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Chasing Yield Through BBBs is Hiking Insurer Credit Risk

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Since the financial crisis of 2008-2009, insurers have been challenged by a continuing low rate environment. With the U.S. Federal Reserve (the Fed) announcing three consecutive rate cuts in the second half of 2019, and with negative interest rate policies in Japan and Europe, there appears to be no break in sight from the era of low interest rates.

The U.S. insurance industry has responded to this decade-long pressure by shifting asset allocations. While some of the moves differ by line of business, one move has affected insurers of all types and sizes: an increase in exposure to BBB-rated bonds.

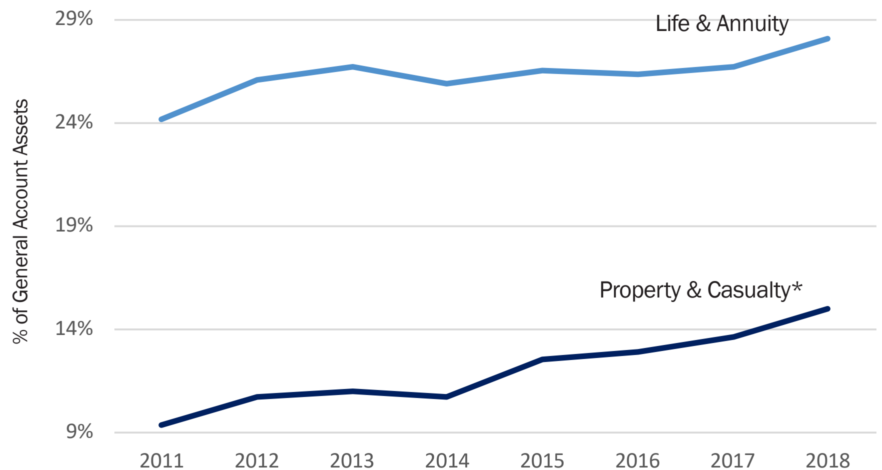
Among property and casualty (P&C) insurers, BBB-rated bonds rose to 15% of the portfolio in 2018 from 9.4% in 2011 (see Figure 1). Life-annuity insurers saw BBB exposure rise to 28% of the portfolio in 2018 from 24.2% in 2011.

Impact Across a Broad Range of Firms

The increase in BBB-rated bonds affected a broad range of insurers, from those with $100 million in General Account assets to companies with well over $20 billion in assets (see Figure 2). While Conning has seen some larger firms reach for yield via commercial mortgages (life-annuity insurers) or boost their net investment income via common stock (P&C carriers), smaller insurers have tended to be much more bond-dependent, making the credit shifts more stark.

Some of the rising exposure to BBB-rated corporate bonds reflects the overall declining credit profile of the U.S. bond market. However, we also see allocations changing due to deliberate choices. Examining the BBB-rated bond allocations for various sizes of life-annuity insurers indicates that the smallest insurers tend to have the least exposure to BBB-rated bonds in their overall bond portfolio.

Figure 1 - Rising Allocations to BBB-Rated Bonds, 2011 - 2018



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*Excluding Berkshire Hathaway & State Farm due to their distorting effects

Growing Risk to Downgrades

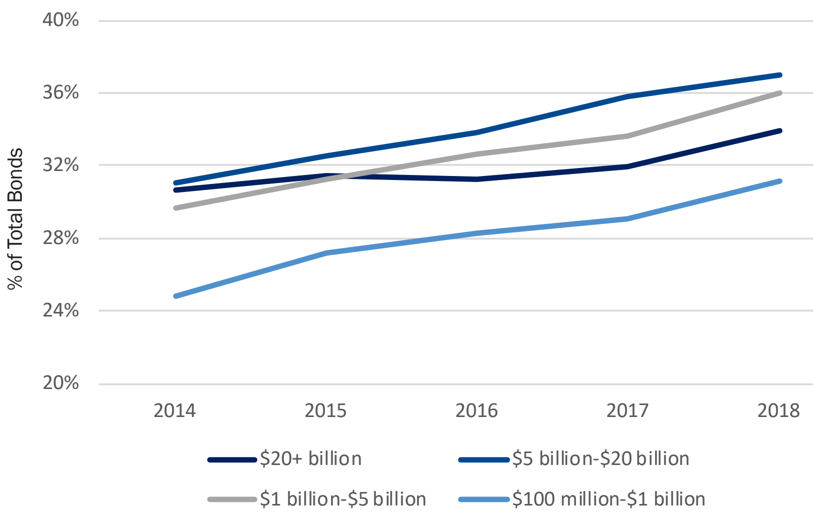
There are potential drawbacks to the increasing concentration of corporate credit risk in insurer portfolios, specifically the danger of downgrades. A *Best's Special Report* on BBB-rated allocations in insurer portfolios with a focus on life-annuity insurers noted BBB bonds' "greater sensitivity to credit deterioration," especially with regard to required risk capital, whether based on current NAIC credit risk factors or A.M. Best BCAR models. At the beginning of 2020, the risk charge more than triples when going from investment-grade to below-investment-grade bonds.

We have seen a similar credit event before, with a similar run-up in embedded asset risk: the 2004-2007 buildup of highly rated structured securities, many of which were more exotic structures than prior mortgage-backed securities. These senior tranches of collateralized debt obligations (CDOs), and the even more exotic CDO-squareds (structured securities created by aggregating other CDOs), provided higher yields for relatively high credit ratings. However, the spread between industry yields and reference rates increased during this period, with industry book yields rising even as the interest rate environment was falling. This indicated that there was embedded risk in insurer portfolios, especially for life-annuity insurers, which have been more driven in the quest for yield than their P&C counterparts.

A similar spread widening is here again, especially now that the Fed has reversed its policy of increasing interest rates. It appears this time that the increasing credit risk is being recognized, where it had been hidden in the 2004-2007 scenario. However, are life-annuity insurers getting fully paid for this credit risk?

Perhaps insurers have been lulled by record low default and downgrade statistics with a relatively quiet credit period. Betting that the quiet times persist does not reflect the reality of past credit cycles, however, and insurers may not fully appreciate their risk exposure.

Figure 2 - BBB Allocations by Company Size, 2014 - 2018



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The Value of Diversification

Diversifying into asset classes with different risk exposures can help insurers reduce potential credit-cycle impacts while maintaining yield.

Conning built a general P&C industry model* to test the benefits of portfolio diversification in four different macroeconomic scenarios: continuing low interest rates, rising interest rates, high inflation, and a stock market crash. For a given macro scenario, other economic variables were modeled stochastically. The five-year economic value was projected for two risk-optimized portfolios: a core-fixed-income-only portfolio and a portfolio allowing for up to 20% allocation of alternative investments (such as hedge funds.)

In all four macro scenarios, the portfolio allowing alternative assets had a projected five-year economic return of at least four percentage points higher than that of the fixed-income-only portfolio at the level of risk represented by the overall industry asset portfolio (the study is available upon request). In a challenging economic environment for insurers of all kinds, and weak underwriting results, improving return for a given level of risk tolerance is important.

Diversification is a common investment tactic but not necessarily one that is easily accomplished. Conning believes that building a properly diversified portfolio requires a highly disciplined approach that accounts for an insurer's business goals as well as its tolerance for risk. We think insurers are best served in the process by an asset manager with a broad range of investment expertise who can help clients build a diversified portfolio that limits reliance an any particular asset class or sector.

A properly diversified portfolio may be its own reward for insurers, as attempting to stay ahead of shifts in investment markets, let alone business trends, can be a trying experience.

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