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The Potential Impact of COVID-19 to Municipal Bonds Held by Insurers

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Executive Summary

- Municipal bonds (Munis) make up a significant portion of property/casualty (P/C) insurers' cash and invested assets (13% or $272 billion as of Dec. 31, 2019).
- Munis make up $492.6 billion or 7% of total U.S. insurers' cash and invested assets.
- More at-risk special revenue bonds make up 6% of P/C insurers' invested assets.
- The virus is a more immediate threat to $126.6 billion in Munis that derive revenue from airports, hotels, tax revenue and transportation.

P/C insurers have significant exposure to Munis that may be significantly affected by COVID-19 and its effects on the economy. Munis make up 13% or $272 billion of P/C insurers' cash and invested assets and $492.6 billion or 7% of all insurers' cash and invested assets as of year-end 2019 (see Table 1). Special revenue bonds backed by airport and toll road revenues and revenues from travel and tourism-related activities are most at risk. Special revenue bonds make up 6% of P/C insurers' cash and invested assets. Related activities and dedicated taxes that are travel-dependent, such as hotel tax and sales tax in tourist-driven economies, as well as mass transportation systems that are reliant on user fees, will lead to reduced revenues for municipalities.

Table 1: Year-End 2019 Municipal Bond Holdings by Industry Type
(BACV, in $millions)

2019	P/C	Life	Health	Fraternal	Title	Total
Municipal Bond Holdings	$ 272,041	$ 194,180	$ 17,564	$ 7,795	$ 1,090	$ 492,670
Invested Assets Total	$ 2,134,737	$ 4,436,174	$ 222,498	$ 146,705	$ 10,636	$ 6,950,749
% of Invested Assets	13%	4%	8%	5%	10%	7%

Moody's Investors Service (Moody's) revised its Public Finance sector outlook to negative from stable for airports, toll roads, not-for-profit and public healthcare, and higher education on March 20.[1] Standard & Poor's (S&P) revised its Public Finance sector outlook to negative for all sectors on April 1. Munis tied to these and other revenue sectors anticipated to be affected total $71 billion for P/C insurers or $126.6 billion across the U.S. insurance industry (see Table 2).

[1] Moody's Investor Services, Public Finance, Sector in-depth report, March 20, 2020.

Table 2: Year-End 2019 Municipal Bond Holdings Associated with Potentially Disrupted Revenue Streams (BACV, in $millions)

Bond Description	Bond Sub Description	P/C	Life	Health	Title	Total
Domestic Revenue Bond	Airport	$6,187	$3,784	$832	$42	$10,846
	Education	$4,348	$3,109	$293	$19	$7,770
	Health	$3,249	$1,894	$577	$17	$5,738
	Higher Education	$13,611	$9,896	$905	$54	$24,466
	Hotel/Motel/Inn	$51	$116	$4	$0	$170
	Metropolitan District	$85	$28	$11	$0	$125
	Nursing Homes	$99	$22	$3	$0	$124
	Tax-Revenue	$13,181	$13,183	$1,165	$27	$27,557
	Transportation	$17,141	$8,911	$1,619	$82	$27,753
Domestic Revenue Bond Total		**$57,952**	**$40,944**	**$5,411**	**$241**	**$104,548**
Domestic General Obligation Bond	Airport	$51	$5	$4	$0	$60
	Education	$1,297	$716	$25	$2	$2,038
	Health	$199	$56	$2	$1	$258
	Higher Education	$3,853	$1,615	$122	$3	$5,593
	Hotel/Motel/Inn	$4	$0	$0	$0	$4
	Metropolitan District	$176	$37	$2	$0	$216
	Nursing Homes	$0	$0	$0	$0	$0
	Tax-Revenue	$4,548	$2,857	$294	$5	$7,703
	Transportation	$2,940	$3,025	$237	$5	$6,207
Domestic General Obligation Bond Total		**$13,067**	**$8,311**	**$686**	**$15**	**$22,080**
Grand Total		**$71,020**	**$49,255**	**$6,097**	**$256**	**$126,629**

Other COVID-19 economic factors putting a strain on municipal revenues include the significant state expenditures on emergency healthcare to fight the virus and decreased tax revenue. Closed businesses, less driving and higher unemployment lead to decreased business tax, income tax, gasoline tax and sales tax revenue. Insurance industry exposure to Munis issued by the state's hardest hit by the virus—i.e., CA, NJ and NY—total $105 Billion (see Table 3).

Table 3: Insurer Municipal Bond Exposure to CA, NJ and NY Issues
(BACV, in $millions)

State of Issue (incl. local issues)	Municipal Bonds Held by Indusry	Municipal Bonds Held by Property Insurers
New York	$ 39,400	$ 18,000
New Jersy	$ 12,000	$ 5,700
California	$ 54,000	$ 22,400
Total	**$ 105,400**	**$ 46,100**

The recently enacted "Coronavirus Aid, Relief, and Economic Security" (CARES) Act includes $454 billion to backstop Fed losses on lending directly to businesses, states, and municipalities, as well as $150 billion in direct federal aid to states and municipalities. The Fed has announced a couple of new programs to lend directly to major corporate employers, and says it expects to announce a Main Street Lending Program, a program for lending directly to small businesses soon. However, so far there are no plans in place to lend directly to state and local governments.

The COVID-19 stresses also exacerbate challenges that municipalities had prior to the outbreak. These include, among others, demographic shifts (populations both aging and relocating, which affect tax receipts), substantial increases in pension and retirement healthcare costs, and the alarming exposure to equity markets. The exposure to equity markets is through the public pensions plans which are predominantly invested in equities. For example, of the $215 billion, as of Sept. 30, 2019, the New York State Common Retirement Fund had about 67% or $143 billion in equity exposure. Equity markets down 25% would mean a decrease of the fund's assets by $35.7 billion to $179.3 billion. If equity markets remain down or continue to decline over time, in order to maintain adequate funding, the fund will seek higher contributions from local municipalities at the same time those municipalities are trying to recover from the economic effects of COVID-19.

On the positive side, default rates for Munis are historically very low. The five-year Moody's rated cumulative default rate (CDR) of Munis from 1970–2018 is 0.16%, which is quite low, especially compared to the five-year CDR of 6.2% for global corporates over the same time period.[2] Additionally, the municipal sector overall is highly rated, with approximately 92% of all the municipal credits that Moody's rates falling into the "A" category or higher as of year-end 2018. Further, at year-end 2018, the median rating for U.S. municipal credits was Aa3. This is in sharp contrast to the median rating for global corporates, which was Baa3.

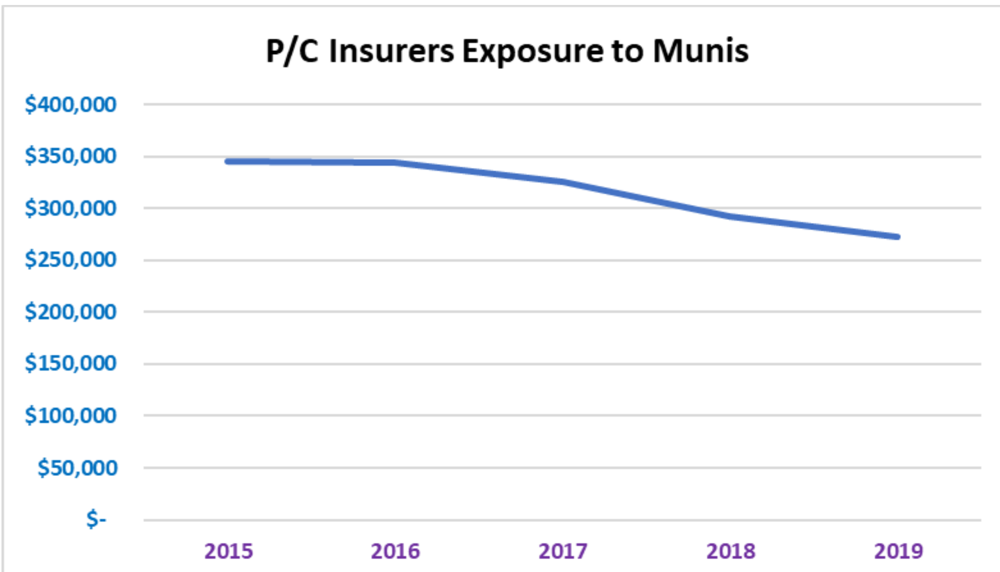
Another mitigating factor protecting insurers against Muni defaults is the insurance provided by financial guarantee insurance or bond insurers. However, if significant defaults materialize, bond insurers' ability to pay claims may become strained. Munis are also protected by debt service reserve funds, in which the issuer has set aside cash to pay for up to a year of debt service in the event that regular sources of repayment or other operations are disrupted. In addition, many insured Muni transactions are protected with legal covenants that require the issuer to adjust tax rates or fees to ensure that budgeted revenues are well in excess of the minimum necessary to pay the debt service. However, in these unprecedented times, the concern is that those reserve funds may be tapped to pay for emergency care. There is also a concern about the ability to adjust or increase taxes if there is no business or wage income to tax.

[2] Moody's Investor Services, Data Report, U.S. Municipal Bond Defaults 1970–2018, Aug. 6, 2019.

Lastly, since the Tax Cuts and Jobs Act (TCJA) made the tax-exempt status of Munis less advantageous to P/C insurers; they have been reducing their exposure to Munis over the last two years (see Table 4). However, even though exposure has been reduced, it is still significant.

Table 4: Municipal Bond Holdings by Industry Type and Year
(BACV, in $millions)

Year	P/C	Life	Health	Fraternal	Title	Total
2019	272,041	194,180	17,564	7,795	1,090	492,670
2018	291,975	195,605	23,176	8,500	1,108	520,364
2017	325,139	194,016	26,277	8,455	1,256	555,143
2016	344,315	183,490	24,677	8,268	1,389	562,138
2015	345,200	177,600	22,700	8,500	1,300	555,300



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