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Genworth 4th Quarter 2015 GAAP Results, Suspends Sales of New Life Insurance and Annuities

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Genworth Financial Inc. (GNW) released its fourth quarter 2015 GAAP financial results on Thursday, February 4, 2016. The key items from the news release are as follows:

- GNW incurred a GAAP net after-tax loss of $292 million, and a net after-tax operating loss of $82 million, in the fourth quarter 2015.
- The principal drivers of the 4th quarter GAAP loss were higher universal life insurance reserves (which led to individual life operating losses), as well as losses related to the sale of the group's lifestyle protection insurance business and the pending sale of its European mortgage insurance business.
- These losses were partially offset by earnings from mortgage insurance (U.S., Canadian, and Australian), fixed annuities, and long-term care insurance.

The company also announced that it is suspending new sales of fixed annuities and individual life insurance, effective in March 2016. Further, the company plans to restructure its life insurance operations, in an effort to separate its long-term care insurance from its life insurance and annuity businesses.

This review will discuss the fourth quarter financial results for GNW, as well as the company's planned restructuring of its U.S. life insurers. Statutory financial information for the GNW U.S. life insurance companies is not filed until March 1, and though the company did provide some information as regards capitalization of the life insurance operations, a more detailed review (and ALIRT Scores) for Genworth Life Ins. Co., Genworth Life & Annuity Ins. Co., and Genworth Life Ins. Co. of New York will not be available until early March.

Genworth Fourth Quarter 2015 Financial Results

As mentioned above, GNW incurred a Fourth Quarter 2015 GAAP net after-tax loss of $292 million. The loss was driven primarily by three items:

1. A $134 million loss related to the pending sale of the group's European mortgage insurance business,
2. A loss of $73 million from the sale of the group's lifestyle protection insurance business,
3. A $184 million loss primarily relating to higher universal life insurance reserves.

Management stated that the higher universal life insurance reserves resulted from a change in its assumptions as regards policyholder persistency, long-term interest rates, mortality, and other items. Management stated that a portion of the $184 million loss also related to reductions in the Deferred Acquisition Cost (DAC) asset for the company's individual life insurance business, which affects GNW's GAAP earnings and shareholders' equity. The company also updated its assumptions as regards term life insurance, which resulted in an additional $10 million loss in the fourth quarter 2015.

The higher reserves may impact statutory earnings and capitalization for Genworth Life & Annuity Insurance Company (GLAIC) and Genworth Life Insurance Company of New York (GLICNY), as these two entities are the issuers of individual life insurance within the Genworth group. However, as Deferred Acquisition Costs assets are not recognized in statutory accounting, the reduction in these assets related to life insurance discussed above will not impact the life insurers' statutory financial performance or capital.

We note that the low interest rate environment is not unique to GNW and its U.S. life insurers, and that other life insurance companies have also reported lower operating earnings throughout 2015.

Other items of note for Genworth from a financial perspective:

- In January 2016, GNW redeemed its outstanding 2016 holding company debt obligations of $298 million (which would have been due in November 2016) for a cash cost of $321 million, which included the aggregate principal amount of the notes, a premium to redeem the notes early, and accrued and unpaid interest. The next debt maturity for GNW is $598 million of senior notes that are due in 2018.

- GNW reported positive earnings in mortgage insurance (in the U.S., Canada, and Australia), fixed annuities, and long-term care insurance.

- GNW's mortgage insurers achieved compliance with the new Private Mortgage Insurer Eligibility Requirements (PMIERs), which came into effect at year end 2015.

- Management noted that it has received approval for rate increases for traditional long-term care insurance in 35 states, with a weighted average rate increase of 29% across $740 million of in force premium volume.

- Management stated that GNW held approximately $1.4 billion of cash and liquid assets at the holding company level as of 12/31/15, which represented a buffer of over $900 million in excess of one and a half times annual debt service and restricted cash. When adjusting for the aforementioned debt redemption in January 2016, the buffer would be $586 million (total cash and liquid assets of $1.1 billion). Management stated the adjusted amount is above its target of maintaining cash of 1.5 times annual debt service expense, plus a risk buffer of $350 million.

- GNW's shareholders' equity totaled $14.6 billion at 12/31/15, down from $16.8 billion in 2014.

In terms of the financial results for the GNW U.S. life insurers, statutory financial statements are not filed with state insurance departments until March 1, which is the regulatory deadline for all insurance companies. However, management stated that the group GAAP losses relating to the sale of the European mortgage insurance business and its lifestyle protection insurance businesses have no financial impact on the GNW U.S. life insurers.

However, the life insurers will be impacted by the life insurance reserve strengthening, as well as an increase to variable annuity reserves (also resulting from changes to the companies' assumptions undergirding these reserves). Management stated that it estimates total statutory net operating losses of $40 million for the life insurers in the fourth quarter 2015, which though not ideal is not a large percentage of consolidated total statutory surplus (Surplus, Asset Valuation Reserve, and Interest Maintenance Reserve) of $4.3 billion at 9/30/15.

GNW management also provided an estimate to the year end 2015 consolidated risk-based capital ratio of 430% for its U.S. life insurers, which would be down slightly from the 438% reported at year end 2014. Management stated that this estimated risk-based capital ratio incorporates the agreement GLICNY reached with the New York Department of Financial Services, whereby GLICNY will record an additional $39 million of long-term care insurance reserves in each year 2015-2018. This amount for will be recognized by GLICNY in the year end 2015 financial statements.

Finally, GNW (through GLAIC) sold certain blocks of term life insurance to Protective Life Insurance Company in the first quarter 2016. This is expected to generate capital of about $100-150 million, which includes an expected tax payment of over $200 million to the holding company. However these factors will be partially offset by a decrease in surplus for the U.S. life insurers (most likely focused at GLAIC).

Strategic Changes to Genworth's Business Operations

In conjunction with the fourth quarter financial release, Genworth announced some strategic changes to its business operations going forward, which include the following:

- **The company will suspend new sales of individual life insurance and fixed annuities, effective in March 2016.** New business sales fell significantly throughout 2015, as management cited the effects of the rating downgrades, distributor suspensions, and lack of scale in the individual life and fixed annuity businesses. As a result of these factors, management felt it was in the company's best interests to exit these businesses, at least in terms of attempting to develop new business.

- GNW through its insurers plans to continue to issue new long-term care insurance.

- As a result of the exit from new life insurance and annuity sales, management stated that it expects to realize annual expense savings of $50 million. In the immediate term, management stated that this will result in a $15 million pretax GAAP charge to earnings in the first quarter 2016. Note that this is in addition to a previously announced plan to reduce expenses $100 million for its U.S. life insurance operations by the first half of 2016.

- Management further stated that it plans to reorganize its insurance companies and ownership structure, with a goal of separating and isolating its long-term care insurance business. Many of these items require regulatory and other potential third-party approvals. These plans include (but are not necessarily limited to):

    - Repatriate all business (mostly long-term care insurance) from its Bermuda reinsurers. As of year end 2014, GLIC ceded $9.3 billion of health (long-term care) insurance reserves while GLAIC ceded $232 million of non-health insurance reserves to Bermuda affiliated reinsurers.

    - Adjust the ownership structure of its U.S. life insurers, whereby GLAIC would cease being a direct subsidiary of GLIC, and would become a "sister" company of GLIC.

    - GLICNY would become a wholly-owned subsidiary of GLIC, where at present GLICNY is jointly owned by GLIC (65.5%) and GLAIC (34.5%).

    - Additional transactions may also occur, which could include intercompany reinsurance of any GLIC annuities or life insurance to GLAIC.

In many respects, the exit from the individual life insurance and annuity business is a reflection of the challenges the company faced in 2015. The high mix of traditional long-term care insurance business, public rating agency downgrades, adverse publicity, and the sharp decline in the share price over the last 15 months (and volatility within that time period) for GNW exerted considerable downward pressure on the company's new business volume, in an overall industry environment of flat (at best) business generation. Those challenges are not likely to abate in the near future, given the continued weakness in the share price (which is visible to distributors and policyholders), ongoing operating losses, and weak overall industry sales picture.

In terms of the financial results for the three life insurers, the suspension of new sales by itself does not impact the capitalization, operating earnings, or investment portfolios for any of the insurers. Moving forward, the lack of new business may result in a lower level of operating expenses as well as sharply lower commissions and other acquisition expenses.

Over the longer term, the elimination of new business could make it more difficult for the companies to improve profitability, as the opportunity for profits from new business to offset legacy business that has been less profitable than expected will no longer exist or would at least be greatly reduced.

As for management's plans to restructure its life insurance entities and separate its long-term care insurance business, it is too early to comment definitively on the size, scope, structure and timing of what may occur. We do note that many of these plans require the approvals of at a minimum the state insurance departments of Delaware (GLIC), Virginia (GLAIC), and New York (GLICNY). Management also referenced other third party approvals would be necessary as well in at least some cases.

We note that other insurance organizations have received regulatory approval to separate long-term care insurance into specific insurance companies.

If the company receives approval to restructure the ownership of GLAIC so that it was no longer a direct subsidiary of GLIC, it would make it easier for the parent company to receive shareholder dividend payments from GLAIC, as these dividends must now pass from GLAIC to GLIC, and then become subject to state insurance regulations on shareholder dividends for GLIC (as prescribed by the state of Delaware).

Conclusion

GNW's fourth quarter 2015 GAAP net loss of $292 million, though certainly not a positive development especially through the lens of company management and its investors, is a manageable event in terms of the solvency of the GNW, and especially for its three life insurance companies. GNW reported shareholders' equity of $14.7 billion at 12/31/15 in spite of the 2015 operating losses, which equaled 15.1% of the company's total general account assets and liabilities on a GAAP basis. This compares reasonably to a ratio of 14.2% for a composite of 29 U.S. publicly-traded life insurance groups as of 9/30/15.

The statutory operating loss for the life insurers is quite a bit smaller, as a large portion of the GAAP loss for the group resulted from the sales of business lines not related to the life insurers. Management estimated only a small decline in the risk-based capital ratio for the life insurance companies on a consolidated basis, and the estimated $40 million statutory operating loss is small when viewed against $4.3 billion in total statutory surplus. The suspension of sales for individual life insurance and annuities is not likely to have an immediate impact on the financial profile for Genworth Life & Annuity, Genworth Life Ins. Co., or Genworth Life Ins. Co. of New York, owing to the significant size of these three companies and their existing assets and liabilities.

Moving forward, Genworth faces significant financial and operational challenges, most notably on restoring and improving its operational profitability. The large mix of long-term care insurance remains a significant potential risk going forward, as the ongoing low interest rate environment (and rates have moved materially lower thus far in 2016), high policyholder persistency, and increased severity and duration of long-term care claims across the industry continue to pressure the long-term care business. Management has taken significant steps to address this, including sizeable reserve increases in 2014, and the company has successfully petitioned state insurance departments for significant rate increases and continues these efforts at this time.

The lack of new life insurance and annuity business could result in some expense savings and conserve statutory capital on the margin, but it also impedes the ability of the company to offset legacy business that may be less profitable than expected with new business (hopefully written at better margins). As a group, GNW plans to remain in the mortgage insurance business which is presently producing strong profits ($141 million in 2015), though weakness in the Canadian housing market (due to the fall in energy prices and its effect on the economy and housing prices, especially in certain parts of Canada) is leading to somewhat higher loss ratios.

Finally, we note that life insurance and fixed annuities have been significant contributors to earnings in previous years (and fixed annuities continued this in 2015), and long-term care insurance reported profitability in 2015 following the large reserve increases in 2014.

We will closely follow future developments in regards to potential restructuring of Genworth's life insurers and will report on them to clients as warranted. We will also report on the life insurers' statutory financial results when they are filed in early March. As always, clients should feel free to call or email us to discuss or with any questions.

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