Insurers' credit quality remains resilient amid Covid-19 pandemic but future risk remains

by Li Mengyan

The Covid-19 outbreak has been a thorn for the global insurance industry[1] on various fronts. Despite the challenges that insurers are facing, their credit quality remains resilient as indicated by the NUS-CRI Aggregate (median) 1-year Probability of Default (Agg PD) in Figure 1. Overall, the Agg PD of the insurance industry has been relatively stable, only slightly increasing from 4bps to 10bps in March and remaining at a low level. Manageable claims and strong capitalization levels are factors that might have contributed to the industry's resilience. Nonetheless, a longer than expected Covid-19 outbreak and decline in their investment portfolios could pose a risk to the industry's credit profile.

The insurance industry currently has a strong balance sheet position supported by satisfactory capital adequacy. In the US, a recent stress test to gauge the capital position of insurers of life, health, property and casualty results shows that most insurance companies have adequate capital resources to cushion the potential loss due to the Covid-19 pandemic. Meanwhile, European insurance companies are also able to keep their capital ratio over regulatory levels and remain safe. Insurers are also having no difficulty to repay their debt or getting access to the bond markets to roll over their maturing debt during the pandemic since investors are attracted by the diversified, highly-rated bonds issued by insurers.

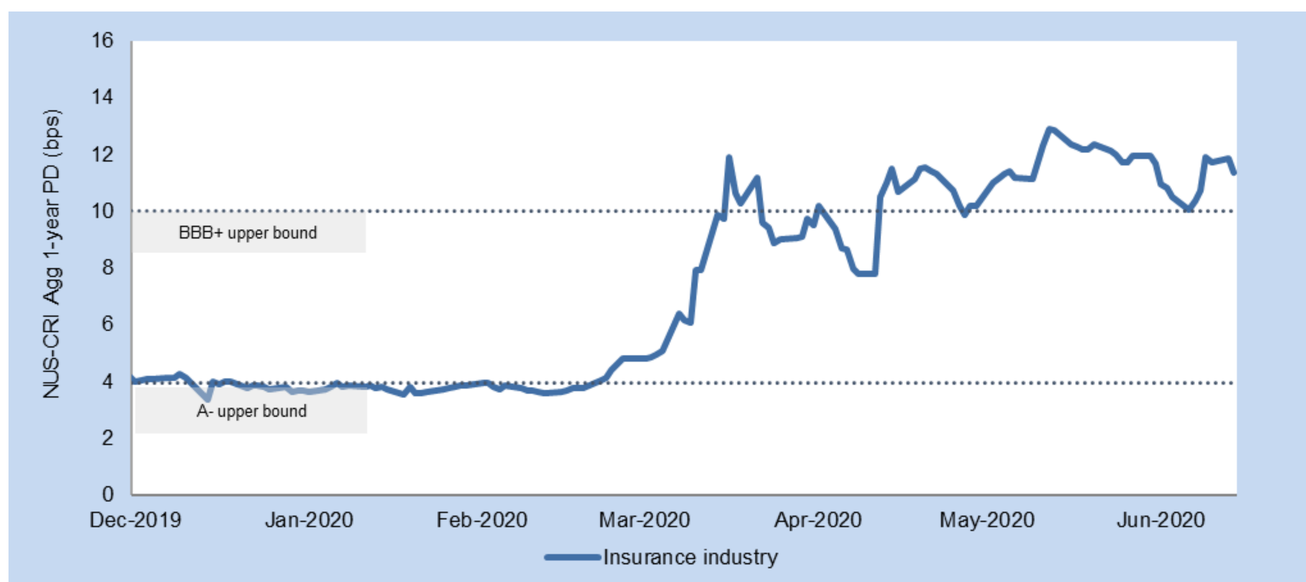

Figure 1: NUS-CRI Aggregate 1-year PD for globally listed companies in insurance industry from Dec 2019 to Jun 2020 bounded by PDiR2.0[2]; *Source: NUS-CRI.*

Despite their current high capitalization level and relatively healthy credit profiles, insurance companies were not spared from the Covid-19 pandemic. Almost all segments of the insurance industry have witnessed a drastic profit decline in 2020 (Figure 2a) due to an increase in claim pay-outs, lower insurance premium and high market volatility. The estimated amount of claims that insurers are likely to face varies widely with projections ranging from USD 40bn to 100bn and the amount could further rise if the lockdown continues. During the lockdown period, P/C insurers are

[1] The insurance industry includes Life/health, Property/Casualty (P/C) insurers, multi-line insurance and reinsurance companies.
[2] The Probability of Default implied Rating version 2.0 (PDiR2.0) provides a more familiar interpretation through mapping the NUS-CRI 1-year PDs to the S&P letter grades. The method targets S&P's historical credit rating migration experience exhibited by its global corporate rating pool instead of relying solely on the reported default rates.

seeing increasing volume of claims related to workers' compensation, events cancellation, etc. Nevertheless, the claims are nowhere close to the level seen during the SARS outbreak as most of the insurance contracts exclude the impact of communicable diseases on business interruption after the 2002-2003 SARS epidemic. Life/health insurers face modest increase in health insurance claims to cover hospitalizations for people infected by Covid-19 and life claims for death. Reinsurance business also get hurt from the mortality claims and losses from numerous lines of business, while the possibility of an increase of natural disasters also weighs on earnings.

Some segments have also seen their insurance premium, one of the major revenue sources of the insurance industry, to drop. The underwriting loss of insurance industry due to Covid-19 pandemic is estimated to reach as high as USD 107bn. Automobile insurers have also seen their income from their insurance premium declined due to the drop of automobile sales, although the shut-down of business activity and lower miles drive lead to lower insurable losses. Similarly, travel insurers' revenue has declined, since many flights are cancelled and tourism is restricted. For Life/health insurers, although they have enjoyed increasing demand for business and they can continue to sell products during the pandemic thanks to the digitization of tools and processes, they might need to tally up the cost of Covid-19 tests, as proposed by the US Congress.

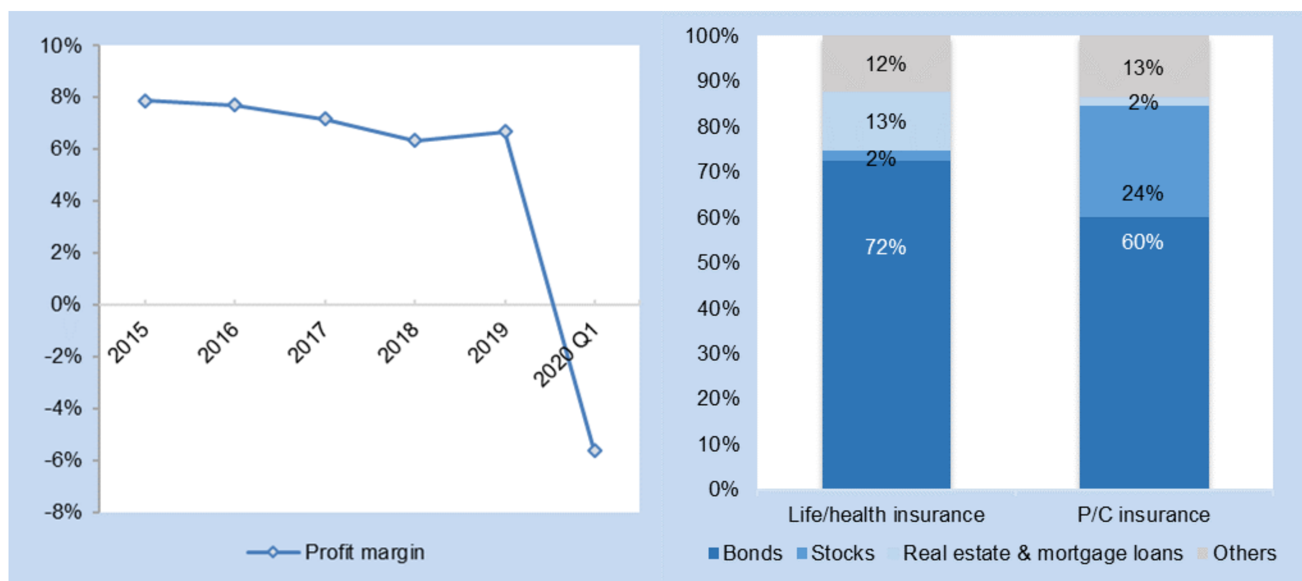

Figure 2a (LHS): Industry average net profit margin of insurance companies over years; Figure 2b (RHS): Investment assets breakdown for Life/health insurance and P/C insurance companies as of 2019. *Source: Bloomberg, NAIC data.*

Apart from the pressure of claim pay-outs and underwriting premiums, market risk also exists on the mixture of assets invested by insurers. Insurers' investment losses caused by Covid-19 are projected to reach USD 96bn. Figure 2b shows the investment assets by category for Life/health and P/C insurers. Bonds account for more than 60% of investments for both sectors, while P/C insurers have higher exposure to the equity market compared to Life/health insurers. Unexpected movements in the bond and stock market might hurt their investment profit. Moreover, insurers are getting more exposed to riskier corporate bond markets for the last few years in the hunt for yield. The proportion of BBB bond investments had gone up from under a third of the life insurers' corporate bond portfolios in 2012 to 43% this year. If the bonds fall below investment grade, insurers would have to sell them or hold more capital against them. On top of that, insurance firms are also gradually increasing their exposure to collateralized loan obligations (CLO) over the years. This exposes insurers to double their regulatory capital held against these CLO holdings if there happens to be a one-notch downgrade from the lowest tranches of investment grade to non-investment grade, further pressuring insurers' capital adequacy.

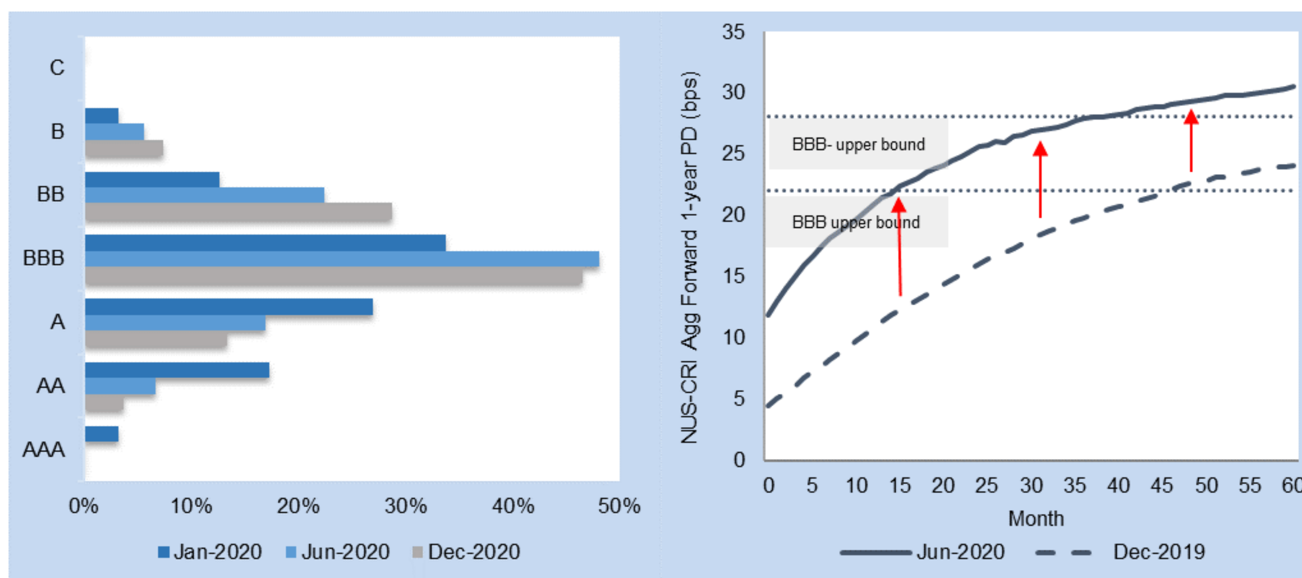

Figure 3a (LHS): PDiR2.0 of insurance industry as of past (Jan 2020), current (Jun 2020) and future (predicted Dec 2020); Figure 3b (RHS): NUS-CRI Aggregate Forward 1-year PD of globally listed insurance companies based on information available in Dec 2019 and Jun 2020. *Source: NUS-CRI*

In all, the credit quality of the insurance industry remains resilient at this point, but credit risk could continue to increase if the Covid-19 outbreak lasts longer than expected. In fact, the biggest risk that the industry faces is from volatility in financial markets which can have a significant adverse impact on their investment portfolio. This is over and above the risk from higher claims and lower underwriting premium due to the weaker economy as premiums are highly related to GDP growth. As shown in Figure 3a, the insurance industry's credit profile has migrated downwards to lower rating levels during the pandemic as per PDiR2.0. There is now a significant increase in the number of insurance companies with a credit profile weaker than the 'A' rating category, compared to Jan 2020 as per PDiR2.0. Looking ahead, we expect the same trend to continue over the next 6 months indicating a worsening credit outlook for the insurance industry. The higher credit risk can be also reflected by the NUS-CRI Aggregate (median) Forward 1-year Probability of Default[3] (Forward PD) in Figure 3b. The industry's Agg Forward PD based on information available in Jun 2020 is upward sloping, with a steeper slope and higher absolute value compared with the Agg Forward PD based on information available in Dec 2019, indicating a higher credit risk in the future.

Credit News

American companies find willing buyers of debt abroad

Jun 28. Due to the Federal Reserve's measures to keep credits flowing through the economy and the attractive yields of US corporate debt, overseas investors started to buy more US corporate bonds. This development could help to prevent an increase in borrowing costs while US companies borrow more debt. Last week, the yield to maturity of investment-grade US corporate bonds included in an ICE BofA index was 2.26%, whereas bonds in a parallel index for Japan only paid 0.52% and the eurozone's investment-grade bonds yielded 0.9%. To avoid being hit by a weakening of the dollar, most overseas investors hedge some or all of their US corporate bonds back into their domestic currencies. At the same time, investors benefit from low currency-hedging costs for yen and euros, which dropped by about 2% since last year. (WSJ)

[3] The Forward PD estimates the credit risk of a company in a future period, which can be interpreted similar to a forward interest rate. For example, the 6-month Forward 1-year PD is the probability that the firm defaults during the period from 6 months onwards to 1 year plus 6 months, conditional on the firm's survival in the next 6 months.

CLOs seek to tie assets to loan index after missing out on Covid selloff

Jun 26. US Collateralized Loan Obligation (CLO) managers are pushing to purchase loans at reduced prices by tying the price at which loans can be added to their portfolios to a leveraged loan index. This allows CLO firms to take better advantage of the falling prices of the loans in March since the index is responsive to market volatility. Hence, if a discount obligation was defined as a percentage lower than a loan index instead of a fixed price, it would have allowed CLO firms to benefit from the loans traded off in March. In the meantime, some CLO firms are also pushing to increase the flexibility of buying distressed loans. Currently, CLO firms cannot buy assets trading below a certain threshold, putting them at a disadvantage to hedge funds and distressed debt lenders. (Reuters)

Riskiest US companies are left behind in rush to buy debt

Jun 26. Many lowest-rated companies in the US are struggling to raise cash despite the recovery in the bond markets. More than 100 US companies have defaulted on their debt so far this year, according to S&P. Bankers argue that funding is available, even for the riskiest firms - but not always at a favorable price. However, some analysts and fund managers acknowledge that for many businesses, despite the Fed's support, brighter funding conditions may be too little, too late. (FT)

US airlines raise USD 10bn in a week

Jun 25. American Airlines, Alaska Airlines and United Airlines increased their debt and equity fundraising to nearly USD 10bn by taking loans and raising their amount of secured bonds. As collateral, they used American's routes, slots and gates at global airports, aircraft, brands, member data or cash accounts of frequent flyer programs. Currently, the Federal Reserve raises liquidity to be in a position for the recovery This year, US airlines raised a total of about USD 46.5bn on top of the USD 50bn government aid package from March. However, investors have been discriminating based on which airline is coming to market. While Alaska Airline pays 4.8% interest on its seven-year debt, American Airlines pays a coupon of 11.75% on its five-year bond. (FT)

Record number of US companies seek relief on loan terms

Jun 24. In May, a record number of 43 US companies sought loan amendments after rising debts and falling revenues left them at risk of breaching the terms of their borrowing, according to a unit in S&P Global Market Intelligence. The lockdown has reduced earnings and forced some companies to take on more debt to survive the economic downturn, causing businesses to be at risk of breaching loan covenants such as exceeding the permitted leverage and liquidity ratios. Most creditors are willing to relax the terms since COVID-19 is 'one time' in nature. Vast majority amendments were to "pro-rata" loan packages which are term loans and emergency bank credit lines that have been drawn by companies desperate for cash. Some companies managed to avoid breaching covenants by using other means such as using last year's profit figures or adding back profits expected without COVID-19. (FT)

Occidental Petroleum sells USD 2bn in debut junk bond deal (Bloomberg)

Mexico's Grupo Famsa seeks Chapter 11 protection (Reuters)

Muzak owner heads back to bankruptcy for new debt-cutting effort (Bloomberg)

Regulatory Updates

'Too big to fail' banking reforms hailed by Financial Stability Board

Jun 29. Reforms to stop the world's largest banks being "too big to fail" have made the lenders more resilient and less susceptible to risky behavior than before the 2008 financial crisis. Not only global systemically important banks (GSIBs) are now better capitalized and have built up more capacity to absorb losses, moral hazard problem has also declined. However, gaps still remain in the new regulatory regime. One area for improvement is the procedure for winding-down a failing lender. IT reliability and sophistication have also been a key problem, considering the advances in technology and data management in recent years. (FT)

Fed balance sheet shrinks as the use of emergency facilities level out

Jun 26. Despite the US central bank bringing about another lending program, The Federal Reserve's emergency lending facilities usage increased only slightly. According to Financial Times calculations, just USD 103bn of the Fed's firepower has been deployed since the release of the new program, which is only 4% of the USD 2.6tn the central bank budgeted, underscoring the strength of the financial recovery it helped to propel. Overall, the Fed's balance sheet fell for the second consecutive week to USD 7.1tn with the decline in demand for the Fed's dollar swap lines from foreign central banks cited to be one of the primary reasons. The Fed is currently launching eleven emergency facilities that allow the central bank to make asset purchases in "unusual and exigent circumstances". Out of the eleven, most of the launched facilities such as the Primary Dealer Credit Facility, Municipal Liquidity Facility and the Commercial Paper Funding Facility usages had leveled. (FT)

Indonesia central bank may buy government bonds with zero to low yields (Reuters)

EU delays reform to futures market by a year (FT)

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