U.S. Insurance Company Earnings Review

Second Quarter 2022

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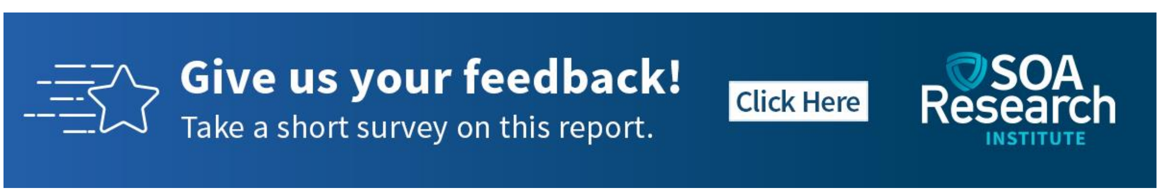
Editor's Note: The following roundup covers eight major publicly traded life insurers: United States-based Aflac Incorporated, Brighthouse Financial, Lincoln National, MetLife, Principal, Prudential Financial, and Unum, plus Toronto-based Manulife, which operates in the U.S. through its John Hancock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

In the second quarter of 2022, publicly traded life insurers reported some of their best financial results since the pandemic began. COVID-19-related claims fell sharply in many product categories. Sales, which had taken a big hit, showed significant improvement as well, though not always to pre-pandemic levels. Sales activity was enough, however, for industry executives to report confidently in their quarterly conference calls that in this regard the worst consequences of the pandemic are over.

Still, no one is sounding the all-clear. Indeed, industry leaders have revealed in their actions continued anxiety over a resurgence of COVID variants and over a possible recession undermining their investments.

Make no mistake, the business environment in 2Q 2022 had its challenges, led by the sharp drop in stock and bond markets. These declines, and their accompanying market volatility, caused "hedge breakage" in the investment portfolios of some carriers. This condition occurs when certain hedges that insurers use to manage the business risk of their annuity blocks — most significantly those with secondary guarantees — don't perform to their expected levels. The markets' decline also pressured the fee income of both annuity writers and sellers of traditional mortality-based life insurance, whose customer balances are often tied to stock and bond prices.

Then there was Prudential Financial. The company surprised investors with a $1.4 billion pre-tax charge. Sizable even for Prudential, the charge was needed to increase reserves on the carrier's block of universal life policies with no-lapse guarantees.

Aside from the obvious question of when Prudential first suspected it might have a problem, investors and other interested parties want to know where similar risk could lie. Analysts believe that the September quarter could include similar acknowledgments from Prudential's rivals.

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

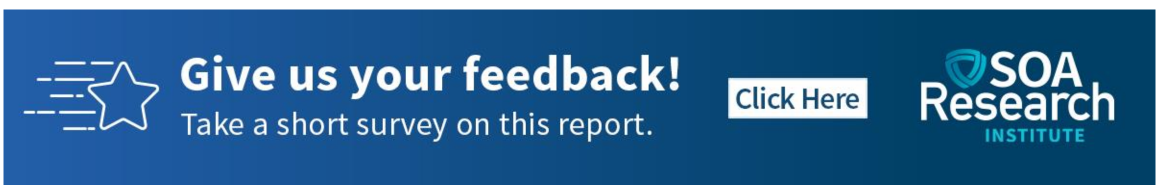
- Mortality/Morbidity: COVID-19-related claims expenses, which cut deeply into carriers' 2021 results and began falling in this year's first quarter, continued improving in multiple product categories in Q2. Several carriers reported the smallest COVID-related earnings hit in their group benefits businesses since the pandemic began.

- Investments/Interest Rates: In response to continued Federal Reserve monetary tightening, interest rates on Treasury securities rose sharply in Q2 while credit spreads also increased considerably. Both developments buoyed life insurers' new money investment yields and reversed decades of pressure on their interest margins.

- Hot Job Market/New Sales: The job market remained strong, with unemployment low and employees demanding and getting sizeable wage hikes. The strength was a boon to writers of group benefits, which recorded robust growth in sales of group life insurance, group disability insurance, 401(k) plans, and other products tied to payrolls.

- Inflation: Carriers described inflation as a development that could be managed through expense control. Some carriers — Unum, for instance — suggested that they could benefit from inflation, since a rising cost of living discourages policyholders from receiving a fixed monthly disability benefit.

- Long-Duration Targeted Improvements (LDTI): Insurers reassuringly cited the overhaul in U.S. Generally Accepted Accounting Principles (GAAP) insurance accounting scheduled to take effect January 1, 2023. Carriers that originally thought LDTI would cut deeply into shareholders' equity next year now think the effect could be minimal, since under the new accounting higher interest rates lower liabilities.



Mortality/Morbidity: COVID-Related Claims Continue to Improve in Group Coverages

A recently updated SOA study of group life insurance found significant “excess mortality” in 2020 and 2021. This validated what investors had already seen in reported financial results: big hits to earnings from COVID-related claims in carriers’ individual life and group life businesses.

The claims tapered in 2021’s final months and into 2022’s first quarter. That improvement seemed to continue in 2022’s Q2, especially in the group area.

At Lincoln National, for example, pandemic-related claims in the company’s individual life insurance business reached $18 million, a 20 percent rise from $15 million a year earlier. But that’s because Lincoln specializes in selling individual life insurance to older, wealthier people. And in Q2 the percentage of U.S. COVID deaths among people aged 65 and older rose to 23 percent from 17 percent in Q1.

By contrast, in Lincoln’s group life and group disability businesses, in which policyholders tend to be much younger than in its individual life business, Q2 COVID claims totaled $21 million, down from $81 million in Q1 2022. That’s the smallest effect on Lincoln’s group business since the pandemic began.

MetLife said the significant reduction in Q2 COVID-related (U.S.) deaths and the further shift upward in the age of death were key drivers of the benefit ratio in its group-life business coming in at 85.8 percent. That’s the bottom of MetLife’s targeted range.

Prudential, another major group-coverage writer, also reported an improvement in its group benefit ratios: to 87.7 percent from 91.1 percent a year earlier in group life and to 73 percent from 80.9 percent in group disability. Prudential said in its Q2 earnings call that the improvements reflected “the transition from a pandemic to an endemic phase of COVID.”

There was little discussion in the earnings calls about whether the sharp drop in COVID mortality in the quarter means that the virus has run its course or that a more deadly variant may emerge. Nor was there much discussion in the calls about whether mortality will be affected by the deferral of care for non-COVID diseases (such as cancer) during the pandemic, by “Long COVID,” or by delayed reactions to vaccines or COVID treatments.

If there was a consensus among executives speaking on these earnings calls, it is that the jury is out on all these issues. While industry executives expressed hope that the ratio of deaths to cases will remain low, many of them are positioning their investment portfolios increasingly conservatively. This could signal that privately industry executives are concerned about potential future deterioration in mortality and/or that the economy might weaken.

Investments/Interest Rates: Rising Rates, Widening Spreads Lift New-Money Yields

For years, life companies’ investment departments have struggled with near-zero Treasury security yields, tight credit spreads, and pressure on insurers' interest margins. Relief finally arrived in March, when the Federal Reserve raised its target for the Fed Funds rate by 25 basis points. When that didn’t curb inflation, the central bank raised the Fed Funds target another 50 basis points in May and 75 basis points in June.

The result: an increase during Q2 to 2.8 percent from 1.6 percent in the yield on one-year Treasury bills and to 3 percent from 2.4 percent on five-year Treasury notes. Credit spreads also widened meaningfully, with the additional interest paid on below-investment-grade bonds over the yield on 30-year Treasury bonds rising to 5.75 percent from 3.35 percent. The result for life insurers was immediate: For the first time in years, several carriers told investors that pressure on their interest margins had reversed. Witness the following examples:

- In MetLife’s institutional retirement business, which houses products such as guaranteed investment contracts (GIC’s) and pension buyouts, interest margins rose 5 basis points year-over-year and 14 basis points sequentially to 103 basis points. MetLife said its yield on new investments was 3.92 percent in the quarter compared with the 3.72 percent yield on maturing investments.

- Unum CEO Rick McKenney told call participants that new-money yields continued to rise in Q2 and “we are now seeing the yields on many of our investment portfolios that back our product lines begin to stabilize after many years of persistent declines,” Mr. McKenney said during his company’s earnings call.

- Prudential sized the positive interest margin in its U.S. business at 20 basis points and at 50 basis points in Japan.

- Aflac said net investment income in its U.S. business rose 2.1 percent year-over-year, specifically noting increased yields on its $12 billion portfolio of floating-rate investments.

Investors received an important heads-up regarding insurers’ alternative investments: hedge funds, private equity, infrastructure and energy investments, private credit, and real estate. Many carriers (especially Principal) reported unusually strong real estate-related returns in Q2 but suggested that this outperformance won’t persist. John Hancock’s chief investment officer said in parent company Manulife’s call much the same about private equity.

Indeed, as part of a larger discussion about positioning itself for a possible U.S. recession, Brighthouse said it continued in Q2 to pare risk in its investment portfolio, with its high-yield-bond holdings dropping by $500 million.

Aflac said it expected its portfolio of so-called transitional real estate investments and privately placed middle-market loans to be among the first asset classes in its investment portfolio to face some pressure should business conditions slow.

In general, then, while not predicting a recession, several carriers signaled in their calls that they were preparing for one. Should a slowdown occur, it would be particularly interesting to see how carriers’ private-debt investments will fare, since in recent years this asset class has seen an enormous influx of cash.

New Sales: The Hot Job Market Benefits Carriers on Many Fronts

Several of the carriers discussed in this report are major writers of group coverage; as the job market strengthens, they benefit in myriad ways. Writers of group disability insurance, such as Unum and Lincoln, profit from higher group disability revenues, since those premiums are directly tied to covered payroll. Retirement savings companies, such as Principal, enjoy the results of more individuals being enrolled in 401(k) plans and from a higher percentage of weekly paychecks being diverted to those plans. Writers of group life, such as MetLife and Prudential, see enrollments increase.

For example, at MetLife underlying growth in premiums, fees, and other revenues in its group coverage area was 4.1 percent year-over-year.

Unum said it was favored by outsized “natural growth,” defined as the incremental premiums it enjoys as a result of rising payrolls at insured customers. This growth came in at 5 percent in Q2, nearly double its growth before the pandemic. Unum also reported unusually strong sales growth of 26 percent in its U.S. business and 20 percent at Unum U.K. Both increases could be traced to the robust job market, the carrier said.

Principal commented that it benefited from employment growth and higher salaries at existing customers. Principal’s Specialty Benefits area, which houses its group coverages, saw an 11 percent year-over-year increase in premiums and fees. The company said the number of its 401(k) plan participants receiving an employer matching contribution rose 10 percent year-over-year. That level of increase normally happens when employers believe that the labor market is so tight, they must sweeten the pot to retain valued employees. In its core small- and mid-sized employer market, Principal said recurring deposits into 401(k) plans rose 14 percent year-over-year.

Inflation: A Challenge Manageable Through Expense Control

After claims, staff costs are insurers’ largest expense. The strong labor market is forcing carriers to pay more for new talent and to retain existing “A” players. Against this backdrop, the across-the-board message from carriers is that they’ll have to take a hard line on expenses to protect profit margins. They also see certain benefits from inflation.

Fred Crawford, Aflac Incorporated president and chief operating officer, said he saw offsetting dynamics, as inflation raised both the company’s payroll expense and investment income.

Ellen Cooper, Lincoln’s president and CEO, noted similar effects, with the company increasing wages to retain top performers, but benefitting from increased deposits into 401(k) plans and increased premiums for group life. “There’s more dollars in the employees’ pockets, and they are able, therefore, to allocate more dollars to savings and also to protection,” Ms. Cooper told investors in the company’s earnings call.

Our view is that because insurance companies don't procure much energy or rely on supply chains, inflation will affect them to a lesser degree than manufacturers. As noted above, some life insurance business will benefit from rising inflation and consequent higher investment income resulting from rising bond yields. In many cases, new policies will tend to be larger since customers need to insure higher incomes, while injured or sick employees are less inclined to file claims, reducing expenses.

Prudential's Surprise: $1.4 Billion Universal Life Charge

Even for Prudential, the charge surprised investors given its magnitude. It also stoked fears that Prudential will be first of many carriers to acknowledge reserve shortfalls for guaranteed universal life. Policyholders are holding their GUL policies far longer and in greater numbers than Prudential projected. That's why it had to boost reserves, saying it acted after "reviewing industry studies, emerging practices, and our own experience," a Prudential executive told investors during that company's call. Prudential also cited a private study but gave no details.

Analysts were intrigued to the point that a question about Prudential's charge surfaced in several competitor calls. Randy Freitag, Lincoln's CFO, said the conservativeness of Lincoln's GUL reserves for statutory reporting purposes meant that whatever the company does with lapse assumptions on its GUL policies, it's unlikely to affect share buyback.

Phil Witherington, Manulife's CFO, said that given more than $1 billion in GUL reserve strengthening at John Hancock over the last five years, the lapse assumption was lowered to less than 1 percent. "We're satisfied" with the adequacy of John Hancock's GUL reserves, he said during Manulife's call.

Experience suggests that this discussion isn't over, even though the other carriers tried to argue that their rival, Prudential, isn't the canary in the coal mine. Our thinking: While reserve adequacy related to lapse assumptions on guaranteed universal life may not be an industrywide problem, Prudential probably isn't alone in having an assumption wide of the mark. Q3 is typically when life companies acknowledge mistakes in forecasting. That's when other carriers may acknowledge their own reserve shortfalls in guaranteed universal life.

A Final Word: LDTI Enters as the New Accounting Regime on January 1

Long-Duration Targeted Improvements (LDTI), the moniker that the Financial Accounting Standards Board (FASB) has given insurers' new accounting rules, will be implemented January 1, 2023. LDTI will essentially scrap "lock in" — the 40-year-old rule under which insurers have locked in reserve assumptions at the inception of contracts.

Under LDTI, insurers will instead begin updating their reserve assumptions at least annually, with the effect running through earnings. Insurers must also update their discount-rate assumptions to reflect current yields on single-A-rated bonds.

The main takeaway from carrier Q2 conference calls is that LDTI's adoption shouldn't be a big deal for shareholders' equity (book value) as 2023 begins. Interest rates were sharply lower on Jan. 1, 2021, when many carriers will show what would have been the historical effect of LDTI. That means shareholders' equity will be revised down sharply for that point in time as carriers restate liabilities upward to reflect interest rates at that time.

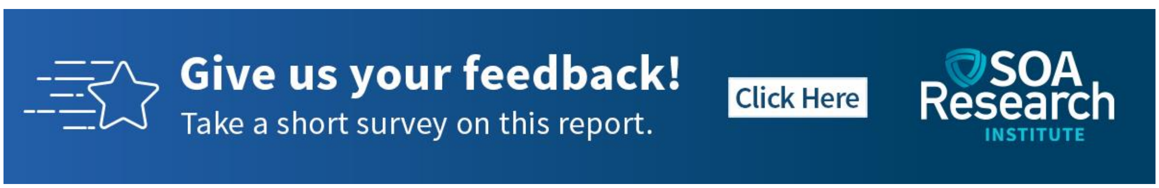
Since early 2021, of course, interest rates have risen, the result being that shareholders' equity in 2023 will need to be revised upward to reflect those rates.

Deanna Strable, Principal's CFO, reassuringly told investors that as of the end of 2022's second quarter, interest rates had risen so much — and credit spreads had widened so materially — that LDTI's effect on Principal's equity would have been immaterial.

Why should any of this matter, especially since the economics of the business isn't changing? Our view is that actuaries should stay focused on what matters: cash profits. To the extent that cash profits will remain largely unaffected by LDTI, we wouldn't be surprised to see Wall Street's current fascination with the new accounting soon fade.

References

- Prudential's comment that COVID-19 will become endemic rather than a pandemic was drawn from the company's Q2 2022 earnings call transcript from August 3, 2022. A copy of that transcript can be obtained from the CallStreet division of FactSet. www.callstreet.com
- 2. Unum's comments on investment yields were drawn from the transcript of Unum's Q2 2022 earnings conference call from August 3, 2022. A copy of that transcript is available through The Motley Fool. www.fool.com
- 3. Lincoln's comments on the impact that strong payrolls are having on the group insurance business were drawn from the transcript of Lincoln's Q2 2022 earnings conference call from August 4, 2022. A copy of that transcript can be obtained from Seeking Alpha. www.seekingalpha.com
- 4. Manulife's comments about the adequacy of reserves in the universal life business of Manulife's John Hancock subsidiary were drawn from the transcript of Manulife's Q2 2022 earnings call from August 11, 2022. A copy of that transcript can be obtained from the Market Intelligence division of S&P global. www.spglobal.com/marketintelligence



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