NAIC National Association of Insurance Commissioners & The Center for Insurance Policy and Research

Capital Markets Special Report

The NAIC's Capital Markets Bureau monitors developments in the capital markets globally and analyzes their potential impact on the investment portfolios of U.S. insurance companies. A list of archived Capital Markets Bureau Special Reports is available via the INDEX.

The U.S. Insurance Industry's Exposure to Bonds with NAIC 2 Designations Continues to Climb

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Executive Summary

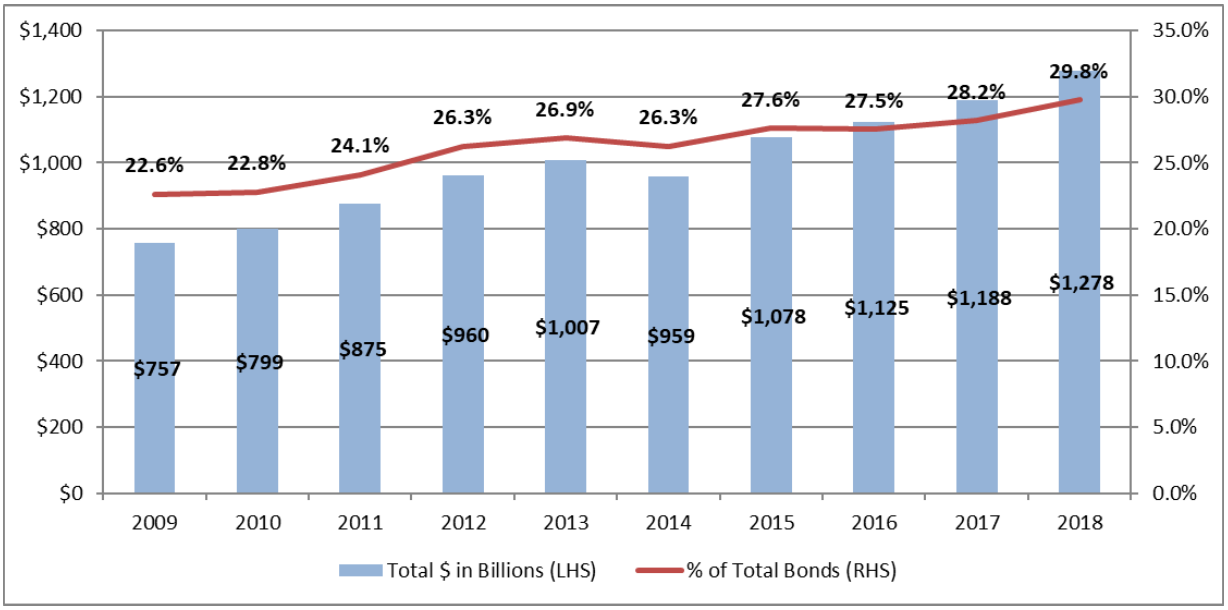
- U.S. insurers increased their exposure to NAIC 2–designated bonds to $1.3 trillion at year-end 2018, or 30% of total bonds from 28.2% at year-end 2017 and 27.5% at year-end 2016.
- The increase in bonds with NAIC 2 designations reflects a reach for yield by the insurance industry at the expense of credit quality, as well as the growing share of BBB-rated bonds in the overall corporate bond market.
- No significant concentrations are evident at the lower end of the BBB-credit quality category for the industry; however, exposures should be monitored closely for deteriorating credit quality.

As corporate issuers have leveraged their balance sheets and increased the amount of debt issued over the last 10 years, the share of corporate bonds rated in the BBB category by nationally recognized statistical rating organizations (NRSROs) has grown significantly as a percent of the total corporate bond market. The NAIC Capital Markets Bureau (CMB) analyzed the U.S. insurance industry's exposure to bonds with NAIC 2 designations—or the BBB-rating category as assigned by NRSROs—to look for trends that might potentially indicate risky investment behavior. 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 over time. Bonds with NAIC 2 designations increased to almost 30% of total bonds as of year-end 2018 from under 20% before the financial crisis.

U.S. Insurer Exposure to NAIC 2-Designated Bonds as of Year-End 2018

As of year-end 2018, the industry held $1,278 billion of bonds with NAIC 2 designations, an increase of almost 70% since year-end 2009 (see Chart 1). Over this 10-year time period, NAIC 2 exposure grew at an average annual growth rate of 6.6%, while total bond exposure grew at 3.2%. The faster growth rate for NAIC 2 exposure can be partially attributed to insurers taking additional credit risk as they allocated greater dollars to NAIC 2-designated bonds at the expense of NAIC 1-designated bonds during the prolonged low interest rate environment. Bonds with NAIC 1 designations represented 65.2% of the industry's total bonds as of year-end 2018, a decline from 71% as of year-end 2009.

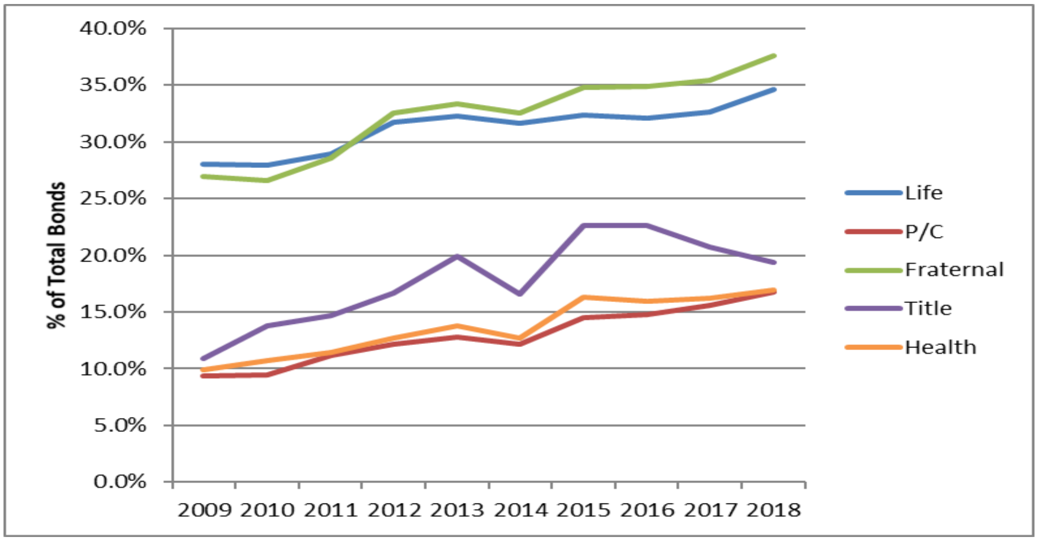
Chart 1: Total U.S. Insurance Industry Exposure to Bonds with NAIC 2 Designations, 2009–2018



The growth of NAIC 2 exposure is also a function of the shift in the structure of the corporate bond market, whereby BBB-rated corporate debt currently represents approximately 50% of total corporate bonds outstanding, compared to about 35% in 2006. 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.

By insurer type, exposure to bonds with NAIC 2 designations also increased, except for title companies (see Chart 2). At year-end 2018, life and fraternal companies had the largest exposures to NAIC 2 bonds, which increased by three percentage points from year-end 2016 to 35% and 38% of total bonds, respectively. Bonds with NAIC 2 designations represented a relatively smaller portion of property/casualty (P/C), title and health companies' investment portfolios, at 17%, 19% and 17% of total bonds as of year-end 2018, respectively.

Chart 2: Industry Exposure to Bonds with NAIC 2 Designations as a Percent of Total Bonds by Insurer Type, 2009–2018



A Closer Look at Year-End 2018 NAIC 2-Designated Bond Exposure

The majority, or 91%, of the U.S. insurance industry's exposure to bonds with NAIC 2 designations were corporate bonds traded both in the public and private markets (see Table 1). Life companies owned the majority of the NAIC 2 exposure, or 81%, while P/C companies owned 14% of the industry's exposure. This is consistent with 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-Designated Bonds by Bond Type as of Dec. 31, 2018 (BACV $ millions)

Bond Type	Life	P/C	Fraternal	Health	Title	Total	% of Total NAIC 2 Exposure
Corporate	946,988	156,875	39,445	19,579	906	1,163,793	91.1%
Structured Securities	56,597	6,520	1,097	510	1	64,726	5.1%
Sovereign/Other Government	13,653	2,680	29	208	22	16,591	1.3%
Municipal	9,774	8,662	154	1,180	51	19,821	1.6%
Other	10,645	2,182	50	354	17	13,248	1.0%
Total	**1,037,657**	**176,920**	**40,775**	**21,830**	**997**	**1,278,179**	100.0%
% Total NAIC 2 Exposure	81.2%	13.8%	3.2%	1.7%	0.1%	100.0%	

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

Table 2 shows that the distribution of the industry's NAIC 2-designated bond exposure by insurer asset size is relatively consistent with that of the industry's total assets, whereby the large insurers (those with greater than $5 billion in cash and invested assets) and the small insurers (those with less than $1 billion in cash and invested assets) hold approximately 84% and 5%, respectively, of total NAIC 2-designated bond exposure.

Table 2: U.S. Insurance Industry NAIC 2-Designated Bond Exposure by Insurer Asset Size as of Dec. 31, 2018 (BACV % of Total)

Cash and Invested Assets	Life	P/C	Fraternal	Health	Title	Total
Greater than $10B	83.5%	43.3%	77.3%	10.7%	-	76.5%
Between $5B and $10B	6.7%	13.7%	-	3.8%	-	7.4%
Between $2.5B and $5B	4.5%	12.9%	5.6%	12.7%	23.8%	5.9%
Between $1B and $2.5B	3.2%	13.8%	8.4%	24.5%	59.1%	5.2%
Between $500mm and $1B	1.1%	5.8%	2.4%	19.8%	9.5%	2.1%
Between $250mm and $500mm	0.6%	4.8%	3.2%	14.7%	-	1.5%
Less than $250mm	0.4%	5.7%	3.2%	13.7%	7.6%	1.5%

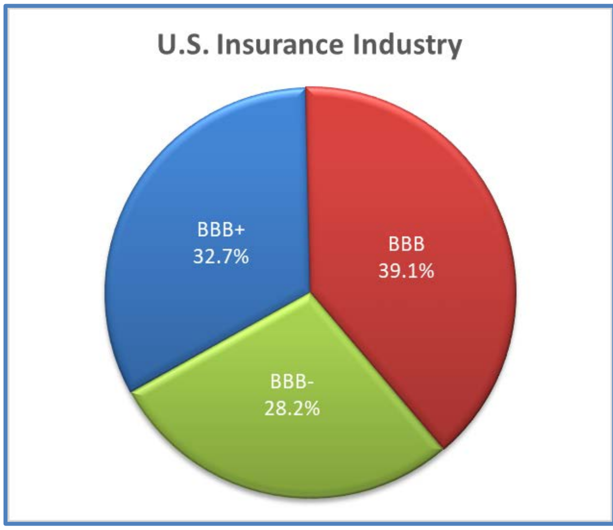
Reported year-end 2018 data was also analyzed to determine if there was any evidence of U.S. insurers skewing the distribution within the NAIC 2 designation category, that is, whether there was a concentration of investments at the lower end of the investment grade credit quality spectrum, or specifically BBB- bonds, as they typically carry higher relative risks in exchange for additional yield. Significant exposure or concentrations of exposure in at the lower end of the credit quality category would raise concerns, particularly because the financial markets are currently in the late stages of the credit cycle whereby lower-rated issuers could face margin and financing pressures if, and when, the cycle turns.

NAIC 2 exposure is reasonably evenly distributed across the NAIC 2 credit quality category for the U.S. insurance industry, as well as for each insurer type (see Table 3). However, in comparison to the distribution of ratings issued by S&P Global Ratings (S&P), U.S. insurers have greater exposure to the BBB and BBB- credit quality categories. For example, U.S. insurers' exposure to BBB- bonds represents 28% of NAIC 2 -designated bonds, while BBB- bonds represent 25% of all "BBB" rated debt by S&P (see Chart 3 and Chart 4). The industry's NAIC 2 exposure should, therefore, continue to be monitored closely, with particular attention to the BBB- credit quality category, which has a greater potential for deteriorating credit quality and the risk of the exposure falling into the below-investment grade rating categories.

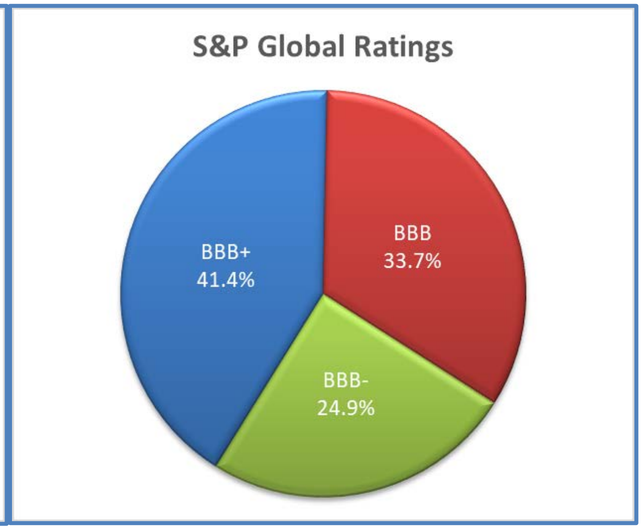
Table 3: U.S. Insurance Industry Distribution of NAIC 2-Designated Bond Exposure as of Dec. 31, 2018 (BACV % of Total)

Credit Quality Category	Life	P/C	Fraternal	Health	Title	Total
BBB+	32.3%	33.9%	33.5%	36.5%	34.8%	32.7%
BBB	39.4%	37.6%	41.9%	34.9%	39.6%	39.1%
BBB-	28.3%	28.5%	24.6%	28.5%	25.6%	28.2%

Chart 3 and Chart 4: U.S. Insurance Industry Distribution of NAIC 2-Designated Bond Exposure (Left Panel) and S&P Global Ratings Distribution of BBB-Rated Debt (Right Panel)



Source: NAIC



Source: S&P Global Fixed Income Research

The NAIC CMB 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.

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