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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 Financial 2017 Financial Outlook. 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 Mark Finkelstein. Please go ahead.

Alan Mark Finkelstein

Senior Vice President & Head-Investor Relations, Prudential Financial, Inc.

Thank you, Cynthia. Good morning, and thank you for joining our 2017 financial outlook conference call. Please find our presentation for today's call on our website at www.investor.prudential.com.

Representing Prudential on today's call are John Strangfeld, CEO; Mark Grier, Vice Chairman; Charlie Lowrey, Head of International Businesses; Steve Pelletier, Head of Domestic Businesses; Rob Falzon, Chief Financial Officer; and Rob Axel, Principal Accounting Officer. We will start with prepared comments, and then we will answer your questions.

Today's presentation includes forward-looking statements. It is possible that actual results may differ materially from the predictions we make today. In addition, this presentation includes references to a non-GAAP measure. The slide deck includes a reconciliation of such measure to the comparable GAAP measure and a discussion of factors that could cause actual results to differ materially from those in the forward-looking statements.

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

John Robert Strangfeld

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

Thank you, Mark, and good morning, everyone. I'd like to welcome you to our 2017 financial outlook presentation. Before Rob Falzon takes you through the specifics, I want to provide some higher-level observations, and I'll begin on slide two.

The key message is that while there are market and regulatory uncertainties, and interest rates are still a challenge, we remain positive on our near term and longer term prospects, and our ability to produce a differentiated return on equity and strong cash flows. We benefit from our complementary mix of high quality Protection, Retirement and Asset Management businesses. Our business mix provides a good diversity in earnings sources, which helps us weather the normal variability in business results or fluctuations in market conditions, while offering solid growth opportunities. At the same time, we have a strong capital position and generate a significant amount of free cash flow in our businesses, which we estimate at about 60% of earnings over time. This allows us to execute a balanced approach towards capital deployment between dividends, buybacks and investments in our businesses, including M&A when we identify opportunities that represent a good strategic fit.

As Rob will describe in more detail, we're pleased that the board approved a \$1.25 billion share repurchase authorization for 2017. Since 2011, we have returned over \$10 billion to shareholders in the form of dividends and buybacks. We're also investing in our businesses. This includes investments in distribution, products, data and digital, and technology. Several of these investments have already started paying dividends such as in our Asset Management business. Other initiative spending will position us to capture opportunities and succeed over longer time horizons. Much of this incremental spend is financed through efficiency gains we have achieved in our businesses. We believe these investments, combined with our track record of innovation and execution, will drive future growth at attractive returns.

Overall, we feel very good about the positioning of our businesses and prospects, and our ability to deliver strong value to our shareholders.

Turning to slide three. This slide shows our historical return on equity since 2010. Recall that back in 2011, we established a long-term ROE objective of 13% to 14%, and then exceeded the top end of that range in 2013, 2014, and 2015. Those years clearly benefited from market tailwinds, including the impact of strong equity markets on many of our fee-based products, and favorable non-coupon investment income.

However, we also executed very well across our businesses, successfully integrated key acquisitions, benefited from innovative jumbo risk transfer transactions, and returned substantial sums of capital to our shareholders. As we look out over the next several years, many of the underlying factors that drove much of the ROE success in 2013 to 2015 remain intact, including strong business execution and effective capital deployment.

However, we're not immune to the multi-year impact of very low interest rates in our two primary markets, the U.S. and Japan. And while we don't consider ourselves to have higher interest rate sensitivity than our peers, the low

rate environment does adversely affect the returns we expect to achieve on new product sales, as well as the return on our in-force business.

In addition, though to a lesser extent, our multi-year strategic investment spending in our businesses that I referred to earlier also has a negative impact on our returns over the shorter timeframes. As a consequence, we have moderated our ROE expectations to a 12% to 13% ROE range over the near to intermediate term. If interest rates were to gravitate back towards more typical historic levels, we would fully expect to return to the 13% to 14% ROE level over time because of our business mix and our execution track record.

Now, before turning the floor over to Rob to discuss guidance, I know there has been a lot of attention on Wells Fargo's distribution of our MyTerm life insurance product, so I'd like to ask Steve Pelletier to spend a minute on it first. Steve, over to you.

Stephen P. Pelletier

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

Thanks, John. Good morning, everyone. First, let me begin by saying that all of us at Prudential are squarely focused on doing what's right for our customers. We stand behind our MyTerm product and the value that it's provided since we launched it in 2007.

Prudential has acted responsibly since we initiated our distribution relationship of MyTerm with Wells Fargo in June 2014. Before the issues at Wells Fargo became public, we surveyed Wells Fargo customers about their experience with MyTerm, including reasons why some of them let their product – let their policies lapse. Since that time, we've expanded our review into how the product was distributed at Wells Fargo bank branches and on the bank's website.

As we announced on Monday, we made the decision to suspend sales of the product through Wells Fargo until we've completed our review. I want to emphasize, we do not gauge the importance of this matter in financial terms, but for purposes of this call, it's probably useful to put some financial parameters around it. MyTerm sales through Wells Fargo, based on annualized new business premiums, were approximately \$4 million from the beginning of the relationship through the third quarter of 2016.

If any Wells Fargo MyTerm customers have concerns about the way in which the product was purchased, even if it is since lapsed, we will reimburse the full amount of the premiums they paid and cancel the policy if it hasn't been cancelled already. We're in discussions with our regulators and other constituents, and we'll respond to their inquiries and requests for information. Now, because our review is ongoing and there is litigation related to the matter, we're unable to provide any additional information regarding the specific topic.

And with that, let me turn the call over to Rob to discuss our financial guidance.

Robert M. Falzon

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

Thanks, Steve. Thinking back up on the presentation, slides four and five set out some key considerations and sensitivities at the business unit level that affect how we think about 2017 results. As many of you are aware, we don't provide guidance at the segment level or specific outlooks for sales or flows, which can vary from one period to another. While I don't plan to go into detail on the potential impact of the items we've shown, we thought these points might be helpful as you think about your own models in the context of our guidance. I won't cover each of the points, but let me give you some of the highlights.

In International Insurance, our focus on death protection products with returns largely driven by mortality and expense margins helps mitigate exposure of results to interest rates. And we've taken steps to re-price or, in some cases, suspend sales of products that are most affected by low and negative rates in Japan, essentially yen-based products with higher cash value structures.

We have less favorable hedged exchange rate for 2017 yen earnings relative to 2016. Using results for the nine months ended September 30, 2016 as a proxy, segment earnings would have been about 2% lower. Due to our significant sales of non-yen products, we expect the impact on future results from a less favorable currency exchange rate to be modest. We're continuing to target low single-digit growth of our Life Planner count in Japan and modest growth for Life Consultants at Gibraltar. In addition, we continue to build out third-party distribution.

In Individual Life, we expect to continue our diversified product strategy, targeting sales of roughly one-third guaranteed universal life, one-third term and one-third other products, including variable life. In Group Insurance, we are benefiting from our multi-year underwriting efforts, especially in disability, and we are expanding our market segment focus to include big market clients. We continue to target an 87% to 91% benefit ratio for the combined life and disability business.

We expect to build on the revenue growth we've begun to achieve in 2016, while maintaining pricing discipline going forward. In Retirement, we continue to see a strong opportunity to expand our pension risk transfer business, although growth will not be linear given the episodic nature of larger cases. We feel that spread compression and fee compression we've been experiencing in our full-service business are manageable headwinds.

In asset management, we are continuing to build out our multi-manager model, and we expect positive net flows and a stable fee yield. While we are continuing to invest in the business, we are starting to see payback in the form of increased net flows.

In the Annuities business, the completion of our recapture of living benefit risks from our reinsurance captive and the changes we've made to our risk management strategy have contributed to higher free cash flows and improved stability, while also providing an ongoing benefit to results that we would estimate at about 5 basis points in return on assets, or ROA. While there is some remaining uncertainty relevant to sales and flows as we work through our distributors on implementation of the DOL fiduciary rule, we're benefiting from the success of our product diversification strategy with our fixed income based PDI product contributing nearly half of our recent Annuities sales. We expect to continue to improve our risk profile and meet a broad range of client needs through ongoing product innovation.

Turning to slide six, here are some of the key assumptions and considerations that underpin our guidance. Our guidance assumes that the S&P 500 ends 2017 at 2,310. This is based on a 6% growth from an average of recent market levels rather than a single point, which we believe is appropriate in light of market volatility.

Our International Insurance yen and Korean won earnings are fully hedged for 2017 at ¥112 per dollar and KRW 1,130 per dollar. Our interest rate assumptions are based on an average of recent forward yield curves, a methodology that we believe is appropriate given market changes post the election.

As a benchmark, we assume a 10-year Treasury rate of 2.5% at the end of 2017. We're assuming continued investments in business initiatives for product, distribution, data, and digital innovation, as well as for systems and technology, including items that will have a longer-term payback period. We're expecting an effective tax rate of

approximately 25%, which does not give effect to possible impacts of post-election tax reform in the U.S. given the uncertainties of these.

Our board has approved a share repurchase authorization for 2017 of \$1.25 billion, as mentioned by John. In thinking about the authorization in relation to 2016, keep in mind that repurchases in 2016 included the redeployment of \$500 million of the proceeds of capital released from our Annuities Recapture, as well as the redeployment of proceeds from our yen equity hedge.

Our 2017 authorization reflects our expectation that about 60% of our after-tax adjusted operating income will become available for deployment over time. As we had mentioned in our last earnings call, we expect to move the evaluation of our dividend level to the first quarter of 2017 to align better with our capital planning cycle. We intend to continue to operate at AA financial strength standards, and we expect our leverage ratios to be within our targets.

Turning now to slide seven, to level set, this slide starts with the results for the trailing 12 months ended September 30, 2016, and removes the impact of market driven and discrete items, and net unfavorable variances from our average expectations into key areas we call out each quarter, such as mortality. We've also adjusted the earliest quarter included, the fourth quarter of 2015, for the change in currency plan rates as we moved into 2016, so that the entire baseline gives effect to the 2016 plan rate.

This leads to a pro forma baseline of about \$9.40 per share. While this should not be viewed as a projection of our full year 2016 results, we believe it provides a useful frame of reference for discussing our 2017 guidance. Starting from this baseline, we take into account market factors, which include a negative impact of about \$0.05 per share from the change in foreign exchange rates, including the hedged rate for the yen going from ¥106 to ¥112. We estimate for 2017, there is a further negative impact of \$0.25 per share to \$0.30 per share from the continued low interest rate environment, mainly driven by reinvestment rates on portfolio turnover and by lower investment yields on recurring premiums, net of the benefits from interest crediting rate adjustments.

These negative market factors are essentially offset by the impact of our assumed appreciation in the equity markets. We expect continued core growth in our businesses with key considerations I reviewed earlier. And we expect to balance our capital deployment between investment in our businesses based on market opportunities and returns to shareholders, including repurchases and dividends.

Putting all those together, our 2017 earnings guidance range for baseline adjusted operating income is \$10.15 to \$10.65 per share.

On slide eight, you can see the estimated impact of our earnings per share from a plus or minus 10% movement in equity markets, and a plus or minus 100 basis point change in interest rates. In each case, these shocks are viewed in isolation and applied at the beginning of 2017 on top of our existing market assumptions. As shown, a 10% move in the equity markets translates to about \$0.20 per share to \$0.25 per share, and a 100 basis point change in interest rates defined as a parallel shift in the yield curve translates to about \$0.15 per share to \$0.20 per share.

We also provided a GAAP balance sheet sensitivity to an immediate decline in our long-term benchmark rate. If we assume that immediate reduction of our long-term benchmark interest rate assumptions from 4% to 2.5% in the U.S., and from 1.9% to 1% in Japan, it would result in an estimated day one decrease of approximately 3% in book value based on GAAP, excluding AOCI and foreign currency re-measurement.

I would like to caution that these sensitivities are not necessarily linear nor entirely symmetrical, and should not be extrapolated over more severe shock levels in either direction. That said, we believe they, along with the business level sensitivities that we showed earlier, provide a useful frame of reference for some of the key assumptions that affect our results.

In conclusion, we believe that our business mix and solid fundamentals will continue to produce attractive financial results, driving solid earnings per share growth, strong cash flows and attractive returns to our shareholders.

Now, I'll turn it back over to John.

John Robert Strangfeld

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

Thank you, Rob. Thank you very much. So, we'd like to open it up for questions.

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] And our first question will come from the line of [ph] Eric Bass (18:01). Your line is open.

Q

Hi, thank you. A question on your expectations for pension risk transfer activity, and do you think that the rise in interest rates is going to have a material impact on expected demand in the market?

Stephen P. Pelletier

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

A

[ph] Eric (18:15), it's Steve. Thanks for your question. The uptick in interest rates definitely improves funding levels or plan funding levels overall, so that's helpful. But actually, we feel that the pipeline is strong, but it's continued to be driven by more fundamental considerations. And by that, I mean plan sponsor awareness of longevity risk and desire to manage it, and increasing PBGC premiums. We really see those as continuing drivers.

We do see right now, a trend in the marketplace of a strong desire by plan sponsors to transfer liabilities that are comprised of large numbers of retirees, but each with a relatively small individual benefit. That type of liability is particularly useful to transfer as it mitigates the impact of that portion of the PBGC premiums that are assessed on a per capita basis. We are very pleased to have been supporting United Technologies and being at the vanguard of this trend with the transaction we've recently announced with them, and we see very strong appetite for this type of strategy on the part of plan sponsors. And honestly, we feel ourselves very well qualified to help on that type of strategy because of our service capabilities. The strength and the scalability of our service platforms enable us to give the right type of quality of service level to all retirees, even those with small benefits, the type of service that they deserve and the plan sponsors expect us to provide them.

Q

Right. Thank you. And I realize that you don't give segment guidance, but I don't know if you could help at all, talk about the geography of the investment expenses you've discussed and how we should think about those affecting segment earnings?

Robert M. Falzon

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

A

So, [ph] Eric (20:13), it's Rob Falzon. The – that spending is actually running across our platforms. And actually, what you'll find is that there is spending that we've budgeted at the enterprise level for those things that sort of apply jointly across platforms, particularly opportunities that we have to take advantage of the platforms working with each other in the marketplace, and then we have initiative spending that occurs at each of the business levels.

So, we're not going to provide more detail in terms of what – how it is allocated between each of the individual businesses, but I would say that, it's to-date been focused primarily – or not primarily, the majority of it has been focused within our U.S. businesses, particularly driven by the opportunities we're seeing in the marketplace for those U.S. businesses, but we also are making investments in systems across all the enterprises, which include our international enterprises.

Q

Okay. Thank you.

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

Thomas Gallagher

Analyst, Evercore Group LLC

Q

Good morning. First question is just on how to think about longer-term impact if the yen continues to weaken. You have the capital hedge, which you should get continued gains from. Would you still expect, if we saw a big move weaker in the yen, let's say, toward the ¥130 to ¥150 range, that the negative earnings impact should largely be offset by capital that gets released in share repurchase or is there only a partial offset? That's my first question.

Robert M. Falzon

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

A

Tom, it's Rob. So the yen equity hedge is designed to protect us from further depreciation in the yen, it would do so even to the more extreme levels that you've described. I would – so, it's a complete hedge. It's not a partial hedge, in response to your question. Now, what I would caveat that with is that, obviously, we have to harvest the gains on that equity hedge. And then, upon harvesting them, we have to redeploy them. We do that in a variety of ways, including stock buybacks, as you mentioned, but also through – when we have opportunities to do so, in reinvestment in super organic or inorganic growth opportunities.

So there could be some delay in terms of when we book those gains and when we're able to, then, harvest and redeploy them, but over time, you should expect that we're able to protect the returns that we're generating from our Japan business through that equity hedge.

Thomas Gallagher

Analyst, Evercore Group LLC

Q

Do you – and just a related question, Rob. Do you have an update on where that gain stands today overall?

Robert M. Falzon

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

A

Tom, I can't provide you that number, but let me give you a couple benchmarks that may be helpful to you. If you recall that at the end of September 30, it was actually in a negative position of around \$800 million; and that's when the yen was trading at about ¥101. The breakeven at that point in time, as of September 30, was ¥108. So with the – [indiscernible] (23:14) the yen appreciated to ¥108 based on where we were as of September 30, that \$800 million would have become a neutral; and so, that any depreciation in the yen beyond ¥108 then puts that into a gain position.

Thomas Gallagher

Analyst, Evercore Group LLC

Q

Okay. That's helpful. And then, last question is, how do we think about your current SIFI designation post election? Should we be considering that you might actively pursue being de-designated? And if that's the case, should we think about what process or procedures are available to you if you are going to pursue a de-designation?

Mark B. Grier

Vice Chairman, Prudential Financial, Inc.

A

Yeah. This is Mark. Let me start with our process issues and – just to remind you that we come up for consideration of re-designation every year. And every year, as part of that process, we have the same option to pursue this in court that we had when we were originally designated. And as we've said, right now, at that process level, we're waiting to see what happens with MET's case. We'll learn from the outcome there and we'll learn from the opinion. And we'll consider the right path for us, again, in the context of that part of the process as things develop over the next six months or so.

I would add that every year, when consideration of our re-designation comes up, we repeat our case that we don't believe that we satisfy the criteria for being designated as systemically important. So, our case is familiar and being heard. Beyond that, in terms of the current context for regulation, I guess there are a few moving parts; one is Dodd-Frank and SIFI designation. And on that front, I think the macro point that we may see reconsideration of the burden of regulation on the economy and the burden of regulation on individual companies is something that we're going to be paying very close attention to. And then, the consideration as it relates to specific issues, like SIFI designation and managing systematic risk or Department of Labor standards, will also be important. The way in which this shakes out is highly uncertain. We could see legislative changes that impact Dodd-Frank dramatically. We could see legislative changes that impact Dodd-Frank more narrowly. But one thing that's out there is the consideration of the elimination of such a thing as a non-bank SIFI. But we also could see changes in implementation as it relates to either FSOC, generally, or the Secretary of Treasury's role as the leader of FSOC, and possibly, ultimately as well, changes in implementation with respect to Federal Reserve supervision and regulation.

So, there is a wide range of the way in which things can develop that would impact us as it relates to designation as a SIFI, and regulation and supervision that goes along with it. Maybe I'll ask Steve to comment on Department of Labor while we're on this general regulatory topic, but my summary on SIFI is that we have our process level in

the works, which we've talked about before, and possibly some other things to consider as we see developments over the next six months or so.

Stephen P. Pelletier

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

A

Thanks, Mark. Tom, I'd just add that we're well aware of discussions about the Department of Labor fiduciary rule, perhaps some anticipation in the marketplace of the possibility of a delay in the implementation of that rule. We'll see how that plays out. But I just want to emphasize that we are ready for April 1 implementation of the rule. I'd also comment that most of our spend in preparing for that rule has been around certain types of data-gathering infrastructure, data-reporting infrastructure. And we believe honestly that, that's a spend that will serve us in good stead no matter what the actual regulatory outcome is. But again, to close where I started, we're ready for April 1 implementation.

Thomas Gallagher

Analyst, Evercore Group LLC

Q

That's really helpful, guys. And, Mark, if I could just ask a follow-up to something you said. If there was – and I think this is a very big question for you, certainly for AIG. If there is an elimination of non-bank SIFI kind of broadly here, what would that mean for you? I think in the past, you've said you're not necessarily holding an explicit capital buffer, but I – clearly, your expenses would probably go down, but what do you think that would mean for your if that comes to pass?

Mark B. Grier

Vice Chairman, Prudential Financial, Inc.

A

Well, let me make a comment and then I'll also ask Rob Falzon to comment on it. It would mean anything with respect to capital. We've said before that we believe that we're very well managed with respect to aligning capital and risk. We're extraordinarily strong in terms of our loss absorption capacity, as well as the various metrics related to measuring either GAAP or statutory capital, or more importantly, for us, maybe economic capital as well.

With respect to expenses, group supervision is an evolving theme in other arenas beside SIFI and the Fed. And we have New Jersey as group supervisor and evolving work on group supervision at the state level in the U.S. We also have evolving international work on various aspects of supervision now, including designation as globally systemically important and also internationally active within the various dimensions of things going on internationally as work on supervision kind of highlighted by ComFrame and the supervisory college approach aspects of work now going on internationally on resolution and recovery, and continuing work going on internationally on capital standards. So there are four or five things happening on the international front that we also have to consider. So, I – this is kind of a long way of saying that SIFI or no, there is a group supervisory environment in which we're going to be operating going forward. I'll ask Rob to comment on expenses, but I just – I want to make sure that we're not thinking that if SIFI goes away, the whole world changes tomorrow morning. We've got other moving parts around the regulatory and supervisory environment for us.

Robert M. Falzon

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

A

So, Tom, with regard to the sort of the more narrow question on the expenses, we disclosed that our enhanced supervision related expenses last year were \$100 million, that, that same number through September 30 of this year was \$100 million on a year-to-date basis. And I would only repeat what Mark said, which is that some component of that is really related to the activities and systems around consolidated supervision or group level

supervision, and that not all of that goes away, which it should under some circumstances we cease to be Fed regulated because we'd need to support group supervision as it would come from other places.

Thomas Gallagher

Analyst, Evercore Group LLC

Q

Okay. Thanks, guys.

Operator: Thank you. Our next question comes from line of Ryan Krueger. Your line is open.

Ryan Krueger

Analyst, Keefe, Bruyette & Woods, Inc.

Q

Hey, thanks, good morning. I just – while we're on the topic of the election impact, do you have any pro forma tax rate sensitivity you could provide us if the base rate is reduced to 20% or 25% or something in that magnitude?

Robert M. Falzon

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

A

So, Ryan, it's Rob. I'm not sure I entirely understand what you're asking, let me take a shot at it and if I don't answer it appropriately, come back at me again. First of all, we're – we haven't done or we're not providing sensitivity analysis around it because there are just far too many moving pieces and far too much uncertainty around what if anything is going to occur there. Our effective tax rate for the upcoming year is at 25%. So that's sort of one data point. Recognize that, that's a combination of our effective tax rates outside the U.S., which is almost half our business, and then within the U.S. for the other sort of the remainder half of our business. Within that, it's not just a matter of the marginal tax rate, but all the other pieces that go around that. So our effective tax rate in the U.S. is a function of DRD and tax advantaged investing we do and a number of other items as well. So you have to pay attention to the full landscape of things that could change.

What I would point out to you is that if you look on our balance sheet, what you'll see is that there is a tax liability including a DTL in there, a deferred tax liability. So to the extent that taxes are lower from a balance sheet standpoint on an effective basis, once you run through all of that math, think about it as that would be, from a balance sheet standpoint, a positive thing, but I don't want to get carried away with that because we have to think through income and product implications of tax reform as well.

Ryan Krueger

Analyst, Keefe, Bruyette & Woods, Inc.

Q

No, that's – yeah. Understood. I know it's a moving target. And then, I guess, second question was on share repurchase. The \$1.25 billion, it's a little bit below the kind of original pace you came into 2016 with before you did the capital redomestication. I'm just wondering if you could provide any color on why the slight reduction.

Robert M. Falzon

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

A

Yeah, Ryan, so going back to some of my opening remarks, what I'd point out to you is that the amount we came into, which I think you're referring to, is the \$1.5 billion that was authorized for 2016, which was before we increased it by \$0.5 billion for the – or some portion of the proceeds coming out of our Annuities Recapture. That \$1.5 billion was a function – was an increase from \$1 billion the year before. And that \$0.5 billion increase was really driven by two items. One, it was an increase in our expected cash flow that we had indicated was going from 50% to 60%, so more distributable earnings coming at of our AOI. And then secondly, also, that we had, had

a significant amount of gains that we had harvested from our yen equity hedge, and that in order to protect the returns coming out of Japan, we were going to need to redeploy that. So, that \$0.5 billion increase off what we had done in 2015 was a reflection of both those. What we've articulated to you in the \$1.25 billion this year is just the one component of that. That is the amount of buybacks that we think is supportable in conjunction with our dividends coming just out of the 60% of our free cash flow. We will continue to look during the course of the year at opportunities for deployment of capital capacity we have, both from yen equity hedge harvesting, to the extent we have that, and from our ongoing balance sheet strength.

Ryan Krueger

Analyst, Keefe, Bruyette & Woods, Inc.

Q

Got it. Thank you very much.

Operator: Thank you. Our next question will come from the line of Jimmy Bhullar. Your line is open.

Jaminder Singh Bhullar

Analyst, JPMorgan Securities LLC

Q

Hi. Good morning. So, I realize your equity market assumptions, it seems like fairly conservative given where the S&P is right now. But can you give us some color on what you're assuming for non-coupon investment income, either directionally versus this year, or magnitude by it's how much higher or lower are you assuming that it will be versus what it's been in the past few quarters?

Robert M. Falzon

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

A

Yeah. Jimmy, what we assume in our forecast is that our alternatives portfolio will produce its expected long-term rate of return. And as you recall, on an AOI GAAP basis, that's about a 5% return on that portfolio. That works out to be somewhere between \$100 million and \$120 million a quarter that you would expect on a normalized basis, given the portfolio as it was constructed as of September 30. Recognize that we're constantly adding and subtracting from that portfolio so that number could change a little bit, but expectation – or the forecast includes an expectation of producing long-term returns.

Jaminder Singh Bhullar

Analyst, JPMorgan Securities LLC

Q

And then, on the Individual Life, it seems like the benefits ratio has gone up in the past couple of years, so I'm not sure if that's – how much of that is just mix of business versus maybe poor results. And have you changed your assumption for just the margins in that business? I realize you made some pricing changes, though.

Robert M. Falzon

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

A

So, Jimmy, you're talking about the Individual Life benefit ratio...

Jaminder Singh Bhullar

Analyst, JPMorgan Securities LLC

Q

Yes, yes, exactly.

Robert M. Falzon

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

A

...going upward, did you say?

Jamminder Singh Bhullar

Analyst, JPMorgan Securities LLC

Q

Going up, yeah.

Robert M. Falzon

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

A

Yeah. So recognize that what we've called out in each quarter is that we've had mortality that we think was outside of what would be our normal expected mortality experience. We've called that out for – in each quarter, and I think if you look at our benefit ratios adjusted for that adverse experience, then you would find that they would be more normal and consistent with our long – with our expectations. And so, we've had a couple of quarters of adverse mortality, but we think that there's nothing systemic there, and that it is not indicative of any long-term change to our expected mortality experience.

Jamminder Singh Bhullar

Analyst, JPMorgan Securities LLC

Q

Okay. And then just lastly, is it fair to assume that as of right now, you don't have any reserves for any potential settlements or charges or fines that you might incur related to the Wells Fargo issue?

Robert M. Falzon

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

A

The Wells Fargo issue broke in this quarter, Jimmy, so that prior to this, we would not have anticipated that event, and therefore, not have reserved anything.

Jamminder Singh Bhullar

Analyst, JPMorgan Securities LLC

Q

Okay. Thank you.

Operator: Thank you. Our next question comes from the line of Michael Kovac. Your line is open.

Michael Kovac

Analyst, Goldman Sachs & Co.

Q

Great. Thanks for taking the question. I wanted to quickly go through what you've provided on slide eight related to the potentially lower interest rate environment. Is that on a GAAP basis? And if you have any numbers on a statutory basis as well.

Robert M. Falzon

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

A

So, it's Rob. So, yes, the answer to – I'm sorry, your – first of all, let me make sure I'm clear on what you're asking. You're referring to the book value impact on the lower part of that slide or are you referring to the 100 basis – the plus or minus 100 basis points?

Michael Kovac

Analyst, Goldman Sachs & Co.

Q

The book value impact.

Robert M. Falzon

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

A

Okay. So, that is on a GAAP basis. If you look at that on a statutory basis, there would not be a significant difference in terms of expected outcomes. Remember, from a statutory standpoint, that the interest rate sensitivity is largely already captured in our AAT testing. And therefore, to the extent that there are incremental or residual adjustments that we have to make on a statutory basis as a result of lower interest rate expectations, that would be fully – we'd fully be able to absorb that within our existing capital capacity. So we're not looking at anything in the way of a material outcome that would result from a – that assumption in reversion rates applied to our statutory books.

Michael Kovac

Analyst, Goldman Sachs & Co.

Q

That's helpful. And then, one as it relates to the Annuities business more broadly and the DOL, we've heard others talk about product innovation over the course of the last several months. I'm wondering if you have any thoughts on – detail on new product rollouts in here in anticipation of the rule or, more broadly, shifts in the annuity marketplace?

Stephen P. Pelletier

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

A

Michael, it's Steve. I'll address your question. We definitely have plans in the course of the year to continue our strategy of product diversification that we've been pursuing over the past couple of years. As Rob mentioned, PDI, introduced a couple of years ago, now represents fully half our sales, and that actually is kind of very much in the lead of a move towards products that – where the benefits are simpler to communicate and is somewhat lower cost in terms of the price point as well. We'll continue that effort in the course of 2017. We have plans to introduce product in that context and in continued pursuit of that diversification strategy. We also have plans to continue to kind of refine the fee-based product that we already have in place and to make it more fully effective in the marketplace.

So, like I say, we've been at the diversification path for a couple of years, and we see it as something that is very much where customers want to go; and we want to provide solutions in that context. We really see this trend in our mind as largely independent of Department of Labor considerations. We see this as a way to provide a wider range of solutions in a way that we're providing more solutions to clients and helping to diversify our own risk.

Michael Kovac

Analyst, Goldman Sachs & Co.

Q

Thanks. That's helpful.

Operator: Thank you. Our next question will come from the line of Humphrey Lee. Your line is open.

Humphrey Hung Fai Lee

Analyst, Dowling & Partners Securities LLC

Q

Thank you. Good morning, and thank you for taking my questions. My first question is related to the investment expenses that you're planning to incur. You mentioned that some of those would be – will have a longer payback

period versus some of the typical kind of expense investments. How should we think about like what portion will have a longer payback period versus those will have a more typical payback period [indiscernible] (41:14)?

Robert M. Falzon

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

A

Humphrey, I wouldn't – I don't think I can give you a breakdown in sort of the duration of the investments and the payback periods on those. What I would say is that we've been at this for a couple of years. When we first articulated this increased level of spending, we said that it would be sort of a three-year to five-year horizon that we would expect that spending to continue, and that, over that period and subsequent to that, we would expect the payback on that; and then, for that level of spending to begin to return to – so a more normal level of investments.

The payback, actually, varies fairly dramatically by business. A number of the things that we've been doing within our Investment Management business have actually resulted in rather fast paybacks. We've also undertaken certain initiatives across our businesses for which we've gotten paybacks and, in fact, those paybacks have been how we've been able to finance many of the initiatives in a way that we've continued to be able to show growth in our earnings.

And so, what you see is a fairly attractive earnings growth rate trajectory going from 2016 to 2017 for our guidance. And that's despite the fact that we continue this level of investment spending, and that's coming as a result of certain businesses like Investment Management beginning to realize some of those benefits, and because some of that spending has resulted in reduced expenses across the platform that have allowed us to support the initiatives.

Humphrey Hung Fai Lee

Analyst, Dowling & Partners Securities LLC

Q

Got it. And then, another question kind of – like, I understand the investigation with the Wells Fargo relationship is still an ongoing investigation. There's probably not much you can really share at this moment, but how should we think about the potential outcome of the investigation? Would that affect your kind of existing variable annuity reinsurance relationship with them in any formal way?

Stephen P. Pelletier

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

A

Humphrey, it's Steve. I'd just address your question on a broader basis regarding kind of the full context – the broad context of our Wells Fargo relationship.

As you'd expect, like a number of insurance companies, we've done business with Wells Fargo in a variety of different institutional and retail capacities across our company over a multi-year period. To put this in context, if you consider the full extent of our third-party sales across all product lines – and I think you could kind of bring the reinsurance consideration into the context of this, looking at the relationship on a more comprehensive basis, but if you look at it through the lens of total third-party sales across all product lines, no single third-party represents a disproportionate amount of our sales volumes. And as for the reinsurance, I think that's been pretty much a separate and discrete conversation with them.

Humphrey Hung Fai Lee

Analyst, Dowling & Partners Securities LLC

Q

Okay. Thank you.

Alan Mark Finkelstein

Senior Vice President & Head-Investor Relations, Prudential Financial, Inc.

A

Cynthia, we have time for one more question.

Operator: Certainly. And that will come from the line of John Nadel. Your line is open.

John M. Nadel

Analyst, Credit Suisse Securities (USA) LLC (Broker)

Q

Thanks for getting me into the wire here. Two questions. Should we be taking away from the dialog around investment spending that 2017's level of investment spending, at least planned, will be higher than what you've been doing in 2016 at least on a run rate basis?

Robert M. Falzon

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

A

John, it's Rob. I would – what we built into guidance is that the level of initiative spending that we've been doing in 2016 would continue into 2017 on a net basis. And again, net basis meaning some of the – what I described in response to Humphrey's question that some of our investment spending is being supported by savings that we're already realizing.

John M. Nadel

Analyst, Credit Suisse Securities (USA) LLC (Broker)

Q

Okay. So in terms of swing factor on a year-over-year basis, we shouldn't expect that to have an impact?

Robert M. Falzon

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

A

Correct.

John M. Nadel

Analyst, Credit Suisse Securities (USA) LLC (Broker)

Q

And then, my second question is recognizing that maybe the timing of the end of October letter, I think that sort of dictates some of the assumptions you need to use for asset adequacy testing relative to the big move in rates we've seen very recently. Should we expect that there's any significant impact on the statutory basis from sort of additional reserves you have to put up?

Robert M. Falzon

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

A

So you're referring specifically to AAT testing in that question, John?

John M. Nadel

Analyst, Credit Suisse Securities (USA) LLC (Broker)

Q

Yes, yes.

Robert M. Falzon

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

A

Yeah. So, the AAT testing has lots of moving pieces to it. Included in those moving pieces are our assumptions with regard to the blocks of business that we have, and included in that, obviously, are also interest rates. What I would say is that, one, we did our assumption update in the second quarter of this year. And what you saw from a GAAP standpoint on that was that was generally a positive outcome from the assumption update. So, directionally, you would expect that, that would have a same sort of an outcome with regard to AAT testing.

John M. Nadel

Analyst, Credit Suisse Securities (USA) LLC (Broker)

Okay.

Q

Robert M. Falzon

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

To that, when we did our AAT testing at the end of last year, the 10-year was at about 2.25%, 2.27%. So, obviously, if interest rates are higher than that, directionally, that would also correlate with a lower AAT. But there are a lot of moving parts, and I would not want to get ahead of my actuaries with respect to how this is going to turn out at the end of the year.

A

John M. Nadel

Analyst, Credit Suisse Securities (USA) LLC (Broker)

Okay. And then, just – related – and somewhat relatedly, and maybe it's a little bit of a tangent, but as things are progressed on the NAIC Oliver Wyman study, and I guess, it's moving to sort of another phase here, any updates on your views or expectations there?

Q

Robert M. Falzon

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

No, John, I think we would reiterate that which we said in the third quarter call, which is that what came out of the Oliver Wyman study was entirely consistent with the way in which we implemented our recapture, that – and we don't see anything in that, that would otherwise cause us, give us pause with respect to how we've done that and the way in which we've done that with our New Jersey, Arizona and Connecticut regulators. I would say that the industry has concerns around some of the details that were in that Oliver Wyman study, not all of which were necessarily proposals for changes, and we are engaged with the industry and trying to get to some of the more granular points around how that may ultimately be implemented by the NAIC. But going back to my original point, we don't see anything there that causes us any sense of alarm.

A

John M. Nadel

Analyst, Credit Suisse Securities (USA) LLC (Broker)

And, Rob, we've had a few companies talk about the sort of capital differential, and maybe it's a reserve differential between the CTE(95) level, which I think is more of a rating agency type level, versus the CTE(98). Have you guys quantified that, and if not, could you?

Q

Robert M. Falzon

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

Well, recall, John, that we hold to CTE(97) over adverse market – or moderately adverse market circumstances. So for – the way in which we're holding capital effectively, if the ruling comes out that ultimately, the CTE(98) is where the NAIC lands, consistent with what's bracketed in the Oliver Wyman study...

A

John M. Nadel
Analyst, Credit Suisse Securities (USA) LLC (Broker)

Q

Yeah.

Robert M. Falzon
Chief Financial Officer & Executive Vice President, Prudential Financial, Inc.

A

...we don't think that, that presents any particular challenge given that while we're at CTE(97), it's sort of a forward-look under somewhat stressful conditions such that we would continue to hold CTE(97) under those moderately adverse circumstances. So, I don't have a quantification for you other than to say that we're well above the CTE(95) and would not have an issue with complying with CTE(98).

John M. Nadel
Analyst, Credit Suisse Securities (USA) LLC (Broker)

Q

That's helpful. Thank you so much.

Operator: Thank you. And, ladies and gentlemen, today's conference call will be available for replay after 1:30 PM today until midnight, December 22. You may access the AT&T teleconference replay system by dialing 1-800-475-6701 and entering the access code of 398840. International participants may dial 320-365-3844. Those numbers, once again, 1-800-475-6701 or 320-365-3844, and enter the access code of 398840.

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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