March 09, 2020

Fixed Income Research

Financials Sector Weightings:

P&C/Reinsurance – Market Weight

Life – Market Weight

Banks – Not Rated

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Energy Exposure in Financials
We Examine Energy Exposure in Banks & Insurers

Refreshed Energy Numbers, but Faded Disclosure Since 2016

- **Energy has once again moved into the spotlight following the significant drop in oil prices over the weekend**. In the IG corporate credit market, E&P spreads have gapped out 200-350 bps this morning alone, while Integrated names are 80-90 bps wider and MLP's are 150-200 bps wider. The energy complex is large and diverse; representing a meaningful chunk of the IG index at 12%, while it is also a notable sector for banks and insurers to lend into. We lived through the energy pressure trade in 2015/2016, and overall Financials seem to weather the storm at that time well. The sector is well capitalized today to handle another round of pressure, although there could be a few bruises along the way that are compounded this go round by record levels of low interest rates and an equity market that is for once a headwind and not the tailwind it has been for the past decade.

- **Energy exposure for the banks and major life insurers we scanned seems to be in the same general ballpark as a percent of tangible equity**. Given the shorter duration of bank exposure and structural benefits of loans versus senior unsecured risk taken by the life insurers, this analysis could make banks the more attractive play in here at flat valuations to lifers. Disclosures are inconsistent across firms unfortunately and less detailed than what we saw in 2016 when energy last melted down, so we're using this publication as a starting point in hopes that disclosures improve from here. For some context on exposures, energy commitments at the Big 6 banks range from 15%-35% on tangible common equity using 12/31/19 data, while for the life insurance universe we scanned, energy ranges from 19%-72% of tangible equity. The tables below breaks down the energy exposures to the best of our abilities between banks and life insurers. We note that this data does not include any Schedule BA related energy exposure at the life companies since the statutory filings disclosing that data were not available as of the writing of this publication.

Financials - Energy Exposure

	Funded	Total Commitments	Total C&I Commits [1]	% of Total [2]	Date of Filing	SH Equity (ex AOCI) or TCE[6]	% of SHE/TCE	On the Run 10-Y Est.
BAC	16,407	36,327	1,062,295	3.4%	2019 10-K	173,192	21.0%	185
C [3]				8.0%	2019 10-K	149,754		190
JPM		41,570	898,520	4.6%	2019 10-K	186,603	22.3%	170
WFC [4]	12,800	35,400	668,952	5.3%	2017 Q3 10-Q	142,993	24.8%	190
GS [5]		25,694	154,210	16.7%	2016 10-K	74,743	34.4%	195
MS		9,461	168,518	5.6%	2019 10-K	65,254	14.5%	185
CMA	2,221	4,300	61,672	7.0%	2019 10-K	6,625	64.9%	
PNC	2,400	7,900	246,211	3.2%	2016 Q4 Pres.	38,571	20.5%	
RF	2,172	4,700	81,666	5.8%	2019 10-K	10,394	45.2%	
USB [7]	2,498	10,262	215,396	4.8%	2017 Q3 10-Q	33,955	30.2%	
AFL		4,281			2019 10-K	22,344	19.2%	170
AIG		13,379			2019 10-K	62,445	21.4%	195
MET		10,000			2019 10-K	44,022	22.7%	170
PFG		2,846			2019 10-K	11,954	23.8%	180
BHF		4,238			2019 10-K	12,997	32.6%	325
PRU		13,862			2019 10-K	36,667	37.8%	185
EQH		3,947			2019 10-K	9,686	40.7%	245
UNM		4,775			2019 10-K	9,576	49.9%	225
LNC		6,685			2019 10-K	12,238	54.6%	195
PL		4,985			2019 10-K	6,914	72.1%	215
ATH		NA			2019 10-K	11,802		

[1] Total Commercial and Industrial loan commitments (Funded + Unfunded)
[2] Reflects total Energy industry commitments (funded + unfunded) as a percentage of total commercial credit commitments, unless noted otherwise.
[3] Includes Commodities
[4] WFC reported $14.2B in outstandings to the Energy industry at Q4 2019, which we estimate is in-line with Q3 2017 levels on a proportional basis.
[5] Includes Natural Resources and Utilities
[6] TCE for insurers equals SH Equity ex AOCI less goodwill.
[7] Total Commercial Commitments estimated based on a 50% utilization rate (peer group average).
Source: Company reports and Wells Fargo Securities.
Pricing as of 3/9/2020

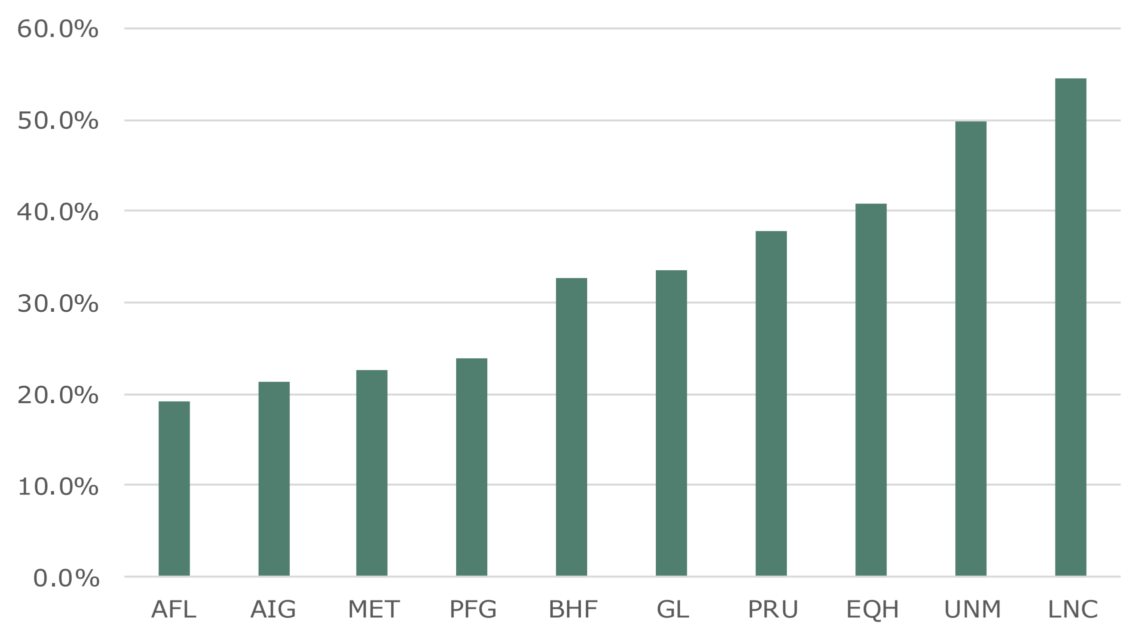
- **Some life insurers screen better than others based on the preliminary work we've done**. For our analysis, AFL, AIG, and MET screen as holding some of the lowest relative exposure to energy among the life group, while PRU, EQH, UNM, and LNC screen as having the highest. Since 2015 as well, MET, AFL, LNC, and AIG have reduced their holdings in energy bonds, while PL, EQH, and PRU have all increased their holdings.

Energy Exposures Within Select Insurance Company Investment Portfolios - 12/31/19 ($MM's)

Ticker	IG Energy Exposure	High Yield Energy Exposure	Total Energy Exposure	Total Energy Exposure /Total Fixed Maturities	Total Energy Exposure /SH Equity (ex AOCI)	Total Energy Exposure /SH Equity (ex AOCI)	Total Energy Exposure /Total Statutory Surplus	Source- Energy Exposure data
AFL			4,281	3.5%	19.2%	19.2%	43.2%	10K, Pg no. 53
AIG			13,379	5.2%	21.4%	21.4%	27.8%	10K Pg no. 116
MET	8,900	1,100	10,000	3.1%	18.8%	22.7%	50.9%	10K, Pg no. 87
PFG			2,846	4.0%	20.8%	23.8%	54.8%	10K, Pg no. 77
BHF			4,238	6.0%	32.6%	32.6%	48.5%	10K, Pg no. 87
GL	1,532	147	1,679	10.2%	30.8%	33.5%	134.3%	Quarterly Fin. Supplement
PRU			13,862	3.5%	34.9%	37.8%	85.4%	10K, Pg no. 115
EQH			3,947	5.9%	27.6%	40.7%	48.5%	10K, Pg no. 118
UNM			4,775	10.1%	48.1%	49.9%	86.0%	10K, Pg no. 78, 192
LNC			6,685	6.4%	47.7%	54.6%	78.1%	10K, Pg no. 75, 170
PL			4,985	7.2%	64.4%	72.1%	115.9%	10K, Pg no. 100

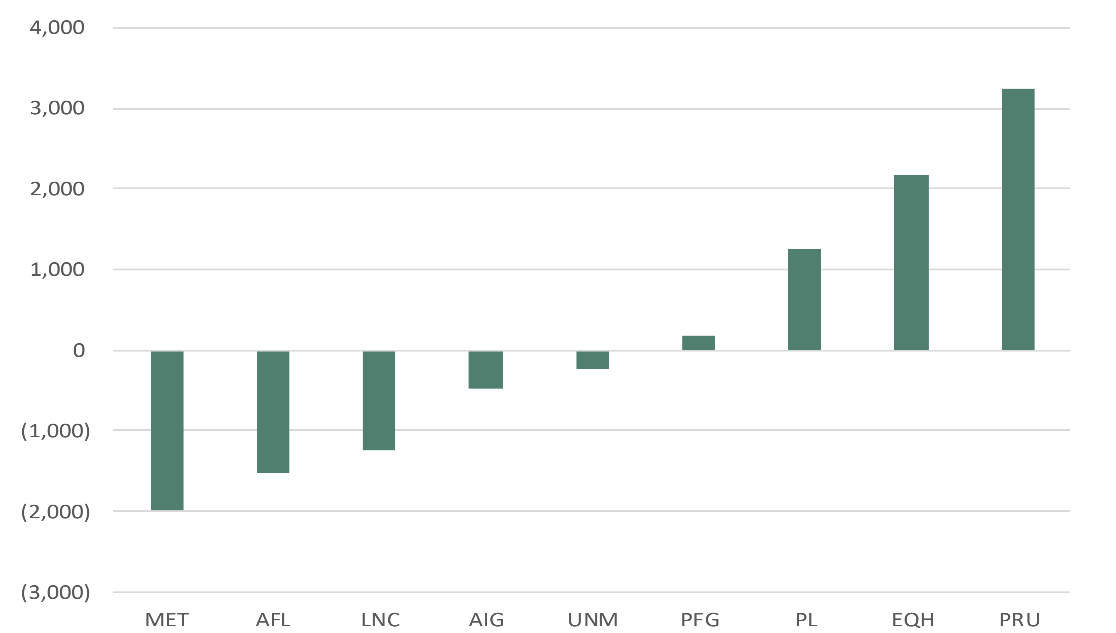
Notes: Only MET & GL break down energy holdings b/w IG & HY, peers don't give a similar breakdown but exposure has historically been heavily weighted towards IG.
The above analysis excludes any potential energy exposure in the alternative investment portfolios (Sch BA assets).
Source: Company reports and SNL.

Fixed Maturity Energy Exposure as a % of Tangible Equity (12/31/2019)



Source: Company Filings, Wells Fargo Securities

Changes in Energy Exposure Since 12/31/2015 ($ in MM)



Source: Company Filings, Wells Fargo Securities

The last piece to the energy puzzle for life companies is to assess the impact of downgrades from BBB to BB in the energy portfolios. The past has taught us that downgrades can be more painful than impairments at times, especially if downgrades involve multi-notch moves. In talking with our own energy team, it seems like around 7% of the IG Energy Index could drift down to HY over the near to medium term, so we wanted to be conservative and assumed 25% of life insurers energy holdings moved from BBB to BB. We stressed that analysis further by assuming 40% of energy holdings were downgraded by the same degree and estimated the impact on each company's RBC ratio. We then looked at how much parent cash would be required to restore the RBC back to pre-energy downgrade levels, and measured that amount against holding company liquidity that is reduced by annual fixed charges.

This analysis is extra punitive because it assumes dividends cannot be upstreamed from the insurance subsidiaries, which in turn would assume share buybacks are curtailed or completely put on hold. In reality, some level of dividends is likely to flow from the insurance subsidiaries, but if reserve charges or other pressures unfold that we cannot calculate, we wanted to see what the holding companies looked like. Under this analysis (assuming 40% of the energy book goes to BB), which is illustrated below, only GL, EQH, and LNC show a shortfall of holding company cash if management opted to try and restore its RBC ratio back to pre-energy downgrade levels.

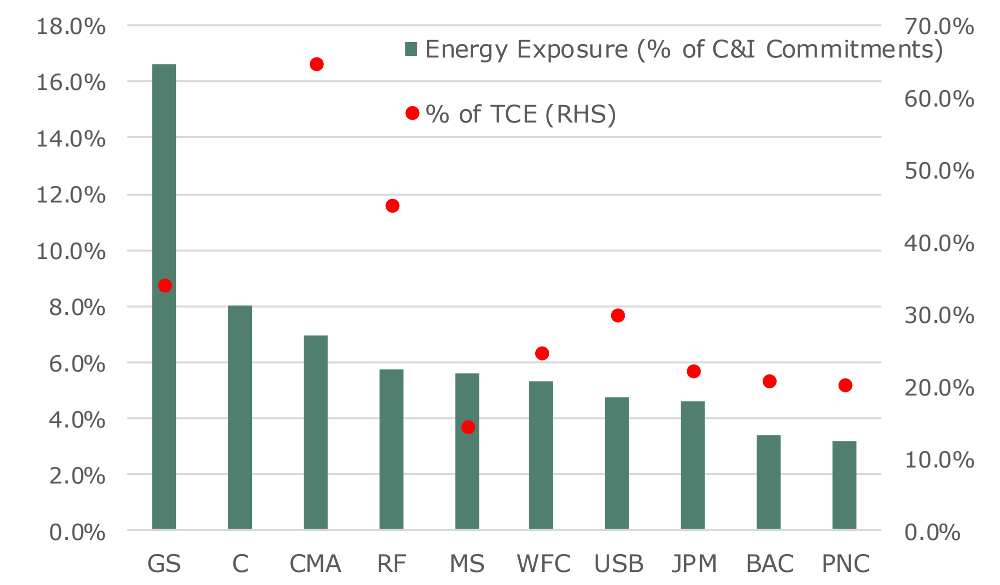
Energy Holdings Downgrade Scenarios on RBC and Holding Company Liquidity

Company	2019 CAL RBC Ratio	25% of Energy Downgraded to BB	40% of Energy Downgraded to BB	2019 CAL RBC Pro-Forma for 40% of Energy Downgraded to BB	Hold Co. Cash Necessary to Restore RBC to 2019 Levels ($MM's)	Hold Co. Cash Net of Annual Fixed Charges ($MM's)	Coverage of Potential Energy RBC Hole at 40% Downgrade Level ($MM's)
AFL	538%	42%	64%	474%	304	1,529	1,225
AIG	400%	15%	23%	377%	706	3,500	2,794
MET	357%	7%	11%	346%	472	1,300	828
PFG	412%	6%	10%	402%	155	1,000	845
BHF	555%	11%	17%	537%	310	492	182
GL	316%	9%	15%	302%	70	(146)	(216)
PRU	426%	10%	15%	410%	779	2,200	1,421
EQH	504%	9%	15%	489%	262	(22)	(284)
UNM	394%	17%	26%	368%	249	463	214
LNC	439%	11%	17%	422%	388	72	(316)
PL	479%	17%	27%	453%	315	NA	NA

Source: Company reports and SNL.

Notes: AIG RBC is for Life only, while hold co. cash is net of the $1.7BN expected tax payment in 2020.
LNC RBC ratio includes 25 points of goodwill that will fall away in the coming years.
AFL capital levels do not include the $7.8BN that resides in Japan, so RBC impact is overstated in our above analysis.

U.S. Banks Ranked by Energy Exposure

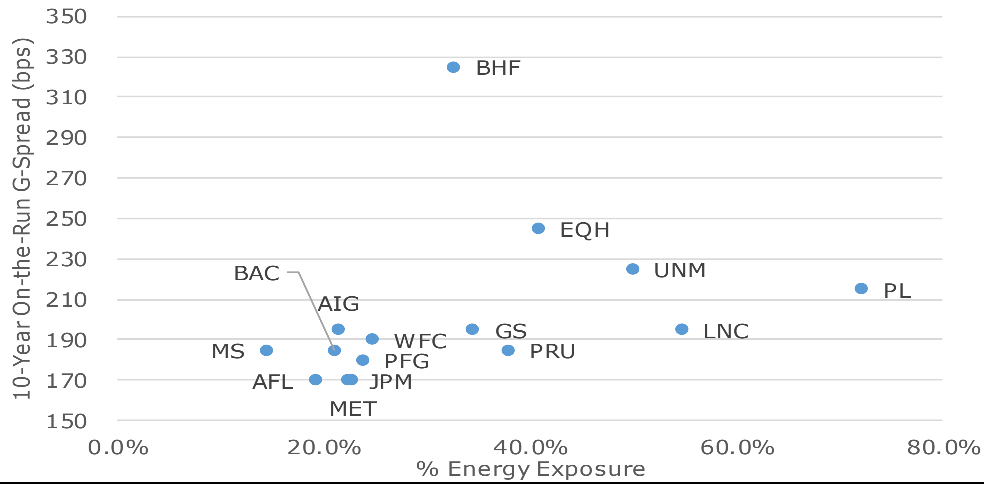


Source: Company Filings, Wells Fargo Securities

- **Due to some inconsistencies with disclosures, the best we could do to level set the energy comparison for banks was to use commitments to the sector**. As a result, exposures are likely overstated in this analysis since funded exposure is less and commitments are likely to come down if pressure accelerates on the space – currently, we calculate the peer group average utilization rate for the banks at ~45% for the Energy sector. The shorter duration of bank loans, along with covenant protection and senior secured status also improves the positioning of banks in our opinion relative to longer duration, senior unsecured lenders in the market. Banks also have a long history with energy; with significant collateral haircuts made in certain parts of the energy markets, such as E&P, while regulators have also taken more targeted action on ensuring lending standards to some of the riskier parts of the energy complex are conservatively managed.

- **Although markets moved significantly today, we have attempted to compare bank and life insurance valuations relative to the amount of tangible equity exposed to the energy sector in the following graph**. As we can see from the chart, there is a high cluster of financial names in the 20%-25% energy exposure range that are trading in the 180-190 bps context to their respective 10 year bonds outstanding. Given some of our prior comments around banks holding more senior, shorter duration exposures that are enhanced with collateral/covenant protection, the graph seems to favor banks holding all other variables equal. The analysis could also point to certain life names that screen further out the risk curve yet trade at levels relatively flat to some of the big banks that more pain could be on the horizon for those insurers if things get worse from here.

Financials - Energy Exposure Summary



Banks Energy Exposure - Total Energy Industry credit commitments (Unfunded + Funded) as a proportion of tangible common equity.

Insurance Energy Exposure - total sector fixed maturity investments as a proportion of shareholders' equity.

Source: Bloomberg, Wells Fargo Securities
Pricing as of 3/9/2020

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