NAIC National Association of Insurance Commissioners & The Center for Insurance Policy and Research
Capital Markets Special Report

Analysis of the U.S. Insurance Industry's Exposure to Below-Investment Grade Investments

This special report provides a brief historical recap of how the U.S. insurance industry has invested in high-yield bonds; a description of the current structure, risks, and recent performance of the high-yield bond and leveraged loan markets; and a discussion of the high-yield market's significance in the context of the investment landscape for insurers.

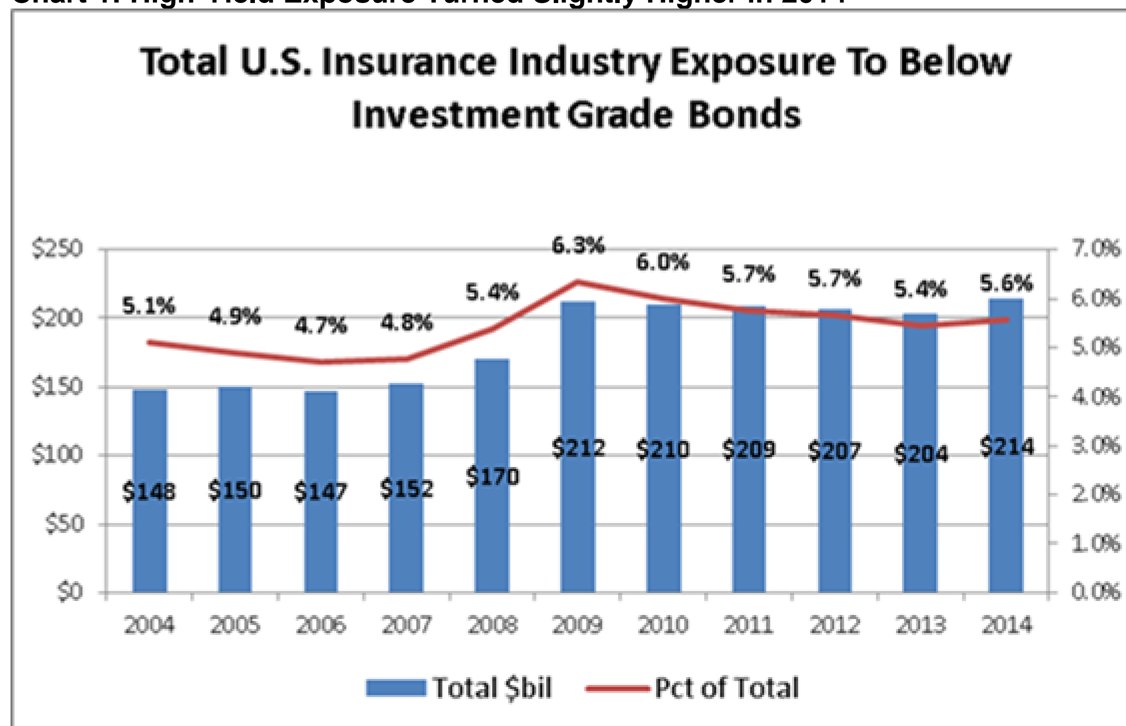
Insurers Reach for Yield, but Largely Avoid Below-Investment-Grade Corporates

Since 2009, the U.S. insurance industry, which primarily invests in intermediate and long-term fixed income assets, has been challenged to source investments that generate sufficient investment income, or yield, and are consistent with conservative investment guidelines and asset-liability matching parameters. This is not dissimilar to other investors and financial institutions. The NAIC Capital Markets Bureau's special report titled "Are U.S. Insurers Reaching for Yield in the Low Interest Rate Environment?"—published July 2, 2015—concluded that while insurers have generally continued with their traditional investment allocations, there has been some increased allocation to investments that have the potential to generate higher returns. Most of the increase, however, has gone to alternative asset classes, such as collateralized loan obligations (CLOs), commercial real estate (CRE) and Schedule BA assets. One area that has *not* seen a material increase in allocation—as a percentage of cash and invested assets—is below-investment grade, or high-yield, bonds.

Insurance Industry Exposure to Below-Investment Grade Bonds

Chart 1 shows the U.S. insurance industry's total exposure to below-investment grade debt (i.e., debt rated below BBB-) for the 10 years ended 2014. From at least 2004–2009, the industry's exposure to below-investment grade bonds—composed mostly of high-yield corporate bonds, as well as sovereign, municipal and structured securities—gradually increased, with a more significant increase occurring in 2008 and 2009, mostly because of credit rating downgrades resulting from the financial crisis. Since then, however, both the book/adjusted carrying value (BACV) of total below-investment grade bonds and their share of total insurance industry cash and invested assets edged downward each year until 2014, when both measures ticked upward.

Chart 1: High-Yield Exposure Turned Slightly Higher in 2014



After growing rapidly over the past 10–15 years, U.S. high-yield corporate debt outstanding—at approximately $1.43 trillion—now comprises roughly 17% of the $8.2 trillion overall corporate bond market. In comparison, other major bond markets include U.S. Treasury securities ($12.8 trillion outstanding), mortgage-related securities ($8.8 trillion), municipals ($3.7 trillion), federal agency securities ($2.0 trillion) and asset-backed securities ($1.4 trillion), according to third-quarter 2015 estimates by industry trade group Securities Industry and Financial Markets Association (SIFMA) and Bank of America Merrill Lynch (BAML) index data. The BAML U.S. High Yield Index, which is a market-weighted index of U.S. publicly traded (i.e. registered and Rule 144a) below-investment grade corporate bonds, has been used throughout this special report as a proxy for the high yield corporate bond market for ease of comparison. As a percentage of the overall U.S. bond market ($39.6 trillion), high-yield corporate bonds account for 3.6%. As of Dec. 31, 2014, U.S. insurers' below-investment grade corporate debt holdings totaled $169.2 billion in BACV, accounting for 79% of total below-investment grade debt holdings, and 4.4% of total bond investments.

In addition to publicly traded corporate bonds, the U.S. insurance industry's below-investment grade corporate debt holdings also include privately placed bonds and leveraged loans, which are, simply, loans to companies that are below-investment grade. Such loans were relatively rarely seen in insurance company portfolios until recent years and currently account for only a fraction of total corporate debt holdings; insurers held leveraged loans totaling approximately $18 billion as of Dec. 31, 2014. There are approximately $1.2 trillion leveraged loans outstanding in the U.S., according to the Loan Syndications and Trading Association (LSTA), nearly three quarters ($872 billion) of which consisted of institutional loans—term loans structured specifically for institutional investors. Pro rata loans—revolving credits and amortizing term loans—comprise the remainder of the leveraged loan market; they are traditionally syndicated to finance companies and banks.

Over the past 10 years, U.S. insurance industry exposure to below-investment grade debt has not kept pace with the overall high-yield corporate bond or institutional leveraged loan market; its 10-year compound average growth rate (CAGR) was just 3.8% through 2014, compared to

8.5% for the U.S. high-yield markets, and approximately 14% for the U.S. institutional leveraged loan market. Consequently, despite the proliferation of high-yield debt in the U.S. capital markets, the U.S. insurance industry's holdings of U.S. high-yield corporate debt relative to the combined total market value of the BAML U.S. HY bond and Standard & Poor's (S&P)/LSTA Leveraged Loan indices was only about 6.8% as of year-end 2014. Demand from other investor classes, mainly HY mutual funds, exchange-traded funds (ETFs) and structured finance vehicles has soaked up an increasing portion of high-yield issuance.

Table 1 and Table 2 break down the U.S. insurance industry's exposure to below-investment grade debt by insurance industry segment and type of obligation. As percentages of total bond holdings, the insurance industry's below-investment grade debt exposure increased only slightly, to 5.6% in 2014 from 5.4% a year earlier. In terms of type of obligation (corporate, structured, muni or government), 79% consisted of corporate debt as of Dec. 31, 2014, up from 76% a year earlier. Note that the corporate debt totals include publicly traded corporate bonds, leveraged loans and private debt placements.

Relative to total bond investments, the life and health segments are the most heavily exposed to below-investment grade debt, accounting for a still-modest 6.1% and 5.3%, respectively, of each segment's total bond investments as of Dec. 31, 2014.

Table 1: U.S. Insurance Industry Exposure to Below-Investment Grade Debt as of Dec. 31, 2014

BACV ($ mil.)	Life	P/C	Health	Fraternal	Title	Total	% Total Below-Investment Grade Exposure	% Total Bond Exposure
Corporate (Unaffiliated)	130,259	30,333	4,888	3,520	201	**169,200**	78.8%	4.4%
Structured Securities	23,820	2,668	181	156	0	**26,825**	12.5%	0.7%
Sovereign/Other Government	3,189	488	45	-	-	**3,722**	1.7%	0.1%
Municipal	708	1,204	96	6	-	**2,014**	0.9%	0.1%
Other	5,268	7,686	10	42	30	**13,036**	6.1%	0.3%
Total	**163,244**	**42,379**	**5,220**	**3,723**	**231**	**214,797**	100.0%	5.6%
% Total Below-Investment Grade Exposure	76.0%	19.7%	2.4%	1.7%	0.1%	100.0%		
% Total Segment Bond Exposure	6.1%	4.4%	5.3%	3.9%	4.6%	5.6%		

Table 2: U.S. Insurance Industry Exposure to Below-Investment Grade Debt as of Dec. 31, 2013

BACV ($ mil.)	Life	P/C	Health	Fraternal	Title	Total	% Total Below-Investment Grade Exposure	% Total Bond Exposure
Corporate (Unaffiliated)	119,321	27,507	4,627	2,915	88	**154,457**	76.2%	4.1%
Structured Securities	28,417	2,308	135	238	0	**31,099**	15.3%	0.8%
Sovereign/Other Government	2,619	429	31	-	-	**3,079**	1.5%	0.1%
Municipal	534	836	85	18	0	**1,473**	0.7%	0.0%
Other	4,091	7,847	598	47	65	**12,648**	6.2%	0.3%
Total	**154,983**	**38,927**	**5,475**	**3,218**	**154**	**202,757**	100.0%	5.4%
% Total Below-Investment Grade Exposure	76.4%	19.2%	2.7%	1.6%	0.1%	100.0%		
% Total Segment Bond Exposure	6.0%	4.1%	5.7%	3.5%	3.0%	5.4%		

Drilling Down: Insurance Industry Exposure to High-Yield Corporate Debt

The tables that follow drill down into the U.S. insurance industry's high-yield corporate debt holdings, which are the principal focus of this special report. For the purposes of this special report, high-yield corporate debt includes publicly traded corporate bonds, leveraged loans and private debt placements. To the extent that they can be readily identified as such from available data, leveraged loans account for 10.7% of year-end 2014 below-investment grade corporate debt exposure. P/C insurers are the most highly exposed to leveraged loans (16% of total

segment HY corporate exposure), followed by life (10%) and fraternal (8%). Health and title companies have virtually no leveraged loan exposure.

Table 3 shows the maturity distribution of the insurance industry's HY corporate debt exposure by credit quality as of Dec. 31, 2014. The key observation here is that the maturity distribution appears to skew shorter as credit quality declines. One caveat: A full 25% of leveraged loan holdings have no reported maturity and are represented in the tables as NA. While this is of little concern from an asset/liability duration matching perspective because most leveraged loans are floating rate, it is somewhat more relevant in terms of credit exposure and asset/liability matching from a cash flow perspective.

Table 3: Maturity Distribution of U.S. Insurance Industry HY Corp. Debt Exposure by Credit Quality, as of Dec. 31, 2014

BACV ($ mil.)	<1 Year	1-<5 Year	5-<10 Year	10-<20 Year	20 Years or More	NA	Grand Total	% NAIC Designation
Bonds								
NAIC3	3,249	23,804	51,836	9,316	4,545	6,320	99,070	58.6%
NAIC4	335	10,131	25,612	1,645	242	4,408	42,374	25.0%
NAIC5	123	2,942	3,367	481	97	1,546	8,556	5.1%
NAIC6 and Other	73	441	130	71	55	391	1,161	0.7%
Total Bonds	**3,779**	**37,319**	**80,946**	**11,513**	**4,938**	**12,664**	**151,160**	89.3%
% Bonds	2.5%	24.7%	53.5%	7.6%	3.3%	8.4%	100.0%	
Loans								
NAIC3	98	2,406	3,549	87	1	2,313	8,453	5.0%
NAIC4	62	2,576	3,542	34	10	1,980	8,203	4.8%
NAIC5	36	737	173	0	-	86	1,031	0.6%
NAIC6 and Other	49	116	25	24	11	129	352	0.2%
Total Loans	**244**	**5,835**	**7,288**	**146**	**21**	**4,507**	**18,040**	10.7%
% Loans	1.4%	32.3%	40.4%	0.8%	0.1%	25.0%	100.0%	
Total Below-Investment Grade	**4,024**	**43,154**	**88,234**	**11,658**	**4,960**	**17,171**	**169,200**	100.0%
% Total Below-Investment Grade	2.4%	25.5%	52.1%	6.9%	2.9%	10.1%	100.0%	

Table 4 shows the maturity distribution of the insurance industry's exposure by insurer type. HY exposures across the insurance industry are shorter in maturity than overall bond exposures, with approximately 80% maturing in less than 10 years. P/C insurers' exposures are relatively more concentrated in the shorter maturities than life companies. Life companies typically have longer duration liabilities and thus invest, on balance, in longer maturities. From year-end 2013 to year-end 2014, the maturity distribution shifted slightly in favor of shorter maturities.

Table 4: Maturity Distributionof U.S. Insurance Industry HY Corp. Debt Exposure by Industry Segment, as of Dec. 31, 2014

BACV ($ mil.)	<1 Year	1-<5 Year	5-<10 Year	10-<20 Year	20 Years or More	NA	Grand Total	% by Industry Segment
Bonds								
Life	3,190	27,918	52,481	9,783	4,481	8,790	106,643	69.0%
P/C	815	6,728	13,237	658	315	1,842	23,595	15.3%
Health	127	907	2,715	143	74	286	4,253	2.8%
Fraternal	126	654	1,261	239	132	324	2,735	1.8%
Title	5	53	6	-	-	23	88	0.1%
Total Bonds	**4,263**	**36,260**	**69,700**	**10,822**	**5,002**	**11,266**	**137,314**	88.9%
% Bonds	3.1%	26.4%	50.8%	7.9%	3.6%	8.2%	100.0%	
Loans								
Life	164	3,548	3,833	113	16	5,003	12,678	8.2%
P/C	16	1,356	1,951	7	1	580	3,912	2.5%
Health	0	64	141	1	-	168	374	0.2%
Fraternal	1	18	36	13	-	111	180	0.1%
Title	-	-	-	-	-	-	-	0.0%
Total Loans	**182**	**4,986**	**5,962**	**134**	**17**	**5,863**	**17,143**	11.1%
% Loans	1.1%	29.1%	34.8%	0.8%	0.1%	34.2%	100.0%	
Total Below-Investment Grade	**4,445**	**41,247**	**75,662**	**10,956**	**5,018**	**17,129**	**154,457**	100.0%
% Total Below-Investment Grade	2.9%	26.7%	49.0%	7.1%	3.2%	11.1%	100.0%	

Table 5 shows the credit distribution of insurance industry high-yield holdings. In terms of NAIC designation, the credit quality distribution of the insurance industry's high-yield debt holdings has, for the most part, not changed between 2013 and 2014. There is some disparity between the credit quality distributions of each industry segment. The life, health and fraternal segments tend to be heavily skewed to higher quality, with approximately 60%–71% of high-yield exposure in NAIC 3 designated holdings; about 26%–34% in NAIC 4 positions, and the remaining 2%–7% in NAIC 5, NAIC 6 and other. The P/C and title segments, however, are somewhat more evenly distributed between designation levels and thus have 36%–55% in NAIC-3 assets, 38%–43% NAIC-4 and the remaining 7%–22% NAIC in NAIC-5, NAIC-6 and other.

The credit quality distribution of insurers' HY bond and loan exposures differ, with HY corporate bond holdings skewed more in favor of higher quality. Table 5 shows that 66% of corporate bond holdings are designated NAIC-3, with just 34% designated NAIC 4 or lower. Leveraged loan holdings are almost evenly split between NAIC 3 and NAIC 4 (47% and 45%, respectively, with just 8% designated lower).

Table 5: Credit Distribution of U.S. Insurance Industry HY Corp. Debt Exposure by Industry Segment, as of Dec. 31, 2014

BACV ($ mil.)	Life	P/C	Health	Fraternal	Title	Grand Total	% Total
Bonds							
NAIC 3	79,151	14,567	2,937	2,342	72	99,070	58.6%
NAIC 4	30,670	9,112	1,683	823	86	42,374	25.0%
NAIC 5	6,653	1,638	169	60	35	8,556	5.1%
NAIC 6 and Other	750	299	98	7	8	1,161	0.7%
Total Bonds	**117,223**	**25,616**	**4,888**	**3,232**	**201**	**151,160**	89.3%
% Bonds	77.5%	16.9%	3.2%	2.1%	0.1%	100.0%	
Loans							
NAIC 3	6,081	2,203	-	169	0	8,453	5.0%
NAIC 4	5,757	2,353	-	93	0	8,203	4.8%
NAIC 5	861	144	-	26	-	1,031	0.6%
NAIC 6 and Other	336	16	-	-	-	352	0.2%
Total Loans	**13,036**	**4,716**	-	**288**	**1**	**18,040**	10.7%
% Loans	72.3%	26.1%	0.0%	1.6%	0.0%	100.0%	
Total Below-Investment Grade	**130,259**	**30,333**	**4,888**	**3,520**	**201**	**169,200**	100.0%
% Total Below-Investment Grade	77.0%	17.9%	2.9%	2.1%	0.1%	100.0%	

Table 6 shows the year-end 2014 industry and sector allocation of the U.S. insurance industry's high-yield corporate bond holdings, along with a comparison to the allocation of the BAML U.S. High Yield Index. The 2014 sector and industry allocations are little changed from 2013. There are some limitations to this analysis based on available data.

It appears that the sector breakdown of the insurance industry's high-yield corporate bond investments is reasonably consistent with the overall HY market, with the only significant difference being that insurance companies appear to be a few percentage points underweighted in Consumer, Non-discretionary (more specifically, in the health care industry).

Table 6: Insurance Industry Exposure - HY Corporate Sector Breakdown as of Dec. 31, 2014

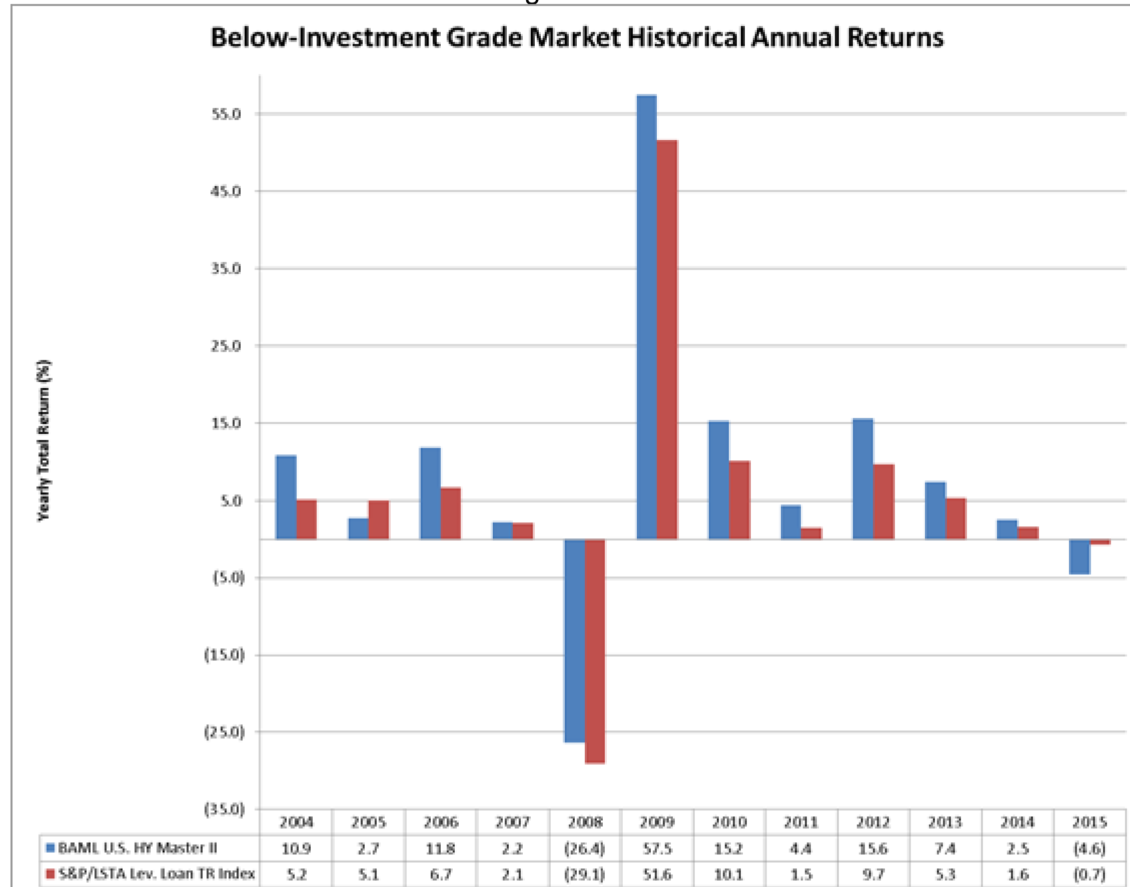
BACV ($ mil.)	Life	%	P/C	%	Health	%	Fraternal	%	Title	%	Grand Total	%	ML U.S. HY Index % YE 2014
Basic Materials	9,267	7.9%	2,084	8.1%	346	7.1%	307	9.5%	26	12.8%	12,029	8.0%	7.3%
Communications	14,154	12.1%	3,452	13.5%	819	16.8%	417	12.9%	35	17.5%	18,877	12.5%	12.4%
Consumer, Cyclical	10,263	8.8%	3,324	13.0%	579	11.8%	308	9.5%	44	22.1%	14,518	9.6%	11.1%
Consumer, Non-cyclical	14,098	12.0%	3,861	15.1%	761	15.6%	415	12.8%	17	8.4%	19,152	12.7%	18.2%
Energy	14,508	12.4%	3,014	11.8%	642	13.1%	457	14.1%	20	9.7%	18,640	12.3%	12.7%
Financial	7,552	6.4%	3,215	12.5%	492	10.1%	329	10.2%	13	6.7%	11,602	7.7%	10.4%
Industrial	10,038	8.6%	2,444	9.5%	518	10.6%	199	6.2%	28	13.7%	13,226	8.7%	9.1%
Technology	3,059	2.6%	1,221	4.8%	206	4.2%	160	4.9%	6	2.8%	4,662	3.1%	4.9%
Utilities	4,774	4.1%	785	3.1%	159	3.2%	139	4.3%	3	1.3%	5,860	3.9%	3.2%
Other	29,510	25.2%	2,218	8.7%	365	7.5%	502	15.5%	10	4.9%	32,605	21.6%	10.7%
Total Corporate Bond	117,223	100.0%	25,616	100.0%	4,888	100.0%	3,232	100.0%	201	100.0%	151,160	100.0%	100.0%

High-Yield Risk/Return and Market Trends

Chart 2 illustrates that below-investment grade debt total returns, which include mark-to-market changes, can be quite volatile. Returns have generally been positive in recent years, however, and have the added benefit of not being highly correlated with other fixed income asset classes. Much investor and media attention has fallen on the high-yield asset class since the middle of 2014, however, and HY corporate and loan market performance has turned negative. The U.S. high-yield bond market—as represented by the BAML U.S. High Yield Master II Index—

generated a meager 2.5% return in 2014 and returned –4.6% in 2015, posting declines in five of the past six months (and 10 of the last 17). High yield bonds have continued to stumble in early 2016 trading; the index has slipped another 2.5% through Jan. 25, 2016. Leveraged loans have been a bit more resilient but have also come under pressure; the S&P/LSTA Loan Total Return Index returned 1.6% in 2014, –0.7% in 2015, and -0.7% YTD in 2016. The superior relative downside performance of bank loans probably is due at least in part to the fact that the leveraged loan market has less exposure to commodity-related sectors.

Chart 2: Historical HY Bond and Leveraged Loan Annual Returns 2004–2015



	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
BAML U.S. HY Master II	10.9	2.7	11.8	2.2	(26.4)	57.5	15.2	4.4	15.6	7.4	2.5	(4.6)
S&P/LSTA Lev. Loan TR Index	5.2	5.1	6.7	2.1	(29.1)	51.6	10.1	1.5	9.7	5.3	1.6	(0.7)

Source: Bloomberg LP

At first, the deterioration in high-yield market performance was limited primarily to energy and mining industry credits, which have been suffering since the back half of 2014, when commodity prices (especially oil) began their precipitous decline, causing credit spreads to widen dramatically. In 2014, HY energy and metals and mining credits returned –7.4% and –8.4%, respectively, while all other industry sectors except gaming logged positive returns, slightly more than offsetting the commodity price-related declines. In 2015, HY energy and metals and mining credits logged respective returns of –23.6% and –26.2%, and several other industries turned negative, including steel (–20.7%), paper (–11.4%) and an additional handful that returned between –3% and –6%. Returns also varied by credit quality, with negative returns concentrated in CCC and lower-rated names (equivalent to NAIC 5 and NAIC 6 designations).

In 2015, as the ripples caused by credit spread widening in the commodity sectors expanded to other sectors of the market, HY credit spreads—as represented by the Markit CDX HY Index, the leading benchmark for HY credit default swaps—increased from a range of 350 bps–400 bps at the beginning of the year to the current range of about 420 bps–540 bps. Leveraged loan spreads have held up a bit better, as new issue loan spreads for large corporates tightened

about 50 bps from the end of 2014 to about 400 bps in 4Q15. In the middle market, new issue spreads widened to 533 bps in 4Q15 from a range of approximately 450 bps to slightly more than 500 bps since early 2013. U.S. loan secondary market bid prices continued to trend lower in the second half of 2015, with multi-quote institutional term loans ending the year close to 93 on average, down from about 98 mid-year. Lower rated names were hit hardest in the "risk-off" environment, while actively traded loan bids fell from around par to below 97.

Secondary market prices for both leveraged loans and high yield bonds have slumped YTD in the "risk-off" environment. High yield bond prices average about 86.5, down 265 bps so far in January, while loans are around 91.40, down 165 bps.

Default Risk / Credit Trends

After years of historically low interest rates, tight credit spreads and strong investor demand that made refinancing easy for all but the weakest borrowers, the credit cycle appears to be turning. As interest rates rise, increased financing costs will likely pose a challenge for marginal credits, and investors will be less inclined to reach for yield, resulting in limited access to refinancing opportunities for issuers. These factors could potentially result in higher default rates. According to Moody's Investors Service, the issuer-weighted global speculative-grade default rate nearly doubled in 2015, to 3.4% from 1.9% in 2014. The U.S. speculative-grade default rate increased to 3.2% in 2015 from 2.2% in 2014. A significant number of corporate defaults in 2015 were in commodity sectors, especially oil and gas. While Moody's expects global default rates to remain below the long-term average of 4.2% (since 1983), Moody's predicts the global default rate will rise to 3.9% (4.4% in the U.S.) in 2016, mainly because of widening spreads, sustained pressure in commodity sectors and China's economic slowdown . The metals and mining and oil and gas sectors are expected to bear the brunt of the defaults. Because they lack the significant energy exposure of the HY corporate bond market, the leveraged loan market fares a bit better than bonds with respect to default rates, both historical and expected: The trailing U.S. leveraged loan default rate rose to 2.0% in 2015 from 0.9% in 2014, according to Moody's, whereas the default rate for bonds increased to 4.3% from 2.0%. Moody's respective 2016 forecasts for U.S. bonds and loans are 3.9% and 3.5%. Recovery rates for both loans and HY bonds have been trending lower since late 2014. According to Moody's, as of Dec. 31, 2015, investors in U.S. first lien loan and senior unsecured bonds recovered 59.6% and 32.2% of par on a trailing 12-month basis—well below the respective 5-year averages of 68.4% and 42.8%.

Credit fundamentals have begun to deteriorate for HY issuers, especially commodity companies. Corporate credit statistics are mixed; leverage ratios are approaching historical highs—net debt/EBITDA of 4.8x for all HY as of mid-2015, according to S&P Capital IQ, up from 2.9x in 2006 and 4.1x in 2014. Debt burdens remain fairly manageable because interest rates remain low, but interest coverage (EBITDA/cash interest) for all HY debt had fallen to 3.0x as of mid-2015 after holding steady around 3.6x in recent years through 2014. Underwriting quality has been mixed as well; LBO-related issuance fell in the second half of 2015 after rising to approach 2007 levels, but so-called covenant-lite loan deals, whose loan agreements contain minimal investor protections, accounted for nearly three quarters of institutional large corporate loan issuance in 2015, up from 68% in 2014.

Market Conditions: Fear in the Air

Supply and demand factors—so-called "technicals"—have weighed heavily on the HY bond and loan markets. According to Thomson Reuters data, HY debt issuance slowed dramatically in the second half of 2015 after several years of record issuance; HY bond issuance in 2015 totaled $253 billion, down 18% year-over-year (YOY). U.S. leveraged loan issuance totaled $783 billion in 2015, down 17% YOY, but still the third largest year on record. The decline in underwriting activity was led by a 36% drop in institutional loans, to $295 billion, while pro-rata issuance rose 1%. Both institutional loan issuance and HY bond volume fell in 4Q15, down 26% and 5%, respectively. HY bond issuance plummeted in December to just $3.5 billion, the lowest level of the year; investors sold off riskier assets, and their risk aversion extended to the primary market.

Volatility, rate uncertainty, lack of investor appetite and lack of current funding needs all weighed on volume, and some lower-quality deals were pulled. On the demand side, HY ETF and mutual fund flows have been erratic and negative, with outflows accelerating in December; HY funds lost $14 billion in assets under management (AUM) in 2015, on top of $24 billion in outflows in 2014. Investors pulled $21 billion from loan funds in 2015, bringing the total outflow for the past two years to nearly $45 billion.

One recent headline that heightened concerns involved Third Avenue Focused Credit, a $788 million HY mutual fund—specializing in distressed debt—that announced it was blocking redemptions for up to a year by placing its assets in a liquidating trust. Faced with poor performance and very large outflows year-to-date (YTD)—41% of assets—the fund could not meet redemption requests. This has focused attention on market illiquidity and the possibility of contagion. While some illiquidity concern is warranted in view of declining market-maker inventories, credit concerns and interest rate uncertainty, it should be noted that Third Avenue Focused Credit is a distressed-debt fund that takes large, concentrated bets on distressed, illiquid credits — the kind that, in aggregate, only account for about 12% of the BAML HY index, and are the hardest to sell to meet redemptions. Conventional HY funds are not likely to have large exposures to distressed credits, or such large concentrations, so investors' worst fears are probably overdone. Nevertheless, HY ETFs have sold off sharply, and HY credit default swaps (CDS) are trending to wider spreads.

Conclusion

The high-yield market has garnered its share of headlines over the past two years, but while continued attention is warranted, the insurance industry's exposure to HY corporate debt and leveraged loans is modest. With the U.S. economic recovery—however mild—still underway against a backdrop of continued uncertainty in world economies and markets, further volatility in the credit markets (especially HY) seems likely, but with limited potential impact on insurers. The Capital Markets Bureau will continue to monitor trends within the below-investment grade market and the insurance industry's exposure to below-investment grade debt and will report any developments as deemed appropriate.

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

The views expressed in this publication do not necessarily represent the views of NAIC, its officers or members. NO WARRANTY IS MADE, EXPRESS OR IMPLIED, AS TO THE ACCURACY, TIMELINESS, COMPLETENESS, MERCHANTABILITY OR FITNESS FOR ANY PARTICULAR PURPOSE OF ANY OPINION OR INFORMATION GIVEN OR MADE IN THIS PUBLICATION.

© 1990 – 2018 National Association of Insurance Commissioners. All rights reserved.