Review & Preview
March 14, 2024

US Life/Annuity Insurers Stay the Course as They Prepare for 2024 Uncertainty

The US L/A segment performed well in 2023, owing to strong liquidity and capital positions, robust annuity sales, and slightly improved new money yields in a benign credit environment

Principal Takeaways

- US L/A segment balance sheets remain well capitalized and growing, as capital in AM Best's business line composites rose in the first three quarters of 2023.
- Carriers with annuity blocks lacking competitive crediting rates or surrender charge protection could see heightened disintermediation risk.
- Private equity and asset manager-owned insurers continue to grow, in both number and assets.
- Segment companies have accelerated the adoption of technological innovation somewhat, although they still lag other industries.

In December 2023, AM Best maintained its Stable outlook for the US life/annuity segment, supported by strong liquidity and capital positions, robust annuity sales, and slightly improved new money yields as a result of higher interest rates over the last two years. Lingering concerns include uncertainty and volatility in financial markets, risks contained within certain asset classes, and remaining legacy liabilities.

The year 2023 saw the dramatic failure of regional banks and a 10% drop in the S&P 500 from the end of July to the end of October. Still, the benchmark index gained an impressive 24% for the year. Treasury rates across the yield curve for maturities greater than one year remained as they were at the start of 2023, but short-term rates did not, further inverting the yield curve. Credit spreads shrank slightly from their levels at the start of 2023.

Balance Sheets Well Capitalized and Growing

The L/A segment remains well capitalized after a nominal 1.6% increase in statutory capital and surplus through September 30, 2023, from year-end 2022 (**Exhibit 1**). Net income for the first nine months of 2023 was steady compared with the first nine months of 2022. Average annual capital increases between 3% and 4% since 2019 have affected the ratio of adjusted capital to liabilities, as the ratio has hovered between 11.5 and 12.5 since 2018 (**Exhibit 2**).

Exhibit 1
US Life/Annuity – Capital & Surplus
($ billions)

	9 Months 2022	9 Months 2023	YoY % Change
Prior Year-End Capital & Surplus	493.9	485.0	-1.8
Net Income	31.6	31.6	0.1
Change in Unrealized Gains/Losses	-20.3	1.1	N/M
Change in Asset Valuation Reserves	11.0	-7.1	-164.8
Other Changes in Surplus	-8.3	5.4	N/M
Contributed Capital	3.1	3.0	-1.3
Stockholder Dividends	-29.0	-24.5	-15.7
Ending Capital & Surplus	483.7	493.0	1.9
Change in C&S from Prior Year-End ($)	**-11.3**	**10.3**	
Change in C&S from Prior Year-End (%)	**-2.1**	**1.6**	

Source: BESTLINK

Analytical Contact:
Michael Porcelli, Oldwick
+1 (908) 882-2250
Michael.Porcelli@ambest.com

Contributors:
Michael Adams, Oldwick
Igor Bass, Oldwick
Wayne Kaminski, Oldwick
Edward Kohlberg, Oldwick
Stratos Laskarides, Oldwick
Christopher Lewis, Oldwick
Jacqalene Lentz, Oldwick
Michael Lynch, Oldwick
Anthony McSwieney, Oldwick
Louis Silvers, Oldwick
Kevin Varvaro, Oldwick
Stephen Vincent, Oldwick

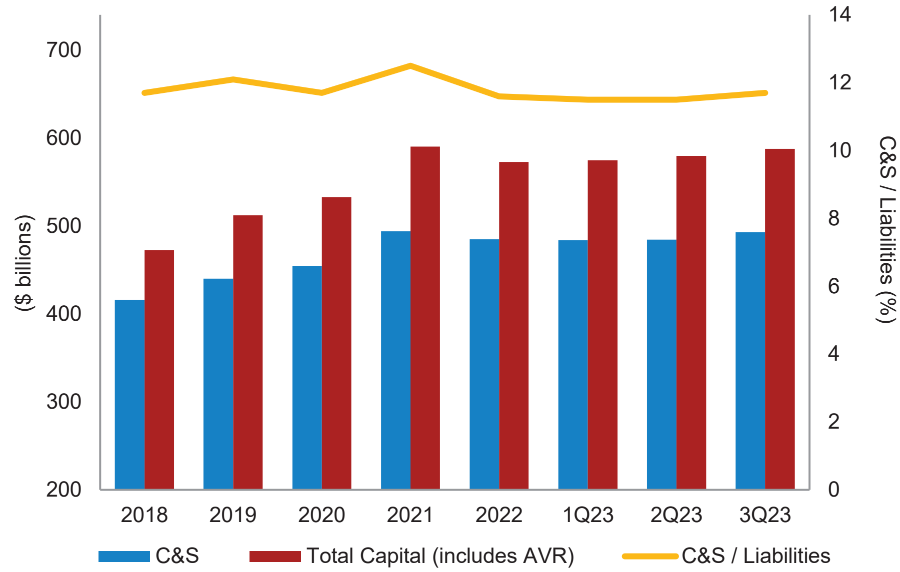
2024-008

AM Best's US L/A business line composites experienced an increase in capital during the first three quarters of 2023 over year-end 2022 levels (**Exhibit 3**), as well as high single-digit compound growth from 2019 through 2021.

Exhibit 2

US Life/Annuity – Capital & Surplus

As of December 21, 2023

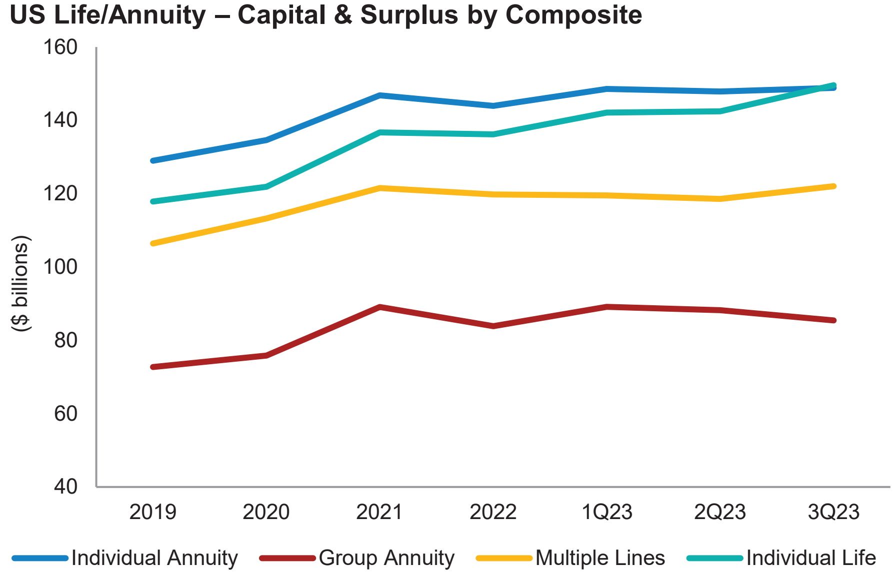


* Liabilities exclude separate accounts.

Source: BESTLINK

Exhibit 3

US Life/Annuity – Capital & Surplus by Composite

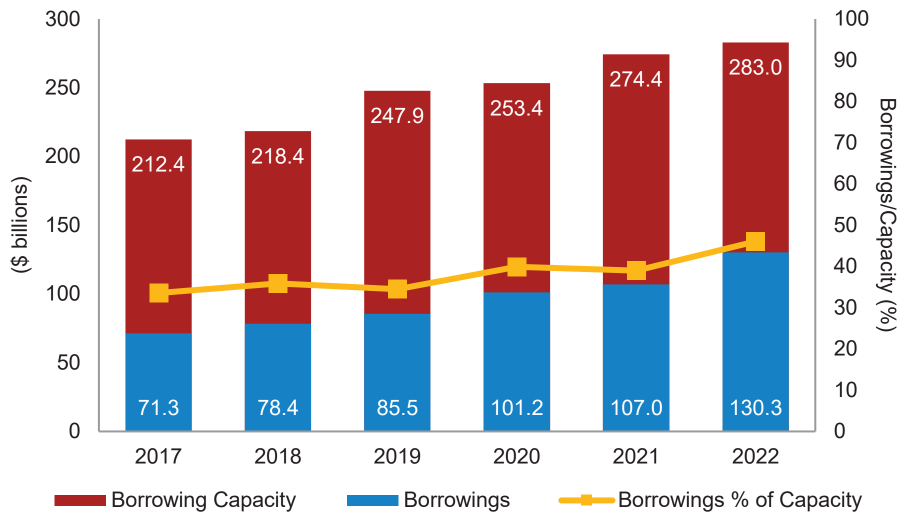


Source: BESTLINK

In recent years, numerous L/A insurers have strengthened their liquidity through membership in their local Federal Home Loan Bank (FHLB), which was founded to support mortgage lending by thrift institutions and insurance companies. Over time, the FHLB has become a provider of funding to a broader array of financial institutions. As of year-end 2022, insurance companies accounted for 9% of FHLB membership. With the uncertainty at the outset of the COVID-19 pandemic, many insurers turned to the FHLB to bolster their liquidity in 2020. They again turned to the FHLB in 2022, this time in search of spread/yield enhancement in the higher interest-rate environment. Both total borrowing capacity and the actual amount borrowed as a percentage of capacity have increased steadily the last five years (**Exhibit 4**). AM Best views the increase in capacity favorably, because it provides companies with access to additional liquidity without having to sell assets at inopportune times. FHLB borrowings provide operating leverage if used for spread enhancement and if the insurer can demonstrate strong asset-liability and liquidity management. These obligations would be viewed as financial leverage if the proceeds are instead used as working capital to fund their core business.

Privately held and mutual insurers typically raise capital by issuing surplus notes, while publicly traded companies have the ability to issue debt. Most companies have actively bolstered their balance sheets in recent years using these options. A significant number of insurance companies have access to additional capital through revolving letters of credit (LOCs) with banks or subsidiaries. Furthermore, most L/A insurers can access supplemental capital from their respective holding companies, if needed.

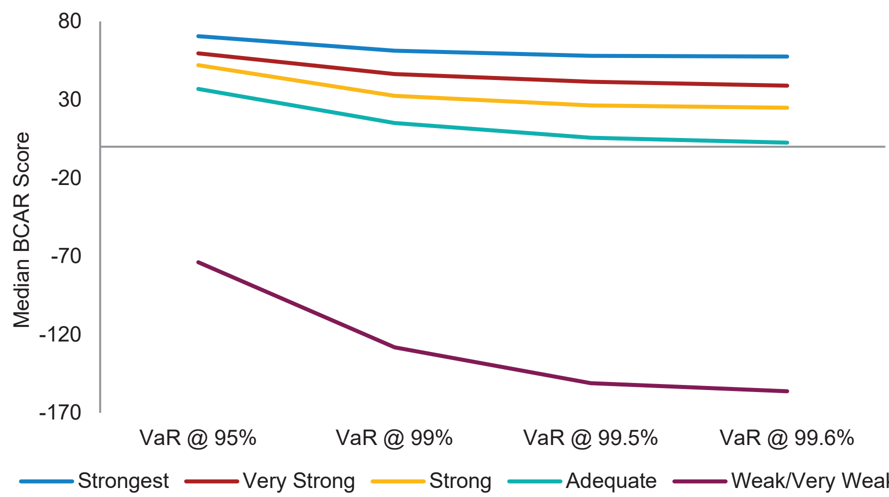
Exhibit 4
US Life/Annuity Insurers – FHLB Borrowings vs. Capacity



Source: BESTLINK

The median Best's Capital Adequacy Ratio (BCAR) scores for the rated entities with balance sheet strength assessments of Adequate or higher have been relatively stable (**Exhibit 5**). BCAR scores for rated entities with Weak or Very Weak assessments have been more volatile year to year, influenced partially by fewer data points. Based on AM Best's criteria, approximately 93% of the rated US L/A entities have a Strong or better BCAR assessment. (A risk-adjusted capital score greater than zero at the 99.5% Value-at-Risk [VaR] level and equal to or less than 10 at the 99.6% VaR is considered Strong.)

Exhibit 5
US Life/Annuity – Median BCAR Scores by Balance Sheet Strength



As of January 4, 2024
Source: BESTLINK

The rising interest rate environment affects both assets and liabilities, but the overall realized impact to balance sheets has been manageable, owing primarily to companies' strong asset-liability management frameworks. Over the near term, most insurers plan to hold assets to maturity, driving unrealized losses, but they are unlikely to be forced to sell to meet liquidity needs. Overall, the L/A industry's capitalization and liquidity remains favorable. AM Best estimates modest growth in the industry's C&S for both 2023 and 2024 (**Exhibit 6**) totaling approximately $50 billion, or roughly 5% each year. AM Best also expects US L/A net income to approach pre-pandemic levels in 2023 and continue growing in 2024.

Lingering Risks in Investment Portfolios

The insurance industry has had time to digest the changes in interest rates, volatile but improving equity markets, ongoing inflation concerns, and a continued inversion of the yield curve. With inflationary pressures expected to subside in 2024, the industry now looks to the future with

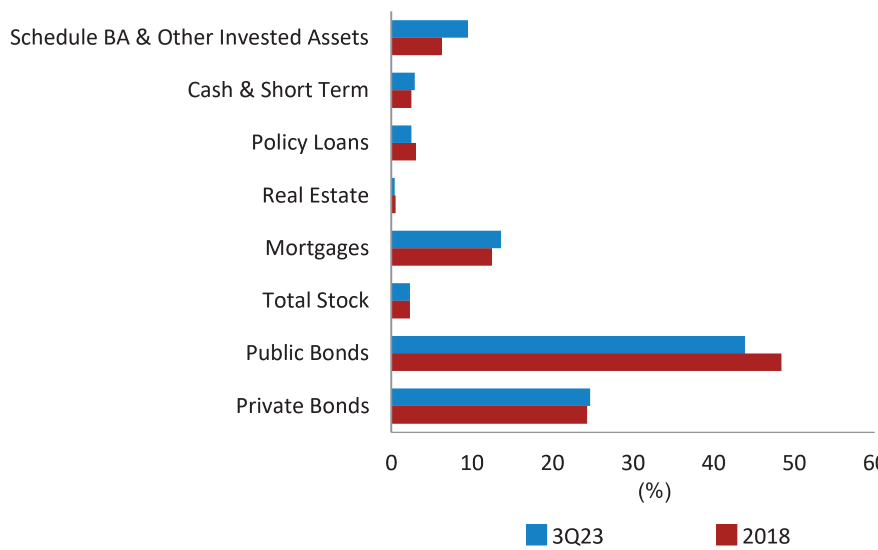
Exhibit 6
US Life/Annuity – Statutory Financial Trends

Profitability	2018	2019	2020	2021	2022	2023E	2024E
Return on Assets (%)	0.6	0.7	0.4	0.6	0.6	0.6	0.6
Return on Equity (%)	10.6	12.2	7.8	10.1	10.3	10.8	9.6
Return on Revenue (%)	4.8	5.6	3.9	5.0	4.8	4.9	4.3
Change in Net Investment Income (%)	2.8	-0.2	-0.3	8.4	-1.3	4.6	3.1
Pretax Operating Gain ($ billions)	47.4	61.8	40.1	56.0	58.8	62.9	58.3
Net Operating Gain ($ billions)	43.9	52.4	34.8	47.8	50.3	53.6	49.7
Realized Capital Gain/Loss ($ billions)	-4.4	-6.7	-10.7	-7.7	-10.6	-9.4	-
Net Income ($ billions)	**39.5**	**45.6**	**24.1**	**40.1**	**39.6**	**44.2**	**49.7**
Capital							
Change in NPW & Deposits (%)	1.0	12.9	-8.1	1.8	9.9	7.8	6.5
Change in Capital & Surplus(%)	1.6	5.7	3.3	8.6	-1.8	4.3	5.7
Change in Net Unrealized Capital Gains/Losses ($ billions)	0.8	19.4	14.5	29.4	-28.3	5.4	-
C&S/Liabilities (%)	11.7	12.1	11.7	12.5	11.6	11.6	11.6
Capital & Surplus ($ billions)	416.2	440.1	454.7	493.9	485.0	506.1	534.8
Asset Valuation Reserve ($ billions)	56.3	71.9	78.3	96.4	87.9	95.5	95.5
Total Adjusted Capital ($ billions)	**472.5**	**512.0**	**532.9**	**590.3**	**572.9**	**601.6**	**630.3**

E = Estimated
Source: BESTLINK

more consensus about the investment landscape but with similar levels of uncertainty as in 2023. So, what does this mean for the risk factors related to insurer investment portfolios?

Exhibit 7
US Life/Annuity – Invested Assets, 2018 v 3Q23



Source: BESTLINK

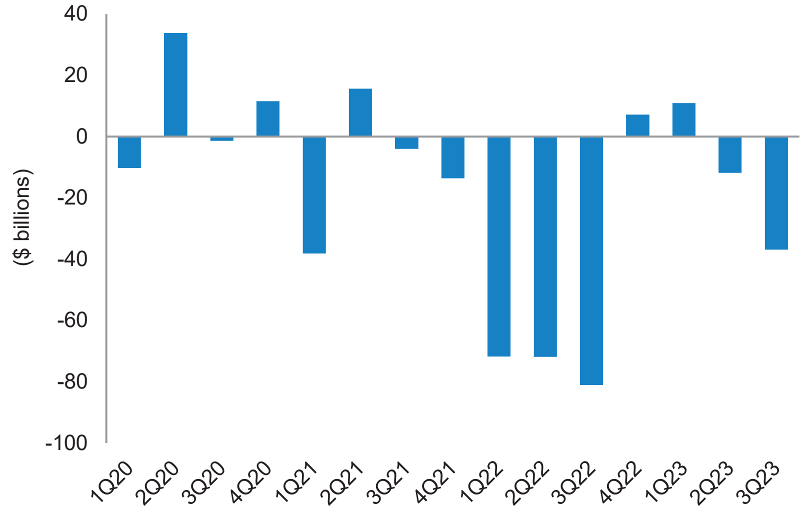
Asset Allocations Focus on Higher Credit Risk Assets with Selective Exposure Changes

L/A insurers' balance sheets, from a risk and credit perspective, have performed well the past year despite concerns about financial market uncertainty, particularly in the commercial property lending sector, as debt refinancing is expected to occur at higher levels over the next two years.

Insurers have improved underwriting capabilities over the past decade, focusing more on structured assets to improve asset-liability matching, yield, and liquidity profiles. Structured assets tend to have more liquidity risk in stressed operating scenarios. This asset risk profile is noted in **Exhibit 7**, which shows that Schedule BA assets have increased in recent years. BA assets lengthen portfolio durations and are used to support capital positions rather than entirely backing liability profiles.

This shift in asset composition has helped insurers mitigate the impacts of rising interest rates while minimizing cash flow volatility, as new money can flow into current market-priced investment strategies. However, these asset allocations cannot completely mitigate all risk, as evidenced by the material decline in the market value of invested assets on insurers' balance sheets over the past two years, making portfolio restructuring more costly. Risks related to investments in these asset classes have been supported by more effective modeling, which has helped the leading asset managers identify market opportunities more so than ever.

Exhibit 8
US Publicly Traded L/A GAAP – AOCI Change in Unrealized Gain/Loss on Investments by Quarter



Source: BESTLINK

Credit Cycle Likely To Be Tested by Volatility

Prior to 2022, interest rates were trending near zero percent. In 2022, as the US started to move to a post-pandemic economy, consistent rate hikes helped curb inflationary pressures, a trend that continued into 2023. The interest rate hikes drove the initial increase in unrealized losses throughout the industry, as the market value of existing fixed-income portfolios across the industry declined. The interest rate increases continued into 2023, resulting in higher bond yields. Portfolio yields grew through the third quarter of 2023, driven by 7.7% growth in net investment income, over the same period in 2022. Invested assets continued to grow and support overall portfolio performance.

The initial rise in interest rates in 2022 drove unrealized losses experienced through accumulated other comprehensive income (AOCI) (**Exhibit 8**). Overall liquidity metrics remain positive, and interest expense coverage remains adequate. Despite some macroeconomic uncertainty, markets finished strong in 2023 and more consistent interest rates should stabilize the effects on AOCI.

Interest rates rose more gradually in 2023 than in 2022, allowing asset managers to reprice incremental cash flows and use excess liquidity to reinvest in newer, market-priced assets to help manage unrealized losses. Diversified liquidity profiles can help insurers absorb market value volatility in their asset portfolios, as new money can be more abundantly deployed in selected asset classes, compared with holding on to lower-yielding, fixed-rate bonds or taking investment losses to make wholesale portfolio changes.

Credit Trends in Commercial Mortgage Loan Allocations Remain the Same

The insurance industry has been averse to commercial mortgage classes such as office and retail in favor of more credit-sound industrial property and multifamily housing (**Exhibit 9**). The much-anticipated decline in mortgage loan metrics has begun to make its impact when we look at the trend in commercial loan delinquencies (**Exhibit 10**). This trend is expected to grow in 2024 regardless of whether the economy has a soft landing. Despite the growth in delinquencies, current market conditions do not generally have a negative ratings impact on insurers' balance sheet and liquidity profiles. As long as the level of interest rates drives higher refinance rates, delinquencies will increase. There will always be potential outliers, which may have outsized negative implications, with impairments expected to develop over time.

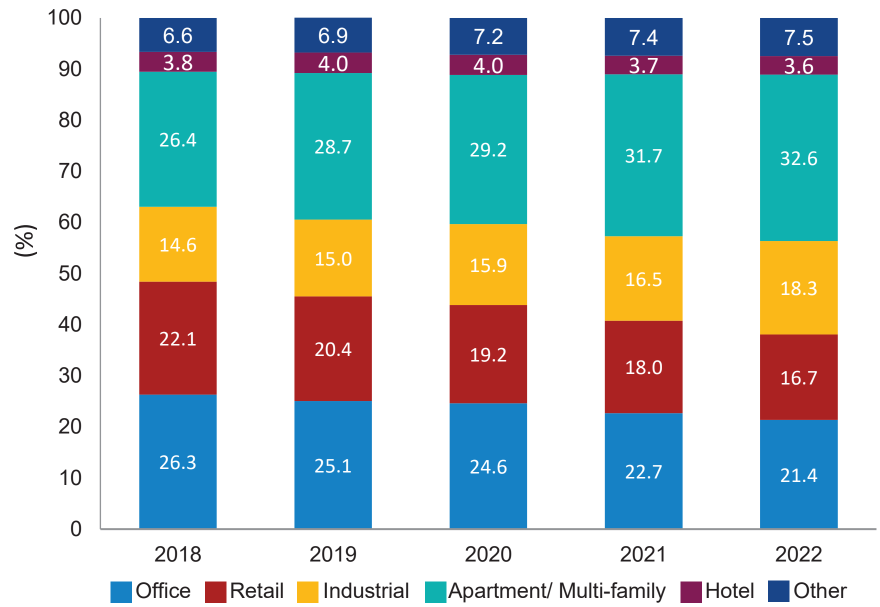
Investment Gains Were Steady

Net income for 3Q23 was level compared with 3Q22, as interest rate hikes slowed (**Exhibit 11**). Despite the impact of rising interest rates on investment returns and the attractiveness of products with investment return components, carriers continued to focus on growing less interest-sensitive business as they balanced risk in their liability profiles. Spread compression is less of an immediate concern in the rising interest rate environment as companies have taken a long-term view of this risk. Competitive pressures continue to create a shift to some marginally higher-risk products. Some insurance companies are looking to expand their sales of registered index-linked annuities (RILAs) to grow their books of business.

The historic drag from the low interest rate environment that has narrowed margins and stifled earnings growth may have leveled off, with investment yields potentially experiencing the first

Exhibit 9

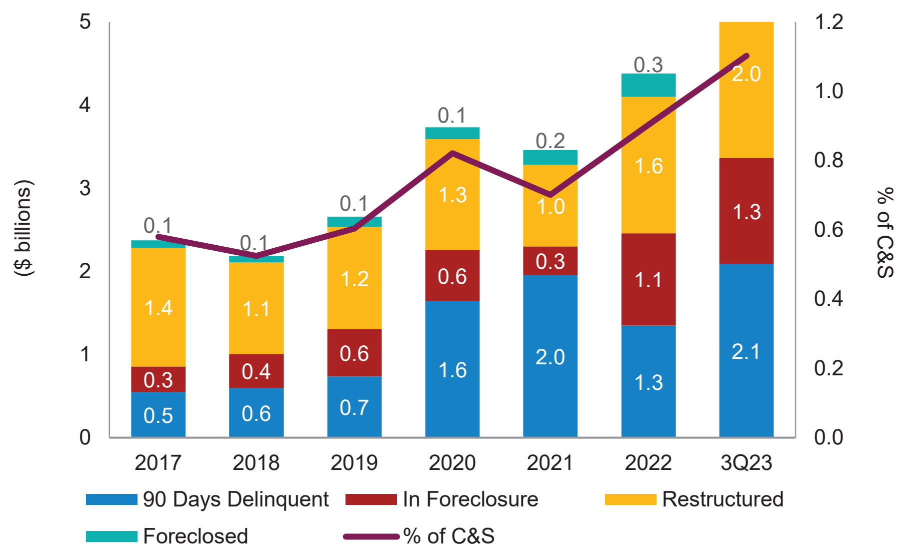
US Rating Units: Mortgage Loan Portfolio by Property Type



Source: AM Best data and research

Exhibit 10

Problem Mortgage Loans



Source: BESTLINK

Exhibit 11

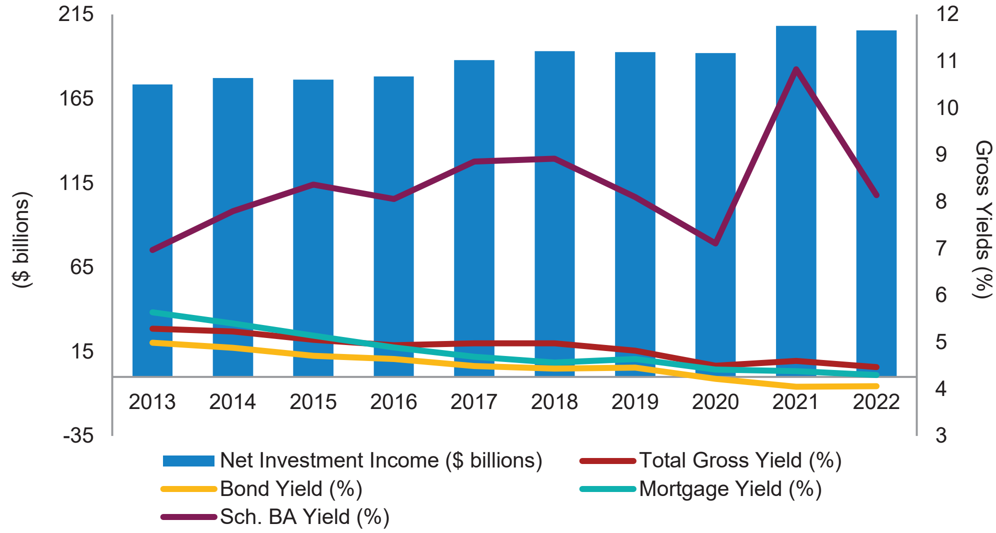
US Life/Annuity – YTD Statutory Quarterly Results

($ billions)

	3Q22	4Q22	1Q23	2Q23	3Q23
Premium & Annuity Considerations	541.6	709.4	191.5	383.4	554.4
Increase in Reserves	80.8	161.6	33.5	66.9	75.5
Net Income	**31.6**	**39.6**	**7.1**	**13.3**	**31.6**
Pretax Operating Gain	42.4	58.8	15.0	29.7	56.0
Separate Account Assets	2,674.9	2,769.0	2,863.8	2,944.2	2,817.3
General Account Assets	5,467.3	5,503.7	5,550.9	5,607.5	5,612.4
Capital & Surplus	483.7	485.0	483.8	484.3	493.0

Source: BESTLINK

Exhibit 12
US Life/Annuity – Portfolio Yields



Source: BESTLINK

sign of improvement since the Federal Reserve started raising rates (**Exhibit 12**). Ongoing growth in general account invested assets, which reached a record $5.3 trillion as of September 30, 2023, has also helped enhance net investment income. Despite the positive change in interest rates, a changing and volatile interest rate environment is likely to continue to create noise on margins until longer-term interest rates and credit spreads return to more stable and normalized levels, which will take several reporting periods before impacting operating performance. The adoption of long-duration targeted improvement (LDTI) contracts by the industry added volatility to reported financial metrics in 2023.

Uncertainty about the US economy and geopolitical risks could create significant headwinds in 2024, but life insurers have mostly favorable risk management practices, including the use of hedges, adjustments to crediting and discount rates, business mix re-evaluations, and a focus on technology and innovation. GAAP accounting for net income is also impacted by hedges, in contrast to statutory accounting, as many companies' enterprise risk management (ERM) programs are set up to manage the economic impacts, rather than the full accounting impacts, of market movements.

Historically, financial metrics at the holding company level have been a positive or neutral rating factor for the lead operating company's balance sheet assessment, but there has been a general rise in financial and operating leverage. Mitigating the rise in operating leverage is the segment's overall liquidity profile, which remains positive, as companies have expanded credit facilities in anticipation of economic uncertainty.

Mortality and Underwriting

For most companies, COVID-19 mortality affected earnings (as opposed to balance sheets), suggesting no significant impact on reserves or capital. The impact of COVID-19 on mortality has declined since the Omicron variant in early 2022. According to research by the Society of Actuaries (U.S. Individual Life COVID-19 Reported Claims Analysis — 2Q 2023 Update), claims counts are reverting toward pre-pandemic levels. Actuaries expect that mortality will remain elevated but move towards pre-pandemic levels through the rest of the 2020s. Most carriers had higher mortality rates than usual between 2020 and 2022, resulting in slightly favorable development for both long-term care and annuities. In 2021, mortality was higher for working age populations, which affected both individual and group life claims.

The longer-term implications of COVID-19 and other mortality factors on liabilities and future pricing assumptions are still uncertain, with most companies not yet making significant changes to their mortality assumptions. Mortality rates have risen for certain carriers, products, or population segments more recently, but whether this is seasonal (reflecting a colder winter in the first quarter of 2023), a function of the carrier's business profile, or part of a long-term mortality trend for insured lives remains to be seen. Companies will have different claims experience depending on their target markets, the products they sell, and their underwriting methods. For example, some reinsurers may have larger or non-standard policies or may be exposed to certain large claims exceeding the cedent's surplus point or corporate retention. As a result, reinsurers' claims experience in absolute terms and relative to the premiums they collect may differ. Insured lives' mortality levels have run lower than the general population's, owing to the effect of insurers' selective underwriting and sales methods.

Higher premiums and fewer death benefits led to lower payout ratios on individual life insurance policies on the books of US-domiciled life insurers from 2020 through 2022, despite concerns about COVID-19 and elevated mortality in certain population segments. The payout ratio, which compares paid death benefits to net premiums written, fell to 48.9% in 2022, from 53.7% in 2021 and 55.7% in 2020. The payout ratio, however, mixes in-force policies with new business. The profitability of more recent business remains to be fully tested, as mortality claims experience for a block of policies will take years to emerge. Companies with robust experience examine processes as part of their enterprise risk management (ERM) frameworks, which separate actual versus expected mortality by in-force and new business. They assess the credibility of recent experience on a face amount, in addition to a mortality count, basis, and are better positioned to maintain strong operating performance or pivot their management strategies. Questions remain about mortality due to COVID-19 and other causes, which highlights the importance of cross-functional collaboration between primary and specialist doctors (e.g., oncologists) working with actuaries to assess mortality trends at a cause-of-death level.

The pandemic expedited innovation, promoting the use of more digitized approaches to underwriting. Big Data in the L/A segment continues to improve, leading to more advanced underwriting standards. AM Best expects to see more granularity and improved underwriting capabilities on the mortality front for both life and longevity insurance. Actuaries typically benefit from large data sets that have stood the test of time. Although historical data does not necessarily betoken the future, it does help actuaries frame problems, to understand the order of magnitude and sense of direction of a certain situation. Modeling can support informed decisions but depends on the type, quality, and timeliness of data.

Interest Rates and Equity Markets

Stock Market Volatility Amid Higher-for-Longer Interest Rates

The Fed has raised rates eleven times since March 2022 to combat high inflation, which has slowed to approximately 3% after reaching a four-decade high in the summer of 2023. The target rate range is now between 5.25% and 5.50%, up from between 4.50% and 4.75% a year ago. The 10-year Treasury rate finished 2023 at 3.86%, roughly in line with year-end 2022, indicating the markets expect a long-awaited dovish pivot from the Fed for interest rate cuts in 2024. Credit spreads narrowed slightly in 2023, highlighting greater investor appetite for corporate securities with stronger balance sheets. Whether bondholders will be properly compensated for the risk they are bearing remains to be seen.

The Federal Open Market Committee (FOMC) seeks to achieve maximum employment and 2% inflation over the longer run. At the time of this report, the FOMC had been providing guidance of potential decreases depending on economic conditions. According to a statement from the FOMC's December 13, 2023, meeting:

> *Recent indicators suggest that growth of economic activity has slowed from its strong pace in the third quarter. Job gains have moderated since earlier in the year but remain strong, and the unemployment rate has remained low. Inflation has eased over the past year but remains elevated.*

On January 25, 2024, the Commerce Department's GDP report showed that the US economy grew at a 3.3% annualized rate in the fourth quarter of 2023, significantly higher than the expected 2%. This leaves the Federal Reserve with plenty of food for thought ahead of the next FOMC meeting, and rate cuts may occur later than some initially anticipated.

Insurers with large annuity blocks that don't provide competitive crediting rates or have surrender charge protection could see heightened disintermediation risk. Long-dated assets could face liquidity pressures in meeting surrender values and the sale of assets at a realized loss. This exemplifies the importance of carriers maintaining robust asset-liability management (ALM) practices as part of appropriate ERM. How this environment will affect the segment remains to be seen, as L/A insurers welcome rising rates but not quickly rising rates. Further, volatile equity markets could lead to a rapid drop in account values, which could bring policyholder guarantees in-the-money. Policyholders seeking fixed crediting rates instead of variable may initiate transfers from their separate accounts to the insurer's general account, which could pose additional risk for insurers. Carriers with large separate account blocks would also face fee income pressure from suppressed separate account asset values, highlighting the importance of company projections and stress testing. Legacy liabilities in risky product offerings—including long-term care, universal life with secondary guarantees, and variable annuities (VAs) with living benefits—also generate uncertainty.

Several carriers have expanded their cash allocations to benefit from higher short-term yields for low relative risk, positioning them favorably over other carriers with legacy investments in riskier asset classes. These riskier classes include collateralized loan obligations (CLOs) and commercial mortgage-backed securities (CMBS) with lower Sharpe ratios, which insurers might be locked into under their duration-matching unless they incur a realized loss.

Potential Management Actions in Response to Higher Interest Rates

Perhaps the biggest impact on life insurers of the new interest rate environment and decades-high inflation is that insurers and distributors will likely re-emphasize their focus on consumers and their needs. AM Best expects that key performance indicators such as faster underwriting and claims processing turnaround times and the fair treatment of customers at claims stage will garner a renewed focus and attention from management as a key strategic differentiator. Rising rates affect all management actions, but the biggest impact may be on consumer behavior and earnings in an inflationary environment, particularly for life insurance, which can be a discretionary purchase, especially in a recessionary environment.

After years of generally investing in shorter-than-average liability durations, many carriers have been extending their asset durations by buying higher-rated, on-the-run bonds with more attractive coupon rates, for better ALM matching and earnings quality. However, companies that have not invested in or responded quickly enough to the need for a robust asset allocation framework will be more pressured than their peers and could offer less attractive products for new business growth and face ALM and liquidity challenges from increased disintermediation on in-force business (especially if many seasoned policies have no surrender charge protections or market value adjustments).

Disintermediation can arise from several policyholder actions, including an increase in surrenders, partial withdrawals, 1035 exchanges, and policy loan utilization. A more gradual increase in interest rates would allow companies to adjust assets more efficiently and effectively. AM Best expects that some carriers will maintain their barbell investment strategies. Some companies may anticipate continued rate increases and not lock themselves into longer-duration investments.

Carriers may take advantage of asset rebalancing opportunities to de-risk their asset allocations—at least partly—from leveraged loans and CLOs, including corporate bonds, commercial mortgage loans, structured securities, direct private debt, and equities. Insurers have been following a years-long trend by growing their structured securities investments. However, the picture for 2024 is uncertain as issuance declined significantly. Rising rates won't end the practice of investing in alternative asset classes such as private debt. The spreads between those assets and public bonds have narrowed, but some alternative securities can offer insurers the ability to control risk through customized credit agreements and structuring.

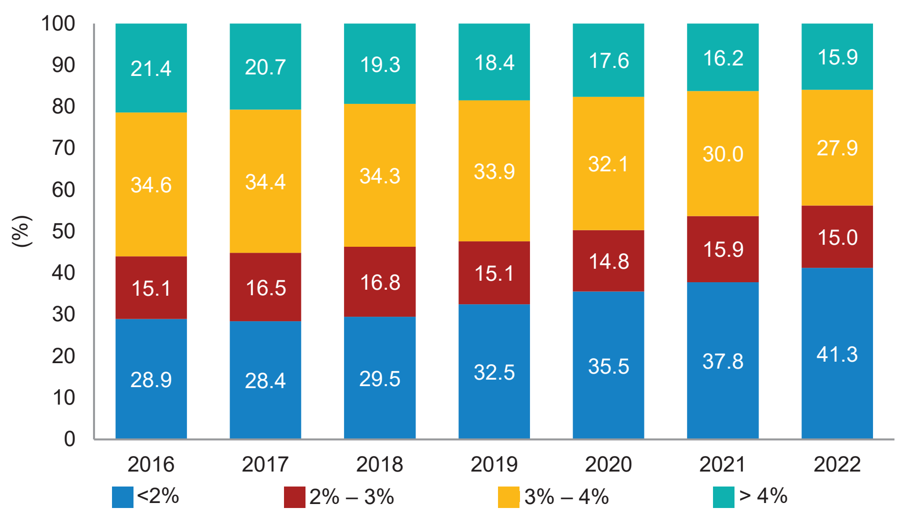
Other ERM practices such as stress testing and more frequent repricing of crediting rates take on heightened importance and should also serve as key risk mitigants. Still, assumptions used in annual cash flow testing can be negatively impacted by rising interest rates, which could lead to additional reserves and lower surplus.

Based on data from the AM Best-rated population (via the Supplemental Rating Questionnaire [SRQ]), L/A account values with a guaranteed minimum interest rate (GMIR) of 4% or higher declined from 21.4% in 2016, to 15.9% in 2022 (**Exhibit 13**). The decline can be attributed partly to the divestment of high GMIR business to offshore non-statutory insurance entities, as many insurers have established affiliated offshore reinsurance entities for tax and capital advantages. AM Best expects this trend to continue over the near term, as L/A insurers seek to optimize capital and de-risk in a more favorable environment for compelling reinsurance pricing and to protect their balance sheets and business profiles against falling interest rates in the event of a recession.

For VAs, carriers may find that if rates rise and stocks fall, some equities-linked VAs are "in the money" and, as a result, carriers need to cover losses. Products that were increasingly common in the days of lower rates, such as RILAs and others with a loss buffer, could be less attractive to insurers.

Actions such as divesting in-force legacy annuity blocks and cutting back or discontinuing sales of higher capital-intensive or interest-sensitive products (universal life products with secondary guarantees, VAs with living benefits, fixed deferred annuities) accelerated between 2020 and 2023, and strategic reviews of divestments and block reinsurance transactions are likely to continue in 2024. A number of L/A insurers

Exhibit 13
US Life/Annuity – Statutory Account Values for Contracts with Guaranteed Minimum Interest Rates



Source: AM Best data and research

exited the individual life and annuity lines of business during the low rate environment, but this trend is likely to reverse, as many new ventures enter the spread business primarily through annuity (re)insurance. These ventures would start with newer and cleaner portfolios offering higher yields, in contrast to legacy players that were competing for business in a lower-rate environment. But for that to happen, we would have to be at the top of the interest rate cycle, which not all participants believe is the case. In addition, the ultra-competitive market for blocks of fixed annuities should continue to force some L/A (re)insurers to look more closely at alternative blocks of business. However, few players have the capability, resources, and appetite to take on large variable annuity blocks or other alternative blocks of business.

New Capital Continues to Flow into the L/A Market

Private equity and asset manager (PE/AM) owned insurers have grown in number and assets over recent years, to nearly 10% of the total L/A industry by admitted assets. Substantial deals in the past three years, primarily in the annuity business, have resulted in strong premium growth for these insurers. AM Best's discussions with these insurers indicate that there is little expectation of a near-term slowdown, as owners maintain a large amount of committed capital to provide to these operating entities once further deals are identified and executed. Although many of these companies and their PE/AM owners have been open to taking on pure life business for a more diversified mix, annuity business to date has been much easier to come by. Several insurance management teams have noted that deal flow declined modestly in 2023, as some potential partners felt more comfortable retaining their annuity business because of the higher interest rate environment.

Despite the rapid growth in premiums and balance sheets, operating results for these types of organization structures have largely followed the greater industry when mutuals are excluded. Median returns on equity (ROE) for PE/AM-owned insurers have mirrored those of stock companies since the beginning of more rapid growth in 2021, with results only slightly below those achieved by the stock entities. With substantial committed capital available at the parent level but not moved to the operating entities until deals are finalized and business is ceded, many have been able to operate relatively lean, enhancing ROE with just-in-time funding. In addition, some PE/AM owners have adopted sidecars, which are reinsurance affiliate or non-affiliate entities that draw on capital from third-party limited partner investors and which can provide incremental just-in-time capital to execute larger deals and earn additional fees for the general partner.

Even though some PE/AM sponsors may pivot new investments away from insurance blocks toward assets yielding attractive returns in the higher rate environment without having to take on and manage the insurance risks associated with an acquired block's liability stream (e.g., mortality, morbidity, lapse, surrenders), certain sponsors may still seek to use sidecars to maintain a presence and PE-like business model. Even if asset manager sponsors maintain their commitment to the long-term nature of life and annuity insurance business, the sidecars to which they retrocede a small share of the business typically follow a traditional private equity model, in which the limited partners commit to a three- to seven-year investment horizon. Furthermore, separate owners and boards would enable the sidecar to provide reserve and risk-based capital (RBC) relief to the asset manager, but the sidecar may pivot the business mix to different types under a separate strategy or risk appetite and underwriting frameworks, which could introduce additional risk. Time will tell regarding eventual exit strategies for these owners.

Private equity owners have invested significantly in human capital, recruiting experienced insurance professionals to support operations and navigate complicated state regulatory environments. AM Best has often viewed the management of these operating entities more favorably than new entrants given the insurance experience of the teams and the owners.

Some newer entrants looked at past successes, mentioning Athene, which was created by Apollo in 2009, as a template for what can be achieved. Apollo's success, however, was primarily the result of opportunities at the time, with low interest rates for over a decade. Given the rise in rates beginning in the second quarter of 2022, the pricing environment and credit cycle differ substantially; current strategies must take advantage of these distinct opportunities.

PE/AM-owned insurers generally are more comfortable taking on investment risks built on the experience of their parent companies in structured products, mortgages, private credit, and other alternatives. These higher-risk assets reflect unfavorably on BCAR scores, although the scores typically remain at the Strong to Very Strong assessment level, slightly below the rest of the industry. A focus on liquidity and having a large parent willing and able to support the operating entities also support these companies' overall balance sheets. Despite annuities being very capital-intensive, PE/AM owners have supported rapid growth by providing the needed capital and eschewing material dividends. Some insurers maintained large cash allocations before rates started rising; these carriers are now benefiting from high yields in short-term money market instruments without being exposed to legacy illiquid investments in alternative asset classes.

The balance sheet strength assessments of entities that are part of PE/AM structures tend to flow through to overall ratings as well, with nearly 98% of ratings of investment-grade quality bbb- or higher and approximately 70% rated "a-" or higher. Operating performance for these companies tends to have more "Adequate" assessments than the industry as a whole, which has a higher proportion in the "Strong" and "Marginal" categories. This was also true for business profile assessments, as PE/AM-owned entities have a higher proportion of "Neutral" profiles than the rest of the industry. A "Limited" profile is much more prevalent than a "Favorable" one due to a more limited track record compared with long-term established players.

PE/AM business profile assessments in the product risk area benefit from more robust surrender charge protection than other organization structure types. Approximately 44% of PE/AM-owned insurers have a market value adjustment provision for their annuity business, compared to only 23% for mutuals and 14% for stock companies. Similarly, a surrender charge of 5% or more was attached to 12% of annuities for PE/AM-owned insurers but only 10% for mutuals and 7.5% for stock. The enterprise risk management assessments of PE/AMs followed the general industry, with the vast majority considered Appropriate for the risks taken on.

Many PE/AM-backed insurers have used affiliated (often offshore) reinsurers for capital management, risk transfers, and tax savings but retain the premium to invest. These reinsurance deals often complicate the accounting. AM Best captures these risks at the consolidated level by looking at the ceding and affiliated captive reinsurance company in the global BCAR model. A group's ERM framework remains paramount—especially governance and the company's track record in maintaining pricing discipline.

Risks are heightened when deals involve a negative ceding commission, where the cedent pays the reinsurer for assuming a loss-making block, as this highlights potential anti-selection as the cedent seeks to transfer a particularly problematic or underpriced block of policies. The validation of all pricing assumptions that influence the amount of the negative ceding commission is critical to the ultimate solvency of carriers and the security of policy owner benefits. Negative ceding commissions that are not negative enough, low reserves based on outdated assumptions, and excess dividends to sponsors or limited partner investors could all adversely impact the solvency of the PE/AM-owned reinsurers.

Other PE/AM-backed insurers look to grow assets under management through reinsurance transactions with third parties that can offer attractive ceding commissions based on higher anticipated investment returns once the transferred assets are rolled into a wider set of investment opportunities. Some of these insurers have emphasized their flow reinsurance business strategies, further indicating their long-term commitment to the industry.

Questions do remain on how some of these entities will modify their strategies over the long term, assuming their stated long-term commitment is unwavering regardless of macroeconomic trends, availability of deals, and regulatory changes. This "new capital" appears here to stay, with billions more committed but on the sidelines, waiting for the next opportunity.

Life and Annuity Sales Trends

Life Insurance Sales Grow Modestly

The L/A industry reported relatively modest life insurance sales growth in 2023 after record sales in 2021 and 2022, as the pandemic greatly increased awareness of the need for life insurance. Coupled with a favorable economic environment due to fiscal and monetary stimuli, this resulted in a favorable sales environment for the life insurance segment. Inflationary pressures in 2023 dampened discretionary income. According to LIMRA, term life sales grew 4% in the first nine months of 2023 compared with the same prior-year period, which indicates consumers sought more cost-efficient term life insurance protection in an inflationary environment that constrains household budgets. Consumers seeking mortality protection and financial security tend to find term coverage affordable. The payout ratio fell for most lines of ordinary life business in 2022, although it was more significant for term life insurance than for whole life. Term life insurance premium grew over 40% in 2022, with higher premiums bringing down the payout ratio.

Mutual life insurers have led the way in sales in recent years, as many publicly traded companies stopped or substantially cut back their life insurance product offerings due to the low interest rate environment, which made achieving profit margin targets difficult. According to LIMRA, sales of both whole and term life both rose through the first three quarters of 2023, while those of indexed universal life and variable universal life sales declined. Permanent whole life increased again in 2023 after a spike in sales in 2022 due to changes in Internal Revenue Code §7702, which allowed high-income policyholders to build up tax-efficient growth in policy cash values. The higher interest rate environment also improved profitability for insurers selling life insurance policies and many mutual insurers have been raising their policyholder dividends, further enhancing the value of participating whole life insurance.

Also according to LIMRA, at the end of third-quarter 2023, new annualized premium for fixed and indexed universal life declined in favor of variable universal life sales. Sales of these products were driven by a small group of carriers, but relatively strong variable universal life sales may indicate greater consumer and distributor confidence with regard to taking on a greater share of the investment risks and potential rewards.

Some life insurers began experimenting with direct-to-consumer (DTC) models during the pandemic, while many others stopped using this model due to higher than expected acquisition costs and an inability to sell more complex policies. Still, the DTC model has proven effective for insurers focused on selling simplified life insurance policies and willing to be flexible, offering a hybrid model whereby consumers can talk to a representative or agent.

Annuity Sales Benefit from Higher Interest Rates

Many L/A insurers seized the opportunity presented by rising interest rates over the past two years to ramp up fixed-annuity production. Rising interest rates enabled L/A insurers to invest in higher-yielding securities and offer higher crediting rates, which in many cases have risen much faster than competing bank CDs. Continued improvements in the customer experience through greater digitization and innovation is also benefiting sales growth. After a record year for fixed-rate deferred annuity sales in 2022, sales were up another 43% through the first three quarters of 2023, according to LIMRA.

Although 1035 exchanges may account for a large portion of these new sales, the industry has expanded market share over the past two years, as customers lock in favorable crediting rates. A significant amount of three- and multi-year guaranteed annuities were sold during the pandemic when credit spreads widened significantly, allowing insurers to invest in higher yielding securities. As these annuities exited the surrender charge period, surrenders increased notably in the first half of 2023. These surrenders will likely prompt annuitants to move their money into annuities with a higher crediting rate, resulting in higher sales for the industry. Some insurers lack capacity to significantly increase annuity sales, but AM Best expects strong fixed-rate and indexed annuity sales to continue for the L/A industry over the near- to medium-term.

As in prior periods of market volatility, demand for VAs declined in 2022 and 2023, because many insurers ceased offering VAs due to their capital-intensive nature and the significant earnings volatility they cause. Many insurers also curtailed the benefits that these products have historically offered and have shifted some of the risk to the policyholder, as with RILAs. RILAs experienced tremendous growth in recent years, with many new carriers entering the market. Although sales of these products moderated somewhat in 2022, as more risk-averse consumers were attracted to the higher crediting rates of fixed annuities, RILAs were still in demand in 2023 owing to the segment's record sales growth.

Many higher-rated annuity providers have tapped into the bank distribution channel. Large banks have been stingier in crediting interest, as they have found fewer opportunities to lend money in the current environment. Many of the leading annuity writers have stepped into this void by offering annuity products to compete with those offered by banks. Often these products are sold at banks eager to expand their suite of products to customers.

Strong Annuity Growth Drives Favorable Operating Earnings

Segment pre-tax net operating gains through third-quarter 2023 rose 31.7% over third-quarter 2022. Total revenue was up, driven by a 2.4% increase in premium and annuity considerations over third-quarter 2022. Full-year 2023 pre-tax net operating gains are expected to be favorable, owing to the rise in net premiums and annuity considerations, as well as total revenue outpacing the growth of total expenses, due primarily to a projected decline in general expenses.

Insurers continued to innovate and offer new annuity products. Annuity sales proved to be a consistent earnings driver for insurers and an attractive product for consumers, driven by the rising interest rate environment of 2022 and 2023. RILAs, fixed-indexed annuities (FIA), income annuities, and fixed deferred annuities all contributed to the strong growth experienced by annuity writers. VAs declined through the third quarter of 2023, due largely to a short period of uncertainty in the equity markets earlier in the year. Overall, annuities grew roughly 18.5% (on a direct basis) in the third quarter of 2023 from the same period in 2022. According to LIMRA, VAs accounted for 27% of the total annuity market, compared with 36% as of third-quarter 2022. Although a recession is still possible, the equity markets experienced a favorable end to 2023 and are expected to contribute to continued growth in annuities in 2024.

Tabular mortality was more favorable in 2022, returning to pre-pandemic levels. This was accompanied by an increase in net underwriting income as well as a decline in benefits paid compared with 2020 and 2021 results. A decline in direct life premiums and smaller increases in life reserves benefited the bottom lines of life companies but the decline in life insurance premiums is a negative for future results.

Operating results for PE/AM-owned companies improved from 2021 to 2022, but the median ROE was the second-lowest of the past five years. The operating results of stock companies also improved from 2021 to 2022, due largely to growth in invested asset bases as well as an increase in premiums in 2022 from 2021. Mutual companies reported the lowest median ROE of the last five years (**Exhibit 14**).

Stabilizing interest rates, stronger equity markets, and favorable mortality and underwriting trends contributed to the positive pre-tax operating earnings through the third quarter of 2023. The past three years were generally challenging for L/A insurers, as they navigated excess mortality from the pandemic and rapid interest rate hikes aimed at easing inflation. Tailwinds for L/A writers in 2024 include mortality approaching pre-pandemic levels and higher interest rates. Headwinds include uncertainty about a soft landing and global political tensions that could impact capital markets.

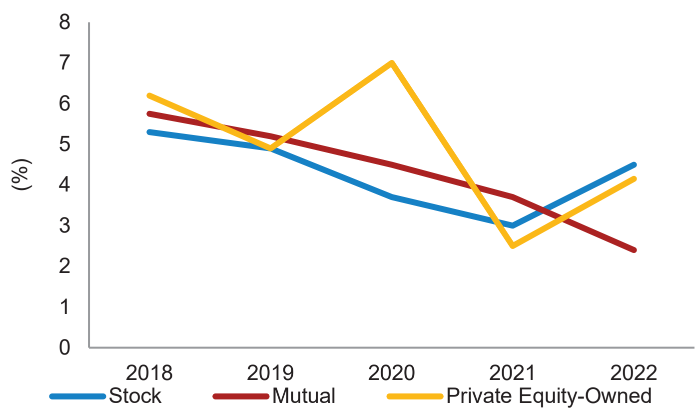
Artificial Intelligence Takes the Spotlight

Interest in artificial intelligence (AI) has exploded in recent years—particularly in 2023, following the release of ChatGPT in late 2022. Human-like responses on a seemingly unlimited number of topics prompted excitement in those outside the tech space.

Although AI has already been integrated in various ways by larger L/A carriers, heightened awareness of more recent advancements prompted many to re-evaluate how they're using the technology and to identify additional opportunities and potential threats. Many companies rated by AM Best have already implemented AI on at least a limited basis. One of the most common uses is that of chatbots for immediate customer service on simple inquiries, allowing agents to use their time more effectively by dealing with more complicated matters. AI has been used to varying degrees in the underwriting process and general data analysis, helping to identify trends that could be useful for determining pricing and identifying fraud.

AI may also enable other advances that benefit the L/A segment—for example, advances in medical research, diagnostic work, and drug development may improve mortality and morbidity considerably. However, AI could also diminish the need for professional advisors when choosing financial products. Additionally, as AI improves, distinguishing AI-generated text, images, audio, and video from human creations will become more difficult. The implications could be massive if AI models are used by bad actors to file fraudulent claims or create more sophisticated cyber attacks.

Exhibit 14
US Life/Annuity – Median ROE by Organizational Structure



Source: AM Best data and research

Having accelerated their digitization efforts during the pandemic, many companies continue to enhance those applications and platforms to provide a more personalized experience for clients and assist agents in the field. Carriers have already seen positive results from these initiatives, as better product recommendations provide cross-selling opportunities by identifying additional needs, and improve retention of clients and persistency ratios.

Despite ongoing initiatives, the L/A industry remains the least innovative per AM Best's innovation assessments when compared to the property/casualty, health, and reinsurance segments. This is expected to continue for the foreseeable future as property and healthcare risks change more rapidly. Life and annuity companies face many of the same challenges as the broader insurance industry, including the fight for talent. When considering innovation, insurers will need to either attract human capital away from more technology-centered businesses or buy platforms and tools from third parties, which can introduce additional risk. Many smaller and medium-sized players that do not have the resources to build in-house instead choose to invest in insurtech through venture funds or direct partnerships. The L/A segment typically lags in innovation but remains committed to continued improvement, and the negative impact on ratings has been negligible to date.

Effective ERM Remains Paramount

Historically strong and effective risk management programs have proven to be necessary if insurers are to remain competitive—which was especially evident during the pandemic years. Persistently elevated mortality claims, losses due to market volatility, and historically high inflation rates could paralyze companies with weaker risk management programs in place. Capital efficiency and planning remain critical in facing continued uncertainties as the pandemic-related mortality losses subside. Continuous stress testing is essential when assessing the potential impact of unexpected events post-pandemic. Many insurers' balance sheets were very strong throughout the pandemic, but they have yet to be further tested by inflation or a recession, as overall expenses continue to rise.

Incorporating advanced analytics should be routine, while advanced security systems to track cyber attacks are essential to protect customer data—traditional risk assessments are not enough anymore. With worsening geopolitical tensions, growing cyber attacks, and concerns about the overall economy, many insurers have considered outsourcing cyber security, to enhance their overall risk mitigation strategies. The rapid rise in interest rates affected insurance company investments and increased regulator focus on performance, as well as whether reserve requirements are sufficient.

Cyber security is emerging as an important aspect of enterprise risk management. The insurance industry holds a vast amount of sensitive customer data, making it an attractive target for cyber criminals. Attacks have intensified as insurance companies have built up digital channels to support closer customer relationships. As risk management practices evolve, insufficient employee training could become problematic in responding to severe cyber attacks. In 2023, a number of insurance companies were targets of a file transfer cyber attack, exposing vulnerabilities in securing data properly. Additional investment in internal training and infrastructure has become even more important to minimize threats.

With new asset managers and private equity firms entering the industry, risk management will be even more challenging, with riskier investments in unproven portfolios. Large legacy blocks have been absorbed by new competitors, transferring risk to unknown offshore entities, particularly in Bermuda and, more recently, the Cayman Islands. Risk management will play an even bigger role as a result. If risk appetites or tolerances are exceeded, an insurance company should have defined breach escalation procedures already built into the risk management process. Risk management has evolved into a large-scale, organization-wide effort. Chief risk officers have been assigned extra responsibilities to build healthy organizational cultures and develop new policies to keep the industry ahead of potential issues.

Despite the evolving risks that have plagued many insurers the last few years, dynamic ERM strategies have for the most part been successfully implemented. Support of organizational leaders helps set an example of the risk-management culture, supported by a team dedicated to the ERM function.

With the advent of new technologies, continued geopolitical tensions, the pandemic aftermath, and environmental threats, the appropriate level of risk-adjusted capital will be vital to the ERM programs. Areas potentially affected by these emerging risks could include strategic investment allocations, the launch of products incorporating specific risks versus rewards, incentive compensation, risk-adjusted financial targets, and dividend practices. For example, life insurers might encounter lower sales and higher-than-expected termination rates from either increased lapses or higher non-renewals.

ERM will be vital for insurers in 2024 as they face uncertainty in the credit cycles and continued exposure to the commercial real estate sector. Managing credit exposures and the overall duration gaps is key for many insurers. Vigilant matching of assets to liabilities are imperative for a successful risk management framework.

Accounting Changes

US L/A companies have significant time and resources to prepare for potential changes stemming from IFRS 17 and GAAP accounting rule changes.

IFRS 17

In the US, the National Association of Insurance Commissioners (NAIC) continues to evaluate a number of regulatory issues, with the implementation of IFRS 17 the biggest current accounting story. Effective for financial periods as of January 1, 2023, IFRS 17 is an International Financial Reporting Standard (IFRS) issued by the International Accounting Standards Board (IASB) for insurance contracts. The standard substantially changes insurance contract accounting in jurisdictions that have adopted IFRS but not in the US, where (re)insurers will continue to report under US generally accepted accounting principles (GAAP) and statutory accounting.

However, subsidiaries and branches of insurance groups, including those of US-based insurance groups in jurisdictions in which an insurance entity is required to file IFRS accounts locally, will have to apply the standard in those filings. IFRS 17 is intended to bring insurance accounting more in line with that of other business sectors and to provide more uniformity to insurance accounting across territories. Disclosure and transparency are likely to improve under IFRS 17, but the standard will also add considerable complexity. AM Best believes that the industry is well prepared for this change and that comparability across certain geographic territories will be a benefit.

GAAP

Rules recently released by the Financial Accounting Standards Board (FASB) are among the most significant changes to GAAP accounting in several decades. These rules simplify and enhance financial reporting for long-duration targeted improvement (LDTI) contracts (ASU No. 2018-12 or FASB 944) while creating a more standardized and transparent GAAP statement.

For public SEC filers, the rules became effective January 1, 2023 (with a transition date of January 1, 2021). The accounting standard aimed to improve the timeliness for recognizing changes in assumptions used to determine liabilities for future policy benefits, including discount rates applied to cash flows; simplify the amortization of deferred acquisition costs; improve accounting for certain market-based options or guarantees associated with deposit contracts; and improve the effectiveness of required disclosures. Following implementation in 2023, the impact for most companies has been benign thanks to higher interest rates, which have diminished the effect of discount rates on AOCI.

The NAIC is tackling a number of key topics. It has adopted a change to the life risk-based capital by requiring that residual tranches of structured securities receive a 30% factor for year-end 2023 RBC filings and a 45% factor for year-end 2024 RBC filings. The change was made to improve oversight of these increasingly opaque investment structures, but the estimated impact on RBC ratio results is likely to be small. In 2023, the NAIC adjusted its guidance on negative interest maintenance reserve (IMR), which has helped soften the statutory accounting impact on capital driven by interest rate increases. NAIC adopted INT 23-01, a temporary accounting change for negative (non-admitted) IMR. Under the guidance, insurers must have an RBC that is greater than a 300% authorized control level; the amount admitted is limited to 10% of capital and surplus and the optional provisions are permitted until December 31, 2025. AM Best sees the additional oversight on certain asset classes as a good way to ensure prudent investment management practices are being followed while considering capitalization. In addition, the provisions for negative IMR will directly impact capitalization, which will help mute noneconomic accounting impacts to better reflect longer-term capital levels.

Challenges on the Horizon

In 2024, we expect segment challenges to remain manageable given insurers' robust risk-adjusted capital, favorable liquidity profiles, and effective ERM practices. Insurers have seen strong annuity sales that continue to build on prior years. Slightly improving new money yields and a benign credit environment continue to foster favorable operating conditions. However, in light of economic uncertainty and potential market volatility, concerns remain with regard to asset classes such as structured securities and real estate. In addition, the need to attract talent amid ongoing labor shortages has carried over from the prior year. Finally, insurers will find navigating evolving technology advancements such as artificial intelligence while maintaining robust risk management programs a challenge.

Published by AM Best

BEST'S MARKET SEGMENT REPORT

A.M. Best Company, Inc.
Oldwick, NJ
CHAIRMAN, PRESIDENT & CEO **Arthur Snyder III**
SENIOR VICE PRESIDENT & TREASURER **Cynthia Young**
SENIOR 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 Europe - Rating Services Ltd. - DIFC Branch*
Office 102, Tower 2, Currency House, DIFC
P.O. Box 506617, Dubai, UAE
Phone: +971 4375 2780
*Regulated by the DFSA as a Credit Rating Agency

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

Best's Financial Strength Rating (FSR): an independent opinion of an insurer's financial strength and ability to meet its ongoing insurance policy and contract obligations. An FSR is not assigned to specific insurance policies or contracts.

Best's Issuer Credit Rating (ICR): an independent opinion of an entity's ability to meet its ongoing financial obligations and can be issued on either a long- or short-term basis.

Best's Issue Credit Rating (IR): an independent opinion of credit quality assigned to issues that gauges the ability to meet the terms of the obligation and can be issued on a long- or short-term basis (obligations with original maturities generally less than one year).

Best's National Scale Rating (NSR): a relative measure of creditworthiness in a specific local jurisdiction that is issued on a long-term basis and derived exclusively by mapping the NSR from a corresponding global ICR using a transition chart.