
INDUSTRY ALERT

# Is Default Risk the Next Big Challenge?

*With a wave of downgrades across the lending industry, here's what insurers need to know about the state of the market.*

When insurers invest premiums generated from policies, it is critical that they *add* to the bottom line and avoid loss of principal, which is needed to service liability claims. In short, insurers need to carefully balance their fiduciary responsibilities to policyholders, shareholders and other constituents, while actively managing investment risk, operational risk, surplus capital and liabilities.

As interest rates have risen rapidly over the past two years, traditional commercial banks have tightened lending and investing activities. Insurers have seen an opportunity to step in and capitalize on commercial and private credit, as well as alternative investments. In particular, residential and commercial mortgage back securities (RMBS/CMBS) as well as direct/whole loans and collateralized loan obligations (CLOs) have offered higher yields, and at the same time are shorter in duration and have interest income sensitivity to interest rate fluctuations. These instruments have been particularly popular with life and annuity insurers, who are looking to capture incremental yield off of these shorter duration investments.

But, economic conditions have shifted and brought the potential for added risk to commercial and private credit investments. The perfect storm of higher inflation, a slower 'return to office' trend and significantly higher interest rates, are increasing the default rate on retail and office commercial real estate (CRE) debt. CRE owners find themselves in a position of lower occupancy, higher labor and maintenance costs, and a potential need to refinance their buildings at significantly higher interest rates. This, coupled with lower values of the underlying collateral for these loans, exacerbates the potential of a default scenario.

At the same time, credit spreads have become more volatile with a number of these financial instruments experiencing downgrades. These downgrades increase insurers' risk-based capital (RBC) haircuts and the amount of capital required to support the investment portfolio.

Faced with the likelihood of increasing default rates, what can insurers do to manage and hedge against this risk in their current investment portfolios?

## Default Risk: Becoming Clearer

Ratings Agencies and other market analysts expect credit default rates to rise in 2024 and macroeconomic headwinds, weaker US growth and 'higher for longer' rates to persist. US leveraged loan defaults are expected to jump to 3.5-4.0%, while US High Yield ('junk') bond default rates are expected to rise to 5.0-5.5%, both rising from the 3.0-3.5% default levels from 2023.[1] A similar trend is developing in US CRE, where office vacancy rates in major US cities are near 20%, the highest since the 1970s. This has resulted in the highest level of delinquencies (c. $18bn) in a decade in 2023[2], with the collapse of "WeWork" the most high profile example.

Case in point: "Tokyo-based Aozora bank shares have tumbled to their lowest level since February 2021 after the Japanese bank warned of a fiscal-year net loss due to its exposure to U.S. office loans." Aozora's announcement came shortly after US regional bank, New York Community Bancorp, announced a surprise net loss of $252 million for the fourth quarter, slashing its dividend and saying it "[built] reserves during the quarter to address weakness in the office sector."[3]

In a recent Chief Investment Officer article, Tuck Hardie, managing director in the financial restructuring group at investment bank Houlihan Lokey, notes that there are loans maturing this year and next that were written when interest rates were significantly lower. Companies may now find they cannot afford to refinance at a higher rate. That pressure is likely to be most acute in the middle market, where significant private credit activity is focused and where businesses have fewer financing options overall.[4]

**Figure 1**

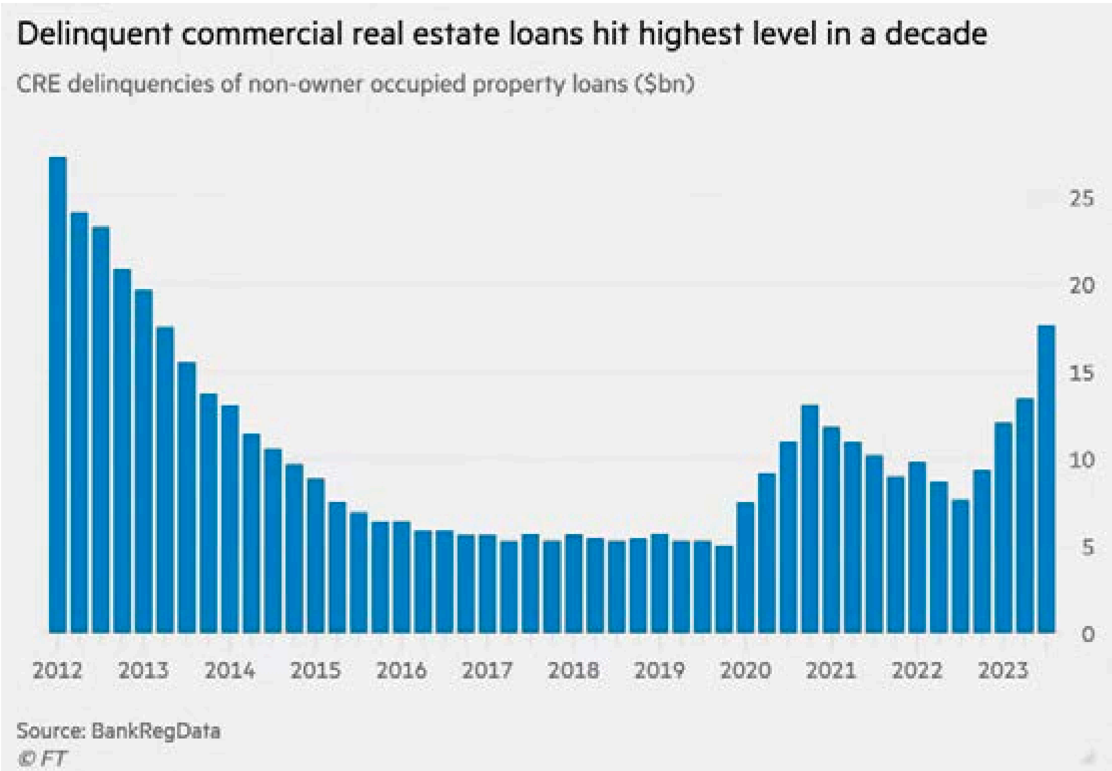


**Figure 1:** "Overdue commercial property loans hit 10-year high at US banks," Financial Times. Nov 8, 2023

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1 Fitch wire, "Leveraged Loan, High Yield Default to Rise in 2024, Fall in 2025," Dec 4, 2023
2 Financial Times, "Overdue commercial property loans hit 10-year high at US banks," Nov 8, 2023
3 CNBC, "Japan's Aozora Bank hits near 3-year lows as bad U.S. property loans prompt loss forecast," Feb 1, 2024
4 Chief Investment Officer, "Private Credit is Changing Everything Even Bankruptcy," Jan 29, 2024

> "Fitch Ratings projects the delinquency rate of commercial mortgage loans that have been converted into securities will increase to 4.5% in 2024 and to 4.9% in 2025 – more than doubling the 2.25% rate in 2023 as of November."[5]
>
> — WALL STREET JOURNAL

In Q2 2023, there were 120 leveraged loan downgrades amounting to $136 billion in the US, the highest total in three years.[6] This worrying trend is likely to persist into 2024, which will put pressure on the US CLO market, where there is a cap of 7.5% on holdings of weaker, CCC – rated tranches. For insurers holding CLO equity positions, this is particularly troubling.

According to FTI Consulting's analysis, "The ascent of private credit likely is having some indirect impact on the default rate, as more non-bank lenders opt for credit estimates (or less) and forgo a full credit evaluation process by the rating agencies for some of their loan exposures, thereby excluding these companies from the pool of issuers tracked by the rating agencies should they later default. Consequently, we believe that, in time, the speculative-grade debt default rate could become a less representative proxy of large corporate failure, if it isn't happening already."[7]

For US Insurance companies, the implications could be significant, as the capital necessary to grow their businesses is consumed by increasing RBC requirements. But, it's not all bleak. Insurers can prepare for this with the right tools and expertise.

## Minimize Risk

As portfolio assets change and default risk increases, some insurers will struggle to obtain a single view of risk across an organization, which makes it even more challenging to set and monitor risk. Poorly defined risk frameworks, controls and associated risk appetite can impact an organization in multiple ways – first with a potential for unwanted risk accumulation across the portfolio, and conversely the potential for overly conservative investment decisions, higher credit losses and lower returns on investment.

For institutions in this environment, having a robust risk framework that incorporates both assets and liabilities to accurately measure credit exposure on a consolidated and real-time basis is mission-critical, especially as markets dislocate and liquidity dries up. Senior management and Chief Risk Officers require a comprehensive view of risk across the entire institution and need to actively monitor their risk appetite across a variety of lenses with early warning signals, while traders and portfolio managers can more effectively manage day-to-day risk accurately on a real-time basis.


[5] Wall Street Journal, "The Bill is Coming Due on a Record Amount of Commercial Debt," Jan 16, 2024
[6] Financial Times, "US Junk Market Hit with Flurry of Credit Rating Downgrades," July 23, 2023
[7] Chief Investment Officer, "Private Credit is Changing Everything Even Bankruptcy," Jan 29, 2024

## 6 Considerations to Minimize Risk

1. **Account for credit, asset-backed and alternative investments:** Leverage a provider and system that can accurately and promptly provide timely valuation updates, event notice processing and expected vs. actual cash flow modeling.
2. **Deploy sophisticated risk tools:** Ensure you have access to tools that can take into account both assets and liabilities when modeling out potential shifts to interest rates, credit spreads and default rates, to understand the true potential impact on P&L and cash flow. These tools should also allow you to have consolidated view of your portfolio and allow you to overlay and monitor risk appetite at all relevant levels with appropriate early warning signals.
3. **Leverage derivative instruments:** Instruments such as interest rate or credit default swaps can hedge against further fluctuations in interest rates and default rates. An advanced valuation platform allows accurate modelling and monitoring of liquidity risk implications.
4. **The benefit of one platform:** Be sure your accounting system can properly process and account for both the underlying investments and the derivatives in the same platform, as well as establish the appropriate hedge links between them.
5. **Integrated credit risk simulations:** Look for tools that deliver large-scale stochastic Monte Carlo simulations to precisely calculate the impact of default and migration together with market risks. This joint evaluation in a correlated framework allows insurers to obtain capital consumption and full loss distributions.
6. **Scenario analysis and stress testing:** Conditions that have not yet materialized – including plausible market stress events and the potential impact of externalities such as ESG and climate risk related shocks – should also be included in the risk management purview.

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