BEST'S SPECIAL REPORT

Our Insight, Your Advantage®

Trend Review
November 5, 2024

Smaller Companies Face Cash Flow Crunch from Uptick in Surrenders

The share of reserves with market value adjustments has increased five percentage points in just two years

Principal Takeaways

- Surrender benefits increased 19% year over year in the second quarter of 2024, while individual and group annuity premiums each grew 21%.
- The share of reserves attached to contracts with market value adjustment charges increased over 5 percentage points the last two years.
- The ratio of premium cash flow in to benefits & surrenders cash flow out has produced a downward trend much steeper for individual annuity companies than for individual life and diversified companies.
- The share of smaller companies with negative total cash from operations has been trending up to a greater degree than for mid-sized and larger organizations, indicating possible shifts in market share.

Surrender benefits increased 19% year over year through the first half of 2024, lower than the 21% premium growth each for individual and group annuities. The industry has recorded fourteen straight quarters of YoY growth in individual annuity premiums. The Federal Reserve reduced interest rates by half a point in September 2024, but they remain nearly double the level in 2019. Higher interest rates, something the industry had not seen in decades, brought about disintermediation risk— the possibility that a policyholders may surrender a policy in favor of another policy or asset offering a higher interest rate. Still, competition has remained generally rational, with no significant widespread race to undercut competition to spur growth.

General enterprise risk management (ERM) practices such as stress testing and more frequent repricing of crediting rates take on greater importance in mitigating risk. Still, assumptions used in annual cash flow testing can be negatively affected by volatile interest rates, which could lead to additional reserves, as well as lower surplus. **Appendix A** shows a distribution of AM Best's Enterprise Risk Management assessments for our rated individual annuity companies.

Surrenders Still Elevated Compared to Historical Norms

Surrender benefits topped $100 billion for the fifth straight quarter and sixth in the last seven quarters, compared with an average $86 billion prior to that going back to 2019. Additionally, annualized surrenders as a share of reserves for the last three quarters are higher than at any other time going back to 2019 **(Exhibit 1)**. However, surrender benefits as a percentage of premium (individual and group annuity and individual life) are at their lowest levels since at least 2019, reflecting strong premium growth. Fifteen companies reported surrenders increasing by more than one billion dollars but only six of those companies reported higher growth in premium than surrenders **(Exhibit 2)**.

More Business Locked In During Surrender Charge Period

Twenty companies account for 73% of industry individual annuity reserves. The industry as a whole and most top players have increased the share of reserves subject to withdrawal penalty.

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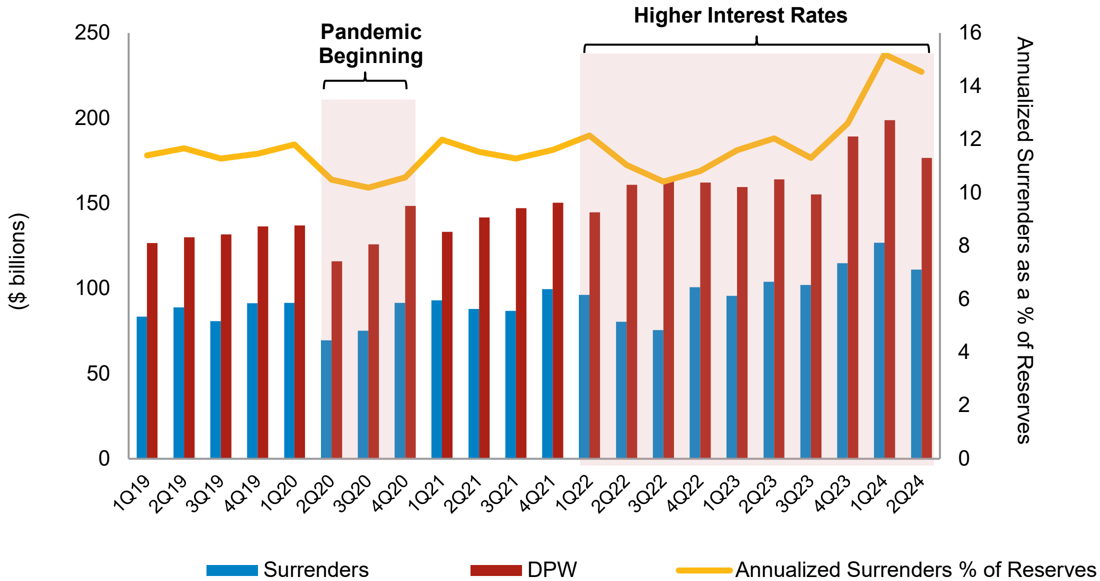
Exhibit 1

Surrenders and Premiums by Quarter



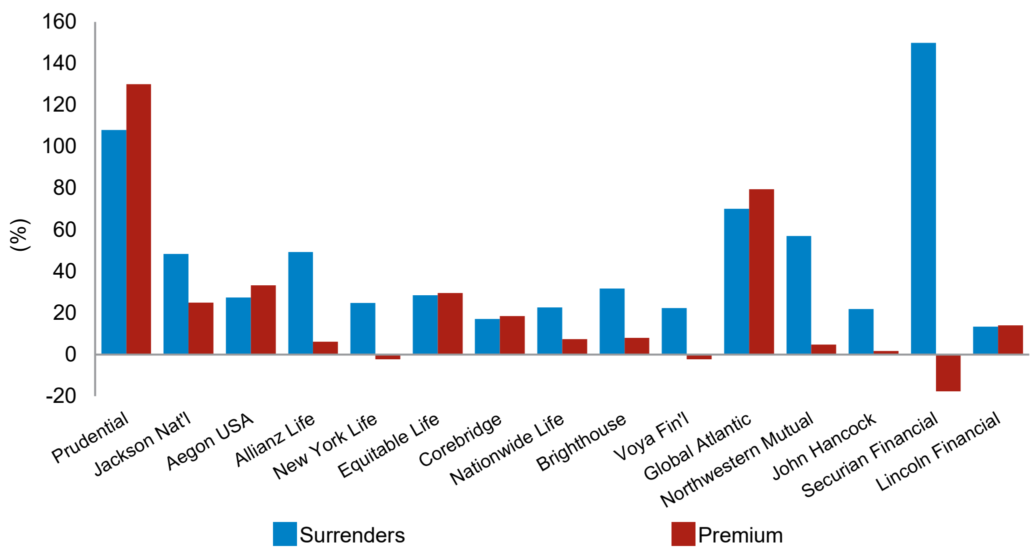
Note: Premium includes individual life, individual annuity, and group annuity.

Source: BESTLINK

Eight of the 20 have a greater share of reserves in contracts that are subject to withdrawal penalties or cannot be withdrawn compared to the rest of the industry **(Exhibit 3)**. Further, market value adjustments (MVAs) are attached to the surrender charges in many contracts; if corporate yields are higher at the time of withdrawal than when the contract was purchased, the MVA increases the surrender charge, further disincentivizing surrenders. The share of reserves attached to contracts with MVAs has grown more than five percentage points in just two years and more than doubled over the last ten years, to 24% in 2023.

Exhibit 2

YoY 2Q24 Surrenders vs. Direct Premium Growth



Notes: For companies with surrenders >$1 billion.
Premium includes individual life, individual annuity, and group annuity.

Source: BESTLINK

Exhibit 3

Surrender Charge Protection on Individual Annuity Reserves, 2023 vs. 2021

	2023 Gross Individual Annuity Reserves ($000)	% w/Withdrawal Penalty or Cannot be Withdrawn		% with MVA		No Surrender Charge	
		2023	2021	2023	2021	2023	2021
Jackson Nat'l	229,826,323	6.0	4.2	1.1	1.3	9.3	10.1
TIAA	190,789,511	70.1	67.7	0.0	0.0	16.2	16.6
Corebridge	188,215,687	49.0	47.8	30.8	30.5	23.1	26.8
Lincoln Financial	182,490,662	13.5	10.9	9.4	6.9	8.1	8.7
Allianz Life	155,959,070	69.1	61.3	39.5	32.9	20.0	23.3
Brighthouse	142,545,127	27.9	21.2	6.1	3.0	17.6	12.4
Athene US	138,813,582	81.3	74.9	66.8	63.0	18.7	25.0
New York Life	129,079,491	57.4	50.6	23.5	22.5	15.7	17.2
Prudential	125,973,394	22.6	8.6	13.0	0.7	4.0	3.8
Equitable Life	118,095,329	45.5	3.0	40.4	0.6	6.6	38.5
Nationwide Life	117,310,262	32.8	22.0	28.1	19.5	5.0	5.0
MassMutual	106,911,513	71.3	58.4	21.6	14.6	19.4	26.5
Global Atlantic	97,454,419	76.4	71.6	39.5	30.6	22.3	26.0
Pacific Life	91,768,074	31.4	28.3	19.0	16.4	14.3	8.7
Ameriprise Financial	83,779,471	14.5	6.8	12.4	4.7	8.8	9.6
American Equity	83,438,119	72.1	72.7	48.8	32.5	27.8	27.3
Aegon USA	74,267,520	6.0	5.9	1.4	0.4	9.7	8.9
Sammons Financial	59,819,546	74.4	72.9	73.2	71.4	21.9	22.5
Thrivent	52,922,289	14.1	5.6	2.9	0.3	23.7	26.9
Fidelity Investments	44,046,618	3.1	3.4	0.0	0.0	0.4	0.4
Rest of Industry	**910,707,458**	**53.3**	**44.8**	**28.8**	**20.5**	**23.3**	**24.8**

Source: BESTLINK

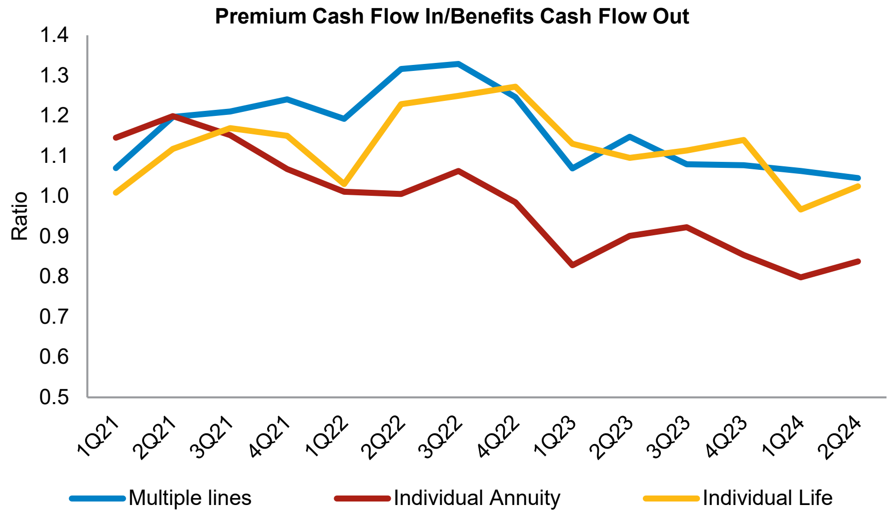
Conversely, most companies have a lower percentage of reserves with no surrender charge compared to the prior year as new business is now locked in. The industry is less concerned about surrenders once policies leave the surrender charge period, typically dropping the crediting rate offered on policies. However, insurers want to retain customers and have them reinvest in a new, current product offering, which restarts the surrender charge period. This helps transfer capital from fully liquid liabilities (no surrender charge protection) to new, long-duration policies subject to surrender charges.

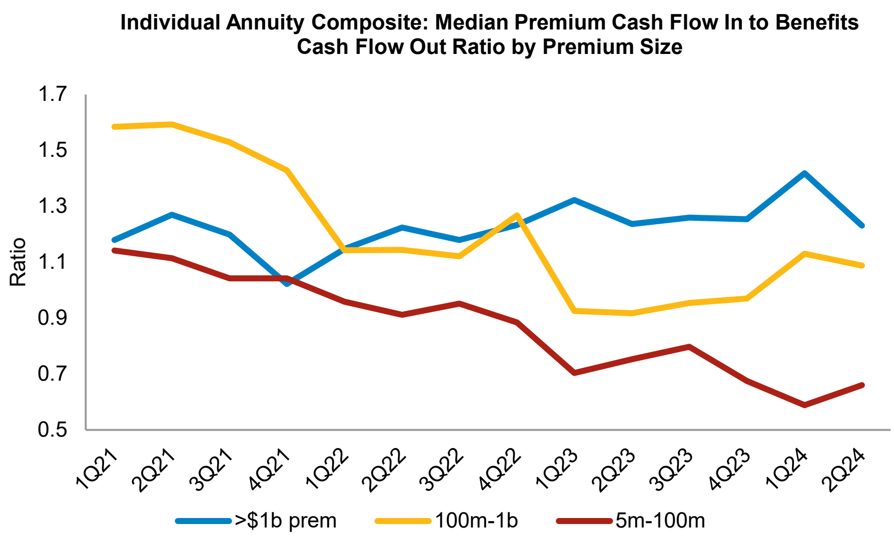
Cash Flow Crunch Hits Smaller Annuity Companies

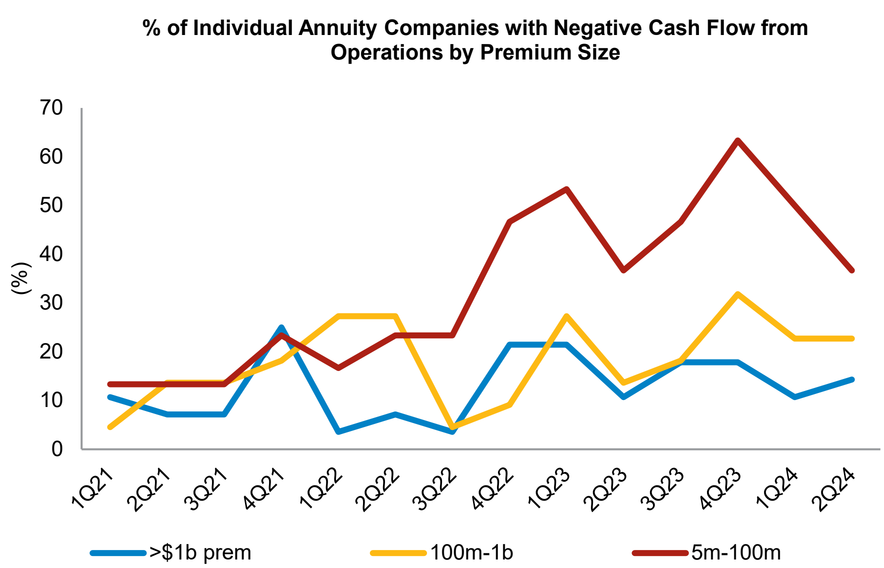
Companies unable to replace surrendered business are most likely to see a shrinking asset base, as maturing bonds may be used to cover additional surrenders instead of being reinvested. The annuity market is highly competitive, with the higher interest rate environment leading to many new entrants, some of which start with newer and cleaner portfolios offering higher yields and without the burden of legacy system upgrades, as well as companies backed by private-equity and investment management firms that can leverage sophisticated investment expertise.

On a cash flow basis, companies in our individual annuity composite have observed a downward trend much steeper in the ratio of premium cash flow in to benefits & surrenders cash flow out than reported at individual life and diversified companies in multiple lines. When the individual annuity composite is viewed by premium scale, those smaller companies have seen the greatest deterioration in the cash flow ratio, with premiums not covering benefits and surrenders cash flow going out. Further, the percentage of smaller companies with negative cash from operations has been trending up to a greater degree than for mid-sized and larger organizations, indicating possible shifts in market share **(Exhibit 4)**. Negative cash flows could lead to the selling of assets at unrealized loss positions, as rising interest rates have depressed bond values.

Exhibit 4
Cash Flow Analysis by Composite and Size





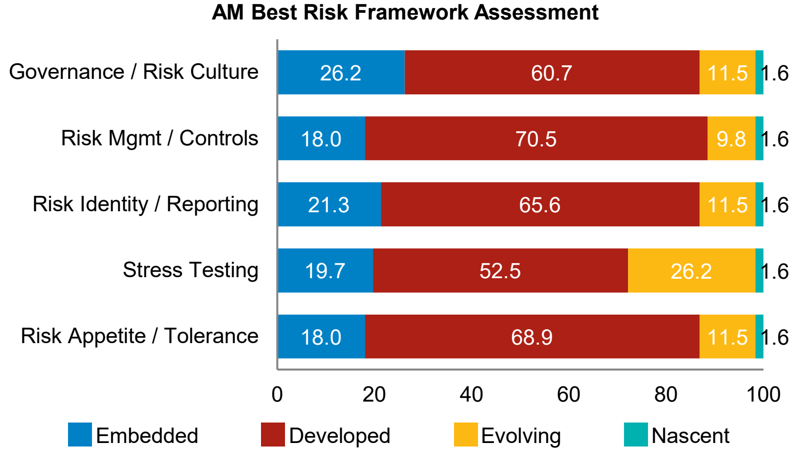


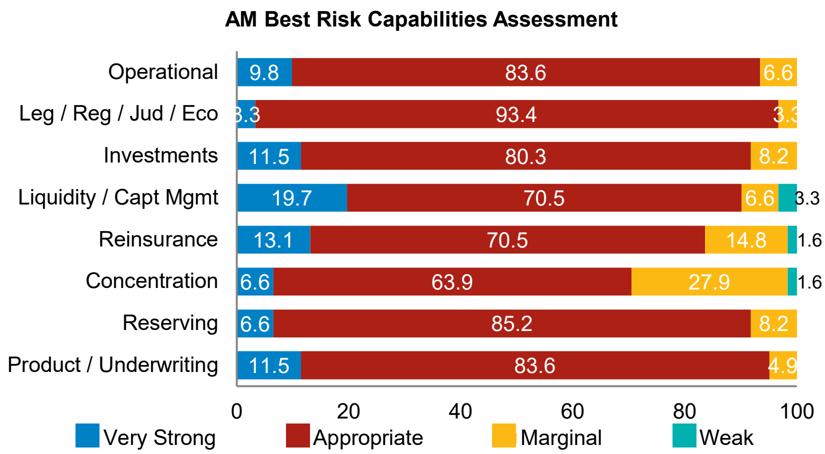
Source: BESTLINK

Appendix A

AM Best ERM Assessments for Individual Annuity Companies

(%)





Source: AM Best data and research

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