The NAIC Capital Markets Bureau monitors developments in the capital markets globally and analyzes their potential impact on the investment portfolios of U.S. insurance companies. Previously published NAIC Capital Markets Special Reports are available via the Capital Markets Bureau web page and the NAIC archives (for reports published prior to 2016).

U.S. Insurance Industry's High-Yield Bond Exposure Declines at Year-End 2022 Amid Rising Interest Rates

Analyst: Michele Wong

Executive Summary

- As of year-end 2022, U.S. insurance companies' exposure to high-yield bond investments declined 8.8% to $269 billion compared to the prior year.
- High-yield bond exposure accounted for 5.3% of total bonds at year-end 2022, a relatively large decline from 6% at year-end 2021, as U.S. insurers reduced risk amid a rising rate environment.
- Corporate bonds and bank loans represented the majority of the year-end 2022 high-yield exposure at 60.6% and 23.8%, respectively.
- The credit distribution of the industry's high-yield exposure remained relatively unchanged, with 61% of the industry's exposure at year-end 2022 to bonds with NAIC 3 designations.
- High-yield exposure, in terms of book/adjusted carrying value (BACV) and as a percentage of total bonds, decreased in 2022 compared to the prior year at all insurer types, particularly at property/casualty (P/C) and health insurance companies.
- Speculative corporate bond default rates have begun to increase in 2023 as the higher-for-longer interest rate environment and expectations of slowing economic growth pressure cash flows and profitability.

The credit quality of the U.S. insurance industry's bond portfolio has materially improved following credit deterioration that resulted from the broad-based economic and financial effects of the COVID-19 global pandemic. As of year-end 2022, U.S. insurance companies' exposure to high-yield bond investments declined 8.8% compared to year-end 2021, reporting book/adjusted carrying value (BACV) of $269 billion. (Refer to Table 1.) The year-over-year (YOY) decrease in high-yield exposure is the first decline in four years.

Table 1: Total U.S. Insurance Industry's High-Yield Bond Exposure by Bond Type, Year-End 2022 (BACV $ in Millions)

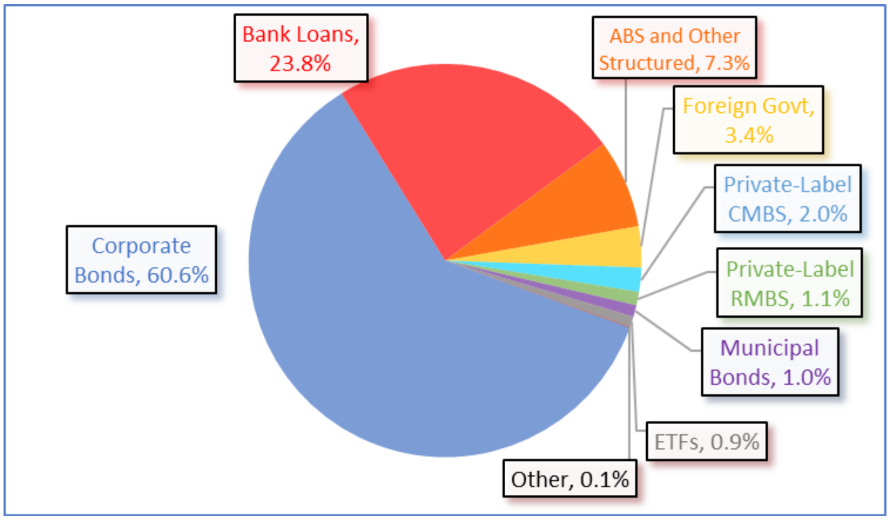
Bond Type	Life	P/C	Health	Title	Total	% of Total HY	% of Total Bonds
Corporate Bonds	117,609	36,890	8,217	115	162,831	60.6%	3.2%
Bank Loans	46,807	14,800	2,025	186	63,817	23.8%	1.3%
ABS and Other Structured Securities	17,191	2,150	237	1	19,579	7.3%	0.4%
Foreign Government	7,135	1,507	426	3	9,070	3.4%	0.2%
Private-Label CMBS	4,572	684	79	-	5,335	2.0%	0.1%
Private-Label RMBS	2,507	272	180	-	2,960	1.1%	0.1%
Municipal Bonds	1,261	1,213	82	0	2,556	1.0%	0.1%
Exchange-Traded Funds (ETFs)	695	1,171	481	2	2,349	0.9%	0.0%
Other	180	8	1	-	189	0.1%	0.0%
Total High-Yield	**197,956**	**58,695**	**11,728**	**307**	**268,686**	**100.0%**	**5.3%**
% of Total	**73.7%**	**21.8%**	**4.4%**	**0.1%**	**100.0%**		

Note: The "Other" bond type includes agency-backed residential mortgage-backed securities (RMBS), agency-backed commercial mortgage-backed securities (CMBS), hybrid securities, U.S. government bonds, and certificates of deposit. Numbers in the table have been rounded.

High-yield bond exposure declined at all insurer types. The largest percentage decreases were evident at title and property/casualty (P/C) insurance companies with YOY declines in BACV exposure of 28% and 16%, respectively. Corporate bonds were the primary contributor to the decrease in exposure at all insurers. Meanwhile, exposure to high-yield bank loans and private-label residential mortgage-backed securities (RMBS) increased at both life and health insurance companies.

Chart 1 shows that corporate bonds accounted for the majority, or 60.6%, of the year-end 2022 high-yield exposure, and bank loans represented 23.8%. High-yield corporate bond exposure has been declining, from approximately 63% and 68% in 2021 and 2020, respectively. On the other hand, high-yield bank loan exposure has been increasing from about 18% and 20% at year-end 2020 and year-end 2021, respectively, to 23.8% at year-end 2022. Asset-backed securities (ABS) and other structured securities, private-label commercial mortgage-backed securities (CMBS), and private-label RMBS together accounted for another 10.4% of high-yield exposure, unchanged from the prior year. Separately, while the share of ABS and other structured securities remained unchanged at 7.3% of high-yield bond exposure at year-end 2022 compared to the prior year, it was up from 5.7% in 2020.

Chart 1: U.S. Insurance Industry's High-Yield Bond Exposure by Bond Type, Year-End 2022



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

Please reference the Capital Market Bureau's Special Report, "Another Year of Double-Digit Growth in U.S. Insurers' Bank Loan Exposure in 2022," published on July 11, 2023, for more information on bank loans.

Similar to previous years, the industry's high-yield bond exposure continues to be skewed toward the higher credit quality of the below investment grade spectrum (i.e., BB-rating category or NAIC 3 designation), and as such, it provides some comfort to the added credit risk being taken by insurers from investing in high-yield bonds. (Refer to Table 2.) Approximately 61% of the industry's bond exposure at year-end 2022 carried NAIC 3 designations, the highest quality in the high-yield credit quality spectrum, and another 29% carried NAIC 4 designations. The credit distribution of U.S. insurers' high-yield bond investments remained relatively unchanged year over year.

Table 2: Credit Distribution of U.S. Insurance Industry's High-Yield Bond Exposure as of Year-End 2022 (BACV $ in Millions)

NAIC Designation	Life	P/C	Health	Title	Total	% of Total
NAIC 3	128,225	29,487	6,855	209	164,775	61.3%
NAIC 4	51,508	22,818	4,317	76	78,719	29.3%
NAIC 5	16,308	5,161	362	22	21,853	8.1%
NAIC 6	1,915	1,229	194	0	3,338	1.2%
Total	**197,956**	**58,695**	**11,728**	**307**	**268,686**	**100.0%**

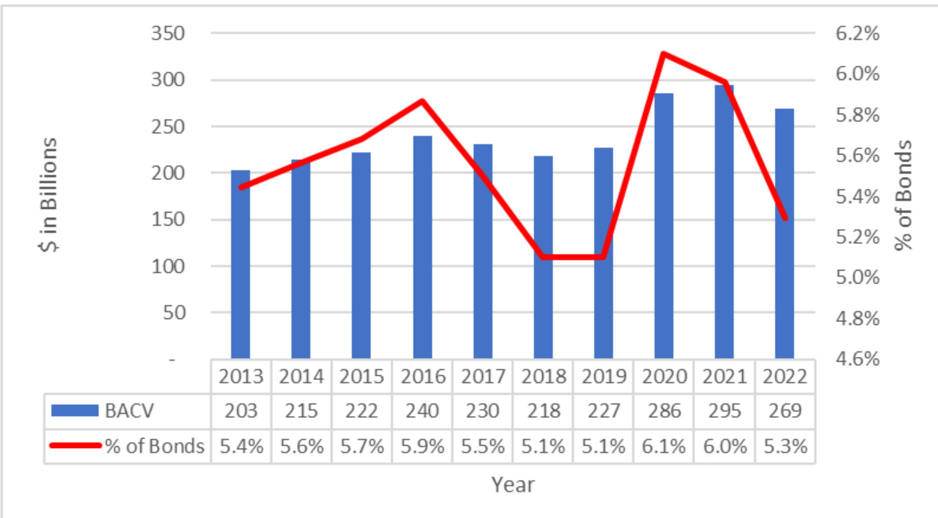
Note: Numbers in the table have been rounded.

Higher concentrations of lower-rated high-yield bonds were evident at P/C and health insurance companies relative to life and title companies. At year-end 2022, bonds with NAIC 4 designations represented approximately 39% and 37% of P/C and health companies' high-yield exposures, respectively, compared to 26% and 25% at life and title companies, respectively. Furthermore, NAIC 3 exposure at P/C and health was 50% and 58%, respectively, of total high-yield bonds, while it was 65% and 68%, respectively, at life and title companies.

Share of High-Yield Bonds Falls to Near Pre-Pandemic Level

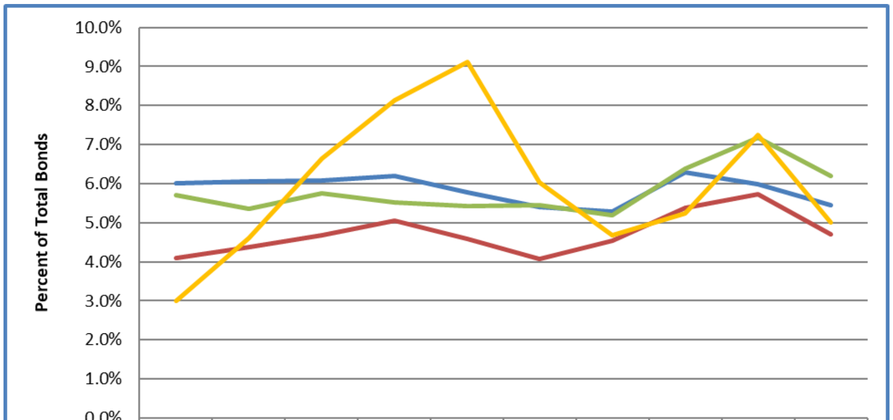
The U.S. insurance industry's high-yield bond BACV exposure declined at year-end 2022 to $269 billion after reaching a historical high of $295 billion at year-end 2021. (Refer to Chart 2.) On a percentage basis, high-yield exposure accounted for 5.3% of total bonds at year-end 2022, a relatively large decline from 6% or the second highest level in the last 10 years. U.S. insurers reduced their high-yield bond investments and, therefore, credit risk, amid the significant rise in interest rates that began in 2022.

Chart 2: U.S. Insurance Industry's Exposure to High-Yield Bonds, 2012–2021 (BACV $ in Billions)



After high-yield exposures increased over the past two to three years, they declined in 2022 at all insurer types. (Refer to Chart 3.) Exposure at P/C and health companies declined one percentage point to 4.7% and 6.2% of total bond exposure, respectively, at year-end 2022. Life insurers' high-yield exposure fell half a percentage point to 5.5% compared to the prior year. While title companies' high-yield exposure rose to 7.3% in 2021, it fell sharply to 5.0% at year-end 2022, more aligned with the pre-pandemic level. Title companies' high-yield bond exposure tends to be more volatile compared to other insurer types given its smaller asset base.

Chart 3: U.S. Insurance Industry's High-Yield Bond Exposure as a Percentage of Total Bonds by Insurer Type, 2013–2022



	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
Life	6.0%	6.1%	6.1%	6.2%	5.8%	5.4%	5.3%	6.3%	6.0%	5.5%
P/C	4.1%	4.4%	4.7%	5.0%	4.6%	4.1%	4.5%	5.4%	5.7%	4.7%
Health	5.7%	5.3%	5.7%	5.5%	5.4%	5.5%	5.2%	6.4%	7.2%	6.2%
Title	3.0%	4.6%	6.6%	8.1%	9.1%	6.0%	4.7%	5.2%	7.3%	5.0%

Higher-for-Longer Interest Rates Pose a Big Challenge for High-Yield

High-yield companies are vulnerable to high interest rates, and particularly so, if they remain elevated for an extended period of time. Additional challenges include slowing economic growth and limited financing opportunities, as banks tighten capital availability and investors become risk averse. As borrowing costs rise, high-yield companies typically have less financial flexibility than investment-grade companies and are unable to withstand the credit and financing pressures, leading to the potential for downward credit migration and higher rates of default.

Following a period of extremely low levels, default rates have begun to increase in 2023 as the higher-for-longer interest rate environment and expectations of slowing economic growth pressure cash flows and profitability. In addition, intensifying geopolitical risks domestically and around the world have introduced another layer of risk and uncertainty, resulting in heightened market volatility.

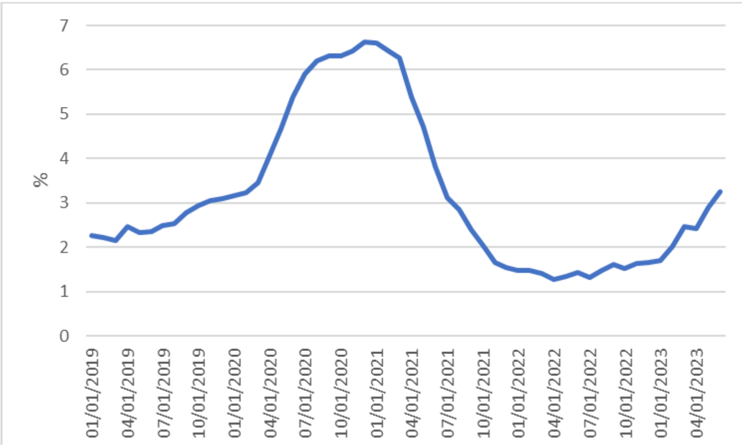
According to data from S&P Global Ratings (S&P), there have been 118 global corporate defaults year to date (YTD) through September. 2023 YTD defaults are almost double the 62 defaults for the same period in 2022. In addition, defaults are easily outpacing the 85 defaults for full-year 2022 and the five-year average of 128 defaults.[1] Credit rating downgrades at S&P are also up about 14% through September compared to the same period last year.

Furthermore, S&P's actual trailing 12-month speculative-grade default rate was 3.2% in June 2023, more than double the 1.4% in June 2022. (Refer to Chart 4.) In its base case scenario, S&P expects the U.S. trailing 12-month speculative-grade corporate default rate to continue to rise and reach 4.5% by June

[1] S&P Global Ratings, Distressed Exchanges Drive 2023 Global Corporate Defaults to 118, Oct. 20, 2023.

2024.[2] If it reaches this expected level, the default rate would exceed the long-term historical average of 4.1% for the first time since mid-2021, when credit markets were in the midst of recovering from the effects of the COVID-19 pandemic. In addition, the European trailing 12-month speculative-grade corporate default rate is expected to also rise to 3.75% from 3% for the same periods.

Chart 4: U.S. Trailing 12-Month Speculative-Grade Default Rate, January 2019–June 2023



Sources: S&P Global Ratings Credit Research & Insights and S&P Global Market Intelligence's CreditPro©

With the significant credit pressures in a high interest rate environment, U.S. insurers' high-yield investments are at risk of downward credit migration. While U.S. insurance companies reduced their overall high-yield exposure in 2022, individual insurers with concentrated exposures, particularly as a percentage of capital and surplus, could be at risk of significant losses if default rates continue to their upward trend.

The NAIC 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 NAIC Capital Markets Bureau at *CapitalMarkets@naic.org.*

[2] S&P Global Ratings, The U.S. Speculative-Grade Corporate Default Rate Could Rise to 4.5% By June 2024, Aug. 17, 2023.