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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 Conference Call. At this point, all the participants lines are in a listen-only mode. However, there will be an opportunity for your questions. Instructions will be given at that time. [Operator Instructions] As a reminder, today's call is being recorded.

I'll turn the call now to Mr. Darin Arita. Please go ahead, sir.

Darin Arita

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

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; Andy Sullivan, Head of US 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 the 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.

With that, I'll hand it over to Charlie.

Charles F. Lowrey

Chairman & Chief Executive Officer, Prudential Financial, Inc.

Thank you, Darin. Good morning, everyone, and thank you for joining us today. I'll start by saying we hope that you, your families and colleagues remain safe and healthy during these extraordinary times.

The events of the past several months have created unforeseen new difficulties for people around the world, while further exposing the deep-seated problem of inequity in our society. It's in times like these that we believe our company's purpose of solving the financial challenges of our changing world and standing by our employees, customers and communities is most important.

After transitioning over 95% of our US employees and most of our international employees to remote work in March, we continue to seamlessly serve customers, while the vast majority of our employees around the world continue to work in that fashion. This allows us to exercise utmost caution as we evaluate how and when to return to the workplace.

In the meantime, I am so proud of our people and how they've continued to focus on meeting the evolving needs of our customers, many of whom face new challenges related to the COVID-19 pandemic and its economic impact. We'll continue to innovate the ways we serve our customers during and after the pandemic.

During the second quarter, we maintained a clear focus on executing against our 2020 initiative, despite the challenging macroeconomic backdrop, by delivering on progress on our cost savings targets, aggressively repricing and pivoting products to mitigate the impact of low rates on our performance, and rotating our international earnings mix.

We're also focused on identifying opportunities for further action, particularly as we look to continue to reduce our sensitivity to markets. And we're exploring the potential to generate additional cost savings on top of our existing 2020 targets.

Throughout this period, we benefited from the strength of our rock-solid balance sheet, which gives us the confidence and the flexibility to navigate changes to the economic environment. I'll touch on each of these points in greater detail before turning it over to Rob and Ken for a look at our second quarter results.

Turning now to our 2020 priorities on slide 3, we remain on track to achieve our \$140 million cost savings target for the full year and have achieved \$75 million in savings year-to-date, with \$45 million in the second quarter. We also continue to make progress in shifting our international earnings mix to higher growth markets.

We remain on track to close on the sale of Prudential of Korea in the second half of 2020, and are advancing our review of strategic options for Prudential of Taiwan, which may include a sale. As I mentioned earlier, we are aggressively modifying our product mix, while exercising a highly disciplined approach to pricing in this low interest rate environment.

Turning to slide 4, while we are encouraged by the progress we're making to position our businesses and operations for the future, we continue to look at ways to work smarter and more efficiently in order to achieve cost savings on top of our target of \$500 million by 2022.

This includes using technology and automation, and leveraging the learnings from operating in a remote work environment to optimize how and where we work. In addition, we're looking at other ways to build upon our repricing and product shift to further mitigate the impact of market sensitivity.

On slide 5, we note how we're embarking on these initiatives with the foundational strength provided by our balance sheet and robust capital position, including highly liquid assets of \$4.5 billion at the end of the second quarter. Prudential Financial and its subsidiaries continue to exceed a AA financial strength rating. Our second quarter assumption update had a modest effect on our financial results, even as we reduced our U.S. long-term interest rate by 50 basis points to 3.25%.

Lastly, we anticipate receiving the US\$1.7 billion of proceeds from the sale of our Korea business by the end of the year. In terms of capital deployment plans, we'll continue to monitor developments in the credit markets and the economy to determine our strategy.

Slide 6 shows our second quarter financial results. This quarter exemplified the benefits of our thoughtful approach to risk management and our complementary business mix. We aim to balance mortality and longevity risk, so we don't have a one-sided exposure. In the quarter, we had net favorable underwriting experience.

Our adjusted operating income was \$931 million in the quarter, while we recorded a net GAAP loss driven primarily by the non-cash effect of non-economic market impacts, which have no effect on our regulatory capital position.

Our US Businesses reported adjusted operating income of \$455 million due to more favorable underwriting, offset by the unfavorable impact of the assumption update and lower fee and spread income. PGIM reported record adjusted operating income of \$324 million as well as record assets under management of \$1.4 trillion, a 9% increase from the year earlier period. This growth reflected strong flows into fixed income as well as market appreciation.

Our International Businesses reported adjusted operating income of \$693 million, as more favorable underwriting, higher earnings from joint ventures, and business growth were offset by the unfavorable impact of the assumption update and lower spread income and higher expenses.

Before turning it over to Rob, I'd like to address the recent disturbing incidents of racial injustice and how we as an organization are responding to the deep-seated and persistent problem of racism and inequity in society. Last month, we announced commitments to advance racial equity, as highlighted on slide 7. These commitments were borne out of the courageous candor of our employees, who have shared their experiences and their expectations, and the listening that has taken place all across Prudential.

Taking a bottom-up approach, we developed concrete and measurable actions spanning our talent practices to how we design and deliver products, to the investments we make, and to how we foster social and racial equity in the communities where we work and do business. We already had a substantive set of programs underway and a body of work that reflects our long-standing commitment to racial equity, including investing over \$1 billion in our hometown of Newark.

We recognize that this moment calls for us to amplify what Prudential has already been doing to drive change within our company and within society. It is [ph] a moral (9:48) and it is a business imperative that aligns directly with our company's purpose to solve the financial challenges of our changing world as well as our multi-stakeholder commitment to employees, customers, shareholders and society. We stand by the promises we make, and we are prepared to be judged for our actions to support our colleagues, customers and communities today and over the long-term.

And with that, I'll turn it over to Rob.

Robert M. Falzon

Vice Chairman, Prudential Financial, Inc.

Thank you, Charlie. And I want to reemphasize your comment about our commitment as a management team to supporting racial equity. This is an issue that is aligned to our purpose, it's part of the fabric of our culture and critical to our success as an organization.

I'll now provide an update on how we are executing on our strategy within our US, PGIM and International Businesses, as well as on the outlook for these businesses, and we'll also provide an update on our investment portfolio.

Turning to slide 8, the US Businesses produced a diversified source of earnings from fees, net investment spread and underwriting income. We continue to execute on three key priorities. First, we've implemented pricing and product actions to simplify and de-risk our business mix, while protecting profitability.

For example, we took aggressive pricing actions aligned with our intention to significantly reduce sales of HDI, our legacy flagship VA product, and launched FlexGuard, our buffered annuity product, which has been well received by the market, supporting our product mix shift to less interest rate sensitive solutions.

And in our Individual Life business, we suspended sales of our single life guaranteed universal life product in July. This will result in the continued shift to variable life and other less interest rate sensitive products.

We will continue to take product and pricing actions, including steps to diversify our mix of business, to maintain profitability in this interest rate environment. As a result, we expect Individual Annuities and Individual Life sales to continue to move lower in the near-term.

Second, as the needs of our customers rapidly evolve, including in response to COVID-19 and its economic impact, we are increasingly leveraging technology to enhance customer engagement and efficiency. For example, we've expanded our process to electronically deliver policies from application submission to policy issuance, and have increased the use of our fast-track automated underwriting process. And we have expanded the use of electronic signatures and self-service customer capabilities across our businesses.

And third, we remain committed to expanding our addressable market. The pandemic has amplified the financial wellness challenges that many US households face, and has highlighted the importance of our financial wellness platform and our life insurance, retirement, and financial planning solutions.

We also continue to see increasing interest in our Assurance IQ platform from customers in the healthcare, life and P&C lines of business. Preparation for the Medicare annual enrollment period in the fourth quarter, we've been progressing well with our agent onboarding and training process.

Now, turning to slide 9, PGIM is a top 10 global investment manager that continues to demonstrate the strength and resilience of its multi-manager business model. Our assets under management reached a record level of \$1.4 trillion, up 9% from the year-ago quarter, driven by net flows as well as the positive impact from equity and credit markets.

PGIM's long-term investment performance remained strong and has rebounded from the temporary downturn in the first quarter. More than 85% of assets under management have outperformed their benchmarks over the last 3-, 5- and 10-year periods.

This strong investment performance, coupled with diversified investment capabilities across asset classes, regions and client segments, has led to continued growth. We generated nearly \$4 billion of net third-party flows during the second quarter, driven by record retail flows of \$9 billion.

Institutional outflows were driven by a single passive equity client redemption. Our public fixed income platform generated flows of \$10 billion, as it continues to benefit from our broad suite of strategies and the leading position of our franchise. PGIM Investments was the number one ranked US mutual fund franchise across active and passive asset managers based on net year-to-date sales.

PGIM's asset management fees were up 3% compared to the year-ago quarter, driven by the growth in average assets under management. In addition, other related revenues increased primarily due to higher strategic investment earnings as a result of strong investment performance and the effect of credit spreads tightening, reversing the widening that had occurred in the first quarter. We also continue to focus on cost discipline to fund growth and further increase our operating leverage.

Turning to slide 10, our International Businesses, including our Japanese life insurance operation, where we have a differentiated multichannel distribution model, as well as other operations focused on high-growth markets.

As expected, Life Planner sales decreased 30% compared to the year-ago quarter, primarily reflecting lower sales in Japan due to COVID-19-related restrictions on sales activities. Life Planner head count, however, increased 5% compared to a year ago. Similar to Life Planner, sales for Gibraltar were 34% lower, but the number of life consultants has declined as we continue to focus on quality distribution.

Chile, market returns in the quarter were higher than average and that contributed to an operating income benefit of approximately \$25 million, reversing the impact we experienced in the first quarter.

With respect to expenses across International, we provided appropriate sales support to protect and care for our captive distribution, as we noted last quarter. This contributed \$55 million to expenses, which we expect to trend lower in the second half of the year.

We have seen some recovery in Japan sales beginning in June, as the state of emergency was lifted. And over time, we expect sales to normalize. In addition, to mitigate the impacts of reduced face-to-face sales, our agents have adapted to increased usage of virtual tools to connect with customers, and we have seen early signs of success. We believe that our needs-based selling approach and death protection product focus continue to provide important value to our customers.

With respect to interest rates, we've successfully managed through decades of low interest rates and other market challenges in Japan. As you have seen us do in the past, we adjust our product offering quickly to meet the needs and preferences of our customers, while also achieving our return expectations. We have already taken actions and will continue to do so, as needed, as we move forward.

Now turning to slide 11, we have a conservative, quality-focused investment portfolio that reflects our robust asset liability management practices, commitment to broad diversification and a disciplined interest rate risk management framework. We also leverage PGIM's expertise across multiple asset classes, including its deep and long-standing experience in private placements and real estate.

Year-to-date credit migration and losses have trended below our expectations. Second quarter credit losses were \$139 million, driven by energy and consumer cyclical sectors. While we expect credit losses to be a multiple-quarter story, we feel comfortable that our exposure is manageable and that we are well-capitalized to weather whatever emerges.

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'll begin on slide 12, which provides insight into earnings for the third quarter relative to our second quarter results. The key point is that our underlying earnings power increased slightly from last quarter, primarily reflecting higher equity markets.

To help you see this, I'll start with pre-tax adjusted operating income in the second quarter, which was \$931 million and resulted in earnings per share of \$1.85 on an after-tax basis. Then, we adjust for the following items: First, the annual review of assumptions and other refinements resulted in a net charge of \$334 million in the second quarter, primarily driven by a reduction of our long-term interest rate assumption by 50 basis points in the US. Next, we adjusted variable investment income to a normalized level, which is worth \$130 million.

Please note that while we have not included an adjustment for variable investment income for the third quarter, the potential exists for continued revaluation of private equity and real estate investments due to the current adverse economic conditions. While returns of our alternative investment portfolio are currently lower than our target returns, and will vary period-to-period, over time, this portfolio has generated income above our targeted returns.

Third, we adjusted underwriting experience by \$155 million. This reflects \$100 million of favorable experience in the second quarter, primarily driven by reserve gains in retirement. We estimate claims experience in the third quarter will include \$55 million for COVID-19.

Next, there are other items that combined may be \$75 million more favorable in the third quarter, primarily related to expenses and markets. We expect expenses, including implementation costs, to be \$130 million lower in the third quarter. This is primarily due to legal expenses in the second quarter. In addition, due to favorable markets in the second quarter, other related revenues in PGIM benefited by \$45 million. And [indiscernible] (19:46) income in our Gibraltar segment also benefited by \$25 million [ph] shift (19:51). We expect operating cost due to COVID-19 to be \$25 million lower in the third quarter. And last, we anticipate net investment income will be reduced by \$15 million, reflecting the difference between new money rates and disposition yields of our investment portfolio.

These items combined get us to a baseline of \$2.63 per share for the third quarter. Please note that this baseline includes items specific to the third quarter that reduced EPS by approximately \$0.19 per share. While we have provided these items to consider, there may be other factors that affect earnings per share in the third quarter.

On slide 13, we provided an update on the potential impact of the pandemic. We have included a sensitivity for operating income based on the US population experiencing 100,000 of incremental deaths due to the pandemic. We estimate that this may lower operating income by \$70 million. And this is less than the sensitivity we provided on our last earnings call, as we have seen a lower fatality rate due to COVID-19 in our US insurance businesses than previously estimated.

Our third quarter baseline includes a net impact for mortality due to COVID-19 of approximately \$55 million. The actual impact will depend on a variety of factors, such as infection and fatality rates, geographic considerations and progress in testing and medical treatments. We have also reduced our estimate for incremental operating costs due to COVID-19 and have estimated the potential reduction in other operating costs, such as for travel and entertainment.

In the second half of 2020, we expect to incur incremental operating costs of \$60 million due to COVID-19, with \$40 million in the third quarter and \$20 million in the fourth quarter. The estimate of these costs is lower than what we provided on our last call, primarily due to lower health benefit costs of our US employees and lower cost to support our sales professionals in Japan, as their productivity is improving faster than previously estimated. We expect to have \$30 million of lower travel and entertainment expenses in the second half of 2020.

Turning to slide 14, we continue to maintain a robust capital position and adequate sources of funding. Our capital position exceeds our AA financial strength targets, and we maintain liquid assets at the parent company that are greater than three times annual fixed charges.

We have substantial sources of funding. Our cash and liquid assets at the parent company were \$4.5 billion at the end of the quarter. We expect to receive net proceeds of \$1.7 billion from the sale of our Prudential of Korea business following the close of the transaction, which is expected in the second half of this year. And another source of funding is free cash flow from our businesses. In May, we added a new \$1.5 billion contingent capital

facility that combined with our previous facility brings our total available contingent capital funding resources to \$3 billion.

Turning to slide 15, and in summary, we remain on track with our objectives for the year as we accelerate the execution of our initiatives. We're exploring the potential to increase our cost savings initiative and looking at additional ways to build upon our repricing and product shift to further mitigate market impacts. And we maintain a rock-solid balance sheet with a robust capital and liquidity position.

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

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] First, with the line of Elyse Greenspan with Wells Fargo. Please go ahead.

Elyse Greenspan

Analyst, Wells Fargo Securities LLC

Hi. Thanks. Good morning. My first question was just on the mortality assumption you laid out for the third quarter. So, if I look at your disclosures, longevity did benefit your results in both the Q1 and the Q2 this year. So I'm just trying to understand why that would at least continue to some degree in the third quarter?

Kenneth Yutaka Tanji

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

Hi, Elyse. This is Ken. I'll take your question about the COVID mortality into the third quarter. So, in our second quarter, we benefited from our longevity business in the UK. Mortality in the UK came in a little bit higher than we had previously estimated, and that resulted in a gain from our UK longevity reinsurance business.

While there was fatalities in the UK in the second quarter, right now that seems to be more contained and we wouldn't expect that to continue given the current fatality rates. So we also, in our new estimate, have incorporated into that sensitivity what we learned from the second quarter, which is also in our life insurance and group insurance businesses, the fatality rates were lower than we previously estimated. So we've incorporated that into our new estimate.

Elyse Greenspan

Analyst, Wells Fargo Securities LLC

Okay. Thanks. And then second, on the capital side, you guys said in your prepared remarks that you would continue to monitor credit markets and the economy in determining your strategy.

I guess, as you have one additional quarter under your belt, how are you thinking about capital return? Is it dependent upon getting the capital, the \$1.7 billion, from the full-year sales toward the end of this year? Or is it more just dependent upon kind of more time going on and seeing how credit markets develop?

Charles F. Lowrey

Chairman & Chief Executive Officer, Prudential Financial, Inc.

Elyse, it's Charlie. I'll take that one. So, as you know, we paused our share repurchases in the second quarter, in line with the risk framework that we had in place. And as you said, until we get better visibility into the depth and

the duration of the pandemic, the possible recession and the credit cycle, we will maintain our financial flexibility and resiliency.

When we get the clarity into those issues I just mentioned, we'll then share the timing of our plan to resume share buybacks and by how much. And that would also include the proceeds from the potential sale of the Korean business. So we're going to focus on maintaining our financial strength. But when we get clarity into the issues going forward, we will certainly let you know, and we'll be transparent about it.

Elyse Greenspan

Analyst, Wells Fargo Securities LLC

Thank you. I appreciate the color.

Operator: Our next question is from the line of Ryan Krueger with KBW. Please go ahead.

Ryan Krueger

Analyst, Keefe, Bruyette & Woods, Inc.

Hi. Good morning. Could you elaborate on, I guess, the things you're considering that would cause a reduction in your market in interest rate sensitivity? And I guess, in particular, I guess I would assume to meaningfully change that, that would require some sort of [ph] an enforced (27:31) reinsurance transaction. But if you could elaborate some on what you're thinking about?

Robert M. Falzon

Vice Chairman, Prudential Financial, Inc.

Ryan, it's Rob. I'll take a shot at that. But, first, let me just bring it up a level and say, as we sort of think about our strategy on a go-forward basis, we think about the elements of that is, in the first instance, simplifying and de-risking the business as we articulated in our opening remarks.

The other components of that are about improving near-term earnings through the efficiency initiatives that we've talked about and which we think has some expansion opportunity associated with them. And then, obviously, continue to expand our addressable market in order to support longer-term growth.

Specifically with regard to the de-risking, I would characterize the repricing and product shifts that we've done as sort of the first steps in transitioning to lower volatility, less interest rate and general market sensitivity across our businesses.

For those products that we've either stepped back from or actually explicitly discontinued, so think about that as being HDI in the variable annuities business and guaranteed universal life in the life business, we'll look actively at opportunities to optimize the economics of the legacy blocks that are associated with those products. And those options range anywhere from simply sort of just running off the blocks to reinsuring and/or looking at selling the blocks.

A couple other things, outside of that, across our products, we're actually looking actively at product design as well as individual and aggregate limits that could reduce the amount of potential volatility that we get from any individual product or grouping of products. So you saw us significantly reduce the retention limits that we have within our Individual Life business, by way of example.

Charlie hit on financial flexibility and resiliency. So we're going to retain our capital in order to make sure that we have that in place. And we think that that's an element of the de-risking, at least in the near-term.

And we're also looking at the investment portfolio and looking at strategic asset allocation, re-optimizing sort of the risk return and volatility trade-offs that are associated with our equity, credit and our interest rate exposures, in light of where we are in the cycle and the opportunities that are in front of us.

And I guess the last thing I'd mention is that, as we look at the growth of the business, on a go-forward basis, our strategic emphasis is really on growing the elements of our business that are less rate sensitive and more predictable and more capital-light like, for instance, PGIM, our asset management business. So those would be the primary things that we're thinking about from a de-risking standpoint.

Charlie, I don't know if there's any further color you'd want to add on to that?

Charles F. Lowrey

Chairman & Chief Executive Officer, Prudential Financial, Inc.

A

Yeah. Thanks, Rob. So, Ryan, let me just try and connect some dots, because over the past 18 months, as Rob said, we've taken actions to begin to accomplish many of the objectives that Rob articulated, namely lower market sensitivity, lower capital intensity of our business mix, becoming more competitive in terms of serving our customers with better processes and lower costs, and then finally, as Rob said, increasing growth, right?

And so let me just tick through a number of things that we've done in order to achieve those objectives. We sold or selling out of lower growth businesses, Italy, Poland, Korea, and exploring options for Taiwan. We acquired assurance around which we have high conviction about growth in a business that isn't as market-sensitive, so lower risk. We've significantly reduced or stopped selling certain highly interest rate sensitive products and annuities and ILI. We introduced less market-sensitive products such as the buffered annuity. We repriced almost our entire product line. We announced and are executing on our Future of Work initiative, which will produce \$500 million in cost savings with a potential to do more. And as Rob said, we're currently exploring other options on books of business that are market-sensitive.

So we're executing on a series of incremental changes that we believe will lead to fundamental change in our business mix and, ultimately, the trajectory of the firm as we go forward. So, that's a foundation off of which we are going to grow going forward.

Ryan Krueger

Analyst, Keefe, Bruyette & Woods, Inc.

Q

Thank you. Appreciate it.

Operator: [Operator Instructions] And next we go to line of Humphrey Lee with Dowling & Partners. Please go ahead.

Humphrey Hung Fai Lee

Analyst, Dowling & Partners

Q

Good morning and thank you for taking my questions. Regarding the kind of potential – hello?

Charles F. Lowrey

Chairman & Chief Executive Officer, Prudential Financial, Inc.

A

Yeah. Humphrey, we can hear you.

Humphrey Hung Fai Lee

Analyst, Dowling & Partners

Q

[audio gap] (32:31) savings. I know it's still probably in the early stage of planning, but is there any way to help us to think about the potential size and scope of that impact? Should it be kind of comparable to what you've been targeting so far? Or just more of incremental to what you – just a modest incremental to what you have been targeting?

Robert M. Falzon

Vice Chairman, Prudential Financial, Inc.

A

Humphrey, it's Rob. I'll take a shot at that. You cut out a little bit, but I think I understood your question. So, as we have been in the course of executing on the efficiency initiatives that we had articulated earlier in the year – earlier last year, we've actually accelerated those actions. And in the course of doing so, we've actually institutionalized continuous transformation capability.

And as a result of that, we're generating new ideas and strategies for further efficiencies that enhance customer experiences. Remember, that's sort of the first priority of that is they enable our businesses, putting us in more competitive positions, and it increases our operating profits, particularly in light of the – which is needed in particular in light of the impact of earnings of a low rate environment.

The levers we're using, Humphrey, are pretty much the things that we've done to-date. So, increased use of technology and automation, process improvements, sourcing, org design, all the things that are classic. We just think there's – as a result of this continuous process, much further that we can go than what we've articulated to-date.

We're also contemplating learnings from the crisis and some of the implications of the pandemic and our experience in that on things like remote work, changes in communications and travel, and use of technology on a go-forward basis. So, all of that leads us to be optimistic that we can expand materially from where we are today, but we're not ready to quantify that. We'll provide more guidance on that when we get further into the year. And once we finished our work, as Charlie indicated, we'll be transparent.

Humphrey Hung Fai Lee

Analyst, Dowling & Partners

Q

Appreciate the color. Shifting gear, looking at PGIM, as you mentioned, flows were very good in the quarter, especially on the retail side. But on the institutional side, even after that \$4.5 billion of passive equity mandates redemption, flows were still kind of negative. So I was just wondering can you comment on what you saw in the quarter and then also how is your pipeline looking out, especially on the institutional side.

Andrew Sullivan

Executive Vice President and Head of U.S. Businesses, Prudential Financial, Inc.

A

Sure, Humphrey. It's Andy. I'll take your question. And you were cutting in a little bit. I'm not sure if it was you or me. So, retail flows are really a result of three things: very strong investment management performance, a broad and wide product portfolio and strong distribution. And we are performing well on all of those fronts.

Our investment performance in the second quarter was very strong. All of our PGIM fixed income strategies outperformed benchmark. 96% of our Jennison equities outperformed benchmarks. So, very, very strong fundamental performance. As you know, we've been building out our global distribution over time.

So we were actually quite pleased with our flows in the quarter. We were the number one mutual fund family year-to-date and had \$9.5 billion in positive retail flows. We did have the \$4.5 billion indexed passive flow related to QMA. That was a very [audio gap] (36:01) mandate, so think in the neighborhood of 1 to 2 bps. So, literally, it was less than \$1 million in fees.

It also was the last of our, what I would call, [audio gap] (36:17). As you look forward, quarter-to-quarter, there will be variability. But over the long run, our fundamental investment performance, the strength of our distribution, we have had strong organic flows over the last five years, and we expect that to continue as we look forward over the next several years.

Robert M. Falzon

Vice Chairman, Prudential Financial, Inc.

A

Hey, Andy, you cut out for one sec. Do you want to repeat the point you were making about? I don't know that it was well heard on the number of large mandate passive funds, that one was a little blurry.

Andrew Sullivan

Executive Vice President and Head of U.S. Businesses, Prudential Financial, Inc.

A

Yeah. Sure. Sorry about that. All I mentioned was the \$4.5 billion outflow was the last large passive mandate that we have in our portfolio.

Humphrey Hung Fai Lee

Analyst, Dowling & Partners

Q

Got it. Appreciate the color.

Operator: And next we go to line of Tom Gallagher with Evercore. Please go ahead.

Thomas Gallagher

Analyst, Evercore ISI

Q

Good morning. Charlie, just a follow up on Ryan's question on, I guess, the range of things you're considering with risk transfer. I hear what you guys are saying on limiting new sales, considering some reinsurance back books, it sounds like, maybe on life insurance. Have you considered anything more transformational?

And the reason I ask that is kind of a more moderate, we'll say, limited approach to the strategy probably from a shareholder standpoint is going to result in very limited growth, as you have some of these businesses that you still own that are shrinking every year. So it becomes kind of a challenge from an annual earnings growth standpoint. Have you considered that? And would you consider something more extreme like an IPO of some of your capital market-sensitive businesses or a bigger reinsurance transaction? Or are you thinking in a more limited scale?

Charles F. Lowrey

Chairman & Chief Executive Officer, Prudential Financial, Inc.

A

So, Tom, thanks for the question. I appreciate it. Let me just take a step back and then I'll answer your question directly, and make a comment about how we think about capital allocation and in particular optimization. Because when we look across our businesses, what we try and do both domestically and internationally is ensure we're optimizing that capital deployment.

So we've mentioned in the past that we're looking at or continue to look at businesses such as ILI, annuities and some of our international operations, as well as LTC. You've seen us take some bold action in terms of Italy, Poland, Korea, potentially, Taiwan, etcetera. So what we're going to do is and what we can assure you is that we will continue to look to ways to optimize capital and capital deployment to maximize outcomes for shareholders, right? Be that through significant dispositions, whatever flavor that may take, through potential share repurchases, or through acquisitions.

And right now, we have acknowledged and we'll continue to acknowledge that there's a high hurdle for any major acquisition, given where its stock price is trading, we get that. But we're looking – as you've seen in the actions we've taken to-date over the last 18 months and I think what you'll see us do going forward is look at all our businesses in order to optimize the capital we deploy and how we do that. And that's our commitment to shareholders, and that's what we're doing.

Thomas Gallagher

Analyst, Evercore ISI

Q

Got you. Appreciate it. I guess, my follow-up is just it looks like you've reduced pretty substantially the expense drag for the subsidies you were planning on or you've been paying to the Life Planners in Japan. Is that because you see greater visibility on a sales recovery emerging? Or have you, I guess, lowered the level of subsidy?

Scott Garrett Sleyster

Executive Vice President and Head of International Businesses, Prudential Financial, Inc.

A

Why don't I go ahead and take that, Tom? This is Scott. I think the answer is multifaceted, but maybe I'll speak first to the question on have we seen a sales recovery. We actually started to see a pretty good bounce back in June to the point where we were starting to get close to even to 2019 sales in both Japan and in Brazil. And that has continued and actually modestly strengthened in the month of July. So we are seeing a pretty good sales recovery, and we're encouraged. But, of course, that has to be tempered by any kind of resurgence that could occur.

In the case of the Life Planners, we were actually able to take what was an initial subsidy that was sort of an uncharacteristic payment that we have, and we were able to roll it into their bonusable plan. So, a portion of the amount that we have for POJ is actually being deferred into their sales comp. So you're not seeing it as directly, but it's still there.

Thomas Gallagher

Analyst, Evercore ISI

Q

Okay. Thanks.

Operator: And next we'll go to Jimmy Bhullar with JPMorgan. Please go ahead.

Jimmy S. Bhullar

Analyst, JPMorgan Securities LLC

Q

Hi. Good morning. First, just on your annual assumption review and the interest rate assumption. Obviously, it's more conservative than it was before, but still fairly optimistic versus market levels. So, just if you could talk about what went into your thoughts on how much to reduce the rate assumption by? And why did you not, like, make a bigger adjustment given where market rates are?

Kenneth Yutaka Tanji

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

A

Hey, Jimmy. It's Ken. In terms of our long-term rate assumption, we followed a very established process that we've had for a number of years, and it considers multiple perspectives. So we look at, again, long-term interest rate forecast of economists, banks and managers, and we look to be at the median of all those. And for this year, when we looked at that, that meant a 10-year US Treasury rate in the long-term of 3.25% and 1% for the JGB in Japan. So we followed the same process we've had for a number of years.

It's also important to know how we grade into that long-term assumption. We do that over 10 years, and the first 2 years follows the forward curve. And as a result, it's not just the long-term assumption, but the path of which we get there. And so, over the next 5 years, our average rate would be 1.25%. In 10 years, it's about 1.9%. So, again, we have a pretty established process. We look at third-party inputs and look to be at the median, and that was the result for this year.

Jimmy S. Bhullar

Analyst, JPMorgan Securities LLC

Q

Okay. And then any color on how your long-term care block has held up recently and whether you've seen any benefit on your claims or reserves from the pandemic?

Kenneth Yutaka Tanji

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

A

We saw a little bit elevated mortality in our policies that are already on claim, but it was fairly modest and I wouldn't call significant.

Jimmy S. Bhullar

Analyst, JPMorgan Securities LLC

Q

Okay. Thanks.

Operator: [Operator Instructions] And next, we'll go to John Barnidge with Piper Sandler. Please go ahead.

John Barnidge

Analyst, Piper Sandler & Co.

Q

Great. Thanks. And most of my questions have been answered. But can you talk about commercial mortgage loan forbearance in the quarter, directionality of that as well? Thank you.

Robert M. Falzon

Vice Chairman, Prudential Financial, Inc.

A

Hey, John. It's Rob. Yeah. To-date, our – we've received forbearance requests that are about 8% or so of the portfolio. We've provided forbearance in 6% of those instances and the remaining 2% are under review. And that excludes a little bit that we've gotten requests on that were declined. But in that, only about 1% of the requests

resulted in a deferral of interest. In all other instances, we remain current on interest and they've been deferrals of principal.

Recall that, across our portfolio, our loan-to-values are actually quite low. And so, as a result of that, when we defer principal, we're actually not particularly concerned about that because we know that the principal amount is actually quite safe. The average loan-to-value across our entire portfolio, based on our internal appraisals, is 56-ish percent. Using external appraisals, it will be about 10 points lower than that, so less than 50%. And so, given that low LTV, accommodations on amortization of principal or repayment of principal we believe is a prudent thing to be doing. And if we can remain [ph] card on (45:53) interest, that keeps the loans performing and that's been sort of our experience to-date.

John Barnidge

Analyst, Piper Sandler & Co.

Great. Thanks for the answer.

Q

Operator: And next we'll go to Suneet Kamath with Citi. Please go ahead.

Suneet Kamath

Analyst, Citigroup Global Markets, Inc.

Thanks. Just a question, first off, on variable annuities. One of the things that folks are talking about now is that the NAIC is reviewing the mean to reversion assumption that they include in VA capital reform. So, just curious, if that was changed, would you expect to see either a big impact on your hedging program or your capital requirements for VA?

Q

Kenneth Yutaka Tanji

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

Yeah. Hi. This is Ken. Just a little bit of backdrop on this for us. We've managed our VA business with a very robust economic view and active hedging for many years. We are very supportive of a statutory framework that also is based on robust economic scenarios, both in terms of the long-term assumptions, but also the dispersion around those assumptions.

A

Our internal scenarios that we use to manage the business are actually more conservative than those being considered by the NAIC. So we continue to advocate for appropriate economic scenarios within the VM-21 framework and we believe that we'll be well-positioned due to the internal framework that we've used to manage the business for many years.

Suneet Kamath

Analyst, Citigroup Global Markets, Inc.

Got it. Okay. And then just to shift over to International, if I could. Obviously, a lot of moving parts in terms of COVID, face-to-face sales, low interest rates, expenses. But as you think about the longer-term outlook for the Japan businesses, when do you see those businesses sort of back to earnings growth as opposed to earnings declines or flattish earnings? Again, just conceptually, how are you thinking about the outlook for that business?

Q

Scott Garrett Sleyster

Executive Vice President and Head of International Businesses, Prudential Financial, Inc.

A

Hi, Suneet. This is Scott again. I'll go ahead and take that. I guess I'd talk a little bit about capital rotation mixed in with that question. We were seeing low growth in the developed markets in Korea, Taiwan and Japan. And you saw that we took actions in Korea and we're considering those in Taiwan.

And the reason that you see a difference between those businesses in Japan is that we have really strong market share in Japan and we have a really high-performing LP model there. The business generates attractive returns over our cost of capital and it generates a lot of free cash flow to the parent. So we really like our Japan operation and we continue to invest in it.

That being said, overall premium growth in Japan has been negative for the last several years and the country continues to face demographic challenges. So the fact that we've been able to continue to grow in POJ has been a significant outperformance in the country.

So I guess what I would say is, is we expect kind of low-single-digit growth in Japan. And if we're achieving that, that's actually very strong relative performance and then in the context of a business system that's creating a lot of value and cash to the parent. In the meantime, we'll look for redeployment in higher-growth markets, but those are going to have to be opportunistic.

Suneet Kamath

Analyst, Citigroup Global Markets, Inc.

Okay. Thanks, Scott.

Q

Operator: [Operator Instructions] And seeing no further questions coming in, Mr. Lowrey, I'll turn it over to you.

Charles F. Lowrey

Chairman & Chief Executive Officer, Prudential Financial, Inc.

Okay. Thanks very much. So, as we come to the end of the call today, I'd just like to thank you for listening and for your continued interest in Prudential. I also want to take a moment to thank all our employees for the steps they continue to take to support our business, our customers and our community, including our collective efforts to address racial equity at Prudential and in society at large.

We continue to make progress on executing our initiatives for the year, and frankly, are working to do more even as the global health pandemic continues. Backed by our financial strength and guided by our purpose, we'll continue to focus on delivering meaningful outcomes and value to all our stakeholders.

Thanks again for joining us today. We appreciate it.

Operator: Ladies and gentlemen, that does conclude your conference for today. Thank you for your participation. You may now disconnect.

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