

## **FITCH AFFIRMS PACIFIC LIFE'S RATINGS; OUTLOOK STABLE**

Fitch Ratings-Chicago-17 May 2016: Fitch Ratings has affirmed the ratings of Pacific LifeCorp (PLC) and certain of its subsidiaries, including Pacific Life Insurance Company (PLIC). The Rating Outlook is Stable. A full list of ratings follows at the end of this release.

### **KEY RATING DRIVERS**

PLC's ratings are based on the company's diverse business profile, very strong statutory capitalization, good liquidity and solid investment performance. Somewhat offsetting these positives are the company's high total financing and commitments (TFC) ratio, significant variable annuity (VA) exposure and earnings pressure.

PLIC had statutory capitalization of \$8.5 billion at year-end 2015, up 8% from the prior year-end driven by statutory net income and unrealized capital gains from derivatives. Favorably, PLIC has diversified its product sales and has moved away from the sale of capital intensive products. The company has a robust VA hedging program, which should lessen the statutory capital impact if equity markets experience significant deterioration. At year-end 2015 the company's RBC was 632%.

PLC has a \$17 billion book of legacy VA business with enhanced rider features primarily written between 2006 and 2008. This block of business has caused higher than expected GAAP and statutory earnings volatility over the past several years. While PLC has been successful in balancing its VA sales mix, the legacy VA business continues to represent almost 33% of total VA assets under management.

Fitch expects prospective earnings to be constrained by hedging costs and lower investment yields. Net operating income was \$561 million in 2015, which resulted in operating ROE of 6.2%. Interest coverage calculated on a pre-tax operating income basis was 6.7x, down from 7.5x in 2014.

Fitch believes any future investment losses, particularly in the company's commercial mortgage loan and RMBS portfolios should remain manageable in context of PLIC's statutory capitalization and earnings. However, PLC's large exposure to 'BBB' rated corporate bonds could have a material effect on earnings and capital in a severe credit market downturn.

Fitch views PLC's future financial flexibility as somewhat constrained given the company's limited access to external equity capital and modest organic statutory earnings generation prospects. While PLC's traditional GAAP-based financial leverage ratio at approximately 20% as of year-end 2015 is consistent with industry norms, the high TFC ratio at 1.2x diverges from that of many life industry peers. This high ratio is primarily driven by the capital intensive profile of the company's aircraft leasing subsidiary, Aviation Capital Group (ACG). Fitch views these activities as well managed and related risks are captured in Fitch's ratings. ACG debt is non-recourse to PLC. PLIC's statutory carrying value of ACG was \$1.8 billion at year-end 2015. The TFC ratio also includes \$1.5 billion of debt related to an investment in commercial mortgage-backed securities (CMBS) variable interest entities that is nonrecourse to PLC.

### **RATING SENSITIVITIES**

The key rating triggers that could result in a downgrade include:

- Financial leverage ratio at or above 30%;
- TFC ratio above 1.4x;
- Decline in statutory capital of 10% or more;
- Significant earnings and capital volatility;
- Losses or rapid growth at aircraft leasing subsidiary.

The key rating triggers that could result in an upgrade include:

- Decline in TFC ratio to 1x or below;
- Decline in financial leverage below 20%;
- Sustained improvement in operating performance as evidenced by an increase in GAAP interest coverage ratios to near 10x;
- Continued reduction in exposure to legacy blocks of VA contracts with enhanced rider benefits.

#### FULL LIST OF RATING ACTIONS

Fitch has affirmed the following ratings with a Stable Outlook:

##### Pacific LifeCorp

- Long-term Issuer Default Rating (IDR) at 'A-';
- \$450 million 6% senior notes due 2020 at 'BBB+';
- \$600 million 6.6% senior notes due 2033 at 'BBB+';
- \$500 million 5.125% senior notes due 2043 at 'BBB+'.

##### Pacific Life Insurance Company

- Long-term IDR at 'A';
- \$150 million 7.9% surplus notes due 2023 at 'A-';
- \$676 million 9.25% surplus notes due 2039 at 'A-';
- Insurer Financial Strength (IFS) at 'A+';
- Short-term IDR at 'F1';
- Commercial paper at 'F1'.

##### Pacific Life & Annuity Company

- IFS at 'A+'.

##### Pacific Life Re Limited

- IFS at 'A+'.

##### Pacific Life Funding, LLC

- Funding agreement-backed note program at 'A+'.

##### Pacific Life Global Funding

- Funding agreement-backed note program at 'A+'.

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#### Applicable Criteria

Insurance Rating Methodology (pub. 16 Sep 2015)

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