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U.S. Insurance Industry's High-Yield Bond Exposure at Year-End 2019 Remains at 5.1% of Total Bonds

Analysts: Michele Wong and Jean-Baptiste Carelus

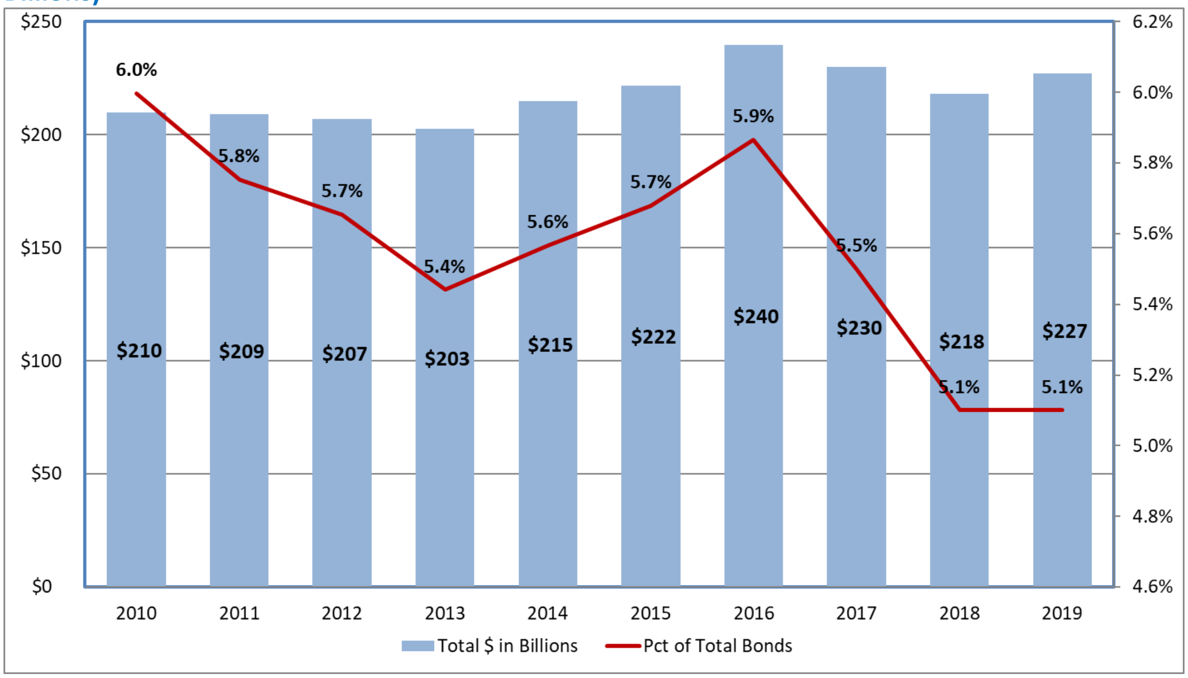
Executive Summary

- As of year-end 2019, U.S. insurers reported $227.5 billion in book/adjusted carrying value (BACV) of exposure to high-yield bond investments, an increase of 4.4% compared to 2018 but unchanged at 5.1% as a percentage of total bonds.
- High-yield exposure as a percentage of total bonds at property/casualty (P/C) companies increased modestly at year-end 2019 compared to the prior year, but it decreased at life and fraternal, health, and title companies.
- Corporate bonds and bank loans accounted for the two largest high-yield investments as of year-end 2019, consistent with prior years. However, bank loans' share of the U.S. insurance industry's high-yield bond exposure increased to 22% as of year-end 2019 from 9% as of year-end 2016.
- The credit distribution of the industry's high-yield exposure is skewed to the higher quality end of below investment grade credits, with approximately 60% of the industry's exposure at year-end 2019 to bonds with NAIC 3 designations.
- With the widespread impact of the COVID-19 pandemic on the global economy, and high-yield corporate bonds in particular, credit quality deterioration within the U.S. insurance industry's high-yield exposure is expected in 2020.

U.S. insurance companies reported high-yield bond exposure with a BACV of $227.5 billion as of year-end 2019, which was an increase of 4.4% from $217.8 billion at year-end 2018. In comparison, the insurance industry's total bond exposure grew 3.7% in 2019; therefore, high-yield exposure grew at a slightly faster rate than total bond exposure, indicating that insurers have taken on some incremental risk in higher-yielding debt, given the prolonged low interest rate environment.

Chart 1 shows the industry's high-yield bond exposure from 2010 through 2019, together with the exposure as a percentage of total bonds. Exposure to high-yield bonds on a BACV basis has remained within a range of $200 billion and $240 billion since 2010. Meanwhile, high-yield bonds as a percentage of total bonds has been declining since year-end 2016 when the metric reached a recent peak of 5.9%. As of year-end 2019, high-yield bonds accounted for 5.1% of the U.S. insurance industry's total bonds, unchanged from the prior year.

Chart 1: Historical U.S. Insurance Industry Exposure to High-Yield Bonds, 2010–2019 (BACV $ in Billions)

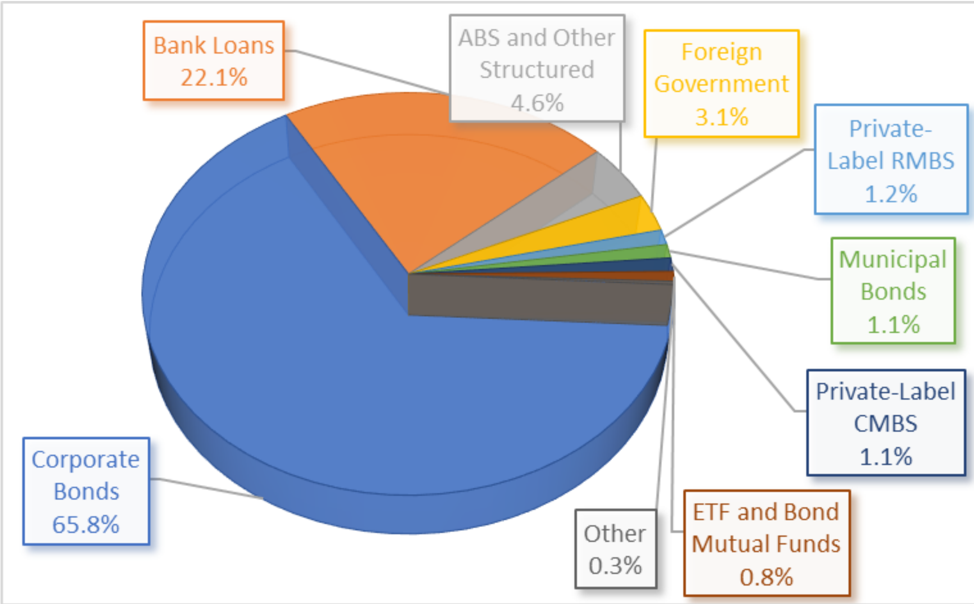


While the industry's overall high-yield exposure as a percent of total bonds was unchanged, it increased at P/C companies to 4.5% at year-end 2019 from 4.1% at year-end 2018. However, this level is lower than the peak for the period analyzed of 5% in 2016. High-yield exposure as a percent of total bonds at the other insurer types declined from year-end 2018 to year-end 2019—from 5.4% to 5.3% for life and fraternal companies, from 5.5% to 5.2% for health companies, and from 6% to 4.7% for title companies. Note that the annual and quarterly reporting for life and fraternal insurance companies has been combined into one blank beginning with year-end 2019.

The Majority of U.S. Insurers' High-Yield Exposure is in Corporate Debt

Although the U.S. insurance industry's high-yield bond exposure consisted of investments in a variety of bond types as of year-end 2019, corporate bonds represented the majority, or almost two-thirds of the exposure (see Chart 2). Bank loans were the second largest at 22%, while structured finance investments, like asset-backed securities (ABS) and other structured securities; private-label residential mortgage-backed securities (RMBS); and private-label commercial mortgage-backed securities (CMBS) accounted for almost 7%. Foreign government bonds, municipal bonds, exchange-traded funds (ETFs) and bond mutual funds, agency-backed RMBS, agency-backed CMBS, and hybrid bonds accounted for the remaining exposure.

Chart 2: U.S. Insurance Industry High-Yield Bond Exposure by Bond Type, Year-End 2019



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

Table 1 provides the industry's high-yield exposure by bond type and by insurer type, both of which have not changed significantly in recent years. As of year-end 2019, structured securities represented 7.1% of high-yield bonds compared to 8.2% as of year-end 2016, as reported in the NAIC Capital Markets Special Report titled "U.S. Insurers' High-Yield Bond Exposure on the Rise" published in December 2017. Foreign government bonds and municipal bonds accounted for 3.1% and 1.1%, respectively, of high-yield bonds as of year-end 2019, compared to 2.6% and 1.2%, respectively, at year-end 2016.

Table 1: Total U.S. Insurance Industry High-Yield Bond Exposure by Bond Type and Insurer Type, Year-End 2019 (BACV$ in millions)

Bond Type	Life	P/C	Health	Title	Total	% of Total HY	% of Total Bonds
Corporate Bonds	112,721	31,657	5,169	111	149,659	65.8%	3.4%
Bank Loans	36,717	11,865	1,468	135	50,185	22.1%	1.1%
ABS and Other Structured Securities	8,889	1,504	140	-	10,533	4.6%	0.2%
Foreign Government	5,802	932	210	2	6,945	3.1%	0.2%
Private-Label RMBS	2,108	588	79	-	2,776	1.2%	0.1%
Municipal Bonds	1,034	1,404	72	0	2,509	1.1%	0.1%
Private-Label CMBS	1,984	438	67	-	2,489	1.1%	0.1%
ETF and Bond Mutual Funds	306	1,349	135	0	1,790	0.8%	0.0%
Other	538	43	2	-	582	0.3%	0.0%
Total High-Yield (HY)	**170,098**	**49,781**	**7,341**	**248**	**227,469**	100.0%	5.1%

Note: The "Other" bond type category includes agency-backed RMBS, agency-backed CMBS, and hybrid securities.

U.S. insurers' exposure to high-yield corporate debt, which includes corporate bonds that are publicly traded and privately placed as well as bank loans, as a percentage of total high-yield bonds increased to 87.9% at year-end 2019 from 83.1% at year-end 2016. However, the composition of the industry's high-yield corporate debt has shifted whereby bank loans represent a larger share of high-yield bond exposure, increasing to 22.1% at year-end 2019 from 9.3% at year-end 2016; and corporate bonds' share of the industry's high-yield bond exposure declined to 65.8% at year-end 2019 from 73.7% at year-end 2016. Note that at year-end 2016 U.S. insurers were not yet reporting bank loans as a separate line item on Schedule D—the reporting standard was effective at year-end 2018—therefore, exposure was estimated to the extent that bank loans could be readily identified as such from available data.

Total U.S. insurers' exposure to bank loans increased by 17.5% at year-end 2019 from year-end 2018, as leveraged loan issuance was fairly robust in 2019. For more information on the U.S. insurance industry's exposure to bank loans, please see the NAIC Capital Markets Special Report titled "U.S. Insurer Exposure to Bank Loans Increased by 17.5% at Year-end 2019" published in June 2020.

The credit distribution of the industry's high-yield bond exposure is skewed toward the higher quality credit ratings (i.e., BB-rating category) of the below investment grade spectrum. This lends some comfort to the added credit risk being taken by insurers overall from investing in these bonds (see Table 2). Approximately 60% of the industry's bond exposure at year-end 2019 carried NAIC 3 designations, the highest quality in the high-yield credit quality spectrum; and another 30% carried NAIC 4 designations. This industry metric has been relatively consistent over the last nine years.

Table 2: Credit Distribution of U.S. Insurance Industry High-Yield Bond Exposure by Insurer Type as of Dec. 31, 2019 (BACV $ millions)

NAIC Designation	Life	P/C	Health	Title	Total	% Total
NAIC 3	105,334	24,484	4,318	131	134,268	59.0%
NAIC 4	45,378	19,636	2,667	70	67,751	29.8%
NAIC 5	15,468	4,016	265	43	19,791	8.7%
NAIC 6	3,919	1,645	92	4	5,660	2.5%
Total High-Yield	**170,098**	**49,781**	**7,341**	**248**	**227,469**	**100.0%**

However, the credit distribution varied greatly by insurer type; for example, at year-end 2019, NAIC 3 exposure for life and fraternal companies was 62% of total high-yield bonds, while P/C companies' was 49%. Furthermore, bonds with NAIC 4 designations represented almost 40% of P/C companies' high-yield exposure, indicating a higher credit risk investment portfolio relative to the overall U.S. insurance industry. In addition, while bonds carrying NAIC 5 designations represented 9% or less of high-yield bond exposure at life and fraternal, P/C and health companies, they represented over 17% of high-yield bonds at title companies.

Shift in the Composition of High-Yield Exposure Likely Following COVID-19 Pandemic

The combination of the COVID-19 pandemic and a sharp decline in oil prices resulted in significant pressure on credit quality in the first half of 2020, particularly for high-yield companies. With the U.S. and many other countries practicing containment and mitigation measures, such as "staying at home" and social distancing, many companies experienced an unprecedented level of business disruption, with significant declines in revenues and cash flows. Amid record-high unemployment and lower consumer discretionary spending, the U.S. economy—along with the global economy—suddenly entered a recession following years of growth. An additional driver of credit deterioration was the sharp decline in oil prices in March and April as both lower global demand and supply side disputes exacerbated price volatility.

With this credit backdrop, the nationally recognized statistical rating organizations (NRSROs) have taken a record number of rating actions in 2020. As of Aug. 17, 2020, S&P Global Ratings (S&P) had taken 1,975 negative rating actions on corporate debt, with downgrades representing half of the rating actions. Non-financial corporate rating actions at Moody's Investors Service (Moody's) totaled approximately 2,100 through July, and downgrades accounted for 43% of rating actions.

Highly leveraged companies have accounted for the majority of negative corporate rating actions at both NRSROs, as they tend to have weaker liquidity and refinancing profiles. Almost 70% of the ratings actions at S&P were among high-yield issuers, while approximately 75% of Moody's rating actions were within the high-yield universe. Furthermore, high-yield issuers accounted for almost 90% of the downgrades at Moody's.

Given the concentration of rating actions within high-yield, particularly downgrades, the credit quality of the U.S. insurance industry's corporate high-yield exposure has likely deteriorated to some degree since year-end 2019. A shift in the credit composition of an insurer's investment portfolio could result in higher risk-based capital (RBC) charges if a credit rating downgrade results in a change to the corresponding NAIC designation category.

Ratings Transition Analysis Shows Credit Quality Deterioration in NAIC 3 and Lower Designations

The Capital Markets Bureau conducted a high-level analysis of ratings transitions in July 2020 to better understand the impact of the record level of rating downgrade activity on U.S. insurer investment portfolios. The analysis focused on bond investments with filing exempt (FE) designations or NRSRO ratings reported by U.S. insurers on Schedule D at year-end 2019. FE designations and NRSRO ratings as of Dec. 31, 2019, were compared to their respective designations/ratings as of June 30, 2020. Note that the analysis did not account for potential trading activity in 2020 and excludes government investments, investments with designations assigned by the Securities Valuation Office (SVO), investments modeled by the Structured Securities Group (SSG), and investments with private letter ratings.

The results of the analysis showed that approximately 9% of the tracked bonds with NAIC 3 designations at year-end 2019 transitioned to an NAIC 4 designation or lower as of June 30, 2020; about 12% of bonds with NAIC 4 designations migrated to an NAIC 5 designation or lower; and 24% of bonds with NAIC 5 designations shifted to the NAIC 6 designation category. Furthermore, rating transitions from investment grade to high-yield were minimal, with 4% of the tracked bonds with NAIC 2 designations migrating to the NAIC 3 designation category, resulting in bonds with NAIC 3 designations or lower increasing to approximately 7% of total bond investments included in the analysis from about 5%.

The 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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