Q2 2013 Earnings Call

Company Participants

- Charles Lowrey, EVP, COO US Businesses
- Ed Baird, EVP, COO International Businesses
- Eric Durant, SVP, IR
- John Strangfeld, CEO
- Mark Grier, Vice Chairman
- Rob Falzon, CFO

Other Participants

- Erik Bass, Analyst
- Joanne Smith, Analyst
- John Nadel, Analyst
- Ryan Krueger, Analyst
- Sean Dargan, Analyst
- Suneet Kamath, Analyst
- Tom Gallagher, Analyst

Presentation

Operator

Ladies and gentlemen, thank you for standing by, and welcome to the Second Quarter 2013 earnings teleconference. At this time all lines are in a listen-only mode. Later we will conduct a question-and-answer session. Instructions will be given to you at that time.

(OPERATOR INSTRUCTIONS)

As a reminder, today's conference call is been recorded. I would now like to turn the conference over to Mr. Eric Durant. Please go ahead.

Eric Durant {BIO 3932339 <GO>}

Thank you, Cynthia. Good morning. Thank you for joining our call to review Second Quarter results. We realize we were relatively late to report this quarter. We hope the wait was worthwhile. In order to help you to understand Prudential Financial, we will make some forward-looking statements in the following presentation. It is possible that actual results may differ materially from the predictions we make today. Additional information regarding factors that could cause such a difference appears in the section titled Forward-

Looking Statements on Non-GAAP Measures of our earnings press release for the Second Quarter of 2013, which can be found in our website at www.investor.Prudential.com. In addition, this presentation may include references to adjusted operating income; or to earnings per share, or EPS; or return on equity, or ROE, which are determined based on adjusted operating income. Adjusted operating income is a non-GAAP measure of performance of our financial services businesses that excludes certain items. Adjusted operating income is not a substitute for income determined in accordance with generally accepted accounting principles, GAAP, and the excluded items are important to an understanding of our overall results of operation. For a reconciliation of adjusted operating income to the comparable GAAP measure, please see our earnings press release on our website. Additional information relating to the Company's financial performance is also located on our website. Who writes this stuff, anyway? Representing Prudential on today's call are John Strangfeld, CEO; Mark Grier, Vice Chairman; Charlie Lowrey, Head of Domestic Businesses; Ed Baird, Head of International Businesses; Rob Falzon, Chief Financial Officer; and Peter Sayre, Controller and Principal Accounting Officer. We will begin with prepared comments by John, Mark, and Rob. We will be referring to slides that you can get on our website, again, at www.investor.prudential.com. After the presentations, we will have at your questions. John?

John Strangfeld {BIO 14004907 <GO>}

Thank you, Eric. Good morning, everyone, and thank you for joining us. The central message today is that we had another strong quarter, and we are tracking well to achieve our goals for 2013. While we have clearly benefited from some tailwinds, including strong investment results, the main driver of our improving results is business fundamentals. And each of our divisions is contributing. Mark and Rob will review the quarter in greater detail in a few minutes, but here are a few highlights. Our Retirement business had record earnings, largely on the strength of the two large pension risk transfer deals we completed late last year. We invested for many years to develop our capabilities in pension risk transfer, and it is pleasing to see initial tangible benefit from the commitment we made. Individual Life Insurance also had a strong quarter, reflecting a solid contribution from the Hartford Life block we acquired early this year. Integration is on plan, and both integration and expenses and cost savings are tracking with our expectations. The expanded distribution in the Warehouse and Bank channels, and the high quality staff that this deal brings us, are exceeding our expectations. Results in International Insurance continue to reflect solid organic growth, as well as increasing expense synergies from our acquisition of Star and Edison. To be sure, challenges remain. It is clear to us that we will continue to focus on building a company that achieves and sustains superior financial performance, especially as measured by return on equity, over time and through challenging environments. We believe our goal and superior performance is supported by the strong foundation we can build upon. First, our portfolio of businesses is balanced and diverse. We believe our set of businesses should produce superior returns over time because of the markets they serve, along with the high value-added products at the core of our value propositions. Second, our businesses are well led and are leaders in their markets, as competitive measures such as sales, flows, and persistency, as well as overall performance will attest. Third, capital management is part of our value proposition. We strive for a disciplined balance of capital deployment between the normal course organic growth, growth through innovative new products or applications, such as pension risk transfer, M&A, and return to our shareholders. And finally, while it is hard to demonstrate except through results, we strongly believe that superior talent and the culture in which they work is, and will continue to be, the biggest driver of our long-term performance. With that, I would like to turn it over to Mark.

Mark Grier {BIO 1391186 <GO>}

Thanks, John. Good morning, good afternoon, good evening, depending on where you are. Thanks for joining us today. I will take you through our results for the quarter, and then I will turn it over to Rob Falzon. I will start with an overview of our financial results for the quarter using slide 2. On a reported basis, common stock earnings per share amounted to $2.30 for the Second Quarter, based on after-tax adjusted operating income of the Financial Services businesses. This compares to EPS of $1.38 a year ago. After adjusting for market-driven and discrete items in both the current quarter and the year ago quarter, EPS was up 31%, amounting to $2.24, compared to $1.71. This increase is largely the result of underlying organic growth in our US businesses, reflecting positive net flows and market appreciation over the past year; the contribution from the Pension Risk Transfer business we put on the books late last year, with performance in the Second Quarter bolstered by strong investment results and case experience; by more favorable claims experience in individual life, together with the contribution of the business we acquired from the Hartford in January; and continued growth of our International Insurance business, which also benefited from strong investment results in the current quarter. On a GAAP basis, we reported a net loss of $524 million for the current quarter. This reflects the accounting impact of foreign currency remeasurement of non yen liabilities on the books of our Japanese Insurance companies, as well as negative mark-to-market on derivatives we use in duration management, driven by rising interest rates. Book value per share, excluding accumulated other comprehensive income, or AOCI, amounted to $54.18 at the end of the Second Quarter, down $3.68 from year end on a reported basis. This comparison is affected significantly by the geography mismatch from asset and liability changes, driven by foreign currency fluctuations where the impact on non-yen liabilities runs through the income statement, while the offsetting gains on the assets are included in AOCI, rather than net income. If you adjust the numbers to remove the impact of this mismatch, book value would be $60.14, up $1.90 per share since year end, after the payment of two quarterly dividends totaling $0.80 per share. As we have told you, we won't consider ourselves to have achieved our ROE goal based on printing a result that is influenced by reducing the denominator due to foreign currency remeasurement. On this appropriately adjusted basis, our reported annualized ROE for the Second Quarter would be 15.5%. Slide three presents the short list of market-driven and discrete items included in our results for the quarter. In the Annuities business, rising interest rates, which enhance expected returns on the fixed income portion of account values and reduce the cost of our guaranteed benefits, were the main driver for the release of a portion of our reserve for guaranteed minimum death and income benefits, and a favorable DAC on locking. These updates produced a benefit totaling $0.10 per share. Charges for integration costs in the quarter totaled $0.02 per share, and within Corporate and other results, we recorded a charge of $0.02 per share to write off bond issuance costs on high coupon debt that we redeemed prior to maturity. In total, the items I mentioned had a net favorable impact of $0.06 per share on current quarter results. Slide four shows two views of our ROE trend. The blue bars are as reported, based on adjusted operating income and equity, excluding AOCI. This view reflects the variability and results from market-driven and discrete items, as well as the impact on ROE in the first two quarters of this year from reduction of the denominator by foreign currency remeasurement. In the green bars, we have removed the impact of market-driven and discrete items, and removed the impact of foreign currency remeasurement that affects our book value through net income to provide a trend that more faithfully reflects our business results. On this basis, annualized ROE was just under 15% for the first half of this year, compared to about 11% a year ago. While there is some tailwind in our ROE from strong current quarter investment results in our Retirement and International Insurance businesses, as I mentioned, and some seasonality that favors the first half in International Insurance, we believe that we are well on track to achieve our goals for the year. Moving to slide 5. On a GAAP basis, the net loss of $524 million for the Financial Services businesses in the Second Quarter includes amounts characterized as net realized investment losses of $2.2 billion pretax, comprised of the items you see here. Foreign currency remeasurement losses primarily represent changes in the value of non yen liabilities relating to products denominated in US dollars and other currencies on the books of our Japanese company, whose functional currency is the yen. The weakening of the yen that we saw in the First Quarter continued into the Second Quarter, causing us to record a loss in the income statement because it would take more yen to pay off these liabilities. We consider this non-economic because the liabilities are matched with assets in the currencies in which they will be settled. This income statement loss results from the accounting geography mismatch that I have mentioned. The current quarter pretax loss also includes $953 million from net negative mark-to-market on derivatives, mainly related to our investment duration management programs, largely driven by rising interest rates. Product-related embedded derivatives and hedging activities had a net negative impact of $124 million in the quarter. Impairments and credit losses on investments were benign in this quarter. The positive contribution you see for other items of $441 million essentially represents net gains from general portfolio activities, driven largely by currency-related gains on sales of non-yen denominated bonds in our Japanese insurance operations. Moving to our business results and slide 6. I will start with our US Retirement Solutions and Investment Management businesses. Reported results are shown on slide 6, along with the adjustments I would make for market-driven and discrete items, to get a view of underlying performance relative to a year ago. Slide seven highlights the Annuity business. After adjusting for reserve true-ups and unlockings, which were mainly driven by rising interest rates in the current quarter, and a decline in the equity markets a year ago, annuity results were $325 million for the quarter, an increase of $94 million from a year ago. Slide eight relates baseline earnings to account values. Stripping out the impact of unlockings and other one-off items we have disclosed, as we have done here in the green bars, the trend of earnings for the Annuities business reflects our account value growth. Account values amounted to $141 billion at the end of the quarter, up 14% from a year ago. The increase was driven by market appreciation, together with $8 billion of net flows over the past year, and produced a 19% increase in policy charges and fees. Results in the Annuity business also benefited from a reduced drag from distribution and other costs, which rose less rapidly than revenues. As slide nine shows, our gross annuity sales for the quarter were $2.5 billion, down from $5.4 billion a year ago. The lower level of current quarter sales reflects actions we have taken to adapt our products to the current environment. As we discussed in our Investor Day in June, we have responded to market changes by pulling a number of levers to maintain appropriate return prospects and improve our risk profile. In February of this year, we introduced our current living benefit feature, called HDI 2.1. The biggest changes in HDI 2.1 brought down some of the value of the guarantee by adjusting payout rates at various age bands. For example, to get a 5% annual income payout, the client must be age 70 when payouts commence, as compared to age 65 in the previous version of the product. We also eliminated the guaranteed doubling of the protected withdrawal value after 12 years. While leaving the rider fees unchanged at 100 basis points for individual contracts and 110 basis points for spousal contracts, we also reduced the commission rates that we pay in February to maintain an appropriate balance between the value proposition to customers and compensation to our distribution partners. We implemented the commission change in a transparent manner, working with our broker-dealer partners, and we have maintained strong distribution relationships. Over the past year, we have also withdrawn our X Shares, or bonus product, and suspended acceptance of subsequent premiums on generations of products offered before 2011. Additionally, in late July we implemented a cap on subsequent purchase payments on the HDI products we offered prior to last August. We believe that our products continues to offer a solid value proposition in an attractive market and we regard our sales level as an outcome rather than a target. Slide 10 highlights the Retirement business. The Retirement business reported record high adjusted operating income of $279 million for the current quarter. This compares to $147 million a year ago, or $156 million if I add back $9 million of costs we incurred then to convert our bank to a trust-only status. The headlines of the improvement in earnings are greater contributions from net investment results and case experience on group annuity and similar contracts, in each case, driven largely by the two major pension risk transfer transactions that we closed late last year. Current quarter results benefited by $95 million from a greater contribution from net investment results. This includes about $35 million of returns that we would consider above our average expectations on non-coupon asset classes. In addition, case experience was $28 million more favorable in the current quarter. About half of this increase came from a true-up of reserves, resulting in reserve releases as we move the administration of a block of the pension risk transfer business to our own platform. The benefit from higher fees driven by account value growth was essentially offset by higher expenses as we continue to invest in this business. Slide 11 shows retirement sales and account values. The top graph on slide 11 shows that total retirement gross deposits and sales were $8.1 billion for the quarter, compared to $12.8 billion a year ago. Standalone institutional gross sales amounted to $4.4 billion in the current quarter, compared to $8.5 billion a year ago. Current quarter sales included $3.5 billion of stable value wrap products sold to plan sponsors, while the year ago quarter included $8 billion of those sales, reflecting the exit of a major provider of these products from the market and reflecting several large case wins. Full service gross deposits and sales were $3.7 billion for the quarter, down from $4.4 billion a year ago, which included a major case win of about $850 million. Net flows remained in the positive column, with strong retention of existing cases. We believe that our ongoing investment in client service capabilities is contributing to our persistency, and will enhance our appeal to plan sponsors as we maintain pricing discipline in the highly competitive mid to large case market, which is our major focus. Referring now to the account values graph on slide 11, total retirement net flows for the current quarter amounted to $2 billion, and account values surpassed the $300 billion milestone, amounting to $301.8 billion at the end of the quarter, up $57 billion from a year ago, and including about $33 billion from the pension risk transfer transactions late last year. Slide 12 highlights the Asset Management business. The Asset Management business reported adjusted operating income of $168 million for the current quarter. This compares to $127 million a year ago, after adjusting for an impairment charge, for an increase of $41 million. The increase came essentially from higher asset management fees, driven by growth in assets under management net of expenses. The segment's assets under management amounted to $826 billion at the end of the quarter, up by 10% from a year ago. On slide 13 you see the results of our US Individual Life and Group Insurance businesses, showing the adjustment for the Hartford integration costs. Slide 14 highlights the Individual Life business. After adjusting for integration costs, Individual Life reported earnings of $152 million for the current quarter, up $91 million from a year ago, the in-force block of business we acquired from the Hartford contributed about $42 million this quarter. The business integration is well on track, and our results reflect initial realization of cost synergies in line with our expectations. The remainder of the increase in Individual Life earnings reflected improved mortality experience in our Prudential business, which was about $20 million more favorable than our average expectations in the current quarter. This contrasts the mortality experience about $50 million less favorable than average expectations a year ago. The year-ago quarter was our most adverse variance from expected levels since late 2003. The benefit from improved mortality on the Prudential business was partly offset by higher distribution costs in the current quarter, reflecting the expansion of our third-party distribution system with the Hartford acquisition, as well as higher sales in the current quarter. Shown on slide 15, individual life sales based on annualized new business premiums amounted to $184 million for the current quarter, including $58 million from the third-party distribution partners that came to us with the Hartford acquisition. This compares to total sales of $91 million a year ago. The current quarter sales increase was mainly driven by our universal life products and reflects our strong competitive position, as some key competitors have recently raised rates or withdrawn products. In addition, the Hartford strength in banks and wire houses has significantly enhanced our distribution through financial institutions, which amounted to $60 million in the current quarter, up by about $40 million from a year ago. Guaranteed universal life products accounted for just over 50% of our current quarter sales. We have taken actions to limit concentration in these products and maintain appropriate returns, including a series of price increases, most recently in May and July of this year. In addition, in May we implemented a cap on the amount of premium that a client can invest when purchasing a contract. Because of the time span of the application and underwriting process, typically 60 to 90 days, we would expect these actions to have an increasing impact on our reported sales going forward. Turning to the next slide highlighting Group Insurance. The Group Insurance business reported adjusted operating income of $22 million in the current quarter, compared to $33 million a year ago. The decrease reflected less favorable group underwriting results, which more than offset improved claims experience in group disability. Slide 17 presents earnings and benefit ratio trends in our Group business. Fluctuations in claims experience and expenses, as well as seasonality, have affected the pattern of Group Insurance results. Group Life accounts for more than 80% of our group insurance premiums, and its results tend to be seasonally weakest in the First Quarter, due to a higher concentration of claims. While the Second Quarter claims ratio was within an expected band, results were off from a relatively strong year-ago quarter. In Group Disability, we are more than one year into what we expect to be a three-year process of bringing down the benefits -- of bringing the benefits ratio down to an acceptable range. We have repriced or allowed to lapse about one-third of the book. In addition, we have enhanced our claims management capabilities. We are beginning to see some progress with increased claims terminations in the current quarter, contributing to the improvement of more than four percentage points in the benefits ratio from a year ago. I will move now to the International Insurance Division, starting with slide 18. Slide 18 shows the results of our International Insurance business, adjusting for integration costs. Slide 19 highlights the Life Planner business. Our Life Planner business reported adjusted operating income of $368 million for the quarter. This compares to $374 million a year ago. Higher expenses and less favorable mortality experience in the current quarter more than offset the contributions of continued business growth and more favorable foreign currency translation. The higher expense level reflected factors, including current quarter technology costs in Japan, which are largely related to product development, a guaranteed fund recovery in the year-ago quarter, and higher employee benefit costs in our Korean operation. Current quarter mortality experience was about $10 million less favorable than average expectations, compared to experience essentially in line with expectations a year ago. The contribution of business growth in comparing the year-ago quarter was dampened somewhat by the benefit last year from accelerated purchases of our cancer whole life product in anticipation of a tax law change in Japan and strong sales of our US dollar retirement income and whole life products in advance of price increases. Foreign currency exchange rates, which reflect our hedging of yen net income at 80 this year versus 85 last year, contributed a benefit of $13 million to earnings in comparison to a year ago. Turning to slide 20, highlighting Gibraltar Life. After adjusting for integration costs, Gibraltar Life reported earnings of $488 million for the current quarter, up $146 million from a year ago. The current quarter benefited from a contribution from investment results about $80 million greater than a year ago. About 50% of this increase came from non-coupon investments, reflecting strong performance in Japanese real estate and equities. About $25 million of the increase in Gibraltar's earnings came from gains on an elevated level of surrenders of non-yen products driven by currency exchange rates, partly offset by less favorable mortality experience in the current quarter. Current quarter results also reflected about $55 million of cost savings achieved thus far from the Star Edison business integration, compared to about $40 million in the year ago quarter. The remainder of the increase came from continued business growth and then $11 million benefit in the comparison from foreign currency exchange rates. Slide 21 shows total international insurance sales. International insurance sales on a constant dollar basis were $850 million for the current quarter, compared to $1.2 billion a year ago. Market developments, along with repricings and other actions we have taken, have produced some volatility in the quarterly pattern of sales results. Seasonality has an impact on our sales trend as well, with a benefit in the first half of the year from accelerated sales efforts toward the end of the fiscal year in Japan on March 31, which benefits First Quarter results for our Life Planner business, and benefit Second Quarter results for Gibraltar. Since most of our business in Japan is traditional insurance products where the pattern of profits is tied to premiums, this also tends to make first-half earnings seasonally stronger than the second half in both Prudential of Japan and in Gibraltar. In the first and Second Quarters of last year, we experienced sales surges in Japan from our cancer whole life product in anticipation of a tax law change, and we experienced accelerated purchases of our US dollar retirement income and whole life products in advance of price increases we implemented, as I mentioned. Gibraltar sales of yen-based single premium whole life products in the bank channel also began to accelerate in the Second Quarter of last year as competitors limited sales of products that were popular in that market, with the greatest volume of sales taking place in the third and Fourth Quarters of 2012. In order to limit our concentration in this product and maintain appropriate returns, we implemented crediting rate reductions and reduced commissions effective January 1 of this year, and we will be discontinuing sales in September. Excluding the products I just mentioned, you can see a sales increase in the red portion of the bars of $132 million for the current quarter compared to a year ago. Looking back over two years to the Second Quarter of 2011, the comparison of the same baseline of products shows an average annual increase of 8%. Slides 22 and 23 break down sales by business and product. Slide 22 presents life planner sales. Life planner sales were $285 million in the current quarter, compared to $402 million a year ago. Sales of cancer whole life and the US dollar products I just mentioned were $47 million in the current quarter, or $130 million below the year-ago level. The decline in sales of these products more than offset a $24 million increase in sales of other products by our life planners in Japan. Sales outside of Japan were down $11 million from a year ago, mainly reflecting lower sales in Korea. Taking a look at the red portions of the bars for the first and Second Quarters of each year, which exclude the sales volatility from cancer whole life and the repriced US dollar products, you can see the seasonality driven decline from the First Quarter to the Second Quarter in each of the last three years, as we would expect. Slide 23 presents Gibraltar Life sales. Sales from Gibraltar Life were $565 million in the current quarter, compared to $769 million a year ago. Sales of cancer whole life and US dollar whole life and retirement income products were down by $275 million from a year ago, reflecting the tax law and pricing changes that I have discussed. Current quarter sales include $64 million from the yen-based single premium product in the bank channel, down $48 million from a year ago. Sales of other products in Gibraltar's portfolio totaled $389 million, up $119 million from a year ago, with the increase driven largely by life insurance protection products, including yen-based recurring premium whole life and term insurance. Slide 24 shows the results for corporate and other. After adjusting for the write-off of bond issue costs in the current quarter, the corporate and other loss was $331 million, in line with the average of the past four quarters, but up $106 million from a year ago. The increased loss came from higher expenses and greater net interest costs, which reflect our pre-funding of several refinancings. Now, I will turn it over to Rob.

Rob Falzon {BIO 4770408 <GO>}

Thanks, Mark. I would like to give you an update on some key items under the heading of financial strength and flexibility, and they are summarized beginning on slide 25. First, focusing on our insurance companies. We continue to manage these companies to levels consistent with what we believe are AA standards. For Prudential Insurance, we managed to a 400% RBC ratio, which we believe gives us some cushion against our AA objective. We began the year with a 456% RBC ratio. While we don't perform a quarterly bottoms-up RBC calculation, we estimate that our RBC ratio remains above our 400% target at Prudential Insurance, after giving effect to the Hartford transaction and other activities in the first half of the year. In Japan, Prudential in Japan and Gibraltar Life reported solid solvency margin ratios of 749% and 896%, respectively, as of March 31, their fiscal year end. These reported solvency margins are strong in relation to our targets. Looking at the overall capital position for the financial services businesses, as summarized on slide 25, we calculate our on balance sheet capital capacity by comparing the statutory capital position of Prudential Insurance to our 400% RBC ratio target, and then add capital capacity held at the parent company and other subsidiaries. As of year-end we estimated that our on balance sheet capital capacity was roughly $3 billion before the funding of Hartford Life acquisition, which closed in early January. We also estimated that about $1.5 billion to $2 billion of this amount was readily deployable. During the first half of this year, we funded the Hartford acquisition, paid two quarterly common stock dividends of $0.40 each, for a total of about $400 million, and repurchased $250 million of our common stock, totaling roughly $1.3 billion of capital redeployment and returns of capital. The net of these uses of capital and the capital generated by our businesses in excess of their organic growth needs left us with available on balance sheet capital capacity of about $2.5 billion to $3 billion at June 30, including about $1 billion that we would consider readily deployable. Our $250 million of share repurchases, which we executed during the Second Quarter, brought our total repurchases under the authorization that ended on June 30 of this year to $400 million, as we had projected. As you know, we announced a new $1 billion repurchase authorization in June, which extends through June 30 of next year. Turning to the cash position of the parent company, cash and short-term investments net of outstanding commercial paper amounted to about $4 billion as of the end of the Second Quarter. This reflects our calls during the quarter of approximately $450 million of senior debt, with an average coupon of about 6%, and $920 million of 9% junior subordinated notes. The cash in excess of our targeted $1.3 billion liquidity cushion is available to repay maturing debt, fund operating needs, or redeploy over time. Now I'll turn it back over to John.

John Strangfeld {BIO 14004907 <GO>}

Okay. Thank you, Mark and Rob. That concludes our prepared comments, and we would like to open it up to Q&A.

Questions And Answers

Operator

(OPERATOR INSTRUCTIONS)

Ryan Krueger, Dowling & Partners.

Q - Ryan Krueger {BIO 15132646 <GO>}

First question on Gibraltar. You mentioned a few factors that benefited earnings this quarter, but even if I normalize for the good alternative performance, the surrender fees, and as well as seasonality, the results still seemed quite strong. And there any other factors we should think about going forward? Maybe expense timing or anything like that that could affect Gibraltar going forward, or if I adjust for those things, is that a good run rate to think about?

A - Ed Baird {BIO 15922078 <GO>}

I think that you fairly point out that a lot of things went in the right direction for Gibraltar this quarter. You are right -- on the investment side, it was higher than we would normally expect. Certainly not all of it, but a portion of it was higher than I think you would want to assume is going to continue going forward. There is a certain seasonality factor as a result of the annual premium mode. Let me explain that. On annual premiums, we book the earnings consistent with the time in which we booked the premium. On POJ, that is in the First Quarter, but in Gibraltar, because they lag by a quarter, that shows up primarily in the Second Quarter. And then on the third side -- actually on the more -- the benefit side was a little better than normal, not so much because of mortality, but because there were surrenders that took place, primarily around the Aussie dollar, which netted against the mortality produced a better little benefit ratio than would be normally assumed. So if you put the three together, you are right. You need a discount to some degree. But even after you have done that, there is a very strong performance result there. One being the factor that Mark highlighted, which is that consistent with the original plan, the costs have come down steadily, we have now expensed about 80% of the $400 million ballpark that we had originally estimated for the expenses, and that has come down nicely. And similarly, we are getting increased gains on the expense savings. So the combination of those two produced about a $50 million swing over the quarter, and as Mark pointed out, those are stable, in contrast to the one timers that you just covered. So net net very strong, but I would not book the whole thing on a going forward basis.

Q - Ryan Krueger {BIO 15132646 <GO>}

(multiple speakers) If I take into consideration all of the factors that you mentioned, it still seems like the earnings were running above $400 million. Is that a fair assessment?

A - Ed Baird {BIO 15922078 <GO>}

I'm not sure I would want to stick a number on it. I would more or less stick with what I just said in terms of how you might want to adjust it.

Q - Ryan Krueger {BIO 15132646 <GO>}

Okay. And then I have one on non-bank. It seems like there's been some increased discussion lately, including some comments from Ben Bernanke, that language in the Collins Amendment may limit the fed's ability to tailor capital rules to insurance companies and away from a bank methodology. So I just appreciate any thoughts or perspective you might have on that issue.

A - Mark Grier {BIO 1391186 <GO>}

Yes, this is Mark. I guess the main thought is that that's an issue that is out there. It is something that does come up when we talk about the consideration of what we consider to be appropriate capital insolvency regimes for an insurance company. And at this point, I would say that it is just something that we have to work through.

Q - Ryan Krueger {BIO 15132646 <GO>}

I know there is a proposed bill out there to modify that. You -- have you seen that gaining any traction?

A - John Strangfeld {BIO 14004907 <GO>}

Well, there are -- yes, there is legislation out there and there also are different opinions about the specific legal interpretation. The more general issue is a reluctance to reopen Dodd-Frank at all, and that is kind of the hurdle that we would have to get over to start looking at changes. And I would have to say the outlook for that is highly uncertain.

Q - Ryan Krueger {BIO 15132646 <GO>}

Thank you.

Operator

Suneet Kamath, UBS.

FINAL

Bloomberg Transcript

Q - Suneet Kamath {BIO 4776228 <GO>}

Great. Thanks. Just to follow up on Ryan's question on non-bank SIFI. So I guess since the last time we spoke, you were designated -- you have decided to contest. So I was just wondering if you can kind of take us through the process of what actually happens as you contest the designation? You had given us in the past, I think, some color around stage I, stage II, stage III. So what actually happens in this contestation process?

A - John Strangfeld {BIO 14004907 <GO>}

I guess the short answer is that I cannot give you a lot more color around the process. We are in the works. Timing-wise, probably somewhere around two months from late July we will have a final determination. As you mentioned, we have been working on our concerns about the preliminary designation, but I cannot add a lot more than that in terms of discussion of the process. I would reiterate that we don't believe that we satisfy the quantitative criteria to be a SIFI, as it is contemplated in Dodd-Frank, and we continue to make that case.

Q - Suneet Kamath {BIO 4776228 <GO>}

Right. I get that. I guess I'm trying to figure out if there's a difference between this process and the whole process going through stage I, stage II, and stage III. Clearly in those stages, you presented your arguments and the FSOC decided to make its own decision. So I'm trying to figure out what is different about this next process that we go through.

A - John Strangfeld {BIO 14004907 <GO>}

Well again, without getting into a lot of detail, we did have a specific preliminary designation to discuss in the context of the last stage of the process, so that would have been different. But otherwise, I would add again, we have had high quality discussions around the nature of our business models and the issues that both we and the Counsel think are important.

Q - Suneet Kamath {BIO 4776228 <GO>}

Okay. And then just moving to the capital position. If I go back to -- not the beginning of the year, but maybe the First Quarter call, I think you talked about $1.5 billion of redeployable capital. I think in the quarter you did the $250 million in buyback, the roughly $200 million of dividend, some capital debt reduction, so that probably adds up to something like $575 million. And then you said the redeployable right now is $1 billion. So I'm just to figure out what was the actual capital generation in the quarter? Because it -- if I just run the math, it does not seem like it was a very sizable number.

A - Rob Falzon {BIO 4770408 <GO>}

Suneet, it is Rob. First, the math that you did, I think, all adds up. As we looked at the overall capital capacity on balance sheet, I would characterize it is as not having changed materially. What change there was is more of a timing issue than an absolute issue, and what did change is the composition of that capital in the way in that you articulated it. We used our redeployable capital to pay dividends, buy back stock, and delever. And that brought the redeployable component down. With regard to the overall pie, the total capital capacity remained relatively unchanged as result of earnings coming in, funding our business growth, and then the items that you mentioned.

Q - Suneet Kamath {BIO 4776228 <GO>}

So the strain, I guess, is the piece that I'm missing in here. The strain from business growth?

A - Rob Falzon {BIO 4770408 <GO>}

Yes. If you look at our -- start with our earnings adjusted for things like NPR and FX remeasurement, which are noneconomic, you took out those items and you took out financing the growth of our business, you would find that that leaves us with a total capacity that is relatively unchanged.

Q - Suneet Kamath {BIO 4776228 <GO>}

Okay, and then just the last one on this topic. If I think about the total capital capacity, I guess the $2.5 billion to $3 billion, and I back out the redeployable, I would get $1.5 billion to $2 billion of excess capital capacity that is not redeployable. I would just like to get a sense of what that is. Because I thought some of that stuff was going to get chewed up by the PRTD deals, as was the Hartford Life deal, but it seems like that number is still pretty sizable in terms of excess capital capacity that cannot be redeployed. So any detail on that would be helpful.

A - Rob Falzon {BIO 4770408 <GO>}

Yes. A couple of thoughts on that. First, recognize that that is a number that cycles through during the course of the year. So we do, as you noted, and have, used the non-monetizable capital. It can absorb risk for writing new business, so we can also absorb risk if things go bump in the night. So that -- while it is non-monetizable, it does not mean that it is not usable. It means that there are different ways in which it can get applied. And what happens in any given year is that things like DTAs burn off and then get added as a result of activities during the course of the year. So when we define non-monetizable, what mean by that is that in the course of the next 12 months, that is the proportion of our capital capacity that exists down in operating subsidiaries that we don't see coming up to the holding company in a way that it would allow us to immediately redeploy it. That is an ongoing process. During the course of any given year, we will be taking capital out of the subsidiaries, but they will be building capital back up again. And as a result of that, the non-monetizable piece -- there will be a component of it -- I don't think you ever see it go way, although it is reduced over time as a result of writing new business and doing things like pension risk transfer.

A - Mark Grier {BIO 1391186 <GO>}

Yes, Suneet, it's Mark. Maybe just to emphasize one point that Rob made. The amount of DTA that is eligible, that counts as an asset for statutory purposes, will roll over. So as some of that is monetized, more will meet the test and be accepted as an admitted asset. There's a little dynamic there that -- the first part of what you said is right -- it does get chewed up. But the second part is, it gets replaced.

Q - Suneet Kamath {BIO 4776228 <GO>}

Okay. Thank you.

Operator

John Nadel, Sterne, Agee.

Q - John Nadel {BIO 6998784 <GO>}

So there's a lot going on in the world today, but a couple of the factors seem to be pretty favorable for potentially driving further activity in the pension markets. Higher rates should, all by itself, be helping to reduce pension funding gaps, and obviously, strong markets should be helping on the asset side. I just wonder if you can help us understand, based on your dialogue with potential customers, how much has the macro environment improving change the potential outlook, I'm assuming for the better, for that activity?

A - Charles Lowrey {BIO 3976922 <GO>}

John, it is Charlie. I think it is fair to say that we are continuing to have very robust conversations with many different companies, and your observation is, in fact, correct. That as interest rates go up, that obviously helps with the valuation of their liabilities. It can help with closing the funding gap, which is a good thing. Another dynamic is occurring as well, which is that as interest rates go up, they will hit certain trip wires, in that they will invest more in bonds, which then creates a portfolio which is better for pension risk transfer.

Q - John Nadel {BIO 6998784 <GO>}

Interesting.

A - Charles Lowrey {BIO 3976922 <GO>}

So I think the environment looks promising. And as we have said, it is a very lumpy business. These transactions will occur when they occur, and that is dependent upon a whole variety of things, including board approvals and funding rates and all sorts of things. But we're having a great many conversations right now with different companies, and we'll see what happens.

Q - John Nadel {BIO 6998784 <GO>}

Would you -- Charlie, not to put you on the spot, but I'll try. Whether it is PRU or just an industry comment, I'm just wondering if you would put odds on a relatively large transaction getting done before the end of this year. I'm not asking you to comment on whether PRU would be a winner or not, but odds better than 50/50 that a large deal would get done or something different?

A - Charles Lowrey {BIO 3976922 <GO>}

Well I'll talk for a moment without answering the question. How's that? And that is that I think these deals have long lead times. And we are in a variety of conversations, but there long lead times. And I cannot comment about the rest of the industry, but they're lumpy, and they will occur when they occur.

Q - John Nadel {BIO 6998784 <GO>}

Fair enough. I thought it would try it. And a quick one for either Mark or Rob. You guys have been doing a lot on the balance sheet related to your debt, and preferreds, and hybrids, and junior subordinates. A lot of activity there. I know some of the reigning agencies view some of these forms of financing slightly differently from a debt-to-capital, how much equity credit they get, et cetera. If you look at the more onerous of those agencies, where do you stand currently from a debt-to-capital perspective and does it imply any capacity?

A - Rob Falzon {BIO 4770408 <GO>}

It is Rob. The way we look at it internally is consistent, whether we think of the low or the major rating agencies. Moody's gives us only a 25% equity credit for the hybrids. We get full equity credit for the hybrids from Standard & Poor's by way of contrast on the other extreme. So when we report our financial ratio to you, it is only giving ourselves the benefit of that 25% allocation to equity, and that is the 24.7% financial ratio that we published for you.

Q - John Nadel {BIO 6998784 <GO>}

Got it, okay. Thank you.

Operator

Tom Gallagher, Credit Suisse.

Q - Tom Gallagher {BIO 3311667 <GO>}

First I had a question on slide 21. I just want to better understand what the message and the take-away is from this, which shows the international sales trends. The red bar on the bottom shows that clearly there is a nice upward trajectory of sales of other products, which I guess would be your traditional products that you sold historically. Should I be thinking about the other bars? The US dollar whole life, the cancer whole life, and the yen-based bank being the more asset-intensive products that are now going to continue to diminish? Is that a fair characterization or way to think about those?

A - Ed Baird {BIO 15922078 <GO>}

Yes let me answer your question a little bit differently than the way you posted, if you don't mind, Tom. What we are trying to communicate here are a couple of things. First, before you even get into the colors of the bar, if you just look at the size of the bar, the first point we are trying to make is that what happened in the Second Quarter of '12 was unprecedented. And so the drop that we're looking at here is driven by two things that happened during that quarter, which will not likely recur. So it had to do with, specifically, did you pay in businesses? During that quarter we saw a 40% increase in Gibraltar sales, and an 80% increase in POJ sales. We knew that that was not a new stable platform or plateau from which we could further build. Particularly because we understood why it happened. It was driven, as Mark pointed out in his opening comments, by the tax law changes on the cancer whole life products and on the interest rate changes on the dollar denominated retirement and other dollar products. And you're right -- those products related more to capital market activity and tax treatment than to the more traditional debt protection. So when those changes took place, there was a spike which will not reoccur. But the other reason for showing as many quarters is to give you the opportunity to observe that if you completely ignore that quarter, and you look at this quarter compared to the quarter in the prior year, i.e., 2011, you will see double-digit growth. The reason for that is because there continues to be underneath these two specific changes, very steady organic growth. And that is a continuation of what has been going on for a long time. In fact, coming into this quarter, we had fifteen quarters of consecutive year-over-year increases in sales. It was inevitable that it would come a break, and I think it was predictable that it would come in this quarter because of that spike that occurred. So I don't think there is much more of a message that we're trying to give here than that. It really was limited to that quarter. I don't think you will see the kind of volatility again unless there is some external or internal change comparable to what happened at that time.

Q - Tom Gallagher {BIO 3311667 <GO>}

That's helpful, Ed. But would you say that those other -- those three products on the top bars, would you expect those to continue to diminish, or --? I just want to get a better sense for where --

A - Ed Baird {BIO 15922078 <GO>}

No, I don't they will continue to diminish, John. And the reason I say it is, it had more -- it will diminish, depending on what you use as your baseline. Will it diminish relative to what it was in the Second Quarter of '12? Yes, maybe. But will it diminish relative to what it was in the quarters other than that? Not necessarily.

Q - Tom Gallagher {BIO 3311667 <GO>}

Okay. And then is it fair to say, though, because then, just based on these bars, you took a bit of a step back in terms of your traditional products in 2012. Probably because you were emphasizing all these other products. And now that seems to have recovered. How would you describe the competitive landscape for your traditional death protection products now? Is it -- based on the sales this quarter, it would appear to be a lot better, but can you shed some light on that?

A - Ed Baird {BIO 15922078 <GO>}

Sure. Yes. You make two key points there, John. One is you are absolutely right. The more traditional debt protection products dropped, relatively speaking, during that Second Quarter of '12, when more of the platform was consumed by the focus on the tax-driven and interest rate-driven activity. But now that that has returned more to normal, you're right. These products have now returned to their more historical organic growth rates. Your second point regarding competition, because our primary focus is through our captive agency distribution, and because the product focuses primarily on debt protection and needs-based analysis, we tend to be less sensitive to the movement of competitors.

That is less true, of course, on the bank channel, which we have discussed previously. But that constitutes less, particularly in this quarter of our productivity. So in general, I would not say that there has been any major movement on the competition that is affecting us, in spite of changes you have seen in prices driven by the changes in the standard reserving rate, which has brought about a broader dispersion of prices. But that is not materially affecting our performance because of our focus on debt protection and our distribution focus, primarily on proprietary distribution.

Q - Tom Gallagher {BIO 3311667 <GO>}

Okay, thanks.

Operator

Sean Dargan, Macquarie.

Q - Sean Dargan {BIO 15387640 <GO>}

As we look at slide 25 with your solvency margin ratio, interest rates have risen since March 31. I was wondering if you could describe what the impact to your SMR will be, and maybe some characteristics of your investment portfolio and how you characterize or classify your investments?

A - Ed Baird {BIO 15922078 <GO>}

Sure. You're exactly right. The second part of your question having to do with the composition of the portfolio is what influences the sensitivity on the SMR. So let me talk you through that. We have, as I believe most of you are aware, an extremely conservative portfolio, far more so than most of the Japan companies, either domestic or foreign-owned. As a result, we have the luxury of being able to define the vast majority, about 70%, of our general account portfolio is either hold to maturity or hold for reserve. Consequently, that does not need to be mark-to-market. Only about 20% of our portfolio is asset for sale, which is a lot less than I think you will find in most companies. Furthermore, what we have inside that category tends to be -- A, currency matched, and B, short-term duration. So those three facts, number one, a small part of our portfolio; number two, currency matched; and number three, short duration, means that we are relatively insensitive to movement here in terms of the SMR. And then, of course, I would just take the opportunity to remind you that, as Mark pointed out, our SMRs are very high, compared to, really, what is expected, I think, of a AA company, or what is going on with the competition. We are in a position that even if there's a relative diminution of it, it will still leave us in a very strong position.

Q - Sean Dargan {BIO 15387640 <GO>}

Thanks. And just a quick follow-up on Gibraltar. How much longer do you expect the elevated level of policy surrenders to continue?

A - Ed Baird {BIO 15922078 <GO>}

That's a good question, and one we have been watching ourselves, because this is relatively unprecedented. It links primarily to the exchange rate and its focused mostly on the Aussie dollar. That exchange rate peaked in April, and when we have looked at the monthly numbers, it would suggest that as the yen has strengthened versus the Aussie dollar, the surrender rate has dropped accordingly. That is what we can observe that you cannot from a quarterly number when we look at the monthly numbers. Which leads me to believe that if it stays at the current level on the exchange rate, that you will see a surrender rate that is below what we witnessed in the Second Quarter. But again, going forward, the primary point is it will be linked to, and largely driven by, the exchange rate

Q - Sean Dargan {BIO 15387640 <GO>}

Thank you.

Operator

Joanne Smith, Scotia Capital.

Q - Joanne Smith {BIO 16931590 <GO>}

Most of my questions have been answered. But I just wanted to go back to the normalized earnings. If you look at maybe $209 million, $210 million for the quarter, given all of the moving parts that we saw, what would you believe to be the sustainable factors during the quarter that increased the run rate of this kind of normalized earnings figure? Is it just the large pension risk transfer transactions, the Hartford Life acquisition, and the benefits of integration at Star and Edison? Or is it more that I might be missing there?

A - John Strangfeld {BIO 14004907 <GO>}

Joanne, this is John. Let me offer a couple observations about that. What you're really seeing here is the cumulative effect of the building blocks that we have been talking about, really for the last three years. So whether that is the strong organic performance in our existing business, which you can see manifested in the fundamentals, or whether it is the outsized organic that you mentioned, like pension risk transfer, or whether it is the M&A in the case of Star Edison, which has really come to fruition, or Hartford, which is in its early, but encouraging phases. And you couple that with active capital management and expense management as well, and the quality and continuity of leadership. All those things are contributing to this. It is these same elements that gave us confidence three years ago to aspire to a 13% to 14% ROE, are the things that are coming to fruition today and are manifested in our results.

Q - Joanne Smith {BIO 16931590 <GO>}

Okay. Then when I look at the normalized ROE, John, I would say you are at or above the target level for 2013. How should we think about that? You're obviously not going to give us an update on your targets, but do you think that the 14% to 14.5%, or I think you X everything out, you came up with 14.9. Is that something that is sustainable? There is a lot of, obviously, favorable market tailwinds that are helping some of these numbers. But just your view on that?

A - John Strangfeld {BIO 14004907 <GO>}

Yes, okay. A couple observations on that, as well. We believe we are on a good track towards the two aspects of our goal. One is achieving that range, and the second is doing it in a way that is sustainable over time. As you point out, firstly, two quarters does not a year make. And then secondly, there are certain elements in the first half, while they are very real, they tend to fluctuate. And the things that fluctuate at the moment are generally fluctuating in a positive direction. Like an example of the investment income fees that was been mentioned earlier. When we are talking about achieving and sustaining a 13% to 14% ROE, we are truly talking about long term, and without a reliance upon those fluctuating elements that drive us into that space. I think that's the extent of what we would say. We're not going to offer an more specificity around guidance, around ROE, et cetera, because that's not something we would normally do during the course of the year. But I think that's the way we think about it in terms of both achieving, getting into that zip code and doing it in a way that is sustainable over time and through different phases in different markets.

Q - Joanne Smith {BIO 16931590 <GO>}

Thanks very much, John.

Operator

Erik Bass, Citigroup.

Q - Erik Bass {BIO 19920101 <GO>}

I just have a couple of big picture questions, I guess in terms of how you're thinking about the US business. Clearly, you've been raising prices and annuities, individual life and group, so sales trends there have been moderating. In retirement, you've seen steady growth, but it is lumpy. So first question is, should we think of the near-term strategy as primarily being focused on maintaining and boosting margins and generating capital as opposed to growth? And then secondly, where do you see the attractive growth opportunities in the market currently?

A - John Strangfeld {BIO 14004907 <GO>}

Sure. I guess I would answer the first part of that question by saying I don't think that increasing margins are maintaining an appropriate level of profitability as mutually exclusive from growth. So if you look at our businesses, I think we are concentrating on making sure that we create shareholder value by selling product with an appropriate risk-adjusted return. And that hopefully will fall to the bottom line and that will create AOI growth over time. So it might not necessarily be topline growth, but it certainly can be bottom line growth, and I think you see that in a number of the businesses. And in terms of growth, as we've said, just in general, as we've said in the Investor Day, we think there are a whole series of macro trends in the US that play right into our strengths as an insurance company, as an asset management company, as a retirement company. And you look at the 10,000 -- whether it's the 10,000 baby boomers that are retiring a day, or the need for lifetime income, these are all trends that we have products for or are working on that really fall into, or play into our strengths over time. We're very excited about the macro trends in the industry. But the one thing we are absolutely focused on is the profitability of the products we have and that sales, as Eric and Mark and others have said, sales are going to be really a result of maintaining a price discipline in all our price lines going forward.

Q - Erik Bass {BIO 19920101 <GO>}

Okay. That's helpful. And just one follow-up. As sales levels come down, I would expect the drag from new business on capital would be decreased a little bit. Does that have a material impact on the amount of capital you generate in the business?

A - Rob Falzon {BIO 4770408 <GO>}

Eric, it's Rob Falzon. Yes, I would say that obviously, we have to consume capital in order to finance business growth, as we've talked about. To the extent, and I don't mean to imply that sales are coming down, if that was your hypothesis coming into it, but to the extent that sales moderate relative to an installed book, it becomes less capital-intensive for us in order to finance that growth.

Q - Erik Bass {BIO 19920101 <GO>}

Okay. Thanks. Any comments on order of magnitude? Or do you look at that as more of a general rule?

A - Rob Falzon {BIO 4770408 <GO>}

I would look at that as a general rule. I think we've provided you in the past benchmarks for the amount of capital that comes out of our operating subsidiaries on average over a very long period of time, and works its way up to the holding company, I think, on average, that's probably a good rule of thumb to sustain.

A - John Strangfeld {BIO 14004907 <GO>}

Just remember that it does vary a lot by product.

Q - Erik Bass {BIO 19920101 <GO>}

Certainly. Thank you, very much.

Operator

Thank you. Ladies and gentlemen, today's conference call will be available for replay after 1.30 PM today until midnight, August 15. We may access the AT&T teleconference replay system by dialing 800-475-6701 and entering the access code of 272223. International participants may dial 320-365-3844. Those numbers, once again, 800-475-6701 or 320-365-3844, and enter the access code of 272223. That does conclude your conference call for today. Thank you for your participation and for using AT&T executive teleconference. You may now disconnect.