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Prudential Financial, Inc. (PRU)

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MANAGEMENT DISCUSSION SECTION

Ryan Krueger
Analyst, Keefe, Bruyette & Woods, Inc.

Good morning, everyone. It's Ryan Krueger from KBW and really pleased to have Prudential Financial with us at the conference virtually this year. With me is Rob Falzon who is Vice Chairman. Previously to that, Rob was the CFO for several years and prior to that he was Treasurer.

Rob, I wanted to kick it to you just to provide some opening remarks, and then we'll get into the Q&A.

Robert M. Falzon
Vice Chair & Director, Prudential Financial, Inc.

Great. Thanks, Ryan, and thank you, everyone, for participating today. I thought what I would do is – I know, Ryan, you're going to want to cover a number of topics, but I thought I'd just share a couple reflections that I have on the current environment and three specifically that I just wanted to sort of share with everyone.

The first is that while we're finding ourselves in a challenging sort of macroeconomic environment, so the pandemic, the recession that's been caused by the pandemic, the associated impacts on the credit cycle and on interest rates, I'd like to remind people this is what we're built for. This is actually what we've planned for. We have a whole series of playbooks that we've devised after the Great Recession and that we anticipate a range of things that could happen both from a pandemic and from a recession standpoint and range of things that are far worse than what we're experiencing. And the intent is to continue to be resilient through that, and we have been. We feel really good about how well we're capitalized, we feel really good about the quality of the portfolio, and we feel really good about our operational integrity and how we've been able to continue to have a good experience for our employees and for our customers throughout this period of time.

Having said that, I think to the extent we have a concern, the concern is actually about customers and what's been exposed during the course of this experience in this relatively short period of time, is just how fragile the economic and their own financial resiliency is for many Americans, and even outside of our own country.

And for that, we're particularly concerned. They're unprepared for disruptions and dislocations because they don't have enough savings for those sort of things. They are unprepared for retirement. And in many instances now actually dipping into some of that retirement savings in order to be able to support themselves in current times. And many are woefully underinsured from a life standpoint.

I don't want to call it a silver lining, but from our standpoint and from an industry standpoint, the opportunity that that creates is the level of awareness about the benefits of what we do, about what we are in fact built to do are all the more present and visible to our customer base.

And so as we look at this, we look at this as the opportunity to execute on what we've talked about before, which is expanding our addressable market by providing more customers with more products and services going across the entire socioeconomic spectrum and not just being focused on sort of the very high net worth that we and many of the industry have been particularly focused on. So, that's kind of my first and second observation.

With regard to that second piece, I think we view ourselves as being very well positioned to execute against the opportunity that's in front of us. We think to do that well, it really requires that you think differently about distribution, you think differently about product. And you think differently about your cost structure from a distribution standpoint. I'd like to use the phrase of sort of omni distributions, not multi-channel distribution, it's actually around omni distribution. It's having a complete continuum that goes from digital to fully advised and with hybrid-type experiences that fall in between that.

From a product standpoint, as you go deeper into the market, it requires that you pivot to things that are frankly more simple, so less complex products that meet the needs of that expanded marketplace. And sort of then segueing into the third component of that, cost efficiency also needs to be priced appropriately for that marketplace. So, that means that we need to think about our cost structure in a way that continues to make us competitive in the marketplace and allows us to mitigate some of the impacts that are occurring as a result of the low rates and the headwinds that that creates to our own profitability.

I think the third and last thing I'd share about the current environment is that as a result of what we're all going through, we've seen this really sort of quantum acceleration and we know we used to label the future work and the future of the workplace. And for us, that's meant sort of a much more rapid adoption of technology and the digitization of the experience for the customer. It's been helpful because in a crisis, regulators removed some of the impediments to our ability to do that, so that's been helpful. But we removed some of our own impediments to do that.

And as we were looking at how do we meet surging demand at our call centers and other – and for – and claims and other types of inquiries coming in, digitizing that experience and creating chats and online resources for people as opposed to their need to speak directly to – wait on the phone on hold to speak to a human has been a massive acceleration of that and a good experience for our customers as a result as well.

And that's gone through the entire food chain, so it's about creating that experience everywhere from underwriting through claims payment. That has, from our own standpoint, not only accelerated our ability to execute on the customer experience and efficiency initiatives that we already outlined at the beginning of last year, but it's also part of what's allowed us to think more expansively about that as we've institutionalized that capability, thinking about how we can go further in terms of creating those kind of experiences for our customers and enhancing margins associated with our businesses.

So, three observations just to kind of where we are in the environment. I think that while a challenging environment, we feel as if we're extremely well capitalized and positioned from a portfolio and operational standpoint. We have a set of initiatives that we're very much focused on that I think are well aligned with serving the needs of customers as they've experienced this both pandemic and economic scenario that we've been under. And we also think that the initiatives that we're doing around our efficiencies will position us to be able to execute on that end and improve the profitability of the firm for our investors.

So, thanks for the opportunity. With that, Ryan, I'll turn it over to your questions.

QUESTION AND ANSWER SECTION

Ryan Krueger
Analyst, Keefe, Bruyette & Woods, Inc.

Q

Thanks, Rob. And some of my questions will build off of those opening comments. To start, it's been almost two years now since you became Vice Chairman and Charlie Lowrey became CEO, and Prudential's strategy has evolved some during that time. Can you discuss some of the key changes that you've made as well as the reasons for doing so?

Robert M. Falzon
Vice Chair & Director, Prudential Financial, Inc.

A

Yeah. So, that really gets to sort of the pivot we made, I think, in the second quarter from the first quarter around the narrative in the first quarter being very much around resiliency and all the things that I talked about and the second quarter really being around how were we going to enhance shareholder value and returns for our shareholders. And I think there were three things that we identified as sort of the priorities that we had that were impacted by the economic environment we find ourselves in. You go back to the beginning of 2019 when Charlie and I kind of stepped into our positions, interest rates have declined around 200 basis points on the 10-year over that period of time. So, it's breathtaking, in a way.

And so, as we think about how do we deal with a low interest rate environment and what are the opportunities in front of us and how we execute against that, the first thing that we really were focused on is that we need to improve the quality of earnings is how I kind of like to describe it. And so from a quality standpoint what that means is that we have less interest rate and market sensitivity in our businesses and that those underlying businesses produce a set of financial outcomes that are more consistent and predictable. And we think if we're able to do that, that leads to a reduction of our cost of capital or [ph] extension of multiples, sort of think (00:08:40) about it that way. And so, we've used the phrase in the second quarter of simplifying and derisking, and that's sort of what that was meant to capture.

The second piece has been around – our focus has been, okay, improve quality of earnings, now improve the profitability of our businesses. And from a profitability standpoint, that gets very much around the initiatives that we announced in 2019, the $700 million of investments we're making in order to generate $0.5 billion of margin enhancement. And as we talked about in the second quarter, and I mentioned earlier the ability to we think expand on that as we've institutionalized that capability in our firm, we've seen sort of more opportunities.

And so that's sort of our second focus, get the quality of earnings up, get margins up, and then growth. And I think growth will come about by virtue of what we're doing from the profitability, obviously. But from a longer-term growth standpoint, it's really very much about the expanded addressable markets that we see for each of our businesses and to the extent [indiscernible] (00:09:54) we can talk about those. But both in our Investment Management business, International business, and in our US businesses we see an opportunity to accelerate our growth by expanding the number of individuals that we can serve.

Probably the other thing that doesn't get noticed enough, I guess, the thing I'd like to say, that we spent a lot of time on is our leadership team. We have – since we've taken the reins, we've – most of our – the leadership of most of our US businesses have changed over that period of time. So, we've had succession planning that have put in place the leaders of those businesses. We stood up a transformation office. We took one of our most successful business leaders and put that person in charge of that capability. That's leading to our ability to have accelerated the execution of the $0.5 billion of benefits, and to think about how we can do that more expansively.

We hired a new Chief Information and Technology Officer, Stacey Goodman, a little over a year ago and significantly redesigned our technology organization, pivoting it away from sort of the traditional focus on maintenance and operations and toward a business enablement and development applications. And under Stacey, if you look at the 10 next most senior leaders there, half of those individuals are new to position from outside the company. And in fact, from outside the industry.

And so, a big, big investment from a technology standpoint. That's been helpful to what we've already accomplished in our initiatives, and we think will be additive to that on a go-forward basis as well. And then, we've selectively – we've put a new Head of Strategy in place and other selective hiring.

So, we spent a fair amount of time on our leadership as well. We think all of that is paying dividends. And if you just give me one more minute, Ryan, to sort of – and couple of things I want to tick off.

So, if I think about – if I just sort of think about PGIM, International, our US Businesses from PGIM standpoint, the company had a record level of AUM in the second quarter, positive flows in that quarter, have strong flows from a retail standpoint. Number one, mutual fund flows to retail in the first half of the year. But also, institutional has been strong as well [indiscernible] (00:12:17) because we have a single large client in the second quarter that was an index low fees, so not very significant from a revenue standpoint, exit out. But otherwise, had good institutional flows. So, performance continues to be good there. Flows continue to be good and we continue to build and invest in our international capability, our retail capability and our alternatives capability.

Those are the levers for growth within that business and we've done something on – relatively recently in all three of those areas that are helping to produce the kind of results that you're seeing within PGIM.

From an International standpoint, we've talked about the way in which we want to expand our addressable market there is in Japan, we have a phenomenal franchise. It continues to grow faster than the overall market does, and we see an opportunity to capitalize on that franchise by providing more products into that marketplace than the traditional protection, life protection type products that we sold. So, we can – as that demographic ages, meeting the new needs of that age demographic through our existing distribution, which is incredibly strong.

Outside of Japan, we wanted to do a major pivot to say, okay, we're going to have a big play in a developed market in the US and in Japan. We want to have more of an exposure to emerging markets outside of that. And so, what you've seen is we've exited out of Italy. We exited out of Poland. We exited out of Korea. We've announced the sale of our business in Taiwan as well. And so, those more mature markets we've exited out of. And pretty much below the radar but not uninteresting, we've expanded what we're doing in Brazil. We have done the group acquisition a little while back. But more recently, we did a bancassurance agreement in order to expand on our very, very strong Life Planner platform that we have in Brazil.

In our foray in Chile, we've done acquisitions through that business. Most recently in Colombia, we're trying to create sort of a pan-LATAM foray capability out of that business, a small expansion in our Africa presence. And so, building in exiting out of the things that are slower growth and were developed and selectively looking to build on where we have an existing presence in emerging markets that [indiscernible] (00:14:23) here sort of complexion to our International Business.

And then, finally from the US Business standpoint, a number of things there. We continue to execute well on the financial wellness platform in the workplace. We've talked about that has a longer-term growth strategy for us, but we think important to our competitiveness in that space on the direct basis, institutional competitiveness, but then, also, the ability to get to the underlying employee and provide more solutions to them to grow our business.

We've been – we bought the insurance business at the end of last year, which has added to our – that distribution capability that I spoke to. So, a big presence in digital, and then they do a hybrid as well distribution, so we feel as if we got now a leading-edge capability on the digital side and an ability to provide more products to sort of a pure distribution broker standpoint into our customer base.

And then, as I mentioned, the success that we've had in accelerating both the costs associated with our initiatives. So, through the middle of this year, we've already incurred $450 million of the $700 million that we said would be needed in order to regenerate the $0.5 billion worth of economies. And we disclosed at the end of last year that we expected to be able to accelerate also the realization of those operating margin improvements from what we were talking about as well. And our performance in the second quarter, I think, kind of reaffirms our ability to do that.

And then, looking as I said to see how we might be able to expand on that in the future. So, those are things that are our priorities and that's the progress I think we're actually making against those priorities.

Ryan Krueger
Analyst, Keefe, Bruyette & Woods, Inc.

Q

Thanks. On the cost saves, as you talked about you have this, the $500 million plan for by 2022. You've also talked about the potential to do more. Can you discuss where you see additional opportunities and then also when do you anticipate that you might quantify the potential there?

Robert M. Falzon
Vice Chair & Director, Prudential Financial, Inc.

A

Yeah. So, we'll be pulling – so, first, in terms of where we are. I think in the first half of the year in-period, we realized $75 million of in-period savings. The number we put out there was an expectation of $140 million for the full period. So, now we're sort of ahead of pace on that. Expectation would be that we would get to a run rate by the end of the year somewhere between $250 million and $300 million. And then, the $0.5 billion number by the end of 2022.

So, the run rate benefit in – as of the end of the second quarter trying to think of a – I'm now going – [indiscernible] (00:17:15) go by memory too much over the numbers. But it's well on the way to the objective for the full year, and so we feel good about where we are both in terms of in-period savings and our run rate.

As we look to expand on that, I think the single most important thing I'd point out is what I mentioned in the room, we talked about – when I talked about leadership, is that we've actually institutionalized this capability, so we set up a transformation unit office. And we took one of our strongest business leaders at a position to put them in charge of that capability. And we're obviously working with consultants in bringing them in as well but we staff that. And their task has been to not only look at the acceleration and execution of what we had in pipeline, but to look across our businesses as opportunities to go further. And I think as we think about that, we think within our existing businesses using the existing levers we have.

So, it's the classic set of leverage you have around automation, digitization, use of technology, location strategies including outsourcing, process redesign, all of those sorts of things, organizational redesign. And [indiscernible] (18:23) just sort of push them further in areas where we've already focused, which has been primarily around sort of our US business and functions. And while we had included both our investment management in International, and some look at that, the reality is we have a lot more opportunity both in investment management and in International when – vis à vis, the very robust process we went through with our US businesses and functions. And so, we think there is more opportunity there to take the same set of tools and apply them across our entire business complex, so more broadly than we did before.

The other thing I've mention is I think we've just scratched the surface on technology. With the new team installed, most of which were put into place this year, maybe end of last year. The – we've only begun to scratch the surface on what we think are the availabilities there, particularly from an infrastructure standpoint and how we think about the spend that we have there, and can use it not only to produce better outcomes but produce better outcomes at a lower cost.

Ryan Krueger
Analyst, Keefe, Bruyette & Woods, Inc.

Q

Thanks. On the second quarter call, you had also discussed potential in-force derisking actions for variable annuities and universal life and secondary guarantees. A couple questions there. I guess one, just what led to that decision? And then secondly, when you're considering reinsurance transactions, how do you balance the potential – I guess, potential outcomes that differ from your view of the economic value of those businesses but you achieved the desired derisking impact that you're looking for?

Robert M. Falzon
Vice Chair & Director, Prudential Financial, Inc.

A

Yeah. So, I'd say, Ryan, we talked about the products pivoting that we're doing and replacing it, we're doing that. And think about that is really just the first step in this broader issue of simplifying and derisking. And so, stepping back from HDI and from single life GUL and looking at things like FlexGuard in annuities as products that have significantly less market sensitivity.

And also associated with that, more predictable and consistent financial outcomes both on an AOI and a GAAP basis because we're sensitive to both those metrics. As we thought of that, I think the sort of related to what I spoke about earlier, we are – we believe that if we can reduce the market sensitivity of our business and in conjunction with doing that improve the consistency and predictability of financial results that that will have a very direct impact on our multiple, on our valuation. And I think that there are certain product lines that we have. And I think HDI would be – maybe a [indiscernible] (00:20:59) to be completely frank about it where we think the economics are actually incredibly compelling. It's a very high ROE business. It has good cash flow that's associated with it. It's extremely well-capitalized and is well-hedged.

Having said that, the market's perception of that business, the public market valuation of that business is not sync up with what we would think would be our own valuation or private valuation for that business. And we try to be more transparent to try to get that synching to occur. But it's not. And I think there's a reality of – even with all that hedging and good outcomes, the reality is it does have some market sensitivity associated with it and it does have some accounting volatility that's associated with, sort of below the line or outside of the AOI. And those become, from a valuation standpoint, I think headwinds from our overall value.

And the challenge we face is that it seems that it's not just applied to that sleeve of the business but rather to the totality of our businesses. When you sort of look at the valuation of the company in total, it seems to be overly influenced by the variable annuity component of our business. And so, we recognize that this isn't just a matter of transparency. This is just a matter of valuation differentials that exist in the marketplace and we need to be responsive to that.

And so, from our standpoint, that was sort of part of the catalyst of recognizing that overall and then using HDI as a very specific example of that, how we can improve valuation by being more thoughtful about how we continue to – we can continue to serve the needs of consumers around life protection and around retirement protection, but do it in a way which we has less market sensitivity and more predictable – and consistent financial outcomes associated with it. So, those are kind of the catalysts that were associated with it.

In terms of how we think about it, obviously we've already taken actions on the new business side. We have blocks of those business which will continue to generate earnings. And when we look at that, we have the option of just running them down and harvesting the cash that's coming off those, and that's one viable option. But we are and will continue to look at other alternatives that can range from selling pieces of those business or reinsuring pieces of those business to getting rid of the entire blocks either through reinsurance or sale as a way to sort of accelerate that transformation.

And we'll be economic about it. We'll look at the tradeoffs to value in the market that we can achieve today or at other points in time against what we think the implication of that would be on the valuation of the stock in the marketplace. And hopefully, make an execution there that optimizes the outcome for our shareholders.

Ryan Krueger
Analyst, Keefe, Bruyette & Woods, Inc.

Q

Thank you. I guess on, I think, it was exactly a year ago, it was actually at our – the same day of our conference last year, you announced the acquisition of Assurance IQ, which is an InsurTech distribution platform, for those unfamiliar. You then got off to a bit of a slower start than expected, but how are things progressing now and to what extent are you, I guess more broadly, integrating it into Prudential?

Robert M. Falzon
Vice Chair & Director, Prudential Financial, Inc.

A

Yeah. So, if I think about Assurance IQ, first it is a proven model for digital distribution and that was what was a very attractive to us about that. They kind of cracked the code on digital distribution linked with this sort of hybrid advisor capability and was actually quite – has been quite successful in a relatively short period of time as an insurgent. And that capability we thought would leapfrog others in the marketplace from the standpoint of us having that capability. And so, we continue to be quite enthusiastic about strategically from that standpoint.

We've talked about the fourth quarter of last year. The fourth quarter of last year was – I think about it as a bottleneck issue for us. The good news for us is that the fundamental indicators of the strength of that platform continue to be quite good. The shoppers to this site continue to grow at double-digits. And the demand by insurers to get on to the platform continues to be really strong as well.

And so, you sort of think about we just need to make sure that we have the operational capability to close that gap, and we had a couple of hiccups in the fourth quarter that Andy and team have been addressing with the assurance team to make sure that we're well positioned for the fourth quarter of this year, when you've got the big driver being the Medicaid, Medicare enrollment period.

And so, we feel really good about drivers to the business, and about having that capability in terms of making us more successful at providing a broad range of products, now all of which, we want to provide. We'd rather take health solutions and P&C solutions from other providers. We don't want to get in that business, but they're important solutions for the customers that we're serving. And so, to be able to do that on a third party through a distribution or brokerage arrangement is actually quite attractive to us.

With regard to our own products, we put our Simply life term product on their platform which was actually transformational for both them and for us, transformation being significant. It hadn't transformed anything yet, but it's been – it was a significant milestone, I guess I should say, for both of us. The fact that we were able to do that actually well ahead of schedule speaks to sort of the rate of which we're learning to adapt to the new world and pivot and change.

And from their standpoint, having our brand and our product on their platform significantly enhances the pull through of that life products to their customer base vis-à-vis the other life products that they have on their platform already. And so, good mutual outcome there. We think we're licensed and I think in 49 states at this point in time. We'll be licensed across all states by end of this year, beginning of next year. So, pretty close there if we're not there already. And so, we feel good again about having got it and actually [indiscernible] (00:27:05) in place.

From a financial standpoint, it will be a fourth quarter story and we'll be prepared to talk about that when we get into the fourth quarter.

Ryan Krueger
Analyst, Keefe, Bruyette & Woods, Inc.

Q

Got it. What's your level of interest in additional M&A at this point? And I guess, what areas would you view as most compelling?

Robert M. Falzon
Vice Chair & Director, Prudential Financial, Inc.

A

I think about our M&A, I describe it as being programmatic M&A, meaning that it's really about where we can do it on an incremental basis to lever existing strong capabilities that we have. And so, think about in the PGIM context. I talk about retail international and alternatives being areas of growth and focus for us. And so, what we've been doing or making small bolt-on acquisitions. They're oftentimes just look like team left-outs. They're acquisitions, but they look more like the left-outs to add to our multi-manager modeling, and we did that with the Wadhwani acquisition, which was a UK-based futures manager a year plus ago or so.

And those are the kind of things that we're looking to do is continue to build those kind of capabilities on sort of an incremental basis by bringing those small shops on, we can get great economies from that. And so, it's a way in which for us to continue to grow flows and maintain profitability. And without – we're on the same multiple concerns when you're doing those kind of acquisitions and if you're doing a large asset management acquisition by way of example.

The second area would be in International, and that's leveraging our emerging market presence that we already have. So, both the Chile and a foray platform and the Brazilian Life platform being perfect examples of that where what we've done is taken a strong capability, but frankly not large enough yet that is changing the complexity of the PFI. So, we want to grow it and think about how do we leverage that capability in that market by growing our footprint. And so, in Brazil, we built over the course of a decade and a half a really strong proprietary distribution capability, life plan or model, similar to what we have in Japan. Number one, sort of non-bank life seller now in Japan.

And then, we add into that a group capability and then bancassurance, and we have other third-party distribution now as well. So, building multi-distribution capability in a market in which we have a strong brand and good success and the same thing will be a foray business we have. It's quite successful. We're in the sort of leading the foray in each of the markets in which we're serving, and we're going to continue to build on that and that could involve selective acquisition.

Now, having said all of that, I would say, there's a high hurdle to any M&A that we would do. And hence, these sort of things are small where we can get very good economics by leveraging existing capabilities and platforms. As we think about deployment of capital given where our particular share prices these days, buybacks create a very compelling alternative to doing M&A and we're very conscious to that to the extent that we're looking at M&A at any point in time.

And when and as we get to the point where we're ready to take a look at our capital capacity and [indiscernible] (00:30:17) got enough visibility on recovery that we want to redeploy that capacity. We know we would think about how we redeploy that cognizant of the very attractive economics that would be associated with buybacks at this point in time.

Ryan Krueger
Analyst, Keefe, Bruyette & Woods, Inc.

Q

If we delve into that a little bit more, if you're – you have a good capital position, but Korea sale has now closed, so it's – how are you thinking about the key indicators that would get you comfortable resuming buybacks?

Robert M. Falzon
Vice Chair & Director, Prudential Financial, Inc.

A

So, I'd sort of dial back and look at the same set of indicators that caused us to put it on pause. That is we're going to the pandemic, we're anticipating what the recession might look like and what specifically the credit cycle associated with that recession might look like. And that said, okay, we should at this point in time be conservative, maintain flexibility, and sit on our capital position.

And as you noted, we still have – we have $4.5 billion worth of highly liquid assets, cash, and then – at the end of the second quarter. And then, we received about $1.7 billion, I think, on the sale of Korea relatively recently as well, so we do have a very strong capital and liquid position.

But we'd be looking at that same dashboard set of metrics that causes us to put it on pause to take our finger off the pause button where I think the observation would be that the recession specifically, again, the credit cycle has been relatively benign to-date. The – if you looked at the framework that we laid out in the first quarter and you compared actual experience against that framework, it's been very benign, a relatively modest credit cycle.

Now we're not necessarily convinced that that means that the credit cycle will remain benign during the entire recession. And so we're keeping our eye on that. So while there's a host of metrics that are at our dashboard, probably the one that's largest and in the center of that dashboard is credit and we're looking at things around ratios of upgrades and downgrades and trends in that – indicators around the financial health of corporate America. And as indicators as to when we think we'll either be through the cycle or that, in fact, the cycle is not going to manifest itself as being as severe as we might otherwise think it might be – will be indicated by history and the framework that we lay down in the first quarter.

So as we think about, Ryan, restarting, I've said in the past that we don't want to start and stop. If we begin, we want to begin so that we can do it programmatically and with conviction. And that means we're going to be cautious to ensure that we're very comfortable that we've seen the worst of the credit cycle. And then depending on how severe that's been, we'll define how much excess capital we have. If it's this benign, we'll have a fair amount of excess capital. If it turned out to be more severe, we'll need some of that capital in order to respond to the impairments that will happen in a more severe credit cycle. And then what's left after that would be – we will think about redeploying.

Ryan Krueger
Analyst, Keefe, Bruyette & Woods, Inc.

Q

Got it. In your 2019 Investor Day, you guided to a 12% to 14% intermediate term ROE, obviously have had a significant change in the environment since then. As you think about that now, do you still think the lower end of that range is achievable in the current interest rate environment or how are you viewing the return profile of the company?

Robert M. Falzon
Vice Chair & Director, Prudential Financial, Inc.

A

Yeah. I think, the walkthrough that we provide now quarterly, which I think is very helpful to the market, I think probably the best way I could go about answering that, Ryan, so in that walkthrough, the baseline – so we do adjustments that take sort of the results in the current quarter and try to give you an idea, if you remove some of the unusual stuff, so we did the second quarter assumption update, and then we had the COVID experience both from a mortality standpoint. Although it's positive in the second quarter, [ph] we're removing (00:34:28) that experience and the costs associated with that and in the customer and efficiency initiatives, you get to a number that was our baseline for the beginning of the third quarter that was around $2.85 a share.

And then with respect to that number, I think it was actually close – actually, I think it was closer to – it was like closer to $2.90, but we assumed some level of ongoing [ph] initiative (00:34:54) spending. And that gets you down to $2.85. And so if you take that $2.85, and you adjust that there, it doesn't reflect the seasonality in our expenses. We've talked about that number. So we've said that our – since in the fourth quarter, we have elevated expenses that generally range $125 million to $175 million. So you have to adjust the number for – it doesn't reflect the seasonality of expenses, the biggest one being that in the fourth quarter.

And then you have to adjust that for the – with the guidance we've given around the headwinds associated with interest rates and $0.03 per quarter compounding against some opportunity for business growth and the savings that are coming about by virtue of initiatives now, we've incurred $450 million of the $700 million of initiatives [ph] we'll spend (00:35:40). So, that number is coming down fairly rapidly as the run rate benefit of those is climbing fairly rapidly.

And I think in next year you see there's actually a crossover in that where the benefits, the in-year benefits exceed the in-year expenses as contrasted what we've experienced last year and this year. And so, I think that if you do that math I think that depending on your own view of what market growth opportunities are out there, probably gets you to a view of what the near-term ROE potential of a company might be.

And the longer term will be now if we look sort of through this recession through COVID, and then how well we can execute against the – on the broader growth objectives that we have.

Ryan Krueger
Analyst, Keefe, Bruyette & Woods, Inc.
Q

Got it. Look, two questions. Do you think that the GAAP accounting changes that are coming like it's now in 2023 will actually change how you operate the business at all? And then somewhat related to that, are there any other regulatory issues that you're paying particularly close attention to at this point?

Robert M. Falzon
Vice Chair & Director, Prudential Financial, Inc.
A

So, targeted improvements has gotten delayed and there's a discussion around advanced adoption. We haven't decided yet, Ryan, whether we're going to advance adoption yet, so that's kind of still out there. I'm not anticipating that we have necessarily changed – any changes from what we've already talked about as a result of targeted improvements, I think the interest rate and market sensitivity that we're already looking to reduce will be further exacerbated under targeted improvements, but that's something we've already talked about doing. So, I don't – targeted improvements in and of itself is not a catalyst to, I think, further change in how we're thinking about our business mix.

I think there's some real benefits that will come out of targeted improvements. We don't have to deal with the deck unlocking. It will just be sort of smooth, just be locked in and amortized out. You having a mark-to-market on both the asset and the liability side, I think there's a benefit to that. Now, instead of just having [indiscernible] (00:37:50) on one side and then people sort of guessing about what's happening. We saw that in the crisis which is assets getting marked down. There was no corresponding mark in the liability and so that was creating a little bit of a panic.

And so I think having symmetry on that is actually beneficial. Incidentally, from a very parochial standpoint, I think it's really great that everyone's got to do the same accounting on annuities. We've always had this market accounting that we've been sort of alone in that and so we want to be switching over to that, it will make the results on that, I think, little bit more comparable.

So, I think those were good outcomes from it. It will introduce more volatility in the way that FASB has chose to introduce us and some of that volatility will be counterintuitive. And that's a frustration we've tried to – the industry tried to – and people that are on this phone [ph] they have a (00:38:41) a part of that effort, trying to get FASB to think very differently about how they're going to do, this idea of retrospective versus prospective in order to match up better with cash flows. They chose not to do that. And I think that's a shortcoming, and I think the industry is continuing a dialogue on how do we at least figure out as an industry to provide supplemental information that may help to at least get through that volatility on a consistent basis between companies. That's something I know our CFO and other CFOs are working on.

So, I don't – I guess the first part of your question, I've wandered on so much [indiscernible] (00:39:14) I remember the second part of your question around targeted – what was the second part, Ryan? I apologize.

Ryan Krueger
Analyst, Keefe, Bruyette & Woods, Inc.
Q

Just are there any other key regulatory developments...

Robert M. Falzon
Vice Chair & Director, Prudential Financial, Inc.
A

Oh, key regulatory...

Ryan Krueger
Analyst, Keefe, Bruyette & Woods, Inc.

Q

[indiscernible] (00:39:25)

Robert M. Falzon
Vice Chair & Director, Prudential Financial, Inc.

A

Yeah. From a capital standpoint, there's a bunch of stuff that's going on. Nothing that's particularly problematic for us. They're looking at the C-1 charges, so the credit charges. We don't think they have that quite right, so they're still working on it. But there's nothing there that would cause us to invest differently than we're currently investing, although we do think it rewards bad behavior in a marginal way that we'd rather not see be there.

The VA accounting that they're rolling out is something we adopted a number of years ago with both New Jersey and Arizona, our regulators. So, while the details of that are always sort of a little different, by and large, that's a construct that we have in place and we're well-capitalized under that construct. And then the change around the capital construct using discount rates around fixed annuities, so PRT, Pension Risk Transfer business, will be affected by that. But again we've already adopted that. That was something we struck with our regulators that we would account for using those current interest rates several years ago, so that's not new accounting for us.

So, while there are a number of initiatives going on there and we're paying attention to all of them and highly engaged, there's nothing that we find that would be disruptive or will change our own – the way we think about executing against our business. We're also paying a lot of attention to what's happening on a holding company in a systemic basis and we're highly engaged in that, both here in the US and abroad.

I think for us, Ryan, probably the things we're paying more attention to are the things that are sort of across the economy, so the two things I'd probably point out would be initiatives around retirement. So, we had the secure app and there's work being done on secure app 2.0 and we're putting [ph] more in (00:41:03) on that. And I think that will be net beneficial to consumers and to the industry. And looking at consumer protection stuff, and that's everything from the DOL rules and then there's SEC rules to privacy issues to make sure that that gets done the proper way as well, which is mainly around sort of the administration of whatever comes out of those regulations. Those are areas we're paying more attention to than anything that might be specifically happening from an insurance standpoint.

Ryan Krueger
Analyst, Keefe, Bruyette & Woods, Inc.

Got it. I think we are, unfortunately, out of time. So, I really appreciate you participating again this year. And I don't know if you want to make any closing comments. But, otherwise, we'll kind of wrap it up.

Robert M. Falzon
Vice Chair & Director, Prudential Financial, Inc.

No, I thank everyone for their interest and support. Ryan, thanks for the opportunity to do this. And I look forward to our ongoing engagement and talking to everyone when we come up with the third quarter results.

Ryan Krueger
Analyst, Keefe, Bruyette & Woods, Inc.

Great. Thank you.

Robert M. Falzon

Vice Chair & Director, Prudential Financial, Inc.

Okay. Bye now.