November 28, 2022

Market Segment Outlook: US Life/Annuity

Our outlook for the L/A industry remains at Stable, owing to high levels of risk-based capitalization and strong liquidity, among other positives, as well as a number of ongoing concerns

AM Best is maintaining its Stable outlook for the US life/annuity segment. Notable factors include the following:

- High levels of risk-based capitalization and favorable earnings
- Strong liquidity profiles
- Product de-risking and regular stress testing as part of improvements to risk management practices
- Pricing discipline, with robust sales of new business in both life and annuity products

In addition, companies have benefited from a variety of innovative initiatives, covering a range from products to systems to staffing. The segment has benefitted from cost savings and a pandemic-driven acceleration in product and systems modernization. In the ongoing search for growth, the segment is engaging with consumers through new distribution channels; cross-selling and direct-to-consumer (DTC) opportunities have also helped diversify insurers' overall distribution strategies. Systems modernization and the growing use of non-traditional insurance talent such as data scientists have created opportunities to better mine the vast amount of data accumulated over the years. Data segmentation has allowed refinement of target markets, identification of new markets, and improvement in the overall customer experience. All of these strategies have helped the industry build upon the overall prominence that life and annuity insurance gained during the pandemic.

We are maintaining the Stable outlook on the segment but note ongoing concerns, including:

- Market volatility in the US and global economies, including rapidly rising interest rates and inflation
- Significant exposures to structured securities, private debt, and real estate
- War for talent amid labor shortages and flexible work alternatives
- Legacy liabilities in risky product offerings, including long-term care, universal life with secondary guarantees, and variable annuities with living benefits

Forward-Looking Capital Management Remains Key

Macro-economic challenges such as inflation and capital markets volatility are expected to hamper profitability compared with prior years. In addition, rising interest rates have decreased the value of bondholdings, which has led to unrealized losses on fixed maturities. However, bonds maturing over the near term may benefit, as insurers can reinvest proceeds at higher rates. Uncertainty about the direction and pace of interest rate changes further demonstrates the need for both a strong asset-liability matching program and routine rigorous stress testing of insurers' portfolios.

Credit losses in both commercial mortgages and fixed-income assets have thus far been largely muted. Structured credit and commercial mortgages continue to pose some risk, but we

Analytical Contacts:
Ed Kohlberg, Oldwick
+1 (908) 439-2200 Ext. 5664
Edward.Kohlberg@ambest.com

Jackie Lentz, Oldwick
+1 (908) 439-2200 Ext. 5762
Jacqalene.Lentz@ambest.com

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have not yet seen a material rise in impairments and believe overall risk to the industry currently remains manageable. The collateralized loan obligation market—to which the life insurance industry remains considerably exposed—remains a concern, albeit at lower tranche levels, due to inflationary pressures and recession fears.

The Stable outlook for the segment is driven largely by the industry's solid capital management, which remains at the forefront of many companies' enterprise risk management (ERM) programs. Despite earnings volatility, capital markets gains and diversified earnings streams have helped offset the mortality impacts of COVID-19. L/A insurers' ERM frameworks have also helped them navigate through the pandemic. Death claims impacted earnings mainly during the first quarter of 2022, and many leading companies generated record sales and reported solid earnings performance in the second and third quarters of the year. There were some notable exceptions, however, as spiking interest rates have significantly impacted the third quarter earnings of companies with interest sensitive liabilities and their ERM programs were put to the test.

Life/annuity insurance is a long-term business that relies on short-term liquidity to meet policyholder obligations. Insurers with strong liquidity management are able to bear long-term investment risk to achieve their required return hurdles. This challenge—while always present for insurers—will require a greater emphasis on liquidity management in the current environment of rising interest rates and potential credit losses. This, coupled with liabilities that have less certain cash flows due to embedded market risks, further demonstrates to insurers the importance of sound liquidity management in uncertain times.

Record Annuity Sales Growth

According to LIMRA, annuity sales have steadily grown in 2022. During the second quarter of 2022, US annuity sales increased 22% to $77.5 billion, the highest quarterly sales figures ever recorded by LIMRA. The growth was due mainly to ongoing equity market declines, coupled with rising interest rates, which has led to solid growth of 76% for fixed-rate, deferred annuity sales and 19% for fixed-indexed annuity (FIA) sales compared with the same period in 2021. Recently, we have seen many companies launch multi-year guaranteed annuities (MYGA) due to the attractive spreads. The formation of several new private equity and asset management-backed insurers has added much capacity to the market recently. This is a trend that we expect will continue, as the spread between the cost of liabilities and potential investment returns remains attractive.

A renewed interest in life insurance has also been a contributing factor. New life insurance annualized premiums increased 17% in the first quarter of 2022, for a fifth consecutive quarter of double-digit premium growth, according to LIMRA. This momentum may slow for rest of the year but remain positive and is nonetheless favorable to the industry's outlook.

Cautious Optimism about COVID Mortality

The mortality impact of COVID has dampened operating earnings, but the increase in claims has been manageable—COVID claims numbers trended lower in the second half of 2022. Additionally, companies have found new ways to sell their products and manage their people through the pandemic. Some companies have also benefited from their mixed books of business, which, by combining mortality and longevity exposures, have created a natural hedge.

M&A Continues with New Market Participants

We are still seeing an abundance of capital looking to be deployed in the life and annuity segments by investment managers and private equity firms. These new entrants have contributed to an intensified competitive environment as they look to acquire legacy blocks of business. This activity has drawn the attention of some legislators. Although these new participants don't necessarily pose a problem directly due to the legal form of ownership, there are many issues to consider. One is the time horizon of the capital deployed. Private equity generally invests over shorter time horizons, while life/annuity insurance is a long-term proposition. This must be fully appreciated by new entrants to the segment if they are to succeed. Another consideration is the growing use of structured assets to achieve investment yields that will outperform that of the cedent.

Market dynamics are also motivating liability-side balance sheet restructuring, as many established insurers continue to move towards fee-based businesses. In other cases, the capital required to support certain riskier products may be driving the shedding of legacy businesses. We expect M&A to continue, but—due to current economic conditions—whether it will be at the same pace as last year is unclear.

ERM Is as Important as Ever

Another important factor is the use of risk management. In the post-financial crisis world, many companies saw their investment in ERM pay off—particularly larger companies that have the scale to support the extra costs for people and systems. Stress-testing and a strong corporate governance structure consisting of risk management committees that address key risks have become integral to the operations of many insurers. This has been a contributing factor to better sizing the capital required to support the business. In addition, workplace challenges such as cyber risk and the war for talent remain front of mind for many insurance executives and operational risk managers.

Accounting Changes and Reporting Challenges

As noted in the past, the full impact of changing accounting standards in 2023 has yet to be determined. Long-duration targeted improvement (LDTI) will change GAAP accounting for life/annuity insurance, but it is not expected to change the fundamentals of the entities we rate. The updated standards will demand significant resources from companies, including collaboration among actuaries, accountants, IT staff, and other professionals.

The segment may see more disruptions as competition evolves, business models change, automation and artificial intelligence advance, and ESG (environmental, social, and governance) awareness grows. Managing risk accurately through uncertainty necessitates a thorough review of strategies to reveal vulnerabilities. Risk culture goes hand in hand with risk management. Poor enterprise risk management can quickly place a company in distress.

Cautionary Market Dynamics

Moving into 2023, we believe the challenges the segment faces will be manageable because of prudent capital and liquidity management, profitability, and ERM practices. Although higher interest rates create an economic benefit owing to improved investment yields, other dynamics in the industry should continue to be monitored. These include market-sensitive lapse rates, asset credit risk, and the ongoing need to attract talent. Insurers who are able to manage technological improvements and transform for the better have the potential to drive the industry forward.

As always, any material unexpected change could drive a review of our outlook, as we continue to monitor adverse factors that could negatively pressuring the industry.

GUIDE TO BEST'S MARKET SEGMENT OUTLOOKS

Our market segment outlooks examine the impact of current trends on companies operating in particular segments of the insurance industry over the next 12 months. Typical factors we would consider include current and forecast economic conditions; the regulatory environment and potential changes; emerging product developments; and competitive issues that could impact the success of these companies. Best's ratings take into account the manner in which companies manage these factors and trends.

A Best's Market Segment Outlook, like a Best's Credit Rating Outlook for a company, can be Positive, Negative, or Stable.

Best's Market Segment Outlook	
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We update our market segment outlooks annually, but may revisit them at any time during the year if regulatory, financial, or market conditions warrant.

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BEST'S MARKET SEGMENT REPORT

A.M. Best Company, Inc.
Oldwick, NJ
CHAIRMAN, PRESIDENT & CEO **Arthur Snyder III**
SENIOR VICE PRESIDENTS **Alessandra L. Czarnecki, Thomas J. Plummer**
GROUP VICE PRESIDENT **Lee McDonald**

A.M. Best Rating Services, Inc.
Oldwick, NJ
PRESIDENT & CEO **Matthew C. Mosher**
EXECUTIVE VICE PRESIDENT & COO **James Gillard**
EXECUTIVE VICE PRESIDENT & CSO **Andrea Keenan**
SENIOR MANAGING DIRECTORS **Edward H. Easop, Stefan W. Holzberger, James F. Snee**

AMERICAS
WORLD HEADQUARTERS
A.M. Best Company, Inc.
A.M. Best Rating Services, Inc.
1 Ambest Road, Oldwick, NJ 08858
Phone: +1 908 439 2200

MEXICO CITY
A.M. Best América Latina, S.A. de C.V.
Av. Paseo de la Reforma 412, Piso 23,
Col. Juárez, Alcadía Cuauhtémoc, C.P. 06600, México, D.F.
Phone: +52 55 1102 2720

EUROPE, MIDDLE EAST & AFRICA (EMEA)
LONDON
A.M. Best Europe - Information Services Ltd.
A.M. Best Europe - Rating Services Ltd.
12 Arthur Street, 8th Floor, London, UK EC4R 9AB
Phone: +44 20 7626 6264

AMSTERDAM
A.M. Best (EU) Rating Services B.V.
NoMA House, Gustav Mahlerlaan 1212, 1081 LA Amsterdam, Netherlands
Phone: +31 20 308 5420

DUBAI*
A.M. Best - MENA, South & Central Asia*
Office 102, Tower 2, Currency House, DIFC
P.O. Box 506617, Dubai, UAE
Phone: +971 4375 2780
*Regulated by the DFSA as a Representative Office

ASIA-PACIFIC
HONG KONG
A.M. Best Asia-Pacific Ltd
Unit 4004 Central Plaza, 18 Harbour Road, Wanchai, Hong Kong
Phone: +852 2827 3400

SINGAPORE
A.M. Best Asia-Pacific (Singapore) Pte. Ltd
6 Battery Road, #39-04, Singapore
Phone: +65 6303 5000

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