U.S. Insurance Company Earnings Review

Third Quarter 2022

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AUTHOR With You in Mind

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

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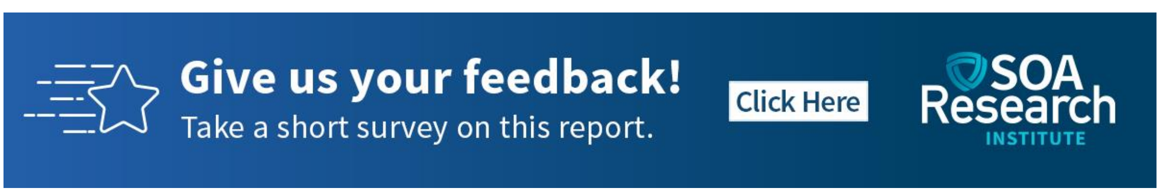
Editor's Note: The following roundup covers eight major publicly traded life insurers: United States-based Aflac Incorporated, Brighthouse Financial, Lincoln National, MetLife, Principal, Prudential Financial, and Unum, plus Toronto-based Manulife, which operates in the U.S. through its John Hancock 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 Q2 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.



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These were the common themes that we saw in third-quarter 2022 earnings among the eight companies we've been asked to follow by the Society of Actuaries. To be sure, there were important differences among the results – a function of each company's business mix, geographic exposure, and balance sheet strength. The same was true of outlooks and strategy: The carriers had differing views on what the next few quarters will hold and how best to confront challenges and opportunities.

In general, though, as is typically the case in this industry, there were several issues and themes that cut across most, if not all, of the industry in this year's Q3. Topping the list: The collapse of income from alternative investments such as hedge funds and private equity, with many of the carriers reporting negative returns tied to the sharp drop in the stock market in 2022's first half.

That same drop in stock values cut into carriers' fees from fee-based products such as mutual funds, variable life insurance and variable annuities, Going the other way, several of the carriers reported the second consecutive quarter in which yields on new investments exceeded the yield on maturing investments. That allowed carriers to continue reversing the decline in average portfolio yields they had been wrestling with for decades. The credit for this turn of events, of course, must go to the sharp increase in interest rates engineered by the Federal Reserve.

There was more.

COVID-related mortality and health claims continue to be an issue for the carriers, although they were dramatically less of an issue in Q2 2022 than they were in Q2 2021. That improvement continued in 2022's third quarter, COVID-19-related claims in Japan being a notable exception.

Pension-risk-transfer deals, in which a company with a defined-benefit pension writes a check to a life insurer, in exchange for which the carrier assumes the company's pension obligations, showed continued promise, with MetLife and Prudential teaming up on a mega IBM deal.

And the broad push by carriers to emphasize capital efficiency, cost efficiency, risk reduction, and higher returns, all for the larger goal of increasing distributable earnings, continued apace.

Following are further observations on these common themes – but also on how Q3 2022 results differed:

Business Mix Makes a Difference

While most of this earnings review is devoted to the idea that the carriers' Q3 2022 results were in important respects similar, there were differences – and at times those differences were striking.

At one extreme, for example, Unum, whose disability product thrives when inflation and short-term interest rates are high and unemployment is low, had another very strong earnings report. Unum is benefitting from the rise in short-term yields, from the fact that when unemployment is low policyholders are less likely than would otherwise be the case to go out on claim, and from the fact that when inflation is high policyholders are also less likely to file for disability because they typically receive a fixed benefit under their policies.

At the other extreme was Lincoln National, a major writer of individual life insurance and of universal life insurance in particular, that recorded a $2 billion charge to reflect the fact that lapses in its universal life book of business with no-lapse guarantees have been running materially below lapse assumption embedded in Lincoln's reserve calculations.

Lincoln did not get into numerical detail, saying only that while it had been studying its reserve adequacy it wasn't until this year that it was able to credibly compare its lapse experience on Universal Life (UL) with a no-lapse guarantee with an industry-sponsored lapse study. Presumably, this is the same study Prudential cited in Q2, when it recorded a $1 billion reserve increase for its book of universal life policies with no-lapse guarantees. Whatever the case, Lincoln told investors participating in the company's third-quarter 2022 earnings call that it felt that the data it had to set reserves wasn't statistically credible until this year.

Equally interesting, Lincoln's problems were not seen in three other companies with large presences in universal life. Prudential apparently took no further action on universal life in Q3. Brighthouse was asked about the matter but management noted that Brighthouse took approximately a $3 billion charge for this business at the time of Brighthouse's separation from MetLife. The business, had been "scrubbed." Manulife, which owns John Hancock, was also pressed on UL reserve adequacy. Management responded that John Hancock has been careful to keep reserves updated.

Our bottom line: Business mix clearly made a difference in Q3, and accounting policy matters, too. This was not a good time to have been heavily involved in secondary-guaranty universal life. And while it seems to have been an open secret in the life insurance business that lapse assumptions on the product were proving to problematic it also seems that different companies chose to acknowledge the problem at very different paces.

The Slumping Equity Market and Declining Bond Prices: Challenges for Almost Everyone, Especially in Income from Alternative Investments

Life insurance companies are exposed to the equity and fixed income markets in so many ways and more than ever. They sell variable life insurance and variable annuities, products whose fees are tied to stock and bond values. Many of them – Principal, Prudential and MetLife, for example – manage money for third parties. Still others – John Hancock and Lincoln, for example – are in the 401K business, a line whose fortunes are clearly tied to market returns. Against that backdrop it was hard for the carriers to avoid feeling the impact of the 22% drop in the S&P 500 that took place in 2022's first nine months and of what some are calling the worst rout in the bond market since the U.S. Civil War.

In the first instance, the broadly based decline in stock and bond values cut into carriers' Q3 variable account values and fee income. But there was a second-order effect even bigger: The impact that the weak stock and bond markets had on carriers' so-called "variable investment income," or VII.

This is the term life companies give to the investment income they earn from alternative investments anchored by hedge funds and private equity. Alternatives are not a large part of carriers' investment portfolios, typically amounting to around 5 percent or 6 percent of the total. But because what carriers expect to earn on their alternatives is typically well above what they earn on their portfolios overall – 10 percent or 11 percent on hedge funds and private equity versus around 5.5 percent for the whole portfolio – if hedge fund or private-equity results fall out of bed it can wreak havoc with carrriers' investment results overall.

That's what happened in Q3 when, because of certain reporting lags, carriers were reporting poor private-equity results from Q2.

Prudential said a shortfall in variable investment income reduced its investment income overall by $300 million and helped reduce pre- tax earnings by 21%.

Brighthouse said that the shortfall in variable investment income in its organization, with the return on the company's hedge fund and private equity holdings coming in at a negative 3.2 %, trimmed overall net investment income by $182 million, or $2.53 per share, Brighthouse normally expects to earn 10 % annually on its alternatives portfolio. The shortfall cut deeply into quarterly earnings at Brighthouse, where the usual run rate for quarterly earnings is in the $3.50 per share area.

Lincoln, MetLife, John Hancock all reported VII shortfalls as well. The only exception we saw was Principal Financial, which reported a strong quarter in its variable investment income, partly due to strength in commodities and in some forms of real estate. It's possible this will reverse during the fourth quarter, given the increase in interest rates.

Covid-Related Mortality and Health Claims: Still an Issue – But Fading

Several of the companies we listened to alluded to the fact that in Q3 they continued to benefit from the drop in COVID-19-related deaths in the U.S. At 40,000 in Q3, those deaths were dramatically below year-earlier levels for the population as a whole. Death rates were probably lower among the insured population since the insured population tends to be healthier than uninsured individuals. This favorable development was enhanced by the fact that a higher percentage of COVID deaths were of older people than during the pandemic. This cuts two ways.

Older people tend to have larger policies than younger people. On the other hand, older people, often retired, tend no longer to be participating in the group life plans that took such heavy mortality hits during the pandemic. This was good news for big group insurance writers such as Prudential, which for the second consecutive quarter said COVID-19 had moved into the "endemic stage," similar to influenza, although Prudential also mentioned that the 40,000 deaths were 15,000 more than it had expected.

We suspect that Prudential, AFLAC, MetLife and other carriers with large operations in Japan were also surprised by what happened in Japan in Q3 – developments that in our judgement are worth monitoring by actuaries in the U.S.

Japan experienced what may have been its worst outbreak of COVID-19 since the pandemic began, with new daily cases running in the hundreds of thousands. The spike led large numbers of Japanese citizens to receive claims checks under supplemental-health policies they had purchased – even if these individuals were recovering at home and hadn't entered the hospital. Such claim payments are likely to fall sharply in 2022's fourth quarter because under pressure from insurance carriers Japan's government agreed to change the rules so that beginning in Q4 only COVID-19 patients who've been hospitalized will be covered under supplemental health policies.

But developments in Japan serve as an important reminder: *Where* care takes place matters. In its call, for instance, Manulife noted that its John Hancock subsidiary had seen a return from at-home care to nursing-home and assisted-living-facility care among John Hancock's long-term-care claimants. The shift, Manulife said, will expose John Hancock to a higher degree of medical inflation than was the case during the pandemic.

Cost Efficiency: The Continued Push

Even before the pandemic, several of the carriers we follow had begun cost-cutting programs. They were a response to low interest rates and pressure on fees in such areas as investment management. Above all, however, the beginning of the move to trim costs reflected views on competition: Life insurers concluded that they could not go head-to-head (especially in the area of investment products) against low-cost rivals such as Charles Schwab & Company and Vanguard unless the insurers became more efficient themselves – and in all aspects of their delivery.

The COVID-19 pandemic accelerated this push to be more efficient, and in Q3 earnings calls we learned more about the carriers' progress.

Prudential, for instance, noted that as a result of its experiment with having employees work from home part of the week that it had been able to half its U.S. office-space needs. The reduction in occupancy will save the company $50 million annually, Prudential said.

Principal Financial reported that its overall expenses in 2022 were expected to come in 4% below 2021's level, this despite the fact that some of Principal's businesses, especially those related to workplace accumulation, continue to expand.

Lincoln National said its expenses were expected to fall $260 million over a two- year period, and that half of this savings had already been realized.

Several of the carriers used their Q3 calls to highlight technology initiatives that they say are making them more efficient with agents and customers – and helping customers stay healthier too.

Prudential, for one, mentioned using artificial intelligence to reduce underwriting times from 22 days to 22 seconds. Prudential also talked about reducing claims delivery times from six days to six hours.

Manulife discussed using automation to reduce the time it takes to bring on a new producer by 90%. And specifically respect to John Hancock Manulife mentioned the announcement it made several weeks ago that beginning in November it would make available to John Hancock policyholder a cancer-detecting blood test called Galleri.

Pension Risk Transfer, Buffer Annuities: Still Seen by Carriers as Major Growth Areas

MetLife and Prudential both see still a great deal of potential in pension-risk-transfer, arrangements in which, in exchange for a large one-time payments, an insurance company assumes the pension liabilities of a corporation. During the third quarter the two companies teamed to assume the liabilities of IBM, with each taking half of $16 billion.

This was the second largest pension-risk-transfer in history, with Prudential's $29 billion deal with General Motors a decade ago being the biggest. Prudential and MetLife believe this market will continue to grow smartly in the future, as these life insurers and others say they are better positioned because of their large pools of other longevity-related risks to assume the longevity risk of a pension plan than the original plan sponsors.

Another area of ongoing growth talked about during the calls was "buffer variable annuities." This is an equity linked product where investors give up some of the upside in the stock market but are given downside protection. This has great appeal to the tens of millions of baby boomers who are entering their late 60s and early 70s. They don’t have the time to wait out a bear market. Both Prudential and Brighthouse Financial are seeing great success selling their products. Prudential reported $1 billion in FlexGuard sales in Q3, bringing to $12 billion FlexGuard sales since its 2020 debut. Brighthouse Financial's SHIELD buffer annuity drove a 50% increase in that company’s total annuity sales in Q3.

References

Comments attributable to AFLAC management, including CEO Daniel Amos, were made during its earnings call November 1, 2022. 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 November 8, 2022. 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 November 3, 2022 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 November 10, 2022. 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 November 3, 2022 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 October 28, 2022. See www.fool.com.

Comments attributable to PRUDENTIAL, including CEO Charlie Lowrey, were made during its earnings call November 2, 2022. 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 November 2, 2022 during UNUM's earnings call. Investors should go to www.fool.com for a copy of that call.

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