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Best's Special Report: Pandemic Creates a Severe Test for Municipal Bond Market

Given the severe medium-term impacts on the municipal bond markets driven by the pandemic, U.S. insurance companies with more significant exposures, particularly revenue bonds for the more vulnerable sectors such as transportation and retail, are more likely to feel the negative market effects, according to a new AM Best special report.

The significant decline in revenue of states and cities during the COVID-19 pandemic likely will affect municipal bondholders. The Best's Special Report, titled, "Severe Test for the Municipal Bond Market" states that insurers' municipal bond exposures are significant. Additionally, more than two thirds of the municipal bonds held by insurers are from 15 states, including states hard hit by the pandemic, such as New York, New Jersey, Illinois, Massachusetts and California. Of the three major insurance segments, property/casualty insurers have the greatest municipal bond exposure, although it has decreased by 20% since 2016, when the Tax Cuts and Jobs Act made the tax-exempt status of this asset class less advantageous. Nevertheless, the segment's exposures remain considerable, as municipal bonds constitute nearly 14% of the property/casualty segment's invested assets, compared with 12% and 4.1% for the health and life/annuity segments, respectively. The life/annuity segment's municipal bond exposures represent 42% of their capital and surplus, exceeding that of other two segments. Companies rated by AM Best account for nearly 90% of the insurance industry's municipal bond holdings.

Given their relative value and tax-exempt characteristics, municipal bonds will continue to play a role in an insurer's strategic asset allocation. However, selecting appropriate exposures will be critical to insurers' ability to manage through this tumultuous cycle. "The expertise and risk management practices of insurers and their investment managers will be tested," said Jason Hopper, associate director, industry research and analytics. "Insurers that have a deep understanding of the municipal bond markets and well-defined risk thresholds based on solid credit risk fundamentals will perform better during and after the pandemic crisis."

All asset classes have been affected by the pandemic, providing yet another illustration of rising correlations during times of stress. AM Best will continue to monitor the overall impact of deteriorating conditions on insurers' ability to maintain adequate capital appropriate for their business and investment risks.

To access the full copy of this special report, please visit http://www3.ambest.com/bestweek/purchase.asp?record_code=297861.

To view a video discussion with Hopper about the report, please go to http://www.ambest.com/v.asp?v=municipalbonds620.

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