Chart 1 shows the industry's high-yield bond exposure from 2010 through 2019, together with the exposure as a percentage of total bonds. Exposure to high-yield bonds on a BACV basis has remained within a range of $200 billion and $240 billion since 2010. Meanwhile, high-yield bonds as a percentage of total bonds has been declining since year-end 2016 when the metric reached a recent peak of 5.9%. As of year-end 2019, high-yield bonds accounted for 5.1% of the U.S. insurance industry's total bonds, unchanged from the prior year.

U.S. insurers' exposure to high-and social distancing, many companies experienced an unprecedented level of business disruption, with significant declines in revenues and cash flows. Amid record-high unemployment and lower consumer discretionary spending, the U.S. economy—along with the global economy—suddenly entered a recession following years of growth. An additional driver of credit deterioration was the sharp decline in oil prices in March and April as both lower global demand and supply side disputes exacerbated price volatility.

With this credit backdrop, the nationally recognized statistical rating organizations (NRSROs) have taken a record number of rating actions in 2020. As of Aug. 17, 2020, S&P Global Ratings (S&P) had taken 1,975 negative rating actions on corporate debt, with downgrades representing half of the rating actions. Non-financial corporate rating actions at Moody's Investors Service (Moody's) totaled approximately 2,100 through July, and downgrades accounted for 43% of rating actions.

Highly leveraged companies have accounted for the majority of negative corporate rating actions at both NRSROs, as they tend to have weaker liquidity and refinancing profiles. Almost 70% of the ratings actions at S&P were among high-yield issuers, while approximately 75% of Moody's rating actions were within the high-yield universe. Furthermore, high-yield issuers accounted for almost 90% of the downgrades at Moody's.

Given the concentration of rating actions within high-yield, particularly downgrades, the credit quality of the U.S. insurance industry's corporate high-yield exposure has likely deteriorated to some degree since year-end 2019. A shift in the credit composition of an insurer's investment portfolio could result in higher risk-based capital (RBC) charges if a credit rating downgrade results in a change to the corresponding NAIC designation category.

The Capital Markets Bureau conducted a high-level analysis of ratings transitions in July 2020 to better understand the impact of the record level of rating downgrade activity on U.S. insurer investment portfolios. The analysis focused on bond investments with filing exempt (FE) designations or NRSRO ratings reported by U.S. insurers on Schedule D at year-end 2019. FE designations and NRSRO ratings as of Dec. 31, 2019, were compared to their respective designations/ratings as of June 30, 2020. Note that the analysis did not account for potential trading activity in 2020 and excludes government investments, investments with designations assigned by the Securities Valuation Office (SVO), investments modeled by the Structured Securities Group (SSG), and investments with private letter ratings.

The results of the analysis showed that approximately 9% of the tracked bonds with NAIC 3 designations at year-end 2019 transitioned to an NAIC 4 designation or lower as of June 30, 2020; about 12% of bonds with NAIC 4 designations migrated to an NAIC 5 designation or lower; and 24% of bonds with NAIC 5 designations shifted to the NAIC 6 designation category. Furthermore, rating transitions from investment grade to high-yield were minimal, with 4% of the tracked bonds with NAIC 2 designations migrating to the NAIC 3 designation category, resulting in bonds with NAIC 3 designations or lower increasing to approximately 7% of total bond investments included in the analysis from about 5%.