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EDITED TRANSCRIPT

BHF.OQ - Q3 2019 Brighthouse Financial Inc Earnings Call

EVENT DATE/TIME: NOVEMBER 05, 2019 / 1:00PM GMT

OVERVIEW:

BHF reported 3Q19 adjusted earnings (less notable items) of $260m.

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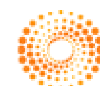

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CORPORATE PARTICIPANTS

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

Edward Allen Spehar *Brighthouse Financial, Inc. - Executive VP & 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*

Ian James Ryave *BofA Merrill Lynch, Research Division - 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*

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 Third Quarter 2019 Earnings Conference Call. My name is Catherine, and I'll be your coordinator today. (Operator Instructions) As a reminder, this 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 Third 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'll hear from Eric Steigerwalt, our President and Chief Executive Officer; followed by Ed Spehar, our 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 Myles Lambert, Chief Distribution and Marketing Officer; Conor Murphy, Chief Operating Officer and John Rosenthal, Chief Investment 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 financial filings with U.S. Securities and Exchange Commission.

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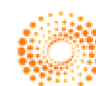

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Information discussed on today's call speaks only as of today, November 5, 2019. The company undertakes no obligation to update any information discussed on today's call. During this call, we will be discussing certain financial measures that are not 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 solid results during the third quarter of 2019. Global equity market performance was mixed and while U.S. interest rates declined, our variable annuity capitalization remained in line with the second quarter. Investment income from alternative investments was strong, given the second quarter market performance, while prepayment income returned to more normal levels. Claim results were in line with the prior quarter and sales remained strong.

Moving forward, we remain focused on executing our strategy, which we continue to believe will generate long-term shareholder value. 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 $126 million of our common stock in the third quarter. And we've continued repurchases in the fourth quarter of 2019, with approximately $49 million of our stock repurchase in October. Since the announcement of our first stock repurchase authorization in August of 2018, we've repurchased a total of $468 million of our common stock through October 2019.

Now let me turn to third quarter results. Our key highlights for the quarter are summarized on Slide 3 of our earnings presentation. First, we had another strong sales quarter. We had approximately $1.8 billion of annuity sales, up 17% compared with the third quarter of 2018. We continue to be very pleased with our sales, as well as the quality of new business we are adding each quarter.

Moving to life insurance. We continue to focus on our hybrid life insurance product, Brighthouse SmartCare. This is 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. We have made good progress, adding major distributors for our SmartCare product, with a network of over 56,000 advisors. And we intend to roll out this product to additional distributors over time.

Results to date are in line with our expectations, and I'm pleased with the strong sales pipeline as we move into the fourth quarter. Second, total annuity net outflows were approximately $1.1 billion in the quarter, down from both the prior quarter and the third quarter of 2018. As we've said previously, we expect to see a continued shift in our business mix profile over time, as we add more cash flow generating and less capital intensive new business, coupled with the runoff of less profitable business. Third, corporate expenses, which do not include establishment costs, were $248 million in the third quarter, consistent with our expectations.

We anticipate 2019 corporate expenses to be in line with the 2018 full year level, as we continue to transition to the Brighthouse operating platform. We are still projecting $150 million of corporate expense reduction on a run rate basis by year-end 2020, and an additional $25 million of corporate expense reduction in 2021. Fourth, we're continuing to make the necessary investments in our technology infrastructure and in our businesses. We refer to these investments as establishment costs.

In the third quarter, establishment costs were approximately $13 million pretax and $85 million before tax through the first 3 quarters of the year.

Let me provide a few perspectives on establishment costs going forward. First, we have made significant progress setting up our technology infrastructure and branding our company. And we are pleased that we have exited 163 transition service agreements or TSAs, with only 56 remaining. Second, we believe establishment costs will be $295 million to $325 million before tax on accumulative basis for 2019 through 2021.

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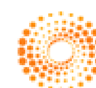

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This is higher than our initial estimates of $175 million to $200 million before tax as a result of 2 factors. The first is that we expect some of the more complex TSAs with MetLife to take a little longer and cost more to exit than previously thought. The second factor is that we're making additional investments in our company, as we transition to our future state operating platform.

We currently expect establishment costs to be between $120 million and $130 million in 2019, $150 million to $160 million in 2020 and $25 million to $35 million in 2021, all on a pretax basis.

In the end, I'm very pleased with respect to how we're doing with establishment costs and exiting the TSAs, but we're being prudent in how we are managing our way through the final couple of years.

Next, let me touch on our earnings results. Adjusted earnings less notable items decreased sequentially, driven by less favorable equity market results as compared with the second quarter of 2019.

We still anticipate low double-digit percentage growth in adjusted earnings per share, less notable items in 2019 versus 2018. Normalized statutory earnings were very strong in the quarter at approximately $600 million. And finally, we continue to prudently manage our variable annuity capitalization. As we have talked about previously, we're managing our VA business to CTE98 or higher. As of the end of the third quarter, our VA assets were approximately $1.5 billion in excess of CTE98, consistent with our strategy and in line with the second quarter results.

Our hedging program continues to perform well across a wide range of economic conditions and in line with our expectations. To wrap up, we delivered solid results during the third quarter of 2019 as we continue to execute our strategy. Our sales remained strong, our hedging program continue to perform well, and we repurchased more of our common stock. Going forward, we remain confident in our strategy, which we believe will enable us to generate long-term value for our shareholders, our distribution partners and the clients they serve. With that, I'll turn the call over to Ed to discuss our third quarter financial results in more detail. Ed?

Edward Allen Spehar - *Brighthouse Financial, Inc. - Executive VP & CFO*

Thank you, Eric, and good morning, everyone. I'm very excited to be on my first earnings call as CFO. I believe in our strategy and most importantly the team executing that strategy. I'm pleased by our solid business results, robust capital position and the talented and engaged employees of Brighthouse Financial. Since the separation, the financial management strategy has been to protect the statutory balance sheet and deliver distributable earnings over time.

Our focus on distributable earnings means a focus on cash. Over the past 3 decades, I have maintained that the surest way to create value in the life insurance industry is to manage for cash.

So I'm thrilled this is a key element of the Brighthouse strategy. Overall, I look forward to working with the entire Brighthouse team to generate long-term value for our shareholders, our distribution partners and the clients they serve.

Now turning to our results. Last night, we reported third quarter adjusted earnings, excluding the impact from notable items, of $260 million, which compares with adjusted earnings on the same basis of $296 million in the second quarter of 2019 and $314 million in the third quarter of 2018. Sequentially, results were impacted by less favorable market performance and lower net investment income, along with a modest increase in corporate expenses. There were 3 notable items in the quarter, which on a net basis lowered adjusted earnings by $429 million. The notable items on an after-tax basis were: establishment costs of $10 million in Corporate & Other, a $23 million benefit in Corporate & Other from a revaluation of tax items related to the separation from MetLife and a $442 million charge from the annual actuarial review, primarily in the Run-off segment.

As part of the annual actuarial review, we examine assumptions in 3 categories. Capital markets, business model and policyholder behavior. The charge associated with this year's annual review is driven by a change in our capital market assumptions, specifically a reduction in the assumed GAAP long-term mean reversion rate for the 10-year treasury from 4.25% to 3.75%.

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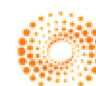

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We continue to assume that mean reversion occurs over the next 10 years. The negative impact from the lower assumed interest rate was primarily driven by our Run-off block of universal life with secondary guarantees.

There was a modest impact on our Annuities segment from the change in the mean reversion rate. Most of our GAAP VA guarantee reserves are currently accounted for as insurance reserves and are therefore relatively insensitive to interest rates. VA guarantees accounted for as embedded derivatives are sensitive to current market rates, not the mean reversion rates. It is also worth noting that the change in the mean reversion rate had no impact on our statutory results.

Turning to adjusted earnings less notable items, I would like to discuss the underlying themes impacting results. Let's begin with market performance. Equity market performance was mixed in the quarter, the S&P 500 total return was 1.7% and the NASDAQ total return was 1.3%. While the Russell and MSCI EAFE indices had negative returns. Bond returns were positive given the declining rates.

All in, these factors drove separate account returns of positive 0.8% in the quarter, less than 1 percentage point below our base case assumption and approximately 3 percentage points below the second quarter of 2019. As a result of less favorable market performance, DAC amortization and reserves increased sequentially for a combined unfavorable impact to adjusted earnings of $25 million or $0.22 per share.

Next, net investment income decreased sequentially by approximately $11 million after tax. The decrease was driven primarily by lower alternative investment returns. In addition, prepayment income returned to more normal levels in the third quarter, which also contributed to the sequential decline in net investment income. Asset growth was a partial offset, primarily driven by our continued strong sales momentum.

Moving to corporate expenses. In the third quarter, corporate expenses were $248 million, up approximately $6 million from the second quarter and consistent with our expectations. As Eric mentioned, we still anticipate 2019 corporate expenses to be in line with the 2018 level, as we continue to transition to the Brighthouse operating platform.

Now I'd like to make a few comments on segment earnings. Starting with annuities, adjusted earnings, excluding notable items, were $233 million in the quarter. As I mentioned, market impacts and net investment income were lower sequentially, which had an unfavorable impact on earnings. Additionally, taxes were higher relative to the second quarter. Adjusted earnings, excluding notable items in the Life segment were $54 million in the quarter.

Sequentially, results were impacted by higher expenses, partially offset by lower life insurance claims. The Run-off segment reported adjusted earnings excluding notable items of $5 million in the quarter. The sequential decrease was driven by lower net investment income and higher reserves, partially offset by lower taxes.

Corporate & Other had an adjusted loss, excluding notable items, of $32 million. Sequentially, results were driven by lower taxes, partially offset by higher expenses.

To wrap up, I would like to provide an update on our capital position as of September 30. Our hedging program continues to perform well and in line with our expectations. Assets above CTE98 were approximately $1.5 billion at September 30, in line with the second quarter. Normalized statutory earnings were approximately $600 million in the third quarter, primarily driven by gains from our VA hedging program.

Year-to-date, normalized statutory earnings were more than $1.2 billion. Statutory combined total adjusted capital was approximately $8.4 billion, up $1.5 billion sequentially. The result this quarter is representative of the total adjusted capital we would anticipate post VA reform, which we still plan to adopt at year-end 2019.

Going forward, we expect changes in reserves will better align with our hedge target.

Finally, our average financial leverage ratio was approximately 23% and our holding company liquid assets were approximately $800 million at the end of the third quarter or roughly 4x our holding company cash target.

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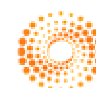

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The sequential decline in holding company liquid assets was primarily driven by share buybacks. It is worth highlighting that we have more than $200 million of annual inflows to the holding company before consideration of any dividends from our operating subsidiaries. These inflows cover most of the roughly $240 million of annual debt service and other holding company outflows. I would also like to note that we plan to take dividends from Brighthouse Life Insurance Company, or BLIC starting in 2020.

Overall, I am pleased with the results this quarter. We maintained our strong VA capital position, and we continue to prudently manage our statutory balance sheet. Adjusted earnings less notable items were solid, and as Eric said, we still anticipate low double-digit growth in adjusted earnings per share less notable items in 2019 versus 2018. With that, we'd like to turn the call over to the operator for your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And our first question comes from Tom Gallagher with Evercore ISI.

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

Just Ed, a few follow-ups on the final things you mentioned at the end there. The BLIC starting to take dividends coming in 2020. Can you expand a bit on that, in terms of whether it's the levels or range and what would the driver and source of that be?

Edward Allen Spehar - *Brighthouse Financial, Inc. - Executive VP & CFO*

Tom, so I don't want to get into specifics about what dividends we might take next year from BLIC, but I would just point out that with the $1.5 billion sequential increase in total adjusted capital, we had a similar increase in unassigned funds at BLIC. So BLIC's unassigned funds were negative $350 million at the end of second quarter and that increased to positive $1.2 billion at the end of the third quarter. And as you know, that's an important number when you think about dividend capacity.

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

And Ed, just a follow-up on that. Any way of gauging dividend capacity. And I know you're not done with the final stat filings obviously for 2019. But can you give some perspective on what -- how that would change capacity for dividends?

Edward Allen Spehar - *Brighthouse Financial, Inc. - Executive VP & CFO*

Well, why don't I talk a little bit about how we think our balance sheet at the end of the third quarter reflects what we believe it will look like under VA reform. So if we first step back and say why do we like VA reform, we like VA reform because we end up with a regulatory framework, that's consistent with how we manage the risk.

And at the end of the third quarter, what you had was a statutory balance sheet that was consistent with how we manage the risk. And therefore, representative of what we would expect TAC to be with VA reform. And the reason for that is we've had a decline in interest rates as you know and year-to-date. And as a result of the decline in interest rates, we've seen an increase in post VA reform reserves and a convergence with the standard scenario reserve, which is what's on our balance sheet today.

Not surprisingly with the increase in the post VA reform reserves, we've also seen appreciation in our hedge portfolio. And those unrealized gains in the hedge portfolio is what's driven the significant increase in TAC that we saw in the third quarter. So I think I would still go back to focusing

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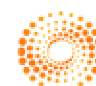

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on that increase in TAC and significant unassigned funds and ask you to, sort of, use that as some guide to think about dividend capacity from BLIC over the coming years.

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

Okay, that's helpful perspective. And then just final quick question. Can you give some perspective on how the hedges performed versus other assumption changes to get your neutral $1.5 billion VA buffer for the quarter?

Edward Allen Spehar - *Brighthouse Financial, Inc. - Executive VP & CFO*

Sure. So as you pointed out, the assets above CTE98 were $1.5 billion at the end of the third quarter, which is essentially the same as the end of the second quarter. But there is a good underlying story to that number. We had approximately a $400 million benefit from our VA risk management program in the quarter, as our hedge portfolio gains were greater than the increase in our total asset requirement. That performance was driven by our interest rate derivatives, where we had about $900 million gain in the quarter. This $400 million positive was offset by the actuarial assumption review on a statutory basis of about $400 million. There were a variety of items that impacted the statutory assumption review, the largest of which was a change in expense allocation to the annuity business. Importantly, this has nothing to do with total company expenses. As you know, total company expenses are coming down. This was simply an allocation. And so that was really the offset. The one other thing I'd point out is that there was no impact on the statutory results from the change in the GAAP mean reversion rate.

Operator

And our next question comes from Erik Bass with Autonomous Research.

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

I was hoping you could provide more detail on exactly what goes into the establishment costs bucket. Kind of how you determine what goes there versus normal course expenses? And how much and what goes into the separation costs is driving ultimately the targeted expense savings that you've talked about.

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

Eric, it's Eric. I missed your last one. Could you just repeat that second part?

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

Yes, the second was just, how much of, kind of, the establishment costs are ultimately driving the $150 million of expense savings over time in terms of the tech that you're adding in efficiencies? I guess, is there a linkage between the 2?

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

Got it, okay. So the first part, look we have a reasonably rigorous process around what goes into establishment costs and what we consider run rate.

And I guess that's probably the best way to think about it, right? If costs are going to continue theoretically forever, well then they're certainly not establishment costs, they're just normal run rate costs.

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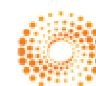

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If you think about like how we started, the branding, the original branding initiatives were onetime costs, right? We were not going to continue those once we felt that the company was at a certain level then those costs no longer go into establishment costs. A number of the costs associated with still being -- still having administrations and operations at MetLife. And then transferring those either to ourselves or mostly to some of our partners like DXC establishment costs, okay?

So onetime in nature ends up in establishment costs, anything that very much looks like just an ongoing expense, ends up in normal corporate expenses. And then with respect to the drivers, yes, I mean, there's obviously a number of very important drivers. Take the move for Brighthouse to multi-asset management, right? That's a real cost saver for us. But also, getting out of legacy systems, transferring to our new administrative platform is a big driver of costs. Those are probably 2 of the bigger buckets. So we do not believe given what I said a little bit higher onetime cost is going to affect either the $150 million target that we have out there or that extra $25 million in the following year. But we are being prudent with respect to the final couple of years here as a said in my opening remarks this is complicated, it's probably not a surprise to many of you that in a few areas it's even more complicated than we thought. Some of these expenses, as I mentioned, are going to go to investments. The patient is opened as it were, and we're going to do some things that otherwise we might not have been able to do. But also, we're going to be rigorous about QA testing, et cetera, et cetera, double staffing from time to time, to make sure that we finish out the movement out of the TSAs the way we've been able to do it so for. Hope that helps?

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

Yes. And then just one follow-up on expenses. You talked about the 150 run rate, I think, getting there by the end of next year. It's -- how should we think about the expense savings coming through in 2020, kind of, over the course of the year?

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

You mean as we head towards the 150?

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

Exactly. So should it be, sort of, ratably throughout the year, kind of, more in the back half, any perspective on how to think about that?

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

Yes. More in the back half, absolutely. We've got a lot to do in the first part, and then you'll see expenses start to come down in the second half of 2020.

Operator

And our next question comes from Elyse Greenspan with Wells Fargo.

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

My first question on Tom -- one of Tom's questions, you guys were going through the components of assumption review. And I think you guys mentioned a change in expense allocation to the annuity business. Just was hoping to get a little bit more color on what's going on there and if you can quantify the impact there?

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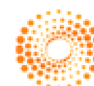

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Edward Allen Spehar - *Brighthouse Financial, Inc. - Executive VP & CFO*

Sure. Elyse, it's Ed. Of that roughly $400 million impact from the actuarial assumption review on stat, something like $240 million of it was related to this expense allocation. And this was -- again no change in the overall expenses, as you just heard from Eric. We continue to have expenses coming down and expect that will be what we'll see next year as well. But what we did see was based on some time study work, some product work that we did that -- we determined that there was a greater level of expenses that should be aligned to the in-force annuity business. And what you have here is you have a multiplier effect. So this roughly $240 million impact that we see from the assumption review is really like roughly a 5x multiplier on the change in the expense allocation because the -- you're assuming that these expenses are going to be higher going forward. And it's an ongoing impact, therefore, on the total asset requirement.

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

Okay, that's helpful. And then in terms of the dividends from the BLIC next year, can you give us a sense of time frame? And just how we should think about -- thinking about capital at the hold co and potential share repurchases in 2020?

Edward Allen Spehar - *Brighthouse Financial, Inc. - Executive VP & CFO*

Elyse, sorry, I just have to go back to pointing you to the unassigned funds of $1.2 billion, and I guess one piece of additional color I would add is that I think I'm going to anticipate what I might get here on this topic of the unassigned funds because we -- I just said we had unrealized gains in hedged portfolio drive, the TAC increase and the improvement on unassigned funds. So I'm anticipating someone might say, well what happens, how should we think about unrealized gains and what that means for both of those numbers? If we go back to when we first started talking about VA reform in 2018, we had communicated that we thought there would be a material benefit to our total adjusted capital from VA reform. And at the time, interest rates were more than 100 basis points, I believe more than 100 basis points above where they are today. If we were to go back to where we were, if rates were to go up 100 basis points, we would anticipate that these unrealized gains in the hedge portfolio would be eliminated. But we would also anticipate that our reserves would come down by a similar amount. And so we would expect that total adjusted capital and unassigned funds would look pretty much like what you saw at the end of the third quarter, everything else being equal.

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

Okay, that is helpful. And then in terms of last question, as we -- people think about I know some of us model in and some of us don't model in these establishment costs into EPS. Is there a rule of thumb to think about modeling them in throughout the quarter results 2020 kind of even or does it feel more front loaded?

Edward Allen Spehar - *Brighthouse Financial, Inc. - Executive VP & CFO*

Yes, I don't think we can give you much guidance on timing, and there's a fair amount of uncertainty around how these report through quarter-to-quarter as you've seen already. I think the best bet at this point is to divide by 4.

Operator

Our next question comes from Ryan Krueger with KBW.

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

I guess what is the interest rate assumption in the GAAP SOP reserves for variable annuities and what would cause that to change? I guess I thought it would have needed to change as part of the assumption review as well?

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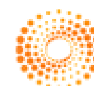

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Edward Allen Spehar - *Brighthouse Financial, Inc. - Executive VP & CFO*

Sorry, Ryan could you clarify that? You try one more time.

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

Yes, I guess, you lowered your long-term interest rate by 50 basis points, but I think you said you it had no impact on the SOP reserves for variable annuities. Can you give us a sense of what the interest rate assumption is in the SOP reserves for variable annuities and what would cause that to -- you to change that?

Edward Allen Spehar - *Brighthouse Financial, Inc. - Executive VP & CFO*

Yes, Ryan, so the separate account return assumption I think which is going to include obviously both the equity and fixed income return is unchanged at 6.5%. So I think maybe that's what you're getting at in terms of the return assumption associated with the VA business. The reason that you saw little sensitivity to the interest rate change for our annuity business is really all of the change in the mean reversion for annuities came through in DAC and is really associated with lower future spread income, so lower gross profits on the fixed side. The VA guarantees most of those are accounted for as insurance. And they are relatively insensitive to this mean reversion rate and the portion is accounted for as an embedded derivative is sensitive to rates, but it's sensitive to market rates not the mean reversion rate.

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

Got it. And then I guess going forward, are you still planning to manage variable annuity capital to an assets above CTE98 framework, or would you anticipate shifting more to an RBC ratio following the full implementation of VA reform?

Edward Allen Spehar - *Brighthouse Financial, Inc. - Executive VP & CFO*

Yes, I think we would -- I mean, I don't know that there's going to be any change in how we manage assets above CTE98, I think the goal would still be to be CTE98 plus in normal markets and to protect CTE95 across markets. But I think managing to an RBC framework is going to work for us now because I think as you've heard us say we have a RBC capital framework that aligns with that how we think we should manage the risk. I would just say on RBC, we ended 2018 with the 485% RBC ratio. And where we sit today, we don't believe there is going to be a material difference in our RBC ratio at the end of 2019 post VA reform.

Operator

Our next question comes from Andrew Kligerman with Crédit Suisse.

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

I wanted to ask you about the establishment costs. So the new guidance is about $120 million higher than original. That's more than a 60% increase in what you're originally guiding. And I think Eric, you said, it was the complexity of the TSAs as one and the additional investments that you're making. Could you break out those 2 pieces in terms of the parts of the $120 million? And maybe provide a little more clarity on how such a big change could occur only in a couple of years.

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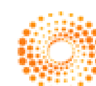

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Eric Thomas Steigerwalt - *Brighthouse Financial, Inc. - President, CEO & Director*

Yes, sure, Andrew. Look, I've been involved in a number of these big transformational efforts. And try as we might to get the original projections correct, it's very difficult. Especially in a situation, where we want to make sure this works, right? We really only have one shot at this, right? As we've discussed previously, MetLife is not in the TSA business. They have their own strategy, and it doesn't include being a TSA provider to Brighthouse. So as we get off these, and we've been pretty successful at getting off the majority of them now, we want to make sure that we get this right, as we move from Met either to internal ops or into some of our large service providers going forward. So in the end, the number here that we will have spent will be somewhere in the $700 million range. It's a big number. So we were reasonably confident in our numbers.

Obviously, when we gave them out, we wouldn't have given them out. But the idea that we've had a revision in these numbers is not overly surprising, given the magnitude of this project. So I would say then kind of to your second question, I would say maybe 60-plus percent would be additional resources associated with finishing off the biggest TSAs, and then that includes things like double staffing for longer periods than you would've liked to, but I think prudence calls for that. And that's what we're going to do. And then, less than 40%, but still a reasonable number, are investments that we're going to the able to make again because as I said before, the patient is open, if you will, and it's a good time to do some things that heretofore, you wouldn't even known would have been valuable necessarily, but now given the focus on advisory experience and customer experience, et cetera, I want to make these investments. So hopefully, that gives you a sense on what we're doing here and why the -- what's the math behind the increase.

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

Yes. And then shifting over to the derivative gains. They were over $1 billion, and I'm trying to get a sense of how they were so big, given that the 10-year treasury yields of 32 basis points in the third quarter of '19 that compared with a 42 bp drop in the second quarter of '19, whereas in the second quarter of '19 the derivative gains were just about $149 million. So maybe you could give a little color on what those hedging instruments were and why the big differential from 2Q '19?

Edward Allen Spehar - *Brighthouse Financial, Inc. - Executive VP & CFO*

Andrew, it's Ed. So I think one piece you need to consider when you look at the second quarter versus the third quarter is the equity side. So we had equity rises in the second quarter, which I think, sort of, mitigated the benefit from some of the interest rate positions. And I guess I would just say that a 30-some basis point decline in a 10 year in one quarter is a significant move. So -- and also consider the fact that when we hedge interest rates and equities, we have at the money as well as out of the money protection.

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

Okay. And can you just -- the change in total adjusted capital, so that was just simply a -- and when you tie that into the capital in excess of CTE98 that was simply an expense allocation, and it boosted the unassigned funds. And does that materially change your dividend capacity at BLIC versus last quarter? Or were you planning to dividend -- I know you didn't disclose the number but you've been dividending a similar amount? Had you not seen that change in unassigned funds?

Edward Allen Spehar - *Brighthouse Financial, Inc. - Executive VP & CFO*

Okay. So Andrew, let me go back to the comments I made about the change on unassigned funds. So because we had a statutory balance sheet at the end of the third quarter, that's really representative of how we manage the risk and therefore representative of what we think we're going to see under VA reform. We captured a large benefit in terms of TAC relative to the second quarter. And so that really explains the $1.5 billion increase both in total adjusted capital as well as unassigned funds.

It really isn't related to the expense fees. I think what you're referencing on expenses is the gain that we saw in -- the gain we would've seen in assets above CTE98 was eliminated by the statutory actuarial assumption review. So it was an effective offset, $400 million positive from our VA

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risk management and you had about a $400 million negative from the actuarial assumption review. And the bulk of that was related to expense allocation, okay? Again, not the level of expenses across the company, simply how much of our expenses we allocate to the (inaudible) business.

Operator

Our next question comes from Jimmy Bhullar with JPMorgan.

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

Just on the expense allocation, just to clarify. There was an offsetting impact I think in the Life business, right? So no impact as you mentioned for the overall company?

Edward Allen Spehar - *Brighthouse Financial, Inc. - Executive VP & CFO*

Jimmy, it is Ed. There was on the GAAP side, not on the stat side.

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

Got it. And then on -- your capital obviously benefited a lot from your hedges and -- especially the interest rate derivatives that you have. Any, sort of, color on the duration of those hedges and, sort of, a waterfall and how much roughly expires within the next 1, 2, 3 years, just so we can get an idea on your sensitivity to future changes in rates and/or other, sort of, factors?

Edward Allen Spehar - *Brighthouse Financial, Inc. - Executive VP & CFO*

Sure. So as you know, we carefully managed the maturity profile of hedges, so that we're never in a position where we have significant roll risk during a market dislocation, elevated period of volatility, et cetera. If you look at our hedges the average life of those hedges are in the range of 2 to 5 years for both equity and interest rates...

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

And pretty even...

Edward Allen Spehar - *Brighthouse Financial, Inc. - Executive VP & CFO*

Interest rates with all those categories.

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

And pretty evenly spread in that period spirit, or is it more that -- like most of them expire in 2 years versus 5?

Edward Allen Spehar - *Brighthouse Financial, Inc. - Executive VP & CFO*

Yes, pretty evenly spread, sort of, going back to a comment I made up front about we want to make sure we manage the maturity profile of this book, so that we're never in a position where we have to roll too much at one time.

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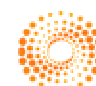

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Jamminder Singh Bhullar - *JP Morgan Chase & Co, Research Division - Senior Analyst*

And then just on establishment costs and there are lot of questions on these. Should we assume that once you're through this period let's say 2021 or whenever, sort of, you're done with your projects, would these expenses entirely go away? Or do some of them -- we have a lot of companies do these projects and then the cost go into the business and the company never really benefited. And so how do you think about should we assume that at some point in the future, let's say 2022, that all of these costs are going to be gone, or would some of them stay which you in one or the other divisions? So how do you think about that?

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

Jimmy, it's Eric. No, they have to go away. I mean, frankly, I hope they could've gone away in '21. Now you see we've still got a little bit in '22, just following our methodology. And I won't go through my longer explanation that I did a little while ago, but these are truly establishment costs. If we got in a situation, where we wanted to make another, sort of, meaningful investment, we would talk about it as that, but establishment costs have to end at some point because the company has to be established at some point.

Operator

And our next question comes from Alex Scott with Goldman Sachs.

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

First question I had is on just the normalized statutory earnings you mentioned, it's $600 million. I think it was also mentioned that some of that had to do with variable annuity hedge gains. So I just -- I wanted to find out, I mean, is that normalized statutory earnings number synonymous with variable annuity distributable earnings? And once you've adopted the reform, like how much economic value were you able to create this quarter?

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

Alex, it's Eric. Let me -- I just want to make sure because I know you all write these numbers down. On my last answer I said '22. And I meant '21 on Jimmy's question. So Ed, I'll turn this over to you now.

Edward Allen Spehar - *Brighthouse Financial, Inc. - Executive VP & CFO*

Okay. Thanks, Alex. So first of all, just let me give a definition of what we mean when we talk about normalized statutory earnings. So we start from net gain from operations, directly from the stat statements. So we take pretax net gain from operations, we adjust out whatever the current period changes in the VA stat reserves, because as we said we're trying to get to, sort of, for managing the business. We then add in the change in the total asset requirements under CTE95. So we basically get the reserve on a basis how we're managing the business. Then we add in realized gains and all of the unrealized gains attributed to the VA business. And then finally, we'll normalize for stuff like the actuarial assumption review, establishment costs, et cetera. So the $600 million -- approximately $600 million number you referenced, let's just say in the neighborhood of $450 million was VA or was the annuity business and the rest was non-VA. This was a particularly good quarter for non-VA. I wouldn't expect that to be, kind of, the normal run rate. We had some timing adjustments related to reinsurance that gave us a benefit above what I would expect normally from the non-VA business.

But that was really the number that we would think is, sort of, normalized statutory earnings, is the number that we would think is more indicative of the type of distributable earnings power that you have over time. Obviously, it's going to move depending on market conditions in the quarter.

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

Okay. And just thinking through RBC at 485, wasn't that long ago where I guess there was a much of a buffer on CTE98, which I think would probably place it closer to 400. So it's a pretty big delta. And I appreciate that the rates have moved a lot and equity markets have moved a lot in that time period. But, I guess, how would you guys think about drawing down that RBC ratio if the normalized statutory earnings let's say aren't coming through or a weaker associated with the environment. Would you be willing to draw that down at all. Or do you feel like you need to have that higher RBC ratio because of the volatility that it'll have?

Edward Allen Spehar - *Brighthouse Financial, Inc. - Executive VP & CFO*

Yes. So I guess the first thing you mentioned the equity market. We shouldn't ignore the fact that the stock market is up 120% year-to-date, right? So that's a very significant positive impact. And as I think you're alluding to, you saw that benefit in the assets above CTE98. At the end of 2018, we had $300 million of assets above CTE98. At the end of the third quarter, it was $1.5 billion. So when we talk about distributable earnings in the 10-K, we've talked about -- we've given ranges based on the assumption of having assets of $2 billion to $3 billion above CTE95. So there is an impact on distributable earnings based on the starting point of where we are with our capital position.

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

Got you. So is it fair to say there is some flexibility to have that RBC come down lower and still be comfortable with the way you're hedging and managing the VA business?

Edward Allen Spehar - *Brighthouse Financial, Inc. - Executive VP & CFO*

Yes. I guess as you said if you look at the VA business post VA reform, RBC of 400 is equivalent to roughly CTE98. Now keep in mind we're not just the VA company, I mean, we have let's just say, round numbers $200 billion of assets with $90 billion of a general account. So there is a good portion of our capital that's non-VA. So you can't just look at if we're pure VA company 400% would be CTE98, but it's not that simple with us. I would just go back to what I said earlier that the plan is still to manage capital, so that we're CTE98 plus in normal markets and to protect CTE95 across market cycles.

Operator

Our next question comes from Ian Ryave with Bank of America.

Ian James Ryave - *BofA Merrill Lynch, Research Division - Research Analyst*

Just a couple. So buybacks have definitely been healthy the last couple of quarters. I'm guessing this had to do with that $400 million dividend from NELICO. Was that a kind of a driver to some of the buybacks last couple of quarters?

Edward Allen Spehar - *Brighthouse Financial, Inc. - Executive VP & CFO*

Yes, Ian, I think that's correct.

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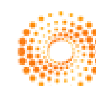

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Ian James Ryave - *BofA Merrill Lynch, Research Division - Research Analyst*

Okay, great. And then relatedly, if I think about all the pieces, right? You have 4x fixed coverage at the holdco, you're going to be getting regular dividends from NELICO and then regular dividends from BLIC in the next year. And thinking about the sources and uses of capital, is there anything to suggest that you couldn't do to a similar level of buybacks per quarter in 2020?

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

It's Eric. There's nothing to suggest we couldn't, no. You, sort of, listed out most of litany, I can even pick up off the last little conversation that Ed was having. Look we have a number of levers, whether it's some room in the RBC ratio, whether it's a potential dividend from BRCD, whether it's the NELICO dividend that we would get, et cetera, or even at this time, what we've got at the holding company with respect to liquidity. So the answer to your question is, no. There's nothing that would prevent something similar. I just want to add that at the same time, we're not oblivious to markets, we are managing this company every single day. So we have -- you're alluding to the $1.5 billion capital return target, which we want to still hit, but we will always manage it prudently. I think we covered your question.

Ian James Ryave - *BofA Merrill Lynch, Research Division - Research Analyst*

Yes. And then just lastly, because we've been talking about the unassigned funds as an important driver when thinking about dividend capacity. So what would be the drivers that would cause to go the other way, perhaps in the fourth quarter or the first quarter of next year?

Edward Allen Spehar - *Brighthouse Financial, Inc. - Executive VP & CFO*

Ian, it's Ed. So we're not going to get into specific numbers, obviously. But I tried to give you a sense that the reason we like VA reform is that we have a statutory framework that we think makes sense for how we manage the risk. And so that means that we should see assets and liabilities moving together. It won't always be perfect, but as I said earlier, in scenario where rates go back up a 100 basis points, I know no one ever seems to think that can happen, but if rates go back up a 100 basis points, we would expect a very similar movement on both sides of the balance sheet and a total adjusted capital number that would be similar to what you saw at the end of the third quarter. The one other thing -- I know you were -- on the first question you were talking about the, sort of, sources and uses, the one other thing I would just add to that which I mentioned in my prepared remarks is that we have over $200 million of annual flows coming in to the holding company, unrelated to dividends from the operating companies.

Operator

Our next question comes from Suneet Kamath with Citi.

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

Just one on capital as well. Eric, you just mentioned the potential dividend out of the reinsurance subsidiary. I know we talked about this on the last quarter call, but any update in terms of conversations of regulators and are you able to size how big a dividend you could take out of that sub?

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

Yes, Suneet. I know even the (inaudible) in my voice sometimes gets commented on, but look we're -- there is a process to do this. We remain very comfortable that we have excess capital in BRCD, but I don't want to front run the regulators. We have a very nice relationship with them. And so we're working through the process. I repeat, I believe, we believe that we have excess capital there. And we've also hedged BRCD's capital position. So we're hedged generally to interest rates here. So I can't comment on where we actually are in the process, but I'll tell you we're in the middle of it.

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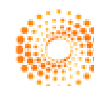

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Suneet Laxman L. Kamath - *Citigroup Inc, Research Division - MD*

Okay. And then just back on the TAC in the quarter. Ed, I guess what you said about if rates go up, you'd see a offsetting movement in terms of the reserves and the capital or the unrealized gains. But if rates just remain flat, would we expect there to be sort of a negative impact on the reserves and no change in the unrealized gain?

Edward Allen Spehar - *Brighthouse Financial, Inc. - Executive VP & CFO*

Suneet, over time you would expect to see that.

Yes. I guess I would say, we've shown you in the sensitivities that we provide in the 10-K, the various impacts of different interest rate scenarios. And clearly, as Eric said, rates low for a long period of time, it does have an impact on the business. We've talked about that. And we've shown you that.

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

Right. Okay. And then just maybe lastly on this improvement in the TAC. Did this -- how much of this was due to the derivatives that you bought last quarter. I know we spent some time talking about that you are opportunistic. But was that -- were those purchases a big driver of this improvement in TAC that we're seeing?

Edward Allen Spehar - *Brighthouse Financial, Inc. - Executive VP & CFO*

Yes. I guess, I would say they clearly helped. I think the bulk of the additional interest rate protection that we added was in the first quarter and it helped. Now I know we've had some discussion about the notional amounts in VA tables. You'll see an increase in notional, again, for VA derivatives when you see the third quarter Q. But it's not really indicative of any material change in our interest rate protection this quarter. I mean, notional is a rough guide. It can have a double counts in there of a offsetting position. So I'm just going to tell you that there was no material change in our projection -- protection third quarter versus the second quarter.

Operator

Our next question comes from Josh Shanker with Deutsche Bank.

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

They might be on another call. So we can -- we're going to stay on for those of you who have to get on another call, but we'll stay on, we've got one more question.

Operator

Okay. Our next question comes from John Barnidge with Sandler O'Neill.

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

Can you talk to me how the battle for shelf space has changed this year given the decline in rates, but also maybe now that you're further removed from Met demonstrating independence as a company?

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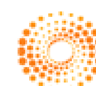

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Eric Thomas Steigerwalt - *Brighthouse Financial, Inc. - President, CEO & Director*

Yes. I don't know, it doesn't seem to have changed that much. Our situation is a little different obviously because we had to brand ourselves, which you're kind of pointing to. But at this point -- we've said over a couple of conference calls that we get inbound calls from distributors, it's business though. You got to fight everyday for it, but I feel really good about our abilities in the marketplace across literally hundreds of distributors. Myles, you want to add anything?

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

Yes, sure, absolutely. What I would say is that with the annuity side of the business, we are getting inbound calls as it relates to expanding and offering our annuity solutions to new firms. We're also expanding with the annuity business into new channels, channels that we haven't been in the past. And as it relates to SmartCare, I mean, we've been incredibly pleased with the demand from a number of firms, major firms out there that would like to have the SmartCare product on their platform. So as it relates to expanding distribution, bringing on new firms and entering new channels, it hasn't been a challenge at all for us.

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

Okay. And then my follow-up. Another life insurer had a large write-down in the quarter on a private equity position. Can you quantify among your private equity investor capital positions you have, maybe what the average investment size, how many of them you have and what is the largest on carrying value?

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

It's John. So we have a portfolio that's well diversified across strategies, managers, geographies and vintages. We own about 300 funds, and the average fund size is a little north of $6 million. And to the last part of your question, our largest 2 indirect underlying portfolio company positions are each about $25 million. The next largest is below $15 million.

Operator

Okay. I am showing no further questions. I'd like to turn the call back to Mr. Steigerwalt for closing remarks.

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

Thank you, operator. For those of you who are able to still be on here, let me just summarize our results this quarter I thought were quite good. Annuity sales continued to be strong, we're very pleased with the quality of the business that we're writing. I'm also pleased with the progress that we've made with our new SmartCare Life product. We now have a network of over 56,000 advisors able to sell that. As you saw, we made good progress exiting the TSAs, and continue to feel good about our ultimate expense reduction plans. Our hedge program continues to perform well. And as we talk throughout the call here, our assets even with the offsets remained $1.5 billion over CTE98. And finally, we've prudently managed our capital. And we'll continue to do so in the future. We believe our balance sheet is well protected for a low rate environment. And thank you for your interest in Brighthouse. We look forward to talking to you next quarter.

Operator

Ladies and gentlemen, this concludes today's conference call. Thank you for participating. You may now disconnect. Everyone, have a great day.

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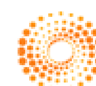

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