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Co. reported 2Q19 adjusted earnings excluding impact from notable items of $296m.

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CORPORATE PARTICIPANTS

Conor Ernan Murphy *Brighthouse Financial, Inc. - Executive VP & COO*

David Rosenbaum *Brighthouse Financial, Inc. - Head of IR*

Edward Spehar *Brighthouse Financial, Inc. - Incoming CFO*

Eric Thomas Steigerwalt *Brighthouse Financial, Inc. - President, CEO & Director*

John Lloyd Rosenthal *Brighthouse Financial, Inc. - Executive VP & CIO*

Myles Joseph Lambert *Brighthouse Financial, Inc. - Executive VP and Chief Distribution & Marketing Officer*

CONFERENCE CALL PARTICIPANTS

Andrew Scott Kligerman *Crédit Suisse AG, Research Division - MD & Senior Life Insurance Analyst*

Elyse Beth Greenspan *Wells Fargo Securities, LLC, Research Division - VP and Senior Analyst*

Erik James Bass *Autonomous Research LLP - Partner of US Life Insurance*

Humphrey Lee *Dowling & Partners Securities, LLC - Research Analyst*

Jamminder Singh Bhullar *JP Morgan Chase & Co, Research Division - Senior Analyst*

John Bakewell Barnidge *Sandler O'Neill + Partners, L.P., Research Division - Director of Equity Research*

John Matthew Nadel *UBS Investment Bank, Research Division - Analyst*

Joshua David Shanker *Deutsche Bank AG, Research Division - Research Analyst*

Ryan Joel Krueger *Keefe, Bruyette, & Woods, Inc., Research Division - MD of Equity Research*

Suneet Laxman L. Kamath *Citigroup Inc, Research Division - MD*

Taylor Alexander Scott *Goldman Sachs Group Inc., Research Division - Equity Analyst*

Thomas George Gallagher *Evercore ISI Institutional Equities, Research Division - Senior MD*

PRESENTATION

Operator

Good morning, ladies and gentlemen, and welcome to Brighthouse Financial's Second Quarter 2019 Earnings Conference Call. My name is Brian, and I will be your coordinator today. (Operator Instructions) As a reminder, the conference call is being recorded for replay purposes. (Operator Instructions).

I would now like to turn the presentation over to David Rosenbaum, Head of Investor Relations. Mr. Rosenbaum, you may proceed.

David Rosenbaum - *Brighthouse Financial, Inc. - Head of IR*

Good morning, and thank you for joining Brighthouse Financial's Second Quarter 2019 Earnings Call. Our earnings release, presentation and financial supplement were released last night and can be accessed on the Investor Relations section of our website at brighthousefinancial.com. We encourage you to review all of these materials, and we will refer to the slide presentation in our prepared remarks.

Today, you will hear from Eric Steigerwalt, our President and Chief Executive Officer; followed by Conor Murphy, our Chief Operating Officer and Interim Chief Financial Officer. Following our prepared comments, we will open the call up for a question-and-answer period.

Also here with us today to participate in the discussions are John Rosenthal, Chief Investment Officer; Myles Lambert, Chief Distribution and Marketing Officer; and Ed Spehar, our incoming Chief Financial Officer.

Our discussion during this call will include forward-looking statements within the meaning of the federal securities laws. Brighthouse Financial's actual results may differ materially from the results anticipated in the forward-looking statements as a result of risks and uncertainties, including those described from time to time in Brighthouse Financial's filings with the U.S. Securities and Exchange Commission.

Information discussed on today's call speaks only as of today, August 6, 2019. The company undertakes no obligation to update any information discussed on today's call.

During this call, we will be discussing certain financial measures that are not based on generally accepted accounting principles, also known as non-GAAP measures. Reconciliations of these non-GAAP measures on a historical basis to the most directly comparable GAAP measures and related definitions may be found on the Investor Relations portion of our website, in our earnings release, slide presentation or financial supplement. And finally, references to statutory results are preliminary due to the timing of the filing of the statutory statements.

And now I'll turn the call over to our CEO, Eric Steigerwalt.

Eric Thomas Steigerwalt - *Brighthouse Financial, Inc. - President, CEO & Director*

Thank you, David, and good morning, everyone. Brighthouse delivered strong results during the second quarter of 2019. Equity markets were strong, and while U.S. interest rates declined, which we will discuss later, we generated additional capital during the quarter. Investment income from alternative investments was higher, as expected, given first quarter market performance. Claims results improved modestly sequentially, while expenses were higher in the second quarter, as expected. Sales remained very strong, and we completed the repositioning of our investment portfolio as well.

Moving forward, we remain focused on executing our strategy, which we continue to believe will generate long-term shareholder value. Also, we recently announced the addition of Ed Spehar to the company as our Chief Financial Officer. Ed is with us today and will officially assume the CFO role on August 12. He is a seasoned leader, with an in-depth knowledge of our business. I am confident that Ed's addition to our management team will help us continue to execute our strategy and deliver a long-term value to shareholders, partners and customers.

I also want to take a moment to thank Conor Murphy for his leadership as the interim CFO over the last 6 months.

As we have previously discussed, one of our goals is to be a consistent returner of capital over time, and we continue to make progress toward achieving this goal. We repurchased approximately $136 million of our common stock in the second quarter. And we've continued repurchases in the third quarter of 2019, with approximately $43 million of our stock repurchased in July. Since the announcement of our first repurchase authorization in August of 2018, we have repurchased a total of $336 million of our common stock for July 2019.

Now let me turn to second quarter results. Our key highlights for the quarter are summarized on Slide 3 of our earnings presentation. First, I'm very pleased with our outstanding sales results in the second quarter. We had approximately $1.9 billion of annuity sales, up 34% compared to the second quarter of 2018 and up 11% sequentially. We continue to be pleased with our sales growth as well as the quality of new business we are adding each quarter.

In February, we launched our new hybrid life insurance product, Brighthouse SmartCare. This launch marked our first life insurance product introduction since becoming an independent public company, and is part of our strategy to reestablish a competitive presence in the life insurance market. The early feedback from our distribution partners has been extremely positive. Results are in line with our expectations in the second quarter, but I'm pleased with the very strong sales pipeline as we move into the third quarter. We continue to add major distributors for our SmartCare product in the second quarter and intend to roll out this product to additional distributors throughout the rest of the year.

Second, we are continuing to make necessary investments in our technology infrastructure and in our businesses. We refer to these investments as establishment costs. In the second quarter, establishment costs were approximately $30 million posttax.

Third, let me touch on our earnings results. Adjusted earnings, less notable items, improved sequentially, driven by higher investment income, primarily from our alternative investment portfolio, given the favorable equity markets in the first quarter of 2019. Equity market performance in the second quarter provided a benefit to adjusted earnings, but to a lesser extent than in the first quarter.

And finally, we continue to prudently manage our variable annuity capitalization. As we have talked about previously, we are managing our VA business to CTE98 or higher. As of the second quarter, our VA assets were approximately $1.5 billion in excess of CTE98, consistent with our strategy. Our hedging program continues to perform well across a wide range of economic conditions and in line with our expectations.

Before turning the call over to Conor to discuss our second quarter results in more detail, let me provide a few perspectives on interest rates. Brighthouse, like all insurance companies, is impacted by the level of long-term interest rates. With that said, we believe our balance sheet is well protected for a low rate environment. We have successfully managed our capital markets exposures through the use of derivatives and existing capital on the balance sheet over the last 2 years.

During the first and second quarters of this year, we proactively added interest rate protection, reducing our sensitivity to changes in long-term interest rates on statutory capital. The net result of our VA hedging strategy was an increase of assets above CTE98 in the quarter to approximately $1.5 billion, as I said previously. This is yet another example of Brighthouse prudently managing its balance sheet.

Despite the current low interest rate environment, we continue to believe in our ability to achieve our $1.5 billion capital return target by 2021.

We believe we have multiple levers to achieve the remainder of our capital return target. First, as I just discussed, we are prudently managing the capital backing our variable annuity block. Despite the low rate environment, we have generated more than $600 million of normalized statutory earnings, given the strong equity market performance in the first half of 2019. Although Brighthouse Life Insurance Company, or BLIC, has ordinary dividend capacity in 2019, we are currently planning for regular dividends for the holding company from BLIC to begin in 2020, post the implementation of variable annuity capital reform in our statutory financials.

Second, as we have said previously, our reinsurance subsidiary, Brighthouse Reinsurance Company of Delaware, is robustly capitalized. And we believe it is possible that over time, excess capital could be released.

Third, we anticipate that New England Life Insurance Company, or NELICO, will continue to be a stable source of capital for the holding company. NELICO's 2019 ordinary dividend capacity is over $100 million. We intend to dividend this amount to the holding company, later this year. We expect NELICO will continue to generate approximately $60 million to $70 million of dividend capacity per year over the next several years.

And finally, we currently have excess capital at the holding company. As a reminder, our goal is to have liquid assets at the holding company of at least 2x our annual fixed charges. And as of the second quarter of 2019, we are well in excess of our target.

To wrap up, we had solid results this quarter, and we continue to take proactive steps to ensure our balance sheet is well protected for a low interest rate environment. We have made significant progress over the past 2 years as an independent company. As we celebrate our second anniversary this week, I want to take a moment to thank all of our employees for their tremendous dedication, focus and hard work over the past 2 years. Going forward, we remain focused on continuing to grow life and annuity sales, reducing expenses, effectively managing our capital and driving long-term shareholder value.

With that, I'll turn the call over to Conor to discuss our second quarter financial results in more detail. Conor?

Conor Ernan Murphy - *Brighthouse Financial, Inc. - Executive VP & COO*

Thank you, Eric, and good morning, everyone. We had strong adjusted earnings results in the quarter and continued improvement in key balance sheet metrics as evidenced by the performance of our variable annuity hedging program.

Last night, we reported adjusted earnings, excluding the impact from notable items, of $296 million in the quarter, compared with adjusted earnings on the same basis of $259 million in the first quarter of 2019 and $197 million in the second quarter of 2018. Overall, investment results were solid, the equity markets performed better than our base case, claims improved modestly and corporate expenses were higher, as expected.

There were 2 unfavorable notable items in the quarter: establishment costs of $30 million after-tax, impacting Corporate & Other; and $12 million after-tax, related to a reinsurance adjustment, impacting the Run-off segment.

A few underlying themes influenced our results this quarter. Overall, net investment income increased approximately $100 million after-tax sequentially. The increase was driven primarily by the alternative investment returns, which improved given the positive first quarter market performance. Prepayments were higher, as was asset growth, which was primarily driven by our continued strong sales momentum.

I would also like to note, through the second quarter of 2019, we have repositioned approximately $8 billion of treasuries into a diversified mix of high-quality spread assets, marking the completion of the repositioning of our investment portfolio. Continuing with the market impact on results, separate account returns were positive 3.8% in the quarter, over 2 percentage points above our base case assumption. Compared with the base case, this resulted in a favorable impact of $20 million after-tax. While separate account returns were higher than our base case assumption, they were below the first quarter 2019 separate account returns, which resulted in higher DAC amortization on reserves on a sequential basis. Variable annuity separate account balances ended the quarter at $99 billion, modestly higher than at the end of the first quarter of 2019. Higher separate account balances, coupled with more processing days, resulted in higher fee revenue sequentially.

Moving on to life insurance, claims were modestly favorable compared to the first quarter 2019, primarily as a result of higher reinsurance recoveries in the second quarter.

Lastly, our corporate expenses in the second quarter were $242 million, up approximately $17 million pretax sequentially, consistent with our expectations. We anticipate full year 2019 corporate expenses to be in line with or slightly below the 2018 full year level as we continue to transition to the Brighthouse operating platform. We are still projecting a $150 million of corporate expense reduction on a run-rate basis by year-end 2020 and an additional $25 million in 2021.

Turning to adjusted earnings at the segment level, which excludes the previously mentioned notable items. Starting with annuities. Adjusted earnings in the Annuity segment were $265 million in the quarter. As I mentioned, separate account returns were strong in the quarter and above the base case, which benefited adjusted earnings to a lesser extent than in the first quarter. Alternative investment returns were positive, driven by the first quarter 2019 market performance, and asset balances increased sequentially, aided by our continued strong sales momentum. Additionally, fee income increased, as I previously mentioned.

Adjusted earnings in the Life segment were $58 million in the quarter. Sequentially, results were favorably impacted by the increase in alternative investment returns and higher reinsurance recovery. This was partially offset by higher DAC amortization.

The Run-off segment reported adjusted earnings of $14 million in the quarter. The sequential increase was driven by higher alternative investment return.

Corporate & Other had an adjusted loss of $41 million. Sequentially, expenses were higher, driven by the timing of ongoing marketing and branding programs.

To wrap up, I would like to provide an update on our capital position as of June 30, 2019. With respect to our variable annuity hedging strategy, results were in line with expectations in the quarter and outperformed the sensitivities outlined in our 2018 Form 10-K. As we previously mentioned, in the first half of 2019, we proactively added more interest rate protection, reducing the sensitivity of our statutory capital to changes in long-term interest rate. The net result of our VA hedging strategy was a sequential increase in assets above CTE98 in the second quarter to approximately $1.5 billion, despite lower interest rates.

Additionally, normalized statutory earnings in the quarter were approximately $280 million, bringing our year-to-date total, as Eric said, to over $600 million. Statutory combined total adjusted capital was approximately $6.9 billion, up $600 million from the prior quarter, driven by gains from our variable annuity hedging program in the second quarter.

We intend to adopt NAIC VA reform for statutory reporting by year-end 2019. We believe the new reserve framework will help pave the way for growth in ordinary dividend capacity in the years to come, as we expect changes in reserves will better align with our hedge target.

Finally, our average financial leverage ratio was consistent with the prior quarter at 24%, and our holding company liquid assets were approximately $900 million at the end of the second quarter. In all, we had another quarter of solid performance, and we continue to prudently manage our balance sheet.

With that, we'd like to turn the call over for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And our first question will come from the line of Elyse Greenspan with Wells Fargo.

Elyse Beth Greenspan - *Wells Fargo Securities, LLC, Research Division - VP and Senior Analyst*

My first question. You guys pointed to the increase on interest rate hedges that you guys purchased in the quarter with the subsequent to the end of the second quarter, we're seeing the 10-year drop, it's now at 1.75%, obviously, at 2% at the end of the quarter. Could you just give us a sense of the interest rate hedges and their ability to work -- continue to work with the 10-year at the level that it's at today?

Conor Ernan Murphy - *Brighthouse Financial, Inc. - Executive VP & COO*

Elyse, it's Conor. Yes, so you're correct. We did add a reasonable amount of protection in the first half of the year. At this stage, we believe, we are well protected for low rate environment.

With respect to the hedging strategy, it is designed to protect the statutory balance sheet, and we're executing our strategy. But we're marrying it up against market conditions as well. So given the implied interest rate volatility being at historically low levels in the first half of the year, we took some opportunity to increase that protection. So we're feeling pretty good. We believe we're well protected at this stage. And with respect to the impacts from here on a statutory basis, we believe that as of right now that we wouldn't be meaningfully different from where we finished the second quarter.

Elyse Beth Greenspan - *Wells Fargo Securities, LLC, Research Division - VP and Senior Analyst*

Okay. That's helpful. And then in terms of the annuities, the sales were pretty strong in the quarter. Some other companies have commented, given lower interest rates as they had to adjust their pricing on some of their products. So have you guys taken action as well? And would you expect an impact on sales from here? Or is just -- is there an offset from new distribution arrangements that could help offset potentially any changes on the pricing side of things?

Conor Ernan Murphy - *Brighthouse Financial, Inc. - Executive VP & COO*

Yes. Let me start from my Chief Operating Officer and pricing hat for a second, and then I'll give it to Myles. We're not seeing a meaningful impact in terms from a pricing perspective. We do revisit the pricing on all of our annuity and Shield-liked products every 2 weeks. But not seeing anything meaningful from a pricing point of view. But I'm going to ask Myles to add some commentary from a sales and pipeline perspective.

Myles Joseph Lambert - *Brighthouse Financial, Inc. - Executive VP and Chief Distribution & Marketing Officer*

Yes. Thank you, Conor. And as everyone knows, the majority of our sales are coming from our Shield product. So we remain very confident that we'll be able to continue sales -- continue to grow sales on that front. So we don't see a significant impact as it relates to our ability to produce sales on a low interest rate environment.

Operator

And our next question will come from the line of Andrew Kligerman with Crédit Suisse.

Andrew Scott Kligerman - *Crédit Suisse AG, Research Division - MD & Senior Life Insurance Analyst*

First question is around the hedging instruments that you are using to protect your statutory balance sheet from -- with respect to interest rates. Could you talk about the types of hedges you're buying?

Conor Ernan Murphy - *Brighthouse Financial, Inc. - Executive VP & COO*

Yes. Well, I think you're probably pretty familiar with the composition that we disclosed. It was about $100 billion of notional in the 10-Ks and 10-Qs. In terms of what changed this quarter is we added more interest rate options. We had about $10 billion of notional at the end of the year. We brought that up to about $17 billion in the first quarter, and we brought it up to about $21 billion in the second quarter.

Andrew Scott Kligerman - *Crédit Suisse AG, Research Division - MD & Senior Life Insurance Analyst*

I see, and are they swapped? So they -- are they future oriented? What options -- what in particular -- I mean if rates rise, are you going to feel the pressure on the opposite direction?

Eric Thomas Steigerwalt - *Brighthouse Financial, Inc. - President, CEO & Director*

Andrew, it's Eric. The composition of the instruments isn't different. I mean swaptions, swaps, options, we use all of them. In this particular case, what we added was interest rate options. And no, we feel pretty comfortable if rates go up. But we feel very comfortable if rates stay where they are at now or even go a little lower with respect to the hedging portfolio.

Andrew Scott Kligerman - *Crédit Suisse AG, Research Division - MD & Senior Life Insurance Analyst*

And Eric, are these options long-term?

Eric Thomas Steigerwalt - *Brighthouse Financial, Inc. - President, CEO & Director*

Longer term. I mean they're certainly not short-dated options. Over the last 2 years, we've discussed being out duration a little bit, they're not 10-year duration. But they're longer than 3 months.

Andrew Scott Kligerman - *Crédit Suisse AG, Research Division - MD & Senior Life Insurance Analyst*

Got it. And then over the statutory financials, I saw that you had a net loss of $100 million. And you've mentioned on the call that normalized, you should be at $600 million of earnings. So could you kind of clarify what the dynamics there that generated a statutory loss of $100 million?

Eric Thomas Steigerwalt - *Brighthouse Financial, Inc. - President, CEO & Director*

Yes. So I think the pieces that you're missing are the elements of the standard scenario, which were not terribly significant this quarter, changes in the CTE95, and then the unrealized gains and losses on the hedging program. So when you adjust for those, that's what's giving you the normalized, stat earning number of $280 million.

Andrew Scott Kligerman - *Crédit Suisse AG, Research Division - MD & Senior Life Insurance Analyst*

I see. And then just lastly, what's the deductible standing at right now?

Conor Ernan Murphy - *Brighthouse Financial, Inc. - Executive VP & COO*

Well, so we haven't had any change overall in the deductible since last quarter. So we're, obviously, more meaningfully above the 95. I think the last time we had spoken about it, we had a number in the sort of $1.2 billion range by potentially going up to about $1.5 billion. But we haven't changed it in the quarter.

Andrew Scott Kligerman - *Crédit Suisse AG, Research Division - MD & Senior Life Insurance Analyst*

So $1.2 billion?

Conor Ernan Murphy - *Brighthouse Financial, Inc. - Executive VP & COO*

Correct.

Operator

And our next question will come from the line of Tom Gallagher with Evercore.

Thomas George Gallagher - *Evercore ISI Institutional Equities, Research Division - Senior MD*

Just a follow-up on the change in the interest rate hedging program. Would you expect that this is going to change the long-term distributable cash flows at the block? So I guess, what I'm getting at is what's -- is there a cost associated with the extra protection you put on, when you think about counting your from long-term economics?

Conor Ernan Murphy - *Brighthouse Financial, Inc. - Executive VP & COO*

No, Tom. I would -- well I've mentioned we did add and actually to some extent, extended maturities here. There's no meaningful change in terms of the overall cost. So you got to put this in the context of the $100 billion of notional.

Eric Thomas Steigerwalt - *Brighthouse Financial, Inc. - President, CEO & Director*

Tom, it's Eric. I might just add this. I don't really think it's a change in the hedging program. We -- we're opportunistic. I'm sure other companies are opportunistic as well. Vol was pretty low in the first quarter. It's not like there's any wholesale change to the program. The program is very well established. It has parameters around its strategy. And we found a way to increase protection and frankly, even duration a little bit. So I just want to say that for everybody, I don't consider a wholesale change in the program itself.

Conor Ernan Murphy - *Brighthouse Financial, Inc. - Executive VP & COO*

And let me just start again as a reminder, and part of what drove the opportunity here was that the implied volatility is at historically low level. So that gives us a chance to -- well, we saw attractive pricing for interest rate options in the first half of the year as well.

Thomas George Gallagher - *Evercore ISI Institutional Equities, Research Division - Senior MD*

And then my follow-up is, Eric, you sound confident that you can still extract some of the excess capital out of the SGUL captive. What -- is there anything you can give us, could you mention how much excess you think might be there? And what would the process be when -- and from a timing standpoint, when would you think you could begin to extract the capital?

Eric Thomas Steigerwalt - *Brighthouse Financial, Inc. - President, CEO & Director*

Yes, Tom. Look, this all revolves around conversations with our regulators. We have a very good relationship with them, we want to keep a very good relationship with them. We feel we're managing the company very prudently. I can't put words in their mouth, but I do think that they pay attention to what we're doing, and I hope they think we're doing a pretty good job. I can't dimension either the size or the timing because it all depends on these conversations. So over time, we will be discussing the capital position in BRCD, and what we think of as excess capital, and obviously, they have to agree. So while I believe over time, we absolutely will be able to extract some capital there, I can't dimension it yet. And as soon as I can, I'll be happy to do so.

Thomas George Gallagher - *Evercore ISI Institutional Equities, Research Division - Senior MD*

Got you. And then just a quick follow-up on that. The current interest rate environment would not persuade you from believing your still material excess capital there?

Eric Thomas Steigerwalt - *Brighthouse Financial, Inc. - President, CEO & Director*

All right. I've been persuaded to spend a lot of time on the definition of the word current over the last 24 hours. So let me be very explicit here. Currently, the 10 year's in the 1 75 area, okay? If we see some of the volatility that we've seen in terms over time here, i.e., rates go back up to some degree, probably not a lot, but to some degree. Then I feel like we have the capability in our normal operating environments and some extra levers to be able to hit the $1.5 billion of capital returns.

Now if you tell me that if we look at the current interest rate environment and it's going to be like this for 3 years, then I would say that there's some headwinds there. And we'd have to take that into consideration if we were going to make a call on that assumption. And I think you all know that because we published these scenarios, they're in the last 10-K. So you all have a pretty good sense of longer term there. So I hope I was clear there. If we see volatility in rates, by the way if equity markets continue to do well and I don't mean like the last couple of days. You know what I'm talking about here. Then again, I feel pretty comfortable. But a longer term rates were lower for a number of years. That'll put some headwinds. Again, I know that's no surprise. I hope that was helpful.

Operator

And our next question will come from the line of Erik Bass of Autonomous Research.

Erik James Bass - *Autonomous Research LLP - Partner of US Life Insurance*

Just first, one follow-up, may be along that vein is -- how should we think about any changes to the previously provided interest rate sensitivities that you've given, both for capital and cash flow?

Conor Ernan Murphy - *Brighthouse Financial, Inc. - Executive VP & COO*

So Erik, again, just maybe, I don't want to get totally redundant or repetitive to Eric's part from -- we have our year-end disclosures for both distributable earnings and cash flows. The cash flows are not as impacted and those are fifty-year scenario. So if you were to compare those today, with where we're at the end of the year, they're similar and probably modestly better.

In terms of the distributable earnings, then it gets back to what you think from an equity market perspective, part of the drivers, the equity market and part of it is interest rate. So as Eric said, the equity markets are okay and the interest rates stay where they are, not for the next few years, then it's going to be a lower number. If both of them were lower, then your -- you know what that looks like because we gave you that scenario in the 10-K.

Erik James Bass - *Autonomous Research LLP - Partner of US Life Insurance*

Got it. And then can you provide any sensitivity to the net income impact, if you were to make any changes to your, I think, 4.25% long-term interest rate assumption, just kind of thinking ahead to the third quarter review?

Edward Spehar - *Brighthouse Financial, Inc. - Incoming CFO*

Eric, it's Ed. So as you know, our actuarial assumption update is done once a year in the third quarter. And so we will discuss it on next quarter's call. But let me provide a little bit perspective on the interest rate assumptions.

So on a GAAP basis, we have a mean reversion rate of 4.25% for the 10 year. On a stat basis, which is how we run the company, the implied interest rate assumptions are lower. So first, under VA reform, there's a prescribed methodology for interest rates, based on a weighted average of historical data. So as a result, our CTE calculation includes an implied mean reversion rate of 3.25% for the 10 year.

Second, we're required to perform cash flow testing for stat reserves on an annual basis, and this exercise includes a variety of interest rates stress scenarios. At year-end '18, we had meaningful cash flow testing margins. And at current rates, we believe we continue to have meaningful margins. So it's fair to say that changing the GAAP mean reversion rate assumption would have no bearing on our CTE calc or our stat balance sheet. So just to give you a sense of the difference between interest rate assumptions on a GAAP and stack basis. Hope that helps.

Erik James Bass - *Autonomous Research LLP - Partner of US Life Insurance*

Got it. And then on that GAAP basis, it's obviously noncash and accounting-oriented. Is there any kind of sizing you can give at this point? Or just wait until third quarter?

Edward Spehar - *Brighthouse Financial, Inc. - Incoming CFO*

Yes. I think you're going to have to wait until the third quarter. As you know, this is an involved process. So stay tuned.

Operator

And our next question will come from the line of John Nadel with UBS.

John Matthew Nadel - *UBS Investment Bank, Research Division - Analyst*

Just coming back to the incremental hedging that you guys have put on impressions or not, obviously, beneficial in the first half of the year, maybe late 2018 into the first half of the year. I know, Eric, that you're describing it as sort of, as no real change in your overall hedge approach but I'm curious how have you guys actually not done what you did? All else equal, what would that $1.5 billion relative to CTE98 look like as of 2Q? Because it seems to me that, that incremental action has been very beneficial.

Conor Ernan Murphy - *Brighthouse Financial, Inc. - Executive VP & COO*

John, it's Conor. Yes, fair question. Had we not put on the additional protection, the CTE numbers would have been consistent with first quarter. They would have been pretty flat. So you would not have seen the increase, and the increase from -- the increase looks like a $400 million. It's probably closer to $300 million in terms of the rounding. So it would have been pretty flat, had we not added the extra protection.

John Matthew Nadel - *UBS Investment Bank, Research Division - Analyst*

Okay. That's helpful. And then I think -- I want to try to paraphrase this, but maybe you can tell me if I've got it right or wrong. The incremental actions and where you guys think your expectation is that it doesn't really have a meaningful impact on distributable cash books?

Conor Ernan Murphy - *Brighthouse Financial, Inc. - Executive VP & COO*

Yes. Are you talking about the protection? Or you talking about the cost?

John Matthew Nadel - *UBS Investment Bank, Research Division - Analyst*

Just net. The -- does it put you in a better position on a statutory basis for dividend potential to the holding company? Or does it not materially change your potential dividend activity as we look out the next year or 2?

Conor Ernan Murphy - *Brighthouse Financial, Inc. - Executive VP & COO*

I don't think it's material. Look, and again, we're going to be able to revisit those at the end of the year with the full adoption or the full implementation of VA reform, that's going to the more meaningful, I don't think this is terribly meaningful to that.

John Matthew Nadel - *UBS Investment Bank, Research Division - Analyst*

Got you, okay. And then just one more question on investment income, so -- I'm not sure if alternatives includes prepayments and make-wholes, I just wonder, if you could just help us understand, may be relative to the total $942 million of investment income this quarter at 2Q. How much of that on an underlying basis would you consider sort of a normalized level of NII?

John Lloyd Rosenthal - *Brighthouse Financial, Inc. - Executive VP & CIO*

It's John. So I think we break alternatives in prepayments into 2 buckets. As you know, the alternative return for the quarter was 4.1%, $76 million on a base of about $1.8 billion returns from alternatives are hard to predict year-to-year, much less quarter-to-quarter, as these quarterly returns are real volatile. It's a long-term asset class for this and as we talk about in the past. But as we disclosed in our presentation, we expect a 9% to 11% long-term return from alts. And again, that's long term. So you can feel free to use those numbers to derive what a normal quarter might look like, but just please keep in mind that there is pretty much no such thing as a normal quarter for alts. On the prepayment side, prepayments were elevated during the quarter, primarily due to 1 mortgage prepayment, 1 bond prepayment. You could -- I'm not sure whether we give that as a separate prepayment number, but you can take off $10 million to $15 million pretax to get a more normalized number from...

John Matthew Nadel - *UBS Investment Bank, Research Division - Analyst*

Okay. Okay, so at quarterly NII, that's in the high $800 million, may be bordering on $900 million seems to be about right?

John Lloyd Rosenthal - *Brighthouse Financial, Inc. - Executive VP & CIO*

I think that's a pretty good guess.

John Matthew Nadel - *UBS Investment Bank, Research Division - Analyst*

Okay. And that's inclusive of all the benefits of the full repositioning, correct?

John Lloyd Rosenthal - *Brighthouse Financial, Inc. - Executive VP & CIO*

Yes, it is.

Operator

And our next question will come from the line of Jimmy Bhullar with JPMorgan.

Jamminder Singh Bhullar - *JP Morgan Chase & Co, Research Division - Senior Analyst*

First, just on your annuity sales. Obviously, the Shield product is helping you grow, you've added distribution as well. I just wanted to get an idea on, of all the distributors or the major ones that you've added over the past year, like Chase, Primerica, are you fully [penetrated] (corrected by company after the call)? Or there is more to go in terms of you getting sort of what you believe is your fair share through some of those distribution outlets?

Myles Joseph Lambert - *Brighthouse Financial, Inc. - Executive VP and Chief Distribution & Marketing Officer*

It's Myles. Thank you for the question. No, we feel like there's still a lot of room for growth as it relates to some of the new distributors that we brought on, selling our flagship product. But in addition to that, we continue to grow distribution to expand into other firms and new channels.

And then lastly what I would say is that the firms that we've been working with over the past several years that are selling Shield, we've seen them continue to grow their business there. So we feel like there's still a lot of runway as it relates to growing our Shield sales moving forward.

Jamminder Singh Bhullar - *JP Morgan Chase & Co, Research Division - Senior Analyst*

Okay. And then on the reinsurance cost adjustment, do you expect an impact on your ongoing earnings from that as well? And if yes, how much is it if you can quantify?

Conor Ernan Murphy - *Brighthouse Financial, Inc. - Executive VP & COO*

It's Conor. No, that is a onetime reflection. There's not an ongoing impact in future quarters.

Operator

Our next question will come from the line of Ryan Krueger with KBW.

Ryan Joel Krueger - *Keefe, Bruyette, & Woods, Inc., Research Division - MD of Equity Research*

In - on the life reinsurance captive, when you did the separation, you had purchased a pretty large amount of interest rates hedges for the stack capital back in that. Are -- do you still maintain all of those rate hedges? So should we think about lower rates, I guess, it's not materially impacting your view of access capital on the reinsurance captive?

Conor Ernan Murphy - *Brighthouse Financial, Inc. - Executive VP & COO*

Yes. The simple answer is, yes. We keep -- we maintain our protection on that as well from an interest rate perspective.

Ryan Joel Krueger - *Keefe, Bruyette, & Woods, Inc., Research Division - MD of Equity Research*

Got it. And then I guess on NAIC VA reform, I think you've already incorporated, I guess, I believe you've incorporated most of the impacts already in terms of when you discuss your capital in excess of CTE98. But I just wanted to, I guess, confirm that, would you expect much additional change when you fully adopt this at the end of this year or do you generally capture the impact already?

Conor Ernan Murphy - *Brighthouse Financial, Inc. - Executive VP & COO*

Not with respect to the CTE calculation.

Ryan Joel Krueger - *Keefe, Bruyette, & Woods, Inc., Research Division - MD of Equity Research*

So just the RBC calculation?

Conor Ernan Murphy - *Brighthouse Financial, Inc. - Executive VP & COO*

Well, that will be a yes. So there will be -- yes, there are elements for the transition that are not complete. But in terms of how we calibrate the CTEs, those already incorporate the impacts of VA reform.

Operator

Our next question will come from the line of Suneet Kamath with Citi.

Suneet Laxman L. Kamath - *Citigroup Inc, Research Division - MD*

Just wanted to try to reconcile a few things, if I could. On the one hand, you seem pretty confident in your ability to get dividends out of BLIC by 2020. But then on the other hand, if we look at your 10-K disclosures, the distributable earnings out of the VA business are pretty sensitive to rates. And if we look at that scenario for, in particular, it shows a pretty big drop-off in the level of distributable earnings. I'm just trying to reconcile those few things and understand if we're in this low rate environment what gives you the confidence that you can get dividends out of BLIC?

Conor Ernan Murphy - *Brighthouse Financial, Inc. - Executive VP & COO*

Well, let me start. I see, you mentioned the differences between sort of scenario 1 and 4. And you're right, it's a meaningful difference. Because in scenario 4, there is a little to no distributable earnings. But remember the difference between those 2 scenarios is a combination of both interest rates and equity market returns. And they're both meaningful, the equity market might actually be a little bigger than the interest rate element. So again, I think back to what Eric had said earlier, if you're isolating the interest rate from the equity market component, yes, that will be a challenge. If you're saying both that we have the low equity markets and prolonged low interest rates, then yes, the ability to -- well, that'll be an additional challenge to the ability to take those out over the next few years.

Now again, remember, we're $600 million in already. We've executed over $300 million of that. I think we've got $264 million to go after the end of July. We also have $600 million of start earnings in the first 6 months of this year. So again, depending on when you're starting point is, if you're starting today, I think you'll have to count that into your distributable earnings calculation as well. And we've made reference to some of the other levers that we have as well.

Suneet Laxman L. Kamath - *Citigroup Inc, Research Division - MD*

Got it. Okay that's helpful. And then just one quick one on the captive, I know it's still very much tied to conversations with the regulators. But I believe on last quarter's call you talked about having those conversations this summer. Any color on whether you've had them and if there's been any initial feedback from the regulators that you can comment?

Eric Thomas Steigerwalt - *Brighthouse Financial, Inc. - President, CEO & Director*

Yes. Suneet, it's Eric. Yes, we have had some conversations and we've got plenty more to go. This stuff never revolves around one conversation, nor should it, frankly. These are ongoing conversations that we have with our regulators. And that'll continue to go on. For as long as they need to. We want them to understand exactly what we're doing, understand how we're prudently managing the company, et cetera. So I'd love to be able to give you a play-by-play here, but it really just doesn't work that way. This will unfold over time. I do believe that we have excess capital there. And as these conversations unfold to the point where I can truly talk about it on a call like this, I definitely will.

Operator

Our next question will come from the line of John Barnidge with Sandler O'Neill.

John Bakewell Barnidge - *Sandler O'Neill + Partners, L.P., Research Division - Director of Equity Research*

Most of my questions have been answered. But on the tax rate, it's danced around a bit, I get there is some level of volatility quarter-to-quarter. But what are your current thoughts on a full year tax rate range?

Conor Ernan Murphy - *Brighthouse Financial, Inc. - Executive VP & COO*

You should expect, it'll be in the mid-teens.

John Bakewell Barnidge - *Sandler O'Neill + Partners, L.P., Research Division - Director of Equity Research*

Okay. And then, given the volatility of the markets on the equity and interest rate side, how the conversations on an annuity sale change this year versus last year because not only has Shield sold well this year but so have fixed indexed annuities.

Myles Joseph Lambert - *Brighthouse Financial, Inc. - Executive VP and Chief Distribution & Marketing Officer*

Can you clarify that question again a little bit?

John Bakewell Barnidge - *Sandler O'Neill + Partners, L.P., Research Division - Director of Equity Research*

Sure. How has the conversation on a sales perspective changed this year versus last year, given the volatility in the market both on the equity side and the interest rate side for your products in the Annuities segment? I ask this in light of Shield having sold well, but also fixed indexed annuities having sold well this year.

Myles Joseph Lambert - *Brighthouse Financial, Inc. - Executive VP and Chief Distribution & Marketing Officer*

Yes. So on the Shield said, I think this type of market volatility on a short-term perspective could slightly impact sales. But to your point, on a longer-term perspective, as clients look for more protection but yet, still remain invested in equity market is actually a good thing for our Shield product. As it relates to what we're seeing with FIA sales, I think it's a similar story. I think for those clients and advisers that are looking to provide maximum protection even though cap rates might come down from an interest-rate standpoint, it's still providing that type of guarantee that customers are looking for. So that they can stay invested in the market with fully protected products.

Eric Thomas Steigerwalt - *Brighthouse Financial, Inc. - President, CEO & Director*

John, it's Eric. I'll just add something too. On the pure fixed side, look, obviously, if we're seeing any pressure on pricing, it's going to be there. And we got to prudently manage our returns, but people are still looking for guarantees. So that's why, I think not only here but at other companies you're seeing fixed annuity sales doing okay, we'll have to see what happens here, where rates go next. But -- I thought I'd just clarify that.

Operator

And our next question will come from the line of Alex Scott with Goldman Sachs.

Taylor Alexander Scott - *Goldman Sachs Group Inc., Research Division - Equity Analyst*

I have a follow-up also on the hedged program. So when I look at the disclosure you guys provide on the movement in your derivatives quarter-over-quarter, spent $800 million. And I think through some of the product sensitivity that you guys have provided around the way the CTE requirements move. I guess it's -- it was a bit surprising that there is that big of an offset in the liabilities didn't move as much. So I'm wondering is it the equity exposure that's driving some of this. Have you -- are the options that you have so far out of the money that now if equity markets move up, there's just not much of a drag from the marks on the equities? And does that change your sensitivity going forward?

Eric Thomas Steigerwalt - *Brighthouse Financial, Inc. - President, CEO & Director*

Alex, let me start. It's Eric. We've had this conversation a couple of times on these calls. It's a big portfolio, right? You got to understand the movements and liabilities. You got to understand the movements on the asset side, volatility changes, frankly theta changes. It's pretty hard from the outside to perfectly predict where this is going. I said previously, I don't consider what we did in the first and second quarter, a big change. I consider generally that we had a strategy as we spun off the company. And we've been following that strategy. Now it's shades of gray on the margin from time to time, and everybody does that. This is a particularly interesting time for us. I know John Nadel calls it prescient. But look, we were looking at volatility. We are constantly watching the markets, et cetera. And I think we've got a reasonable handle on our liability calculations as well. So we're managing the hedge portfolio, all the time. Not necessarily trading all the time certainly, but managing it all the time. So I think maybe a couple of quarters ago I was like it would be hard for anybody on the outside to sort of get within better than $300 million-ish, okay? So I know you're trying to get it right down to the penny, but that's not the easiest thing to do. Conor, I'll turn it over to you. I know you want to add something.

Conor Ernan Murphy - *Brighthouse Financial, Inc. - Executive VP & COO*

Well, actually, I think you've -- you really captured it. What I was going to say is, again, I appreciate that you're a very detailed analyst, and you've gone through the portfolio in great detail but in order to be -- to do this calculation completely, as Eric said, you need not just the components of the hedges, but the liability changes as well. And your elements of yes, time decay and basis risk and fees and everything else. So to Eric's point, you're going to be able to get a reasonable assumption, but you won't be able to do it as fine-tuned as I think you'd like to.

Eric Thomas Steigerwalt - *Brighthouse Financial, Inc. - President, CEO & Director*

And maybe I'll just add this as well. Our goal with the hedging program is to protect the stat balance sheet. And now I think tomorrow is our 2-year anniversary, I have no issues with all of you wanting to understand. Do you really have a handle on this hedging portfolio and this hedging strategy. And I do believe it's starting to unfold that we do. We know what we're doing here, I feel really good about the strategy. There's not been wholesale changes in the strategy. Again, at the margin we do some things, but I feel really good about our ability to protect the stat balance sheet and that is the ultimate goal of the hedging program. I hope those comments were helpful.

Taylor Alexander Scott - *Goldman Sachs Group Inc., Research Division - Equity Analyst*

Yes. Those comments were very helpful. One more follow-up on that. I guess just around the options that I think if 1Q hedged balances were still intact, the options associated with equities were like 40% to 50% out of the money now. So have you taken the opportunity to pull any of those? And further -- and I'm not talking about small changes, but I think that was like the need of this equity options was very far out of the money. So just interested if those were pulled in or not?

Eric Thomas Steigerwalt - *Brighthouse Financial, Inc. - President, CEO & Director*

So in retrospect, as you can eventually find out where these positions are, you'll be able to take a look at what we're doing but I don't want to comment on like what we're doing right this minute. Conor, you want to add anything?

Conor Ernan Murphy - *Brighthouse Financial, Inc. - Executive VP & COO*

I think, yes I would agree with Eric. And look, you'll get the 10Q in due course, and you'll get the schedule BAs. But the -- I would say broadly speaking, we talked about a pretty meaningful increase in our interest rate option protection across the other elements of the portfolio, it's not meaningfully different, including the equity option.

Operator

And our next question will come from the line of Humphrey Lee with Dowling & Partners.

Humphrey Lee - *Dowling & Partners Securities, LLC - Research Analyst*

Just a follow-up on your comment about the hedged program. I understand it's going to be dynamic and you would be optimistic in terms of fine-tuning your protection. I guess like, based on your earlier comment, it sounded like you're planning anything incremental at least right now. But what could trigger some further fine-tuning, and if so what are some of those potential actions would be?

Eric Thomas Steigerwalt - *Brighthouse Financial, Inc. - President, CEO & Director*

Well, I love your fine-tuning. That's a good phrase, Humphrey. Because that's what it is, it's fine-tuning. Just watching as we see liability changes, watching the markets every day but again, I would consider it more fine-tuning. And when you do that, you get secondary order affects like you might change duration a little bit to the positive, right? A little longer duration. So I don't see anything right now that would have us do anything, but I do like your phrase, fine-tuning. Because that's how we think about it.

Humphrey Lee - *Dowling & Partners Securities, LLC - Research Analyst*

I'm glide you liked that. So I'm shifting gear. For one-off, I know the segment is going to be volatile quarter-over-quarter -- at any given quarters. But I still think you've said to that kind of $15 million based on expectations for a number of quarters now. It was the third quarter we were just coming up. Could that be any kind of potential area of concern as you're kind of looking through the -- your book?

Eric Thomas Steigerwalt - *Brighthouse Financial, Inc. - President, CEO & Director*

Okay. Well -- and just to reiterate, that range, if you will, is X notable items. I think -- look, it is nothing materially different. I think we'll have an opportunity with our Investor Outlook Call later in the year, perhaps to revisit the run rates. This is -- it's a small amount. I think we talk about it currently in the $10 million to $15 million range. And it doesn't take a lot to move that number very much. But broadly speaking, I think the run rates are largely intact and we'll revisit them at the end of the year and let you know if they need to be tweaked.

Operator

And our next question will come from the line of Josh Shanker with Deutsche Bank.

Joshua David Shanker - *Deutsche Bank AG, Research Division - Research Analyst*

We have a lot of good information even some more data on sensitivities. And we're always getting more but the one area that we don't have great detail on is volatility. The VIX yesterday went up to 25 from 15 at the beginning of the quarter. Can you update us a little bit on how should we think about equity markets vol? And also you never really talk about that what are the sensitivities to earnings and capital from interest rates vol?

Conor Ernan Murphy - *Brighthouse Financial, Inc. - Executive VP & COO*

It's Connor. Okay. So look, it's hard. I -- as VIX is probably not the best determinator, if you will, for the vol calculation for us. I -- yes, it's meaningful and higher volatility is generally a positive for us. I will say in Q2 specifically, vol was really not a factor, it was a very benign second quarter, but...

Joshua David Shanker - *Deutsche Bank AG, Research Division - Research Analyst*

No, I'm asking about third quarter, of course.

Conor Ernan Murphy - *Brighthouse Financial, Inc. - Executive VP & COO*

Yes. Look, there's going to be a lot of -- we have a long way to go in the third quarter. So I'm going to stay away from any predictions on where that may come out other than what I said previously that in terms of interest rates we would be broadly speaking where we finished the second quarter currently.

Eric Thomas Steigerwalt - *Brighthouse Financial, Inc. - President, CEO & Director*

But Josh, it's Eric. It could help. I mean you obviously know that. But yes, I mean from the point of view of early August, it's pointless to speculate, where it'll be at the end of the quarter.

Joshua David Shanker - *Deutsche Bank AG, Research Division - Research Analyst*

I read it this morning, I'm actually not looking for speculating but I'm looking for, is there a rule of thumb that we can sort of think about this or are you going to point to help us to frame it?

Eric Thomas Steigerwalt - *Brighthouse Financial, Inc. - President, CEO & Director*

Not really. I mean you know higher is good, that you definitely know. And I'm not trying to be a smart guy here. But these calculations are pretty complicated. The overall hedging strategy isn't really that complicated, but the calculations are so. So it's not perfectly linear. So I don't want to give out some rule of thumb here. Higher is better and you all know that. So I'll leave it at that.

Joshua David Shanker - *Deutsche Bank AG, Research Division - Research Analyst*

And interest rate vol, is there a big impact? How should we think about that?

Eric Thomas Steigerwalt - *Brighthouse Financial, Inc. - President, CEO & Director*

Less than equity. Interest rate vol would be -- would have an effect less than equities.

Joshua David Shanker - *Deutsche Bank AG, Research Division - Research Analyst*

Is a positive -- is this higher vol positive or negative in interest rate for the calculations?

Eric Thomas Steigerwalt - *Brighthouse Financial, Inc. - President, CEO & Director*

Similar.

Joshua David Shanker - *Deutsche Bank AG, Research Division - Research Analyst*

Similar, higher vol, better, okay.

Eric Thomas Steigerwalt - *Brighthouse Financial, Inc. - President, CEO & Director*

You're getting there. Anything else, Josh?

Operator

Ladies and gentlemen, I would now turn the call back over to Mr. Steigerwalt for closing remarks.

Eric Thomas Steigerwalt - *Brighthouse Financial, Inc. - President, CEO & Director*

Thanks. While everybody is still on here, I just thought maybe I'd spend 2 minutes here on just to wrap up on where we're on our sort of second anniversary. Look, we all know low interest rates pose a challenge to the industry and we have talked about that a lot today. Over the last 2 years, we've prudently managed our capital and we'll continue to do so in the future. And we believe our balance sheet is well protected for a low rate environment as we've discussed on a large part of this call. We began returning capital to shareholders almost 2 years ahead of our plan, and have continued repurchasing stock even as interest rates have declined. Also, we're maintaining our capital return target of $1.5 billion by year-end '21, because at this time, as we've discussed again on this call, we're not assuming rates will stay at the current level for an extended period although, they could and then we'll have a different conversation. We do have other levers that we could and can pull to offset some of the low pressure from interest rates. And obviously, we would also have to talk about where equity markets are as well.

Let me just say a few more things. Look, I couldn't be more pleased with our annuity sales. They continue to be robust, a couple of you asked Myles some questions today. And I think you can sense that he still feels very good about our prospects going forward here. In addition, let's remember that our Shield product has a meaningful risk offset to our inforce block of variable annuities. So it was designed that way years ago, and it is working as advertised. We're also reestablishing our presence in the life insurance space. So I'm really excited about the momentum going into the third quarter here. We made good progress exiting the TSAs. And I'll tell you we feel really good about our expense reduction plans. I do want to say this, my guess is that our one-time establishment costs will be a little higher. So we'll get into that probably in the third quarter, certainly on an investor call, maybe that's one spot, it's probably going to take a little longer and cost a little more. And I think it'll be important for you all to know that. With respect to the investment portfolio, we're now fully transitioned to our multi-manager strategy. And the cost savings that are associated with that. We've also repositioned approximately $8 billion of treasuries into a diversified mix of high-quality spread assets. So I feel good about that, John's looking at me right now. We've almost fully transitioned to the multi-manager strategy.

We've talked about the hedging program a lot today. I hope all of you are starting to get the feeling that this strategy is working and that we are managing it well through various economic cycles.

And finally, I'll just say we remain committed to executing on our strategies. So we laid out a strategy and we have, I don't know 8-ish targets out there. And it's our goal to hit as many of those as we possibly can no matter what the economic conditions, but we'll always be transparent, with respect to what the economic conditions ramifications are on that strategy.

So thank you all for paying attention over the last 2 years, and thanks for being on board today.

Operator

Ladies and gentlemen, thank you for your participation on today's conference. This does concludes our program., And, we may all disconnect. Everybody, have a wonderful day.