Q1 2020 Earnings Call

Company Participants

- Jan Willem Weidema, Head of Investor Relations
- Matt Rider, Chief Financial Officer

Other Participants

- Albert Ploegh
- Andrew Baker
- Benoit Petrarque
- David Motemaden
- Farooq Hanif
- Fulin Liang
- Johnny Vo
- Nick Holmes
- Robin van den Broek

Presentation

Operator

Good day, and welcome to the Aegon Q1 2020 Results Conference Call. Today's conference is being recorded. At this time, I would like to turn the conference over to Mr.Weidema. Please go ahead, sir.

Jan Willem Weidema {BIO 15133400 <GO>}

Thank you. Good morning everyone and thank you for joining this conference call regarding Aegon's first quarter 2020 update. We would appreciate it if you could take a moment to review our disclaimer on forward-looking statements, which you can find at the back of the presentation. Given the unprecedented impacts of the COVID-19 crisis, our CFO, Matt Rider, will give you an update on our financial performance and capital position for the first quarter of 2020. At the end of the presentation, we will of course leave more than sufficient time for your questions.

I now hand it over to Matt.

Matt Rider {BIO 20002664 <GO>}

Thanks Jan Willem and good morning everyone. Thank you all for your continued interest in Aegon and for joining us on today's call. Due to the unprecedented situation caused by

COVID-19, we consider it important to provide you with an update on our first quarter financials.

Before we start with that, I would like to take the opportunity on the next slide to share with you our response to the pandemic, which has clearly changed the world as we know it. We are acutely aware of the disruption, fear and pain that this outbreak has caused for so many, our employees, our customers and for people in the communities in which we operate.

Our number one priority is to protect the health, safety and security of all our stakeholders. We are dealing with extraordinary circumstances, and I'm pleased to say that our resilience, experience and business continuity plans have enabled us to serve our customers at a high level. Our purpose to help our customers achieve lifetime of financial security remains the same. We believe we are well positioned to manage through this difficult period. We have introduced a global framework to protect the health and safety of all our employees. It is important to keep our staff engaged and motivated. Most of our staff in the US and Europe are currently working from home. In China, the majority of our staff has returned to the office.

To ensure that our services can continue uninterrupted, various solutions have been implemented. For example, call center staff can answer calls from home, and we have enhanced our capability to digitally interact with customers. This has been done while abiding by the same high standards regarding cybersecurity to which we always hold ourselves. We are also working closely with our critical outsourcing partners to avoid disruption in our operations so that we can continue to serve our customers. We are offering information and guidance on, for example, travel and medical insurance to affected customers. For those customers facing overwhelming financial challenges, we are providing financial relief on a case-by-case basis.

For example, we are offering flexibility on mortgage payments in Netherlands and fee waivers on withdrawals from retirement plans in the United States. And last but not least, we are supporting the communities in which we operate as we can only overcome this crisis together. We have donated medical supplies and food to the elderly and supplied protective gear to frontline healthcare workers. Furthermore, the Aegon Transamerica Foundation made a donation to direct relief to support their ongoing relief efforts during this pandemic.

With this, I'd like to now turn to the next slide. Today, I'm going to talk about 3 topics; Aegon's financial performance for the first quarter 2020, our capital position and the management actions we are taking to deal with the current uncertainty. The COVID-19 pandemic led to volatile financial markets and to even lower interest rates in all of Aegon's markets, which resulted in negative impacts on underlying earnings. Adverse claims experience related to COVID-19 was limited in the first quarter.

Life sales and net deposits were also largely unaffected in the first quarter as lockdowns in many of our markets were only put in place in the second half of March. In coming months, we expect those sales that depend on face-to-face contact to be impacted negatively. Furthermore, we will also likely see some of our customers tapping into their pension savings forced by the current circumstances. Our capital position remains solid and with the group Solvency II ratio of 208% above the target range. Capital ratios of the US, the Netherlands and UK operations are all above the bottom end of their respective target zones. Holding excess cash remains in our target range and we're maintaining more than adequate liquidity buffers. This together with several management actions that we have taken to protect the value of the balance sheet, provide the stability that is so important in this crisis.

At this time, it is difficult to provide an update on our medium-term targets due to the uncertainty around how the pandemic will play out and the continued economic impact that it will have. However, we believe that the effects of the COVID-19 crisis will have a material impact on our results in 2020, although the impact is uncertain at this stage. In light of the extraordinary circumstances, it is very unlikely that we will reach our annual 10% return on equity target in 2020. Let us turn to Aegon's financial results for first quarter on the following slide.

On Slide 4, you see the group is reporting net income of EUR1.3 billion, and underlying earnings before tax of EUR366 million. Underlying earnings in the UK, the Netherlands, asset management and in our international businesses held up well. Asset management, in particular, benefited from performance fees from Aegon Asset Management joint venture in China. In the US, underlying earnings were negatively impacted by an intangible adjustment of EUR37 million as a result of significantly lower interest rates. We also observed adverse mortality concentrated in March with an impact of EUR62 million.

This was mainly driven by higher frequency of large claims at older ages in the universal life and traditional life business, even after adjusting for normal seasonality. Long-term care benefited from increased claims terminations. Majority of claims terminations in long-term care and mortality experience in life can't be attributed to the COVID-19 disease. Retirement plans earnings are under pressure from lower fees resulted from lower average asset balances.

We also saw an adverse impact due to increased market volatility, for example, from transfers of assets from off-balance equity type to general account investments. Earnings in variable annuities were impacted by higher reserves as account values became less than the guarantees, primarily from the significant decline in interest rates and equity markets in March. Fair value items amounted to a gain of EUR1.4 billion as losses in the US were more than offset by gains in the Netherlands. In the US, our hedge programs worked well and were highly effective.

The macro hedge protected Transamerica's RBC ratio and generated a better than expected result from put options as increased implied volatilities were reflected in option prices. The variable annuity dynamic hedge program and index universal life hedges were also highly effective. However, market volatility and unhedged risks led to negative impacts as did the underperformance of alternative investments.

In total, U.S. reported EUR660 million of fair value losses. In the Netherlands, we saw a large positive contribution from the impact of credit spread widening on the valuation of our liabilities, which resulted in a benefit of EUR1.1 billion related to the liability adequacy test. In addition, the interest rate hedges performed well and contributed another EUR800 million.

I now turn to Slide 5. The group's solvency ratio increased to 208% during the first quarter and remains above the top end of the target range of 200%. This increase was primarily due to normalized capital generation and on balance the positive impact from market movements in the first quarter. The significant negative overall impact from lower equity markets and low interest rates in the US were more than offset by significant positive impact of the increased EIOPA volatility adjustment on the Solvency II ratio of the Netherlands.

We would like to also provide an estimate of the group solvency ratio per the end of April in light of the current market volatility. We estimate group solvency ratio of between 190% and 200%. The estimated decrease since March is mainly driven by the impact of a lower EIOPA VA, this more than offsets a higher RBC ratio in the US, resulting from credit spread tightening and higher equity markets. In the first quarter, normalized capital generation after holding and funding expenses amounted to EUR311 million.

For the US, normalized capital generation suffered from adverse mortality results. Netherlands had strong capital generation supported by a realized gain on our Dutch mortgage servicing business from an intercompany sale.

Let me now move back to solvency and discuss our main units. As Slide 6 shows, all our main units are above the bottom end of their respective target ranges despite the significant market movements of the first quarter triggered by the COVID-19 pandemic. In the US, the RBC ratio decreased to 376%. Falling interest rates in equity markets were the primary drivers.

Furthermore, 10 percentage points decrease of the RBC ratio resulted from widening credit spreads on unhedged credit risk in the variable annuity book. Another 6 percentage point decrease resulted from defaults and credit migration. The impact of these adverse market movements was amplified by the partial lack of a tax offset. Severity of the first quarter market movements led to inadmissibility of certain deferred tax assets in the US. The RBC ratio has strengthen since and is estimated to be between 390% and 400% at the end of April. This increase since the end of the first quarter is driven by a partial reversion of the impact from untargeted risks and higher equity markets.

In the Netherlands, the Solvency II ratio improved markedly from 171% to 249%. This was mainly driven by the significant increase of the EIOPA volatility adjustment during the quarter. Together with the positive impact from widening credit spreads on the own employee pension scheme, this more than offset the negative market impacts from widening credit spreads and mortgage spreads on asset values. Significant increase of the Solvency II ratio again demonstrates the sensitivity of our Dutch business to credit spreads.

The record high level of EIOPA VA, 46 basis points has increased the ratio at the end of March. If we would apply an EIOPA VA of say 15 basis points, this would lead to a ratio of 194% for the Dutch business for the end of March. The group Solvency II ratio on that same basis would have been 187% instead of the reported 208%.

In the UK, the Solvency II ratio increased to 160% for the end of the quarter. The increase was driven by normalized capital generation, market variance on balance also had a positive impact on the ratio. Negative impacts from lower interest rates in equity markets were more than offset by the positive impact of widening credit spreads on the valuation of the own employee pension scheme.

Let me now take you to the next slide and zoom in on hedging and other management actions. We are taking several steps to protect the economic value of Aegon's balance sheet and the current crisis as outlined on Slide 7. As already mention, the hedge programs have performed well. At the end of the first quarter, we have rebalanced the macro equity hedge in the US to increase downside protection while controlling hedging costs. Macro equity hedge has now changed emphasis from tail projection toward a more linear protection. It still has a target to protect the RBC ratio decline. In case of 25% downturn in the equity markets in the quarter, the decline in the RBC ratio is limited to 25%. The protection between an equity market downturn between 0% and 25% is now a bit more linear.

We're satisfied with our current asset allocation and have, therefore, not taken any major actions to shift the allocation in recent weeks. However, we do capture the opportunities that this situation offers and our focus on our reinvestments on corporate bonds, new issuance did benefit from higher spreads. We focused reinvestments on higher credit -- higher-rated credit and in industry areas less affected by the COVID-19 crisis. We are monitoring crisis-affected asset classes closely. In the underwriting and pricing areas, we have repriced the variable annuity products as of May 1st, which leads to lower withdrawal rates and lower guarantees, and therefore, leads to better economics.

This was followed by the first new variable annuity product launch on TCS' BaNCS platform. This product features principal protection and customers benefit from upside potential, which makes this product well suited for the current markets. Furthermore, we have adjusted some specific underwriting requirement to further protect our balance sheet.

For example, we currently restrict coverage for new policies for certain age groups, postponed coverages for customers with confirmed COVID-19 exposure in the US and have adjusted underwriting criteria in travel and income protection in the Netherlands. Coverage [ph] that was in place prior to the COVID-19 outbreak will obviously be honored.

Next to this we have implemented several capital preservation measures. We're currently limiting project and discretionary spend as far as possible to preserve earnings and capital generation. At Transamerica, we are planning for the merger of two of our largest U.S. legal entities, TLIC and TPLIC in the second half of the year. This will further streamline our legal entity structure and improve the sufficiency of asset adequacy testing. We will further observe how the current situation develops over time and will take further measures that we deem appropriate.

Let me now turn to Slide 8 to give you some more insight into our US asset portfolio. On this slide, you see the asset allocation of the US general account in comparison with industry data from 20 of our US peers. In general, Aegon's US general account is a liquid, well-diversified investment portfolio.

First of all, please note that we are currently holding significantly more cash in comparison to the industry as a whole. Especially considering the COVID-19 pandemic impacts, it's important to maintain strong liquidity positions across our operations. Aegon US holds only a small equity position, about half of the position is common equity and the other half were convertibles and preferred stock. More than half of the commercial mortgage loan portfolio is invested in multifamily real estate loans, which are less affected by the current crisis.

Another fifth of this portfolio is allocated to commercial real properties, which are skewed toward high-quality grocery-anchored centers. Overall loan-to-value ratio is below 70% for 99% of the portfolio, and there is no loan with an LTV ratio above 90%. The US fixed income portfolio is invested in government bonds, high-quality MBS and ABS securities and about two-thirds in corporate bonds. CLOs only represent a small fraction of our investments. Let me give you some more detail on the fixed income and corporate bond portfolios on the next two slides.

Slide 9 gives you a breakdown of the US fixed income security portfolio by rating and by NAIC class. The NAIC class determines the capital charge for credit risk. Securities are downgraded. This credit migration will increase required capital. As you can see that the portfolio is weighted toward investment-grade bonds, as only 7.5% have a below investment-grade rating and less than 6% are allocated to the riskier NAIC classes, which attract more heavy capital weighting. Of the BBB rated securities, only about 20% are rated BBB minus. Please note that the mortgage-backed securities are modeled individually by the NAIC and a class is assigned based on the expected loss according to these models.

This is independent from the rating from rating agencies. Securities without an expected loss in the modeled scenarios are assigned Class 1. 97% of all mortgage-backed securities in our portfolio are included in Class 1. From this, you can deduct the impact of potential rating migrations on the RBC ratio. We provide two model calculations for hypothetical scenarios on the slide. For example, if 50% of the BBB minus rated bonds would be downgraded by one notch and one NAIC class, you would expect an impact of about 12 percentage points on the RBC ratio. It is clear that certain industry sectors will be hit more severely in this crisis than others.

To provide some insight, let me zoom in closer on the corporate bond portfolio on the next slide. Aegon US holds a corporate bond portfolio of EUR37 billion. Of this, about 7%

is in below investment-grade bonds and about 10% are rated BBB minus. However, in this COVID-19 crisis, not all industry sectors and subsectors are being equally affected.

On the right-hand side of the slide, we highlight our exposure to three industry sectors, which might see more severe impacts in the coming months. Transportation sector is suffering in the current situation, especially airlines. Our investments in the transportation sector focus on BBB and above rated bonds, and our exposure to airlines is less than $200 million.

In consumer cyclicals, our below investment-grade exposure is limited and 75% of our exposure is the automotive, retail and consumer services. Our energy exposure is well diversified across the oil and gas industry. About half our exposure is the midstream, a part of the value chain that is more resilient to low oil prices. As with all sectors under stress from the current crisis, we are monitoring our exposures very closely. Currently, we have seen very little by way of impairments in our portfolio, but we are well aware that this is likely to change in the coming months.

Let me conclude my presentation with the next and final slide. The COVID-19 pandemic brings about unprecedented disruption to our customers, employees and the communities in which we operate. In this challenging situation, our focus is on maintaining a solid capital position and strong balance sheet. With the group solvency ratio of 208% and the three main units above the bottom end of their respective target zones, we have a good starting position. Holding excess cash of EUR1.4 billion and ample liquidity in the units provides us the financial flexibility and strength to maneuver through the crisis. That said, it is very unlikely that we will meet the annual return on equity target of more than 10% this year, given that our first quarter return on equity was 7%.

Nevertheless, our commitment to achieve the target once markets normalize is unchanged. Given the global macroeconomic uncertainties, it is currently too early to tell what the impact of COVID-19 pandemic will be on the other medium-term targets. Short-term normalize capital generation will be negatively impacted by adverse market movements and higher mortality rates, but we'll benefit from management actions and lower expected new business strain. We are committed to review opportunities for returning capital to our shareholders as soon as appropriate and will take a decision on the interim dividend in August.

In the meantime, we will focus on securing the planned remittances to the group. Let me close by saying that I am pleased that our resilience, experience and business continuity plans have enabled us to operate at a high level. This allows us to focus on taking right management actions to position the company strongly as we emerge from the COVID-19 crisis to ensure the best possible outcome for our shareholders and customers.

I am happy now to take your questions.

Questions And Answers

Operator

(Question And Answer)

Thank you, sir. (Operator Instructions) We will now take our first question from Farooq Hanif from Credit Suisse. Please go ahead.

Q - Farooq Hanif {BIO 4780978 <GO>}

Hi, there. Good morning, everybody. Just firstly, on the U.S. capital position. Clearly, it's recovered in April, but there are headwinds from potential downgrade, impairments, et cetera? At what level of capital position, would you be worried about being able to remit capital from the U.S. to the holding? And how likely do you think given what you've seen so far in 2Q, that could be a reasonable risk? That's question one. Question two is, if you make a decision -- I mean, clearly, you're not paying a full year '19 dividend. To what extent do you think that surplus capital could be used to support capital in the subsidiaries? And would you consider -- I mean are you considering using that extra surplus capital to inject back into the subsidiaries? And then lastly, on sales impact. Could you give an early read on what's happening in 2Q? Thank you.

A - Matt Rider {BIO 20002664 <GO>}

Thanks for your questions, Farooq. I would just -- so on the U.S. capital position, I would just remind you that according to our own capital management policy, as long as the U.S. RBC ratio would be above 350%, then it would be expected to remit its normal planned dividend. And I think that's pretty much all I would say about it right now other than maybe to say that the -- so the normal remittance pattern for the U.S. would be pay half their normal remittance in June and the other half in December. Probably too early to tell about December, but the June dividend to the group, unless something crazier happens in the markets, we would expect to receive. So that, I think, is the U.S. capital position.

With respect to the 2019 final dividend, I think what we've said here is that we would look for opportunities to return that capital to shareholders at the earliest possible convenience. But we are going to wait to see how the COVID-19 crisis plays out. So as I said in the overall presentation, we would make a decision on the interim dividend in August of this year. And at the same time, we would obviously have thoughts on how we might -- or what we might be doing with the 2019 dividend. But for right now, as you know, we have foregone it, but we have to look for ways to return that as quickly as possible. Also recognizing, as you mentioned, that we don't know how this is going to play out, particularly in the credit markets in the U.S. and also with respect to the mortality.

On the sales side, the first quarter sales that we reported were not so much affected by the pandemic crisis just because the lockdowns really didn't happen until the middle of March. But we are going to see impacts. We are going to see them in 2Q. Face-to-face sales in the U.S. are going to be negatively impacted. We've already seen negative impacts from sales in the high net worth business in -- in Hong Kong. I would say on -- for example, on retirement plans business, it's a bit of a mixed bag in that you're seeing that companies are not placing a super high priority on replacing their pension plan administrators. So it's going to be tougher to win contracts that are not out for RFP. But by the same token, you're not going to lose as many because, obviously, you're not getting approached by other companies where they -- from companies that are our existing customers. So we are seeing negative sales impacts. What we -- we are encouraged a bit by some of the ways that, particularly, I would say, in the U.S. and in China, asset management as well, have adapted their business models to more digital interactions with customers. But there are -- there's no way to avoid it. There are going to be negative impacts on sales, and it's mainly going to come from normally face-to-face type of sales.

Q - Farooq Hanif {BIO 4780978 <GO>}

Great. Thanks.

Operator

We will now take our next question from Robin van den Broek from Mediobanca Bank. Please go ahead.

Q - Robin van den Broek {BIO 17002948 <GO>}

Yes. Good morning, everybody. Good morning, Matt. Just coming back on the RBC ratio in the U.S. I mean I think your commentary would suggest that since the end of March, there is some improvement you have, I think, still the San Francisco building coming through. You mentioned the TLIC mergers within your variable annuity business. So if you would give a pro forma indication of that RBC ratio, where do you think that would sit? And what does the impact be on clearing of captive structures within the organization in the U.S.? That's the first question.

Secondly, when it comes to your dividend policy, it is linked to normalized capital generation as it stands. However, I think in normalized capital generation, you are assuming only a 20 basis point impact on cost of risk. Well, during the global financial crisis, your cost of risk was more around 100 basis points. So that could suggest that, that normalized capital generation number basically doesn't mean that much for the next few years. How willing would you be to tap into your hold of cash buffers to still continue the dividend promise that is on the table? That's the second question.

Third question is more around your U.S. payers. I mean your long-term interest rate assumption is still at 4.25%, while payers are moving to 2% to 2.5%. I think at the Morgan Stanley conference, you gave a fairly limited impact from changing that assumption, but there's a comment in that presentation also saying that the starting point of interest rates is sort of important. So could you update that number basically assuming that U.S. is up 60 basis points rather than 2% at the beginning of the year. And is there any knock-on effect from changing the long-term interest rate assumption for PDR testing within your framework? Sorry to ask that many questions by the way.

A - Matt Rider {BIO 20002664 <GO>}

No. That's okay. We kept tracking them. So maybe -- so first of all, on the pro forma RBC ratio for the U.S., we did say that the U.S. RBC ratio at the end of April had improved somewhat given tightening credit spreads and the improved equity markets. So we think it's in a 390% to 400% range. But in terms of a pro forma outlook, I would be very reluctant to do that. You tell me what credit markets are going to do, in particular, credit migration and credit defaults and then I can sort of give you a number, but we run scenarios internally to test these kind of things. And I think it's just best to leave that one live. We need to see how this one plays out. But for the time being, we are more than adequately capitalized in the U.S. and we're in a, like I said, a good starting position there to withstand some pain that is going to be coming.

You mentioned a couple of the management actions, the TLIC and TPLIC merger. That is still going on for the second half of the year, though we will get some basically cash flow testing benefit from that. The sale of the pyramid is still on target for the end of the year. We're still in exclusive negotiations with a single party. They have to get financing. So we'll see how that -- we're still in a process, but we still anticipate that, that would come through.

Maybe on dividend policy, you called out that -- and rightfully so, our dividend policy is tied to normalized capital generation. We try to do that to give you an indication that we try to pay out 45% to 55% of normalized cap gen. But our own remittance targets, they're really more driven by the combination of what our outlook is, but importantly, where you're sitting in the -- sort of in the target zones for capital. So in the case of the U.S., like I said in answer to the first question, as long as they are above 350% RBC ratio and there's not terrible things on the horizon, then we would expect a normal remittance out of the U.S. So it's not just linked to the capital generation. It does have to do with the solvency level within the business unit. So that's an important one.

On the -- yes, so at the Morgan Stanley conference, I had talked a bit about that impact of the long-term rate assumption. And you have it right. We -- so our long-term rate assumption is 4.25% in the U.S., which has a 10-year grading period. And I would say it's a bit on the long end relative to U.S. peers. We've updated that number. So let's say that we were -- and again, we would make any change to assumptions for the U.S. with respect to a long-term interest rate assumption as well as other experience factors in the first half of the year, so in the second quarter.

So if we were to move that by 100 basis points down to 3.25% and retain that 10-year grading period, we would see something like a $300 million to $325 million impact on the IFRS results, and that would be basically intangibles write-off. And then if we made a similar adjustment to the assumption for separate account bond portfolio returns, then that's probably another 100 basis points. There would be a longer-term impact of this. So those are -- those -- I want to be clear on this, when those were onetime adjustments, but we would also see a running additional cost of about $10 million per quarter, $10 million per quarter. And on the -- yes, it's interesting. You bring up the premium deficiency reserve testing. That's one. I'm just going from memory, but I think we were sitting at the sufficiency of about $250 million at the end of 2019. We're already pretty decently covered by those forward starting swaps, but on that level of detail, I'm going to have to get IR to get back.

Q - Robin van den Broek {BIO 17002948 <GO>}

Okay. And anything else on other assumptions you feel less comfortable with going into H1 social review?

A - Matt Rider {BIO 20002664 <GO>}

No. We're just going to have to look -- we're just going to have to continue to work through our processes. What we've seen so far. And I think I've talked about this in other quarters. But for example, like the long-term care assumption seems to be tracking well with respect to our expectations. We did -- you've noticed the poor mortality result that we had in the U.S. for the first quarter. It was really isolated in the month of March. So it's -- by the way, that wouldn't even be taken into account into our experience review. There's a bit of a lag. But we'll have to see how that one evolves over time.

Q - Robin van den Broek {BIO 17002948 <GO>}

Okay. Thank you very much.

Operator

We will now take our next question from Fulin Liang from Morgan Stanley. Please go ahead.

Q - Fulin Liang {BIO 21126177 <GO>}

Hi. Thank you for taking my questions. I think my first question is about the U.S. RBC ratio because I did a calculation based on the sensitivity you provided. So I had expected about 14 percentage points for due to interest rates and about 22% for due to equity and then you would have like 8 percentage points from the capital generation. So net-net, I was actually expecting your solvency ratio to be around something 410%, obviously, your reported is much lower than that. I'm just wondering whether any actual material, actual impact to the solvency, which is not actually interest rate and equity market related. So that's my first question. Sorry for the long question.

And secondly, is the -- so coming back to the assumption, the LTC -- LTC assumption, can you actually mention, kind of talk, because one of your competitors in the U.S. was asked by the regulator to -- for basically reserve enhancement due to one of the reasons regulatory quoted is mobility improvement assumption being too aggressive. So I just wanted to actually compare your assumption to your competitors' assumption where you are about that assumption. So that's the second LTC assumption?

And lastly is about impairment. So in first quarter, your impairment is slightly larger than 2019, but this still like you kind of you show in the slides, way lower than the average, which -- but given what you've seen in April, do you think actually this amount will go at a much higher? Thank you.

A - Matt Rider {BIO 20002664 <GO>}

Okay. Fulin, thank you for your questions. It's nice to hear your voice after the Morgan Stanley conference. So it's probably an appropriate place to start because at that conference, we had put an estimated RBC ratio for the U.S. at that moment in time. By the way, based on March 12 economics at 410%, which is obviously where you're coming out when you do our, let's say, the basic sensitivities. I would make a couple of points on this. One is that once you start getting into very, very volatile markets, then there is some interplay between the sensitivities, and they're not all perfectly linear in the way that you would expect them to be. But there were a couple of notable points that caused that difference between, let's say, that 410% and where we've published the 376% for the first quarter. I think the first one is a -- it's basically the effect of spread widening and credit migrations and defaults. And a lot of that spread widening is actually happening in the variable annuity book.

There is a large portion of the variable annuity underlying assets that are based on bond funds. And in fact, a lot of our guaranteed benefits like withdrawal benefits and accumulation benefits are underlaid by what we call, volatility control funds. What these funds do is if -- basically, if their equity market declines, then there is program trading out of equities and into more high-quality corporate credit. So while we were -- while that trading was happening, effectively, corporate credit spreads blew out that's something that you couldn't get from the sensitivities. And we estimate that, that would have had about a 16 percentage point difference in off of the basic sensitivities that you had mentioned.

Another one is the fact that there is -- we had significant DTAs that were generated, deferred tax assets on a statutory basis in the U.S., but there are limitations to how much of those DTAs can be used as admitted capital. So effectively, we were capped out on the amount of DTAs that we could admit. And that accounted for about 7 percentage points. There were also some interest rate movements. So we always assume sort of parallel shifts in the yield curve. I think from that March 12 number, interest rates in the 10-year range had come down by about 15 basis points by the end of the quarter, but there were some other nonlinear movements, and those accounted for about 7 percentage points.

And then finally, we saw the legal settlement that's reflected in the press release related to monthly deduction charges on universal life contracts. That accounted for about 4 percentage points. So I think if you add that up, you'll get to about that 376% number that we're publishing. I would mention that all the -- like the spread widening point in the -- especially on the VA portfolio, that's effectively unhedged risk, and that's now come back as a consequence of spread tightening since the end of the first quarter. I apologize for the long-winded answer, but I was bluntly expecting that one.

The other question. Yes. The other question you had was on -- so I wouldn't comment on another competitor, but I can comment on the state of Maine. So Maine had had one of our competitors, basically grade in additional reserves for their long-term care book over a period of 6 or 7 years. There, I saw reports that Maine had contacted other state regulators, other state insurance departments. Frankly, I don't know if they have contacted Iowa. We asked the question and didn't get an answer. I can only really tell you that we are in constant contact with our regulator. There's no specific study being done by the Iowa regulator on long-term care provisions. And I would just emphasize that our -- that again, our experience is tracking well with our expectations.

You asked a specific question there, what is our assumption with respect to morbidity improvement. We assume 1.5% annual morbidity improvement. And I think we've previously telegraphed that if we were to remove that assumption, it would roughly have, I think, $600 million or $700 million impact generally in both IFRS and capital. So I hope I've answered your question well there.

Yes, impairment. So it's really -- yes, our impairments are still low. But impairments are going to come and credit migration is going to come. So that, as I had answered one of the questions earlier, we do not know the speed nor the depth at which the credit migration and default impacts are going to come through the statutory balance sheet. I can say that in the first couple of weeks of the -- I previously talked about the RBC ratio now probably being in a 390% to 400% range, I think, since the beginning of the quarter, there's not -- there's still not been so much -- again, so much credit migration and defaults yet. But again, much too early to tell, this is going to take quite some time to play through the credit markets.

Q - Fulin Liang {BIO 21126177 <GO>}

Thank you very much.

Operator

We will now take our next question from Nick Holmes from Societe Generale. Please go ahead.

Q - Nick Holmes {BIO 3387435 <GO>}

Hi guys. Thank you very much. Just a couple of questions. The first is with the variable annuity book, are you worried about an increase in the cost of hedging if markets remain volatile, which is probably quite likely? And secondly, with the RBC ratio, it's really the same question. How vulnerable is that ratio to an increase in variable annuity hedge costs? If markets do remain volatile, and we see a lot of the sort of movements that have, as you were explaining in your last question, actually caused unexpected losses to the ratio.

A - Matt Rider {BIO 20002664 <GO>}

Thanks for your question, Nick. So just a reminder, this is a 1 quarter -- or first quarter trading update. So we haven't gone into a lot of the detail that we would normally do for a results release, so I don't have an update on expected hedging costs. What I can say about it is that in the dynamic program that we have that is associated with the WB and AB books, our hedge costs are more, let's say, influenced by actual volatility, actual volatility. So they are going to increase there. There's no question about it.

What we did do a pretty good job was, I think, in the course of the first quarter and coming into the second quarter is on the macro hedge. And that's where we had gone in with some out of the money put options and have actually done quite a bit better on that hedge than what we would have expected because you get the benefit of the higher implied volatility in the option prices, and that we've since pivoted a bit. So that we're more out of options and the high prices of puts for the implied vol and more into linear instruments.

But the actual running cost of the hedge program, that's -- I would say that's a second order concern to me, both in terms of capital in regards to earnings. What is -- what's more of the thing that we have to watch out for is the impact of credit markets, credit migration on the balance sheet in the U.S. together ultimately with the impacts of additional mortality due to COVID-19. So as long as the hedging programs are effective, that's perfectly good. They performed extremely well in the first quarter and have continued to do so as we've gone through the month of April. And frankly, that's in a very volatile environment. That was a terrific result.

Q - Nick Holmes {BIO 3387435 <GO>}

Great. Just a very quick follow-up. I think a lot of your competitors are using just dynamic hedging rather than a macro hedge. Is that something that you would say is correct? I mean you're using both macro and dynamic. Is that unusual, would you say, in the industry?

A - Matt Rider {BIO 20002664 <GO>}

You -- there -- how do you want to say it, there are many ways to skin a cat, and you're trying to hedge basically the same risk. I mean really the macro hedge, and I think you know this well relates mainly to variable annuity exposure. People do it in dynamic programs. We tend to do it in -- have typically done it more in a tail risk scenario. But it's just a choice. It's always -- it's a trade-off between the hedge costs and what kind of downside protection that you're looking at.

So right now, as we were in put option programs before for the macro hedge that was a pretty good trade because we're operating at very high solvency levels in the U.S., and we did it to minimize the cost while protecting a big downside. So we're super successful at doing that. But at this moment in time, I think I mentioned in my presentation that we go to more linear instruments, so it will be more like a dynamic program that other companies might use. I hope that answers your question.

Q - Nick Holmes {BIO 3387435 <GO>}

Yeah. Great. Thanks very much, Matt.

Operator

We will now take our next question from Albert Ploegh from ING. Please go ahead.

Q - Albert Ploegh {BIO 3151309 <GO>}

Yes. Good morning all and thank you for the questions. I've got three. Basically, the first one on the U.S. mortality. You alluded in the presentation, it was not very much linked to COVID-19 in the first quarter, so more seasonal and clearly bigger than normal. But can you update a bit on what your expectations are on the COVID itself on the mortality and maybe for the remainder of the year or at least the second quarter so far.

The second question on the U.S. capital generation, yes, and setting aside for the moment, the new business strain and discussion on the normalized impairments. But can you help us out a little bit on, let's say, the headwinds from lower rates so far this year in relation to the EUR 1.1 billion generated last year. So front book -- back book kind of yields? And then what kind of offsets you at least have from still elevated credit spreads? Just feeling what the normalized generation is going to?

And then the third question is on the new business strain. It seems to me that the U.S. still was a pretty normal quarter, I think is somewhere on the slide, EUR 230 million. The sales clearly will be more complicated in the second quarter. Do you see any risk to cost assumptions underlying sales volumes, if I recall correctly, that, that was an issue in the latter half of last year. Thank you.

A - Matt Rider {BIO 20002664 <GO>}

Thanks for your questions, Albert. So maybe on U.S. mortality, yes, it was a poor quarter, and it was, in particular, it was a poor month. So most of that for mortality came through in the month of March. I talk about this as not being necessarily COVID-19 related. But we do have a bit of an issue in that. You can't tell for sure. Because of that, if you're in February, March, people were becoming infected and we're dying, but like COVID-19 cause of death was not being printed on death certificates. So at this moment, it's just -- it's safe to say that it was not COVID-19 related.

But looking forward, yes, we have many estimates related to mortality rates that we're already seeing in the U.K. and other places and transposed over to the U.S. But what we don't know is how this is going to happen in the insured population. So we have estimates, but it's just simply too early to share those. We're going to watch this play out over the coming quarters and not provide any specific guidance in that respect.

On the U.S. capital generation, you specifically mentioned lower rates and credit spreads. So maybe just to give you a little -- we always give these numbers. So for U.S. reinvestment yields in the first quarter, so this is new money yields were coming in at 3.64%, and the back book yield was 4.5%. Now that was an interesting one because in the first quarter, you saw 10-year treasury come down by 125 basis points. But generally, corporate credit spreads had blown out by like almost 95 basis points. So net-net, it wasn't that big of an impact, but there is a strain for generally lower interest rates. And these are numbers that we have talked about before on the statutory side that we do reinvest for $4 billion to $5 billion per year.

And if reinvestment rates are down by 100 basis points, they're not now, but if reinvestments are down by 100 basis points, then you're looking at $40 million to $50 million pretax impacts on capital generation per year. And it compounds if rates remain low. So that is something clearly that we are watching out for.

New business strain was a bit of a normal quarter in that - yes, a normal quarter and that sales weren't impacted that much yet. And actually, we saw a little bit higher new business strain as a consequence of the lower rate environment. But as we see those face-to-face sales, particularly in variable annuities and indexed universal life and on products within the high net worth business in China come down, then you are going to see that -- you are going to see that new business strain come down. Now that has obviously like a beneficial impact on normalized capital generation in the short term. But in the long term, it's going to start affecting us. So right now, we know that it's going to happen.

The expense side is an interesting one. It would be hard to bake in a long-term expense assumption based on crisis experience. But we're just going to continue to do our work, update our expense assumptions in the first half of the year. But my expectation is that you would never -- yes, you would never base your long-term assumptions in a very strange environment, such as what we're in now.

Q - Albert Ploegh {BIO 3151309 <GO>}

Thank you, Matt.

Operator

We will now take our next question from Johnny Vo from Goldman Sachs. Please go ahead.

Q - Johnny Vo {BIO 5509843 <GO>}

Hey. Good morning. Just three questions, if I may. Just the first question, you said that your RBC ratio has gone from -- to about 390% to 400%, but the group's solvency ratio has gone to about 190% to 200%. So is it fair to assume that the negative movement has all come from the Netherlands? Or has there been debt redemption or something going on to account for the move in the group solvency down?

The second question is, just your comment on the U.S. hedge program and the move from implied to realize, which suggests that you're leaving open gap risk in equity markets. So can you sort of give us a sensitivity for a 20% drop in equity markets and the change in your RBC ratio when you use options when -- versus when you're not using options?

And the third question is in the Netherlands business, is the regulator stopping you remitting from the Dutch entity to the holding company? Or can you still remit from the Dutch entity to the holding company? Thank you.

A - Matt Rider {BIO 20002664 <GO>}

Yes. So maybe on the first one, Johnny, so you have it exactly right. So we would -- we see the improvement. So for April, we see that improvement in the U.S. RBC ratio, but EIOPA VA has come back now for the Netherlands. So, excuse me, so that one is, we would think it's probably more in the 215% to 225% range. So on balance, the group ratio is coming down into that 190% to 200%. So it's just a mix thing.

The U.S. hedge program, you're talking about GAAP risk and equity markets and quantifying the linear versus out of the money impacts for a 20% decline. I'm not going to comment on that now. We've published new sensitivities. I think they should be pretty, pretty okay, linear for smaller movements. But I'm going to let IR come back to you on that one. I don't have the figures in front of me.

On the Dutch regulator, I might answer this question a little bit more broadly. It has been -- it's been interesting the response of various regulators to the EIOPA guidance about being careful about recommending to not make dividend payments. Some regulators like, for example, Poland, have just said, no money going out of legal entities even intergroup, other regulators like the Netherlands are fine to have the money come from within the group, but they put their restriction based on the EIOPA guidance, and it applies to other insurance companies in the Netherlands only on external dividends. So from a Dutch regulatory standpoint, they're not putting a restriction on intercompany dividends or intergroup dividends, but other regulators could potentially have concerns about that. And it's -- by the way, it's a pretty broad spectrum of approaches. It's a little bit -- I would say, a little bit unhelpful not to get a unified approach from EIOPA.

Q - Johnny Vo {BIO 5509843 <GO>}

Okay. Thank you.

Operator

We will now take our next question from David Motemaden from Evercore. Please go ahead.

Q - David Motemaden {BIO 18818634 <GO>}

Good morning. Matt, I had a few questions on the U.S. First, just some of your peers in the U.S. have provided some level of sensitivity to COVID deaths in the population, for example, if there are 100,000 COVID deaths in the U.S., what sort of impact that would have in terms of mortality for their books. So wondering if you could provide some detail in a similar way, if that's possible.

Second, just on the legal entity merger, the TPLIC/TLIC merger in the second half of the year. I was wondering if you could just quantify how much you expect this to benefit capital? And if that's something you view as being fungible? And then just lastly, a quick follow-up on the LTC book, where the competitor in Maine, it was, I guess, a financial exam that they went through. And I guess I'm just wondering when was the last time TLIC underwent a financial exam in Iowa. Thank you.

A - Matt Rider {BIO 20002664 <GO>}

Okay. Thanks for your question. So on the potential impact of COVID-19 deaths, yes, we're doing some internal scenario testing on this one. But at this point, we're not giving any guidance to the market.

On the main question, yes, so the last time Transamerica Life Insurance Company went through an audit by the state. I think that they do it every 5 years. So I think we're just starting now a new one, so a new quinquennial audit. But as I mentioned before, we're not getting any specific questions on the long-term care book at this point.

Yes, on the legal entity merger, I'm going to, yes, I think -- so maybe just a couple of points on this one. We expect that it will -- that it will happen in the second half of the year. It will have a beneficial impact on the, say, cash flow testing adequacy results. It's a bit unrelated to the sale of the pyramid. So this is one that will definitely -- this is one that will definitely go through. I don't have in front of me an impact on the ratio for this one.

Q - David Motemaden {BIO 18818634 <GO>}

Great. And if I could just follow-up on the financial exam in Iowa. So that's just started. Is there any sense for when that will conclude?

A - Matt Rider {BIO 20002664 <GO>}

These things take a while. I'm not -- I'm going to let IR come back to you, but it's going to be something like -- these are like year exams.

Q - David Motemaden {BIO 18818634 <GO>}

Yep, understood. Thank you.

Operator

We will now take our next question from Benoit Petrarque from Kepler Cheuvreux. Please go ahead.

Q - Benoit Petrarque {BIO 15997668 <GO>}

Yes, good morning all. Two questions on my side. So the first one will be on the U.S. solvency ratio. I'm going to think a bit worse case there. But in an event, you will kind of get close or eat the 350% level. I was wondering how we have to think about remittances. Obviously, we don't get to this level every day. So do we have to think about a gradual decrease of potential remittances as you get close to the 350%? Or will remittances kind of drop to 0 when you eat the 350%? I'm just wondering how it works in practice when you get close to the 350% level in terms of kind of speed of the decrease there of the remittances.

On rating migration, that's number two, so you've said, okay, we have a big uncertainty and nobody knows how much rating downgrades will get eventually. But do you plan at this stage to potentially take some prudence in terms of cash remittance from the U.S. just because of the kind of big elephant in the room, which is rating migration probably taking place, by the way, early next year. So just wondering how you plan to take that into account in your capital planning? Thank you.

A - Matt Rider {BIO 20002664 <GO>}

Thanks, Benoit. So maybe on just specifically on the capital management policy that we follow, the bottom end of the target range for the U.S. is 350%. And according to our own internal policy, as long as you're at or above 350%, and we would expect your sort of fully planned remittance. And then if you dip below that, that's when we would expect lower remittances, lower remittances. We're not in that place yet. We're sitting there, as I said, right now, between 390% and 400%. And I think I mentioned that on the -- in the presentation itself, that we would expect to get the first remittance or the first half of their annual remittance in June of this year, barring really unforeseen circumstances.

But that also allows us to take a bit of time, right? So we don't know exactly how deep and how long this is going to be. So we need to see this play a bit out in the markets. So the next time that they would pay a dividend would be in December. So if we get into December and we see credit markets have really deteriorated or really low solvency ratios or something like that, then we would take a prudent decision there. But it is simply too early to tell about the second half. We're good with the first half that sort of teed up. But the second half, let's wait until we see how this plays out a bit.

And that sort of plays into the rating migration point. There is going to be rating migration. There are going to be increased defaults. It's probably going to take some time to work through the system. One thing that we have seen is that rating agencies have been much quicker this time to downgrade and to do those actions. But for right now, we're not seeing it so much even through the April results.

But it's coming. Credit migration and default is going to be coming, and we want to take it step-by-step and make those decisions according to our capital management policies, looking at the best information that we have at this point in time. But it's hard to project forward not knowing what that path is going to be like. All I can tell you is that we are taking management actions internally to preserve the economic value of the balance sheet. We will be taking expense actions. And we were, like I said, pretty good shape as we entered into the crisis with the balance sheet. To begin with, we already had many of these capital management actions teed up like the TLIC/TPLIC merger. But yes, I would say it really is too early to -- it really is too early to tell.

Q - Benoit Petrarque {BIO 15997668 <GO>}

Okay. Thank you very much.

Operator

We will now take our next question from Andrew Baker from Citi. Please go ahead.

Q - Andrew Baker {BIO 3694545 <GO>}

Hi guys. Thanks for taking my question. Just one quick one last from me. Has there been any impact on the TCS project migrations or timing or costs associated with that project? Have you seen any operational issues since the crisis has begun with TCS specifically?

A - Matt Rider {BIO 20002664 <GO>}

I would say small operational issues, but they were pretty quickly taken care of. So just the availability of laptops for the TCS employees to be able to work from home was a short-term issue that got solved. There had been some delays in the implementation of that bank's system. But now that has been -- we just implemented the first variable annuity product as of May 1.

So there -- yes, so that one, I think I mentioned in the presentation, we look at those outsourcing relationships pretty closely here. But so far, we're being able to operate in a controlled environment. And I mean -- sort of as a testament, I mean, just think about it, we normally report half year results. Here, we're doing a 1Q update. The whole thing was done from home. So our controls from a financial standpoint and operations standpoint have really hung in there. So it's actually been better than what anybody could have expected from an operational standpoint.

Operator

That concludes today's question-and-answer session. I'd like to turn the conference back to the host for any additional or closing remarks.

A - Jan Willem Weidema {BIO 15133400 <GO>}

Thank you for your continued interest. This concludes today's call.