Big BBB debt rollover is just three years away: A.M. Best

By Editorial Staff *Thu, Dec 5, 2019*

The next downturn will be characterized more by ratings transitions than large-scale impairments, AM Best said, because the non-cyclical industries issuing much of the BBB debt often maintain stable cash flows and remain resilient during downturns.

By year-end 2022, $2.5 trillion of the debt of U.S. investment-grade corporations will mature, accounting for roughly half the U.S. investment-grade corporate bond market. Of those maturing bonds, 34% is rated BBB, according to a new AM Best Special Report.

"Given that these bonds must be refinanced or repaid by then, close attention should be paid in the next few years to the interest rate environment, credit spreads and ratings issued to bonds," the ratings agency warned in a press release this week.

The Best's Special Report, "U.S. Life/Annuity Insurers' BBB Bond Exposures Continue to Grow," notes that the U.S. life/annuity industry has increased its bond allocations to NAIC Class 2 Securities markedly over the last decade, to more than 34% of overall holdings from 27% in 2009, as current market trends remain attractive for BBB debt issuance.

The prolonged low interest rate environment remains conducive for debt issuance, and debt issuance by non-cyclical consumer-focused industries (e.g., pharmaceuticals, telecommunications, cable, utilities, technology, food and beverage and health care) has been growing.

But AM Best believes that the next downturn will be characterized more by ratings transitions than large-scale impairments, because those industries often remain resilient during economic downturns. Their stable cash flows could mitigate concern about BBB bonds' greater sensitivity to credit deterioration.

Life/annuity insurers with higher BBB bond exposures are writing in very competitive lines of business, for which yield enhancement is important. These insurers have consistently held the highest percentage of Class 2 bonds (rated the equivalent of BBB+ to BBB-). Their allocation to Class 2 bonds remains weighted toward the BBB category, these holdings have declined in more-recent years to 43% in 2018 from 51% in 2013.

Allocations to the BBB+ and BBB- categories have increased by roughly similar percentages of the BBB drop, to 34.1% and 23.2%, respectively, in 2018, for life/annuity insurers. During the same 2009-2018 time frame, U.S. property/casualty and health segments also have increased the holdings of BBB debt to approximately 16% from the 8-9% range.

AM Best considers Class 2 bond exposures in the balance-sheet strength and operating performance assessments of its rating process. Liquidity risks also need to be considered, particularly as blocks of business age and policyholder behavior trends emerge from what was expected. As the products being sold become less interest-rate-sensitive, AM Best anticipates that the level of BBB holdings will drop off.