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# MetLife, Inc. (MET) CEO Michel Khalaf on Q3 2019 Results - Earnings Call Transcript

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Q3: 10-30-19 Earnings Summary

*Press Release* *10-Q* *Slides*

EPS of $1.27 misses by $-0.13 | Revenue of $16.92B (3.16% Y/Y) beats by $550.34M

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## Earning Call Audio

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00:00 -55:47

MetLife, Inc. (NYSE:MET) Q3 2019 Earnings Conference Call October 31, 2019 8:30 AM ET

**Company Participants**

John Hall - Head of Investor Relations

Michel Khalaf - President & Chief Executive Officer

John McCallion - Chief Financial Officer

Steve Goulart - Executive Vice President & Chief Investment Officer

Ramy Tadros - President, U.S. Business

Kishore Ponnavolu - President, Asia

**Conference Call Participants**

Jimmy Bhullar - JPMorgan

Tom Gallagher - Evercore ISI

Andrew Kligerman - Crédit Suisse

Suneet Kamath - Citi

Ryan Krueger - KBW

Erik Bass - Autonomous Research

Humphrey Lee - Dowling Partners

Alex Scott - Goldman Sachs

Josh Shanker - Deutsche Bank

John Barnidge - Sandler O'Neill

**Operator**

Welcome to the MetLife Third Quarter 2019 Earnings Release Conference Call. At this time, all participants are in a listen-only mode. Later, we will conduct a question-and-answer session. Instructions will be given at that time. As a reminder, this conference is being recorded. Before we get started, I refer you to the cautionary note on the forward-looking statements in yesterday’s earnings release.

With that, I will turn the call over to John Hall, Head of Investor Relations.

**John Hall**

Thank you, operator. Good morning everyone and welcome to MetLife's third quarter 2019 earnings call. Before we begin, I refer you to the information on non-GAAP measures on the Investor Relations portion of metlife.com, in our earnings release, and in our quarterly financial supplements which you should review.

Joining me this morning on the call are Michel Khalaf, President and Chief Executive Officer; and John McCallion, Chief Financial Officer. Also here with us today to participate in the discussions are other members of senior management.

Last night, we released an expanded set of supplemental slides. They are available on our website. John McCallion will speak to those supplemental slides in his prepared remarks if you wish to follow along.

The content for the slides begins following the romanette pages that feature a number of GAAP reconciliations. After prepared remarks, we will have a Q&A session that will extend to the top of the hour. In fairness to all participants, please limit yourself to one question and one follow-up.

With that, I'll turn the call over to Michel.

**Michel Khalaf**

Thank you, John and good morning everyone. There is a growing sense of urgency and excitement at MetLife. We are renewing our commitment to being a purpose-driven company. We are making good progress on a strategy that defines the right markets, solutions, and competitive differentiators and we are building a culture that is customer-focused and highly collaborative. I am confident we are assembling all the right ingredients to win in the marketplace and create long-term value for our shareholders.

Turning to our third quarter results, MetLife delivered solid earnings despite a challenging capital markets environment marked by falling interest rates. We continue to build a company that can perform well across economic cycles.

As we reported last night, net income totaled $2.2 billion, up from $880 million in the third quarter of 2018. This result mainly reflected the impact of declining interest rates on our derivative portfolio as accounting rules require us to mark our hedges to market through the income statement but not the assets or liabilities being hedged.

Quarterly adjusted earnings totaled $1.2 billion or $1.27 per share compared with $1.4 billion or $1.38 per share in the third quarter of 2018. Excluding all notable items, we reported quarterly adjusted earnings of $1.4 billion or $1.54 per share compared with $1.5 billion or $1.53 per share a year ago.

Our adjusted return on equity, excluding AOCI other than FCTA and ex-notables, was 12.9% and MetLife's book value per share as noted in our press release was up 13% to $48.56 from a year ago.

During the third quarter, we completed our annual actuarial assumption review which John McCallion will discuss in greater detail. As part of the review, MetLife changed its long-term interest rate assumption from 4.25% to 3.75%.

Along with other insurance adjustments, the impact of the actuarial review on adjusted earnings was negative $160 million with an incremental $19 million effect on net income. The overall results were in line with our expectations and with the disclosures we provided to you on our second quarter call. We believe this reflects our progress in becoming a simpler company, that derives more of its earnings from protection and capital-light businesses.

Excluding just the impact of our annual actuarial assumption review and other insurance adjustments, which is on a basis consistent with the consensus estimate, adjusted earnings were $1.44 per share. Market conditions in the third quarter were mixed. While lower recurring investment margins and the strengthening of the U.S. dollar had a negative impact on adjusted earnings, MetLife also benefited from higher variable investment income driven by strong private equity performance.

Investments is an area where MetLife enjoys longstanding advantages. The size of our portfolio coupled with the capabilities of our investment team allow us to differentiate through higher-yielding, private placements, commercial mortgages and private equities, all of which have generated significant alpha across economic cycles.

Moving to specific third quarter business highlights. Our market-leading U.S. group business reported strong results. The drivers were volume growth, especially sales of voluntary benefits as well as favorable expense margins and solid underwriting. Our U.S. group business has longstanding strategic partnerships, some of which date back a century.

Today, it offers the widest range of employee benefits products anywhere in the industry. This helps our customers meet the ever-evolving needs and expectations of their current and potential employees. In short, we help win the war for talent.

In addition, the size and scale of the business make it easier for us to invest in enrollment technology, claims management and privacy protection. This fuels a virtuous cycle that allows us to strengthen our relationships with customers while preserving and extending our advantages.

We are the leading player in the large market segment with over 25% market share and we see further growth through greater voluntary product penetration. We are also extending our reach into the regional and small markets, where we believe our competitive advantages provide the same opportunity to drive growth and market share.

Turning to our other MetLife businesses, excluding notable items, adjusted earnings in our Retirement and Income Solutions business were down compared with a very strong third quarter of 2018 despite good volume growth and pension risk transfer sales. This quarter, lower interest and underwriting margins had a negative impact.

In our Property & Casualty business, adjusted earnings were down compared with a strong third quarter a year ago, driven mainly by higher cat losses and lower underlying underwriting margins. In our Asia business, strong volume growth and higher variable investment income drove an increase in adjusted earnings more than offsetting the effects of a strong U.S. dollar.

Our Latin America business benefited from volume growth and equity market performance while facing headwinds from tax items, recurring investment margins and foreign exchange pressures. In our EMEA business, lower underwriting margins and higher taxes offset volume growth and favorable expense margins.

Finally, while adjusted earnings were down in MetLife Holdings, the performance of that business is firmly within our expected range for the year.

Moving to expenses, excluding notable items and pension risk transfers, our direct expense ratio for the third quarter was 12.2% compared with 13.1% a year ago. This was driven by favorable items related to the market impact on employee benefits costs revenue growth and continued discipline around expenses. We remain on-track to deliver $800 million in margin expansion by 2020 as promised.

Over the longer term, we intend to achieve greater economies of scale. We have made significant progress on this front opening multiple centers of excellence here in the U.S. and around the world that lower costs, improve controls and drive down development.

Overall, we are shifting from one-off cost initiatives to a continuous efficiency mindset where we will drive savings and greater efficiency to support continued investment and growth. Capital deployment is one of the most critical and carefully considered decisions, we make at MetLife.

We are committed to deploying capital, where it will generate the highest risk-adjusted returns. This means, exercising the same discipline across all potential uses of capital, whether to underwrite organic growth, support in-force business, finance M&A, all fund common dividends and share repurchases.

With a volatile third quarter equity market, we opportunistically push forward some of our planned annual share buyback activity for the year. In total, we repurchased $785 million of MetLife shares in the quarter. During the first three quarters of 2019 combined, we returned more than $3.2 billion to shareholders through common dividends and share repurchases.

In closing, we are pleased to deliver another good quarter, the latest installment in our improving track record of consistent execution. We have a collection of great businesses and clear advantages that we believe will continue to set us apart. I am encouraged by our progress and look forward to sharing more about our next horizon strategy and our businesses at MetLife's upcoming Investor Day on December 12.

With that I will turn the call over to John McCallion to cover our third quarter performance in greater detail.

**John McCallion**

Thank you Michel, and good morning. I will begin by discussing the 3Q, 2019 supplemental slides that we released last evening along with our earnings release and quarterly financial supplement. Starting on Page 4, the schedule provides a comparison of net income and adjusted earnings in the third quarter of 2019.

Net income was $2.2 billion or $962 million higher than adjusted earnings of $1.2 billion. This variance is primarily due to higher net derivative gains resulting from the decline in interest rates during the quarter. Overall the results in the investment portfolio and hedging program continue to perform as expected.

I will now discuss the impact of our annual actuarial assumption review starting on Page 5. During the actuarial assumption review and other insurance adjustments reduced net income by $179 million of which $160 million impacted adjusted earnings.

The most significant driver was the reduction of our long-term U.S. 10-year treasury interest rate assumption from 4.25% to 3.75% with the rate mean reverting over the next 8 years. This impact was in line with our prior guidance of $50 million after-tax for every 25 basis point reduction disclosed on our second quarter 2019 earnings call.

With regards to long-term care, our statutory reserves have grown to $15.6 billion as of September 30, 2019, which is $2.7 billion higher than GAAP reserves. We also continue to have substantial LTC loss recognition testing margin of $1.8 billion as of September 30, 2019 which compares to $2.1 billion at 3Q, 2018.

Roughly half of the decrease was due to an approximate 10 basis point reduction in our average lapsed rate assumption, while the remainder was due to the change in our U.S. 10-year treasury mean reversion rate. The impact from these changes was broadly in line with the sensitivities we provided a year ago on our 3Q, 2018 earnings call.

On page six we provide a breakdown of the actuarial assumption review by business segment. In MetLife Holdings, approximately $100 million of the net income impact was due to the lowering of the mean reversion interest rate to 3.75%, with the remaining impact driven primarily by refinements in assumptions related to our regulatory closed block. We also had a few minor adjustments outside the U.S. in Asia, LatAm and EMEA.

We had two notable items in the quarter as shown on page seven and highlighted in our earnings release and quarterly financial supplement. In addition to the $160 million after-tax, or $0.17 per share, related to our annual actuarial assumption review and other insurance adjustments, expenses related to our unit cost initiative decreased adjusted earnings by $88 million after tax, or $0.09 per share. Adjusted earnings excluding both notable items were $1.4 billion, or $1.54 per share.

On page eight, you can see the year-over-year adjusted earnings, excluding notable items by segment. Excluding all notable items in both periods, adjusted earnings were down 6% and down 5% on a constant currency basis.

On a per share basis, adjusted earnings, excluding notable items, were up 1% on both a reported and a constant currency basis. The better results on an EPS basis reflect the cumulative impact from share repurchases. Overall, positive year-over-year drivers include solid volume growth and better expense margins.

Investment margins were mixed, as continued strength in variable investment income was offset by lower recurring interest margins. In addition, underwriting was generally less favorable relative to a very strong 3Q 2018.

With regards to business performance, Group Benefits adjusted earnings excluding notable items were up 10% year-over-year, driven by volume growth and better expense margins. The business continues to benefit from strong volume growth with adjusted PFOs in the quarter up 6% and year-to-date sales up 10%, led by growth in voluntary products across all market segments. In addition, we saw solid underwriting in the quarter.

Group Life mortality ratio was 87%, which is modestly below the mid-point of our annual target range of 85% to 90%. Although, this was less favorable compared to a very strong result of 85% in 3Q, 2018. The interest adjusted benefit ratio for Non-Medical Health was 70.3%, which is below our annual target range of 72% to 77% and favorable to the prior year quarter of 71.6%, after excluding a notable insurance adjustment. The primary driver was strong disability results, which benefited from renewal rate actions and higher claim recoveries.

Retirement and Income solutions, or RIS, adjusted earnings were down 16% year-over-year. The key drivers were lower investment margins as weaker recurring interest regions exceeded the positive contribution from variable investment income and less favorable underwriting margins. This was partially offset by favorable expense margins.

RIS investment spreads were 102 basis points in 3Q 2019, down 23 basis points year-over-year and down 17 basis points sequentially. Strong private equity returns were more than offset by the ongoing pressure from low rates and the inverted yield curve as well as the recent dislocation in the repo market during the quarter. We continue to expect spreads to remain in the bottom half of our 2019 guidance range of 100 to 125 basis points.

RIS adjusted PFOs were up 13% year-over-year, driven by $1.3 billion of pension risk transfer deals in 3Q 2019. Excluding PRTs, RIS PFOs were down 9% due to lower sales of institutional income annuities.

Property & Casualty, or P&C, adjusted earnings were down 34%, primarily due to unfavorable underwriting in the quarter. The auto combined ratio was 98.7%, unfavorable to the prior year quarter of 95.5%, primarily due to higher vitally injury severity.

In addition, pretax cat losses of $70 million were $21 million higher than the prior year quarter, but in line with our expected 3Q 2019 cat load. While underwriting results were unfavorable this quarter, we expect our full year 2019 combined ratios for auto and home to be within their targeted range. With regards to the topline, P&C adjusted PFOs were up 2%, while sales were down 4% versus 3Q 2018.

Asia adjusted earnings, excluding notable items, were up 5% and up 6% on a constant currency basis. The positive year-over-year drivers were favorable volume growth as assets under management, excluding fair value adjustments, grew 13% year-over-year. In addition, results also reflected better investment margins and lower taxes. These were partially offset by less favorable underwriting margins.

Asia sales were down 7% on a constant currency basis. Excluding the impact of the divested business in Hong Kong and a large group case in Australia in the prior year quarter, Asia sales were up 1% year-over-year.

In Japan, sales were down 15%, primarily driven by a 32% year-over-year decline in foreign currency-denominated annuity products. FX annuity products, which are primarily sold through bank channels, had another soft quarter given the further drop in U.S. interest rates. This resulted in an overall reduction in bank market sales. In addition, our A&H sales in Japan were down 15% year-over-year, which is a function of changes in the tax laws associated with certain products. Other Asia sales were up 7% due to strong growth in Korea, China, and India.

Latin America adjusted earnings, excluding notable items, were up 2% and 7% on a constant currency basis. The primary drivers were the favorable impact from capital markets on our Chilean encaje and volume growth across the region. These were partially offset by lower investment margins, primarily due to lower inflation in Mexico and Chile.

Latin America adjusted PFOs were up 4% and 8% on a constant currency basis, driven by growth across the region. Latin America sales were up 12% on a constant currency basis, driven by higher sales in Chile, Mexico and Brazil.

EMEA adjusted earnings excluding notable items were down 15% and down 13% on a constant currency basis. The main drivers were less favorable underwriting, primarily related to employee benefits in the U.K. and the Gulf as well as higher taxes. These were partially offset by favorable expense margins. EMEA adjusted PFOs were up 6% on a constant currency basis and sales were up 13% on a constant currency basis, reflecting growth across the region.

MetLife Holdings adjusted earnings excluding notable items were down 18%, driven by lower recurring interest margins and the impact of $30 million of favorable items in 3Q, 2018. These were partially offset by favorable expense margins.

With regard to underwriting, the life interest adjusted benefit ratio was 67.5% but 51.9% excluding the impact from the annual actuarial assumption review. While this ratio is higher than the prior year quarter of 50.9% on the same basis, it was firmly within our annual target range of 50% to 55%.

Corporate & Other adjusted loss excluding notable items was $135 million. This result compared favorably to the prior year quarter, which had an adjusted loss of $149 million due to lower taxes and interest expense on debt. This was partially offset by less favorable expense margins.

The company’s effective tax rate on adjusted earnings in the quarter was 17.6%, which was aided by increased tax-exempt income and the timing of some tax benefits in Argentina. We would view the run rate to be 18.8% and within our 2019 guidance of 18% to 20%.

Now let's turn to page 9 to discuss variable investment income in more detail. This chart reflects our pre-tax variable investment income for the past seven quarters, including $326 million earned in the current quarter. Our private equity portfolio, which is accounted for on a one quarter lag had another strong quarter. For the year-to-date, VII was $834 million pre-tax and we now expect to be above our 2019 guidance range of $800 million to $1 billion.

Now, I will discuss recurring investment income. Our new money rate was 3.65% versus a roll-off rate of 4.19% in 3Q, 2019. This compares to a new money rate of 4.04% and a roll-off rate of 4.37% in 3Q, 2018. Lower interest rates have pressured the spread. As we have noted previously, we would not expect parity to occur until we have a sustained U.S. 10-year treasury yield of roughly 3% to 3.25%.

Turning to page 10. This chart shows our direct expense ratio from 2015 through 2018, as well as the first three quarters of 2019. We are committed to and have a clear line of sight towards achieving our goal of $800 million of pre-tax profit margin improvement by 2020. This would represent an approximate 200 basis point decline in our annual direct expense ratio from 2015 baseline year.

We believe the annual direct expense ratio best reflects the impact on profit margins as it captures the relationship of revenues and the expenses over which we have the most control. We have made consistent progress towards achieving our target by 2020.

As the chart illustrates, we have already achieved 140-basis point improvement in the annual direct expense ratio from 2015 to 2018. For 3Q 2019, we posted another strong result as the direct expense ratio excluding notable items and PRTs came in at 12.2%. This was aided by roughly 30 basis of favorable items including lower employee benefit costs related to market movements in the third quarter.

Looking ahead to the fourth quarter, we would expect our direct expense ratio to be higher than our 2019 year-to-date trend. This is a function of the strong growth we have enjoyed in our Group Benefits business where we will incur seasonal enrollment and other costs prior to receiving associated premiums. In addition we estimate costs associated with our unit cost initiative to be a few cents per share higher in the fourth quarter as we execute on the final elements of this program.

I will now discuss our cash and capital position on Page 11. Cash and liquid assets at the holding companies were approximately $3.5 billion at September 30th, which is down from $4.2 billion at June 30th. Holdco cash decreased this quarter given the timing of subsidiary dividends and our capital management actions. We returned $1.2 billion to shareholders in the form of share repurchases and common dividends in the quarter, clear evidence of our ongoing commitment to capital management.

Next, I would like to provide you an update on our capital position. For our U.S. companies, preliminary third quarter year-to-date 2019 statutory operating earnings were approximately $3.4 billion and net earnings were approximately $3 billion. Statutory operating earnings decreased by $195 million from the prior year period, primarily due to the impact of a prior year dividend from the investment subsidiary, partially offset by lower VA rider reserves and improved underwriting results.

We estimate that our total U.S. statutory adjusted capital was approximately $20 billion as of September 30th, 2019, up 9% compared to December 31st, 2018. The increase in operating earnings and derivative gains were partially offset by dividends paid to the holding company.

Finally, the Japan solvency margin ratio was 896% as of June 30th, which is the latest public data. Overall, MetLife continued to deliver strong results leveraging our diverse market-leading businesses to drive capital-efficient growth, while maintaining expense discipline across the firm. We have been able to grow book value per share 13% year-over-year, while generating an adjusted ROE of 12.9% excluding notable items in the quarter, despite the challenging macroeconomic environment. In addition our cash and capital position as well as our balance sheet remains strong and resilient.

Finally, we are confident that the actions we are taking will continue to create long-term sustainable value for our customers and our shareholders.

And with that, I will turn the call back to the operator for your questions.

**Question-and-Answer Session**

**Operator**

Thank you. [Operator Instructions] Your first question comes from the line of Jimmy Bhullar from JPMorgan. Please go ahead.

**Jimmy Bhullar**

Hi, good morning. So, I had a question on group insurance margins and if you could just discuss what drove your strong results this quarter? And then also relatedly, everyone's had pretty good margins in the last couple of years now, so have you seen companies start to reflect that in their pricing? And what have you seen as you're going through renewal season right now?

**Ramy Tadros**

Good morning, Jimmy. It's Ramy Tadros here. In terms of the margins this quarter and if you look at the year-on-year comparisons with respect to life, we're actually slightly up between this year and last year. We came in at 87% and slightly higher -- lower than our midpoint. And what drove the difference quarter-to-quarter -- quarter-on-quarter is the higher incidence.

With respect to the Non-Medical Health loss ratio, clearly that was below the low end of our guidance. And that's largely driven by the lower claim sensitivity -- severity rather with respect to disability and higher recoveries.

Look -- if you look at these ratios, they do fluctuate quarter-to-quarter. And we would expect generally to come in towards the middle range -- the middle part of our range. Having said that, I would emphasize that if you look at it year-to-date -- our year-to-date numbers in mortality -- if you look at last year for example, our year-to-date numbers for mortality came in -- we were below the bottom half of our range. And you looked at Q4 and we came in, smack in the middle of that range.

So if you think about the competitive environment, we still operate in a highly competitive environment. But when we look towards 2020, we're pleased with our rate actions and we're pleased with our renewal actions as well.

**Michel Khalaf**

Maybe -- hi, Jimmy its Michel. Maybe I just would add one comment with regards to Non-Medical Health, which is coming in favorable and below the -- sort of in the lower half of the range, which we think will continue for the year. And that's a combination of the favorable disability experience as well as the shift in product mix to voluntary, which has a lower benefit ratio and that we continue to see strong momentum in voluntary, and we think that will persist and continue.

**Operator**

Your next question comes from the line of Tom Gallagher from Evercore ISI. Please go ahead.

**Tom Gallagher**

Good morning. A couple of quick ones for you. Is there – John, is there any go-forward earnings impact from the actuarial review, is my first one. Second one is just, can you discuss how well hedged? Or to what degree you have hedges for your long-term care cash flows?

**John McCallion**

Good morning, Tom.

**Tom Gallagher**

…thanks.

**John McCallion**

Yeah. You broke up there. I think I got it. The first one, I think the quick answer is no. First, I think 100 of the 160 was right in line with what we shared back in 2Q with regards to the drop in long-term interest rate. So that came in as expected.

And then we had a variety of other items and it was mainly the regulatory closed block that drove the remainder there.

In terms of long-term care, we do have some quite a bit of hedges on. And actually I'd say, we've locked in kind of the investment returns for the next five years or so. We have a number of forward starting instruments that we've entered into over time. So we're kind of protected for the next five years. And obviously, we have hedges beyond that. But rollover reinvestment risk would persist beyond that.

**Tom Gallagher**

Okay. Thanks.

**Operator**

Your next question comes from the line of Andrew Kligerman from Crédit Suisse. Please go ahead.

**Andrew Kligerman**

Hey, good morning. First question, Ramy could you elaborate on what you were saying about pleased about renewal actions. Could you give us a sense of maybe pricing? Is it up in group? Is it flat? What made you pleased?

**Ramy Tadros**

Good morning, Andrew. I mean, look if you think about by way of context as we just look into 2020, when we think of our business, we look at overall growth in the business across both renewals as well as sales. So sales are an important component of that growth but we also focus very heavily on renewals in getting our rate actions combined with strong persistency.

We're still in the midst of our 2020 sales and renewal season. It's more mature for national account less earlier in the season for regional and smaller accounts. But with respect to national account activity, strong quote activity. We're still winning our fair share. We're seeing less of the jumbos come to market and we're defining jumbos as sales over $20 million.

And we have expectations in terms of targets, in terms of renewal rates and sales and so far so good, where we're actually in line with our expectations. And we also continue to see strong momentum in voluntary, as Michel mentioned, and we continue to deploy new capabilities in the market, especially around enrollment and reenrollment in the voluntary space.

**Andrew Kligerman**

Okay. So -- all right. Well, as I go through the next question maybe Ramy you could just say up or down on pricing or neutral. But the next question would be with regard to capital. So you've guided to a 65% to 75% payout ratio. And last quarter the payout ratio was 88%. This year – this quarter it was 100%.

You're kind of at the midpoint of your liquidity at the parent company. So the question is, can you keep this payout ratio well above your guidance. And maybe you could give some color on redeployable capital at the subs in addition to what you have at the parent?

**John McCallion**

Good morning, Andrew. It's John. Let's just to kind of level set. I'd say our guidance has been a 65% to 75% free cash flow ratio on average over a two year period. And obviously, in any quarter that can fluctuate one way or the other.

In terms of – and what we've said in the past is without barring other strategic investments that would meet risk-adjusted returns that we believe would be appropriate, this capital in our minds belong to the shareholders. And Michel has talked about that quite a bit. And so all else equal, that would be used for dividends and share repurchases.

But to your point, I think Michel commented that in his opening remarks, we have accelerated a bit of that this year. I wouldn't consider this a run rate. And I think as Michel mentioned, we probably pulled -- we're opportunistic this quarter and given timing of cash flows and things like that.

**Andrew Kligerman**

So there's capital in the subs as well that might be re-deployable? Curious if there are any numbers you could give us?

**John McCallion**

Well, we have -- we've talked about our normal operating level and a minimum of 360% under an NAIC RBC ratio for the combined U.S. entities. Last year, we were above that. But I'd say I think about our 65 to 75 on average for a two-year period is the right number and it can be -- it can fluctuate from quarter-to-quarter. And then I referenced Michel's comments earlier that we were opportunistic this quarter and we accelerated some of the share repurchases in the quarter given market dynamics and timing of cash flows.

**Andrew Kligerman**

Got it. And just a quick up/down from Ramy on the pricing in group?

**Ramy Tadros**

I would say in line.

**Andrew Kligerman**

In line. Thank you very much.

**Operator**

Your next question comes from the line of Suneet Kamath from Citi. Please go ahead.

**Suneet Kamath**

Thanks. Just first on statutory results. John, any thoughts on AAT reserves as you go into the year-end filing?

**John McCallion**

Not at the moment. We're working through the process now. It's that time of the year and I don't -- there's nothing concerning at this point. We're just going through the process.

**Suneet Kamath**

Got it. And then on the RIS spread, I think you said still feel comfortable with the lower half of the 100 to 125 guide. Was that for the fourth quarter? Or was that sort of a full year expectation?

**John McCallion**

Yes. So, my commentary is regarding full year and we've talked about this guidance as a full year guidance. So, we said we'd be within the 100 to 125, albeit at the bottom half of the range.

And maybe just a little additional color because it's a good question. I think -- look, sequentially we're down about 17 basis points, 12 of that was in RIS which is the allocation of VII. They had actually a pretty high VII allocation in the second quarter.

And then the remaining drop was the function of just lower rates and the inversion of the curve as well as I mentioned just a little bit of the dislocation we saw in the repo market. But as we look forward and the projected forward curve does support a view that we're -- we believe we're at the bottom of the spread compression or near it, let's say, and at least for the near-term and maybe you say next several quarters.

And so maybe in other words to look at this you'd say that this spread is a decent run rate in our mind. And we think of that as VII which has been a heavy contributor probably normalizes some and we see an improvement at least based on the forward curve in the spread ex-VII over the next several quarters.

**Suneet Kamath**

Great. Thanks John.

**Operator**

Your next question comes from the line of Ryan Krueger from KBW. Please go ahead.

**Ryan Krueger**

Hi, thanks. Good morning. Outside of the few cents of higher expense initiative costs in the fourth quarter, can you help us think about the potential sizing of typical seasonality in the direct expense ratio for 4Q?

**John McCallion**

Hard to estimate exactly from a sizing perspective, but we do typically see it happen in the third and fourth. I'd say, we did not see it come through yet in the third. So we do expect there to be an uptick in the fourth quarter on that direct expense ratio as you said ex the UCI onetime time costs.

It's not so predictable. It depends on some of the marketing costs that we deploy in our enrollment capabilities there, as we move through enrollment season and so it can vary. But I'd say, there's an upward trend and probably as I said heading -- it's ahead of what we've seen certainly year-to-date without question.

**Ryan Krueger**

Okay. Got it. And then on P&C, can you give a little bit more color on what you saw in the underlying loss ratio? And to what extent do you think it may remain somewhat elevated near term?

**Michel Khalaf**

Yes. I mean, if you look at the year-on-year results with respect to P&C, I would say the drop is 50:50. We've had a -- 50% of the drop was due to the elevated cat losses this quarter. I'd remind you should compare that as -- compared to a fairly benign Q3 of 2018. But the losses this quarter were very much inline with our expectations for third quarter.

The other 50% of it is the higher severity in the auto liability coverages and particularly bodily injury cranes. This has been consistent with what many others have seen in the industry we continue to monitor these trends and we have a track record of adjusting our rate activity accordingly and looking to take rate actions to make sure we continue to remain within our target combined ratios.

**Ryan Krueger**

Okay. Thank you.

**Operator**

Your next question comes from the line of Erik Bass from Autonomous Research. Please go ahead.

**Erik Bass**

Hi. Thank you. Just curious how is low interest rate environment affecting product demand and new business margins in the RIS business?

**Michel Khalaf**

Hi Erik. So the place where we felt it a bit this quarter is in the immediate annuity sales. We are the largest seller of the institutional income annuities and we've seen some softness in terms of sales this quarter. As the rates come down the value proposition for the individual buying those annuities decreases clearly. So we've seen some softness there in terms of sales.

In terms of PRT haven't seen it. We still are looking at a very robust pipeline into the rest of the year and into next year and in particular in the jumbo space where we are most active. Clearly of course, if you look at our liability balances in RIS lower interest rates actually grow these balances, if you think about the mark-to-market effect on the fixed income balances there.

**Erik Bass**

Got it. Thank you. And then one question on investments, in your alternatives portfolio, you talked about continued good performance, some private equity, like one that your competitors had and issue with mark down on a specific position. So just wondering, how much exposure you have to large single company positions, either in public or private securities?

**Steve Goulart**

Well like our -- its Steve Goulart. Like our overall investment portfolio, it is broad and diversified. Recall our private equity portfolio is over $6.5 billion across dozens of different managers and more than that in funds. So it's fairly diversified. Obviously some managers may invest in similar investments. But we're scratching our head a little bit too and we can't figure out what might have happened in one of our competitors. We're certainly aware of nothing in our portfolio that would cause an action like that today.

**Erik Bass**

Got it. Thank you.

**Operator**

Your next question comes from the line of Humphrey Lee from Dowling Partners. Please go ahead.

**Humphrey Lee**

Good morning and thank you for taking my questions. Looking at sales in Japan, I think in your prepared remarks, you talked about some of the moving pieces. But given the ongoing low interest rate, and I guess the uncertainty of some of the tax regulation, how should we think about the sales in Japan going into the fourth quarter, and I guess going into 2020?

**Kishore Ponnavolu**

Yeah, Humphrey this is Kishore Ponnavolu. There are two parts to this, right? One is the annuities that John referenced vis-à-vis the bank channel. Of all the channels we have that's probably the most volatile ups and downs. So we've had a couple of high watermarks in the past four quarters. So the year-over-year comparisons are going to be somewhat challenging for the next two to three quarters as far as the annuities are concerned.

When you think about the -- John referenced the interest rate is one driver. There are couple of other drivers as well. Seasonality is another driver and what's going on with the -- mutual fund sales is another driver. But the reality is the overall market is down and we're holding our share. And we'll go up and down with the market. And what we won't do is chase after market share by giving up value.

Vis-à-vis, the A&H side, as you're very well aware of the tax law clarification and changes and that has impacted some of our products, we withdrew a product in the second quarter. So essentially if you take that effect out, our A&H sales are actually up year-over-year. It's going to take some time to make up for a lost product and the lost sales associated with the product. But the fact is as Michel referenced, we're very proud to be very customer-centric and to take actions that are appropriate, that are the right things for the customer.

And there are a lot of actions that we have in place to come back up. But two to three quarters year-on-year comparisons again are going to be a little challenging, but we'll make up. There are a lot of other tools in our arsenal. Thank you.

**Humphrey Lee**

I appreciate the color. Just to revisit back on the Group Benefits margin. Like -- looking at the earnings growth, I think you were guided -- you're guiding for mid-single-digit growth for 2019 and year-to-date at 25%. Like while we understand that there is definitely favorable underwriting in the industry, but the magnitude definitely outpaces the rest of the industry. Like I guess, what do you think if the driver for your block strong performance compared to your peers? And how sustainable is that?

**Michel Khalaf**

Yeah. I mean if you just look at the overall earnings number, it's driven by three things. The solid underwriting results is one of them, and you saw us coming with strong underwriting results, but there are two other components to it. We've had also strong volume growth especially in voluntary. And we've also had favorable expense margins including positive market impact on some of our employee costs in the Group Benefits business. So it's a combination of the three.

I would still continue to guide you back to those ranges and to the midpoint of those ranges. We do operate in a competitive market. And over time, we expect to be back in the middle of those underwriting ratios that we look at.

**Humphrey Lee**

Got it. Thank you.

**Operator**

Your next question comes from the line of Alex Scott from Goldman Sachs. Please go ahead.

**Alex Scott**

Hi. Thanks for taking the question. I guess, when you guys had your outlook last year there was a stress sensitivity for interest rates that suggested about $200 million for 2020. So I'd just be interested if there's any action you've taken this year that would have changed that at all. Because, I mean, just looking at distressed scenario, it does look like we're about there or maybe even a little worse than the stress case that you outlined, so any color? And I guess additionally, how much of that $200 million would maybe already be in the result at sort of the 144 EPS that was reported?

**John McCallion**

Good morning, Alex. It's John. Yes, we did give a sensitivity back in the outlook call. We showed a 100 basis point parallel shift in the curve from rates projected to based on the forward curve at that time. And as you said, we are well below that. I think the 10-year is probably down more like 150 and also wasn't parallel. We had a LIBOR drop of maybe 100 or so. So the dynamics are a little different in that sensitivity.

I think in general, I'd say that we feel that sensitivity was broadly in line but we've had some additional pressures come through that are in the numbers. For example, as we've mentioned before, SEC lending has not performed as well as it has in the past. It's still ROE-accretive and a good tool for us but maybe not as profitable of a tool as it has been in the past, which is a good reason to have a diversified book of market-leading businesses, right and to kind of have that at different times when we need it.

So I'd say that the impact of interest rates has probably been a little heavier than what that 100 basis point drop has shown. I'm not so sure that necessarily carries forward, based on what we see to next year. But I'd probably would all else equal go back and say that again, it was meant to be a drop relative to what you would have otherwise expected, not necessarily a year-over-year drop if you think of it that way. So you'd have to work off your own models there and think of it that way. But I think it's probably relatively in line and you'd have to apply some proportional approach to it. Hope that helps.

**Alex Scott**

Yes that's very helpful. And then maybe a follow-up on just thinking through top line growth, you have some businesses growing nicely. Holdings obviously, running off. Sales may be slowing a bit in Asia. When I think about all of the puts and takes, do you expect top line to be growing over the next couple of years? And I guess related, do you think you can get any operating leverage coming through in the form of that direct expense ratio still maybe continuing to drop a little bit as you achieve that?

**John McCallion**

Yes, in a month or maybe less or a little over a month we'll be giving you an outlook. I think we can go business-by-business. It's a little hard to do things at an aggregate level when you think of PFO sometimes, right just because the accounting for instruments can vary. So you have to think about that volume growth or opportunity based on different metrics. Sometimes PFOs are really good. Other times assets under management are better. And I think you're going to have to think of it business-by-business. But I think we believe we have a diverse set of businesses that gives us the ability to compete and win in a variety of economic cycles. That's one.

Two, to your point of operating leverage, I think we've been showing that we can deliver despite -- in a variety of markets. We're well on track to meet our commitment by 2020 and I think if you did your own math today off of the annualized PFOs from a direct expense ratio, we're very close to the 800 I think mathematically already.

**Alex Scott**

Thank you.

**Operator**

Your next question comes from the line of Josh Shanker from Deutsche Bank. Please go ahead.

**Josh Shanker**

Thank you for taking my question. First question, I just want to understand the -- I guess the product introduction cycle and maybe the sales cycle in Asia. Obviously, we're seeing sales down in Japan, but up in other Asian countries? Are there new products coming in? Are the older products getting, sort of, I guess stable in the marketplace? What's happening in the various sales cycles?

**Kishore Ponnavolu**

So, this is Kishore. A couple of points. Overall, Asia, if you take Japan and Asia, the Other Asia together were down. Let's take Other Asia; we're up 8% on a constant currency basis. As John referenced Hong Kong, so if you exclude Hong Kong, which has now moved into discontinued ops, we're up 15%. And the three countries that drove that are Korea, China, and India.

Now, we have a portfolio of countries and that's the good thing about the resiliency, right? So, if you exclude Hong Kong, overall, John referenced that Asia is actually up 1%, right? So, that's how it works.

Now, with regards to each country, it's hard to go in and talk about product cycles because it's complicated per se. In Japan, generally speaking, our product cycles are longer because it's a more mature market and we take a little longer to react to changes in the marketplace or customer demands. But at the same time, these are all the things we're working on is to shorten that, increase our response time and to be able to react to these changes effectively. I hope that helps.

**Josh Shanker**

It helps. Great. Give more detail on the products, but I'll keep digging. And then in Property & Casualty, I'm trying to find out if 3Q 2018 was a light cash -- light catastrophe quarter or 3Q 2019 was a heavy? We haven't seen these kind of U.S. cat losses that some others, so trying to figure out how to think about that going forward?

**Michel Khalaf**

I would say Q3 2018 was a light one and Q3 2019 was right in line with expectations.

**Josh Shanker**

Okay, that's great. Thank you.

**Operator**

Your next question comes from the line of John Barnidge from Sandler O'Neill. Please go ahead.

**John Barnidge**

Thanks. I understand the P&C business has more of a Northeast bend, but can you kind of talk about exposure to the California wildfires please?

**Michel Khalaf**

Sure. If you look at our exposure in Q3 of last year, it was pretty benign in terms of the fire exposure. And you're right in terms of our geographic concentration, if you look at our market share in California, in home and compare that to the average market share that we have nationally, our market share in California is less than 75% -- 75% smaller than our national market share. So we're relatively less exposed there.

**John Barnidge**

Okay. And sticking with P&C. I get that you're talking about the increase in cats. But backing out both cats and reserve development, the underlying combined ratio looks like an increase 250 basis points from a year ago and 91.4 versus 88.9. Can you talk about maybe social inflation you may be seeing?

**Michel Khalaf**

I mean it's really the two factors I've talked about. So if you back out the cats, if you look at the earnings number, that just – that explains about half the difference. And the other half is specifically inflation in bodily injury claims. And there you talk about medical inflation cost, more litigation, more attorney-represented claims. And that's the trend we're watching carefully and taking appropriate rate actions against it.

**John Barnidge**

Is there anything you can say around loss cost trends, peg it at a certain percent? Thank you.

**Michel Khalaf**

Yeah. Not really at the moment.

**Operator**

And at this time, there are no further questions. I'd now like to turn the conference back over to John Hall.

**John Hall**

Thank you, everyone, for joining us today. Have a happy Halloween. Talk to you soon.

**Operator**

Ladies and gentlemen, that does conclude your conference for today. Thank you for your participation and for using AT&T Executive Teleconference. You may now disconnect.