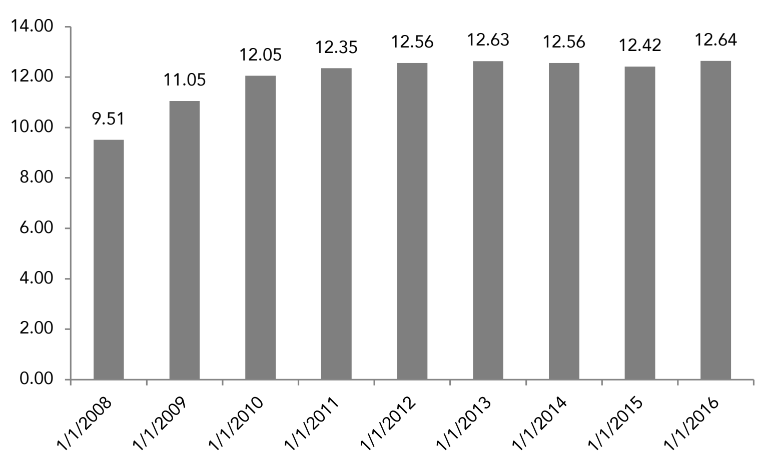
BANKING

Loan growth has been slow, but banks are optimistic for the coming year given the increased clarity in the tax and regulatory environment along with an improved outlook for loan demand due to continued macroeconomic growth. Low interest rates continue to negatively affect banks and insurance companies. These companies can make loans at a decent rate, but the loans rolling off of their books are at a higher rate, meaning they can't match to the loans falling off, negatively affecting their interest income. The only way to offset this pressure is loan growth, which remains very competitive. Deposit costs, however, are starting to increase as well.

GENERAL CAPITAL OUTLOOK

Overall capital levels remain quite strong because of the macro-prudential regulatory environments within the banking sector that have prevented banks from returning capital built up since the financial crisis. Bank capital ratios (as measured by CET1 ratios - shown in Figure 1) are no different from the insurance industry, as improved profitability, regulatory restrictions on capital return, strong economic growth and a benign credit environment have resulted in elevated capital levels. Bank capital levels have grown so much that they now exceed their fully phased-in Basel 3 requirements. As a result, the multi-year trend of improving capital ratios is likely come to an end, as regulators are allowing banks to return capital to shareholders in the form of increased dividends and share repurchases. The latest Federal Reserve Comprehensive Capital

FIGURE 1: TIER 1 COMMON CAPITAL (CET1) RB RATIO (%)



Source: Miles Capital, Bloomberg

Analysis and Review (CCAR) results - an evaluation of the capital planning and adequacy of the largest U.S. bank holding companies - have allowed some banks to return more than 100 percent of their last twelve months earnings[1]. While a dramatic decline in capital is unlikely in 2018, some of the cushion that bondholders have come to enjoy will be gone.

A FOCUS ON EXPENSE REDUCTION

Given the declining rate of loan growth and the slow pace of interest rate hikes, banks are expected to continue their focus on expense reduction to help drive earnings growth. Expenses increased after the financial crisis as greater regulatory oversight required investments in compliance systems and personnel. Now that these investments are largely in place, banks have turned to improving efficiency by optimizing their branch networks. Online and mobile banking solutions are displacing the need for the expansive footprints and are allowing banks to reduce headcounts. Careful pruning of branches has resulted in a 26 percent increase in average assets per employee since 2011[2].

NAVIGATING REGULATORY CHANGES

A general trend toward an easing of regulatory environments is poised to have a significant impact on banks. Much of the regulation imposed since the financial crisis has been for the sake of shoring up the balance sheets of these institutions. Now that the regulators consider these capital levels to be sufficient, banks are being given the chance to return this capital, thereby reducing the capital stored in the bank, a relatively negative change for bond investments. More broadly, many of the potential changes in regulations are credit negatives because they would reduce the amount of capital or liquidity held by banks.

With the expected easing of some of the restrictions on banks, there could be a potential for greater mergers and acquisitions among smaller regional banks, allowing them to cut costs. Still, M&A activity among banks is expected to be muted over the coming year due to remaining Systemically Important Financial Institution (SIFI) thresholds that increase the regulatory oversight on larger institutions.

LIFE INSURANCE

Low unemployment and a strong macroeconomic environment have led to more people participating in group insurance through their employer or buying annuities annuities to save for retirement[3] — all of which can be beneficial for life insurance companies. The sector, however, is still facing considerable headwinds. Fixed annuities, policies that offer guaranteed rates, structured settlements and long-term disability products are particularly sensitive to interest rates because these products were priced years ago using higher long-term rate expectations than has been experienced in prevailing rates. As a result, margins for these products have been under pressure in the current low-rate environment.

CAPITAL LEVELS

Companies in the life insurance sector have benefited from the strong performance of their shares and a slight increase in interest rates during 2017. The result has been solid capital and statutory ratios as well as strong profit levels.

IMPACT OF LOW INTEREST RATES

The continuing low interest rate environment remains the largest headwind for life insurers. Unlike the P&C industry, a majority of life insurance liabilities have long durations that need to be matched with longer-term assets. Given the longer duration of these assets, the life insurance sector is particularly sensitive to changes in interest rates. Even while life insurance companies are welcoming the increases in rates, the overall impact is likely to be muted. Reinvestment yields have trended downward, though some insurers have benefited from higher allocations to private equity and hedge fund performance in the recent year.

CORPORATE TAX RATES AND DTAS

Overall, a reduction in the corporate tax rate is a significant positive for insurers' earnings outlook, but these cuts could present a few problems for companies. Some insurance operating companies have a significant amount of deferred tax assets (DTAs) on their balance sheets. Reducing the tax rate would require a reduction in DTAs that could, in turn, lead to a reduction in risk-based capital ratios and surplus positions. These reductions could mean lower free cash flows to the holding companies in the near term as companies rebuild their capital positions.

[1] 2018 Barclays Americas Select Franchise Conference
[2] FDIC Quarterly Banking Profile, Bloomberg News, 2017
[3] CreditSights, Healthcare News

PROPERTY & CASUALTY (P&C) INSURANCE

Catastrophe-related losses remain the top-line trend within the P&C insurance sector, with most companies still grappling with a record-setting 2017 in terms of natural disasters[4]. Auto insurance lines , are returning to profitability as pricing has begun to catch up to higher accident costs resulting from higher loss cost inflation and increased incidence (Figure 2). The higher costs have been a result of higher repair costs (back-up cameras) in newer vehicles, distracted drivers (cell phones) and an increase in miles driven by customers.

CAPITAL LANDSCAPE

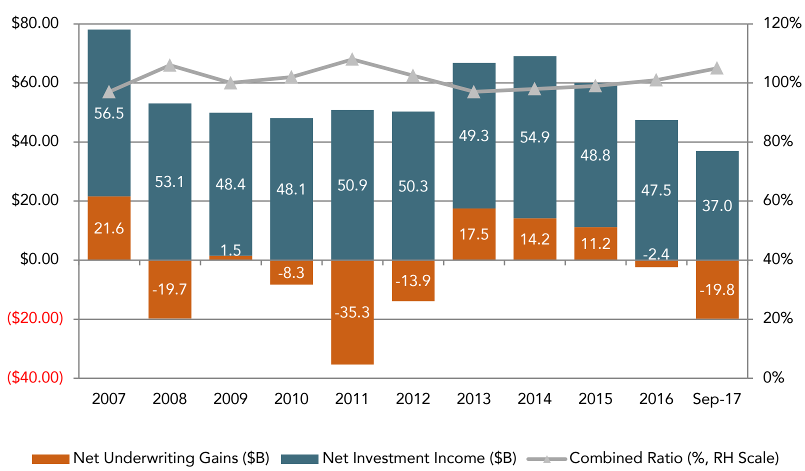
P&C capital levels have been negatively affected by large hurricane-related losses, higher auto claims frequency and severity, and the challenging interest rate environment. Despite these headwinds, P&C capital has shown consistent growth. This growth is owed, in part, to product line and geographic diversification and losses ceded to European and Bermuda-based reinsurance companies. However, higher P&C capital levels can be a double-edged sword in that higher capital levels can mean lower returns on equity for shareholders, precipitating premium price wars in order to gain share.

PRICING CHALLENGES

The latter half of 2017 saw considerable catastrophe-related losses associated with hurricanes Irma, Harvey and Maria, earthquakes in Mexico, California wildfires and typhoons in the Pacific. Total insured losses for these events were considerable. Consequently, 2017 is expected to go down as one of the costliest years in terms of insured global catastrophe losses. Among most of the primary insurance underwriters, these losses are primarily an earnings event, as capital levels, while lower, remain robust.

Catastrophe premium pricing has been declining over several years. The decline is largely the result of third-party (alternative) capital in the form of private equity funds underwriting catastrophe bonds at lower premium rates. These private equity bonds are funded by investors (generally endowments) seeking diversification away from traditional investments. Catastrophe bond investors usually have lower return thresholds (about 7 percent) which they can use to undercut pricing of Bermuda-based reinsurers whose return thresholds are around 15 percent. The result has been a gradual increase of alternative capital as a percent of total reinsurance capital from 4.4 percent in 2006 to 14.7 percent in the first half of 2017[5].

FIGURE 2: US P&C INDUSTRY - STATUTORY UNDERWRITING GAINS, NET INVESTMENT INCOME, COMBINED RATIO



Source: Company Reports (Statutory Data), SNL, Credit Sights

AUTO INSURERS

Auto insurance loss cost inflation remains a sore point for the industry, but there are signs among some insurers that the issue is inflecting. Today's cars have more technology and are therefore more expensive to fix in the event of a collision. There's a high correlation between economic growth and miles driven[6]. Throw cellphones into the mix and you have a higher number of distracted drivers logging more miles in their cars. The result is higher accident incidence and loss costs for auto insurers. Auto insurers have been dealing with combined ratios of over 100 percent for the past couple of years, but recent results seem to imply that the industry has had some success adjusting prices to reflect for the higher costs.

[4]PropertyCasualty360.com, "2017 to Be One of the Costliest Catastrophy Loss Years Ever", Nov 21, 2017.
[5]The Economist, "Natural Disasters Made 2017 a Year of Record Insurance Losses", Jan 11, 2018.
[6]BusinessInsider.com

Conclusion

Changing political headwinds, an easing of federal regulatory oversight, and increasingly volatile environmental patterns have set up the financial sector for a period of significant change moving forward over the next year. At the same time, economic fundamentals remain conducive to growth, buoyed by corporate tax reductions. The lasting impact of these changes in the banking and insurance industries will differ significantly by sector and investor type and warrant close attention as this new chapter in the financial sector narrative unfolds.

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Disclosures

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