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Prudential Financial, Inc. (PRU)

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MANAGEMENT DISCUSSION SECTION

Operator: Ladies and gentlemen, thank you for standing by, and welcome to the Prudential Quarterly Earnings Call. At this time, all lines are in a listen-only mode. Later, we will conduct a question-and-answer session. Instructions will be given to you at that time. [Operator Instructions] And as a reminder, today's conference call is being recorded.

I would now like to turn the conference over to Mr. Darin Arita. Please go ahead.

Darin Arita

Senior Vice President, Head of Investor Relations, Prudential Financial, Inc.

Thank you, Cynthia. Good morning and thank you for joining our call. Representing Prudential on today's call are Charlie Lowrey, Chairman and CEO; Rob Falzon, Vice Chairman; Steve Pelletier, Head of Domestic Businesses; Scott Sleyster, Head of International Businesses; Ken Tanji, Chief Financial Officer; and Rob Axel, Controller and Principal Accounting Officer. We will start with prepared comments by Charlie, Rob and Ken and then we will take your questions.

Today's presentation may include forward-looking statements. It is possible that actual results may differ materially from the predictions we make today. In addition, this presentation may include references to non-GAAP measures. For a reconciliation of such measures to the comparable GAAP measures and a discussion of factors that could cause actual results to differ materially from those in the forward-looking statements, please see the slide titled Forward-Looking Statements and Non-GAAP Measures in the appendix to today's presentation, which can be found on our website at investor.prudential.com.

Also in response to your request, we are changing the timing of our earnings release date starting next quarter. We will report our third quarter results on Monday, November 4, and host the conference call on Tuesday, November 5 at 11:00 AM.

With that, I will hand it over to Charlie.

Charlie F. Lowrey

Chairman & Chief Executive Officer, Prudential Financial, Inc.

Thank you, Darin. Good morning, everyone, and thank you for joining us. As we outlined in our Investor Day in early June, we are accelerating our strategy to bring greater financial opportunity to more customers and to enhance the value we provide to our investors. Across each of our businesses, we are energized by our purpose of making lives better by solving the financial challenges of our changing world. As expectations of our customers rapidly evolve, it's imperative that we move quickly and with urgency to achieve our purpose.

Despite what we would characterize as a mixed quarter, we remain confident about the financial goals we shared with you during our Investor Day. At that time, we increased our return on equity goal to a range of 12% to 14% from the prior range of 12% to 13%. We also articulated how we can achieve a high single-digit earnings per share growth rate over the intermediate term with potential for a low double-digit growth rate over the longer term. The strength of our distinct business model and ability to execute our strategy gives us confidence that we will achieve our financial results.

Our U.S. Financial Wellness businesses, PGIM and our international business offers unique scale and growth opportunities that cannot be easily replicated. In the near term, however, we expect several factors to impact our level of earnings. First, as we discussed on Investor Day, there will be implementation costs from accelerating our strategy. Second, the significant decline in long-term interest rates over the past six months, obviously, affects our spread income and reinvestment rates of our general account. Third, this quarter's assumption update in Individual Life reduced future earnings. And fourth, we expect lower earnings in Gibraltar.

Now, we have ways to mitigate some of these effects. We believe the actions to accelerate our strategy will lead to \$500 million of margin improvement, of which we expect to realize a run rate level of \$50 million by the end of this year. In addition, we can adjust our pricing, streamline distribution and optimize our inforce book all of which we are seriously pursuing.

As we said during our last call and on Investor Day, we're also very focused on connecting our track record of operating fundamentals with commensurate financial outcomes. Quite frankly part of this is on us to produce better financial results and we get it. But part of this relates to better aligning external expectations with our internal forecasts and part of this call is focused on trying to do that.

As a result, we enhanced our disclosures this quarter to help give you better visibility on our expected results and Ken will cover this in more detail. We also continue to explore ways to reduce the variability of our quarterly earnings which as you know has been and remains an ongoing effort.

Turning back to the second quarter financial results, we generated return on equity of 12.9% which is inline with our 12% to 14% goal. We grew adjusted book value per share by 5% from a year ago to a record level of \$97.15. We also maintained a rock solid balance sheet. This provided the foundation for us to return \$911 million to shareholders through share repurchases and dividends.

Our quarterly dividend of \$1 per share represents a 4% yield on our adjusted book value. Our holding company's highly liquid assets stood at \$4.9 billion at the top end of our target range of \$3 billion to \$5 billion.

Turning to slide 3. Our adjusted earnings per share was \$3.14, up from \$3.01 a year ago. Our sales and net flows varied by business and were mixed in this quarter, but we continue to see a robust pipeline of opportunities. During the quarter, PGIM had net outflows driven by a large client withdrawal which was unfortunate, but frankly inevitable from time to time when you are the 10th largest asset manager in the world.

Also Gibraltar had lower sales as we focused on recurring premium product and profitability over the total sales amount which is consistent with the way in which we run this business.

On the positive side, our Retirement business achieved record account levels of \$478 billion and net flows of \$15 billion driven primarily by a robust pension risk transfer pipeline. And our Individual Annuities and Individual Life sales were up 29% and 27% respectively. Our Individual Annuities business continue to generate consistent quarterly dividends to the parent company with more than \$1.1 billion produced over the past 12 months. Finally our Life Planner head count in our International business reached an all-time high.

And with that I'll turn it over to Rob to touch on strategic highlights from the quarter.

Robert Michael Falzon

Vice Chairman, Prudential Financial, Inc.

Thanks, Charlie. I will provide more color on how we're growing our three differentiated businesses: U.S. Financial Wellness, PGIM and International. As shown on slide 4, U.S. Financial Wellness represents our workplace and individual solutions businesses that produce a diversified source of earnings from fees, investment spread and underwriting income.

Our broad set of integrated capabilities including advice, retirement, investments and insurance solutions continue to help people with their financial wellness needs. Our Financial Wellness proposition is resonating with workplace customers, resulting in higher sales and it is resonating with the employees of those customers driving higher participation rates in their employee benefit programs and increased engagement with our advice platform.

We believe this success has the potential to increase the intermediate term earnings growth rate of our underlying U.S. businesses into the mid to high single digits.

There are three drivers of this earnings growth in Financial Wellness. First, we expect increased operating margins across our workplace and individual solutions businesses.

This will result from the comprehensive at-scale solutions that our businesses provide and the investments that we're making to enable our broad capabilities, while enhancing the customer experience.

In the current quarter we incurred about \$20 million of the implementation costs to support programs that will accelerate our Financial Wellness strategy. We believe these actions along with the other programs over the next three years will lead to \$500 million of margin improvement by 2020.

Second, we expect increased revenues in our Workplace Solutions businesses, due to the competitiveness of our Financial Wellness platform and the increased utilization of the existing employer-offered benefits by our clients' employees.

Since the end of the first quarter this year, the number of people who activated our digital Financial Wellness platform has increased from 8.1 million to 8.6 million as of June 30.

This platform provides a digital venue to address a variety of needs, including education on financial wellness topics, assessment of financial health and tools that enable people to take action and improve their financial outcomes.

In addition, our Prudential Pathways program has been adopted by 650 of our workplace clients. In this program, employees of our workplace customers participate in financial seminars, delivered by Prudential's financial advisers and designed to help educate people so they can improve their financial outcomes.

And third, we expect increased revenues in our individual solutions business due to our ability to provide additional solutions, to the employees of our workplace customers, and to other retail customers.

One way we deliver these solutions is through LINK by Prudential, which is our highly interactive personalized online resource that enables people to create a path toward achieving their financial goals.

We began to deploy LINK on our workplace platform last quarter. And we have already made it available to roughly 1.3 million people, up from 200,000 at the end of March. Our goal is to double this to 2.5 million people by year end.

Ultimately, we believe our solutions can change the way people approach their financial health, produce better results for employers and significantly expand our addressable market, thereby enhancing our long-term growth potential.

Turning to slide 5, PGIM, our asset management business has \$1.3 trillion of assets under management. It is a top 10 global asset manager ranking as the fifth largest investor in fixed income, and the third largest investor in the alternative investments area with significant real estate and private platforms.

PGIM is the investment engine of Prudential and benefits from a symbiotic relationship, with our U.S. Financial Wellness and International Insurance businesses. PGIM's asset origination capability and investment management expertise provide a competitive advantage to our businesses helping those businesses to bring enhanced solutions and more value to our customers, both retail and institutional.

And our businesses in turn provide a differentiated source of growth for PGIM through affiliated AUM flows that complement its successful third-party track record. Consistent with our historical earnings growth, we expect PGIM to generate mid to high single digit earnings growth through a market cycle.

This is driven by revenue growth from our proven ability to capture industry flows and market share in the areas where we already have leading capabilities, while expanding our margins.

Our strong investment performance and expertise across a broad range of asset classes, has allowed us to attract flows into higher-return strategies such as emerging markets and alternatives. This focus on higher-yielding strategies and asset classes has resulted in our ability to maintain a 22 basis point overall asset management fee yield.

90% or more of the assets under management have outperformed their benchmarks over the last 5 and 10-year periods, and this investment performance has driven 16 consecutive years of positive third-party institutional net flows, which we're confident will continue despite the \$5 billion third-party net outflows that we experienced in the current quarter. These institutional outflows were mainly driven by a single fixed income client withdrawal of \$5 billion.

We serve many of the world's largest pension funds and other institutional investors and as a result will experience large idiosyncratic inflows and outflows from time-to-time. Our third-party net retail inflows were \$1 billion driven by fixed income flows partially offset by equity outflows. We're encouraged by our pipeline of mandates and our ability to continue to grow PGIM via the investments we've been making to expand our global distribution, the growth opportunities we see in markets such as alternatives, U.S. defined contribution in retail, and international, and the investments we're making in technology.

Now turning to slide 6. Our international business includes our world-class Japanese Life Insurance operation, where we have a differentiated business model with unique distribution as well as other expanding businesses in high-growth margins like Brazil. We anticipate being able to grow earnings in our international business at a mid single digit rate over the intermediate term driven by sustainable revenue growth and stable margins, while continuing to produce ROEs in the mid-teens.

Life Planner sales which are about half of the total international sales in the current quarter, increased by 5% compared to the year ago quarter. This was driven by higher U.S. dollar sales in Japan and continued growth in our Brazil operations. Sales for Gibraltar, which represents the other half of international were 26% lower than a

year ago. This reflects lower single pay U.S. dollar fixed annuity sales in our Life Consultant channel as we continue to focus on recurring pay protection products.

In addition the recent decline in U.S. interest rates resulted in lower [ph] crediting grades, (14:18) which also affected sales. Additionally, sales were affected by continued competitive conditions at the bank channel and lower production in our independent agency channel. We expect these channels to be more volatile sources of growth measured in the short-term due to the competitive market pricing dynamics. We'll continue to innovate new products and consider pricing actions while focusing on maintaining our target level of profitability to improve sales over time, particularly in our Life Consultant channel.

In summary, our differentiated businesses, thoughtful strategies and quality execution continue to serve our customers well and will generate profitable and attractive returns consistent with the intermediate term expectations that we articulated during our recent Investor Day.

And with that, I'll hand it over to Ken.

Kenneth Yutaka Tanji

Chief Financial Officer & Executive Vice President, Prudential Financial, Inc.

Thanks, Rob. I will begin on slide 7 with some enhanced disclosures that we've added this quarter to provide more insights about our earnings for the upcoming third quarter and beyond relative to our current second quarter earnings.

First, we began with our second quarter pre-tax adjusted operating income, which was \$1.7 billion and resulted in earnings per shares of \$3.14. Then when we adjust for these items we get a baseline of \$3 per share for the third quarter before including the impact of future share repurchases, business growth and market impacts.

Now there are three categories to consider. First, the second quarter included a net unfavorable impact of \$49 million from this year's annual actuarial review, which will not occur in the third quarter.

Second, we assumed variable investment income will return to a normalized level, which is worth \$90 million. And third, there are other considerations we expect will lower results by \$30 million in the third quarter.

Gibraltar earnings are expected to be \$15 million lower due to lower sales and lower interest rates and Corporate and Other is expected to have \$15 million of higher expenses. While we have provided these items to consider, there may inevitably be other factors that affect third quarter earnings per share.

Also as Rob mentioned, we incurred about \$20 million of implementation costs to accelerate our Financial Wellness strategy in the current quarter. We hope this slide provides enhanced visibility for future EPS considerations.

Also on slide 18, we have provided information regarding seasonal items by business. One item to note is the end of the Wells Fargo fee arrangement in the first quarter of 2020, which has recently been approximately \$15 million per quarter.

Turning to slide 8. I'll provide an update on capital deployment, liquidity and leverage. We feel very good about the overall strength of our capital position. We returned \$911 million to shareholders during the current quarter through dividends and share repurchases.

Our share repurchase authorization for the remainder of the year is \$1 billion as of June 30. And over the last five years, we've increased our dividend per share by 16% per year on average. As Charlie noted, our quarterly dividend of \$1 represents a 4% yield on our adjusted book value.

We also continued to maintain a rock solid balance sheet. Our regulatory capital ratios continue to be above our AA financial strength targets and our financial leverage ratio remains better than our target.

We are also pleased that Moody's recently acknowledged our financial strength with our credit upgrades. Our cash and liquid assets at the parent company was \$4.9 billion at the end of the quarter consistent with the first quarter of 2019 and at the top end of our \$3 billion to \$5 billion liquidity target range. We look to continue to invest in our businesses to grow, assess acquisition opportunities to build scale or gain capabilities, and return capital to shareholders.

Turning to slide 9 and in summary, we are focused on accelerating our strategy and remain confident in our planned initiatives for growth. We've generated an ROE that is within our goal of 12% to 14% along with a record high adjusted book value per share. We continue to generate strong cash flows that support consistent growth in dividends and other distributions to shareholders and we maintain a robust capital and liquidity position with financial flexibility.

Now, I'll turn it back over to the operator for questions.

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] We'll go to line of Nigel Dally with Morgan Stanley. Your line is open.

Nigel P. Dally
Analyst, Morgan Stanley & Co. LLC

Q

Great. Thanks and good morning. So looking at slide 7, you've baselined the earnings at \$3, would annualize to \$12. This is a quite significant reduction from the \$12.75 midpoint guidance you provided at the outlook call. Now in your prepared remarks you highlighted a number of factors behind that but hoping you can get – run through each of those in some more detail?

Kenneth Yutaka Tanji
Chief Financial Officer & Executive Vice President, Prudential Financial, Inc.

A

Yeah, sure. This is Ken. So, we don't want to update guidance, but what I thought I could do is highlight a few items to consider that were not in our guidance that we gave last December. Now first is we've articulated the Financial Wellness implementation cost, we announced at Investor Day. That's going to trim EPS in the second half of the year.

We also updated this quarter our mortality assumptions in Individual Life and that will have an ongoing impact into the second quarter. And then interest rates that we assumed in our guidance, now where we find ourselves were about over 100 basis points below that. Now, that is partially offset by equity markets that are higher, but those two net to a negative. So if you added all those together, that's worth about \$0.50 relative to our guidance for the second half of the year.

Nigel P. Dally

Analyst, Morgan Stanley & Co. LLC

Q

Okay. And just also I think it looks like Gibraltar earnings are going to be somewhat softer than expected, just details behind that one too?

Kenneth Yutaka Tanji

Chief Financial Officer & Executive Vice President, Prudential Financial, Inc.

A

Yeah. And that's also captured in the interest rate comment that I made, but maybe I'll turn it over to Scott for a little bit more background on that.

Scott Garrett Sleyster

Chief Operating Officer & Executive Vice President-International Business, Prudential Financial, Inc.

A

Yeah. So in terms of Gibraltar, our earnings were impacted by several factors, some of which will persist through year end. Net of the favorable assumptions in Gibraltar, earnings were down about \$35 million year-over-year. And the key contributors to this decline were really driven by two factors.

Underwriting, which was still favorable to our pricing assumptions, was less favorable than last year and that represents about a third of that. And then the balance of the decline was largely driven by higher expenses related to certain technology and end of life system spends, process improvements in automation and investments that we're making to support future growth.

At Investor Day, I noted that TII is starting to leverage some of the capabilities that have been deployed in the U.S. as part of the Customer Office and Financial Wellness initiatives.

And additionally given increased scrutiny on suitability and sales compliance, we're also investing in process and systems that support our distribution including those that ensure appropriate oversight. So, we are accelerating some of these efforts and we expect this level of spend to persist through year-end and into early 2020.

I think looking forward to the balance of the year, as Ken noted, the recent decline in rates and lower sales will also weigh on Gibraltar's year-end results. Meanwhile, the total Japan operations continue to generate strong cash flow to PFI. We distributed \$1.1 billion in the second quarter alone.

Nigel P. Dally

Analyst, Morgan Stanley & Co. LLC

Q

That's very helpful. Thank you.

Operator: Thank you. Our next question will come from the line of Elyse Greenspan with Wells Fargo. Your line is open.

Elyse Greenspan

Analyst, Wells Fargo Securities LLC

Q

Hi. Thanks. Good morning. My first question, so you guys updated – expanded your ROE range at your Investor Day, which obviously was pretty close to the end of the quarter, and now you've reset your forward earnings expectations for a couple of your main businesses. And so I guess to this pushback in your mind, you're hitting kind of the top end of that ROE target that you had just [ph] relayed (23:21) to The Street?

Charlie F. Lowrey

Chairman & Chief Executive Officer, Prudential Financial, Inc.

A

Yeah. So, our ROE objective is 12% to 14% and that is a range. And for the first half of the year, we're at 12.9%. When we set that objective, we did assume rates at the time would continue to increase consistent with the forward curve. We've given sensitivities that show the impact of rates, which is gradual over time.

And so, as we think about that if rates will persist, you would see, that have some impact into our ROE. But our initiatives that we have to expand margins and to accelerate our strategy, we think will keep us within our 12% to 14% ROE objective in the intermediate term.

Elyse Greenspan

Analyst, Wells Fargo Securities LLC

Q

Okay. And then, in terms of the Financial Wellness plan, you guys – the initiatives there, you guys called out some expenses in the quarter.

When you guys played that out at the Investor Day, you've told us what the expenses were and then also the saves – obviously takes a little longer for the saves to start rolling into the numbers.

Can you just give us a sense of when we should start seeing some of the saves come into the numbers? And then also, in terms of sequentially, how much higher those expenses could be, as we think about them building up from the second to the third quarter?

Robert Michael Falzon

Vice Chairman, Prudential Financial, Inc.

A

So, Elyse, it's Rob. The – our view on the initiatives that we're undertaking with respect to Financial Wellness and both the cost and benefits for that are still consistent with what we outlined on Investor Day.

We think through the year, we'll have about \$135 million in expenses, \$20 million of which you saw in the current quarter. And then, we would expect that those expenses will generate about \$50 million of run rate earnings by the end of the year.

You'll see those fully in 2020, given that they sort of build into a run rate through the course of the year. The initiatives are all in flight, but are back-ended in the context of sort of one will be incurring the costs on a quarter-to-quarter basis.

So, less in the second quarter, comparable to slightly more of this kind of a level in the third quarter that's included in the slide that Ken walked you through, in terms of expectation for costs related to Corporate and Other in the third quarter and then a net more elevated level in the fourth quarter.

Elyse Greenspan

Analyst, Wells Fargo Securities LLC

Q

Okay, great. And one last quick question for Corporate. In the past you guys have guided to higher expenses in the fourth quarter. I know, slide 7 was setting the base for the third quarter. But are you still expecting that in this year at Q4 corporate expenses would be higher, than what we see during the average of the first three quarters?

Charlie F. Lowrey

Chairman & Chief Executive Officer, Prudential Financial, Inc.

A

Yes. That's been our – that's been the pattern of our expenses. And we would expect that to continue this fourth quarter. And we'll give you a little bit more specific guidance around that, at the end of the third quarter.

Elyse Greenspan

Analyst, Wells Fargo Securities LLC

Q

Okay, thank you for the color.

Operator: Thank you. Our next question will come from the line of Ryan Krueger with KBW. Your line is open.

Ryan Krueger

Analyst, Keefe, Bruyette & Woods, Inc.

Q

Hi. Good morning. You mentioned that you still believe you can generate the high single-digit intermediate-term EPS growth. Is that – does that contemplate some of the step down function in the near-term earnings power? Or is that – or should we think about that more as the growth rate off of the lower near-term EPS base?

Robert Michael Falzon

Vice Chairman, Prudential Financial, Inc.

A

Ryan, it's Rob. The change in expectations with regard to this year vis-à-vis the guidance we provide you, it's not material in the context of what we would expect in terms of that intermediate-term growth rate.

So, I don't think, we would view that as being a material input into our ability to achieve that more elevated level of growth.

Ryan Krueger

Analyst, Keefe, Bruyette & Woods, Inc.

Q

Okay. And then, as you mentioned, potential inforce action as one of the possible offsets, can you expand some on – in terms of what you might be contemplating there?

Stephen P. Pelletier

Chief Operating Officer-US Business & Executive VP, Prudential Financial, Inc.

A

Ryan, it's Steve. I'll take that part of your question. In Individual Life, we're looking at three main drivers in an effort to improve returns in that business over the next few years.

What you mentioned is one of them. I'd just – first, I mention though that we continue to generate strong sales in the business. The new business that we've been writing over the last few years, I should point out has been priced using much more current assumptions that are very different from the assumptions used to price the legacy products that have generated some of the recent charges we've taken.

We remain quite disciplined in our pricing and our new sales have a very well diversified mix and we think these newer sales will help significantly in profitably growing the business over the next several years.

Second part of the plan is exploring different options for optimizing our inforce management as you referenced. That largely refers, Ryan, to exploring a wider range of reinsurance options.

And third, we continue to be focused on the cost effectiveness of the Individual Life business platforms. That certainly includes ongoing and continuing efforts to enhance the cost effectiveness of the businesses operating platform, but we're also exploring some innovative new ways of delivering our life insurance products to the marketplace in a cost effective way.

All of this is intended to improve returns in a business that remains an important part of our overall business mix. It serves an important need in the marketplace and is a critical part of our Financial Wellness value proposition.

Ryan Krueger

Analyst, Keefe, Bruyette & Woods, Inc.

Thank you.

Q

Operator: Thank you. Our next question comes from the line of Tom Gallagher with Evercore. Your line is open.

Thomas Gallagher

Analyst, Evercore ISI

Good morning. First question I wanted to ask you is on, Japan. Can you provide a little perspective on what's going on in that market more broadly? Gibraltar, I know you highlighted the weaker sales levels on the FX products. POJ looks like they held up better. Are you seeing significant increase in competitive pressures from the domestics? And also I think I'd heard a mention of some regulatory scrutiny. Is that on the FX product and maybe some elaboration there? Thanks.

Q

Scott Garrett Sleyster

Chief Operating Officer & Executive Vice President-International Business, Prudential Financial, Inc.

Hi, Tom. This is Scott. Let me start, I think I gave you a pretty good run down on Gibraltar. Let me start with POJ then and then come back to your more details in your question.

A

So in the case of POJ, our inforce block continues to grow and the inforce block was actually up almost 5% year-over-year. And additionally our Life Planner account in Japan was also up about 5%, I think a little more than 5% year-over-year. And you may recall that's comfortably ahead of the 2% to 3% Life Planner overall growth that we noted on Investor Day.

So I would say the fundamentals of the POJ business remain quite strong and, sort of, most of the challenges that we're facing have been on the Gibraltar side. I talked a little bit about the spends on accelerating some of the Customer Office and Financial Wellness.

I also alluded to just enhancing the overall collection of data and automation that we have in light of the – I would say really global, not really restricted to Japan, focus on sale suitability. So, we're trying to get that in place and probably accelerating that.

In the case of Gibraltar sales I think that's really where the market dynamics have been more challenging for us. As you know, particularly in our third-party distribution channels, we try to be very focused and disciplined about the products that we sell and meeting our return hurdles. And with that in mind, we are experiencing sales declines. We try to focus on recurring premium debt protection products. We find those to be much more persistent and so in the long run, we view those as really the most attractive products for us to sell, but we also think they're the most beneficial to our customers. So therefore, we're focusing less on single premium products which tend to be more variable and subject to more pricing and I'd say other market factors like interest rates.

The good news is that our recurring premium sales have in fact increased nicely within the life consultant channel. However, this has been more than offset with lower sales on single-pay U.S. dollar annuities that are impacted both by competition and by the change in rates. I'd say the other notable decline in sales was in the bank channel which primarily relates to trying to maintain the pricing discipline that I commented on earlier.

And then lastly, we experienced a smaller decline related to the tax law change in the independent agency channel. And as you know those – the new regs are out, but there's a big backlog on developing new products at the FSA. I guess the point I would make there and on that is that despite these challenges, Gibraltar's inforce block actually grew 2% year-over-year, which again goes back to reflecting the high persistency of the recurring premium products that we sell there.

Thomas Gallagher

Analyst, Evercore ISI

Q

That's helpful, Scott. Just as a quick – as a follow-up on Japan, POJ or Life Planner in total is – does have very good persistency as well. It's still about 90, but that's actually been declining, and it declined 90 basis points sequentially. Is there anything going on persistency in that part of the business?

Scott Garrett Sleyster

Chief Operating Officer & Executive Vice President-International Business, Prudential Financial, Inc.

A

I don't really think so. That was a really – that was a very small change. And if you look at it over the – and the way we tend to is look at over longitudinally over a long period of time, it still remains quite stable. So I don't think we see anything at this point that we view as significant. We, of course, watch it every quarter.

Charlie F. Lowrey

Chairman & Chief Executive Officer, Prudential Financial, Inc.

A

And Tom, this is Charlie. Let me just give a little – sort of a history of the bank channel because it's important to understand how we think about the bank channel and that is the marginal sales aspect of it. So, in a bank channel, sales can get away from you pretty quickly and we watch that like a hawk. And so, what we're really focused on, as Scott said, is the profitability of the business and the type of product that we sell and that the sales volume will vary as a function of that. So, there is more competition especially on the yen base side and that's hurt our U.S. dollar sales and recurring premium sales. But in our minds, what we're doing is protecting the level of profitability and the type of sale we have and letting sales volume vary as a result of that. And that's the way we've approached bank channel in the past and it's completely consistent with the way we're doing it now.

Thomas Gallagher

Analyst, Evercore ISI

Q

Understood. Thanks.

Operator: Thank you. Our next question comes from the line of Suneet Kamath with Citi. Your line is open.

Suneet Kamath

Analyst, Citigroup Global Markets, Inc.

Q

Thanks. On the assumption review, are there going to be any impacts on your statutory results either in terms of stat earnings or year-end cash flow testing from these changes?

Charlie F. Lowrey

Chairman & Chief Executive Officer, Prudential Financial, Inc.

A

Yeah. For Life the stat assumptions are prescribed, so there wouldn't be a stat impact for the Life update. And then there would be – and the favorable impact on the Retirement update would be – would flow through to stat. So, that's the extent of it.

Suneet Kamath

Analyst, Citigroup Global Markets, Inc.

Q

Okay. And then on the Life assumption review, I mean, we've been tracking this obviously every year and it seems like over the past, call it, four years, you've had maybe \$900 million or so of these assumption changes just in the Life business alone. So, maybe some color on why is it this business that's getting so much of this impact? And are you confident that kind of have this behind us now in terms of the current assumptions?

Stephen P. Pelletier

Chief Operating Officer-US Business & Executive VP, Prudential Financial, Inc.

A

This is Steve. Let me make some kind of overall comments and then I'd invite Ken to expand further. You're right about our experience over the past few years in the Individual Life business and the annual reviews and most of that experience has been around adjustments on the mortality front including this year's.

As a reminder though if you extend to look back over the past six or seven years, our mortality experience has been largely aligned with our expectations over that period. In addition when you look at it from a Prudential total company standpoint, as we've seen the negative mortality experience in Individual Life, that's been offset to a quite meaningful degree with positive longevity experience in our Retirement business very much as designed and intended.

With that said though, as I mentioned earlier, the ongoing impacts of the assumption updates that we've taken cumulatively over the past few years have brought us to a place where we want to bolster and improve the current levels of return in the business and the three-point plan that I mentioned earlier is really how we think about that going forward over the next few years.

Kenneth Yutaka Tanji

Chief Financial Officer & Executive Vice President, Prudential Financial, Inc.

A

Yeah. And the only thing I'd add is just a reminder that some of the updates that we took a few years ago were related to systems conversions and going through that process and that part is behind us.

And then also in terms of assumptions and evaluating the experience where it's credible, we call it like we see it and we stay current with that. So, that's the – that's our philosophy with assumptions.

Suneet Kamath

Analyst, Citigroup Global Markets, Inc.

Q

Okay. Thanks.

Operator: Thank you. Our next question comes from the line of Andrew Kligerman with Credit Suisse. Your line is open.

Andrew Kligerman

Analyst, Credit Suisse Securities (USA) LLC

Q

Thank you. Just trying to digest the response to Suneet's question just simply because it's happened so many times in the last four years, but I think Ken just said you call it like you see it. But Steve, you mentioned that you're exploring different options for the inforce management including reinsurance. So, if you're doing that and the reinsurer is taking a look at your block, why wouldn't we expect another charge to come as they may be uncomfortable with the block?

Stephen P. Pelletier

Chief Operating Officer-US Business & Executive VP, Prudential Financial, Inc.

A

As I mentioned, Andrew, we're looking at a range of reinsurance options. We already have, of course, an active reinsurance program and that's been one where our dealings with the reinsurers have been quite productive even over the past few years as we've had some of these updates. And we will continue to explore different options including as I mentioned an expanded range. So, it's part of that picture, but not the – but not by any means the totality of...

Andrew Kligerman

Analyst, Credit Suisse Securities (USA) LLC

Q

Could that conceivably end up in another charge?

Charlie F. Lowrey

Chairman & Chief Executive Officer, Prudential Financial, Inc.

A

Yeah, we don't want to go into specifics and the theoretical.

Andrew Kligerman

Analyst, Credit Suisse Securities (USA) LLC

Q

Okay.

Charlie F. Lowrey

Chairman & Chief Executive Officer, Prudential Financial, Inc.

A

So – but reinsurance can also be used to narrow volatility as we reinsure more business and trim some of the larger case exposure. So there's a number of various ways that we can think about the benefits associated with reinsurance and we're looking at that.

Andrew Kligerman

Analyst, Credit Suisse Securities (USA) LLC

Q

Got it.

Robert Michael Falzon

Vice Chairman, Prudential Financial, Inc.

A

It's Rob. The only thing I'd add on is to repeat essentially what Ken said is the intent of the assumption update was to bring current the valuation of the liability to our best estimate of what mortality experience we're actually seeing in the underlying block. And so we would not expect a third party to look at that and then come to some different conclusion than we did.

Andrew Kligerman

Analyst, Credit Suisse Securities (USA) LLC

Q

Got it. And then just in the earlier questions I think your response – a response was that there is some backlog with the FSA and some regulatory considerations. Could you elaborate on that?

Scott Garrett Sleyster

Chief Operating Officer & Executive Vice President-International Business, Prudential Financial, Inc.

A

That was simply related to the change in the tax law that occurred in February and then was reiterated in July. So, carriers like Prudential are designing some new products, but you have to file those products and go through the queue. So it's kind of the usual thing, but since it was related to a single action by the JFSA there is just a queue.

Andrew Kligerman

Analyst, Credit Suisse Securities (USA) LLC

Q

Got it. And then just with the recent activity at the Japan Post, they had some miss-selling. Any higher degrees of scrutiny occurring with the regulators?

Scott Garrett Sleyster

Chief Operating Officer & Executive Vice President-International Business, Prudential Financial, Inc.

A

I guess what I would say one we're not really – we don't distribute through Japan Post...

Andrew Kligerman

Analyst, Credit Suisse Securities (USA) LLC

Q

Right.

Scott Garrett Sleyster

Chief Operating Officer & Executive Vice President-International Business, Prudential Financial, Inc.

A

...on the one hand. But to the broader question, I think it was about two years ago the FSA shifted to more of a principle-based kind of a framework kind of moving to global standards. And as they do that I think they're rolling out their exam process and focusing more. And I think people are, as they go through that process they're saying, gee, I want to make some modifications or change this or get in line. So I think that's really – it's a fairly – I would say a fairly orderly and expected process, but it is in fact a process that's underway. It's already a couple years out and my guess is it has a couple more years to go before it's fully rolled out.

Andrew Kligerman

Analyst, Credit Suisse Securities (USA) LLC

Q

Thanks so much.

Operator: Thank you. Our next question comes from the line of Humphrey Lee with Dowling & Partners. Please go ahead.

Humphrey Hung Fai Lee

Analyst, Dowling & Partners Securities LLC

Q

Good morning, and thank your for taking my questions. I have a follow-up question related to Gibraltar's earnings headwind. I think, in Ken's remark, you talked about roughly \$15 million lower earnings power from lower sales

and also high investments. I just want to see if that is kind of your expectation for the foreseeable future as you mentioned the headwinds will be through 2020?

Kenneth Yutaka Tanji

Chief Financial Officer & Executive Vice President, Prudential Financial, Inc.

A

I guess, what I would say is we're trying to just based off of some of the things are going on and the benefits from putting some of these things in place, we're trying to get that done more quickly. So I don't think I'd say on the expense side, you'd expect a lot of that to run through all of 2020, but I guess I would say I expect this over the next three to four quarters, not the next two.

Humphrey Hung Fai Lee

Analyst, Dowling & Partners Securities LLC

Q

Okay. And then in terms of the lower sales and expense impacts, how should we think about that? Because I recall from your Japan Investor Day that you highlighted for both your POJ and Gibraltar business, like sales doesn't really affect your inforce earnings, so I'm a little surprised to see a earnings drop as a result of lower sales. So just wondering, if it's just more of expenses as opposed to sales?

Scott Garrett Sleyster

Chief Operating Officer & Executive Vice President-International Business, Prudential Financial, Inc.

A

Well, I think I gave you a proportion that it was skewed a little heavier to expenses. But when you're looking at multiyear sales, we've come down and it appears that we're bottoming out at these new levels. And by the way, we are taking actions whether it be in products or incentives and some new designs to help offset, so we're not if you will standing still while we're experiencing that. But the cumulative effect of the sales levels being off where they are and kind of plateauing at this level is also part of the equation.

Humphrey Hung Fai Lee

Analyst, Dowling & Partners Securities LLC

Q

Okay. And then shifting gears to Retirement. Looking at some of the earnings run rate and outlook seems to be a little bit weaker than where it has been – granted low interest rate definitely has the pressure, but I was just wondering, if there's any other things that may have affected the earnings outlook for Retirement in general?

Stephen P. Pelletier

Chief Operating Officer-US Business & Executive VP, Prudential Financial, Inc.

A

Humphrey, its Steve. I'll address that part of your questions. The impact on Retirement run rate earnings is largely in the net interest income area. Part of it is what you just spoke about, some spread compression as a result of the current rate environment. But another aspect of it is that at the end of last year, we released a significant amount of AAT reserves in the Retirement business and transferred the assets backing them back to the parent company and that also contributes to lower investment income for the business in 2019.

Humphrey Hung Fai Lee

Analyst, Dowling & Partners Securities LLC

Q

So in terms, I guess, when – if we want to dimension the impact of the AAT reserve releases on the investment income like how should we think about that?

Stephen P. Pelletier

Chief Operating Officer-US Business & Executive VP, Prudential Financial, Inc.

A

Yeah. So when we updated our assumptions in our Retirement business for AAT that led to a release of those reserves, but also if you recall last year we did strengthen our Long-Term Care reserves and so that led to essentially a net – no net impact overall for the company. So although you'll see lower earnings in the Retirement segment related to that those reserves went to Long-Term Care which is not included in AOI.

Humphrey Hung Fai Lee

Analyst, Dowling & Partners Securities LLC

Got it. Thanks.

Q

Operator: Thank you. Next we'll go to the line of John Nadel with UBS. Your line is open.

John Nadel

Analyst, UBS Securities LLC

Hey. Thank you. Good morning. I have a couple of quick ones. Rob, it sounded like with your commentary about PGIM and an expectation that institutional net flows will continue to string on an annual basis to positive, I assume that's with an eye toward your pipeline for the back half of the year. Could you just maybe expand on that?

Q

Stephen P. Pelletier

Chief Operating Officer-US Business & Executive VP, Prudential Financial, Inc.

John, this is Steve. I'll address that part of your question. Yes, I think, the circumstances around this particular outflow this quarter were mentioned by Charlie. I just mentioned a little bit more about it. It really was a matter of a client looking to consolidate the number of managers they work with. We're quite familiar with that dynamic. We have very frequently been the beneficiary of it. This was one particular time when the dynamic worked against us. But we still have a great deal of confidence in the ability of the business to continue to demonstrate strong fundamentals and strong net flows continuing the 16-year string on the Institutional front.

A

I would say that's borne out of a number of things. Number one, we do see an attractive near-term pipeline in the marketplace and we like our prospects for competing for that opportunity set given strong investment performance, deep expertise across a range of asset classes, and investment strategies, and investments that we've made in our distribution platform. All of those things taken together have been the contributors and the drivers of solid net flows and we expect they'll continue to be.

John Nadel

Analyst, UBS Securities LLC

Thank you. And then maybe for Ken or Rob, looking at slide 18 of the deck. I wanted to make sure that I understand how to interpret this, because I think the seasonal portion of this is tremendously helpful and thank you for that. I'm looking at the column that provides the baseline range and I just want to understand the width of the range by segment. Are we to take that to mean that the – driven by seasonal and other factors in some quarters, the earnings can be at the low end of the range and in some the high end of that range? Is that the way to interpret that?

Q

Kenneth Yutaka Tanji

Chief Financial Officer & Executive Vice President, Prudential Financial, Inc.

Yeah. So, let me maybe explain what that is. This is really just factual. So it's – it is just – if you look at the last four quarters and you adjust for assumption updates, market experience updates, variable investment incomes, the things that are noted in the footnotes.

A

John Nadel

Analyst, UBS Securities LLC

Yeah.

Q

Kenneth Yutaka Tanji

Chief Financial Officer & Executive Vice President, Prudential Financial, Inc.

That's the actual range that has occurred over the last four quarters.

A

John Nadel

Analyst, UBS Securities LLC

Into the last four. Got it.

Q

Kenneth Yutaka Tanji

Chief Financial Officer & Executive Vice President, Prudential Financial, Inc.

Yeah. Just – it's there to give you a sense for what the highs and lows have been.

A

John Nadel

Analyst, UBS Securities LLC

Got you. Okay. So this isn't sort of a guide saying this is the kind of – this is just actual. It doesn't include any growth expectations without....?

Q

Kenneth Yutaka Tanji

Chief Financial Officer & Executive Vice President, Prudential Financial, Inc.

No assumptions. It's just the facts of the last four quarters.

A

John Nadel

Analyst, UBS Securities LLC

Got you. Perfect. And then my last one is, I wanted to try to differentiate between run rate and actual dollar contribution thinking about the Wellness initiative. You've talked about a \$50 million run rate contribution to earnings by the end of this year, but my sense is that the actual dollar contribution they're earnings in 2019 will be negligible. And first I wanted to make sure I understand that correctly.

Q

And then second if we fast-forward and think about 2020, how should we differentiate between run rate and actual contribution?

Robert Michael Falzon

Vice Chairman, Prudential Financial, Inc.

So John, it's Rob. Let me try to address that. With regard to 2019 specifically recall that the expenses are largely back-end weighted as well. So what you'll see...

A

John Nadel

Analyst, UBS Securities LLC

Yeah. I'm separating the expense item.

Q

Robert Michael Falzon

Vice Chairman, Prudential Financial, Inc.

A

Yeah. So the idea is in 2019 we'll incur those expenses and get to that run rate level of savings by the time we've incurred all those expenses, but because it happens so late in the year to your point there will be a relatively modest contribution in 2019 from an earnings standpoint simply because both the expenses and the earnings are going to be concentrated in the latter part of the year.

As you get into 2020 and beyond what you see then is from a pure earnings standpoint, you'll see a combination of the benefit of the run rate from the prior year and then some portion of the building run rate during the course of that year contributing into the current year. What we intend to do is and we'll begin at the end of this year we'll provide better visibility into both the sources of the expenses so you understand what initiatives they're linked to and then importantly – how much and where we should expect to see the earnings benefits associated with those initiatives. Right now, it's just not material enough to provide that kind of detail. As we get further into this year and we have more materiality, we'll provide that kind of insight and I think that will provide you a better basis then for being able to assess not just the run rate impact, but how much of that run rate would be in the current year as opposed to for the succeeding year.

John Nadel

Analyst, UBS Securities LLC

Q

That's helpful. If I can just squeeze one more follow-up on that. So if you achieve \$500 million what's the calendar year where we should see the full contribution of that \$500 million?

Robert Michael Falzon

Vice Chairman, Prudential Financial, Inc.

A

That would be – we would achieve that by the end of 2022, and so you would see in 2023 the full year benefit of that.

John Nadel

Analyst, UBS Securities LLC

Q

Perfect. Thank you.

Charlie F. Lowrey

Chairman & Chief Executive Officer, Prudential Financial, Inc.

A

Welcome.

Operator: Thank you. We'll go to line of Alex Scott with Goldman Sachs. Your line is open.

Alex Scott

Analyst, Goldman Sachs & Co. LLC

Q

Hi. I just wanted to touch on Individual Annuities. I guess, the ROA seems to continue to trend down there and I know the long-term ROA target was a bit lower than where you have been running, but I guess equity margins have been strong. It was a little bit of a surprise to me that we'd that kind of accelerating down to the long-term ROA trend this past – as it has with that the economic backdrop? Appreciating the rate gone down too, but can you help us think through that? Should we just assume we're at that long-term ROA now? Any color would be appreciated.

Kenneth Yutaka Tanji

Chief Financial Officer & Executive Vice President, Prudential Financial, Inc.

A

Yeah. Sure. It's Ken. On – so first our ROA is evidence is the high profitability of our variable annuity business and the strong ROE. And as we mentioned in the past, we expected the ROA would trend down over time as our business persists and moves into lower fee tiers, but also as a result of our strategy to diversify our product mix. Now it's should also probably useful to know that our earnings are less sensitive to markets than our account values and that's due to our hedging program.

And so in the second quarter you saw as you mentioned the combination of two things, equity markets rising and interest rates falling and both those lead to increases in account values. And so it was really a denominator that led to the trimming of the ROA. And the point is here is our hedging program makes our earnings more stable than our account values.

Alex Scott

Analyst, Goldman Sachs & Co. LLC

Q

Got it. Okay. And then maybe a follow-up just thinking more high level, you guys up to the high end of the ROE guide for the intermediate term, but the outlook – has anything changed since that time? Or just thinking through how much lower the earnings power is today from what I thought at the time you're making those comments. It seems a bit more aspirational sitting here today than it did at that time. So can you help me think through is there anything other than the Financial Wellness program I should be thinking about that would get you closer to the midpoint of that intermediate range?

Robert Michael Falzon

Vice Chairman, Prudential Financial, Inc.

A

So Alex, it's Rob. I think, Ken did a good job of walking through sort of the impacts of – sort of think about the guidance that we gave and then the change in that guidance being reflected in sort of a handful of items that we've articulated. When we think about what we've articulated on Investor Day, I think what's important to understand is that when we're at Investor Day we were talking about direction and we were talking about strategy, and then the associated financial outcomes that results from that direction and strategy. And as we think about those, we measure those in years not in quarters. Obviously in guidance and in calls like this we talk about sort of the more near-term results.

On Investor Day, I think what I can reflect on is, first Charlie had in his remarks indicated that we – that march toward what we continue to believe is an achievable level of higher earnings and higher ROE would be non-linear, and I think you're seeing some of that non-linearity in the current quarter. Ken talked about both the potential for the Life assumption update, he told – I think, he mentioned that we were taking a hard look at those assumptions during the Investor Day. And also we provided then and previously market sensitivity, so none of that I'd considered to be particularly new information, and Scott, even when he talked about the international business, as you mentioned earlier, spoke to the fact that we would be adopting many of the initiatives that we had begun in the U.S. into Japan and that we would expect to be making similar type investments there. So I think that per Charlie's opening remarks that we remain very confident in the messages that we delivered on Investor Day regarding both the intermediate and long-term prospects for our businesses and nothing that's occurred in the current period causes us to feel any differently about what we messaged on Investor Day.

Alex Scott

Analyst, Goldman Sachs & Co. LLC

Q

Got it. Thanks for the responses.

Operator: Thank you. We will go to the line of Erik Bass with Autonomous Research. Your line is open.

Erik Bass

Analyst, Autonomous Research US LP

Hi. Thank you. I just wanted to come back to the mortality topic. And I was curious is the deterioration related to any specific vintages or types of policies? Are you really reflecting a broader trend?

Stephen P. Pelletier

Chief Operating Officer-US Business & Executive VP, Prudential Financial, Inc.

Erik, it's Steve. I'll address your question. Main point is that the update is really related to longer-dated vintages, earlier vintages in our book of business. In regard to looking at specific product categories, the one-time impact is largely experienced in the Universal Life block. The ongoing impact is primarily in Universal Life, but with some impact in other parts of the business as well including [indiscernible] (58:09).

Erik Bass

Analyst, Autonomous Research US LP

Got it. And then – I mean, you're having not quite a complete offsetting adjustment, but obviously the Retirement business is benefiting on the longevity side, but you have differences in business mix there. So what is it I guess it's driving the positive adjustment on that side?

Stephen P. Pelletier

Chief Operating Officer-US Business & Executive VP, Prudential Financial, Inc.

Yes. The way we look at that Eric is that when we perform our annual review of assumptions and other refinements the nature of the updates we make just as you're commenting, they vary from business-to-business and will naturally lead to differences in the extent and magnitude of one-time impacts versus ongoing impacts. The nature of the updates we made in our Retirement business led us to record the more meaningful onetime adjustment that we mentioned in expected benefit payments. And while there were some ongoing benefits from our review in the Retirement business, they're not of the same magnitude of the negative ongoing impact that we see in Individual Life. So, that's why we emphasize that point about Individual Life.

Erik Bass

Analyst, Autonomous Research US LP

Got it. And just to be – so, make sure, we have it correct, what would you size that ongoing impact for Individual Life? And is it something that should persist into perpetuity?

Kenneth Yutaka Tanji

Chief Financial Officer & Executive Vice President, Prudential Financial, Inc.

Yeah. It's about \$25 million a quarter. And it would be reoccurring for the foreseeable future.

Erik Bass

Analyst, Autonomous Research US LP

Got it.

Kenneth Yutaka Tanji

Chief Financial Officer & Executive Vice President, Prudential Financial, Inc.

A

But, I want to mention that the things that Steve has in mind and the business has in mind to help offset some of that that we talked about earlier.

Erik Bass

Analyst, Autonomous Research US LP

Q

Thank you. That's helpful.

Operator: Thank you. And due to the lapsed time, I'd like to turn the conference back over to Mr. Charlie Lowrey for any closing comments.

Charlie F. Lowrey

Chairman & Chief Executive Officer, Prudential Financial, Inc.

Thanks. I'd like to summarize our thinking and the actions we're taking, because we talked about a lot of different things on this call, and I'll divide into a couple of categories. One is the clarity of earnings, and two are some of the operational actions that we've highlighted.

So in terms of clarity of earnings, we are in the process of simplifying our earnings and clarifying the visibility of our drivers and financial outcomes, and we're taking efforts to help you understand our earnings trend and have taken some material steps this quarter to do so and we will continue to do so.

In terms of actual operations, we position 2019 and our guidance in 2019 in terms of a year of transition, and making investments that would enable us to grow in subsequent years, and we're taking actions accordingly. So we talked about the investment in future work, which should produce \$500 million of margin improvement over the next three years.

Now there are costs associated with that as Rob indicated and these initiatives are beginning to come through this year, and so those costs are upfront, which means there's a lag in terms of payback. So that's the first point. The second is we aren't happy with the performance of our Life business. And consistent with Steve's comments, we are seeking to increase the performance of the business as well as looking at ways to optimize the inforce book.

And finally, there have been higher expenses in certain businesses like Scott called out with Gibraltar. And as we think about changing the way in which we operate, we have to spend money on new ways of becoming more efficient, investing in technology and platforms, et cetera. And some of these costs will be ongoing. It's really a cost of doing business in the current environment and others will be transitory, as surge and then levelling-off, and Gibraltar falls into the latter category with higher expenses, tapering off during the first half of probably next year.

Now all this is to say that, not everything can be solved overnight, nor will the results coming from the solutions be linear, but we do have a real sense of urgency as you would expect us to have and that we spoke about on Investor Day. And what I can assure you is that we firmly believe that many of these initiatives and challenges actually provide extraordinary opportunities over time, which is why we have high conviction around the ROE and EPS targets that we stated on Investor Day.

Now on a personal note and speaking for the entire management team, we don't like disappointing our investors or other constituencies. On the contrary, we like to excel. And while I can't make any statements as to what the next quarter or quarters will provide, what I can absolutely assure you of is that we're working on executing our plan with the intended results of changing the trend line in the right direction. We look forward to keeping you updated on our performance and the tangible progress that we make as we strive to develop better financial outcomes for our customers and just as importantly sustainable results for our shareholders.

Thank you all for taking the time to join us today.

Operator: Thank you. And ladies and gentlemen, that does conclude your conference call for today. Thank you for your participation and for using AT&T Executive Teleconference Service. You may now disconnect.

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