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**

Credit Spreads Expected to Tighten for Corporate Bonds in 2011

Gross investment yields on fixed-income instruments — in particular, corporate bonds — are a function of two components: current yields on a risk-free benchmark and a spread premium. The primary contributor to the spread premium is the credit spread. Credit spread may be defined as the additional yield an investor receives for a security with credit risk, over the yield it would receive for a risk-free security, such as U.S. Treasuries. Credit risk varies, depending on credit quality — ranging from speculative (or high-yield; that is, rated below BBB-/Baa3) to investment grade (or high-grade; that is, rated BBB-/Baa3 and higher). Generally, the higher the credit risk, the wider the spread; that is, the more investors want to be compensated for the credit risk of the investment.

Differentials in credit spreads are readily apparent when comparing corporate bond issues with different credit-quality ratings from a nationally recognized statistical rating organization (NRSRO). This differential even plays out with companies whose credit ratings are on negative watch by an NRSRO as opposed to those that have stable outlooks, according to Standard & Poor's fixed-income research. And, as of March 2011, industry analysts anticipate continued economic growth in the United States to stabilize credit quality.

The duration of a corporate bond also is a determinant of credit spread. The longer the bond's maturity, the more likely an adverse corporate or economic event could occur — or, from an investor's standpoint, the lower confidence level that something will not occur — that has the potential to negatively (or positively) affect the credit risk of the bond. Therefore, bonds with longer duration, all other factors being the same, are compensated via additional spread.

Factors That Impact Credit Spread

Corporate bond credit spreads also take into account other factors in addition to credit risk and duration. One of these factors is call (or prepayment) risk; while not all corporate bonds have this feature, it represents the ability of a company to "call the bond," or repurchase the bond from investors (by paying it off) after a minimum time period as defined in the bond offering. Often, companies call bonds when interest rates decrease, so that they can reissue the debt at a lower interest rate (in effect, refinance). Bonds that have call risk are compensated via a wider spread, resulting in a higher yield to investors. In theory, this compensates the investor for the possibility that they might need to reinvest the cash at a lower yield. Call provisions became prevalent in the late 1970s during a period of sustained high interest rates. Premiums for this call risk became the norm in the early 1980s, as investors realized that they had not been adequately compensated for this risk.

Event risk is another factor that impacts corporate bond credit spread, and it varies by industry. Event risk represents the risk of a natural disaster, regulatory change or corporate transaction, the initiation of which is independent of the operations of the company, which could cause a credit rating downgrade to the bond. Bondholders are compensated for this through a wider spread, as they demand more reward for this risk.

The liquidity of a bond also plays a role in spread differential. Bonds that trade easily, and whose prices are readily available, tend to have narrower spreads than bonds that are not traded often and, therefore, are less liquid and difficult to price. Liquidity is an advantage for bondholders, as it implies that the bond can easily be traded for cash or other investments.

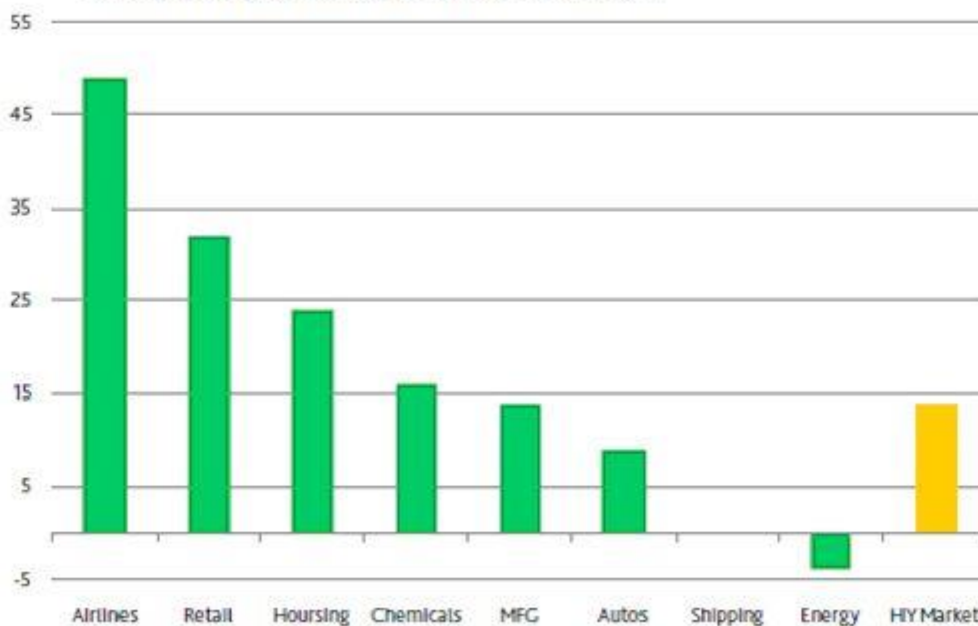
Consequently, liquid bonds are deemed less risky. On the other hand, this liquidity premium is attractive to investors, such as insurance companies, that tend to be more inclined to a buy-and-hold investment strategy.

Economic Influences on Credit Spreads

Regardless of credit quality, economic conditions in the United States can influence the direction of credit spreads. In a recession, spreads tend to widen for high-yield and investment-grade bonds to compensate for default and other risks that could negatively impact a company's ability to pay full and timely debt service. In a growing economy, spreads tend to compress, as corporate debt is perceived as less risky, especially when company profits are on the rise.

Market dynamics of supply and demand also influence credit spreads over time. According to Moody's, "cash flow growth amid corporate borrowing restraint and accommodating monetary policy and forthcoming fiscal stimulus" should aid in spread tightening throughout 2011. This lower level of activity on the new issue front will be matched with an increased supply of funds to be invested as retail investors gain greater confidence in the economy.

In addition, world events can impact credit spreads, particularly by industry. Earlier this year, economists predicted that the United States was well on its way to recovery; however, given the recent crises in Japan, turmoil in Libya and the Middle East, and sovereign debt issues, the status of the U.S. and the global economy is uncertain. For example, recent turmoil in Libya and the Middle East has resulted in a widening of high-yield bond spreads for the airline and chemicals industries, according to Moody's research. The U.S. housing crisis has resulted in spread widening for the retail and housing sectors' high-yield debt. The crises in Japan have impacted its supply chain, leaving its overseas customers and trading partners uncertain about shipments and deliveries. As a result, certain industries in the United States could be impacted, such as auto and electronics. Generally, concerns about volatility can create supply/demand imbalances with a "flight to quality."



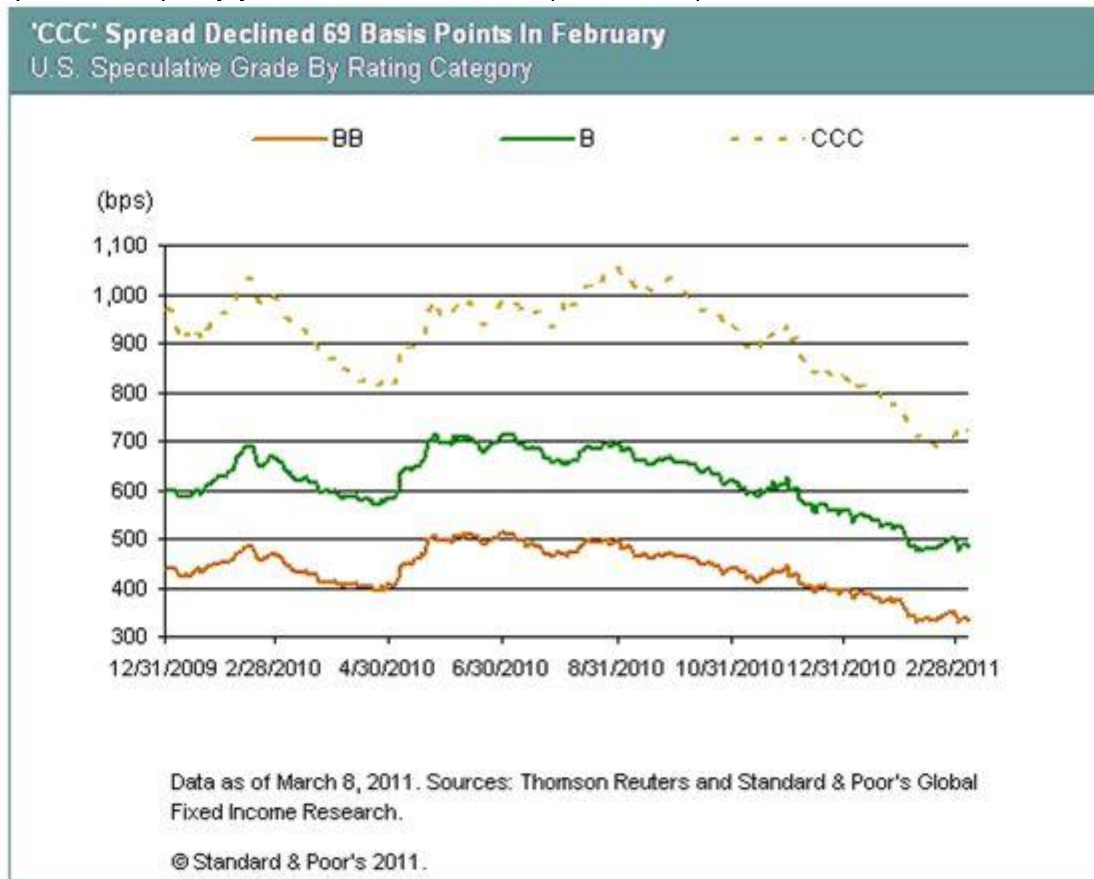
Investment-Grade vs. High-Yield

Overall, spreads for high-yield and investment-grade were projected to tighten throughout 2011; however, this was before the earthquake and tsunami disaster in Japan and before military air

strikes occurred in Libya. As default rates climbed when the financial crisis emerged around 2007, spreads on high-yield (or “junk bonds”) correspondingly widened. Then, in the beginning of 2010, credit spreads narrowed, due in part to improved U.S. economic activity. However, by the spring of 2010, spreads widened once more, due in part to sovereign debt concerns; this was followed by a market rally that attracted investors back into high-yield bonds. By November 2010, according to Bank of America Merrill Lynch research, high-yield bonds traded tighter relative to investment-grade bonds as investors preferred the higher returns of the riskier asset type.

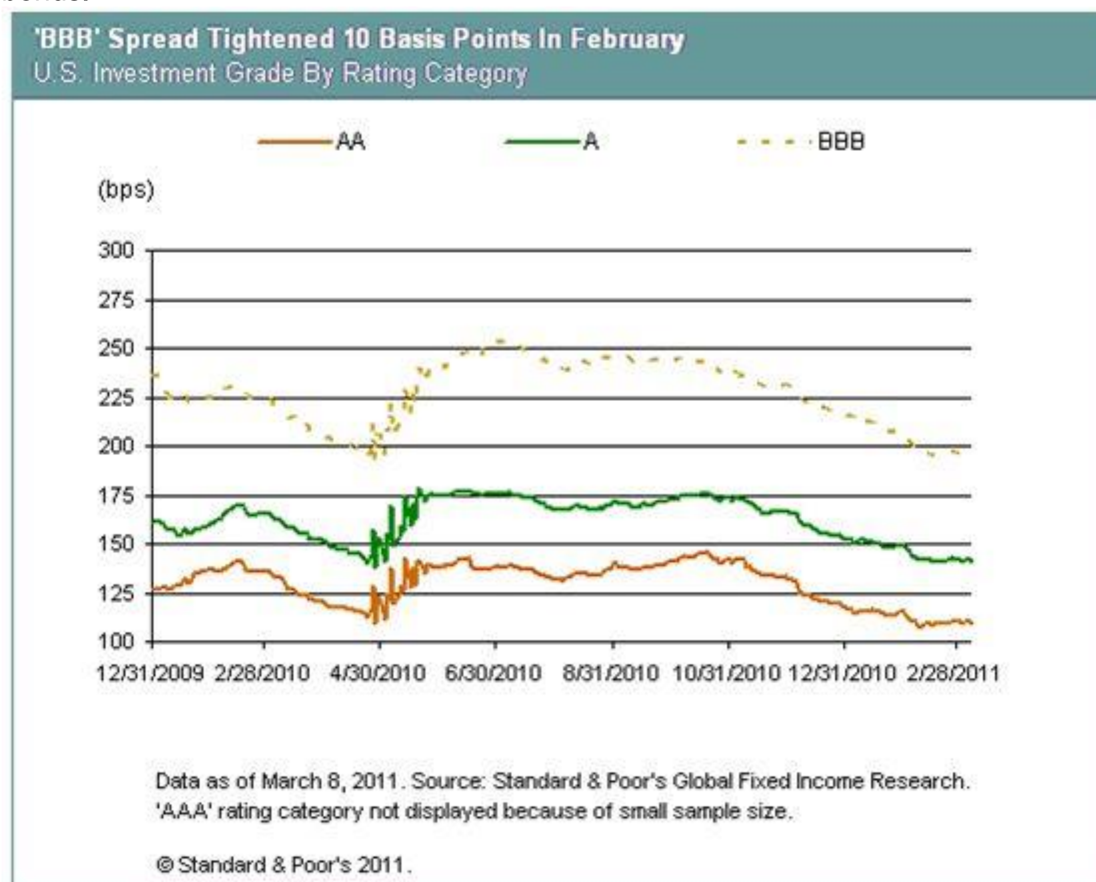
Although recent turmoil in the Middle East, along with eurozone concerns and doubts about the U.S. economic recovery, has resulted in waning demand and slower corporate bond issuance, the high-yield market is still considered robust in historical terms. A stabilization of corporate credit quality also has occurred, due mostly to a surge in company profits, further encouraging spread tightening.

The high-yield bond spread as of mid-March 2011 was approximately 517 basis points (bps) according to Standard & Poor’s, compared to about 600 bps as of December 2010. Standard & Poor’s research stated that, despite some volatility in high-yield spreads that occurred in the month of March, high-yield spreads have actually tightened since the beginning of 2011 to levels not seen since late 2007. Industry analysts expect high-yield spreads to tighten by 120 bps to 150 bps by year-end 2011, to 320 bps to 350 bps.



The investment-grade bond spread as of mid-March 2011 was approximately 170 bps, according to Standard & Poor’s. This represents a decrease from about 180 bps in December 2010. Industry analysts expect spreads to tighten possibly to 120 bps by year-end 2011, due in part to favorable liquidity conditions. In addition, a decreased supply of structured securities also

has attracted investors seeking relatively higher yielding investments to high-grade corporate bonds.



What Lies Ahead?

As world and U.S. economic events continue to evolve — especially pertaining to the crisis in Japan, Middle East and eurozone concerns, and the uncertainty of the U.S. economic recovery — investor sentiment could shift yet again. “Headline risk,” or the possibility that a negative news story will spread to other media outlets and cause a significant change in the value of an investment, could also influence spread. As historical behavior dictates, to the extent there is positive market news, investors tend to be more willing to invest in riskier assets, thereby increasing demand for higher yielding securities and narrowing spreads. Alternatively, if doubts deepen about the U.S. recovery and/or foreign affairs, we could see a flight to quality, resulting in a higher demand for government debt and, therefore, wider spreads in the corporate bond market.

For the time being, as progress is being made in Japan, particularly as it relates to restoring power to its damaged nuclear reactors, investors are becoming more comfortable with risk again, as evidenced by spreads on corporate bonds narrowing once again as investors exit the safety of U.S. Treasuries. We will continue to monitor developments domestically and abroad to assess the impact on corporate credit spreads, as well as the spread of other types of fixed-income investments.

Impact on Insurance Company Holdings in Corporate Bonds

Changes in market yields will have an impact on the market value of an insurance company’s holdings. Higher market yields mean that bond prices will be lower. Unless there is an Other Than Temporary Impairment warranted, this will not have a material impact for life insurance

companies. Property insurance companies, on the other hand, are required to report at lower of cost or market for bonds with an NAIC designation below an NAIC 2.

March 25, 2011
Major Insurer Share Prices

		Close	Change % Week	Change % QTD	Change % YTD	Prior Week	Prior Quarter	Prior Year
Life	Aflac	$52.65	3.9	(6.7)	(6.7)	$50.65	$56.43	$56.43
	Ameriprise	60.97	(0.2)	5.9	5.9	61.12	57.55	57.55
	Genworth	13.07	2.7	(0.5)	(0.5)	12.73	13.14	13.14
	Lincoln	30.32	2.6	9.0	9.0	29.56	27.81	27.81
	MetLife	45.07	2.5	1.4	1.4	43.98	44.44	44.44
	Principal	31.90	0.5	(2.0)	(2.0)	31.75	32.56	32.56
	Protective	26.30	2.1	(1.3)	(1.3)	25.75	26.64	26.64
	Prudential	60.96	0.5	3.8	3.8	60.65	58.71	58.71
	UNUM	26.19	2.0	8.1	8.1	25.68	24.22	24.22
PC	ACE	$62.32	2.4	0.1	0.1	$60.86	$62.25	$62.25
	Axis Capital	33.26	2.1	(7.3)	(7.3)	32.59	35.88	35.88
	Allstate	31.40	0.9	(1.5)	(1.5)	31.13	31.88	31.88
	Arch Capital	95.95	5.5	9.0	9.0	90.97	88.05	88.05
	Cincinnati	32.46	(0.4)	2.4	2.4	32.60	31.69	31.69
	Chubb	60.26	3.7	1.0	1.0	58.13	59.64	59.64
	Everest Re	82.98	1.5	(2.2)	(2.2)	81.79	84.82	84.82
	Progressive	20.86	0.9	5.0	5.0	20.67	19.87	19.87
	Travelers	58.98	1.4	5.9	5.9	58.16	55.71	55.71
	WR Berkley	30.60	1.6	11.8	11.8	30.13	27.38	27.38
	XL	23.13	5.4	6.0	6.0	21.95	21.82	21.82
Other	AON	$52.29	0.6	13.6	13.6	$51.98	$46.01	$46.01
	AIG	36.54	2.9	(24.3)	(24.3)	35.51	48.27	48.27
	Assurant	39.51	1.1	2.6	2.6	39.08	38.52	38.52
	Fidelity National	13.76	0.1	0.6	0.6	13.74	13.68	13.68
	Hartford	26.66	4.5	0.6	0.6	25.51	26.49	26.49
	Marsh	29.80	2.1	9.0	9.0	29.20	27.34	27.34
Health	Aetna	$36.73	4.5	20.4	20.4	$35.14	$30.51	$30.51
	Cigna	42.62	2.6	16.3	16.3	41.56	36.66	36.66
	Humana	66.07	1.7	20.7	20.7	64.94	54.74	54.74
	United	43.75	2.8	21.2	21.2	42.57	36.11	36.11
	WellPoint	69.35	4.0	22.0	22.0	66.68	56.86	56.86
Monoline	Assured	$14.74	1.9	(16.7)	(16.7)	$14.46	$17.70	$17.70
	MBIA	10.42	3.6	(13.1)	(13.1)	10.06	11.99	11.99
	MGIC	8.75	1.5	(14.1)	(14.1)	8.62	10.19	10.19
	PMI	2.77	1.5	(16.1)	(16.1)	2.73	3.30	3.30
	Radian	6.74	0.7	(16.5)	(16.5)	6.69	8.07	8.07
	XL Capital	23.13	5.4	6.0	6.0	21.95	21.82	21.82

March 25, 2011
Major Market Variables

		Close	Change % Week	Change % QTD	Change % YTD	Prior Week	Prior Quarter	Prior Year
Dow Jones Ind		12,220.59	3.1	5.6	5.6	11,858.52	11,577.51	11,577.51
S&P 500		1,313.80	2.7	4.5	4.5	1,279.21	1,257.64	1,257.64
S&P Financial		220.06	0.5	2.5	2.5	218.96	214.77	214.77
S&P Insurance		195.10	2.1	3.7	3.7	191.05	188.22	188.22
US Dollar $			Change %			Prior		
	/ Euro	$1.41	(0.6)	5.2	5.2	$1.42	$1.34	$1.34
	/ Crude Oil bbl	105.56	4.1	14.5	14.5	101.45	92.22	92.22
	/ Gold oz	1,429.00	0.7	0.6	0.6	1,419.00	1,420.78	1,420.78
Treasury Ylds %		%	Change			%	%	%
	1 Year	0.27	0.05	(0.00)	(0.00)	0.22	0.27	0.27
	10 Year	3.44	0.17	0.15	0.15	3.27	3.30	3.30
	30 Year	4.50	0.09	0.17	0.17	4.42	4.34	4.34
Corp Credit Spreads -bp			Change %			Prior		
	CDX.IG	83.03	(7.3)	(2.3)	(2.3)	89.54	85.00	85.00

March 25, 2011
Major Insurer Bond Yields

	Company	Coupon	Maturity	Price			Spread	
				Current	Change	Yield	B.P.	Change
Life	Aflac	8.500%	5/15/2019	$121.06	$0.99	5.28%	214	(35)
	Ameriprise	5.300%	3/15/2020	$106.17	($1.19)	4.46%	112	(3)
	Genworth	6.515%	5/15/2018	$99.92	($0.94)	6.53%	356	(1)
	Lincoln National	8.750%	7/15/2019	$125.98	($1.52)	4.88%	170	(2)
	MassMutual	8.875%	6/15/2039	$136.50	($0.85)	6.14%	163	(2)
	MetLife	4.750%	2/15/2021	$100.56	($1.34)	4.68%	118	(0)
	Mutual of Omaha	6.800%	6/15/2036	$95.71	($1.44)	7.17%	284	2
	New York Life	6.750%	11/15/2039	$114.64	($1.44)	5.71%	119	(2)
	NLV Financial	7.500%	8/15/2033	$116.39	$0.04	6.14%	196	(12)
	Northwestern Mutual	6.063%	3/15/2040	$105.21	($1.13)	5.69%	115	1
	Pacific Life	9.250%	6/15/2039	$132.03	$0.42	6.70%	220	(19)
	Principal	6.050%	10/15/2036	$103.93	($0.84)	5.75%	138	(4)
	Prudential	4.500%	11/15/2020	$98.07	($1.10)	4.75%	130	(5)
	TIAA	6.850%	12/15/2039	$113.11	($1.61)	5.90%	136	2
P&C	ACE INA	5.900%	6/15/2019	$111.18	($1.05)	4.27%	109	(5)
	Allstate	7.450%	5/15/2019	$118.78	($0.86)	4.65%	150	(8)
	American Financial	9.875%	6/15/2019	$122.69	($1.09)	6.29%	310	(7)
	Berkshire Hathaway	5.400%	5/15/2018	$110.31	($1.22)	3.74%	80	(3)
	Travelers	3.900%	11/15/2020	$95.20	($1.13)	4.52%	109	(3)
	XL Group	6.250%	5/15/2027	$98.78	($0.39)	6.37%	244	(11)
Other	AON	5.000%	9/15/2020	$101.62	($1.45)	4.79%	137	(1)
	AIG	5.850%	1/15/2018	$104.08	($0.47)	5.13%	225	(16)
	Fidelity National	7.875%	7/15/2020	$109.81	($0.94)	6.45%	321	(82)
	Hartford	5.500%	3/15/2020	$102.22	($1.16)	5.19%	189	(3)
	Marsh	9.250%	4/15/2019	$126.30	($1.05)	5.21%	203	(7)
	Nationwide	9.375%	8/15/1939	$122.65	$0.99	7.45%	297	(15)
Health	Aetna	3.950%	9/15/2020	$96.78	($1.62)	4.37%	97	6
	CIGNA	5.125%	6/15/2020	$104.71	($0.83)	4.49%	113	(4)
	United Healthcare	3.875%	10/15/2020	$96.25	($1.18)	4.36%	94	(4)
	Wellpoint	4.350%	8/15/2020	$100.12	($1.50)	4.33%	96	0

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

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