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U.S. Insurance Industry's High-Yield Bond Exposure Grows Following COVID-19-Related Credit Deterioration in 2020

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Executive Summary

- At year-end 2020, the U.S. insurance industry reported $286 billion in high-yield bond exposure, an increase of just over 25% compared to year-end 2019 due in part to the broad-based credit impact of the COVID-19 pandemic.
- High-yield bonds accounted for 6.1% of the industry's total bond exposure, the highest level in more than 10 years and an increase from 5.1% at year-end 2019.
- High-yield corporate bonds, asset-backed securities (ABS) and other structured securities, and private-label commercial mortgage-backed securities (CMBS) were the primary contributors to the increase in high-yield exposure.
- Fallen angels—including Ford Motor, Occidental Petroleum, and Kraft Heinz—accounted for approximately 20% of the year-over-year (YOY) increase in U.S. insurers' high-yield bond exposure in 2020.
- The credit distribution of the industry's high-yield exposure is skewed to the higher quality end of below investment grade credits, with 62% of the industry's exposure at year-end 2020 to bonds with NAIC 3 designations.
- Except for title companies, high-yield exposure as a percentage of total bonds at all insurer types are near or at their highest levels since 2012.

Following more than 10 years of a relatively benign credit environment, the economic and financial effects of the COVID-19 pandemic, combined with a sudden and sharp decline in oil prices, led to significant pressure on credit quality in 2020. As a result, the nationally recognized statistical rating organizations (NRSROs) took a record number of negative rating actions, affecting fixed income securities across many bond categories, including corporate, municipal, and structured securities.

In the corporate bond universe, high-yield companies have dominated rating actions as they generally have weaker liquidity profiles and limited financial flexibility to withstand the negative credit effects of macroeconomic shocks. Companies at the lower end of the investment grade spectrum (i.e., rated Baa3

or BBB- at Moody's and Standard & Poor's [S&P], respectively) were also vulnerable, with several issuers downgraded to high-yield—typically referred to as "fallen angels." In addition, local and regional governments suffered the majority of rating actions taken on municipal issuers, which were primarily negative outlook revisions. For structured securities, ratings of CMBS and collateralized loan obligations (CLOs) experienced the largest share of downgrades as a percentage of outstanding ratings.

Record Negative Rating Actions Leads to Jump in High-Yield Bonds

U.S. insurance companies reported high-yield bond exposure with a book/adjusted carrying value (BACV) of $286 billion as of year-end 2020, an increase of 25.7% compared to year-end 2019. (See Table 1.) High-yield bonds represented 6.1% of the industry's total bond exposure, increasing from 5.1% at year-end 2019. The increase in high-yield bond exposure is partly attributed to the broad-based credit quality deterioration resulting from the effects of the COVID-19 pandemic, including an unprecedented level of business disruption with significant declines in revenues and cash flows, sharp declines in oil prices, record levels of unemployment, and a global recession (albeit short-lived). In addition, in their search for higher yields, U.S. insurers have not only invested in relatively illiquid investments (such as mortgage loans, private equity, and hedge funds), but also they have invested down the credit quality spectrum. Favorable market dynamics—including a significant amount of bond issuance and relatively low default rates in 2020—provided attractive investment opportunities in the high-yield market.

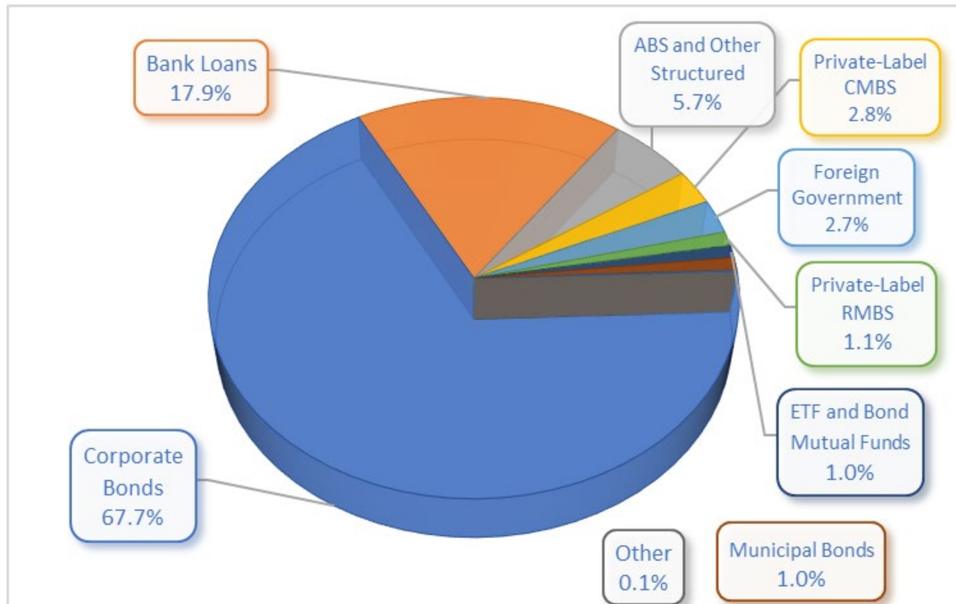
Table 1: Total U.S. Insurance Industry High-Yield Bond Exposure by Bond Type, Year-End 2020 (BACV $ in millions)

Bond Type	Life	P/C	Health	Title	Total	% of Total HY	% of Total Bonds
Corporate Bonds	145,454	40,846	7,151	138	193,589	67.7%	4.1%
Bank Loans	36,703	12,422	1,850	121	51,096	17.9%	1.1%
ABS and Other Structured Securities	14,050	1,899	231	0	16,179	5.7%	0.3%
Private-Label CMBS	6,932	972	85	-	7,989	2.8%	0.2%
Foreign Government	6,259	1,107	445	5	7,816	2.7%	0.2%
Private-Label RMBS	2,563	518	135	-	3,216	1.1%	0.1%
ETF and Bond Mutual Funds	399	2,139	340	16	2,894	1.0%	0.1%
Municipal Bonds	1,196	1,526	97	0	2,820	1.0%	0.1%
Other	383	9	28	3	423	0.1%	0.0%
Total High-Yield	**213,940**	**61,439**	**10,361**	**283**	**286,022**	**100.0%**	**6.1%**
% of Total	**74.8%**	**21.5%**	**3.6%**	**0.1%**	**100.0%**		

Note: The "Other" bond type includes agency-backed RMBS, agency-backed CMBS, hybrid securities, and U.S. Government bonds.

Chart 1 shows the various asset classes that make up the U.S. insurance industry's high-yield bond exposure. Corporate bonds accounted for the majority, or two-thirds, of the year-end 2020 exposure, and bank loans represented almost 18%. ABS and other structured securities, private-label CMBS, and private-label residential mortgage-backed securities (RMBS) together accounted for almost another 10%.

Chart 1: U.S. Insurance Industry High-Yield Bond Exposure by Bond Type, Year-End 2020



Note: The "Other" bond type includes agency-backed RMBS, agency-backed CMBS, hybrid securities, and U.S. Government bonds.

While the share of bank loans decreased to 18% from 22% at year-end 2019, the shares of corporate bonds, ABS and other structured securities, and private-label CMBS each increased in 2020. Corporate bonds' share increased to 67.7% at year-end 2020 from 65.8% at year-end 2019, ABS and other structured securities' share increased to 5.7% from 4.6%, and private-label CMBS' share increased to 2.8% from 1.1%. The share of the remaining asset classes experienced minimal YOY changes, if any.

Despite the record number of downgrades to corporate bonds, the number of fallen angels in 2020 was lower than prior periods of market stress, such as the financial crisis in 2008–2009 and the oil crisis in 2015–2016. Nevertheless, several large issuers (in terms of outstanding debt) lost their investment grade ratings—including Ford Motor, Occidental Petroleum, and Kraft Heinz. U.S. insurers' exposure to these three fallen angels accounted for approximately 20% of the YOY increase in high-yield bonds in 2020 and approximately one-quarter of the 100 basis points increase in high-yield bond exposure as a percentage of total bonds.

The industry's high-yield bond exposure is skewed toward the higher quality of the below investment grade spectrum (i.e., BB-rating category) and provides some comfort to the added credit risk being taken by insurers from investing in high-yield bonds. (See Table 2.) Approximately 62% of the industry's bond exposure at year-end 2020 carried NAIC 3 designations, the highest quality in the high-yield credit quality spectrum, and another 28% carried NAIC 4 designations. Exposure to bonds with NAIC 3 designations increased from 59% at year-end 2019, while exposure to bonds with NAIC 4 designations decreased from 30%. High-yield exposure has been primarily concentrated in the NAIC 3 and the NAIC 4 designation categories for the last 10 years.

Table 2: Credit Distribution of U.S. Insurance Industry High-Yield Bond Exposure as of Year-End 2020 (BACV $ millions)

NAIC Designation	Life	P/C	Health	Title	Total	% of Total
NAIC 3	139,896	31,420	6,080	178	177,574	62.1%
NAIC 4	54,258	22,791	3,686	73	80,809	28.2%
NAIC 5	17,355	5,586	413	22	23,376	8.2%
NAIC 6	2,430	1,642	182	9	4,263	1.5%
Total	**213,940**	**61,439**	**10,361**	**283**	**286,022**	**100.0%**

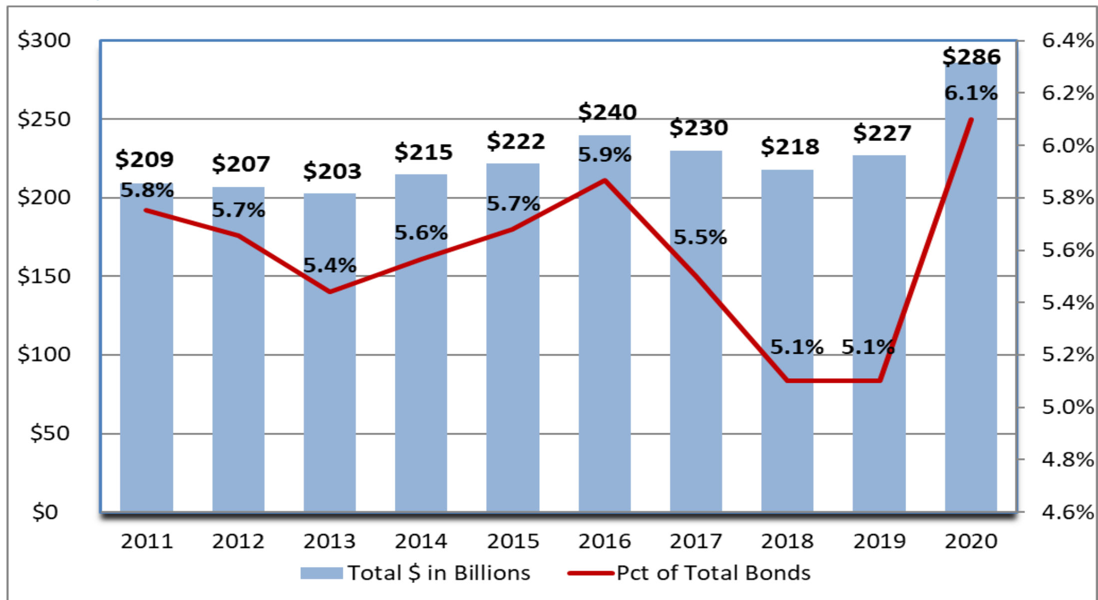
The credit distribution of the industry's high-yield bond exposure varied by insurer type. For example, at year-end 2020, NAIC 3 exposure for life and title companies was 65% and 63%, respectively, of total high-yield bonds, while property/casualty (P/C) and health was 51% and 59%, respectively. Furthermore, bonds with NAIC 4 designations represented more than 35% of P/C and health companies' high-yield exposure, indicating high-yield investment portfolios with more credit risk relative to the overall U.S. insurance industry.

High-Yield Exposure Reaches Highest Level in More Than 10 Years

The U.S. insurance industry's high-yield bond exposure as of year-end 2020 reached its highest levels in more than 10 years as shown in Chart 2. On a percentage basis, exposure to high-yield bonds began declining after year-end 2016 when the metric reached a high of 5.9%, falling to a low of 5.1% at year-end 2018. At year-end 2020, however, the metric climbed to 6.1% of total bonds, the highest level since the 6.3% reached in 2009.

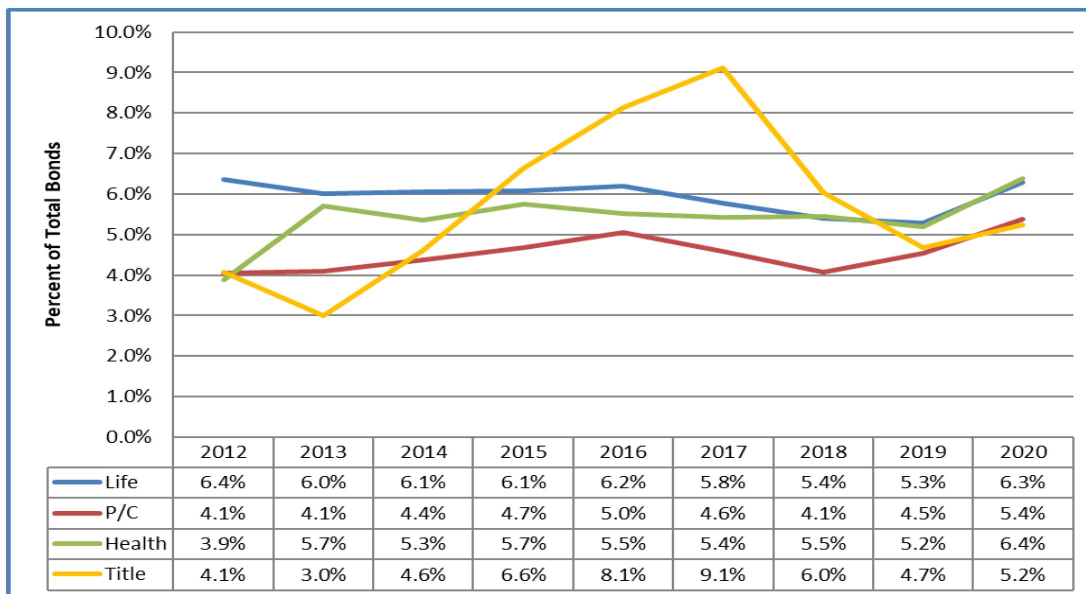
Over the 10-year period, exposure to high-yield bonds in BACV terms has grown at a faster pace than bonds overall. High-yield exposure has grown almost 37%, despite declines in several years, while overall bonds have grown steadily throughout the period with total growth of 30%.

Chart 2: Historical U.S. Insurance Industry Exposure to High-Yield Bonds, 2011–2020 (BACV $ in Billions)



High-yield bond exposure increased for all insurer types at year-end 2020 compared to year-end 2019. (See Chart 3.) Exposure as a percentage of total bonds at year-end 2020 was near or at its highest point for all insurer types, except for title companies, since 2012.

Chart 3: U.S. Insurance Industry High-Yield Bond Exposure as a Percentage of Total Bonds by Insurer Type, 2012–2020



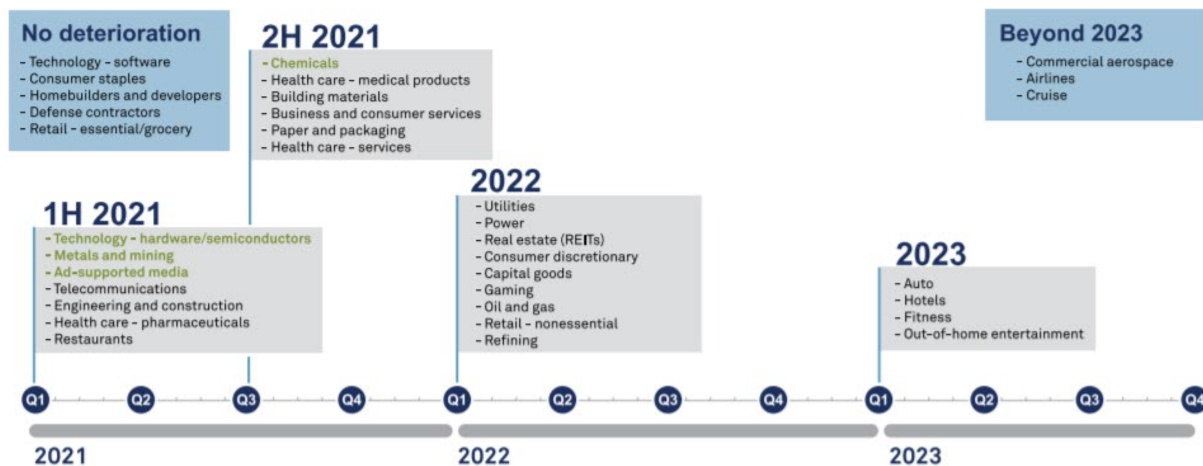
	2012	2013	2014	2015	2016	2017	2018	2019	2020
Life	6.4%	6.0%	6.1%	6.1%	6.2%	5.8%	5.4%	5.3%	6.3%
P/C	4.1%	4.1%	4.4%	4.7%	5.0%	4.6%	4.1%	4.5%	5.4%
Health	3.9%	5.7%	5.3%	5.7%	5.5%	5.4%	5.5%	5.2%	6.4%
Title	4.1%	3.0%	4.6%	6.6%	8.1%	9.1%	6.0%	4.7%	5.2%

Title companies' high-yield bond exposure has been more volatile compared to other insurer types. Between 2012 and 2020, it peaked at more than 9% of total bonds at year-end 2017 but has been reduced significantly in recent years to levels more in line with the industry average.

Credit Environment Improves but Risks Remain

The overall credit environment has stabilized and is improving, with rating upgrades outpacing downgrades in 2021. For corporate bonds, while sectors that were significantly impacted by the COVID-19 pandemic will take a few more years to fully recover, other sectors are expected to return to pre-pandemic operating levels much sooner. For example, in North America, S&P Global Ratings (S&P) expects the credit metrics of the telecom, technology, health care, and building materials sectors to recover to 2019 levels by the end of 2021, while that of commercial aerospace, airlines, and cruise operators are not expected to fully recover until later than 2023.[1] (See Chart 4.)

Chart 4: S&P Global Ratings Time Frame of Recovery of Credit Metrics to 2019 Levels for North America



Financing conditions remain favorable for issuers—investment grade and high-yield alike—across all asset classes, with interest rates expected to remain low and investor appetite for yield strong. High-yield issuers in particular have taken advantage of the abundant credit availability to refinance existing debt at lower yields, providing them more financial flexibility at least for the near term. Risks to continued favorable financing conditions include sustained high inflation or another unforeseen shock to the economy.

While the U.S. insurance industry's high-yield exposure is likely manageable given its overall capital strength, individual insurers with concentrated exposures, particularly as a percentage of capital and surplus, could be at risk of significant losses if default rates spike or rise dramatically. However, S&P

[1] S&P Global Ratings, *COVID-19 Heat Map: Pent-Up Demand and Supply Shortages Further Improve Recovery Prospects for Credit Quality*, June 8, 2021.

expects the U.S. trailing 12-month speculative-grade corporate default rate to decline to 4% by March 2022 from 6.3% in March 2021. In addition, the European trailing 12-month speculative-grade corporate default rate is expected to also decline to 5.25% from 6.1% for the same periods. Lower default rates reflect stabilizing credit metrics, vaccination progress, favorable lending conditions, and a strong economic rebound.

The NAIC Capital Markets Bureau will continue to monitor trends in the U.S. insurance industry's high-yield bond investments and report as deemed appropriate.

Questions and comments are always welcome. Please contact the Capital Markets Bureau at CapitalMarkets@naic.org.

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