
P/C Insurers Shifting Investments Out of Municipal Bond Market: Best

Property/casualty insurers are shifting investments out of the municipal bond market due to corporate tax reform, but will need to monitor continuing Federal Reserve rate hikes for their impact on their investment portfolios, according to a new report by A.M. Best Co. Inc.

Historically, municipal bonds have been an “integral part” of the property/casualty segment’s investment portfolio due to low default rates and attractive tax-equivalent yields, the Oldwick, New Jersey-based ratings agency said in a report released on Monday. The segment held $428.1 billion in municipal bonds at year-end 2016, but that figure declined to $413.0 billion at year-end 2017.

“Insurers are beginning to shift away from these assets now that the tax-equivalent yield has become less attractive,” the report stated. “A.M. Best expects this trend to continue over the next several years, as bond holdings come to maturity and the proceeds are reinvested in government bonds and high-quality corporates, which are now offering more attractive after-tax yields. However, municipal bonds will always have a place in an insurer’s fixed-income portfolio, given their diversification, high credit ratings and low historical default levels.”

The property/casualty’s total invested asset base in 2017 was $1.7 trillion – a $299 billion increase during the preceding 5-year period – consisting of about 58.0% bonds, 19.1% stocks, 6.7% cash and short-term investments, 11.2% affiliated investments and 5.0% in all other investments, according to Best.

Net investment income of $51.1 billion, accounting for a 3.1% investment yield, more than offset a segment-wide underwriting loss of $24.9 billion, driven by a significant rise in the frequency and severity of natural catastrophes, according to Best. The segment operating ratio, meaning its combined ratio minus the net investment ratio, increased to 94.6% in 2017 from 91.7% in 2016 owing to substantial underwriting losses, according to Best.

But U.S. property/casualty insurers “may need to re-examine their investment policies to maximize their returns while continuing to service their liabilities to policyholders” amid expectations that growth will moderate in 2019 as the effects of the tax cuts on consumer spending dissipate, according to Best. In addition, government spending, the other recent driver of economic growth, is set to end September 2019, when the agreement between the White House and Congress to increase spending caps ends, Best noted. The International Monetary Fund is projecting 2.5% GDP growth for the United States in 2019, down from the projected 2.9% growth in 2018.

Property/casualty insurers “will need to keep an eye on moves by the Fed” as the frequency of rate hikes increased in 2018 compared with 2017, with the Federal Reserve expected to raise rates a fourth time in December 2018, Best stated in the report. In addition, the European Central Bank is expected to end its 3-year €2.4 trillion bond buying program at its next meeting in December.

“As monetary policy tightens, conditions for global economic growth are tilted to the downside and include the potential for an escalation in U.S. trade policies with both the EU and China, volatile geopolitical tensions, and high levels of debt for consumers, governments and corporations," Best said. "Globally, market observers expect yields to rise across the curve. Changes in market conditions could lead to insurers re-examining portfolio metrics such as asset allocations, credit quality and durations. With yields back on the rise, insurers will also have to balance the risk/reward tradeoffs with their equity allocations, particularly in a market in which valuations have been stretched from historic norms."

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