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 Bureau Special Reports are available via its web page and the NAIC archives (for reports published prior to 2016).

U.S. Insurance Industry's High-Yield Bond Investments Near $300 Billion at Year-End 2021

Analyst: Michele Wong

Executive Summary

- The U.S. insurance industry reported $295 billion in high-yield bond investments at year-end 2021, an increase of 3% compared to year-end 2020, amid the credit markets recovering from the impact of the COVID-19 pandemic.
- High-yield bonds accounted for 6% of the industry's total bond exposure, just below the highest level in more than 10 years of 6.1% recorded at year-end 2020.
- Bank loans and asset-backed securities (ABS) and other structured securities were the primary contributors to the increase in high-yield exposure in 2021.
- The credit distribution of the industry's high-yield exposure is skewed toward the higher quality end of below investment grade credits, with 61% of the industry's exposure at year-end 2021 to bonds with NAIC 3 designations.
- High-yield exposure, in terms of book/adjusted carrying value (BACV) and as a percentage of total bonds, increased in 2021 compared to the prior year at all insurer types except life insurance companies.
- Material declines in high-yield corporate bond and leveraged loan issuance in 2022 reflect investor risk aversion in a rising rate environment and pose significant financing challenges.

U.S. insurance companies reported high-yield bond investments with a book/adjusted carrying value (BACV) of $295 billion as of year-end 2021, an increase of 3% compared to year-end 2020. (See Table 1.) The modest year-over-year (YOY) increase in exposure follows a sharp increase of more than 25% in 2020. Additionally, for the first time in three years, the industry's high-yield bond exposure increased at a slower pace than the growth in total bond exposure. Credit quality stabilized and began to recover in 2021 following significant credit deterioration the prior year due to the economic and financial effects of the COVID-19 pandemic globally.

Table 1: Total U.S. Insurance Industry's High-Yield Bond Exposure by Bond Type, Year-End 2021 (BACV $ in Millions)

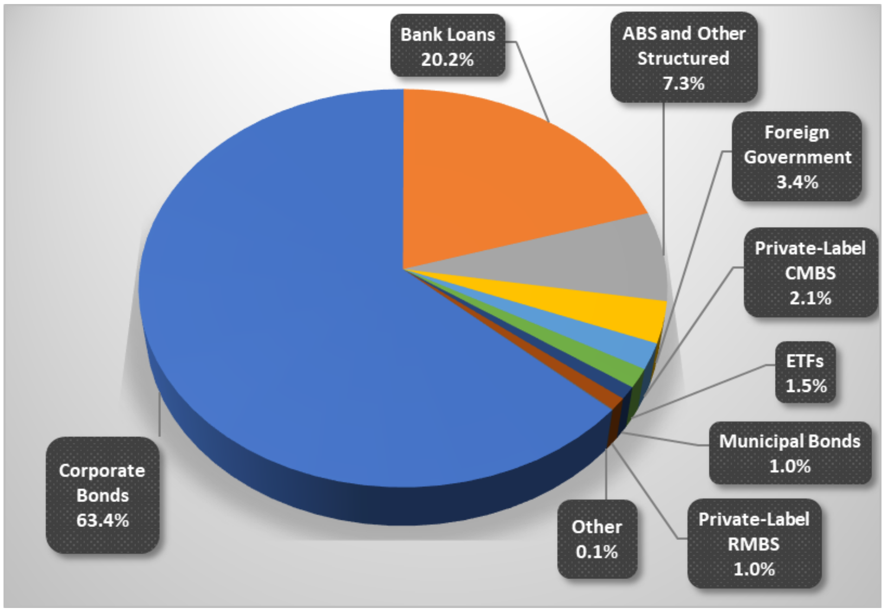
Bond Type	Life	P/C	Health	Title	Total	% of Total HY	% of Total Bonds
Corporate Bonds	134,230	43,503	8,846	182	186,760	63.4%	3.8%
Bank Loans	40,883	16,550	1,984	218	59,635	20.2%	1.2%
ABS and Other Structured Securities	18,873	2,294	272	6	21,445	7.3%	0.4%
Foreign Government	7,922	1,499	487	3	9,910	3.4%	0.2%
Private-Label CMBS	5,373	752	85	-	6,210	2.1%	0.1%
Exchange-Traded Funds (ETFs)	457	3,137	933	16	4,543	1.5%	0.1%
Municipal Bonds	1,582	1,306	99	1	2,988	1.0%	0.1%
Private-Label RMBS	2,265	548	125	-	2,937	1.0%	0.1%
Other	216	2	5	3	226	0.1%	0.0%
Total High-Yield	**211,801**	**69,589**	**12,835**	**429**	**294,655**	**100.0%**	**6.0%**
% of Total	**71.9%**	**23.6%**	**4.4%**	**0.1%**	**100.0%**		

Note: The "Other" bond type includes agency-backed RMBS, agency-backed CMBS, hybrid securities, and U.S. government bonds. Numbers in the table have been rounded.

High-yield bond exposure at life insurance companies decreased 1% YOY, while it increased significantly at property/casualty (P/C), health, and title insurance companies evidenced by growth of 13%, 24%, and 52%, respectively. Bank loans and corporate bonds were the primary contributors to the increase in BACV at P/C companies. In addition, corporate bonds contributed the most to the exposure increase at health companies, and bank loans primarily contributed to the increase at title companies.

Chart 1 shows that corporate bonds accounted for the majority, or 63%, of the year-end 2021 high-yield exposure, and bank loans represented 20%. Exposure to corporate bonds declined from approximately 68% the prior year, while exposure to bank loans increased from 18%. Asset-backed securities (ABS) and other structured securities, private-label commercial mortgage-backed securities (CMBS), and private-label residential mortgage-backed securities (RMBS) together accounted for another 10.4%, an increase from 9.6% in 2020. Separately, the share of ABS and other structured securities rose to 7.3% of high-yield bond exposure from 5.7% in 2020, while the shares of private-label CMBS and private-label RMBS declined YOY.

Chart 1: U.S. Insurance Industry's High-Yield Bond Exposure by Bond Type, Year-End 2021



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 titled "Significant Increase in U.S. Insurers' Bank Loan Exposure as of Year-End 2021" published on June 1, 2022, for more information on bank loans.

The industry's high-yield bond exposure is skewed toward the higher quality of the below investment grade spectrum (i.e., BB-rating category), and as such, it provides some comfort to the added credit risk being taken by insurers from investing in high-yield bonds. (See Table 2.) Approximately 61% of the industry's bond exposure at year-end 2021 carried NAIC 3 designations, the highest quality in the high-yield credit quality spectrum, and another 29% carried NAIC 4 designations. There was, however, a slight shift in composition, with exposure to bonds with NAIC 3 designations decreasing from 62% at year-end 2020 and exposure to bonds with NAIC 4 designations increasing from 28%. U.S. insurers' high-yield exposure has been concentrated in the NAIC 3 and NAIC 4 designation categories for at least the last 10 years.

Table 2: Credit Distribution of U.S. Insurance Industry's High-Yield Bond Exposure as of Year-End 2021 (BACV $ in Millions)

NAIC Designation	Life	P/C	Health	Title	Total	% of Total
NAIC 3	136,671	35,559	7,689	282	180,201	61.2%
NAIC 4	54,856	26,924	4,606	110	86,495	29.4%
NAIC 5	14,816	5,440	342	29	20,628	7.0%
NAIC 6	5,457	1,666	198	9	7,331	2.5%
Total	**211,801**	**69,589**	**12,835**	**429**	**294,655**	**100.0%**

Note: Numbers in the table have been rounded.

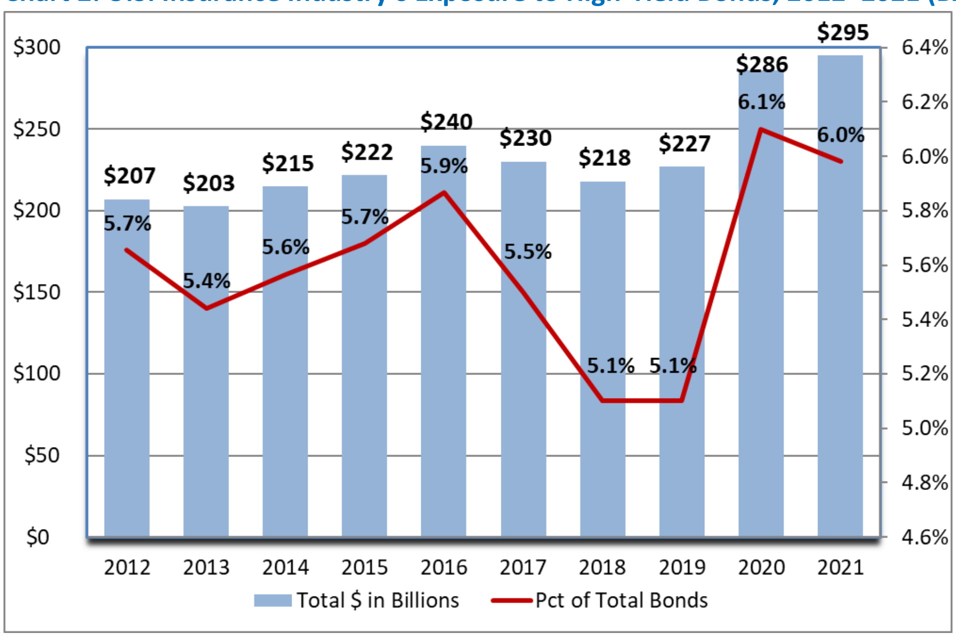
The credit distribution of the industry's high-yield bond exposure varied by insurer type. For example, at year-end 2021, NAIC 3 exposure for life and title companies was 65% and 67%, respectively, of total high-yield bonds, while for P/C and health, it was 51% and 60%, respectively. Furthermore, bonds with NAIC 4 designations represented approximately 39% and 36% of P/C and health companies' high-yield exposures, respectively, indicating higher concentrations of lower-rated high-yield bonds at these two insurer types compared to life and title companies.

A Historical Perspective of High-Yield

The U.S. insurance industry's high-yield bond exposure of almost $300 billion at year-end 2021 is the highest BACV reported over the last decade. (See Chart 2.) From 2012 to 2021 , high-yield bond exposure increased approximately 42% while total bond exposure grew approximately 34% as insurance companies sought higher relative yields offered by high-yield bonds, among other asset classes, amid the low interest rate environment of the past decade. In addition, most recently, credit quality deterioration from the impact of the COVID-19 pandemic resulted in some migration of the industry's investment grade bond exposure into high-yield territory, particularly in 2020.

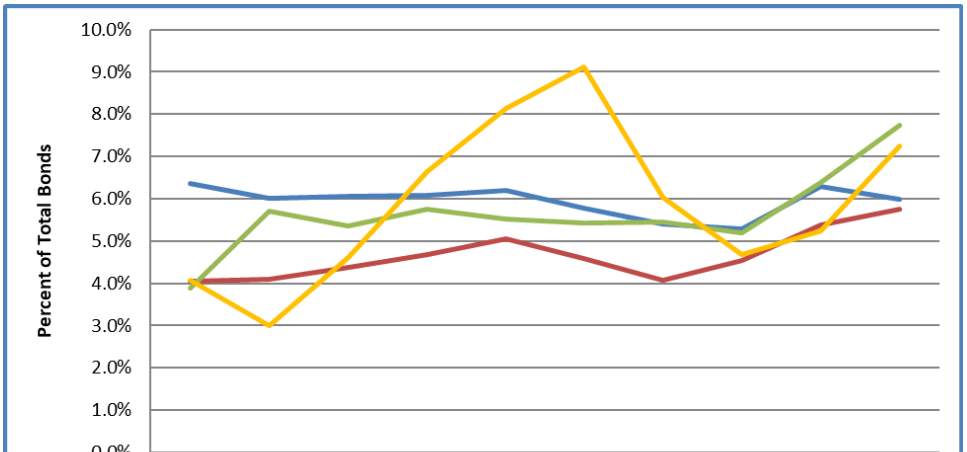
On a percentage basis, high-yield exposure accounted for 6% of total bonds at year-end 2021, the second highest point over the 10 years ending 2021. While exposure declined modestly from 6.1% at year-end 2020, as a percentage of total bonds, it remains elevated relative to the last 10 years. The most recent period when U.S. insurers' high-yield-bond exposure exceeded 6% of total bonds was in 2009 during the financial crisis when it reached 6.3%.

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



All insurer types, except for life companies, have increased their high-yield bond exposure since at least 2018. (See Chart 3.) Exposure at P/C and health companies peaked at year-end 2021 at 5.7% and 7.7% of total bond exposure, respectively, for the 10-year period. While it was about two percentage points below its peak in 2017, title companies' high-yield exposure rose sharply to 7.3% in 2021 from 5.2% in 2020. 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, 2012–2021



	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
Life	6.4%	6.0%	6.1%	6.1%	6.2%	5.8%	5.4%	5.3%	6.3%	6.0%
P/C	4.1%	4.1%	4.4%	4.7%	5.0%	4.6%	4.1%	4.5%	5.4%	5.7%
Health	3.9%	5.7%	5.3%	5.7%	5.5%	5.4%	5.5%	5.2%	6.4%	7.7%
Title	4.1%	3.0%	4.6%	6.6%	8.1%	9.1%	6.0%	4.7%	5.2%	7.3%

Rising Interest Rates and Recession Fears Drive Credit Environment

The credit environment in 2022 has destabilized and become less favorable and more volatile than 2021 amid persistent and elevated inflation, rising global interest rates at a relatively aggressive pace, fears of an economic recession across most geographic regions, and geopolitical risks (including Russia's invasion of Ukraine and lingering lockdowns in China related to the COVID-19 pandemic). In addition, investors have become risk averse in the face of slowing economic growth and fears of an economic recession, demanding higher yields and returns for taking on incremental risk.

Given this environment of rising interest rates and risk aversion, bond issuance has experienced a significant slowdown in 2022, and financing conditions have become challenging. According to the Securities Industry and Financial Markets Association (SIFMA) statistics, U.S. bond issuance—including U.S. Treasury securities, mortgage-backed securities (MBS), corporate bonds, municipal bonds, federal agency securities, and ABS—has declined approximately 30% year-to-date (YTD) through September 2022 compared to the same time period in 2021. The data indicates declines of about 48% and 40% in the YTD issuance of mortgage-backed securities and ABS, respectively.

High-yield issuers in particular have faced the greatest financing challenges in the primary markets. SIFMA data shows an almost 70% decline in high-yield corporate bond issuance for the first nine months of 2022 versus the comparable period in 2021. While high-yield issuers took advantage of the abundant credit availability and attractive yields in 2021 and prior years to refinance existing debt, their financial flexibility will be reduced significantly in a higher interest rate environment and amidst lower economic growth prospects.

Leveraged loan activity has also been affected despite their relative attractiveness in a rising rate environment due to their floating rate nature. According to Standard & Poor's (S&P) data, leveraged loan issuance for 2022 has declined roughly 70% in Europe and 40% in the U.S.

While the U.S. insurance industry's high-yield exposure is likely manageable given its overall capital strength, individual insurers with concentrated exposures, particularly as a percentage of capital and surplus, could be at risk of significant losses if default rates spike or rise dramatically. S&P expects the U.S. trailing 12-month speculative-grade corporate default rate to rise to 3.5% by June 2023 from 1.4% in June 2022. While this is a significant increase, the expected default rate will remain lower than the long-term historical average of 4.2%. Furthermore, the European trailing 12-month speculative-grade corporate default rate is expected to also rise to 3% from 1.1% for the same periods. Default rates are expected to climb amid slowing economic growth, rising interest rates, and deteriorating credit metrics as profit margins decline amid persistent inflation.

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 Capital Markets Bureau at CapitalMarkets@naic.org.