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Growth in the U.S. Insurance Industry's Exposure to Bonds with NAIC 2 Designations Stabilizes at Year-End 2019

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Executive Summary

Trends in U.S. Insurer Exposure to NAIC 2-Designated Bonds

The BBB-rated segment of the corporate bond market has grown steadily over the last decade, from approximately one-third of the market in 2009. According to S&P Global Ratings data, as of Oct. 1, 2020,

debt.¹ The growth primarily reflects an increase in leverage across corporate issuers as financing conditions have been supportive with an attractive cost of debt and strong investor demand given the lower-for-longer interest rate environment. Similar dynamics are also evident in other asset classes, including municipal bonds and structured securities, but to a lesser extent.

Accordingly, the U.S. insurance industry's exposure to bonds with NAIC 2 designations—or the BBB-rating category as assigned by nationally recognized statistical rating organizations (NRSROs)—has also grown over time. 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. Bonds with NAIC 2 designations increased to almost 30% of total bonds as of year-end 2019 from under 23% at year-end 2010. (See Chart 1.)

The growth rate in NAIC 2 exposure over the 10-year period can be partially attributed to insurers taking additional credit risk as they allocated greater dollars to NAIC 2 bonds at the expense of NAIC 1 bonds during the prolonged low interest rate environment. Bonds with NAIC 1 designations represented 65% of the industry's total bonds as of year-end 2019, a decline from 71% at year-end 2010. However, the growth rate has stabilized recently, with the increase in the share of bonds with NAIC 2 designations remaining relatively unchanged from year-end 2018 to year-end 2019.

Chart 1: U.S. 1f1 0 000000000000000000000000000000082 Tm0 g0 G[end)5()9(2)7(0)7(1)JT#TQq0.00000912 0 612 79

Table 1: U.S. Insurance Industry Exposure to NAIC 2 Bonds by Bond Type as of Dec. 31, 2019 (BACV \$ millions)

Bond Type	Life	P/C	Health	Title	Total	% of Total
Corporate	1,010,130	161,140	21,685	882	1,193,838	90.2%
Structured Securities	69,976	7,621	747	2	78,346	5.9%
Sovereign/Other Government	15,922	2,656	308	24	18,909	1.4%
Municipal	10,238	7,335	1,146	36	18,755	1.4%
Other	10,501	1,797	1,549	10	13,857	1.1%
Total	1,116,768					

1.116.768

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

Approximately 75% of reported year-end 2019 bond data was 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- rated bonds, as they typically carry higher relative risks. Concentrations of exposure at the lower end of the credit quality category would raise concerns, particularly because the credit market experienced significant and broad-based stress beginning in March 2020 as a result of business interruptions stemming from social distancing and "stay-at-home" measures to contain and mitigate the spread of the COVID-19 pandemic.

The NAIC CMB's analysis indicates that NAIC 2 exposure is fairly evenly distributed across the NAIC 2 credit quality category for the U.S. insurance industry, as well as for each insurer type. (See Table 2.) As of year-end 2019, the BBB+ and the BBB credit quality categories each represented 35% of the industry's NAIC 2 bond exposure, and the BBB- credit quality category accounts for the remainder, or 30%. However, there is evidence that credit quality is deteriorating within the NAIC 2 exposure on a year-over-year basis. The industry's exposure shifted modestly to the lowest credit quality category, or BBB-, at year-end 2019 as its share increased two percentage points to 30% from 28% at year-end 2018. It also increased across each of the insurer types. (See Chart 3 and Chart 4.)

Table 2: Estimated U.S. Insurance Industry Distribution of NAIC 2 Bond Exposure by Insurer Type as of Dec. 31, 2019

Chart 3 and Chart 4: Estimated U.S. Insurance Industry Distribution of NAIC 2 Bond Exposure as of Year-end 2019 (Left Panel) and Year-end 2018 (Right Panel)

The NAIC Capital Markets Bureau 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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