Prudential plc to "Demerge" Jackson National; Jackson National RBC Ratio Changes

(February 1, 2021)

U.K.-based Prudential Plc (PRUplc) made several announcements last week (January 28, 2021), which included the following:

- PRUplc will be pursuing the separation of its U.S. business Jackson Financial Inc. ("JFI") through a "demerger", whereby shares in JFI would be distributed to PRUplc shareholders.
- At the point of demerger, PRUplc expects to retain 19.9% ownership of JFI, and management stated that PRUplc plans to sell down this remaining share "opportunistically".
- Following the proposed demerger, JFI plans to list its shares on the New York Stock Exchange, under the stock ticker "JXN".
- PRUplc management stated that it expects the demerger will occur in the second quarter 2021 and is subject to shareholder and regulatory approvals and other standard closing conditions.
- PRUplc appointed Steven Kandarian as Non-Executive Chair of JFI's Board of Directors. Mr. Kandarian is the former CEO of MetLife Inc. (MET), and held that position in 2017 when MET executed the spin-off of Brighthouse Financial Inc. to its shareholders.
- Jackson National Life Insurance Company (JNLIC), JFI's lead life insurance company, is revising its calculation methodology for the statutory accounting of policy reserves and capitalization, effective December 31, 2020. Management stated that this will result in an approximately 80 basis point reduction in JNLIC's 12/31/20 risk-based capital (RBC) ratio, to an estimated 340-355%.
- At the time of JFI's separation from PRUplc (expected in the second quarter 2021), management estimates that JNLIC's RBC ratio will be between 425-450%. Management stated that it expects JNLIC's RBC ratio to achieve this level through surplus infusions from JFI's planned capital raising efforts (debt and hybrid securities issuance). PRUplc does not expect JFI (and by extension JNLIC) to pay a pre-separation dividend to PRUplc.
- Additional information on the financial performance of PRUplc and JNLIC will be forthcoming when JNLIC files its year end 2020 statutory financial statement and when PRUplc releases its Full Year 2020 financial results, which will both occur the first week of March 2021.

Management for PRUplc stated that the demerger would allow for a more significant and earlier reduction in PRUplc's ownership of JFI than would have been possible through a combination of an initial public offering (IPO) of JFI followed by subsequent secondary sales of stock. In addition, the demerger reduces PRUplc's and JFI's exposure to equity market fluctuations that would be greater (and longer) in a more protracted separation.

PRUplc management further stated that this accelerated process will allow PRUplc to focus its business activities exclusively on the Asian and African markets, where the company believes it has significantly higher growth opportunities. To that end, PRUplc stated that it is considering an additional common stock issuance of between $2.5-3.0 billion to enhance its ability to participate in the Asian and African markets, as well as to improve the group's financial flexibility.

ALIRT Thoughts: Demerger

- PRUplc's announcement that it will be pursuing a demerger of Jackson Financial Inc. (JFI) does not greatly change the dynamics for Jackson National Life Insurance Company (JNLIC) or JFI's New York state insurer Jackson National Life Insurance Company of New York (JNLNY). The prior plan was for an initial public offering (IPO) of a minority interest in JFI, to be followed by secondary equity sales that would reduce PRUplc's ownership over time.

- This plan would have been similar to IPOs conducted by AXA (its U.S. life insurance and annuity business comprised of Equitable Financial, 2018), ING (VOYA Financial, 2013), and General Electric (Genworth, 2004). In all three of these cases a minority interest (between 25-30%) was sold via the IPO, with additional shares sold over a multi-year period to reduce the ownership percentage.

- The execution of the demerger speeds up this process considerably, as PRUplc plans to divest (to PRUplc investors) over 80% of JFI via the transaction. This would result in a quicker transition for PRUplc and "frees up" more capital for investment in the favored Asian and African markets, as well as for share buybacks and/or shareholder dividends (though these activities were not referenced in PRUplc's press release). PRUplc would plan to divest of its remaining 19.9% ownership of JFI "opportunistically".

- There is precedent for this type of transaction, as in 2017 MetLife (MET) divested over 80% of ownership in Brighthouse Financial (BHF), via a spin-off to MET shareholders. BHF was at the time a newly-created holding company, which served as the owner of insurers and other entities that constituted the "retail" individual life insurance and individual annuity business of MET, especially business distributed by registered broker/dealers and independent insurance and annuity distributors. Immediately after the spin-off, MET held a 19.2% ownership in BHF stock, which MET subsequently sold down over the following year.

- BHF's business has similarities to JFI, in terms of reliance on third party distribution, a significant block of variable annuities, some life insurance, and their positioning within their groups (MET and PRUplc respectively). PRUplc's forthcoming appointment of Steven Kandarian to JFI's Board of Directors may be due in part to Mr. Kandarian's role of MET CEO at the time of the BHF spin-off.

- Assuming the demerger is successful, Jackson National Life Insurance Company (JNLIC) and Jackson National Life Insurance Company of New York (JNLNY) will be the principal insurance subsidiaries of a newly created publicly-traded U.S. dominated holding company (JFI). JFI will have its own capital structure, and per today's announcement JFI plans to issue its own debt and hybrid securities. JFI management stated a large portion of the proceeds from these activities (if successful) will be contributed to its operating subsidiaries, especially JNLIC.

- As is the case with any change in ownership of an insurer, there are no changes that will result from the planned separation of JFI from PRUplc to any existing JNLIC and JNLNY policy contract.

ALIRT Thoughts: Risk-Based Capital (RBC) Ratio Change

- As regards to JNLIC's risk-based capital (RBC) ratio, JNLIC management stated that the expected reduction in the ratio is due to the revision of JNLIC's calculation of statutory policy reserves and capital, specifically regarding the "credit" companies such as JNLIC receive for their hedging program for variable annuities.

- At year end 2019 JNLIC (along with many other insurers) adopted changes in its reserve calculations and required risk-based capital for variable annuities ("VM-21"). JNLIC management stated that as a result of this adoption, the company's prior modeling for statutory reserves and capitalization required this "one time" adjustment.

- ***JNLIC management stated that this adjustment <u>does not</u> represent a change in its hedging program or objectives and <u>does not</u> represent a change in the performance of JNLIC's business. Management also stated that its hedging program continues to perform well and within the company's expectations.***

- ***In addition, management stated that this adjustment is "one time" in nature, and the company does not anticipate additional adjustments in JNLIC's RBC ratios or other metrics as a result of this change in modeling.***

- ALIRT notes that many insurers have made changes to their statutory and GAAP accounting associated with variable annuities and other industry products over the last several years.

- JNLIC's risk-based capital ratio equaled 366% at year-end 2019, and thus the expected year end 2020 RBC ratio (management estimated between 340-355%) is not out of line with the prior year.

- However, JNLIC sold (via reinsurance) its fixed and fixed indexed annuity reserves in force (and accompanying assets) to Athene in June 2020, and thus its total policy risks at year end 2020 are less than what JNLIC held at the end of 2019. Also, JNLIC's aggregate total surplus and "pure" capital ratio at 9/30/20 were much higher than at 12/31/19.

- JNLIC management further stated that it expects JNLIC's RBC ratio will rise to between 425-450% at the time of JFI's separation from PRUplc, as JFI plans to infuse capital into JNLIC from the proceeds of planned debt and hybrid security issuance by JFI.

- It is not known at this time as to how much JFI plans to raise from these activities, over what timeline these activities will take place, and whether these capital raising efforts will prove successful. However, ALIRT notes the robust conditions at present in terms of market demand for bonds and other fixed income securities, which may indicate that JFI has a significant probability of success in its planned capital raising initiatives.

- As a result of the planned capital infusions, the reduction in JNLIC's RBC ratio at year end 2020 may prove to be temporary.

ALIRT Thoughts: Ratings

- Public insurance financial strength ratings for JNLIC and JNLNY were lowered between one and two "notches" for all the four major public rating agencies subsequent to (1) PRUplc's March 2020 announcement of its plan to conduct a partial IPO of JFI, and (2) PRUplc's August 2020 announcement that it plans to fully divest of JFI.

- As a full separation of JFI from PRUplc is still the expected outcome, it does not seem likely that this announcement of the planned demerger of JFI from PRUplc will lead to additional rating downgrades (A.M. Best announced this morning that its ratings are unchanged). However, ratings can be adjusted at any time, and we note that the ultimate effects on insurers from the Covid-19 pandemic and resulting economic disruption are yet to be fully realized.

Ultimately, the goal for JFI (and JNLIC/JNLNY) is to continue to build on its strong market position in individual annuities, which includes JNLIC's (and JNLNY's) significant market penetration across virtually all material annuity distribution channels. When there are news items or changes (ownership, ratings, financial results, etc.) this task can become more difficult for an insurer, but ALIRT does not believe that these announcements result in a significant negative change to JFI, JNLIC or JNLNY.

We will continue to monitor the planned separation of JFI from PRUplc, and its possible impacts on JNLIC and JNLNY, and will report back to clients as material information becomes available. We are happy to discuss this with clients at any time.

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