U.S. Insurance Company Earnings Review

Fourth Quarter 2022

MARCH | 2023

SOA Research INSTITUTE

U.S. Insurance Company Earnings Review

Fourth Quarter 2022

AUTHOR With You in Mind

Eric N. Berg, CPA, CFA
Stuart Lippe
William Ellsworth, CFA

SPONSOR Society of Actuaries Research Institute

Editor's Note: The following roundup covers eight major publicly traded life insurers: United States-based Aflac Incorporated, Brighthouse Financial, Lincoln National, MetLife, Principal, Prudential Financial, and Unum, plus Toronto-based Manulife, which operates in the U.S. through its John Hancock subsidiary. The rationale for choosing these carriers was that, together, they provide a broad view of the life insurance industry's four major business segments: individual life insurance, annuities, disability insurance, and group insurance. This roundup is based on Q4 2022 earnings calls to which With You in Mind's team of former Wall Street analysts and portfolio managers brings years of experience following these companies.

CONTENTS

U.S. Insurance Company Earnings Review

Fourth Quarter 2022

Executive Summary

Life insurers' results in the fourth quarter of 2022 reflected an industry in transition, as COVID-related challenges were replaced by concerns over a possible recession in 2023. In the quarter, carriers focused on investment portfolio credit quality, the hedging of risks, balance sheet strength, and expense management — all evidence of a cautious outlook overall.

Their results revealed pockets of strength and weakness. For example, while asset outflows and sagging equity and fixed income values reduced assets under management, revenues, and earnings in asset management operations, sharply higher interest rates drove record sales of fixed and "buffer" annuities. Employer-focused group and retirement businesses benefitted from solid employment and wage growth in all but the largest case markets, with the small- to mid-sized case markets coming in especially strong.

By contrast, variable investment income — that is income generated by alternative investments — was a decided weakness as results significantly lagged companies' long-term targets.

In the category of burdensome but not troubling was the industry-wide, first-of-the-year implementation of the new insurance accounting regime titled Long Duration Targeted Improvements, or LDTI. The verdict rendered in companies' Q4 earnings calls: LDTI may require considerable effort as life insurers recast their 2021 and 2022 financial statements to be comparable with statements beginning in 2023 and moving forward. But the companies emphasized that LDTI is an accounting change; it won't materially affect how they manage their businesses.

Here are highlights of the other themes discussed in this report:

- Variable Investment Income: While private equity/venture capital performance drove much of the lower-than-expected returns in long-term variable investment income, broadly sagging values made real estate another headwind for so-called alternative investment returns.

- Asset Management Business: Poor capital markets returns contributed not only to lower variable investment income, but also to substantial asset outflows for life insurance companies with significant asset management businesses.

- Fixed and "Buffer" Annuities: Despite a challenging environment, life insurers enjoyed strength in these lines of business during the fourth quarter. Indeed, sales levels may have led to a record year for some individual carriers and for the industry.

- Employment**:** Growing employment and wages among small businesses fueled success in group and retirement products, such as 401(k) plans and group life.

- COVID-19 and Related Expenses: Over the past year, these have fallen so significantly that they're no longer pushing mortality and morbidity expenses outside normal ranges. Notably absent from the Q4 calls were lengthy discussions of COVID-19 and where its incidence and mortality rates are headed.

- Recession Concerns: Life insurers are strengthening balance sheets and hedging risks. These kinds of actions during the past two-and-a-half years reflect an increasingly cautious outlook by major insurers regarding markets and the economy.

- Expense Management: Caution also seems to be the word of the day regarding expense management as many insurers are engaging in some form of budget tightening to offset potential revenue shortfalls.

- Long-Duration Targeted Improvements (LDTI): The long-anticipated changes in insurers' accounting rules seem to require considerable effort to implement but are expected to generate little fundamental change to carriers' basic business practices and their underlying financial positions.

Variable Investment Income

Sagging Property Values Join Private Equity as an 'Alternatives' Headwind

Most firms aim for long-term returns in variable income from alternative investments in a tight range around 10 percent annually (approximately 2.5 percent quarterly). But fourth quarter results of our coverage universe tended toward 0 percent, with Lincoln National's +0.4 percent and Brighthouse Financial's -0.2 percent from alternatives reflective of performance across the industry.

Private equity/venture capital returns were a significant driver of these lower-than-expected returns. Private equity results are included in variable investment income with a one quarter lag. Poor third quarter private equity returns, driven by falling equity markets, thus negatively affected Q4 variable investment income. The fallout was made worse by the fact that unlike prior periods, when real estate returns were favorable, real estate values in Q4 broadly declined.

Manulife underscored this one-two punch as it reported that higher discount rates reduced the appraised values of its properties, especially in North America. Manulife also noted that weakness in appraised commercial real estate values was widely based and not concentrated in the office sector, which was already sagging because of employees working fully or in part from home.

Lower prepayment income from mortgages and decreased sales activity also factored into relatively poor real estate contributions to variable investment Income in the fourth quarter. Real estate performance had been strong since mid-2020, in contrast to weak equity (S&P 500 down 18.1 percent, NASDAQ down 32 percent) and fixed income markets (high grade bond indices down 13 percent) in 2022.

Asset Management Businesses

Poor Capital Markets Returns Contribute to Substantial Asset Outflows

Poor capital markets returns contributed not only to lower variable investment income, but also to substantial asset outflows for life insurance companies with significant asset management businesses. At Prudential Global Investment Management, which is the money management business of Prudential Financial, net outflows of $11.7 billion in Q4 2022 ended a year in which assets under management dropped 19 percent to $1.2 trillion from $1.5 trillion. Manulife's Global Wealth and Asset Management business, which houses John Hancock Life's U.S. mutual fund and 401(k) businesses, experienced net outflows of $8.3 billion in Q4 2022, compared to net inflows of $8.1 billion in Q4 2021.

Principal's asset management operations suffered net outflows in the quarter totaling $3 billion. As a counterweight, however, it had positive net inflows of $3.9 billion for all of 2022. In its call, Principal noted strength in the quarter and, indeed, throughout 2022 in its private credit and specialty fixed-income offerings. The company also pointed to increased investor interest in its growth-oriented equity products in 2022's second half.

Fixed and “Buffer” Annuities

Strong Sales Led to a Possible Record Year for the Industry and Individual Carriers

Despite a challenging environment, life insurers enjoyed strength in some lines of business during Q4 2022. Aflac Incorporated ended the year with 10 percent product sales growth, while Unum experienced a 24 percent year-over-year increase in quarterly sales in its flagship Unum U.S. segment, mostly from its group disability business.

Several firms (Brighthouse, Lincoln, Prudential) enjoyed strong sales of fixed annuities and fixed indexed annuities, as these products benefitted from higher interest rates (fixed annuities) and from customers seeking to protect against equity market weakness (fixed indexed annuities). Sales of these products were especially strong in Q4 2022. Indeed, Brighthouse described 2022 in its earnings call as a record year for industry fixed annuity sales as well as its own.

At the same time, Brighthouse observed that net interest margins remained attractive. That’s likely the result of sharply higher yields on investment-grade securities allowing for reasonable interest margins despite attractive customer crediting rates. Registered Index-Linked Annuities (RILAs), a type of “buffer” annuity, emerged as a very popular product in 2022 and is now offered by many of the major life insurers. These annuities differ from fixed indexed annuities in that their customers have downside risk should markets decline. The risk is reduced, however, by the “buffer,” or downside risk reduction offered to the client in the contract.

Will competitive conditions deteriorate in the fixed annuity and buffer annuity markets? So far, there seems to be enough demand to go around for life insurers. But past industry behavior suggests that carriers will eventually compromise on pricing or contract terms to the benefit of customers.

Employment

Strong Small Business Growth Boosts Group and Retirement Businesses

In employer-focused businesses — namely retirement offerings and group insurance — the underlying fundamentals of employment growth and wage increases remained particularly strong in the small business sector. Principal was a major winner in this regard since it’s focused on that sector. The company’s retirement business also enjoyed increases in participant deferrals, company matches, and higher incentive compensation.

Of course, lower markets generated declines in account values, fees, and alternative investment income in Principal’s retirement businesses during 2022. But management said during the earnings call that the company will benefit from passage of SECURE 2.0, a new law increasing tax-free retirement savings options. Other carriers agreed that SECURE 2.0 should expand the U.S. retirement market overall and promote greater plan participation by workers, new plan formations, and higher contributions.

Principal’s focus on the small- to mid-size employer market has paid off from the onset of the COVID pandemic (around February 2020). Since that time, firms with fewer than 250 employees have collectively hired a net 3.7 million individuals, while employers of more than 250 employees have collectively cut a net 800,000 jobs. Principal currently estimates that employment growth in its target small- to mid-sized business market exceeds 4 percent.

By contrast, MetLife is heavily exposed across the large employer market. So, should layoffs in that market continue or broaden, MetLife would face significant headwinds in its U.S. group benefits business.

COVID-19 and Related Claims

Little Discussion as the Pandemic May Be Transitioning to Endemic

Over the past year, COVID-related expenses, most of which affect group business results, have fallen so significantly that they're no longer pushing morbidity and mortality expenses outside normal ranges. And at both MetLife and Lincoln, group life profits rose sharply in Q4 2022 over the year-ago quarter, driven mostly by lower COVID-19 claims.

Unum stated that the disease is in the "endemic" stage: constantly present but restricted to particular places and/or populations. Unum didn't express a view about whether "long COVID" — the lingering and often devastating effects of the disease — would affect disability claims. (The other carriers generally avoided commenting about long COVID.)

Operating mostly in Japan, Aflac functions in a market with a significantly lower COVID-19 death rate than that of the U.S., despite the two countries' relatively similar incidence rate. Like other life insurers, Aflac had little to say about COVID-19 in its Q4 call and didn't try to forecast where incidence and mortality might be heading.

Recession Concerns

Life Insurers Strengthen Balance Sheets and Hedge Risks

Credit strengthening actions over the past two-and-a-half years reflect an increasingly cautious outlook by major life insurers regarding markets and the economy. Consistent with these actions, they have also become more cautious about risk-based capital (RBC) levels and share repurchase — preserving or maximizing the former and moderating the latter — even if they have strong financial positions.

At carriers such as Lincoln, whose risked-based-capital ratio fell significantly to below 400 percent in Q3 2022 because of charges in its universal life insurance business, management seems particularly motivated to replenish lost capital.

Balance sheet strength is also a top priority at Brighthouse, where management said that during 2022 it added a substantial amount of low interest rate protection (through various derivative positions) and began considering as a core element in its business the hedging of interest rate exposure. These moves were likely geared to protect against the adverse consequences the company suffered during prior long periods of unusually low interest rates. Brighthouse also plans to dynamically adjust its hedge portfolio to respond to evolving market conditions.

Lincoln addressed the same concerns when discussing its new hedge program, which focuses on capital protection. Similarly, Unum discussed the fact that it spent heavily throughout 2022 to protect future yields in its long-term-care business. At MetLife, holding company cash is being held at a level $2 billion above its long-term target to provide enhanced financial flexibility should business conditions deteriorate.

Expense Management

Tightening and Targeting Signal Efforts to Offset Potential Revenue Shortfalls

Caution among life insurers was also on display with respect to expense management. Prudential and Lincoln have specific cost savings targets for the next few years, with deployment of new technology a significant driver of these savings at Prudential. The company anticipates that the technology will result in more timely underwriting and claims processing, along with reduced customer waiting times. Broadly embracing the "hybrid" home-office work model, Prudential is aggressively reducing its real estate footprint, resulting in significant cost savings.

While not conducting specific cost savings programs, Brighthouse and Principal remain highly focused on managing expenses to offset potential revenue shortfalls. This watchful waiting attitude is permeating the entire industry.

A Final Word

Dubbed Long-Duration Targeted Improvements (LDTI) by the Financial Accounting Standards Board (FASB), a new set of insurers' accounting rules took effect January 1, 2023, with carriers recasting results for 2021 and 2022 in the first quarter of the year.

It's important to recall that the changes mandated by LDTI are targeted: They won't materially affect insurers' underlying economics, free cash flow generation, or capital positions. As highlighted in Q3's earnings calls, under LDTI carriers must update their reserve assumptions at least annually. They must also update their discount-rate assumptions to reflect current yields on single-A-rated bonds.

The fourth quarter's calls found Lincoln explaining that LDTI will reduce reported earnings in its life insurance business and increase — by a similar amount — earnings in its annuity business. This would make LDTI's effects neutral from an overall earnings standpoint.

The story was the same at Brighthouse, where management expects that overall adjusted non-GAAP earnings won't be materially different under LDTI, but that reported results in some business lines will change a bit.

Bottom Line: As in Q3, actuaries will likely continue to focus most of their attention on statutory earnings even as they, like other stakeholders in the life insurance industry, learn the new GAAP accounting. Nor do we expect that actuaries' day-to-day work will change much when the new LDTI rules are fully implemented.

References

Comments attributable to AFLAC management, including CEO Daniel Amos, were made during its earnings call February 2, 2023. Interested readers should go to www.fool.com to obtain a copy of the call transcript.

Comments attributable to BRIGHTHOUSE FINANCIAL management, including CEO Eric Steigerwalt, were made during its earnings call February 10, 2023. Interested readers should for a copy of the call transcript go to www.investor.brighthousefinancial.com

Comments attributable to LINCOLN NATIONAL, including CEO Ellen Cooper, were made during its earnings call February 9, 2023. A copy of that call transcript can be obtained at www.seekingalpha.com

Comments attributable to MANULIFE management, including CEO Roy Gori, were made during its earnings call February 16, 2023. Please go to www.seekingalpha.com for a copy of that call transcript.

Comments attributable to METLIFE management, including CEO Michael Khalaf, were made during its earnings call February 2, 2023. Please see www.seekingalpha.com for a copy of that call transcript.

Comments attributable to PRINCIPAL FINANCIAL, including CEO Dan Houston, were made during its earnings call January 31, 2023. See www.fool.com.

Comments attributable to PRUDENTIAL, including CEO Charlie Lowrey, were made during its earnings call February 8, 2023. Interested readers should go to www.seekingalpha.com for a copy of that call transcript.

Comments attributable to UNUM management, including CEO Rick McKenney CEO, were made February 1, 2023, during UNUM's earnings call. Investors should go to www.fool.com for a copy of that call.

About The Society of Actuaries Research Institute

Serving as the research arm of the Society of Actuaries (SOA), the SOA Research Institute provides objective, data-driven research bringing together tried and true practices and future-focused approaches to address societal challenges and your business needs. The Institute provides trusted knowledge, extensive experience and new technologies to help effectively identify, predict and manage risks.

Representing the thousands of actuaries who help conduct critical research, the SOA Research Institute provides clarity and solutions on risks and societal challenges. The Institute connects actuaries, academics, employers, the insurance industry, regulators, research partners, foundations and research institutions, sponsors and non-governmental organizations, building an effective network which provides support, knowledge and expertise regarding the management of risk to benefit the industry and the public.

Managed by experienced actuaries and research experts from a broad range of industries, the SOA Research Institute creates, funds, develops and distributes research to elevate actuaries as leaders in measuring and managing risk. These efforts include studies, essay collections, webcasts, research papers, survey reports, and original research on topics impacting society.

Harnessing its peer-reviewed research, leading-edge technologies, new data tools and innovative practices, the Institute seeks to understand the underlying causes of risk and the possible outcomes. The Institute develops objective research spanning a variety of topics with its strategic research programs: aging and retirement; actuarial innovation and technology; mortality and longevity; diversity, equity and inclusion; health care cost trends; and catastrophe and climate risk. The Institute has a large volume of topical research available, including an expanding collection of international and market-specific research, experience studies, models and timely research.

Society of Actuaries Research Institute
475 N. Martingale Road, Suite 600
Schaumburg, Illinois 60173
www.SOA.org