ALIRT INSURANCE RESEARCH

Independent Analysis of Insurance Company Risk Trends
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China Oceanwide Acquisition of Genworth Update

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Genworth Financial Inc. (GNW) and China Oceanwide Holdings Group Co. Ltd. (CO) announced on January 4, 2021 that they would not extend the "end date" under their merger agreement. This is a change from the seventeen previous extensions the two companies have agreed upon since their original agreement to merge in 2016.

In a press release, the two companies cited uncertainty surrounding the completion and timing of remaining steps that are required to close the transaction. Specifically, they mentioned challenges in CO finalizing its financing from Hony Capital, as well as the Covid-19 pandemic and associated restrictions.

Managements for GNW and CO stated that the merger agreement remains in effect, CO is continuing to work toward the closing of the transaction, and GNW remains open to completing the transaction in the event that CO can successfully complete the remaining steps. However, the agreement to merge can now be terminated by either party at any time, which is a significant change from the status of both entities since October 2016.

In addition, GNW stated that it will focus on its contingency plans, with an objective of meeting its near-term holding company debt liabilities, which total $1.1 billion in 2021. This includes a potential partial initial public offering (IPO) of its U.S. mortgage insurance business. This follows the sale of GNW's Canadian mortgage insurance business in 2019, the issuance of $750 million of debt by its U.S. mortgage insurance operations in 2020, and the settlement of litigation with AXA in 2020.

GNW also stated that its contingency plan also includes a reduction in expenses. Management stated that these expense reductions will be more heavily oriented at the life insurance companies (life insurance, annuities, long-term care), which reflect the current and anticipated future lack of new business, given the decreased likelihood of the CO acquisition (CO had planned to restart new business in the GNW life insurers at some point).

In this review, we highlight the possible impact to GNW and especially its U.S. life insurers in the event the merger with CO occurs, as well as the possible effects in the event the merger does not take place.

Merger Between GNW and CO Occurs

The direct impacts for the GNW U.S. life insurers from the proposed merger of GNW and CO are quite small. CO committed to infuse $175 million into Genworth Life Insurance Company (GLIC) and $100 million into Genworth Life Insurance Company of New York (GLNY). These proposed infusions would equal 4% and 13% of each company's 9/30/2020 total surplus, and thus would only constitute a small boost to each company's financial position and solvency. This is especially true for GLIC, given the $28 billion in traditional long-term care insurance policy reserves at 9/30/2020. No infusion was committed for Genworth Life & Annuity Insurance Company (GLAIC).

CO management has stated on multiple occasions that its financial support of the GNW U.S. life insurers would end at the infusions mentioned above, which were largely agreed upon to receive regulatory approval from the state insurance regulators of Delaware (GLIC's state of domicile) and New York (GLNY).

Thus, the benefit to the GNW U.S. life insurers and by extension their policyholders from the CO/GNW combination pales in comparison to the positive impact the merger would have for the common shareholders of GNW. This is as the agreed upon price per GNW common share of $5.43 considerably exceeded GNW's share price in October 2016 (when the merger was announced) and remained well above GNW's share price throughout the 4¼ years since announcement.

In addition to the boost to its shareholders, one of the principal attractions (in ALIRT's view) to GNW of the combination with CO was the enhanced liquidity GNW would have received. CO had committed to contribute $1.5 billion to the GNW holding company in the event the transaction has closed, which was to be done in three equal installments of $500 million. The most recent plan was for these infusions to take place over about a six-month period once the acquisition closes.

The $1.5 billion in proceeds committed by CO would have greatly enhanced GNW's financial flexibility to meet its holding company obligations, especially as relates to the following:

- Holding company debt maturities of $338 million in February 2021, and $661 million in September 2021.

- Interest payments on holding company debt (forecasted to equal $144 million from October 2020 to September 2021).

- Payments due to AXA related to the settlement of litigation with AXA, which regarded the alleged mis-selling of payment protection insurance by a former U.K. subsidiary of GNW (which was subsequently sold to AXA). Payments by GNW to AXA are estimated to equal $449 million in 2022 (June and September), and approximately $100 million thereafter.

- Additional holding company debt maturities (after 2021) of $2.6 billion ($399 million in 2023, $400 million in 2024, and $785 million in 2025).

Thus, the combination with CO would provide GNW bondholders (and AXA) greater comfort that upcoming GNW holding company obligations would have been met in a timely fashion. The increased financial flexibility may also stabilize the public rating agency ratings of the GNW holding company, and by extension the GNW U.S. life insurers.

Merger between GNW and CO Does Not Occur

While GNW's life insurance subsidiaries (specially GLIC and GLNY) would forego agreed upon surplus infusions, this capital support – as mentioned earlier – would not have an appreciable impact on either of the company's solvency profile. Lacking these infusions, as well as GNW management's current stance that it will not infuse surplus into these entities absent outside support (at least for now), the three GNW insurance subsidiaries will likely remain under considerable financial pressure. In addition, GNW management states that if the CO acquisition of GNW does not occur, GNW's life insurance subsidiaries will remain largely in run-off and will not seek new business.

The primary impacts in the event the merger of GNW and CO does not occur will clearly be borne by GNW shareholders and bondholders. GNW common shareholders will not receive the agreed upon $5.43 per share, a level that GNW's shares last reached in 2015.

GNW bondholders will not have the added security of the aforementioned $1.5 billion of pledged commitments from CO. This is the area that GNW will need to address over the near term, given the significant debt maturities over the next eight months, as well as upcoming obligations related to the legal settlement with AXA. Longer term, GNW still has significant holding company debt obligation that come due in 2023-2025.

Holding companies do not usually have significant financial resources on their own, as they serve largely as an owner of the companies that actually conduct the business operations of the group. As a result, holding companies are dependent on their subsidiaries for proceeds necessary to meet their obligations, which can relate to principal and interest on public or private debt, dividends or other remuneration provided for shareholders (preferred or common shares), regulatory and filing expenses, and other expenses.

GNW management stated that given the uncertainty surrounding the completion of the transaction between GNW and CO, it will be focusing on executing its contingency plan to boost its liquidity and ensure its ability to meet its holding company financial obligations (including but not limited to the items enumerated above).

Management stated that it holds approximately $1.0 billion in cash and liquid assets at the GNW holding company as of 12/31/2020. This includes $340 million that is earmarked specifically to pay down the company's debt maturity in February 2021. This leaves $660 million in remaining proceeds, which would be sufficient (barely) to meet the September 2021 maturity, but would not leave anything additional to cover interest on the company's debt or any other holding company expenses, nor would it leave anything for the $449 million of payments due to AXA in 2022 related to the litigation settlement.

Management stated among the steps GNW is considering include a possible partial initial public offering (IPO) of shares in GNW's U.S. mortgage insurance operations, which may provide substantial cash proceeds to GNW to pay down holding company debt (principal and interest) and/or meet other expenses.

GNW's mortgage insurance operations (conducted by mortgage insurance companies, which are legally separate from any GNW's U.S. life insurers or any other GNW affiliate) have been profitable of late, with annual GAAP net income that averaged $360 million over the five years 2015-2019, and $286 million in the first nine months of 2020. However, in light of the economic difficulties brought on Covid-19 and the associated government edicts and lockdowns, mortgage insurance earnings may deteriorate going forward, and indeed this occurred in the second quarter 2020 when GNW reported a modest GAAP loss in its mortgage insurance operations. In the event mortgage insurance operating performance deteriorates this could lead to a lower potential valuation for a partial IPO, and/or more difficulty in executing such a transaction to begin with. This could be especially if credit and equity market conditions deteriorate generally.

Other possible options could include sales of existing blocks of business, dividends from GNW's mortgage insurers or other subsidiaries, or other asset sales. It is not possible to predict what (if any) of these options GNW may pursue, or the possible success of any of these options or any specifics in terms or conditions.

Note that none of GNW's three major U.S. life insurers have the legal ability to pay any shareholder dividends at this time, given large historical operating losses for each company, and thus GNW needs to tap other sources of funds and liquidity to meet maturing debt, litigation expenses, and other holding company expenses. This will likely be true not just for near-term (over the next few years) but also for more distant obligations.

Current ALIRT Results

The table on the following page shows the Total ALIRT Scores for the three major Genworth U.S. life insurers for the last five years and as of 9/30/2020, with commentary on each insurer following thereafter. A reversal to operating losses for GLAIC in the first nine months of 2020 (from strong earnings for the full year 2019) was the principal driver of the lower ALIRT Score, while a sharp increase in surplus (boosted by higher interest maintenance reserve) for GLNY helped bolster the ALIRT Score. GLIC's ALIRT score rose modestly in the first nine months of 2020.

In the end, whether CO acquires GNW or not (and GLIC and GLNY receive the committed capital infusions mentioned above), the task for the GNW U.S. life insurers remains the same: Continue to manage the blocks of business in a mostly run-off status, while soliciting additional rate increases from state insurance regulators for traditional long-term care insurance. As is the case for any life insurer, there is the possibility of heightened investment losses in light of the weak economic conditions owing to the Covid-19 pandemic and related government edicts (stay-at-home orders, quarantines, mandated social distancing practices, etc.). Such losses could reduce surplus and/or earnings for the GNW life insurers.

With that said, CO had planned to restart new business in the GNW life insurers at some point, most likely in annuities and/or life insurance. In the event CO does not acquire GNW, the GNW life insurers are likely to remain in run-off, and GNW management stated that its contingency plan addresses the need to reduce expenses, especially in its life insurance companies (which includes annuities and long-term care insurance).

Total ALIRT Scores for the Genworth U.S. Life Insurers						
	2015	2016	2017	2018	2019	9/30/20
Genworth Life Insurance Company	40	38	34	31	35	37
Genworth Life & Annuity Ins. Co.	42	37	33	35	46	39
Genworth Life Ins. Co. of New York	31	31	22	21	33	44

Genworth Life Insurance Company

- Genworth Life Insurance Company (GLIC) primarily offers long-term care insurance. GNW (including GLIC) ceased sales of life insurance and fixed annuities in early 2016.
- ***China Oceanwide (CO) has committed to infuse $175 million of capital into GLIC, when the merger between CO and GNW is complete. However, this represents a relatively small amount in comparison to GLIC's 9/30/2020 total surplus of $3.9 billion, and thus in the event the merger does not occur it will not have a major impact on GLIC's surplus position or financial profile.***
- GLIC's ALIRT Score declined from 2015-2018 due to ongoing operating losses in each year, which are largely related to losses and reserve strengthening in GLIC's long-term care insurance business. The operating losses, coupled with net capital losses in 2014, 2015, 2017, and 2018, contributed to a steep decline in GLIC's surplus position, which fell 32% from 2013 to 2018. Most of this reduction occurred in 2018, as total surplus fell 24% on large operating losses and net capital losses.
- The lower surplus boosted GLIC's leverage measures and the company's investment risk to surplus measures and led to a significant reduction in the company's risk-based capital ratio to a low level.
- As mentioned earlier, GNW continues to receive and seek state regulatory approval for rate increases for long-term care insurance, which may help ameliorate losses in GLIC's long-term care insurance.
- The Total ALIRT Score for Genworth Life Insurance Company (GLIC) was a low 37 at 9/30/20, which was up two points from year end 2019 but still trailed the ALIRT Composite Score (45).
- GLIC benefitted from improved operating returns in the first nine months of 2020, which in turn contributed to an 18% increase in surplus and reduced asset and operating leverage measures.
- However, GLIC remains impacted by high health (long-term care) insurance exposure, above average asset and operating leverage, and elevated investment risk to surplus measures (especially NAIC Class 2 (BBB rated), non-investment grade, and Level 3 bonds).
- **GLIC is below ALIRT's minimum qualitative credit rating standards.**

Genworth Life and Annuity Insurance Company

- Genworth Life and Annuity Insurance Company (GLAIC) is licensed to sell business in all states except New York. New business is minimal, as the company ceased writing new life insurance and annuities in March 2016 (it began selling small amounts of fixed and indexed annuities again in 2018), though the company continues to service this business. GLAIC also has variable life insurance and variable annuities in force though it has not been active in either business for quite some time.
- GLAIC's Total ALIRT Score declined in each year 2014-2018 (from 50 in 2014 to 35 in 2018), which tracked a decline in the company's total surplus position, which fell in each year 2014-2018.

- As was the case for GNW overall, GLAIC incurred large operating losses in individual life insurance in each year 2015-2018, which averaged $194 million annually (pretax) over the four years. The losses reflected increases in policy reserves as a result of adverse mortality in GLAIC's universal life insurance, as well as the impact of the decades-long low interest rate environment. Operating losses in individual life insurance continued in 2019 (albeit at a narrowed pace).
- GLAIC also incurred individual annuity pretax operating losses of $96 million in 2018, a reversal from strong earnings in both 2016 and 2017. The worsening performance reflected in part the weaker equity markets in 2018. Earnings for individual annuities rebounded in 2019, in part as the improved stock markets led to releases for reserves covering variable annuity secondary guarantees.
- The Total ALIRT Score for GLAIC equaled 39 at 9/30/20, which was down seven points from 46 at 12/31/19. This decrease was mostly driven by operating losses incurred in the first nine months of 2020, which was due in part to a lower level of reserve releases as well as lower premium income.
- The adoption of a change to variable annuity reserve methodology likely contributed to the operating losses, as this change served to cushion risk-based capital ratios, at the expense of greater volatility in reserves. The lower level of stock market appreciation in the first nine months of 2020 as compared to the full year 2019 also contributed to the reduced level of reserve releases for variable annuities.
- Net capital gains helped to offset the operating losses somewhat, but surplus still declined 5.7% in the first nine months of 2020, which led to slightly higher asset leverage and investment risk to surplus measures.
- Additionally, GLAIC's score remains adversely impacted by negative cash flow, high reinsurance usage, above average operating and asset leverage, and the generally declining surplus position.
- Offsetting this somewhat is GLAIC's above average net investment yield, lack of health (long-term care) insurance exposure, and solid risk-based capitalization.
- GLAIC's increased premiums written in the first nine months of 2020 stemmed almost entirely from deposit type contracts, which reflect increased borrowings from the Federal Home Loan Bank to boost liquidity.
- **GLAIC's ALIRT qualitative credit rating remains "A-" (7th highest);** however, we note the considerable decline in earnings and surplus, and the ongoing individual life insurance operating losses.

Genworth Life Insurance Company of New York

- Genworth Life Insurance Company of New York (GLNY) largely writes long-term care insurance in New York. GNW (including GLNY) ceased new sales of life insurance and fixed annuities in early 2016.
- ***In March 2020, GNW and CO received regulatory approval for CO's acquisition of Genworth Life Insurance Company of New York (GLNY), with the condition that GNW contribute $100 million in additional capital to GLNY. In the event that the merger does not occur, this infusion will not occur, which will lead to a lower level of capital than might otherwise be the case.***
- GNW increased policy reserves numerous times over the last several years, both as a result of its own internal analysis as well as under agreements with its state regulator, the New York Department of Financial Services (NYDFS).
- Management stated that a portion of the statutory reserve increases are the result of NYDFS' refusal to allow future rate increases to be included in the asset adequacy analysis until they are approved. In 2018, the NYDFS approved a long-term care insurance rate increase for GLNY, which was only the second increase approved by the NYDFS (the first was in 2014). As a result of the rate increase, GLNY did not have to post additional asset adequacy analysis reserves in 2018, though the company did increase overall long-term care insurance reserves substantially during 2018.
- The markedly lower surplus (down from $586 million in 2016 to $353 million in 2018) produced sharply higher asset and operating leverage measures, as well as much higher investment risk to surplus measures, and these are key factors in the very low total ALIRT Score. The risk-based capital ratio of 291% at year end 2019 remained well below industry average and also reflected the lower surplus and the significant share of business in traditional long-term care insurance.

- The ALIRT Score for GLNY increased eleven points in the first nine months of 2020 to 44 at 9/30/20, which was much higher than the year end 2018 score of 21. GLNY's higher ALIRT Score reflected a sharp improvement in reported operating earnings, solid net capital gains, and an 61% increase in surplus in the first nine months of 2020. The growth in surplus led to sharp reductions in the company's asset and operating leverage as well as lower exposures to Class 2 bonds and mortgage/real estate loans.
- However, GLNY's score continues to reflect significant use of unaffiliated reinsurance, high health insurance exposure (long-term care insurance focus), negative cash flow and premium growth, and high exposures to NAIC Class 2 (BBB rated) bonds, mortgage-backed and asset-backed securities, and level 3 (difficult to value) bonds.
- Also, we note that in past years GLNY increased policy reserves significantly in the fourth quarter, and thus the improvement in operating results in the first nine months of 2020 could reverse if reserves are increased in the fourth quarter.
- **GLNY remains below ALIRT's minimum qualitative rating standards, due to the continued negative trends in surplus and operating results.**

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