CONNING

The Conning Commentary

Strategic Issues for Insurance Industry Executives

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2021 outlook

What does recovery look like?

The prospect of a new year is an inviting thought, especially this year as it is associated with the closing out of 2020. With so much volatility experienced in 2020, the coming year should prove much more stable by comparison. As we illustrated the extremes of economic and capital market metrics for 2020 in the December *Commentary*, we thought it appropriate to start our 2021 Outlook with a similar set of metrics, both for the economy and our estimates for the insurance industry sectors we cover. A significant caveat for the 2021 forecast numbers is that they do not reflect the change of control of the Senate and the related implications.

The rollout of vaccines has provided a boost in confidence for economic and jobs recovery, and a "return to normal" appears fully reflected in stock market valuations as of this writing. Based on the initial recovery in mid-2020, prior to the return of partial shutdowns in the fourth quarter, it would be a mistake to underestimate the resilience of the U.S. economy.

Based on the data in the table at right, the answer to what does recovery look like for insurers depends on who you ask and what sector you are looking at. Property-casualty insurers should benefit from both exposure growth and the continuation of robust commercial lines rate increases. Life-annuity insurers, in contrast, face continued low interest rates that dampen portfolio yields, which will outweigh any pandemic-related boost in life insurance sales. The result should be further restructurings and encroachment by asset manager buyers. The health sector prospects remain highly tethered to politics and policy changes; with Democratic control of the executive and legislative branches, the outlook for health insurers is less optimistic relative to the prior status quo.

Key 2020 Economic and Insurance Metrics

	2020 Estimate	2021 Forecast
GDP Growth	(3.5%)	4.0%
Unemployment Rate	8.2%	6.3%
New Car Sales	14.4 million	16.9 million
Housing Starts	1.385 million	1.568 million
10-Year Treasury Yield (average)	0.88%	0.99%
S&P 500	15.8%	4.3%
P&C DPW % Change	1.9%	5.3%
P&C Net Income ($ in billions)	$48.7	$52.1
L&A Premium % Change	(7.8%)	2.5%
L&A Net Income ($ in billions)	$12.6	$18.9
Health Net Income ($ in billions)	$39.1	$38.1

Prepared by Conning, Inc. Sources: Federal Reserve Bank of Philadelphia, Survey of Professional Forecasters; Action Economics; ©2021 Conning Property-Casualty Forecast & Analysis by Line of Insurance, 2020Q4 edition; ©2020 Conning Life-Annuity Forecast & Analysis by Line of Business, fall 2020 edition; ©2020 Conning Health Insurance Forecast & Analysis by Line of Business, fall 2020 edition

What about the election?

With a Biden presidency and now a change of control of the Senate following the run-off election results in Georgia, we have a revised political landscape compared to the baseline expectation of a continuation of divided government just a month ago. Our special election edition *Commentary* in December was based on that prior baseline. Our overall view was that divided government was a stable outcome, but an increase in regulations and a less business-friendly environment is a net negative for insurers. That view is now subject to revision and possibly substantial revision.

With the removal of a Republican-controlled Senate as a check, the extreme vagaries in the Democrat agenda are now on the table. It is too early to tell whether the inclination will be toward moderation or toward the more progressive policy ideas such as the Green New Deal, expanding the Supreme Court, "Medicare for all," and a liberal approach to amnesty and immigration. Except for the health sector, many of these may not have a direct impact on insurers, although they are more likely to be detrimental rather than positive for growth.

The more likely and immediate effects will be around spending and increases in taxation. Spending priorities are expected to revolve around infrastructure, shutdown-related aid relief, and direct aid (bailouts) to state and local governments. Some of this spending would be beneficial to economic growth, employment, and equity markets. With the spending will come an increase in taxation. Corporate tax increases will be negative

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for all insurers, but increases in personal income tax rates will be a positive for life-annuity insurers as tax-advantaged life products will be more attractive.

The larger implication of increased spending and taxation is the corollary for an increase in inflation. We expect the new political landscape will give rise to the concept of unbridled spending having no consequences (or the effects can be tamed). Said another way, the drumbeat of Modern Monetary Theory will likely be louder and gain in prominence. So the important question is: what are the inflationary impacts to insurers? We are not intending to address that question here, but will cover inflationary implications in our subsequent research. Higher interest rates are certainly a positive for life-annuity insurers, but higher inflation is generally a negative for most insurers.

Interest rates weigh heavy on insurers

For life-annuity insurers, the collapse in interest rates and potential for them to remain low for some time will have a much greater impact than the pandemic itself. The search for yield has taken many forms involving asset strategies, product designs, and approaches to capital management. We expect insurers to continue to be creative in all these areas. In this environment, we see further opportunities for noninsurer activity and realignment of traditional life insurers. We anticipate that asset manager partnerships, through which insurers can access proprietary asset capabilities, will remain in vogue. One outcome is likely to be an increase in risk in life portfolios.

For property-casualty insurers, the interest rate situation has been described by some as equivalent to a catastrophic event for long-tailed lines. While we agree that investment income contribution will be diminished, we are not quite as pessimistic, because the property-casualty sector has a degree of control over pricing as an offset.

There are several other factors in addition to low interest rates that support continued upward pricing pressure and discipline. However, the traditional struggle between attractive rates and the attraction of new capital is beginning to show signs of stress in the pricing environment. While we are still bullish on a favorable commercial lines market for insurers, recent reinsurance renewals were a disappointment relative to expectations. This in turn will have a dampening effect on the amount of new capital entering the re/insurance sector in 2021 compared to the torrid pace of 2020.

But there are many other important changes

The pandemic as well as public and private reaction to it will have long-lasting impacts for how most businesses operate. For insurers, the important changes revolve around automation and product distribution. Insurers, like everyone else, were forced to expand their use of technology in everything from sales generation to underwriting to processing to claims. In many ways, 2020 was a huge catalyst to accelerate these changes. We see 2021 as both a turning point and a point of no return in modernization efforts for insurers.

No doubt many InsurTech firms will lead the way in these innovations, and we expect an elevated level of M&A and partnership activity, continuing a trend already underway. The pandemic's effect on face-to-face sales will increase the penetration of direct distribution. These changes are profound for many insurers and will create opportunities for differentiation.

Steve Webersen

Property-casualty

While 2020 was a year of surprises and volatility, 2021 presents a year of uncertainty—uncertainty with respect to the investment environment, the strength and momentum of the recovery, the ongoing impact of the pandemic/financial crisis on sectors of the economy and on individual lines of business, and the possible changing nature of catastrophe risk. Uncertainty, however, is the basis for the property-casualty value proposition, and population sensitivity to risk should create opportunities for insurers.

The outlook for the sector is for moderate growth, a return to underwriting profitability (with the assumption of average catastrophe activity), and a weakened contribution from investment income (continuing to pressure pricing). Growth is expected to be strongest in commercial lines (7.0% DPW growth), while personal lines will be held back by slow growth in personal auto. In commercial lines, all lines other than workers' compensation are expected to see strong rate-driven growth. Personal auto, benefiting from a sharp turn in frequency due to the response to the pandemic, will see softer pricing and slower growth.

The uncertain risk environment should create opportunities for new products and new approaches to doing business—with innovative InsurTech firms seizing on market disruption to address emerging needs. Having had several months to adjust to the pandemic and the changed operating environment, 2021 should see the introduction of new products and coverages.

Low interest rates

In its December meeting, the Federal Reserve Open Market Committee's decision was to leave the target range for the federal funds rate unchanged once again. Virus-related economic softness is likely to leave Fed policy on hold for at least the start of 2021, leaving interest rates at historically low levels. The consequence of this will be lower reinvestment rates and further downward pressure on portfolio yield during the coming year.

Historically, investment contribution is the more important component of property-casualty earnings. From 1993 to 2018, the average underwriting contribution to return on surplus was negative, while the investment contribution was 11% (average ROS during that period of 7.4%). Due to higher asset leverage relative to underwriting leverage, the impact of a decline in book yield has a much stronger influence on returns. There is recognition that the low interest rate environment needs to be reflected in much better underwriting margins for property-casualty insurance businesses. The property-casualty investment portfolio book yield, which had climbed as high as 3.3% in 2018, is forecast below 3.0% for 2021. Further price-firming will be needed to improve underwriting margins to offset the declining investment contribution.

The hard market: how long will it last?

After a decade-long period of soft market conditions, the property-casualty market has finally entered a long-anticipated hard market cycle. Rates for most lines of business are increasing, while companies are tightening up on policy terms and conditions (if they are even willing to commit their capacity). Brokers are finding less competition for accounts, often putting them and their clients in a “take it or leave it” situation.

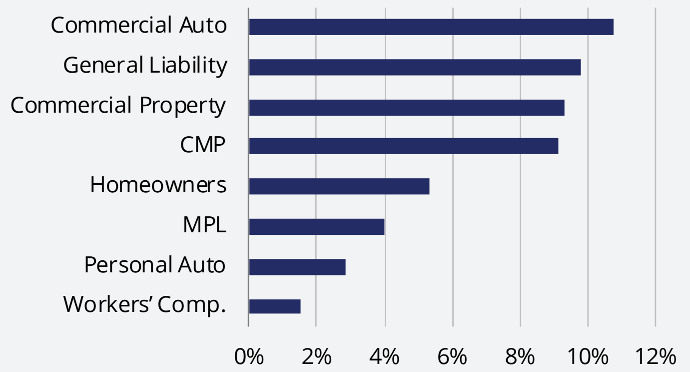
According to most predictions, the hard market is likely to continue for at least the next 12 to 18 months. At a minimum, the absence of higher investment returns will require the industry to maintain its focus on underwriting profitability. However, rate increases will be asymmetrical and will vary both by line of business and according to the insured’s loss history. The lines of business with the largest projected rate increases (10% or more) are those where results have been unsatisfactory and/or deteriorating, specifically: umbrella/excess liability, directors & officers, professional liability, commercial auto, and commercial property. Rate increases, albeit smaller ones, are expected for general liability and workers’ compensation.

While the January 2021 renewals saw rate increases for most lines of business, the overall opinion is that the renewal season was a disappointment. This feeling is not unique to the 2021 renewal season and has been expressed in prior years when price increases are less than initially expected in September and October. However, the dynamics of the 2021 renewal season, which included early reinsurance submissions and a later-than-average signing process, allowed buyers the time to negotiate better rate concessions and less stringent terms and conditions than initially expected.

Another key factor that dampened the upside of the January renewals was the abundance of both traditional and alternative capital underlying the industry. Thanks to improvements in the investment markets, the global reinsurance capital largely recovered from events of prior years. Further, in anticipation of a seller-friendly renewal season, several existing players, including Beazley, Hiscox, and QBE, raised capital. There were also several new companies that entered the market, including Conduit Re and Inigo Ltd., which raised $1.1 billion and $800 million, respectively. In the alternative market, cat bond activity was robust, while syndicated sidecar and collateralized reinsurance activity was more muted.

Barring larger-than-expected catastrophes, the property sector could expect improved underwriting results in 2021. For the time being, insurers and reinsurers will continue to push for higher prices on loss-affected and loss-exposed business. In the casualty sector, the industry not only will have to get current pricing to adequate levels for most lines of business, but also companies may have to address legacy liability deficiencies that are a drag on earnings.

Forecast Direct Premium Growth 2021 by Line



Prepared by Conning, Inc. Source: ©2021 Conning Property-Casualty Forecast & Analysis by Line of Insurance, 2020Q4 edition

Continued consolidation in personal auto

Dynamics in the personal auto insurance market will be shaped by activity from the year just passed. The market was already experiencing declining rates prior to the pandemic, but the lockdown/stay-at-home directives that followed contributed to an estimated 8% decrease in incurred losses relative to the prior year—an 11% decrease in frequency due to reduced economic activity and reduced driving. This is expected to yield further downward pressure on auto insurance rates in 2021.

State Farm may not have started the trend of significant rate cuts, but its market share makes the group’s pricing moves the most consequential—cutting rates by an average of 11%, which will be mostly realized in 2021. Aware of both the changed environment and the competitive pressures, other leading insurers are responding to improve their competitive position.

Further consolidation in the market is expected as well, catalyzed by acquisition activity during 2020 from two of the

Top Ten Private Auto Liability Insurers, Actual vs. Pro Forma
$ in millions

Rank	Group	DPW 2020Q3	Market Share	Group	Pro Forma DPW 2020Q3	Market Share
1	**State Farm**	**$18,011**	**16.1%**	**State Farm**	**18,207**	**16.3%**
2	Progressive	15,820	14.1%	Progressive	15,820	14.1%
3	Berkshire Hathaway	15,345	13.7%	Berkshire Hathaway	15,345	13.7%
4	**Allstate**	**9,390**	**8.4%**	**Allstate**	**10,886**	**9.7%**
5	USAA	6,701	6.0%	USAA	6,701	6.0%
6	Liberty Mutual	5,262	4.7%	**Farmers**	**5,636**	**5.0%**
7	**Farmers**	**4,673**	**4.2%**	Liberty Mutual	5,262	4.7%
8	Nationwide	2,464	2.2%	Nationwide	2,464	2.2%
9	American Family	2,412	2.2%	American Family	2,412	2.2%
10	Travelers	2,230	2.0%	Travelers	2,230	2.0%

Prepared by Conning, Inc. Source: ©2020 S&P Global Market Intelligence line's market share leaders—Allstate and State Farm. Zurich's proposed acquisition of MetLife's car and home insurance operation is another indication of the push among auto insurers to gain scale.

One area where this may have a particular impact is in the market for nonstandard auto insurance. Allstate and State Farm targeted insurers in the nonstandard space, realizing that this segment of the market presents an avenue for growth. The Allstate and State Farm transactions were followed shortly thereafter by Kemper acquiring nonstandard and Hispanic market specialist American Access Casualty, bolstering Kemper's already large nonstandard auto presence.

InsurTech: proof of concept

InsurTech looks to resume its period of growth and maturity in 2021. After idle periods within the InsurTech ecosystem, business model transformation, M&A, and a "new normal" will drive continued evolution. On one end, recent stock offerings by Lemonade and Root have continued to push the overall maturity of the segment, especially by risk-bearing firms. Upcoming market entries, such as by Metromile (via a SPAC) and Next (anticipated), suggest some investor interest in new insurance companies. That said, stock price performance has been mixed. Root is down over 30% since its October listing, while Lemonade is up over 100%. This would appear to indicate that subsequent insurer IPOs may not be extended the same grace period by investors.

M&A will continue to be an area of great activity in the new year. This will include established brokers and insurers continuing to acquire InsurTech companies, such as seen with the December acquisition of Insuramatch by Travelers. Deloitte ranked "add new technology capabilities" as a top reason for insurance M&A, and insurers and brokers look to continue to make select acquisitions of top capabilities that complement their businesses. In addition, larger InsurTechs will continue to add new—mostly vertically integrated—acquisitions where they can. The year 2020 ended with the aforementioned Next acquiring Juniper Labs, a data and analytics company than can become an underlying and supporting part of Next's insurance offerings. Earlier in 2020, we saw Hippo acquire Sheltr in a transaction that brought ancillary products for homeowners to the insurer. More InsurTech firms, whether risk-bearing or more on the provider side, could make deals into 2021.

Venture capital and funding for InsurTech look to be at the verge of a bifurcation with plenty of investors looking to get into the earlier rounds with an initial bet and deal sizes for maturing firms continuing to grow. However, the middle rounds of funding (such as B & C) saw a lack of both deals and dollars in 2020. Investors may be hesitant to back firms that need money to continue to grow but are still a long time from being mature. Further property-casualty-focused funding will continue to move beyond the personal lines space and into commercial lines. Overall economic conditions also will set the tone here, with continued recovery acting as an accelerant, while another downturn could shake investor confidence.

Finally, business models and focus areas will continue to evolve in the new year. While MGAs are a viable and popular entry point for startups to prove their concept, valuable flexibility can be achieved by converting to a "full-stack" business model. Further, Covid-19 will continue to motivate the needs of insurers to innovate in digitization and contact-less technology, such as for claims. Data and analytics will continue to be the foundation of insurer strategies across the value chain.

The move to distribution's new normal

The distribution landscape has been changing for property-casualty insurance with a growing focus on direct channels, but the need for change became more apparent with Covid-19. Almost overnight, face-to-face interaction was banned and all companies and industries had to adjust to a virtual environment.

Direct response channels account for more than 30% of the personal auto market. The homeowners line has been slower to adopt a non-agent-based distribution format, but is seeing a boost as well. As insurance becomes increasingly multi-channel, approaching omnichannel, it is less meaningful to categorize distribution by individual channel segment. Sales that begin online but are completed by the agent blur the boundaries that were once reasonably clear.

The pandemic has changed the way companies in all industries conduct business and has made a lasting change on customer expectations. With the shift away from face-to-face interactions, the needs for a simplified digital experience as well as great customer service increase in importance for insurers. With today's user experience, customers expect to have all the information they are looking for at their fingertips—insurance companies are not exempt from this. Insurers that do not believe their operations are fully digitized will begin to rely more heavily on digital partners to bring their companies to the "new normal."

Looking ahead at the future insurance distribution landscape, we recognize additional potential points of disruption. In 2019, Tesla announced it was offering its own auto insurance to its drivers. GM, too, announced in late 2020 its new insurance unit, OnStar Insurance—using its technology subsidiary, Onstar. Tesla claims to offer premiums 20%-30% lower than rivals, as it is able to estimate risks of accidents and repair costs based on real-time data from its drivers. Depending on the success of these approaches, other auto makers may decide to (re)enter the market of insurance, creating a one-stop shop for customers. Technology will continue to open the doors to more real-time data for companies to analyze risks of products more efficiently.

Catastrophes

With numerous natural catastrophe-related records broken in 2020, the question for 2021 is whether 2020 was a catastrophe outlier or a harbinger of a "new normal." The twelve named storms that made landfall in the U.S. were the most of any Atlantic hurricane season. There were 30 named storms in the season, using up all the letters of the English alphabet for the hurricane naming convention, and leading to NOAA resorting to the Greek alphabet to name the supernumerary storms. Hurricane Iota (ninth letter of the Greek alphabet) was the first Category 5 storm of 2020 as well the latest-landing ever, striking on November 14. The PCS tally of insured natural catastrophes losses totaled $58.0 billion as of mid-December, but newly revised estimates based on analysis by Aon, Swiss Re, and Munich Re put wildfire losses $2.5 billion higher ($11.5 billion total) than previously estimated, which would put U.S. natural catastrophe losses at more than $60 billion in the year. This compares to $252.5 billion in 2019.

Wildfire losses in California, Colorado, Oregon, and Washington were among the most destructive in history, ranking with similarly catastrophic losses of 2017 and 2018. If the weather in the west and northwest remains bone-dry in the coming year, we may be in for another year of elevated wildfire losses. The magnitude of wildfire losses has led insurers and catastrophe modeling firms to realize that secondary perils (traditionally small to midsized events, such as river floods, landslide, and wildfires that are the result of a primary peril) are not so secondary after all. Modelers that traditionally focused their efforts on wind and earthquake are now developing wildfire models. Unfortunately, though, California requires rates to be based on historical losses and does not permit insurers to use catastrophe modeling to price wildfire risk.

Insurers broadly agree with Munich Re that there are "clear indicators that climate change is changing the risks." Companies that fail to mitigate climate-related catastrophe exposures may be exposed to future litigation to the extent they run afoul of developing environmental impact considerations in ESG (environmental, social, governance) guidelines.

There continues to be a global coverage gap between insured catastrophe losses and economic losses. In both 2000 through 2009 and 2010 through 2019, around 27% to 28% of total global catastrophe economic losses were insured. In the U.S., the percentage is closer to 50% (source: Munich Re). This coverage gap means addressing the catastrophe coverage remains a sizable opportunity for (re)insurers to explore. What is more, coverage exclusions and limitations for new and emerging perils, such as pandemic, flood, and certain cyber losses, also suggest that insurers should continue to try to find ways to be more relevant to the needs of their customers.

Summary

The uncertain environment in 2021 presents both challenges and opportunities for property-casualty insurers. Capital is flowing into pockets of the market, attracted by hardening market conditions and opportunities for innovative solutions to distribution and coverage needs. Recent events have challenged the relevance of the sector and it will be critical in the coming year to re-establish the industry's role as the foundation for risk management. With new risks emerging and the nature of catastrophe risk changing, 2021 will present ample opportunities for (re)insurers to strengthen their value proposition.

Alan Dobbins
Jerry Theodorou
Bill Burns, ACAS
Alan Walters, CPCU, ARM
Alyssa Gittleman

Life-annuity

Now that we have collectively shouted "good riddance" to 2020, we look ahead to 2021. Following a 63% decrease in net operating gain in 2020, the life-annuity industry will be looking to rebuild its profitability. A closer look at profitability reveals, however, that the individual annuity line was responsible for that decrease, as it reported a $2 billion loss compared to a $21 billion gain in 2019.

Based on midyear 2020 data, we projected the industry would have a 4.8% decrease in surplus, but because of a late-year equity market rally and managements' discretionary capital actions, the impact on surplus for 2020 will likely be much less. In 2021, life-annuity insurers will be looking to stabilize their positions and then return to their previous pattern of stock buybacks and moving capital up to parents to be redeployed. Improving sales and finding ways to increase portfolio returns will be the first steps in those efforts to stabilize their positions.

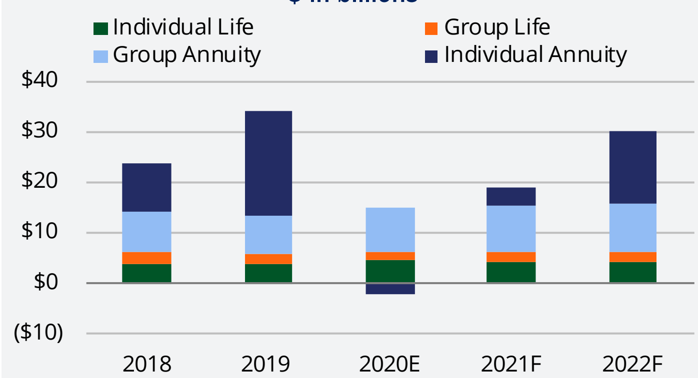
What does 2021-2022 recovery look like?

This year will have its challenges, including the low interest rate environment and the prospect of tighter regulations, but there will also be opportunities for increased sales, a point of no return for digital transformation, and a transformation of the industry driven by private equity's entrance.

In 2021, individual life sales may see a boost as consumers have become more aware of personal mortality risk and as employment continues to improve. However, traditional life products will be challenged in the very low interest rate environment. Indexed life, term life, and LTC hybrid policies will help buoy life sales.

Group life sales are driven primarily by growth in employment. The large increase in unemployment in 2020 was in sectors where employees are least likely to have benefits, in particular

Net Operating Results by Line of Business
$ in billions



Prepared by Conning, Inc. Historical data source: ©2020 S&P Global Market Intelligence, forecast ©2020 Conning Life-Annuity Forecast & Analysis by Line of Business, fall 2020 edition group life coverage. Premium growth for group life is expected to be low as the economy slowly recovers.

Individual annuity sales may be disrupted as new fiduciary regulations are applied to distributors. In addition, the prolonged low interest rate environment is likely to depress fixed annuity sales. Group annuity premiums increase in 2021 as the economy stabilizes and PRTs (pension risk transfers) increase.

Capital management returns to normal

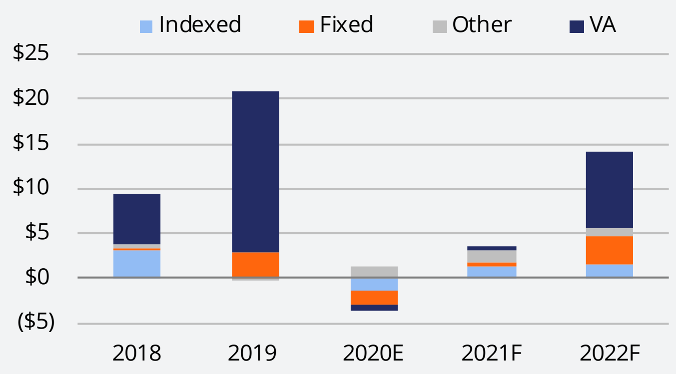
During 2020, it appeared the life-annuity industry's capital would take a hit. However, with equity market recoveries reducing reserve contributions, the change in capital may be minimal. Equally important, life-annuity management teams took active measures to support capital by adding surplus to operating subsidiaries and slowing stockholder dividends. As a result, the life-annuity industry is entering 2021 with a relatively intact capital position.

As the industry continues to recover in terms of sales and profitability during 2021 and into 2022, we would not be surprised to see management teams reverse some of the capital support efforts instituted last year. Stockholder dividends, in the form of either transfers to parent companies or the resumption of share buybacks, are likely to resume. There is also the possibility that those dividends may increase as insurers readjust the capital in their operating companies to more normal levels.

The industry has a prior track record of this readjustment after the 2008 financial crisis. The industry's capital decreased 10.9% in 2008 even after receiving $69 billion in capital contributions to support it during the crisis. It took three years for it to rebuild its capital and repay the $69 billion capital contribution.

Just as individual annuities contributed to lower operating results for the life-annuity line in 2020, they will also help increase 2021's results. Lower reserve contributions for individual annuities reflects improving equity markets in 2021. Stronger equity market growth enables VAs (variable annuities) to reduce some reserves for guaranteed benefits added in 2020. The combination of improved sales, lower surrenders, and negative Separate Accounts indicate that, in 2021, operating results and margins begin to return to more normal levels.

Individual Annuity Net Operating Results by Product
$ in billions



Prepared by Conning, Inc. Historical data source: ©2020 S&P Global Market Intelligence, forecast ©2020 Conning Life-Annuity Forecast & Analysis by Line of Business, fall 2020 edition

Covid-19-driven customer awareness of mortality risk

An issue dogging the life industry for decades has been the core value proposition of life insurance: financial protection against an untimely death. Mortality rates have been improving among the insured, and the immediacy of the risk has not been one much on the minds of consumers—until 2020. With the first rapid spike of excess mortality in the spring, consumers were made more aware of their mortality risks, but it remains to be seen whether it leads to lasting sales changes.

Some encouraging signs came during the summer of 2020, when application activity increased 14% year-over-year in July 2020, according to MIB Group, Inc. For a while, it looked like the spike in application activity may simply have been pent-up demand after lockdown policies were loosened. Applications were seen to fall off through November 2020, although there was a small upswing in October. During 2021, it should become clear how application activity responds to subsequent pandemic waves. Under the noise resulting from application pipeline disruptions, we expect to see a modest overall increase in sales due to this heightened awareness of mortality risk. However, people tend to have short memories, so we do not expect that increase to last long after the pandemic is officially declared to be over.

Relative winners and losers from investment spread and technology

Over the course of 2021, two trends are likely to define the relative winners and losers within the life-annuity industry. Insurers with digital distribution platforms and InsurTech-driven back offices are better positioned to both expand sales and squeeze expenses than those lacking such technologies. At the same time, companies that can increase, or maintain, investment returns in a lower-for-longer environment are positioned to offer higher crediting rates and retain profitable spreads.

The digital sorting begins

Even as sales recover, the digital transformation of the life-annuity industry will continue in 2021. The Covid-19 crisis accelerated the life-annuity industry's efforts to meet the growing demands of clients and distributors for digital sales and service. As the WFH conditions created by Covid-19 fade, the question many insurers will consider is what lessons they learned over the prior year represent new competitive advantages going forward.

A key competitive challenge will be in how that transformation occurs, as there are likely to be digital leaders and slow followers. Large multinational insurers have demonstrated they have the financial and other resources to invest in InsurTech startups in order to identify and acquire a digital advantage. For example, in December, Prudential Financial's PruVen Capital launched a $300 million fund that will invest in technology startups in InsurTech, financial technology, health technology, real estate technology, and enterprise IT verticals.

That said, we have yet to see those investments and acquisitions bear fruit in terms of altering business models. This could reflect a focus by those insurers on investing in back-office improvements to squeeze expenses out of their businesses. Given the pressure on portfolio yields, we would not be surprised to see that trend continue.

Smaller insurers, however, may be at a disadvantage in their ability to invest significantly in InsurTech. Even so, the need to improve expense ratios and digitize their business remains strong in 2021. As a result, these insurers are likely to seek strategic partnerships to remain digitally competitive. Part of that competition will involve gaining shelf space on the emerging digital agencies such as Ladder and Bestow, or developing their own captive digital agency, such as Haven Life. Large or small, and regardless of how they acquire the new digital capabilities, 2021 will likely be the digital point of no return. Companies with minimal digital capabilities may find themselves on a dead-end street.

Investment performance creates competitive and profitability advantage

The competitiveness and profitability of life and annuity products depend on portfolio returns generated by insurers. With portfolio returns continuing to decrease in 2021, insurers are faced with the unenviable choice of reducing crediting rates, spread margins, or both. Reducing crediting rates lowers the consumer attractiveness of a product compared to its competitors. Lowering spread margins reduces profitability. Recent trends in both annuities and UL suggest that, in 2021, insurers are likely to lower both, with spread margins taking a larger hit.

Until the economic crisis brought about by Covid-19, the average crediting rate for our index of four annuity specialists ranged between 1.97% and 2.08%, or an 11-basis-point range. In comparison, the average spread margin was between 2.24% and 2.49%, a 25 bps range.

What is noticeable is that, over the period 2018 through the third quarter of 2020, these annuity specialists credited an average of 46% of the portfolio return earned on indexed annuities to their contract owners. To us, this suggests that competitiveness plays a larger role in how portfolio returns are allocated than does profitability.

Of course, profitability remains crucial. This low interest rate environment will lead some insurers to re-evaluate their portfolio return allocation. For example, during 2020, the average amount credited to index annuity contracts by those four insurers was just 44%. Crediting rates declined by 10 bps, while spread margins increased by 11 bps.

Annuities are not the only example of insurers reacting to lower portfolio returns by maintain crediting rates. Universal life crediting rates have generally been persistent in the face of decreasing portfolio rates. One factor affecting UL, compared to annuities, is that UL insurers have additional product levers beyond portfolio yields to try to maintain profitability.

In the third quarter of 2020, UL crediting rates increased compared to 2019, with the median crediting rate increasing

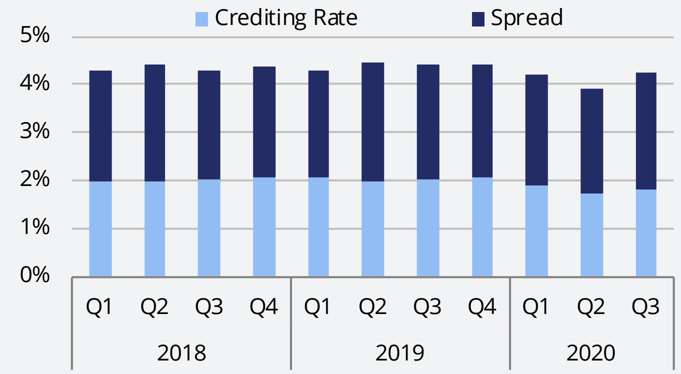
Life/Annuity Sales by Line of Business, Year-Over-Year Change

	2020	2021
Group Annuity*	7.7%	2.0%
Individual Annuity	(22.5%)	3.8%
Group Life	(9.0%)	0.3%
Individual Life	(12.5%)	3.3%

** Includes GIC deposits, which are not considered revenue*

Prepared by Conning, Inc. Source: ©2020 Conning Life-Annuity Forecast & Analysis by Line of Business, fall 2020 edition

Fixed Indexed Annuity Insurers Spread Margin & Crediting Rates*



**Average spread of American Equity, Athene, F&G Life, and Lincoln National. Total height of column represents the total investment return.*

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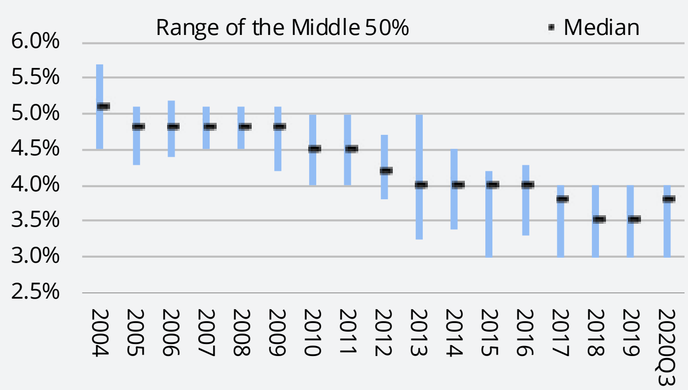
Universal Life Credited Rates



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to 3.8%, according to insurers participating in LIMRA surveys. The median crediting rate had been 3.5% for 2018 and 2019. In the first two quarters of 2020, the 25th percentile crediting rate was below 3%, which was a historical first. Historically, 3% had been a standard minimum guaranteed crediting rate for UL.

In general, the industry has been reluctant to push through that 3% lower barrier for UL crediting rates. However, as ten-year rates remain low, insurers may lose that reluctance this year.

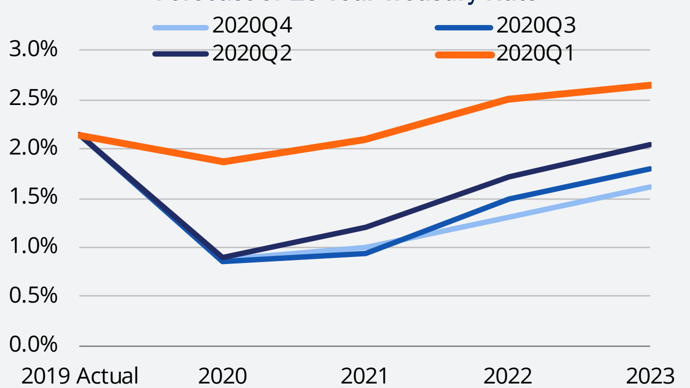
Lower for longer: a chronic problem is now an acute one

Throughout 2020, forecasters kept decreasing their projections for the ten-year rate. The fourth-quarter 2020 Survey of Professional Forecasters from the Federal Reserve Bank of

Philadelphia shows projections over a percentage point below the forecast from the first quarter.

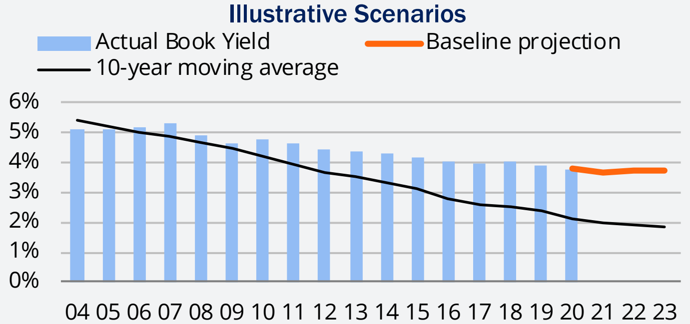
Expectations for portfolio rates for the life industry are now similarly low, with baseline projections for the net portfolio yield decreasing from 3.90% in 2019 to 3.68% in 2021, with rates remaining at about that level for the remainder of the projection period. These projections are driven by the results from the Philly Fed Survey as well as expectations of insurers continuing to reach for yield.

Forecast of 10-Year Treasury Rate



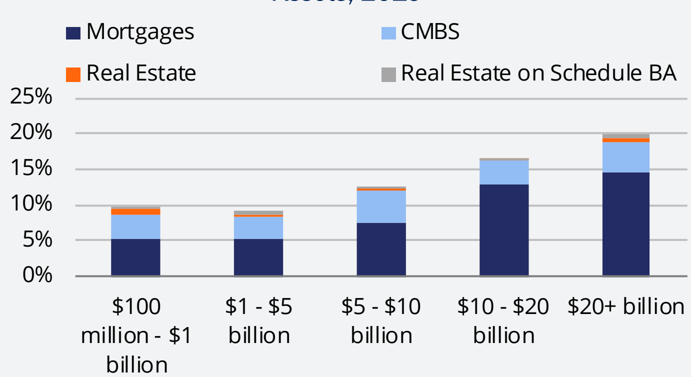
Prepared by Conning, Inc. Source: Federal Reserve Bank of Philadelphia Survey of Professional Forecasters

Life Insurance Book Yield vs. 10-Year Treasury Rates—Illustrative Scenarios



Prepared by Conning, Inc. Historical data source: ©2020 S&P Global Market Intelligence, forecast ©2020 Conning Life-Annuity Forecast & Analysis by Line of Business, fall 2020 edition

Investment in Commercial Real Estate by Insurer Size Approximate Direct and Indirect, as a % of Investable Assets, 2019



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As higher-yielding assets mature and must be rolled over into new investments, life insurers will find their portfolio rates continuing to decrease as ten-year interest rates continue to put downward pressure on the largely fixed-income portfolio.

A turning point for asset allocations: opportunities for proprietary asset origination

The growing trend of life insurers owned by asset managers, such as Athene/Apollo and Global Atlantic/KKR, has competitive implications for the "lower for longer" yield environment. These investment-firm-backed insurers have access to specialty asset classes through their owners. For example, it its third-quarter 2020 earnings call, Athene's CEO commented on how it leveraged its Apollo relationship: "These are bespoke investment opportunities that come up through our affiliation with Apollo. This quarter, we participated in an Apollo-led consortium to form a real estate investment partnership for assets owned by the Abu Dhabi National Oil Company, ADNOC."

Similarly, the largest insurers, such as Prudential or Northwestern, often have specialty asset management units of their own that can access specialty asset classes. As 2021 continues to exert pressure on insurers, the largest insurers and these investment-firm-backed insurers may have an advantage in maintaining and even improving portfolio yield. Smaller insurers will need to consider the best avenue to improving their access to some of the enhanced yield opportunities offered by these specialty asset classes.

Commercial real estate waits for the other shoe

CRE (commercial real estate) has been important to the largest life insurers in attempting to maintain yield. However, even once Covid-19 risks have dissipated, insurers may find this investment sector challenged.

Two large subsectors of CRE held in life insurer portfolios, office space and hospitality (e.g., hotels), may have particular difficulty bouncing back to pre-pandemic occupancy rates. While hotels will retain value for recreational visitors once widespread vaccinations reduce traveler worry, business travel may remain low as more vendors and clients have become comfortable with video conferencing in place of in-person meetings. Even more devastating, the value proposition for office space may be much lower now that video conferencing infrastructure has been found adequate for operations.

During 2020, many commercial building owners did not yet face a reckoning with respect to their tenants. Leases for office space tend to be multiyear in nature, but the disruptive aspect of the pandemic may provide tenants with practical leverage to renegotiate terms. Full fiscal reckoning of pandemic impact on CRE was deferred during 2020, and delayed losses may become realized during 2021.

The NAIC has recognized the shift in risks in its own CMBS modeling for year-end 2020 RBC, with scenarios that are more negative than the ones projected in 2019. Some insurers already may be divesting from CMBS, but other forms of CRE investing, such as first lien mortgages and Schedule BA real estate investments, can be more difficult to exit.

Product changes: COI and other levers

In managing blocks of business in 2021, insurers will be looking for ways to maintain profitability and grow sales. For UL, in 2021, we expect companies to continue to shift product designs away from embedded financial guarantees and toward financial risk-sharing and morbidity-related guarantees.

One lever insurers have been using has been COI (cost of insurance) fee increases, which has led to lawsuits and regulatory actions. COI increases have been spurred in recent years on old blocks of business as they have suffered adverse mortality experience and lower investment returns. In 2021, companies will be assessing their Covid-19 excess mortality experience, and there could be additional COI increases. However, insurers may not get regulatory permission for COI increases for existing policies if regulators consider the heightened mortality from Covid-19 unlikely to persist once widespread vaccination has occurred.

Some of the shift away from investment guarantees and toward indexed cash values as well as LTC/hybrid product designs has been intended to reduce financial risks for insurers. With continuing financial uncertainty, insurers will likely emphasize products that highlight aspects only insurers can guarantee: financial protection against untimely death or disability.

Fixed indexed annuities overtake traditional VAs, RILAs the hot new product

FIA (fixed-indexed annuity) sales are projected to overtake traditional variable annuity sales in 2020. That year, indexed annuities are forecast to be 39% of total sales, compared to traditional VAs at 38%. This will be the first time in decades that traditional VAs did not represent the majority of individual annuity sales.

While FIAs continue to attract consumers, RILAs (registered index-linked annuities) are the annuity product with the strongest growth potential in 2021. RILA sales were up 25% YTD through the third quarter, compared to the same period in 2019, while traditional VA sales were 13% lower YTD through the third quarter.

Consumers are attracted to the increased opportunity for higher returns in exchange for a limited risk of loss. While the number of insurers offering the product is limited, they have been growing. The RILA market is dominated by Equitable and Brighthouse with 61% market share. However, we count twelve companies offering RILAs at the end of 2020, with many having come on line in the past two years. We expect other insurers to enter the RILA market in 2021 and 2022.

Underwriting

During 2020, many insurers halted applications for life insurance from older age groups or otherwise reduced activity in sales as peaks in mortality were occurring. In addition, some regulators forbade asking about Covid-19 status from applicants, although insurers could, as always, ask if applicants were currently ill from any cause and put off application until later.

The long-term mortality effects of Covid-19 and the effectiveness of new vaccines are as yet unknown, and public policy may again change. As a result, insurers may continue their caution in mortality underwriting in 2021. Automated underwriting systems may need recalibration as mortality expectations change. Co-morbidities contributing to Covid-19 mortality are partially known, but in underwriting policies that may last for decades, insurers may question their assumptions on long-term mortality trends.

Minnesota Life/Securian issued a $100 million mortality cat bond in October 2020, which was the first mortality cat bond issued in quite some time. We may see increased use of such instruments in 2021 as insurers and reinsurers consider their potential pandemic mortality exposure in the future.

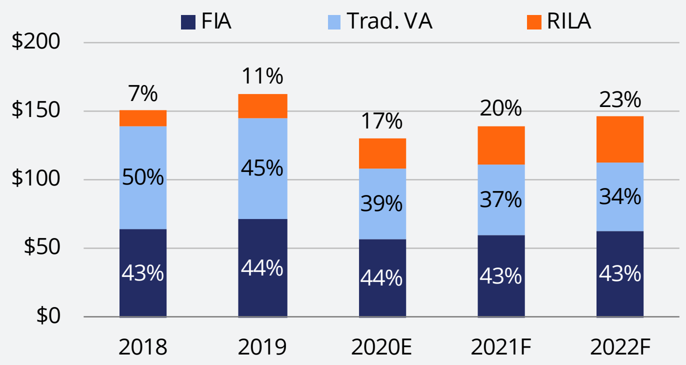
Other product shifts and features: can insurers increase sales and take less risk?

The continued popularity of VAs and RILAs among consumers suggests that in 2021 consumers are willing to assume more investment risk to generate higher returns. This bodes well for insurers that have been working to de-risk their products. The RILA, for example, reduces insurer exposure to investment losses from option losses on indexed annuities. Companies continue to de-risk their VA products even to the point of stopping the sale of certain benefits. For example, at the end of 2020, Prudential announced it was stopping the sale of VAs with living benefits. Similarly, Aegon announced in December that its Transamerica subsidiary would stop selling VAs with interest-sensitive living benefits. It is also considering a broad range of options for the block of business. At the same time, product repricing is underway for life insurance and annuities. Together, this paints a picture of 2021 being a year when insurers strive to find ways to reduce risk. As long as consumers are willing to take on risk, this trade-off should benefit the industry.

Regulations likely to increase: ESG and DEI disclosures

A Biden administration is expected to increase reporting requirements around ESG and DEI (diversity, equity, and inclusion). In the short term, this will likely be via the SEC and

Annuity Sales by Product
$ in billions, % on columns is % of total for the year



Prepared by Conning, Inc. Source: ©2020 S&P Global Market Intelligence and LL Global, Inc.

take the form of risk alerts, guidance, and rulemaking that will require companies to disclose how these risks affect their bottom line. Even absent a disclosure requirement, companies are already increasing their voluntary disclosures on the topic, and many are announcing their actions on these topics.

In addition to addressing ESG and DEI concerns inside their own companies, the insurance industry will need to be mindful of how it is investing. With public access to ESG and DEI disclosures, companies will likely face increased pressure to invest based on these principles, even absent explicit requirements in the short term. The University of California completed the full divestment of its $126 billion portfolio from the fossil fuel industry during 2020, just five years after adding environmental goals to its investment framework. With a significant portion of the insurance industry's investment portfolio typically needing to be reinvested every year, the University of California example demonstrates that the investment allocation changes could start to be noticeable relatively quickly.

Consumer Financial Protection Board

Analysts expect the CFPB under Biden to follow the model pursued under former President Obama in terms of calling out predatory practices and assessing hefty penalties. A Biden administration is also expected to revive investigations based on the principle of "disparate impact." Under this concept, regulators could use data to see if there are underwriting or pricing disparities by race or ethnicity, even if there is no evidence of outright, explicit discrimination. The CFPB also plays an important role in drafting new rules and regulations, and a new CFPB director will be able to roll back changes made during the Trump administration.

M&A continues to transform the U.S. life (re)insurance industry

The lower for longer environment combined with Covid-19 and the possibility of higher corporate taxes has set a table for increased life-annuity M&A activity in 2021. It is challenging for insurers to find solutions for blocks of annuities struggling to remain profitable as portfolio yields decrease. While 2020 saw some M&A activity, Covid-19's business disruption slowed new deals from forming. As the pandemic recedes in 2021 and business resumes a more normal course, we expect pent-up demand to be released and deal number and volume to increase.

Of course, for every seller, there must be a buyer. Here again the stars align for more M&A in 2021. Investors outside the life-annuity industry are also struggling to generate acceptable risk-adjusted returns. Recent history has shown that some of that external capital has been attracted to life-annuity M&A activity. One needs only look at the $3 billion of external capital that flowed into Apollo/Athene's ACRA or the $1 billion that went to Global Atlantic's IVY Co-Invest sidecars to be reminded of that. We would not be surprised if other investment-firm-backed insurers followed suit and launched their own third-party capital vehicles during the year.

Remember that, in the life-annuity industry, M&A involves more than just the acquisition of a company. Reinsurance is by far the more common method used to acquire blocks of business. Again, 2021 could be a year when more reinsurance transactions take place. The prior year saw several multi-billion-dollar reinsurance deals along with the expansion of interest from traditional fixed annuities to VAs. Combined with the continued growth of investment-firm-backed insurers and stronger inflows of third-party capital, this reinforces a forecast of greater M&A activity in 2021.

With third-party capital seeking to acquire or reinsure blocks of annuity business, the type of liabilities they seek may expand. In October 2020, for example, Venerable announced it acquired and reinsured $12 billion of legacy VA business from Equitable Holdings. This was a major VA transaction that signaled the opening of a new set of annuity liabilities for acquisition. Until then, the focus had been on fixed annuities. During 2021, it would not be surprising to see other VA blocks enter the market, especially for acquirers with the expertise to manage the complex hedging needed for VAs. Looking a bit further ahead, closed blocks of LTCI also may come to market, especially as premium rates and reserves have been significantly strengthened by the primary LTCI insurers.

A development worth watching during 2021 will be the emergence of a fee-based insurance platform. Traditionally, annuity insurers have generated revenue from premiums and net investment income. However, we have seen a potential new business model that relies on reinsurance commissions and asset fees rather than premium. Midwest Holding's American Life & Security launched this model in 2019. It reinsures more than 99% of its premium to affiliated and unaffiliated reinsurers. In return, its revenue is largely ceding commission, reserve adjustments, and asset fees. Should this model prove profitable, and it has in 2019 and through the third quarter of 2020, we would not be surprised to see other firms consider this model. Obvious first followers would be new investment-firm-backed insurers.

Distribution landscape changes: Consolidation and role of private equity

RIAs (registered investment advisors) are a growing distribution channel, in comparison to broker-dealers. With the adoption of the recent DOL and SEC fiduciary rules, having an RIA relationship is proving attractive to some broker-dealers. This is leading to the emergence and growth of hybrid-RIAs.

This growth, in combination with the relatively steady compensation model generated by RIAs, has attracted the interest of private equity firms. Those firms see RIAs and other distributors as sources of recurring revenue.

Private equity is supplying some of the capital used in acquiring RIAs. Many of the leading RIA consolidators are or have been backed by PE. Recent examples include investments made by Stone Point Capital (Focus Financial), Thomas H. Lee Partners (HighTower Advisors), TA Associates (Wealth Enhancement Group), and Oak Hill Capital Partners (Mercer Advisors).

Private equity is attracted to FMOs and IMOs because those firms' revenue streams represent a source of relatively predictable cash flows for the private equity firm. In addition, RIA capital requirements are low compared to insurance company investments.

Summary

The differences between the beginning of 2020 and 2021 are dramatic. Every part of society and the economy has been shaken, including the insurance industry. Shaking can be disconcerting, but it also brings opportunities to break out of old patterns and grow in new directions for those bold enough to act.

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Health

The health insurance outlook for 2021 is largely dependent on just two forces: how does the Covid-19 pandemic play out, and how the new administration shapes health care policy.

Covid-19

Utilization. As 2021 begins, there is a potential for a decrease in health care utilization, at least during the first half of the year, until vaccines are widely distributed and administered. During the first wave of the virus in 2020, in-person health care utilization decreased dramatically. Insurers noted in earnings calls that utilization levels decreased to around 60% to 75% of normal levels. These numbers have since returned to between 90% and 95%, but due to the current wave of infections at the start of this year, this number may begin to decrease. Across the country, more than 100 hospitals have postponed elective surgeries. Multiple states have also begun placing statewide or localized orders postponing elective procedures. The state of Massachusetts, on December 7, 2020, announced that, beginning December 11, hospitals in the state would "curtail" inpatient elective procedures that could be safely postponed. Other state efforts include Indiana, which has postponed elective surgeries between December 16 and January 3, and New York, which has ordered all hospitals in Erie County to postpone elective surgeries beginning December 4. These efforts are put in place to help increase the number of available beds to treat Covid-19 patients, as well as increase available staff to help treat the incoming Covid-19 patients. These measures are likely to remain in effect for at least the first quarter until warmer weather appears, making the first part of 2021 look like 2020, although with much less uncertainty.

With the potential for decreased in-person visits, the number of telemedicine visits could increase in the first half of the year. With the decrease in in-office visits in March and April of 2020, the number of telemedicine visits increased dramatically. Since then, that percentage has decreased, but not to pre-Covid-19 levels. Going into 2021, telemedicine will continue to play a more important role in health care, especially if in-person visits were to decrease.

Vaccine. As more vaccines are distributed across the country, they will also need to be paid for. Note that the ACA requires insurance companies to have a minimum annual loss ratio of 80% for individual and small group coverages and 85% for large group coverages. With the decrease in utilization in 2020, insurers looked to make up the difference in their Covid-19 responses to policyholders. This includes covering the vaccine at no charge to individuals. UnitedHealth, for example, plans to cover both doses of the vaccine at no charge, regardless of where it is administered. This includes employer, individual, and Medicare plans through the end of the national public health emergency period.

Membership levels

Group enrollment is expected to increase in 2021 as the economy and employment are expected to improve. Covid-19 caused a large increase in layoffs and unemployment in 2020, which, in turn, saw a decrease in group enrollment. The decrease in group enrollment has been tempered, however, because many employers have continued benefits coverage for furloughed employees. If job furloughs become permanent job eliminations in 2021, or if more layoffs occur due in part to new state restrictions as cases rise, enrollment could decrease further and stay lower until employment fully recovers. Currently, based on the Philadelphia Fed's fourth-quarter 2020 Survey of Professional Forecasters, unemployment is projected to decrease to 5.8% by the fourth quarter of 2021. Conning estimates that this increase in employment expected for the year will see a positive group enrollment increase in 2021.

For those who have lost coverage in 2020, health insurers saw an increase in enrollment for Medicaid and individual marketplace business. As 2021 unfolds, enrollment for Medicaid is projected to decline, while individual comprehensive enrollment is expected to increase.

Medicaid

Enrollment in Medicaid has also increased since March 2020. According to an analysis from Kaiser Family Foundation, between February and July 2020, Medicaid enrollment increased by 4.3 million people or 6.1%. As individuals have lost their jobs, some have qualified for Medicaid. As employment levels continue to improve, Medicaid enrollment levels are expected to decrease. This will be counterbalanced somewhat with positive enrollment levels from both Missouri and Oklahoma, which will begin implementing their Medicaid expansion plans in July 2021.

Enrollment on ACA Exchanges

	2021 Coverage 11/1/2020-12/15/2020	2020 Coverage 11/1/2019-12/17/2019	% Change
New Consumer	1,827,144	2,062,474	(11.4%)
Renewing Coverage	6,407,578	6,241,376	2.7%
Total	8,234,722	8,303,850	(0.8%)

Prepared by Conning, Inc. Source: Centers for Medicaid and Medicare Services, Weekly Enrollment Snapshot: Week Six, December 5, 2020, issued December 18, 2020

Individual

Over the past two years, the ACA insurance exchanges have seen an increase in insurer participation as rates and costs have stabilized. Multiple insurers have either returned or expanded their exchange offerings for 2021 enrollment. Through mid-December 2020, CMS (Centers for Medicare & Medicaid Services) reported total enrollment for the 2021 federal exchange is down only 0.8%, but last year's totals included New Jersey and Pennsylvania, and both states transitioned to their own state-based exchange for 2021 enrollment. These two states accounted for 7% of all enrollment during the 2020 enrollment period, so adjusting for those states results in an increase of roughly 6%. Final data from the federal and state exchanges will be available later in January, and we expect total enrollment will increase due to the increased insurer participation mentioned above and from Covid-19-driven enrollments.

Regulation

ACA Supreme Court case. The ACA Supreme Court decision will continue to be a highly anticipated verdict in the first half of 2021. The decision, which is expected to separate the individual mandate from the full ACA, would not disrupt the health insurance industry.

ACA improvements a focus of Biden administration. The Biden administration ran its campaign to both protect and build upon the ACA. With the new administration beginning January 2021 and Democrats controlling both houses, more substantial changes are possible than if Congress had remained divided. Initial actions will likely focus on smaller, departmental, or executive actions to counteract what the Trump administration changed. For example, this may include increasing the amount that HHS (Department of Health and Human Services) spends on ACA enrollment advertising or changing regulations regarding short-term health insurance. Larger changes will take more time to develop and will have to be crafted carefully, given that Democrats' control of the Senate is only by virtue of the Vice President's tie-breaking vote.

M&A and other company actions

As we begin 2021, the health insurance industry has already begun to see new M&A transactions. Centene announced and completed the acquisition of PANTHERx, a specialty pharmacy that focuses on orphan drugs and rare diseases, in December 2020. Centene also announced on January 4, 2021, that it has agreed to acquire Magellan Health, which provides behavioral health services and owns a pharmacy benefits manager. As insurers continue to see a decrease in health care utilization in the beginning of 2021, health insurer revenue is expected to continue to be positive, providing insurers with more cash on hand. This, in turn, may increase the number of M&A transactions announced during the year.

Other noteworthy events in 2021 include the IPO of Oscar and the disbanding of Haven Health. In December 2020, Oscar Health filed for an IPO. While no dollar amounts have been disclosed yet, this IPO comes on the heels of a $140 million funding round in December 2020 and proves to be a high-profile offering in 2021.

On January 4, 2021, it was announced that Haven Health, the joint venture started by Amazon, Berkshire Hathaway, and J.P. Morgan, is shutting down. The intent of the company was to use data and analytics to help reduce health care costs while also providing better health care services. The company has received much press since its founding, due largely to the companies involved. However, according to multiple reports, it was difficult for Haven and its work to permeate into the three companies. Haven's closing illustrates the challenges in effecting change in the complex world of health insurance.

Summary

As was the case in 2020, the health insurance industry in 2021 will depend on Covid-19 developments as well as a new Presidential administration. The number of cases and deaths from the virus and how quickly can a vaccine be administered and reduce infections will be important as the year progresses.

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