Invesco Investment Insights

Estimating the Capital Exposure to Fallen Angels: An Insurer's Perspective

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Like all investors, insurers are currently grappling with an economic and market downturn caused by the COVID-19 pandemic, the likes of which haven't been seen since the global financial crisis. Of particular interest to insurance CIOs is the degree of BBB-rated exposure – which has increased substantially in recent years – and the threat of widespread downgrades and the corresponding impact to Risk Based Capital (RBC). While this concern is valid, we believe the likely impact in the months and years ahead won't be as dire as some insurers fear.

Increase in BBB Exposure

First one must acknowledge the significant increase in BBB exposure in recent years. Currently BBB-rated bonds constitute just over 50% of the investment grade universe, compared to about 25% in the 1990s and about 35% just before the 2008-09 crisis.[1] Because most insurers rely heavily on BBB corporate bonds as their portfolio's core building block, the Life industry average as of year-end 2018 (most-recent available) was 25% of invested assets, while P&C and Health averaged 10-11%[2] – this results in a significant exposure to potential downgrades. The concern is heightened by the fact that investment RBC charges increase substantially when moving from investment grade to high yield, as indicated in table 1. Many experts worry that a wave of downgrades from investment grade into high yield territory will overwhelm the high yield market and produce a vicious cycle of forced sales by ratings-conscious investors, leading to further spread widening, increasing market-wide sales pressure further, causing RBC levels to skyrocket, and so on. This scenario is certainly possible – but is it likely?

Table 1

Portfolio Exposure[2]
(% of 2018 invested assets)

	Life	P&C	Health
BBB (NAIC 2)	25.3	10.3	10.8
BB (NAIC 3)	2.4	1.3	1.9
B (NAIC 4)	1.1	1.0	1.3

Risk Based Capital (RBC) C1 Charges (%)

	Life*	P&C	Health
BBB (NAIC 2)	1.3	1.0	1.0
BB (NAIC 3)	4.6	2.0	2.0
B (NAIC 4)	10.0	4.5	4.5

*pre-tax

There is little doubt that with an economic slowdown caused by COVID-19, downgrades will increase. However, it is important to acknowledge that the bulk of these downgrades will likely be issuers that were already below investment grade before the slowdown; by definition, these issuers' creditworthiness is more challenged than their investment grade counterparts irrespective of the economic backdrop. Underscoring this, recently S&P noted that roughly 80% of the ratings action taken since early February have been on issuers that were already considered high yield. While this warrants close monitoring as well, high yield exposure is quite low throughout the insurance industry, representing less than 5% of invested assets.[3]

1 Source: Moody's Data Report, Global corporate ratings transitions during recessions, 10/14/2019. Most recent available disclosure available.
2 Source: SNL, as of 12/31/2018. Most recent available disclosure available.
3 Source: SNL, as of 4/28/2020

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Downgrades in Recessions

Returning to the BBB-rated cohort, one could examine downgrade experience in past recessions to estimate what may happen following the COVID-19 experience. In table 2 below, we have analyzed Moody's data from 3 previous recessions – 1990, 2001, and 2008[4] – and we have added an even more conservative scenario assuming twice as many downgrades as the worst experienced in these three recessions. A few things are striking about these results: first, the insurance industry is very highly capitalized going into this economic slowdown. Second, P&C and Health companies have very little sensitivity to downgrades compared to Life because their initial BBB exposure is lower and RBC charges do not increase as much from BBB to BB. And third, even assuming significant downgrades do occur, RBC multiples are likely to remain strong.

Table 2: Downgrade rates - Worst 12m Cohorts from Prior Recessions

	1990	2001	2008	2x worst
BBB (NAIC 2)	8.4%	7.4%	5.4%	16.8%

RBC Multiples (%)	Life	P&C	Health
Initial	415-425	300-310	310-320
Assuming 1990 Downgrades	400-410	300-310	310-320
Assuming 2001 Downgrades	400-410	300-310	310-320
Assuming 2008 Downgrades	400-410	300-310	310-320
Assuming 2x Worst Case	390-400	300-310	310-320

Source: Moody's Data Report, Global corporate ratings transitions during recessions, 10/14/2019

In addition to the RBC estimates above, it is important to recognize the efforts being made by policymakers to limit the economic harm from the COVID-19 pandemic. In the U.S., the Federal Reserve ("the Fed") has undertaken a number of aggressive measures including slashing interest rates, providing massive liquidity, purchasing new corporate bonds via the Primary Market Corporate Credit Facility, and purchasing existing corporate bonds and bond ETFs via the Secondary Market Corporate Credit Facility. And in a second round of measures, the Fed has changed its terms on the corporate buying program to include fallen angel debt. If a company was rated BBB before March 20, 2020 and is now rated BB- or higher, it is eligible for this program. Meanwhile, the federal government has passed multiple relief packages releasing trillions of dollars to support families, education and public health groups, business, and state & local governments.

This should not be viewed as a call for complacency; it is clear the COVID-19 pandemic is unlike anything experienced in recent memory, and the economic consequences will be significant. Likewise, it is important to acknowledge that while this analysis holds many other factors constant, in reality there are myriad ways insurers' capital levels are being affected in the current environment. But we do believe insurance companies are well-positioned to manage through this crisis, and rather than implementing large adjustments in credit portfolios immediately, it may be best for insurers to continue monitoring developments and selectively adjusting exposures as conditions evolve.

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4 Moody's methodology examines monthly cohorts throughout the recessionary period and reports results for the worst-performing cohort (i.e. the cohort with the worst 12-month rating drift).