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Growth in the U.S. Insurance Industry's Exposure to Bonds with NAIC 2 Designations Stabilizes at Year-End 2019

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Executive Summary

- Following gradual annual increases over the last decade, U.S. insurers' exposure to NAIC-2 designated bonds as a percentage of total bonds was unchanged at 30% at year-end 2019 compared to year-end 2018.
- The increase in U.S. insurers' bonds with NAIC 2 designations over the last 10 years reflects a reach for yield by the U.S. insurance industry at the expense of credit quality in the lower-for-longer interest rate environment, as well as the growing share of BBB-rated bonds in the overall corporate bond market.
- U.S. insurers increased their book/adjusted carrying value (BACV) dollar exposure to NAIC 2–designated bonds 3.6% to $1.32 trillion at year-end 2019 from $1.28 trillion at year-end 2018.
- While no significant concentrations are evident at the lower end of the 'BBB' rating category for the U.S. insurance industry, year-end 2019 data exhibited an increase in the share of BBB- credit quality category to 30% from 28% at year-end 2018, reflecting a year-over-year (YOY) deterioration in credit quality.
- Amid the COVID-19 pandemic, the number of fallen angels, or companies downgraded in 2020 from investment grade (particularly in the 'BBB' rating category) to speculative grade, as of October exceeded that during the financial crisis. The NAIC Capital Markets Bureau (CMB) estimates that the U.S. insurance industry's exposure to the largest corporate fallen angels was less than 1% of total NAIC 2 bond exposure at year-end 2019.

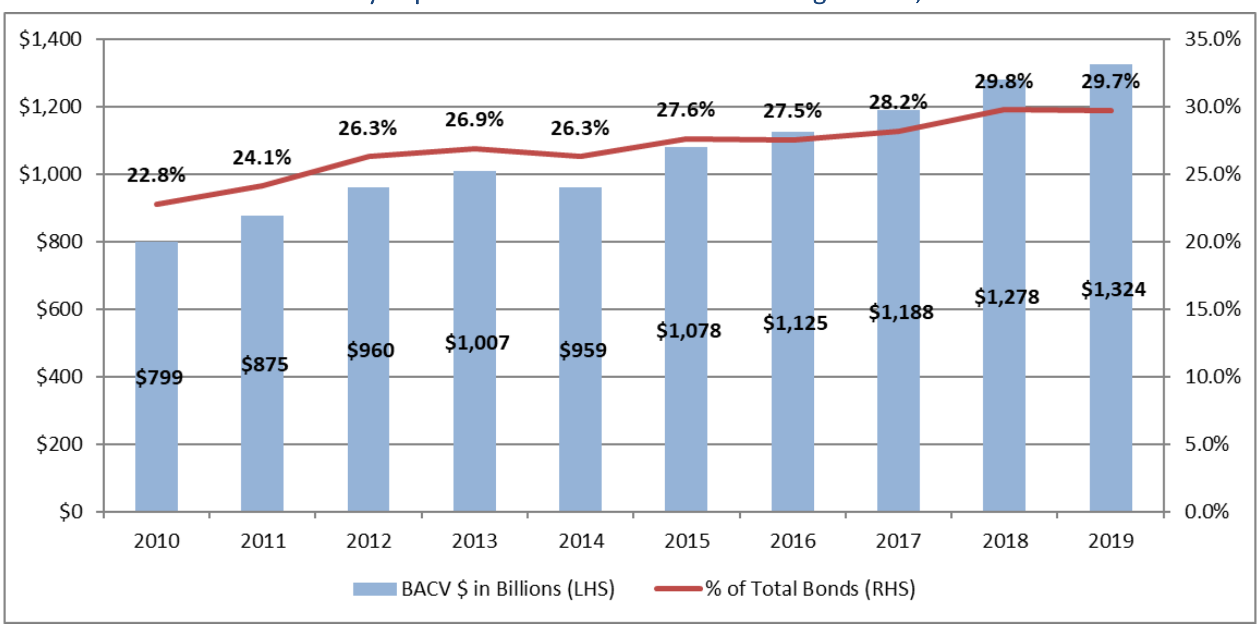
Trends in U.S. Insurer Exposure to NAIC 2-Designated Bonds

The BBB-rated segment of the corporate bond market has grown steadily over the last decade, from approximately one-third of the market in 2009. According to S&P Global Ratings data, as of Oct. 1, 2020, the 'BBB' rating category accounted for almost 40% of global corporate debt and 41% of U.S. corporate debt.[1] The growth primarily reflects an increase in leverage across corporate issuers as financing conditions have been supportive with an attractive cost of debt and strong investor demand given the lower-for-longer interest rate environment. Similar dynamics are also evident in other asset classes, including municipal bonds and structured securities, but to a lesser extent.

Accordingly, the U.S. insurance industry's exposure to bonds with NAIC 2 designations—or the BBB-rating category as assigned by nationally recognized statistical rating organizations (NRSROs)—has also grown over time. The industry has experienced a steady increase in NAIC 2-designated bonds in terms of book/adjusted carrying value (BACV) and as a percentage of total bond exposure. Bonds with NAIC 2 designations increased to almost 30% of total bonds as of year-end 2019 from under 23% at year-end 2010. (See Chart 1.)

The growth rate in NAIC 2 exposure over the 10-year period can be partially attributed to insurers taking additional credit risk as they allocated greater dollars to NAIC 2 bonds at the expense of NAIC 1 bonds during the prolonged low interest rate environment. Bonds with NAIC 1 designations represented 65% of the industry's total bonds as of year-end 2019, a decline from 71% at year-end 2010. However, the growth rate has stabilized recently, with the increase in the share of bonds with NAIC 2 designations remaining relatively unchanged from year-end 2018 to year-end 2019.

Chart 1: U.S. Insurance Industry Exposure to Bonds with NAIC 2 Designations, 2010–2019

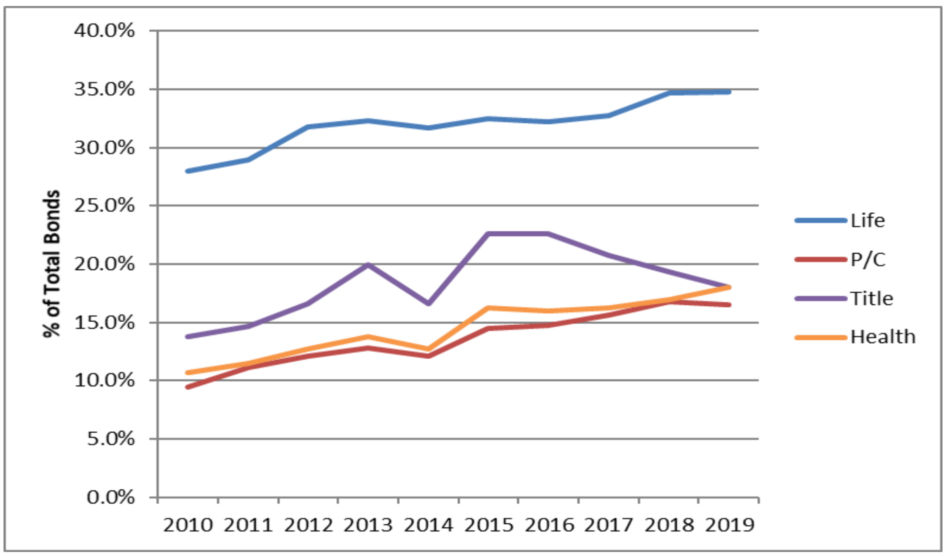


The growth of NAIC 2 exposure has also been a function of the shift in the structure of the corporate bond market whereby BBB-rated corporate debt represented approximately 40% of total corporate bonds outstanding in October 2020, compared to almost 33% in 2009. Note that the insurance industry's exposure to bonds with NAIC 2 designations at 30% of total bonds is significantly below that of the overall market.

[1] S&P Global Ratings *Credit Trends: State of Play: Record Issuance Lifts Global Corporate Debt By 6%*, Nov. 10, 2020.

The rising trend in U.S. insurers' exposure to bonds with NAIC 2 designations over the past 10 years is also evident in each of the insurer types. (See Chart 2.) At year-end 2019, life insurance companies (including fraternal companies) had the largest exposure to NAIC 2 bonds at 35%. While life companies' exposure has increased from 28% of total bonds at year-end 2010, year-end 2019 exposure was unchanged compared to year-end 2018. Bonds with NAIC 2 designations represented a relatively smaller portion of property/casualty (P/C), title and health companies' bond investment portfolios but have increased nonetheless over the last decade. For this time period, the share of bonds with NAIC 2 designations at P/C and health companies increased seven percentage points to 17% and 18%, respectively, as of year-end 2019, while it increased four percentage points to 18% at title companies. While the rising trend is continuing at health companies, it stabilized in 2019 at P/C companies and has been declining at title companies since 2016.

Chart 2: U.S. Insurance Industry Exposure to Bonds with NAIC 2 Designations as a Percent of Total Bonds by Insurer Type, 2010–2019



Year-End 2019 NAIC 2 Bond Exposure Reflects Potentially Rising Credit Risk

The U.S. insurance industry's exposure to bonds with NAIC 2 designations totaled $1.32 trillion as of year-end 2019, an increase of 3.6% compared to year-end 2018 and accounting for 29.7% of total bonds. The majority, or 90%, of the exposure was to corporate bonds traded both in the public and private markets. (See Table 1.) Life companies owned the majority of the NAIC 2 exposure, or 84%, while P/C companies owned almost 14% of the industry's exposure. This is consistent with year-end 2018, as well as the overall profile of the U.S. insurance industry's total cash and invested assets, whereby bonds represent the majority of the industry's assets, and life companies account for the largest bond exposure by insurer type.

Table 1: U.S. Insurance Industry Exposure to NAIC 2 Bonds by Bond Type as of Dec. 31, 2019 (BACV $ millions)

Bond Type	Life	P/C	Health	Title	Total	% of Total
Corporate	1,010,130	161,140	21,685	882	1,193,838	90.2%
Structured Securities	69,976	7,621	747	2	78,346	5.9%
Sovereign/Other Government	15,922	2,656	308	24	18,909	1.4%
Municipal	10,238	7,335	1,146	36	18,755	1.4%
Other	10,501	1,797	1,549	10	13,857	1.1%
Total	**1,116,768**	**180,548**	**25,435**	**953**	**1,323,705**	**100.0%**
% of Total	84.4%	13.6%	1.9%	0.1%	100.0%	

Note: The "Other" category includes hybrid bonds, exchange-traded funds, bond mutual funds and affiliated bonds.

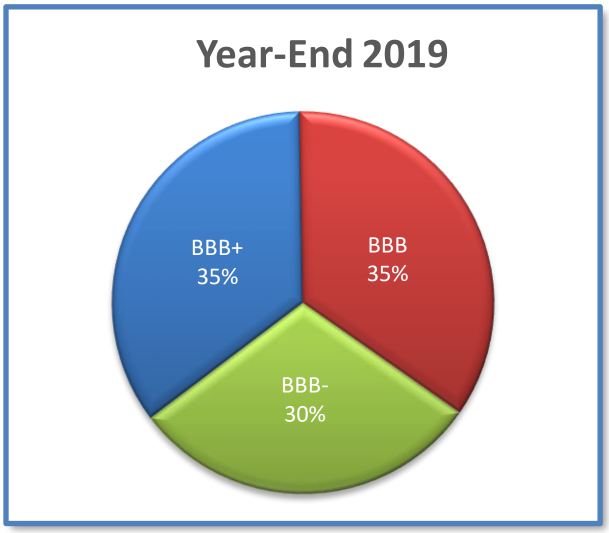
Approximately 75% of reported year-end 2019 bond data was analyzed to determine if there was any evidence of U.S. insurers skewing the distribution within the NAIC 2 designation category; that is, whether there was a concentration of investments at the lower end of the investment grade credit quality spectrum, or specifically BBB- rated bonds, as they typically carry higher relative risks. Concentrations of exposure at the lower end of the credit quality category would raise concerns, particularly because the credit market experienced significant and broad-based stress beginning in March 2020 as a result of business interruptions stemming from social distancing and "stay-at-home" measures to contain and mitigate the spread of the COVID-19 pandemic.

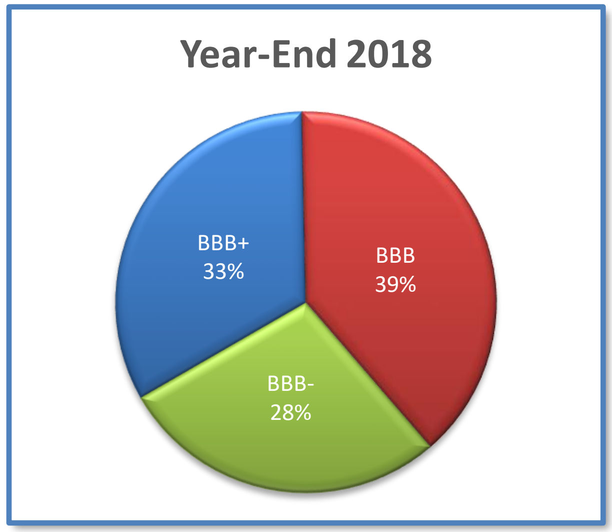
The NAIC CMB's analysis indicates that NAIC 2 exposure is fairly evenly distributed across the NAIC 2 credit quality category for the U.S. insurance industry, as well as for each insurer type. (See Table 2.) As of year-end 2019, the BBB+ and the BBB credit quality categories each represented 35% of the industry's NAIC 2 bond exposure, and the BBB- credit quality category accounts for the remainder, or 30%. However, there is evidence that credit quality is deteriorating within the NAIC 2 exposure on a year-over-year basis. The industry's exposure shifted modestly to the lowest credit quality category, or BBB-, at year-end 2019 as its share increased two percentage points to 30% from 28% at year-end 2018. It also increased across each of the insurer types. (See Chart 3 and Chart 4.)

Table 2: Estimated U.S. Insurance Industry Distribution of NAIC 2 Bond Exposure by Insurer Type as of Dec. 31, 2019

Credit Quality Category	Life	P/C	Health	Title	Total
BBB+	34.4%	36.2%	36.7%	34.8%	34.7%
BBB	35.3%	34.1%	32.4%	36.8%	35.0%
BBB-	30.3%	29.7%	30.9%	28.3%	30.2%

Chart 3 and Chart 4: Estimated U.S. Insurance Industry Distribution of NAIC 2 Bond Exposure as of Year-end 2019 (Left Panel) and Year-end 2018 (Right Panel)





Given the stress in the credit markets resulting from the effects of the COVID-19 pandemic, the industry's NAIC 2 exposure warrants ongoing monitoring—with particular attention to the BBB- credit quality category which can have a greater potential for deteriorating credit quality and the risk of the exposure falling into the below-investment grade rating categories.

Fallen Angels Rise in 2020

With many companies experiencing unprecedented levels of business disruption and significant declines in revenues and cash flows amid the COVID-19 pandemic, record levels of unemployment resulting in lower consumer demand, and a significant decline in oil prices, NRSROs have taken a record number of negative rating actions in 2020. While the majority of the rating actions have been concentrated in speculative grade issuers, investment grade issuers have also been affected.

Several investment-grade companies, particularly those in the 'BBB' rating category, were downgraded to speculative grade—commonly referred to as 'fallen angels.' At S&P Global Ratings, for example, there have been 46 fallen angels in 2020 as of Oct. 21, surpassing the 35 fallen angels in 2009 during the financial crisis. This year's fallen angels have been broad-based in terms of sectors, including large corporate debt issuers such as Ford Motor Company, Occidental Petroleum, Kraft Heinz, Apache, EQT Corp. (a utility company), Delta Air Lines, Nordstrom, Macy's and Continental Resources.

As of year-end 2019, the NAIC CMB estimates that the U.S. insurance industry's exposure to the aforementioned largest corporate fallen angels was limited, at less than 1% of total NAIC 2 bonds and less than 0.5% of total corporate bonds. While the increase in risk-based capital (RBC) requirements associated with the fallen angels is likely minimal on an industry-wide basis, it could be more significant for individual insurers, particularly small and mid-sized insurers or insurers with exposure concentrations in any or all of these affected corporate debt issuers.

The NAIC Capital Markets Bureau will continue to monitor trends in the U.S. insurance industry's exposure to NAIC 2-designated bonds, looking for indications of outsized risks, if any.

Questions and comments are always welcome. Please contact the Capital Markets Bureau at [CapitalMarkets@naic.org.](mailto:CapitalMarkets@naic.org)