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 US insurance companies. A list of archived Capital Markets Bureau Special Reports is available via the **index**

The Insurance Industry's Exposure to U.S. Government Investments

Over the past several weeks, the major headlines in the global financial markets have focused on the negotiations in Washington, D.C., relating to the debt ceiling and the federal budget deficit. Although a plan to raise the debt ceiling and reduce the deficit was passed by the U.S. Congress and signed by President Barack Obama yesterday, the issue is expected to remain on Wall Street's radar as it relates to the long-term stability of the United States' sovereign debt ratings. This brief special report will, therefore, focus on the insurance industry's exposure to U.S. government and government-related investments and the potential impact of a sovereign debt rating downgrade on insurance company investment portfolios.

Following the passage of the Budget Control Act of 2011, Moody's confirmed the Aaa government bond rating of the United States, but assigned a negative outlook to the rating. Moody's commented that the initial increase of the debt limit combined with a commitment to raise it further by year-end have "virtually eliminated the risk" of default on the U.S. government's debt obligations. Fitch Ratings (Fitch) commented that "the risk of sovereign default remains extremely low" but the United States "must also confront tough choices on tax and spending against a weak economic back drop if the budget deficit and government debt is to be cut to safer levels over the medium term." Fitch has been conducting a previously scheduled review of the United States' AAA sovereign rating and expects to conclude the review by the end of August. Standard and Poor's (S&P) has yet to comment on how, if at all, yesterday's developments would affect the United States' AAA ratings that were placed on review for possible downgrade on July 14, 2011.

U.S. Government and U.S. Government-Related Exposure

The insurance industry's exposure to the U.S. government and government-related debt as reported in Schedule D totaled $676.6 billion as of Dec. 31, 2010. This includes not just U.S. Treasury and direct agency issues, but also exposure to the Government National Mortgage Association (Ginnie Mae), Federal National Mortgage Association (Fannie Mae) and Federal Home Loan Mortgage Company (Freddie Mac). Life insurance and property/casualty insurance companies held $629.7 billion (or 93.1%) of the total outstanding exposure, with life insurers representing $411.6 billion (or 60.8%) and property/casualty insurers representing $218.1 billion (or 32.3%). The life insurance companies' exposure represents 12.5% of the life insurance industry's total invested assets; the property/casualty insurance companies' exposure represents 13.6% of the property/casualty insurance industry's total invested assets. Health, fraternal and title insurance companies held a total of $46.9 billion, or 6.9% of the total outstanding exposure.

Insurance Industry Exposure to U.S. Government and Government-Related Debt as of Dec. 31, 2010
(as reported in Schedule D and in 000's)

Issuer Obligations	Life	PC	Health	Fraternal	Title	Grand Total
U.S. Treasuries	93,806,809	80,498,339	10,587,647	1,453,263	-	186,346,058
Fannie Mae/Freddie Mac	21,087,459	16,190,559	3,352,695	336,222	-	40,966,936
Ginnie Mae	25,150	49,801	78,143	26,212	-	179,306
Other Government Agencies	54,615,935	14,668,076	2,342,326	1,706,214	-	73,332,551
Class One Bond Funds	-	7,444	-	-	-	7,444
Total Issuer Obligations	**169,535,353**	**111,414,220**	**16,360,811**	**3,521,912**	**478,942**	**301,311,238**
Mortgage Pass-Throughs						
U.S. Treasuries	1,827	8,481	44,595	14,204	-	69,107
Fannie Mae/Freddie Mac	242,798	1,096,027	748,969	126,706	-	2,214,500
Ginnie Mae	13,562,510	13,308,217	1,634,588	345,407	-	28,850,723
Other Government Agencies	3,334,976	2,624,741	95,130	614,045	-	6,668,891
Total Pass-Throughs	**17,142,110**	**17,037,466**	**2,523,283**	**1,100,362**	**154,792**	**37,958,012**
Mortgage CMOs						
Fannie Mae/Freddie Mac	186,858,956	80,522,941	11,317,076	8,802,659	-	287,501,631
Ginnie Mae	38,028,485	9,140,163	315,339	2,304,523	-	49,788,510
Class One Bond Funds	40,709	21,976	-	-	-	62,685
Total CMOs	**224,928,150**	**89,685,079**	**11,632,416**	**11,107,181**	**-**	**337,352,827**
Grand Total	**411,605,613**	**218,136,765**	**30,516,510**	**15,729,455**	**633,734**	**676,622,077**

Note: A detailed breakdown was not available for title insurance companies as of the published date of this report.

In addition to the debt reported in Schedule D, the insurance industry also owned $29.1 billion of short-term debt reported in Schedule DA that was direct U.S. government or government-related obligations. Furthermore, an additional $13.7 billion of exposure was reported in Schedule DL, Part 2, representing securities lending collateral. These additional exposures bring the grand total of exposure to U.S. government and government-related debt to $719.4 billion, or 14.1% of the industry's total invested assets.

The exposure to Government Bond Funds and Class One Bond Funds (which are required to have at least 95% of assets in government issues) across the industry was relatively small, at approximately $70 million. Large insurers typically manage their own short-term cash and do not rely on such mutual funds. Therefore, the exposure is primarily in smaller insurers, which might have a more significant impact on the insurer despite the small exposure.

An additional asset class that potentially results in additional exposure to the U.S. government is municipal and state bonds; for example, in cases where bonds have been pre-refunded or defeased with U.S. Treasuries. We estimate this scenario to total approximately $58 billion. U.S. Treasuries also are used to defease other assets and asset classes. For example, CMBS transactions often allow for defeasance of underlying loans in lieu of prepayment. We do not believe that the total exposure to defeased transactions is material. However, defeased transactions and defeasance agreements might be vulnerable to downgrades of the United States' sovereign debt ratings and the additional market value volatility that would result.

We also reviewed Schedule DB for any derivatives exposure to the U.S. government or government-related entities through sold or written credit protection, but did not find any such exposure. There is the potential that Treasuries have been used to post collateral under derivatives transactions. We are exploring the ability to quantify this amount based on the data provided in Schedule DB and hope to provide an update of this review at a later date.

Impact on Risk-Based Capital and Asset Valuation Reserve

U.S. Treasuries, Ginnie Mae pass-throughs, and Fannie Mae and Freddie Mac direct obligations are exempt from the requirement for a rating or designation; they are NAIC 1 designation by regulatory provision. They are also exempted from reserve and capital charges in both risk-based capital (RBC) and asset valuation reserve (AVR) calculations. There is, therefore, no immediate impact on any of the aforementioned securities in the event of a downgrade of the United States' long-term sovereign debt rating.

Ginnie Mae collateralized mortgage obligations (CMOs), Fannie Mae and Freddie Mac pass-throughs and CMOs are currently designated NAIC 1, with a 0.40% RBC charge for life companies and AVR based on the AAA rating of the U.S. government. The RBC charge and AVR would not be impacted until the ratings fall below A-, as the NAIC designation is based on a formulaic translation of the external ratings provided by the nationally recognized statistical rating organizations. Ratings of A- or higher translate into a designation of NAIC 1; BBB-rated securities translate into a designation of NAIC 2 and so on.

The rating agencies also have noted that a number of structured securities that rely on U.S. Treasuries as part of the structure's credit support are at risk of being downgraded.

Other Investment-Related Impacts

In addition to the relatively direct impacts noted above, there could be other considerations. A downgrade to the United States' long-term sovereign debt ratings might also have an impact on bank certificates of deposit (CDs) and other accounts whose classification relies on their guarantee by the Federal Deposit Insurance Corporation (FDIC). As the market considers the potential implications of a downgrade and the government's ongoing funding needs, this could have an impact on the interest rate swap curve. As a result, the market value of different hedge positions might experience significant changes.

As noted in a previous special report titled, "The Treasury Yield Curve and Its Impact on Insurance Company Investments," U.S. Treasuries serve as a benchmark for pricing fixed-income securities. The role of U.S. Treasuries as a benchmark is not likely to change, given that it is the largest and most liquid market, as well as a broad-based measure of risk-free interest rates. In part, this is one of the reasons why there has been relatively little impact on market rates, despite the pressures on the United States' long-term sovereign debt ratings. Ultimately, as Treasuries are deemed to include a credit component, this could have an effect on credit spreads generally.

This situation will continue to evolve over the coming months. The Capital Markets Bureau will continue to follow these and other developments related to this topic and will provide further research and insights as the situation warrants.

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