Q4 2012 Earnings Call

Company Participants

- Charles Lowrey, Head of Domestic Operations
- Ed Baird, Head of International Operations
- Eric Durant, SVP IR
- John Strangfeld, CEO
- Mark Grier, Vice Chairman
- Rich Carbone, CFO

Other Participants

- Eric Bass, Analyst
- Jay Gelb, Analyst
- Jeffrey Schuman, Analyst
- Joanne Smith, Analyst
- Mark Finkelstein, Analyst
- Nigel Dally, Analyst
- Randy Binner, Analyst
- Sean Dargan, Analyst

Presentation

Operator

Ladies and gentlemen, thank you for standing by, and welcome to the Fourth Quarter 2012 earnings teleconference. At this time, all lines are in a listen-only mode. Later, we will conduct a Question-and-Answer session and instructions will be given to you at that time.

(OPERATOR INSTRUCTIONS) And as a reminder, today's conference call is being 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. Representing Prudential this morning are John Strangfeld, Chief Executive; Mark Grier, Vice Chairman; Rich Carbone, Chief Financial Officer; Ed Baird, Head of International Operations; Charles Lowrey, Head of Domestic Operations; and Peter Sayre, Controller and Principal Accounting Officer. Before we get started, 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 and non-GAAP measures of our earnings press release for the Fourth Quarter of 2012, which can be found on our website at www.investor.prudential.com. In addition, in managing our businesses we use a non-GAAP measure we call adjusted operating income to measure the performance of our financial services businesses. Adjusted operating income excludes net investment gains and losses as adjusted and related charges and adjustments as well as results from divested businesses. Adjusted operating income also excludes recorded changes in asset values that are expected to ultimately approve to contract holders, and recorded changes in contract holder liabilities resulting from changes in related asset values. Our earnings press release contains information about our definition of adjusted operating income. The comparable GAAP presentation and the reconciliation between the two for the quarter are set out in our earnings press release on our website. Additional historical information related to the Company's financial performance is also located on our website. John?

John Strangfeld {BIO 14004907 <GO>}

Thank you, Eric. Good morning, everyone. Thank you for joining us. Now that we've closed the books on 2012, I'll kick things off with some high level comments on the year as a whole. First, earnings. Earnings per share based on adjusted operating income of the Financial Services Businesses were $6.27, compared to $5.83 a year ago. This is an increase of about 8%. If you remove the market driven and discrete items and business integration costs we've disclosed each quarter, which Rich and Mark will review with you for the Fourth Quarter, the EPS increase will still be about 8%. This is because these items reduced pre-tax adjusted operating income by roughly $200 million in 2011 and again in 2012. Second, financial strength. The capital positions of our US and Japanese insurance companies continue to meet the high standards. We believe AA we've managed them to, as you will hear from Rich shortly. We have capacity to remain strongly capitalized even in stress environments. We've improved our ratio of capital debt to total capitalization. It is under 25% at year-end, and the quality of our investment portfolio has never been better. With this strong financial position, we're able to consider potential deals, but we will do so with great care and selectivity. We believe our acquisition of the Hartford Individual Life Business, which closed in January, offers attractive financial returns, strategic benefits, talent enhancements, and manageable execution risk. We like our prospects with this, yet we know we need to prove it out. We also remain in the market for opportunities to add out sized organic growth, particularly in the area of pension-risk transfer. We closed our transactions with GM and Verizon in the Fourth Quarter, and we will consider additional transactions on a case-by-case basis. At the same time, we take a balanced approach to investing in businesses and returning capital to our shareholders. During 2012, we returned about $650 million of capital through our share repurchase program, and an additional $750 million through our common stock dividend. We intend to declare quarterly dividends starting with the First Quarter of 2013. Third, commercial momentum. We're a leader in the markets in which we've chosen to compete. Our Retirement Business achieved record account values last year, reflecting the major pension-risk transfer transactions I mentioned, as well as continued strong sales of investment only stable value products. AUM has climbed to a record high in asset management, as institutional and retail net flows over the past year amounted to $30 billion. In annuities, the products we're offering reflect today's market environment. We believe they provide our clients an attractive value proposition and our shareholders appropriate returns and risk. We believe the Hartford Life acquisition will produce attractive returns as well as enhanced distribution and excellent talent for our Individual Life Business. And as for Group Insurance, we are confident we will resolve recent performance issues and we will fix this business, a business which remains a significant participant in its markets. Finally, International Insurance continues to benefit from expanded distribution across multiple channels, and from successful integration of Star and Edison. So to conclude, we've turned the page on another year. We feel that we have a good head of steam as we begin 2013. We have high expectations for ourselves this year. And we look forward to reviewing our progress with you as the quarters unfold. With that, I will turn it over to Rich.

Rich Carbone {BIO 1482557 <GO>}

Thanks, John, and good morning, everyone. Last night, we reported common stock earnings per share of $1.69 for the Fourth Quarter, and that's based on adjusted operating income for the Financial Services Business. This compares to $1.78 per share in the year-ago quarter, and that's also on a reported basis. As we saw from your reports, there was a lot of activity during the quarter. Market driven and discrete items were as follows. In the Annuities Business market performance relative to our assumptions caused us to release a portion of our reserves for guaranteed minimum debt and income benefits and led to a favorable DAC unlocking. These items are partially offset by a write down of capitalized software costs for a net benefit of $0.06 per share. In retirement, the favorable legal settlement related to previous losses on client investments managed by a third party produced a benefit of $0.11 per share. In asset management, we recorded a gain on a sale of a previously impaired investment, that was partially offset by a write down of capitalized software cost for a net benefit of $0.05 per share. In individual life, we incurred costs relating to the Hartford Life acquisition that closed in January, resulting in a charge of $0.02 per share. In Group Insurance, we increased legal reserves resulting in a charge of $0.03 per share. In International Insurance, Gibraltar Life absorbed integration costs of $0.01 per share, relating to the Star Edison acquisition. And corporate and other results included costs of $0.08 per share charge, reflecting a catch up adjustment, for accrued employee benefit liabilities. In addition, we recorded a $0.02 per share charge to write-off bond issuance costs on high coupon debt we redeemed prior to maturity. In total, the items I just mentioned had a net favorable impact of about $0.06 per share on the Fourth Quarter results. In the year-ago quarter, market driven and discrete items produced a net benefit of about $0.26 per share, mainly driven by favorable unlockings related to the 11% S&P 500 increase, and a gain on our sale of a stake in a Mexican private funds manager. Taking these items out of both the current and the year-ago quarters, the EPS comparison would be $1.63 for the current quarter versus $1.52 for the year-ago quarter, an increase of about 7%. This improvement in earnings reflects organic business growth, cost synergies from the Star Edison acquisition, and the initial contribution from the pension-risk transfer business that came on board in November and December. These contributions were partially offset by higher than normal level of expenses in several of our US businesses during the current quarter. We estimate that expenses over baseline, or run rate levels, including such items as fund, start up costs and asset management, and costs for process improvements across several businesses, had a negative impact of about $0.14 per share on current quarter results. A favorable catch up in our effective tax rate in the quarter mitigated about half of this impact. Now, Mark will discuss much more of the details of our businesses in a few minutes. Moving to the GAAP results of the Financial Services Business. We reported a net loss of $214 million, or $0.48 per share for the Fourth Quarter. This compares to net income of $522 million or

$1.08 per share a year ago. The GAAP net loss for the current quarter includes amounts characterized as net realized investment losses of $1.7 billion, pre-tax. This compares to $598 million of pre-tax net realized investment losses in the year-ago quarter. The main driver of this $1.7 billion in net realized losses was $1.5 billion of losses from asset and liability value changes driven by currency fluctuations. These currency-driven losses primarily represent changes in the value of non-yen liabilities on the books of our Japanese companies whose functional currency is the yen. During the quarter, the yen weakened in relation to the currencies of these products, causing us to record a loss in the income statement since it will take more yen to pay off the liabilities. We consider this non-economic because the liabilities are appropriately matched with investments in the currencies in which they will be settled. Said another way, the value in yen of these investments increase along with the liabilities. The loss in the income statement is offset by a gain in AOCI, a component of equity, but not through the income statement. With the end result that GAAP equity is essentially unaffected despite the volatility in reported net income. The remaining $200 million of the $1.7 billion of realized losses includes net losses of $134 million from product related embedded derivatives and hedging activities and $59 million of impairments and real credit losses. Book value per share on a GAAP basis amounted to $79.19 at year-end. This compares to $69.07 a year earlier. As of year-end, gross unrealized losses on general account fixed maturities were $2.1 billion, down from $4.3 billion a year ago. And we were in a net unrealized gain position of roughly $19 billion. Excluding AOCI, book value per share amounted to $57.86 at year-end, and this compares to $58.39 a year ago. The comparison of our book value on this basis is affected by the accounting geography mismatch from the asset and liability changes driven by currency fluctuations that I just mentioned earlier. This accounting miss match reduced book value by approximately $2.40. Now turning to our capital position. First, I'll focus on our insurance companies. We are continuing to manage these companies to what we believe are AA standards. Prudential Insurance began the year with an RBC of 491%. Our statutory results for 2012 are not final. We estimate that RBC for Prudential Insurance as of year-end 2012 will be in excess of our 400% threshold after paying a $600 million dividend to the Holding Company. In Japan, Prudential of Japan and Gibraltar Life each reported solvency margins comfortably above their targets, as of their most recent statutory reporting date which was September 30, 2012. I'm confident that at the end of this current fiscal year, which ends March 31, 2013, our Japanese Companies will continue to report strong solvency margins relative to their targets. Looking at the overall capital position of the Financial Services Business, we calculate, as you know, we calculated our balance sheet capital capacity for the Financial Services Business by comparing the statutory capital position and Prudential Insurance to a 400% RBC ratio threshold, and then add capital capacity held at the parent Company and under subsidiaries. We began 2012 with on balance sheet capital capacity that we estimated was in the range of $4 billion to $4.5 billion. During the year, we added about $3 billion to capital, essentially driven by earnings, excluding GAAP charges that do not affect our capital capacity, most notably the FX measurement I just spoke about. And we deployed a total of about $2 billion to fund capital needs of our businesses, including asset adequately testing reserves. In addition, we returned about $1.4 billion to shareholders through our share repurchase program and our common stock dividend. This year's dividend of $1.60 represented a 10% increase in the 2011 annual dividend. And we'll be paying quarterly dividends starting in the First Quarter of 2013. We also used a portion of this capital capacity to reduce our leverage. The net results of these activities brought on balance sheet capital capacity to roughly $3 billion as of year-end before funding the Hartford Life acquisition. Including about $1.5 billion to $2 billion that we estimate is readily deployable, a modest increase from the estimate that we have provided you back in November. Turning to the cash position at the parent, at year-end cash and short-term investments at the parent Company net of outstanding commercial paper was in excess of $5 billion. We utilized a portion of this cash in January to fund the $615 million seeding commission to Hartford Life for the Hartford Life acquisition, I should say, and to repay about $1.2 billion of maturing debt. The remaining cash in excess of our targeted $1.2 billion of liquidity cushion is available to repay maturing debt and fund operating expenses. And now, Mark is going to review more of the details of our businesses.

Mark Grier {BIO 1391186 <GO>}

Thank you, John. And thank you, Rich. I'll start with our US businesses. Our Annuity Business reported adjusted operating income of $304 million for the Fourth Quarter, compared to $373 million a year ago. The reserve true-ups and DAC unlocking that Rich mentioned had a net favorable impact of $57 million on current quarter results. The benefits of current quarter results was mainly driven by market performance in relation to our assumptions, which reflect the lower assumed long-term rates of return that we implemented in connection with our annual actuarial review in the Third Quarter. The market performance we consider reflects both the fixed income and equity elements of the particular funds underlying our customer accounts. This benefit was partly offset by a $9 million charge for impairment of capitalized software costs. Results for the year-ago quarter, included a net benefit of $176 million from a favorable DAC unlocking and reserve true-ups, largely driven by strong equity markets in that quarter. Stripping out the unlockings and true-ups, and the current quarter software impairments, annuity results were $256 million for the current quarter, compared to $197 million a year ago for a $59 million increase. This increase reflects higher fees driven by account value growth with average separate account values for variable annuities up by $23 billion from a year ago. Higher expenses were a partial offset to the benefit from our growing base of fees. Current quarter results include costs of $17 million that we estimate to be in excess of a baseline level for our current business volume. This is for items including business process improvements and areas such as technology and back office functions that are intended to give us a more efficient cost structure going forward. As Rich mentioned, these types of costs affect the current quarter results of several of our businesses. Our gross variable annuity sales for the quarter were $3.8 billion, compared to $4.4 billion a year ago, and down substantially from $5.9 billion in the Third Quarter. The lower level of current quarter sales reflects actions we've taken to adapt our products to the current environment. In August, we launched HDI 2.0, an updated version of our product with an increase in rider fees, a higher minimum issue age, and lower pay out rates than the earlier product. We also withdrew our X shares, or bonus product, over the summer. And in September, we suspended acceptance of subsequent premiums on generations of products offered before 2011. We filed a prospectus late last month for a further update of our variable annuity product, which we expect to rollout later this month. The new product, HDI 2.1, will limit the 5% roll up period for protected withdrawal value to a maximum of 10 years and reduce pay out rates at various age bands, while retaining rider fees at 100 basis points for individual contracts and 110 basis points for spousal contracts, and continuing our highest daily value proposition backed by auto rebalancing tailored to the risk profile of each individual contract. We believe the updated product will continue to be attractive to clients focused on retirement income security while offering appropriate return prospects in the current interest rate environment and contributing to the improvement of our risk profile. The Retirement segment reported adjusted operating income of $225 million for the current quarter, compared to $100 million (sic) a year ago. Current quarter results include a benefit of $78 million from recovery under a settlement of losses we recorded in 2007 attributed to client funds managed by a third party. Excluding this recovery, results for the Retirement Business are up by $7 million from a year ago. Current quarter results benefited by about $40 million from a greater contribution from net investment results from institutional investment products, largely representing the initial results from the two major pension-risk transfer transactions that we closed in November and December. This contribution and higher fees driven by growth in account values were partly offset by a lower contribution from net investment results associated with our full-service products, reflecting the impact of lower reinvestment yields over the course of the past year and the loss of spread income on bank deposits that we transferred to third parties in connection with our decision to restructure our savings and loan to a trust only organization. In addition, higher current quarter expenses affected the comparison of results to a year ago. Current quarter results include approximately $16 million of costs that we estimate to be in excess of a baseline level for the current business volume in Retirement for items including business process improvements, as I mentioned earlier. Total Retirement sales and deposits for the quarter were $43.1 billion, including $33.6 billion for the General Motors and Verizon pension-risk transfer transaction. The General Motors and Verizon transactions added over 150,000 retirees to the base of more than 3.5 million individuals covered by our group annuities. And brought our total group annuity account values to more than $60 billion at year end. These groundbreaking transactions improved the balance of risks in our businesses, enhance our return prospects by deploying capital into a business that we know well, and build our leadership potential in a market where we see great opportunities. Excluding the General Motors and Verizon transactions, gross sales in deposits were $9.5 billion in the current quarter, compared to $14.7 billion a year ago. The decrease is mainly a result of lower current quarter standalone sales of stable value RAP products to planned sponsors and fund managers, which contributed $5.3 billion in the current quarter and $8.8 billion in the year-ago quarter to sales of our institutional investment products. These sales are mainly driven by large case business and tend to be lumpy from one quarter to another. In addition sales for the year-ago quarter included $1.6 billion from two longevity, reinsurance cases, another emerging area in the pension-risk transfer market. Full-service retirement gross deposits and sales were $3.9 billion in the current quarter, essentially unchanged from a year ago. We continue to see limited activity in the mid to large case market, which is our major focus. The Asset Management Business reported adjusted operating income of $139 million for the current quarter, compared to $256 million a year ago. Current quarter results include a $9 million charge for impairment of capitalized software costs. While results for the year-ago quarter benefited by $96 million from the sale of our stake in a private pension fund manager in Mexico. We have reclassified results from our International Investments Businesses, including this sale to the Asset Management segment, to reflect our alignment of the management of these businesses. Excluding these items, the Asset Management Business produced adjusted operating income of $148 million for the current quarter, compared to $160 million a year ago. The contribution to results from what we call other related revenues, which encompasses incentive, transaction, strategic investing, and commercial mortgage activities, increased by $13 million from a year ago. As the $41 million benefit to current quarter results from the sale of a real estate related investment that Rich mentioned was largely offset by less favorable results from co-investments and lower performance based fees. Stripping out the discrete items I mentioned, and results from activities that come under the heading of other related revenues, adjusted operating income from the Asset Management Business was down $25 million from a year ago, as higher expenses in the current quarter more than offset the benefit of higher asset management fees driven by growth in assets under management. Third quarter results include approximately $49 million of costs that we estimate to be in excess of a baseline level, with the largest single item being about $20 million for costs associated with the launch of a new closed-end mutual fund. The segments Assets Under Management stood at $827 billion as of year end, up about $110 billion or 15% from a year earlier. Adjusted operating income for our Individual Life Insurance Business was $99 million for the current quarter, compared to $138 million a year ago. Current quarter results include a charge of $15 million relating to our acquisition of the Hartford's Individual Life Business that we closed in early January, mainly representing transaction costs. Excluding this charge, results from Individual Life were down $24 million from a year ago. This decrease reflected higher expenses, including non-deferrable costs associated with a substantially higher sales level in the current quarter. In addition, results for the year-ago quarter benefited by approximately $10 million from reduced amortization of deferred policy acquisition costs and other items driven by favorable separate account performance, relative to our assumptions, mainly due to the 11% increase in the S&P 500 in that quarter. Individual Life Insurance sales based on annualized new business premiums, amounted to $144 million for the current quarter up from $75 million a year ago. The increase was driven by strong current-quarter universal life sales through third party distribution, and reflects our improved competitive position as some key competitors have recently raised rates or withdrawn products from the market, together with our expanding distribution through banks and wire houses, as well as accelerated purchases of these products as we implemented price increases during the Fourth Quarter. The Group Insurance Business reported a loss of $12 million in the current quarter, compared to adjusted operating income of $42 million a year ago. Current quarter results include a charge of $20 million to increase legal reserves. Excluding this charge, Group Insurance results are down $34 million from a year ago. The decrease reflected less favorable group life underwriting results in comparison to a very strong contribution in the year-ago quarter as well as higher expenses. Current quarter expenses include approximately $18 million of costs that we estimate to be in excess of a baseline level for items including business process improvements. Group Insurance results continue to reflect unfavorable performance from our Disability Business. The actions we are taking to address this performance include enhancements of claims management, pricing discipline on new business, and repricing of cases that are up for renewal. For example, for mid to large cases, which constitute about three quarters of our group disability premiums in force, we repriced about one third of the business in the period from February 2012 through the January 1, 2013 renewal date for calendar year business, with average rate increases in the low double digits. Group Insurance sales for the quarter were $58 million, compared to $69 million a year ago with the entire decline driven by group disability. Most of our Group Insurance sales are recorded in the First Quarter based on the effective date of the business. Turning now to our International Businesses. Gibraltar Life's adjusted operating income was $315 million in the current quarter, compared to $202 million a year ago. With all major aspects of the Star Edison business integration now completed or nearing completion, Gibraltar's results for the current quarter absorbed $10 million of integration costs, compared to $94 million in the year-ago quarter. Excluding integration costs, Gibraltar's adjusted operating income was $325 million for the current quarter, compared to $296 million a year ago. Current quarter results reflect about $50 million of cost savings achieved thus far as a result of the business integration, compared to about $10 million of early saves that benefited the year-ago quarter. We remain well on track to achieve our targeted annual cost savings of about $250 million after the business integration is fully completed. In addition, foreign currency exchange rates including the impact of our hedging program, contributed $16 million to the increase in earnings from a year ago. The benefit of continued business growth was more than offset in the comparison of results by a less favorable level of policy benefits, mainly reflecting mortality experience, better than our average expectations in the year-ago quarter, and higher expenses in the current quarter largely driven by items such as technology upgrades which tend to be non-linear. Our Life Planner Business reported adjusted operating income of $332 million for the current quarter, compared to $300 million a year ago. The increase came mainly from continued business growth. On a constant dollar basis, insurance revenues including premiums, policy charges, and fees, were up by 8% from a year ago. In addition, foreign currency exchange rates contributed about $13 million to the increase in earnings from a year ago. International Insurance sales on a constant dollar basis amounted to $1.1 billion for the Fourth Quarter, compared to $829 million a year ago. Sales from Gibraltar Life were $806 million in the current quarter, compared to $542 million a year ago. Current quarter sales include $429 million from our single premium yen-based whole life bank channel products, compared to $41 million a year ago. This sales surge, continuing from the Third Quarter, reflected actions by competitors earlier in the year, which limited the alternatives available to bank customers with significant funds available for investment in Life Insurance products. In order to limit our concentration in this product and maintain appropriate returns, we have implemented crediting reductions and reduced commission rates effective January 1 of this year. Along with taking actions to manage the mix of our bank channel sales, we have also broadened our distribution commencing sales in December through SMBC, one of Japan's mega banks. With the addition of SMBC, we are now distributing through each of Japan's four largest banks with our main focus on death protection products. Excluding the bank channel single premium product, Gibraltar's current quarter sales were $377 million, compared to $501 million a year ago. The decrease reflected acceleration of sales into the first half of the year, as we anticipated, due to a tax law change in April that affected our cancer whole life product and crediting rate reductions that we implemented in the Second Quarter for our US dollar retirement and whole life products. Life Planner sales were $283 million in the current quarter, compared to $287 million a year ago. Sales by Life Planners in Japan amounted to $192 million, down $10 million from a year ago. This reflected a decrease of $38 million in our sales of cancer whole life product and US dollar products, reflecting the acceleration of sales into the earlier part of the year due to the tax law change and our crediting rate reductions. Life Planner sales outside of Japan were $91 million, up from $85 million a year ago. Corporate and other operations reported a loss of $371 million for the current quarter, compared to $285 million loss a year ago. As Rich mentioned, the current quarter loss includes a $54 million charge to increase our recorded liabilities for employee benefits based on completion of a review, and a $15 million charge to write-off bond issuance costs for debt that we redeemed prior to maturity. Excluding these items, the corporate and other loss was $302 million in the current quarter, or $17 million greater than a year ago. The greater loss in the current quarter was driven by higher interest costs, mainly reflecting our deployment of capital debt in our businesses. To sum up, I'd say we've made solid progress over the past year toward the achievement of our longer-term objectives. In the Annuities Business, we've adapted our products to the current environment, maintaining our compelling value proposition, while improving our return prospects and our risk profile. In Retirement, we've built our leadership position in the pension-risk transfer market with two major groundbreaking transactions totaling more than $30 billion in account values. In the Asset Management Business, we've grown our base of fee producing assets under management with $30 billion of institutional and retail net flows over the past year. We've strengthened our Individual Life Business with the Hartford Life acquisition, gaining strategic benefits in distribution and talent as well as solid financial prospects. We've taken steps to improve our Group Insurance results, including a change in the management team, discontinuation of long-term care sales, product repricing, and enhancement of claims management. And our International Business continues to perform well, benefiting from the successful integration of the Star and Edison businesses and business growth across multiple channels. Thank you for your interest in Prudential today, and I'll turn it back to John.

John Strangfeld {BIO 14004907 <GO>}

Thanks, Mark. Before we move on to your questions, I'd like to make a few final remarks on our results and our strategic progress. As we have discussed, despite what was admittedly a noisy quarter for us, you've heard numerous indicators of very sound fundamentals. And by many measures, we've had a strong year both in terms of current year results and in future positioning. We've managed pricing discipline, expense and product initiatives, and capital deployment to position us well going forward. Our view of earnings power and our potential to achieve and sustain a meaningfully differentiated return in our sector is reinforced by the actions that we took in 2012. The improvement in organic performance, the impact of substantial business flows, beneficial new deals and initiatives, coupled with the core strengths of our Company give us confidence in the future. Realistically speaking, there will continue to be some noise. And going forward as in the past, we will continue to ensure that our underlying performance is clear to you, as we report and discuss our results. Which leads me to one other point, when we gave you our guidance for 2013 earnings and ROE last November, we had in mind the impact of FX remeasurement on retained earnings as of September. We will not consider ourselves to have achieved our ROE goal to the extent that it was made possible by reductions in equity from currency remeasurement. We will make the apples-to-apples comparisons for you. And similarly, our compensation plans will also reflect this alignment. In other words, we won't be declaring victory based on the impact of things like the FX revaluation. Rather, as we have said often, we will get there the right way or not there at all. And we believe that we are on a good track. So with that, we'd like to open it up to questions.

Questions And Answers

Operator

(OPERATOR INSTRUCTIONS) Our first question will come from the line of Eric Bass with Citigroup. Your line is open.

Q - Eric Bass {BIO 19071725 <GO>}

Hi. Thank you. I guess if we could just talk a little bit about the International Business. And you outlined some of the higher expenses that affected earnings this quarter, just hoping you could give a little bit more color on what these costs were and what if any of these expenses are likely to continue? And then, as we think about modeling this business, what type of seasonality should we expect in earnings in 2013?

A - Ed Baird {BIO 15922078 <GO>}

Yes, Eric. This is Ed Baird. There were in this quarter the kinds of seasonal factors, as well as normal fluctuations, that frankly you're going to find in almost every quarter. Now while some of these have a certain regularity to them, others do not. So for example, on the IT, it was lumpier in this quarter. But the totality for the year of the IT expenses was still well within the budget. So I would just caution on taking the results of this quarter, or any one quarter, and trying to do a straight linear extrapolation from there. I think you'll find it more fruitful if you look at the totality of it for the year. And if you do that I think you'll find something more reliable. That's particularly true on the earnings, but it's even true if we get over on to the sales side.

Q - Eric Bass {BIO 19071725 <GO>}

Okay. That's helpful. And then within the businesses, are there seasonal trends in terms of whether it's investment income or dividend payments or other things that we should expect to recur?

A - Ed Baird {BIO 15922078 <GO>}

Yes. Just to drill down on that, if you think in simplistic terms as the money coming in and the money going out, there's sort of two channels on each of them. On the money coming inside of it, there is certain seasonality or other causes of fluctuations. So for instance, on the premium, particularly these days where there's more of a shift away from recurring premium to single premium or to advance pay, so that can start to cause in a quarter-by-quarter some fluctuation on the incoming premium. Secondly, as your question touches upon, you can get the same on investments. Beyond the normal shift that can take place naturally from quarter-to-quarter, you do get for example, in the Third Quarter, you tend to get more dividends. So if you're doing a third to Fourth Quarter sequential comparison, you're going to see some downward pressure there that is actually completely natural and not indicative of any broader story. The same will be true on two channels where the out flow and you already raised one of them. One would be around expenses. You're going to see quarter-to-quarter certain natural fluctuations that can be caused simply by scheduling, as particularly true when you've got major projects going on such as the Star Edison integration, where those kinds of expenses are naturally going to have a certain lumpiness to them. And you can even get it in the mortality with a book this big, quarter-to-quarter you're going to see certain fluctuations in mortality. But I would observe that this quarter, as frankly with all of the others we've seen during the year, it's well within standard deviation. And so if you're comparing one quarter to a prior quarter, one could be at the high end, one at the lower end. But there is no underlying trend there that I would note or bring attention to.

Q - Eric Bass {BIO 19071725 <GO>}

Okay. Thank you, very much.

Operator

Thank you. Our next question comes from the line of Nigel Dally with Morgan Stanley.

Q - Nigel Dally {BIO 1512203 <GO>}

Great. Thanks. Good morning. First, just with the $100 million of expenses above your baseline, could we read those as one-time in nature impacting only Fourth Quarter results? Or will some of those expenditures continue through 2013?

A - Charles Lowrey {BIO 3976922 <GO>}

Sure, Nigel. This is Charlie. I think the former is true. We did take about $100 million, as you said, above the baseline charges. But I think we wouldn't have lined those off if we didn't think they were one-timers. And to give you some examples of what they were, and Mark gave a couple, but one would be the fund formation fees that we had for $19 million in the Fourth Quarter, but $33 million for the year. A second would be increased costs and retirement that should make the Full Service Business more competitive. We're always looking to do that. And third are some technology and back office expenses in annuities that will improve both expense management and I think the product itself over time. So these are just three examples of the kinds of things that we think were non re-occurring and that's why we lined them off.

Q - Nigel Dally {BIO 1512203 <GO>}

Okay. Second is capital. Rich, you mentioned your capital estimates included what was necessary to satisfy the asset adequacy test. It is possible to put some numbers around how much capital that absorbed and which business lines that related to? I'm presuming it's predominantly long-term care, but was it related to other business lines as well?

A - Rich Carbone {BIO 1482557 <GO>}

It was predominantly long-term care, about $1 billion dollars that we added.

Q - Nigel Dally {BIO 1512203 <GO>}

Okay. Very good. Thank you.

Operator

Thank you. Our next question comes from the line of Mark Finkelstein with Evercore Partners. Your line is open.

Q - Mark Finkelstein {BIO 6253120 <GO>}

Hi. Good morning. I guess going back to some of Rich's earlier comments, and maybe just thinking out to 13 on capital generation. Obviously, there's a lot going on, you have two PBRT transactions that are large, good cash flow generated out of those. You have the Hartford integration. You have lower Star Edison costs. How should we think about capital generation in 13 vis-à-vis historically giving relationships of capital generation to operating earnings?

A - Rich Carbone {BIO 1482557 <GO>}

Yes. We haven't quite fine tuned that yet. But I think the 50% rule that we've been throwing out lately, that 50% of our cash flow is available to the Holding Company and some of that's going to pay Holding Company expenses. But some of that is also going to emerge as excess capital during the year.

Q - Mark Finkelstein {BIO 6253120 <GO>}

So, 50% and then you pay Hold Co costs and interest costs?

A - Rich Carbone {BIO 1482557 <GO>}

Right.

Q - Mark Finkelstein {BIO 6253120 <GO>}

Okay. Fair enough. I guess I want to go back to the single premium yen denominated whole life product. It was up sequentially something like $100 million in production. I think last quarter, Ed, you talked about the margins being in your target but maybe at the lower end of that range. Just looking at the production levels, I guess how do you feel about the margins on that product kind of taking a deeper look at it? And where do you think the margins will go as you re-price and take the commissions down?

A - Ed Baird {BIO 15922078 <GO>}

Yes, Mark. This is Ed. The character of the bank channel is different than our other channels that are captive, in that it has the capacity to produce much more dramatic growth than you can get through a captive agency system. And that's why as we described at our Tokyo Investor Day, our strategy there is a little bit different than in our core captive agency systems. The goal is the same in all of our channels and that is profitable growth. And in the bank channel that requires more careful and frequent monitoring because of the capacity to have major sales in a relatively short period of time. Each of our products contributes to the high ROE and to that balance between growth and profitability in a different way. But we are very careful with the bank to be at the conservative side, both of product design and of pricing. And again, I'll try and briefly recap some of the things we got into in detail in our Tokyo Day. What we do is both in the design of the product and in pricing we're very conservative. So on the pricing side, we endeavor to be at the low end, if not frankly at the bottom, in terms of crediting rate and other aspects of the design. That in turn allows us to be equally conservative in our investment portfolio. And I'm sure you're aware that our portfolio compared to others is considerably more conservative, both in terms of its ALM matching, in terms of not taking a currency bet, in terms of the matching on the currency. So right across-the-board, we're more careful there. So when we saw in this quarter the rise, what we did was we moved very quickly to insure that we would bring down our position from a comparative and competitive perspective. So that going into this next quarter, you will see us positioned again towards the more conservative end. So it sounds like you are already aware that we did adjust downward both the implied crediting rate, the commission rate. We also put in just as a backstop sort of an overall maximum as to how much we would distribute during any one quarter. In order to address the issue that Mark raised in his opening comments, which is just to make sure we don't have any concentration of risk in any particular tranche of business that's coming in during the quarter.

Q - Mark Finkelstein {BIO 6253120 <GO>}

Okay. All right. Thank you.

A - Ed Baird {BIO 15922078 <GO>}

Sure.

Operator

Thank you. Our next question comes from the line of Jay Gelb with Barclays. Your line is open.

Q - Jay Gelb {BIO 21247396 <GO>}

Thank you, and good morning. I wanted to touch base on a couple items. The first is, Mark, could you provide us your updated views on PRU, potentially being designated a bank SIFI?

A - Mark Grier {BIO 1391186 <GO>}

Excuse me. Yes, as you know from our acknowledgments, we're in the process of being reviewed by the FSOC, ultimately leading up to the FSOC level right now at the staff level. And I would reinforce what we've said before, which is that we're engaged in a high quality process that includes a lot of effort, a lot of work, and a lot of engagement. And the opportunity for us to address issues that we think are important here has been ample. We don't believe, as you've heard us say before, that the quantitative evidence will lead to a conclusion that we're a SIFI, but we're not sure exactly what other considerations there might be in the process. So we're putting our best foot forward and working hard on where this may go. Just a reminder before I move on to one other comment. There are other things in the arena of SIFI going on. The designation as a global SIFI for example, would also impact our relationship here as a domestic SIFI and with the Federal Reserve as a regulator. So that's also out there and that process is continuing as well during the first half of this year. And a sub point that you've heard me make before is that it's more important that we get this right than which label we put on it. So we're also actively engaged in discussions around solvency and capital standards and the process by which we might be assessed and measured by any group supervisor that may come out of either domestic SIFI or global SIFI or comframe [ph] or someplace else as one of these other processes moves along looking at large companies like Prudential. So I don't have a specific update. And I'm not going to handicap the odds, but I would say that we're engaged in a high quality process. And we also have the opportunity to provide our input and our comments. And right now as well to work hard on the question around solvency and capital standards.

Q - Jay Gelb {BIO 21247396 <GO>}

Understood. And then related to that, there's I believe $250 million of share repurchase authorization still existing through the first half of 2013. Prudential did not repurchase stock in the Fourth Quarter. Do you anticipate that Prudential will achieve that $250 million of buyback in the first half?

A - Rich Carbone {BIO 1482557 <GO>}

Yes. Rich.

Q - Jay Gelb {BIO 21247396 <GO>}

I'm sorry, I didn't catch that.

A - Mark Grier {BIO 1391186 <GO>}

Yes. Rich Carbone answered that.

A - Rich Carbone {BIO 1482557 <GO>}

Yes. It's Rich. Sorry for the short comment.

Q - Jay Gelb {BIO 21247396 <GO>}

Thank you.

Operator

Thank you. Our next question comes from the line of Jimmy Bhullar with JP Morgan. Your line is open.

A - Rich Carbone {BIO 1482557 <GO>}

I think we lost Jimmy.

Operator

We'll continue on. We'll go to the line of Joanne Smith with Scotia Capital.

Q - Joanne Smith {BIO 16931590 <GO>}

Hi. Yes. I just wanted to cover the Life Planner Business in Japan. I understand that you've had some pretty good results there for the first three quarters of the year. But they did slow a little bit in the Fourth Quarter and I did listen to the conversation about seasonality and some of the fluctuations, the natural fluctuations in that business. But I'm just wondering if you could just give us a little bit more information on where some of the weaker spots were? I mean you still delivered growth in earnings, but you had double digit growth in prior quarters. And this was about 6% as I calculated on an adjusted basis.

A - Ed Baird {BIO 15922078 <GO>}

Yes, Joanne, I would go back to the earlier comment about being careful for the quarter. It has a lot to do with simply the timing. If you look at the year for the Life Planner model, you'll find that they had an extraordinarily strong year. So that both sales and earnings up in strong double digits in the 20% range. And what's healthy about the sales I would comment on is the character of it. What I mean by that is it's coming across evenly through all three sources of drivers. In other words, we're seeing both the growth in the headcount of about 3% to 4%. We're seeing growth in productivity. And we're also seeing growth in average premiums which is a broader trend that we've highlighted in the past that's also true in our Gibraltar Business and that's reflective of the fact of the retirement and gradually tapping into the higher income group of the aging population. So both the quality of the sales and the quality of the earnings in POJ on an annual basis I think you'll find to be extremely strong. I cannot find anything in the Fourth Quarter that's outside the normal range in which there might be embedded a story.

Q - Joanne Smith {BIO 16931590 <GO>}

Thank you for that, Ed. And just on the Gibraltar Business, I know it's probably a little bit premature to be talking about M&A at this juncture, but seems that the Star Edison integration has gone quite smoothly. You're realizing a lot of the synergies, the expense synergies already. I was wondering if you could just kind of give us an outline of what the M&A landscape looks like in Japan and the rest of the Asian region if you have any interest in that?

A - Ed Baird {BIO 15922078 <GO>}

Sure. Let me start with a broad sort of philosophical approach to the M&A. Our general preference is to acquire companies in countries that we're already in, such as the Star Edison acquisitions. We have a long and I think fairly stated successful track record in that type of acquisition. So we always look for those, Japan, Korea, those kinds of countries, places that we would be open to for that. But in addition we also consider the possibility of entering new markets. That we would do as Mark expressed earlier in this conversation, on a careful and selective basis. But a cautious expansion of the footprint is something that we would consider. And so geographically they would be in the kind of regions you referenced. The intrinsic growth rates that are possible in Southeast Asia and Latin America are places that interest us. We're not really interested in general in the mature markets of Western Europe, where we don't have any meaningful presence on to which we can both do business. But getting back to the core part of your question of Japan, specifically, yes, at the moment, our group is still quite actively engaged, although successfully over the major hump with the integrations of Star and Edison. We do keep an open mind looking at the kind of companies there. It will be interesting to see, now that the new solvency margin rules are out whether or not that puts a certain degree of pressure on some companies that under the old measures had adequate solvency margins, but under these new more stringent solvency measures may not feel quite so comfortable. So we do continue to monitor that having made a handful of acquisitions there over the last decade. We do have a certain degree of quiet confidence about our abilities there.

Q - Joanne Smith {BIO 16931590 <GO>}

Thank you, very much, Ed.

A - Ed Baird {BIO 15922078 <GO>}

Sure.

Operator

Thank you. We'll go back to the line of Jimmy Bhullar with JP Morgan. Your line is open. Please check your mute key. We'll continue on to the line of Randy Binner with FBR.

Q - Randy Binner {BIO 15145081 <GO>}

Great. Thanks. I wanted to ask a question about the forward currency hedging program and how it's running through earnings? And I think what we saw in the quarter was that the yen kind of hedge rate of 85 on the dollar was the reason that you saw kind of positive cash flows into the Japanese businesses. In the guidance for 2013, I think assumes a yen at 80, so the first part of the question is, is that 80 where you're hedged at for the yen for 2013?

A - Rich Carbone {BIO 1482557 <GO>}

It's Rich Carbone. Yes, we're hedged at 80 for 2013.

Q - Randy Binner {BIO 15145081 <GO>}

And then, how should we think about that going forward if the yen continues to weaken? When do you kind of re-strike those hedges? And how should we think about it if the yen stays at 95 or goes to a 100? I mean what would be a reasonable expectation of where that might have to float up to thinking about 2014?

A - Rich Carbone {BIO 1482557 <GO>}

So let me just give you a little bit of background. Half of our earnings that come out of Japan are in dollars, US dollars and Aussie dollars, and half of our earnings that come out of Japan are in yen. We hedge 100% of the next year's earnings, the yen earnings completely. So 2013, fully hedged at 80, no impact of the declining yen, regardless of where it goes. 2014 we are 78% hedged as of today. 2015 we are 22% hedged for 2015. And as this year progresses, we begin to leg in to 14 and 15 and 16, so by the end of 2013, we'll be 100% hedged in 14.

Q - Randy Binner {BIO 15145081 <GO>}

Okay. The 78% in 14 and the 22% in 15, that's at 80, right?

A - Rich Carbone {BIO 1482557 <GO>}

That is not at 80 because remember, you're not hedging at spot rates, you're hedging at forward rates so you're averaging in the forward rate. And that's going to change, dependent upon the interest rate differential between the dollar, the interest rate differential between US interest rates and Japanese interest rates. That's hard to predict where we sit here today.

A - Mark Grier {BIO 1391186 <GO>}

And it's rolling three years forward so it will not all have gone on at the same time. It won't match exactly the 80, as Rich said, it's at forward rates not spot. And it's a rolling implementation.

Q - Randy Binner {BIO 15145081 <GO>}

So, I guess in layman's terms, though, it would be reasonable to expect that wherever you're hedge edge, if the yen weakens materially, let's say it goes to 100 or 105, you should be able to keep your hedging level below that because your lagging into it over time?

A - Rich Carbone {BIO 1482557 <GO>}

That's correct and we're using forward rates, not spot. We're hedging it to forward not the spot which is lower than the spot.

Q - Randy Binner {BIO 15145081 <GO>}

That's helpful. Thanks.

A - Mark Grier {BIO 1391186 <GO>}

Well, having said that, it will run its course. At the end of the day.

A - Rich Carbone {BIO 1482557 <GO>}

The hedges roll forward three years from the current year. So we'll be renewing hedges now further out into 14 for example, that are at rates that are not as attractive as 80.

Q - Randy Binner {BIO 15145081 <GO>}

No, understood. I think just simplistically people worry about half the business coming from Japan and what the impact is, so I just wanted to clarify the structure of the yen currency hedge.

A - Rich Carbone {BIO 1482557 <GO>}

Yes, but half the business coming from Japan is in dollars.

Q - Randy Binner {BIO 15145081 <GO>}

No, understood.

A - Rich Carbone {BIO 1482557 <GO>}

Okay. Thank you.

Q - Randy Binner {BIO 15145081 <GO>}

I think the dollar piece is the dollar piece, but the yen piece is what would move the translation right?

A - Rich Carbone {BIO 1482557 <GO>}

Absolutely.

A - Mark Grier {BIO 1391186 <GO>}

Yes.

Q - Joanne Smith {BIO 16931590 <GO>}

Okay. Thank you.

Operator

Thank you. Next we'll go to the line of Sean Dargan with Macquarie.

Q - Sean Dargan {BIO 15387640 <GO>}

Yes. Thanks. This is a follow-up to Randy's question. So if half of your business in Japan is in US dollars and Aussie dollars, what is the impact of demand for products denominated in those currencies in a weakening yen environment?

A - Ed Baird {BIO 15922078 <GO>}

Yes, the dollar products have represented for awhile somewhere between 30% and 40% of our sales. And if you look back over oh, probably the last five years, what you'll see is that there isn't a strong correlation between the currency shift. To the extent that I could find any, and this isn't much of a trend, it tends to be that when the yen is strengthening, they'll tend to go more to the dollar, and when it's not, maybe less to it. But I'd be careful about that. I don't want to overplay that, because again we've been selling dollar denominated retirement income product as a lead product in Japan for about seven years now. And I've not seen material fluctuations based on what has over that period of time obviously been very substantial swings in the exchange rate.

Q - Sean Dargan {BIO 15387640 <GO>}

Okay. And does the weakening yen impact BSMR for your Japan companies at all?

A - Ed Baird {BIO 15922078 <GO>}

Let me think of where it would. No, I don't believe it does. No, it doesn't. We're protected on the local books.

Q - Sean Dargan {BIO 15387640 <GO>}

Okay. Thank you, very much.

FINAL

Bloomberg Transcript

Operator

Thank you. We'll go to the line of Jeff Shuman with KBW. Your line is open.

Q - Jeffrey Schuman {BIO 1817576 <GO>}

Thanks. Good morning. If I understood Rich correctly, you gave us a picture of capital capacity at 12-31 which I think was $3 billion on balance sheet, $1.5 billion to $2 billion readily deployable. But I think you said that was before Hartford, so can you help us pro forma that? We know you wrote the check for the seating commission, but we don't really know all-in what was the impact to capital capacity. So can you help us there, please?

A - Rich Carbone {BIO 1482557 <GO>}

I think the way you'll want to think about that is that we're going to write the check. The check will take down for that moment in time the check will take down our capital capacity. We're going to rebuild that capital capacity by only buying back the $250 million of shares during the year, during the First Quarter, excuse me. The first half, sorry, the first half. And then the retained earnings build will restore our capital capacity at some point throughout the year.

Q - Jeffrey Schuman {BIO 1817576 <GO>}

You're telling me that we'll rebuild, but I guess, are you going to help us understand what the pro forma view of 12-31 is?

A - Rich Carbone {BIO 1482557 <GO>}

No, I'm not going to give you projection on total capacity because there's a whole lot of stuff that will happen between now and March and now and June and now at the rest of the year.

Q - Jeffrey Schuman {BIO 1817576 <GO>}

Okay. And I guess just kind of big picture, wondering if you could help us reconcile the thinking a little bit. Whatever the all-in investment in the Hartford is, does it leave you with some readily deployable capital, not as much as some other points in time. Mark's been very open in talking again about the regulatory overhangs. And I was surprised that John opened up early on by talking pretty openly about considering possible transactions and pension-risk transfer deals, and so forth, so it would seem like a time when maybe you were going to have to conserve capacity a little bit, but could you help us there, please?

A - Mark Grier {BIO 1391186 <GO>}

Yes, this is Mark. We've been asked over the last few years a number of times with respect to the regulatory issues, whether or not we should be hoarding more capital in anticipation of the possible imposition of a so-called SIFI buffer, or whether or not we should be throwing capital overboard so we don't have to get permission to deploy it if we wind up in a different regulatory regime. And what we've said all along with respect to that issue is that we believe we're doing the right thing. We have a lot of discipline around the deployment of capital and a lot of discipline around the levels of capital that we believe are appropriate for us in our businesses given our risks. And so with respect to the regulatory issue, we continue to behave on the basis that we're soundly and well capitalized and soundly and well run with respect to risk and capital discipline. So on that one, in the context of the way in which you're asking the question, we would not currently be shading this one way or the other. And as I said, we've had advice that goes both directions. We would not be shading this one way or the other because we're doing what we believe is the right thing, and remember as Rich said, we generate a lot of capital. We have capacity, both the on balance sheet capacity and the ability of the Company to generate capital are sufficient to allow us to contemplate either out sized organic transactions, as John referenced, to support the ordinary organic growth of our businesses and also to consider the possibility of additional deals where they fit our requirements.

Q - Jeffrey Schuman {BIO 1817576 <GO>}

Okay. Thank you, Mark.

Operator

Thank you. And with that, we will conclude our Question-and-Answer session. Today's conference will be available for replay after 1.30 PM. today until midnight February 14. You may access the AT&T teleconference replay system by dialing 800-475-6701 and entering the access code of 272217. International participants may dial 320-365-3844. This does conclude your conference call for today. Thank you for your participation and for using AT&T executive teleconference service. You may now disconnect.